Seeking Alpha

Closed End Funds

Closed-End Funds: Senior Loan Funds Q3 2021 Update

Aug. 09, 2021 11:21 PM ET | AFT, BGB, BGT...

Summary

- Senior loan funds are showing some opportunities at some wide discounts.
- These funds should benefit from increasing interest rates, but that could be years before playing out.
- Be aware of certain other risks in these investments, as well as the other benefits they can provide.
- Discounts remain in this space, but overall CEF discounts have been getting more narrow this year.
- This idea was discussed in more depth with members of my private investing community, CEF/ETF Income Laboratory. Learn More »

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Written by Nick Ackerman, co-produced by Stanford Chemist

Several months ago we took an in-depth look at closed-end funds that invest in senior loans. We went over the pros and cons, and some unique risks that are present in CEFs. Of course, CEFs have to contend with the premium/discount mechanics in their structure - and they can also include leverage to make them more volatile as well. Several funds have now released their year-end data - so we will get an update of distribution coverage figures.

This is another update for Q3 as senior loan funds are pertinent to the current environment. The main draw for senior loan funds at this time is the idea of increasing interest rates. Most of these investments are tied to floating interest rates tied to LIBOR plus a spread. Therefore, when rates do rise again in the future, these funds should see some of the first benefits. This is in contrast to other fixed-income investments such as U.S. Treasuries, municipal bonds and other investment-grade corporate bonds.

Though as a friendly reminder, they will still have to break through the "floor" rate before seeing an impact. This means that it might not be as immediate until rates rise sufficiently enough. Stanford Chemist went more in-depth on this subject previously. Additionally, Jerome Powell is indicating that rates should be set to 0% for a considerable amount of time. In fact, they don't anticipate raising rates for at least a couple of years. That being said, you never can say it will never happen.

CEF Senior Loan Screen

We will be using mostly the same metrics to screen senior loans this time as we did previously. We want to be able to find the best "value" in the space by having the deepest discount. That being said, the one thing we change is the discount. In the original post, a 10%+ discount was sufficient to populate a list. Then we had to use a 7% or greater discount to find a good list of names. This time, we will have to go even more narrow as the CEF space gets even tighter - using a 5%+ discount.

We also want only actual senior loan funds. The CLO funds are labeled as senior loan funds. While not completely unrelated - they aren't exactly what we are looking for. So funds like Oxford Lane Capital (OXLC) and Eagle Point Credit Company (ECC) are out.

Another metric we used were funds that have a minimum 5 years' worth of history. We want to be able to have a bit of a track record to gauge how the fund operated through some different market environments.

Highland Income Fund (HFRO) is going to be removed from this list. They are working to convert themselves into a diversified holding company. The fund has too many red flags despite being the "senior" loan fund with the deepest discount. They have been converting to a different style of investments anyway. So they show up as a senior loan fund but they are hardly a senior loan fund anymore.

Invesco Dynamic Credit Opportunities Fund (VTA) will also be taken off this list. The reason being is they are looking to convert to an interval fund structure and become private. Reducing most liquidity to quarterly or annual repurchases from the fund.

Additionally, Saba Capital Income & Opportunities (BRW) will also be removed. That fund is going through an overhaul after being taken by Saba from Voya. It too will emerge as something other than a senior loan fund.

The table includes the name, ticker, premium/discount, 5-year annualized total NAV return, 10-year annualized total NAV returns (if available,) distribution rate and distribution coverage. A high distribution is nothing if they aren't supporting it from net investment income. Though the caveat here is that I am taking whatever the last report available is and calculating it against that. Since they don't all line up in the same fiscal year-end, we will have different periods being reported.

The data is from the closing on 07/19/2021. We will also be sorting the list from deepest discount to lowest discount. After the screening metrics we used above, we are left with 12 funds.

