Seeking Alpha α

Closed End Funds

CEF Weekly Market Review: A Few Lessons From The Dip

Jul. 31, 2021 1:13 PM ET | ARDC, DCF, DHY... | 3 Comments | 18 Likes

Summary

- We review CEF market valuation and performance over the penultimate week of July and highlight recent events.
- The CEF market had a brief dip early in the week which provided a dress rehearsal for a larger future drawdown and echoed some historical patterns.
- We continue to favor funds with a history of strong alpha generation in this environment of compressed yields.
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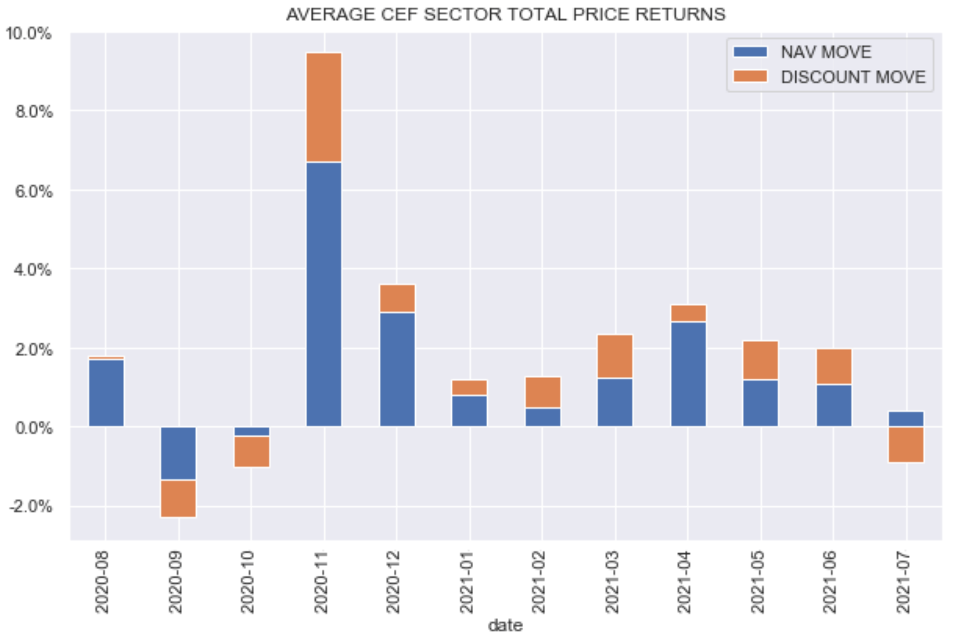
This article was first released to Systematic Income subscribers and free trials on 25-July.

Welcome to another installment of our CEF Market Weekly Review where we discuss CEF market activity from both the bottom-up - highlighting individual fund news and events - as well as top-down - providing an overview of the broader market. We also try to provide some historical context as well as the relevant themes that look to be driving markets or that investors ought to be mindful of. This update covers the period through the penultimate week of July.

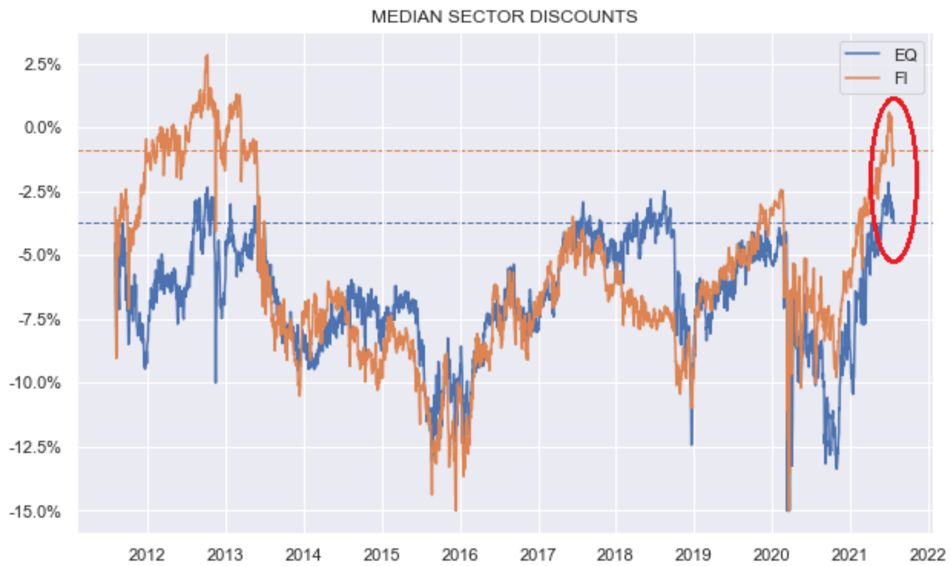
Market Overview

Despite the S&P 500 and Treasuries reaching higher levels than at the end of June, CEF prices remain below their June highs in aggregate. As the chart below highlights, this has to do with the fact that discount widening outpaced increases in NAVs, causing prices to fall in aggregate.



