Seeking Alpha α

Closed End Funds

CEF Report July 2021 | Complete Euphoria

Jul. 21, 2021 7:00 AM ET | AVK, BRW, HFRO... | 1 Comment | 3 Likes

Summary

- The CEF market remains expensive and getting more expensive almost daily. Muni CEFs have joined taxables with an avg premium valuation.
- So today we are in a place that most CEF investors have never experienced - a very tight valuation.
- We go through the difference between relative discounts and absolute discounts and how focusing on the former can create value in today's market.
- Mutual funds/ETFs become an option to rotate into in order to capture NAV moves while reducing/eliminating discount risk.
- We discuss BRW and AVK as small opportunities in today's market.
- I do much more than just articles at Yield Hunting: Alt

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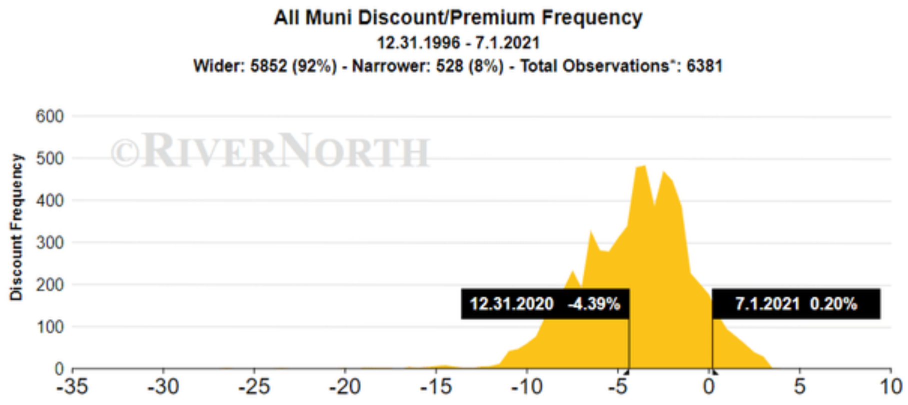
(This report was issued to members of Yield Hunting on July 7th.)

The State of the CEF Market

The end of June marked a seminal event that hasn't occurred in more than 8 years, both taxable and tax-free CEFs, on average, trading at a premium. Taxables have been there for some time but munis snuck in there at the end of the second quarter. I didn't think we would get there so quickly - opining not long ago that it would likely be at the end of the summer. But here we are.



(Source: RiverNorth)

At the same time, taxables have increased their premium in the last week of June to, on average, +1.4%.

Both munis and taxables are trading at valuations (prices relative to NAV) that are in the top 8% of all historical observations going back to 1996. The last time they were this rich was very briefly in 2012.

Even equity CEFs are trading tight with the average CEF at a -5.4% discount, in the higher 25% of all observations.

Investors have clearly forgotten what happened a mere 16 months ago when the average CEF fell by more than 25% in a month! The recovery has been steady but also consistent. It was a rising tide lifting all boats ("discounts") nearly across the board. I posted a chart on the monthly that showed the number of taxable funds that are trading at a -5% or larger discount.

The number of funds that meet that screen is the lowest level I've ever seen at just 24. Some of those deserve that discount - like **Highland Income Fund (HFRO)**, a fund I wouldn't touch even with a "risk-free bet" from DraftKings.

So today we are in a place that most CEF investors have never experienced - a very tight valuation. So today investors need to focus on relative valuations as deep discounts are no longer available anywhere in the space. Investors will need to settle on smaller discounts and more tactical trading opportunities to mitigate that downside risk.

Relative Discounts vs. Absolute Discounts

Absolute discounts are those that are wide at an absolute level. Any fund that trades at double-digit discounts can be thought of as wide. The widest observed observations of discounts would point to absolute discount levels in the teens as being extremely compelling. [For one brief moment, discounts were in the 20%-30% range in March 2020].

A year ago, you could buy just about any taxable bond CEF and have done very well over the course of the last 12 months. Discounts have steadily climbed to these rich levels. So the level of absolute discounts today is very tight. But there tends to always be relative discounts.

Relative discounts are options for rotational trades. Some investors like to keep their CEF allocation (the amount they have invested in CEFs) static not attempting to make strategic allocation shifts. Others like to make contrarian or counter-cyclical strategic moves where, based on overall valuations, they toggle back and forth between CEFs and other asset types/classes.