Name	Ticker	Premium/Discount	Distribution Rate	Distribution Coverage	5-Y NA
Average		-7.41%	6.99%	81.58%	5.8

Apollo Senior Floating Rate Fund	(AFT)	-9.28%	6.51%	96.06%	5.5
Invesco Senior Income	(VVR)	-8.68%	5.99%	82.27%	6.0
Nuveen Credit Strategies Income Fund	(JQC)	-8.38%	10.45%	34.24%	4.9
Nuveen Short Duration Credit Opps Fund	(JSD)	-8.32%	7.30%	91.56%	5.3
Nuveen Floating Rate Income Opportunity	(JRO)	-7.80%	7.29%	93.17%	5.6
Blackstone Strategic Credit	(BGB)	-7.56%	6.36%	98.37%	6.5
Nuveen Floating Rate Income	(JFR)	-7.15%	7.24%	93.25%	5.6
Blackstone Long-Short Credit Income	(BGX)	-7.10%	6.75%	98.49%	7.9

Nuveen Senior Income	(NSL)	-6.41%	7.17%	87.15%	5.3
BlackRock Floating Rate Income	(BGT)	-6.21%	6.12%	53.53%*	5.1
BlackRock Debt Strategies	(DSU)	-6.18%	6.64%	76.18%	6.6
BlackRock Floating Rate Inc Strategies	(FRA)	-5.81%	6.10%	74.73%	5.2

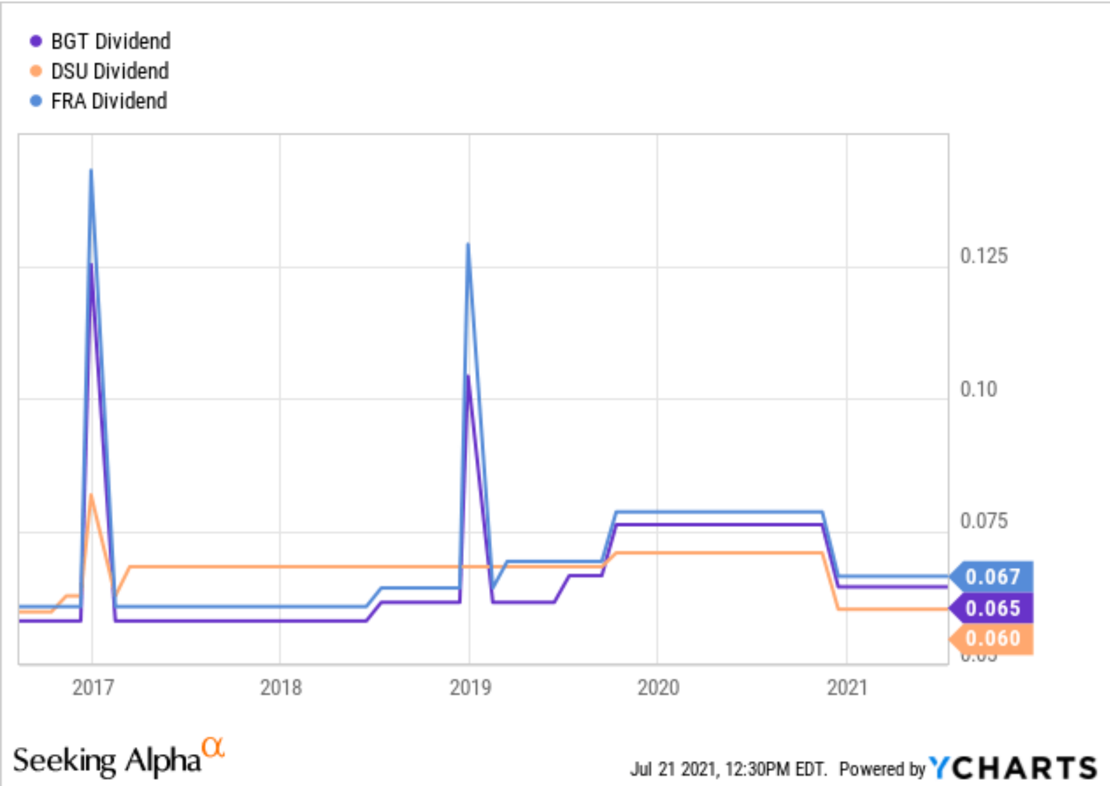
(Source - CEFConnect, SEC Filings, Author Compiled)

**Only reporting for a 2 month period*

BGT, DSU, FRA

For BlackRock Floating Rate Income (BGT) they changed their fiscal year. This reporting period was for only 2 months. With such a short time frame the coverage really isn't giving us a clear picture. Besides that though, the other BlackRock funds BlackRock Debt Strategies (DSU) and BlackRock Floating Rate Inc Strategies (FRA) also have relatively weaker coverage too. At the same time, they are paying out some of the lowest yields interestingly enough. For this list, the average yield comes to 6.99%.