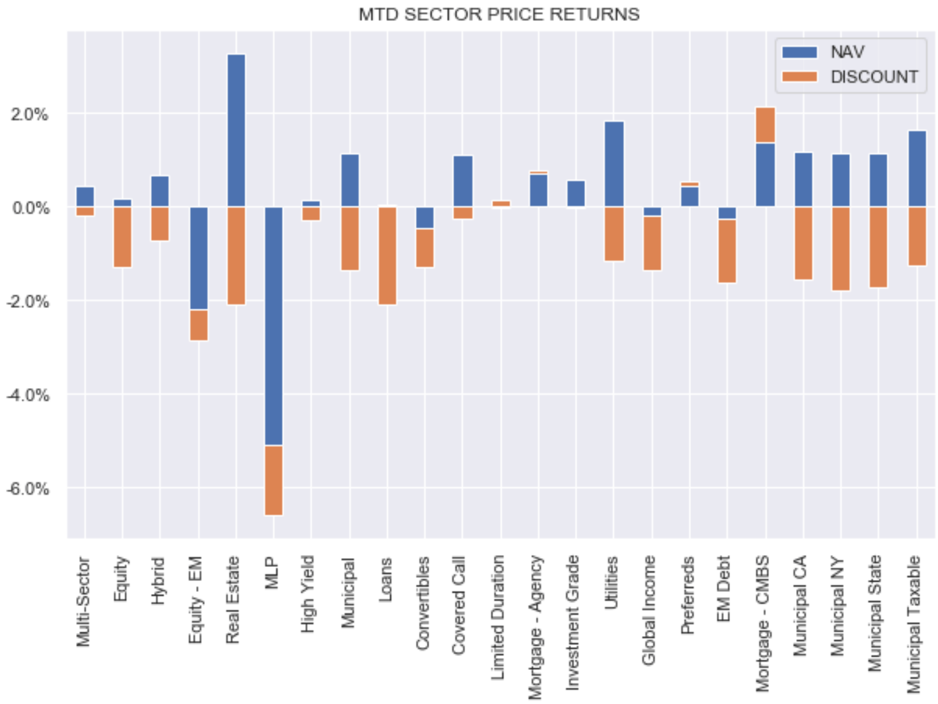
Source: Systematic Income

We can see this bounceback very clearly in the following chart where the hyperbolic run-up in June was mostly offset by widening discounts so far in July.



Source: Systematic Income

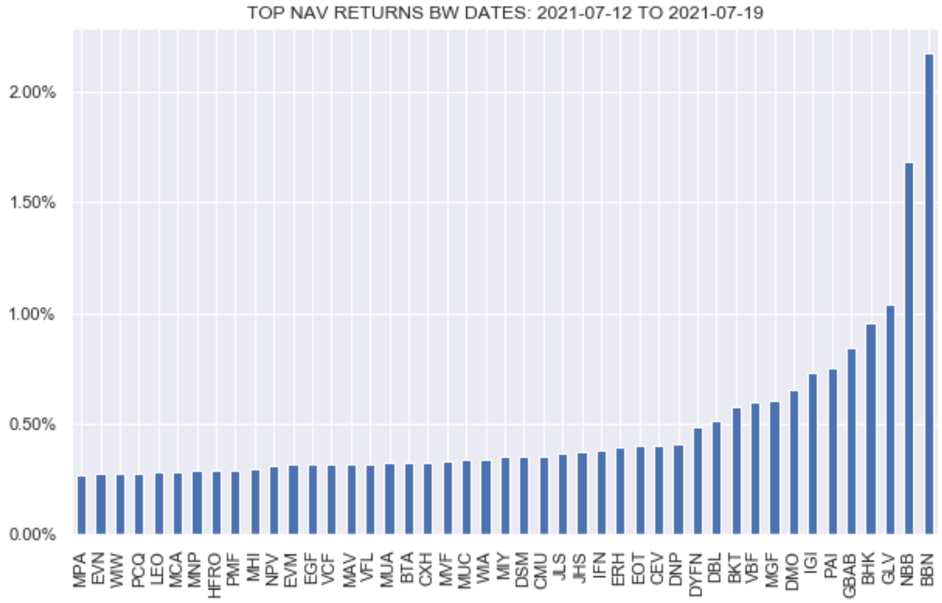
That said, not all sectors are in the red in July. In fact, about a third of CEF sectors have rallied so far in the month. There is no real pattern to the moves - a number of low-beta sectors like Munis along with higher-beta sectors like MLPs and Equities have moved lower.