RiverNorth does this with several of the CEFs they co-manage. For example, below is from their website for the **RiverNorth Flexible Municipal Income Fund (**RFM**).** The fund is tactically managed with two advisors, MacKay Shields and RiverNorth. MacKay buys individual munis for the portfolio while RiverNorth buys muni CEFs for the portfolio. The allocation between the two sub-advisors depends on the type of investing environment for CEFs.

(Source: RiverNorth)

As an individual investor, you can do the same. You can toggle between CEFs and other, "safer" asset types without discount risk. Or you can move to cash. We would recommend not moving to cash at this point in the cycle (it's way too early).

Previously, I was shifting from CEFs to individual preferreds and baby bonds. But the prices of those securities are now quite rich as well (though a few opportunities remain). For example, we were discussing the preferreds of CEFs as a place to go to get mid-single digit yields with greater safety than the underlying common shares of the CEF.

But in the last few months, even those securities have become rich. **NexPoint Strategic Opportunities (NHF-A)** is up 5.5% in the last three months. **RiverNorth Opportunistic A (OPP-A)** is up 5.2%. **Oxford Lane Capital (OXLCP)** is now up 4.4%. While not crazy valuations, they are now far above where my limit orders.

Mutual funds/ETFs become an option to rotate into in order to capture NAV moves while reducing/eliminating discount risk (or the risk that the discount widens out significantly). We highlighted some of these options in "Swap Options For Reducing Discount Risk".

Relative Value Opportunities Come Fast

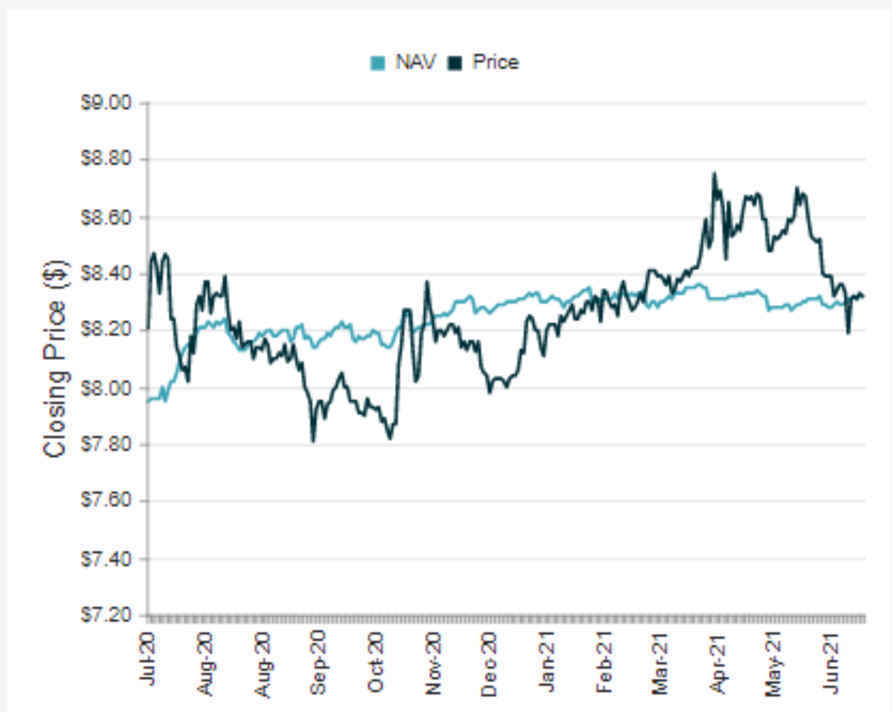
My preferred tactic from here given my already reduced exposure to CEFs are relative value and tactical opportunities. These can come in many shapes and sizes. First, changes in distribution rates can be a great way to play the relative value game. Second, corporate actions like tender offers can produce some alpha opportunities. Thirdly, external factors like esoteric or "dumb trading" can also create opportunities. Lastly, what seems to have really been working in this CEF bull market is strong yields and wider discounts.

On the last point, we are seeing a lot of new entrants into the CEF space in the last 9 months. This tends to happen during "boom times" where all sorts of risk management are thrown out the window. These newbie CEF investors are looking for two things: wide discounts and higher yields. But those two factors can come with a lot of baggage. Often, wider discounts are warranted either by bad management or higher fees. The yields are completely arbitrary and shouldn't really factor in - it is the underlying portfolio yield that matters.