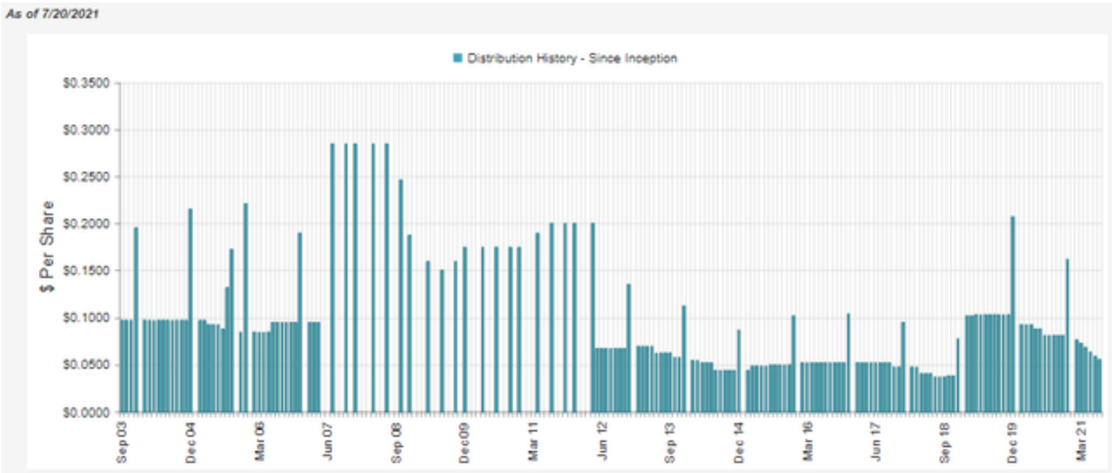
BGT, DSU and FRA also cut their distribution heading into 2021. That means their coverage going forward should be better as well. That should bring them in line with the other funds but potentially still shy of the 100%+ coverage we would like to see. The reason for the trim, of course, is because rates were slashed to 0% by the Fed. This is basically the whole point of running these screens periodically for senior loan funds now. Since they should benefit first when rates rise eventually.



Data by YCharts

JQC, JSD, JRO, JFR

The only other lower coverage than BGT is Nuveen Credit Strategies Income Fund (JQC). BGT and JQC are ultimately bringing down the average distribution coverage ratio we see above. However, for JQC, they are winding down their capital return program. As this tapers off, the distribution is going to be continually adjusted lower and lower in the final year. That being said, this fund is really bringing up the average yield of this small group of funds for the time being.



(Source - CEFConnect)