Source: Systematic Income

The recent market wobble highlights some of the typical patterns we tend to see during an uptick in market volatility.

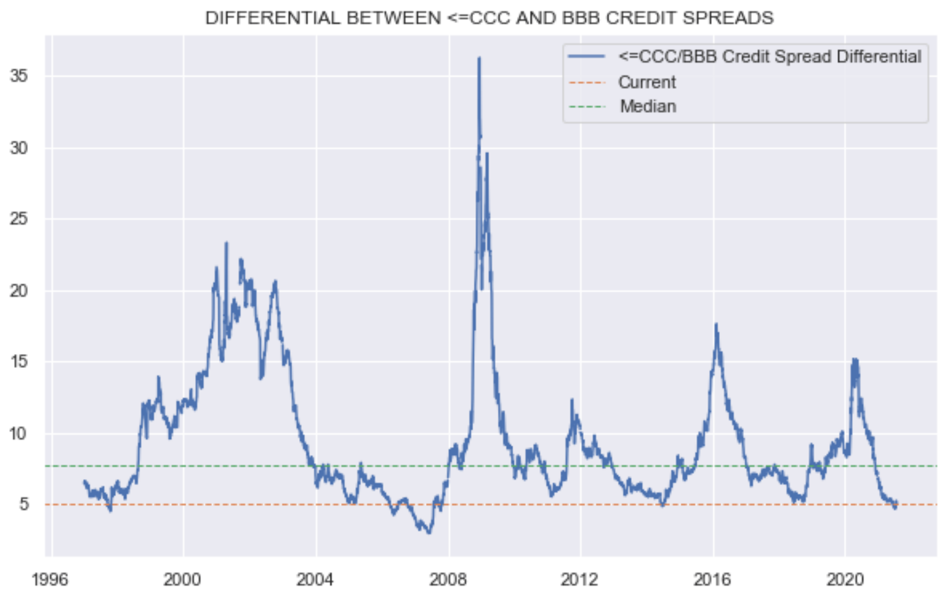
First, unsurprisingly, higher asset-quality funds have tended to hold in much better than lower asset-quality funds. The chart below shows best-performing CEFs by NAV over the recent ~3% drawdown in SPX.



Source: Systematic Income

Higher-rated credit funds like muni (MVF and PCQ), investment-grade ABS (JLS) and corporate CEFs (VBF), longer-duration funds such as those in the taxable muni sector and lower leverage/more idiosyncratic asset funds such as DMO outperformed in NAV terms.

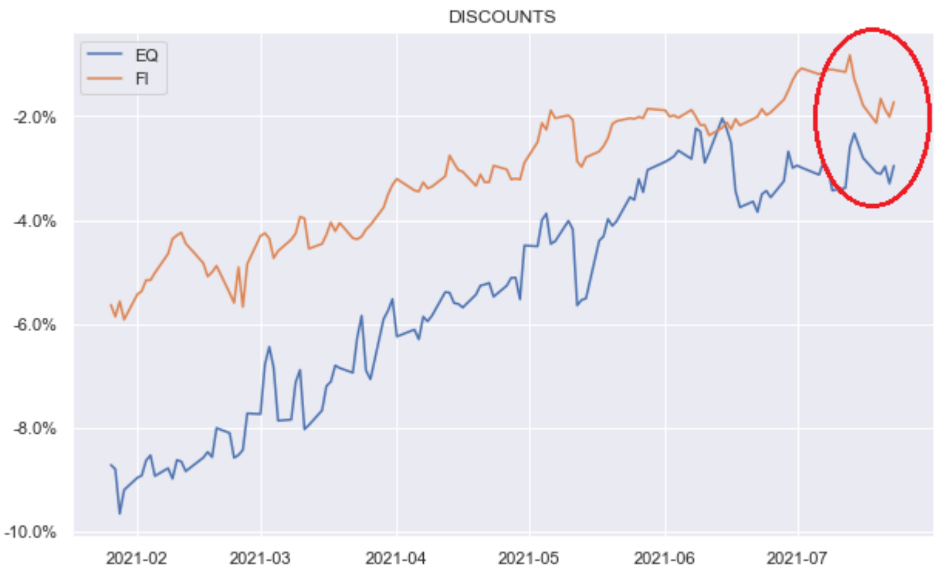
One of the key themes in credit markets is yield compression which means that investors get paid very little in historical terms for moving lower in quality. For example, the chart below shows the yield differential between BBB-rated and bonds rated CCC and below is close to historically low levels, substantially exceeded only prior to the GFC. This suggests that the opportunity cost of being in higher-quality assets is very low. To be fair, the default outlook in credit appears to be very benign given large consumer savings levels, the fiscal boost still feeding through the system and an early-to-middle cycle macro environment. The chart also highlights that previous periods of yield compressions have tended to last several years so we don't expect a sharp widening in credit spreads near-term. That said, some reallocation to higher-quality and more resilient assets will allow investors to put capital to work at more attractive levels during the occasional drawdowns.