But even this approach is fading. My screen for higher discounts and higher yields returns just 12 funds today. If I look back to the start of the second quarter, it returned 53 funds- a remarkable decline. I still think these present some opportunity to float with the current towards tighter discounts and will continue to post them on our Morning Notes.

Sometimes, these purchases can be held for months or even years. They do NOT necessarily have to be "trades" in the sense that you're holding them for a few hours or days.

For example, **Nuveen Credit Opportunities 2022 Target Term Fund (**JCO**)** was trading at a 6%+ premium to its NAV. For a target fund that liquidates in a year that is a massive headwind that should be sold immediately. The fund finally came back to Earth on June 25th with the price falling $0.15 and the shares trading at a 1.6% discount. I commented on the chat and my Morning Note (the next day) that I picked up a bunch of shares at $8.19 that someone was dumping.



(Source: CEFConnect)

At that price, and a June 1, 2022 liquidation, the fund looks compelling from a risk-return standpoint. The fund WILL NOT reach its target payout of $9.83. That's a given. But they will return NAV at that point. The question becomes what the fund sponsor, Nuveen, does between now and then. Do they reduce leverage and start winding down the fund in the next few months or do they keep it going as is until next June? The path they take will decide your overall rate of return and risk assumed.

If they take the former approach, you can expect several distribution cuts and far less NAV movement. The latter will likely keep the distribution close to where it is but with more NAV risk. While this won't be the first fund to miss the target, there haven't been all that many that have not achieved the target so it is still very much a work in progress with no concrete action plan by sponsors.

The opportunity in JCO dried up as quickly as it arrived. So you have to be quick to pounce on them allocating some shares at a moment's notice. Other times, speed is not required, just classic due diligence and an eye on the market.

Two Funds That Looks Compelling

A couple of funds that look interesting in terms of those tactical actions that can drive the price are **Saba Capital Income & Opportunities (**BRW**)** and **Advent Claymore Convertible Securities&Income (**AVK**).**

BRW is a "new" fund made from the takeover of PPR by activist hedge fund, Saba. The fund is currently undergoing a tender offer of up to 30% of shares at a 1% discount to NAV. The shares trade at a -4.72% discount.

The danger is what does the fund trade at post-tender. If the discount widens out dramatically, the gains from the tender will be offset by the losses on your remaining shares. However, Saba has attempted to mitigate this by instituting a managed distribution policy at 8% of NAV to entice investors to buy/hold.

We think the downside risk here is fairly low and the fund, once the new distribution rate is applied on CEFConnect, could trade even tighter than -4.7%. It's possible but not overly probable. In this market, all norms and fundamentals have been thrown out the window.

The second fund, AVK, is a Guggenheim run fund. The portfolio is a mix of converts (60%), high yield (29%), and stocks (10%). I did a write-up on this fund not too long ago and discussed the portfolio being a broad reopening trade strategy.

The opportunity is from recent trading that has widened the discount out by over 3%. The discount had tightened to just -3% but is now at -6.1% for a 7.3% yielding fund. The NAV has been very strong thanks to solid portfolio management of the fund. In fact, the NAV is number one YTD in the category and number two over the last year.

We think the recent trading widening out the discount presents a nice opportunity to get a high-caliber fund performing well at a -6% discount. There are so few funds trading at that level today and paying over 7% and this is one of them.

Concluding Thoughts

The CEF market is clearly expensive, and getting more expensive seemingly by the day. Avoiding typical pitfalls like getting overly invested now in higher-risk funds is key to avoid large drawdowns. I continue to hold an allocation to CEFs that makes sense for me and each investor should assess how much they require from the asset type.

Rotating and finding discountless risk options like mutual funds and ETFs can help reduce your portfolio risk at this point. The market can remain expensive for a long period of time so "getting out" and waiting has its own set of risks as we've detailed many times.

We will continue to highlight small windows of opportunities to capture alpha trades in our Weekly Commentaries and Morning Notes. These take more work than you are likely used to but in order to achieve alpha in these markets, more work is required.

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Agree wholeheartedly. Actually bought AVK in the $13 range and sold a week or so ago at $19.50. Would like to get back in at lower levels.

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