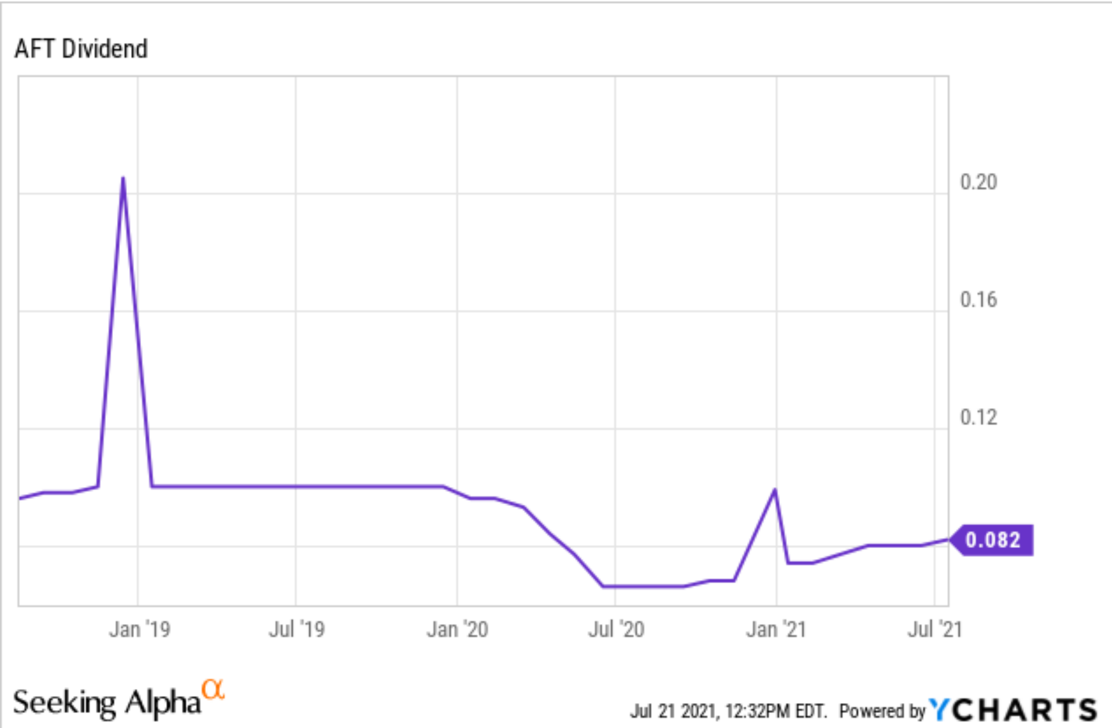
If the other Nuveen funds on this list - Nuveen Short Duration Credit Opportunities (JSD), Nuveen Floating Rate Income Opportunities (JRO) or Nuveen Floating Rate Income (JFR) are any indication - then JQC's yield could eventually be around 7.28%. Possibly a bit lower as those funds are also showing a shortfall in actual distribution coverage. For the most part, we want to see net investment income [NII] coverage on the higher end. Ideally, it would be over 100%. The reason for this is that capital appreciation can be harder to generate in a fixed-income portfolio.

AFT

Interestingly enough - AFT comes to the top of the list again as the deepest discounted fund. This time the discount comes to 9.28%. A decline from the 10.37% discount previously.

Unlike the other funds we were discussing; AFT has been raising its distribution. That is despite the coverage not being over 100%. Though a portion of this has to do with the fact that they were the first to cut. In fact, they cut quite drastically for several announcements after the Fed slashed rates.

It went from a $0.10 monthly payment to finally bottom out at $0.066. That was good for a 34% reduction from peak to trough. Despite this, I believe that AFT remains a reasonable fund worth investing in. Part of the deeper discount could simply be because investors don't like to see those types of downward reductions. The 5 and 10-year NAV performances come about in line with the rest of this group as well.



Data by YCharts

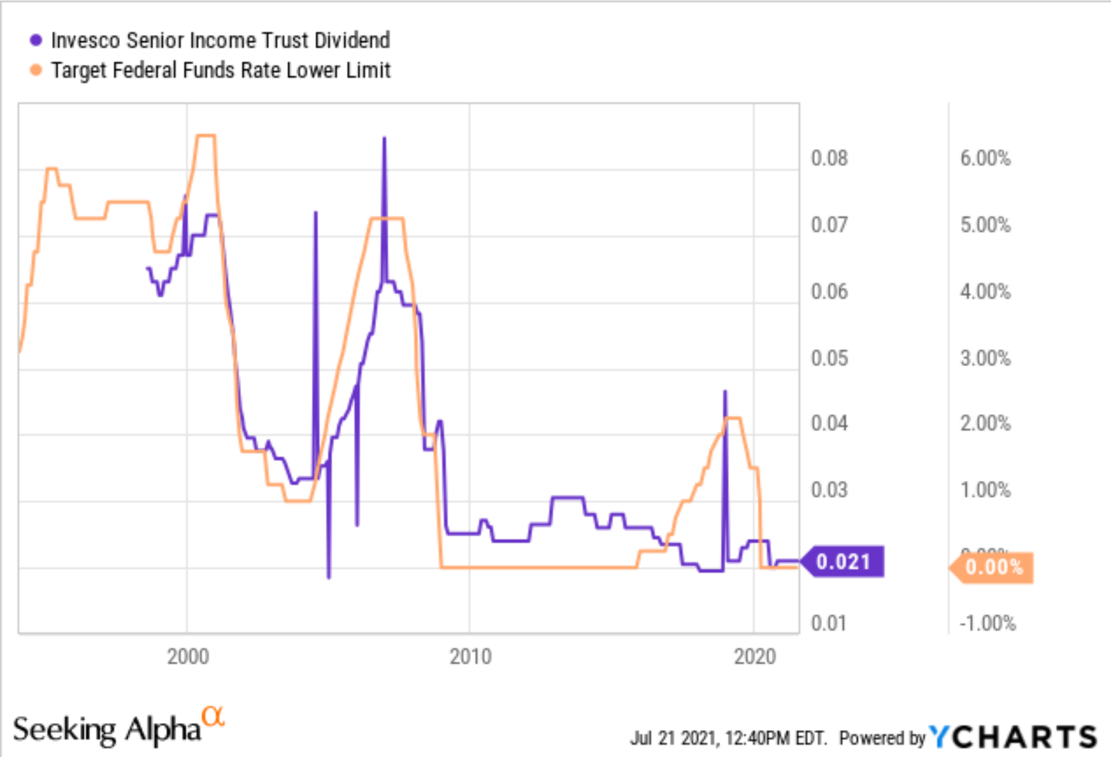
We noted that it did seem like they overcut their distribution in our previous coverage:

> AFT certainly does seem like an appealing place to start if we are looking for the best discount at this time. The yield relative to its peers is still intriguing at current levels. I would also anticipate that they probably over-cut relative to peers. Thus, we have been seeing an increase over the last couple of quarters from the fund

With that, we continue to see them increase the distribution to the current $0.082 amount from the $0.074 distribution in the previous screening.

VVR

Finally, I wanted to touch on VVR. They raised their distribution rate at the end of 2020. Again though, they also were amongst the first to slash their rate soon after the Fed did. Going from a $0.024 monthly rate to a $0.02. That works out to roughly a 16.7% distribution trim. VVR has quite a long history in the CEF space as well. They launched on 06/24/1998. Since that time, the fund has grappled with lower and lower interest rates. Thus, their distribution history might not look that appealing - but it is simply following interest rates themselves for the most part.



Data by YCharts

One notable exception where the distribution didn't follow the Fed rate was through 2016 to 2019. During that period they actually kept lowering the distribution before eventually ramping up. Ramping up just in time to get whacked by 0% rates brought on by COVID. Though during that time they did pay a large special distribution too. That compensated for some of the declines that we saw while rates were heading higher.

Though I'd also like to note that through 2011 to roughly 2013 they were raising in that time too. Ahead of when the Fed began actually raising.

BGB, BGX

BGB and BGX remain as the highest distribution coverages - which is great to see. The other Blackstone fund Blackstone Senior Floating Rate Term Fund (BSL) has now fallen off of the list due to its narrow 2.61% discount. BSL had over 100% distribution coverage as well. The only one that did at that time.

The really interesting thing is that when we covered this group at the end of December 2020 - these three funds had well over 100% coverage.

From there, they cut their distributions and so that still isn't being fully reflected yet either. Over the next few months, we should see more reports coming out to get updated coverage figures. However, I suspect that their coverage levels increase from where they are now based on the lower distributions. BGB and BSL have both increased their distributions a bit last quarter. BGX kept theirs in line.

Conclusion

Senior loans could be set to take advantage of increasing interest rates when they arrive. Everyone has been watching the 10-year treasury increase quite rapidly as 2021 kicked off. However, now the reverse is true and it has given up a lot of those gains.

Data by YCharts

Discounts across this group and all CEFs have really tightened going through 2021. This is certainly helping out our CEF investors with appreciation in their portfolios. Though it also creates a scenario where finding buying opportunities can be quite difficult now. It also means that there is less of a cushion when volatility does kick back in.

Despite what could take years to pay off, keeping a close eye on senior loan funds now might prove beneficial later if we can get in before the herds. That is why we will continue to screen this group of funds. AFT still seems like a fine area of the senior loan fund group to start. VVR is also appealing at these levels.

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This article was written by

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