Source: Systematic Income

The second pattern we saw in the recent market environment is that of discounts driving much of the price drawdown in CEFs. This is the picture we see in the month-to-date return in the chart above which drove many sectors to negative July price returns despite rising NAVs. With discounts trading near historically rich levels, we expect pullbacks from discount widening to be relatively large. This may make it more difficult for investors to maintain conviction in some of their CEF holdings as well as have a resilient base of capital to reallocate to more attractive opportunities.

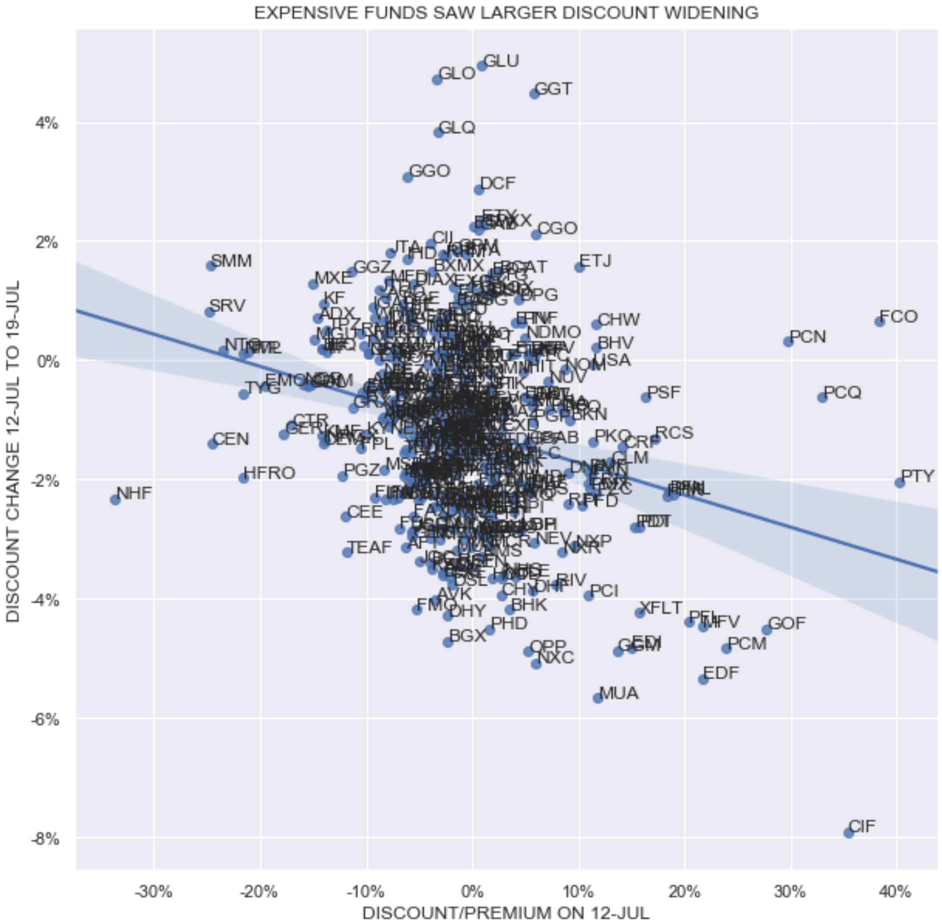
The third common pattern is that equity discounts did not widen as much as fixed-income discounts over the recent drawdown.



Source: Systematic Income

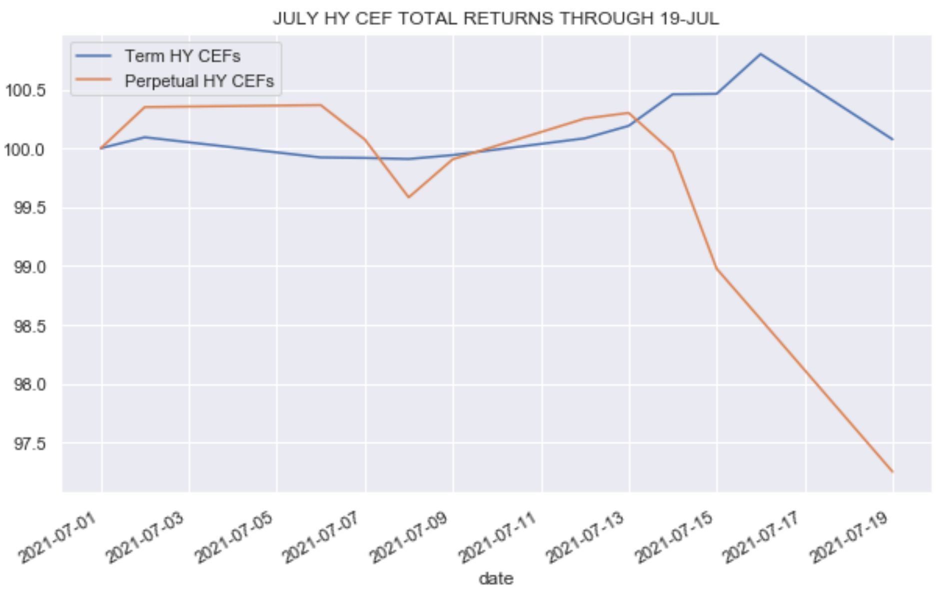
This dynamic remains somewhat counterintuitive since equity CEFs have a higher volatility than fixed-income CEFs and discounts tend to be procyclical - widening in sympathy with lower prices and vice-versa. It is possible that the higher-beta equity CEFs have more of a buy-the-dip mentality because their prices tend to fall more than those of fixed-income CEFs (due to their higher NAV volatility). It is also possible that the overall tighter discount level of fixed-income CEFs is driving the higher discount volatility of these sectors.

The fourth pattern was that CEFs with expensive discount valuations saw their discounts/premiums drop more than less expensive CEFs. Anecdotally, these include the typically high premium funds like CIF, EDI, EDF, PCM, XFLT, PFL and others. More systematically, the following chart shows starting discounts/premiums on 12-July (x-axis) and the amount of discount widening or premium deflation (y-axis) with a decent relationship. This pattern highlights that investors in these funds are bearing higher drawdown risk which can potentially result in permanent capital loss due to sustained premium deflation (funds like PGP come to mind) and make it more difficult to reallocate to more attractive opportunities due to sharp capital losses.



Source: Systematic Income

The fifth typical pattern was that term CEFs outperformed perpetual CEFs. The chart below shows July total price returns through 19-July of perpetual high-yield CEFs (orange line) versus term high-yield CEFs (blue line) with the term CEFs holding in much better than perpetual CEFs. The sector was chosen as it has the largest number of term CEFs in the CEF space. This pattern is expected and we saw very much the same dynamic over the much larger drawdown in March of 2020. Term CEFs tend to carry lower leverage and duration and, more importantly, have a discount anchoring dynamic through the likelihood of termination. There is no free lunch, however, as term CEFs also offer less upside particularly when underlying asset valuations and CEF discounts are cheap though neither is the case in the current market environment.



Source: Systematic Income

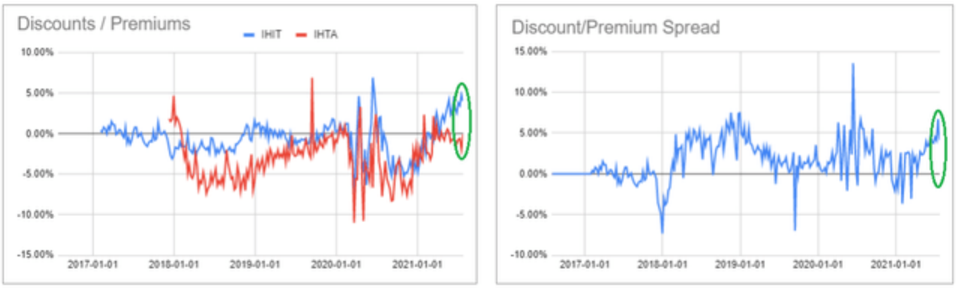
Two more patterns are worth highlighting, both of which move beyond the CEF space. One is that senior securities outperformed CEFs. For example, over the biggest drawdown day on Monday, the average CEF in the High Income Portfolio fell 0.7% while the average senior security fell just 0.06%. A related pattern was that there was much less diversification in CEFs than in senior securities. For example, the majority of senior securities in the High Income Portfolio actually rose while ¾ of CEFs in the portfolio fell. These patterns also held more systematically in the broader CEF and preferreds / baby bond markets.

Occasional drawdowns are useful reminders of these persistent trading patterns in income markets. Investors considering ways to set up more resilient portfolios should take these “standard” patterns into account.

Market Commentary

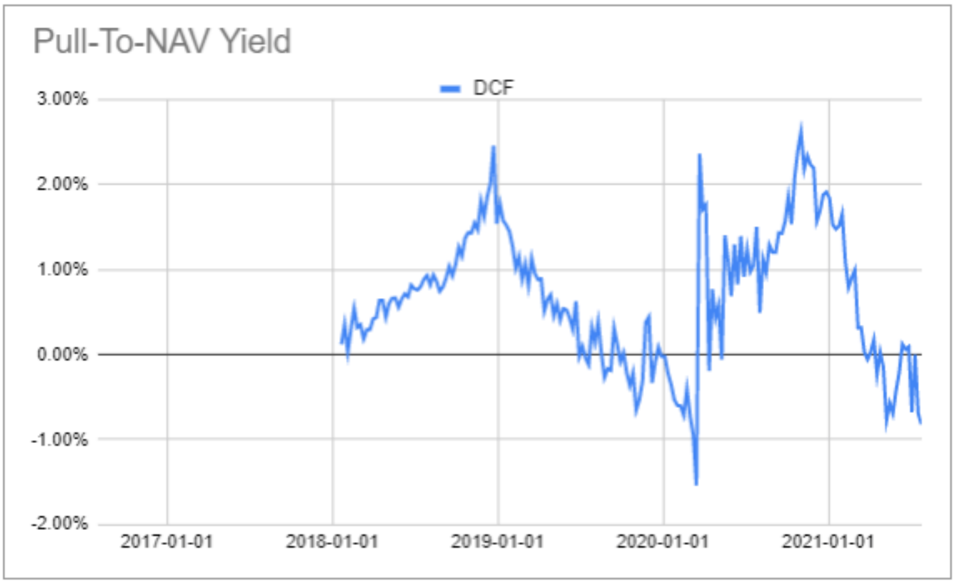
The recent run-up in CEF valuations drove a few rotations in our Income Portfolios in the past week. Specifically, we rotated from the CMBS-focused Invesco High Income 2023 Target Term Fund (IHIT) to the sister fund Invesco High Income 2024 Target Term Fund (IHTA). The two funds follow a similar allocation focus with the key difference being that IHTA is somewhat higher-beta due to its longer-duration holdings to match its longer termination date.

The chart below shows that the valuations of the two funds tend to follow each other. Recently, however, they have diverged with IHIT trading at a significant premium versus IHTA. This doesn't make a ton of sense to us, particularly as both are term funds, so we made the shift.



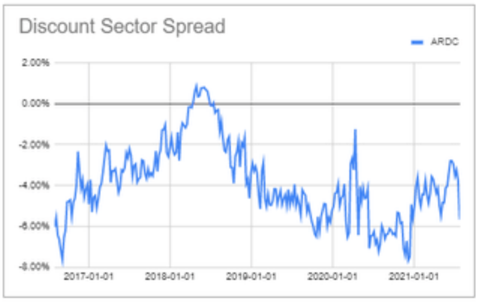
Source: Systematic Income CEF Tool

We also reduced our allocation to the Dreyfus Alcentra Global Credit Income 2024 Target Term Fund (DCF) also due to its high valuation in favor of the Ares Dynamic Credit Allocation Fund (ARDC). We entered DCF at a pull-to-NAV yield (the annual tailwind from the expected discount compression to zero on the termination date) of around 2% and when the fund's discount was trading at the sector average level, providing very attractive margin-of-safety in case of change into a perpetual fund. However, now this tailwind has turned into a near 1% potential headwind which makes it much less attractive here.



Source: Systematic Income CEF Tool

ARDC shares the multi-sector credit allocation profile of DCF as well as sector-beating NAV returns and attractive valuation.



Source: Systematic Income CEF Tool

The OFS Credit Co. (OCCI) released their June NAV of $13.79 – a drop from $14.24, though when the $0.54 distribution is taken into account, it was a small increase over the previous month. NAV growth has notably flatlined in the CLO Equity space so we shouldn't expect a big move in OXLC either for its June number. Both OCCI and ECC are trading at around a zero discount which looks more interesting than the 10% or so premium of OXLC.

		NAV			Discount / Premium		Distributions / Yield			
Fund	Price	Official	Official Date	Estimated	Last Official	Estimated	Dist.	Freq	PX Yield	NAV Yield
OXLC	$7.31	$6.44	2021-05-28	$6.63	13.51%	10.33%	0.068	M	11.08%	12.58%
ECC	$13.20	$12.97	2021-06-30	$13.12	1.77%	0.63%	0.100	M	9.09%	9.25%
OCCI	$13.89	$13.79	2021-06-30	$13.95	0.73%	-0.40%	0.540	Q	15.55%	15.66%

Source: Systematic Income CEF Tool

Nuveen June coverage numbers were finally released. A few tax-exempt funds saw a recovery in their recent dips in coverage while the Taxable Municipal Income Fund (NBB) had an odd drop. In the suite of four preferreds funds the Preferred & Income Opportunities Fund (JPC) coverage has been pretty strong and is now at 107%. We have discussed a few times how these funds have taken their borrowings nearly all the way back from their deleveraging in 2020 which suggests that they should at some point also raise their distributions which they cut shortly after the deleveraging. Less tactical investors, particularly those who are worried about a potential market dip, should consider the Cohen & Steers Tax-Advantaged Preferred Securities and Income Fund (PTA) which is not only trading at the widest discount in the sector but is part of the Cohen & Steers stable which, unlike Nuveen, was not forced to deleverage in 2020, allowing it to post stronger returns versus the Nuveen suite.

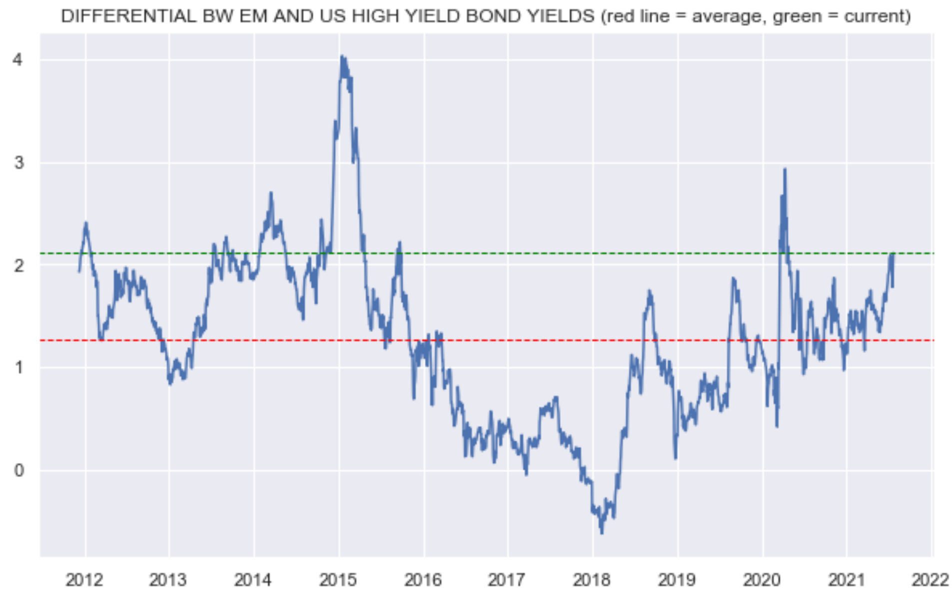
It was interesting to see the Municipal sector discount, which rose sharply in June, move back toward fair-value recently. That said, the sector's fair-value is still very elevated due to low market volatility, low real rates, low term premium and other key factors. So long as inflation expectations remain relatively anchored and the yield curve remains, well-behaved muni CEFs are likely to continue trading at historically expensive levels.

Source: Systematic Income

Stance and Takeaways

In the CEF space, we maintain a three-pronged approach seeking out a few niche sectors that remain attractive such as high-yield external EM Debt as well CLO Debt, allocating with a margin-of-safety mindset and tilting to inexpensively valued funds with strong historical alpha.

High-yield Emerging Market credit continues to look attractive in the broader fixed-income space, particularly against high-yield US corporate credit. The current yield advantage of EM (marked as a green line below) is nearly 1% above its 10-year average (marked as a red line).



Source: Systematic Income

The table below from TCW shows that high-yield EM debt looks attractive not only relative to its own history but relative to a number of other credit asset classes.

EM Credit Trading At the Wider End of Historical Ranges vs. DM Credit

EM vs. DM Spread Ranges

Index	6/30/21	12/31/19	Change	Tight	Post-GFC* Range (● 12/31/19 ◆ 6/30/21)	Wide	Current Percentile vs. Range
EMBIGD HY	582	487	96	323		1203	29%
EMBIGD	340	291	50	237		721	21%
CEMBI BD	296	311	-14	243		641	13%
Euro HY	346	357	-11	290		1260	6%
EMBIGD IG	150	143	7	136		401	5%
Euro IG	53	59	-5	44		249	4%
U.S. HY	370	424	-54	355		1139	2%
JULI (U.S. IG)	107	124	-17	106		386	0%

Source: TCW

On the fundamental side, COVID-related outflows from EM debt have fully reversed, growth expectations are high, external balances are healthy relative to the last decade, issuers are less reliant on external debt financing making any Fed taper tantrum much less damaging, if it happens, than it would have been in the past, reserves keep increasing and current account balances of the more fragile issuers have improved.

For investors who want to tighten up on duration and minimize potential discount volatility we like the Nuveen EM Debt 2022 Target Term Fund (JEMD), trading at a 1% discount and a 4.52% distribution rate with a sub-2 duration and a December 2022 expected termination date. For investors happy to take on a bit more risk we like the DoubleLine Income Solutions Fund (DSL), trading at a 2% discount and a 7.33% distribution rate. The fund is a multi-sector fund with a 45% allocation to EM debt.

As far as CLO Debt, our positive stance in the Eagle Point Income Company (EIC) has been due to two factors - the attractive yields on BB-rated CLOs as well as the fund's wide discount range of 7-10% over the past few months - well wider of the broader Loan CEF space. KKR has recently summarized the attractive absolute and relative pricing of the asset class below.

BB/B Loans and BB CLOs Look the Most Attractive

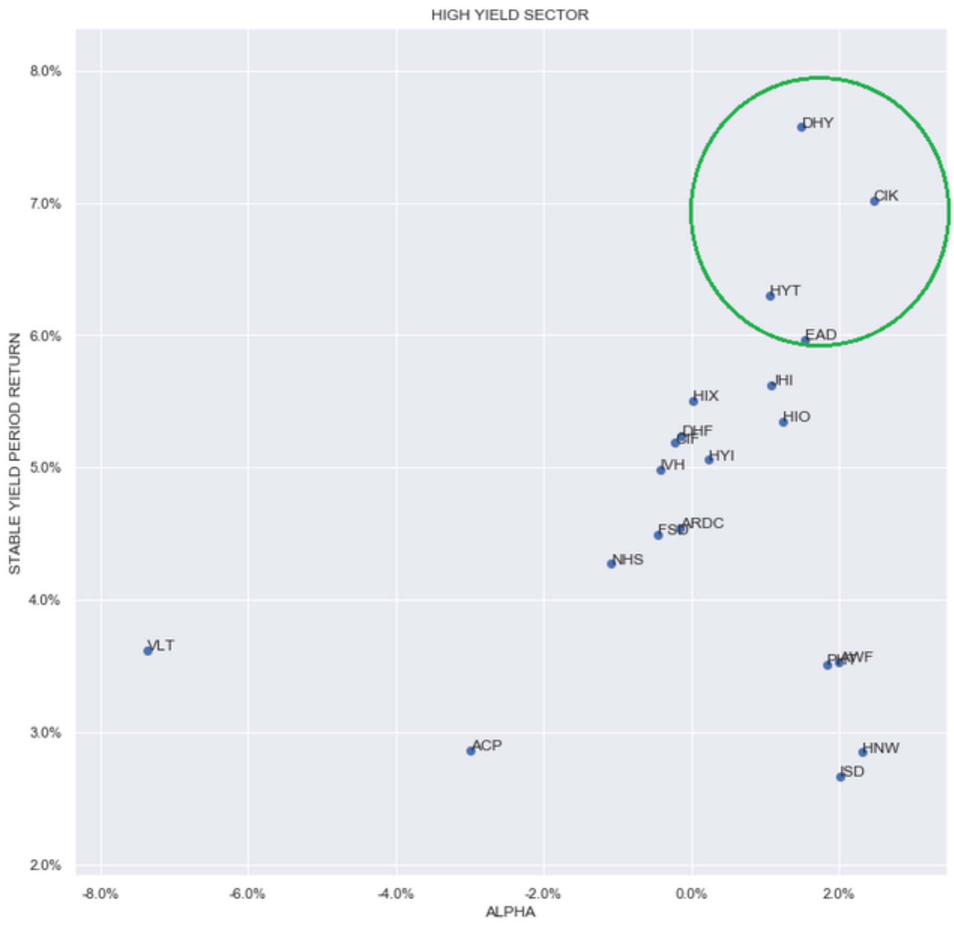
		Spreads Percentile		
	Current Spread	1yr	5yr	10yr
US Bonds				
US High Yield	304	100%	100%	100%
US BB	219	98%	85%	92%
US B	349	98%	95%	97%
US CCC	583	100%	100%	100%
US BB to BBB	112	98%	37%	62%
US Loans				
US Bank Loans	406	95%	66%	83%
US BB	300	54%	42%	71%
US B	420	97%	74%	87%
US CCC	763	100%	100%	100%
US CLOs				
US A	205	80%	77%	88%
US BBB	310	89%	81%	90%
US BB	635	84%	62%	66%

Data as at June 30, 2021. Source: ICE BofA, LCD, KKR Credit analysis.

Source: KKR

We are also increasingly tilting to CEFs with a strong track record of generating alpha. This is because record low credit yields decrease the total return that funds can generate through "beta" as well as lower the likelihood of further gains from falling yields - a tailwind that fixed-income investors have enjoyed over the last few decades.

There are many different ways to measure alpha. The chart below does this in two ways.



Source: Systematic Income

The x-axis shows the familiar risk-adjusted return metric and the y-axis shows what we call *stable yield alpha* which tries to adjust for any duration tilts across individual funds to isolate security selection rather than duration profile. The "best" quadrant is circled in green. Within the circled fund we like Credit Suisse High Yield Bond Fund (DHY), trading at a 3.9% discount and a 7.5% distribution rate, and Wells Fargo Advantage Income Opportunities Fund (EAD), trading at a 4.8% discount and an 8% distribution rate.

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