Seeking Alpha α

Closed End Funds

Discounts And Premiums Not All Created Equal

Aug. 24, 2021 3:45 PM ET | CEN, CLM, CRF... | 12 Comments | 16 Likes

Summary

- Funds at the largest discounts don't necessarily make great investments, with several of the deepest discounted funds worth avoiding.
- Similarly, funds at large premiums don't necessarily make terrible investments either.
- One should consider other factors before buying or selling a fund, and the discount/premium is only one metric.
- This idea was discussed in more depth with members of my private investing community, CEF/ETF Income Laboratory. Learn More »

Richard Drury/DigitalVision via Getty Images

Written by Nick Ackerman, co-produced by Stanford Chemist

When looking at closed-end funds, starting with the discount or premium of the fund is an important place to start. In fact, it is one of the first things I check amongst investment policy, a quick review of the holdings, performance, and distribution.

> Seemingly the easiest metric to look at, but that can be deceiving. For the discount/premium I'm not just looking for the funds with the deepest discount. What I'm looking for is how the discount/premium is relative to the fund's historical range. One can look at a 1-year z-score to gauge how the fund is trading relative to its more recent history. Though I always like to check out the 3 and 5-year averages too. In addition to that, I want to look at the since inception discount/premium graph as well.

However, it is important to remember that a premium or discount is only one measure of the fund's valuation. It takes more than just a discount or premium to know if a fund is worth investing in. In general, this is a good rule for investing - not using just one metric to make a buy or sell decision.

With that being said, there are various reasons why a fund might trade at a deep discount, or a fund that trades at a premium is still worth holding too. One of the reasons could be simply that the historical range of the fund supports it.

Closed-End Funds

CEFs offer higher juiced-up distributions. We call them distributions because this more correctly classifies them. The source of "dividends" comes from more than just income; it can come from income, capital gains, or a return of capital. Return of capital isn't always bad either, as we have delved into in the past.

Another reason CEFs can offer more monthly or quarterly income is that they can use more complex strategies. This can include the utilization of leverage or options strategies. Both of these strategies can potentially enhance returns or even potentially mitigate drawdowns - in the case of options being used. These strategies do involve a more actively managed portfolio. This involves investment managers running the fund on a day-to-day basis. That also increases costs for the funds to operate, increasing their expense ratios.

This is exactly where CEFs can fill a role in one's portfolio; primarily as a way to juice up portfolio yields and income. The average distribution rate for all CEFs as of July 29th is 6.23% (using CEFConnect's data.) This is much higher than we would see for individual stocks and even higher than the typical ETF.

Factor In The Z-Score

A fund that trades at premiums for a significant amount of time can continue trading there as long as nothing drastic changes. Additionally, a fund at a deep discount can seem to stay there perpetually as well. This is where that z-score can come in handy, which is another way to value a CEF relative to its historical range.

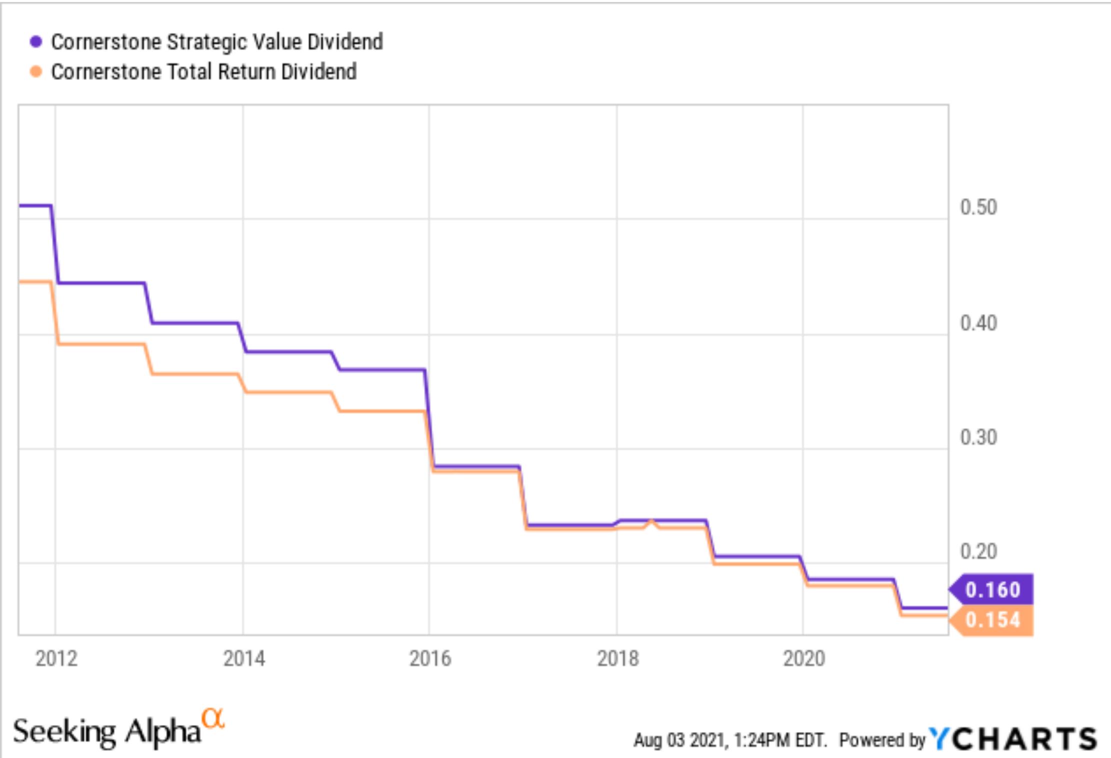
> A Z-score is a numerical measurement that describes a value's relationship to the mean of a group of values. Z-score is measured in terms of standard deviations from the mean. If a Z-score is 0, it indicates that the data point's score is identical to the mean score. A Z-score of 1.0 would indicate a value that is one standard deviation from the mean. Z-scores may be positive or negative, with a positive value indicating the score is above the mean and a negative score indicating it is below the mean.

However, it could also indicate the investors' caution or perceived quality of the fund as well. Though due to inefficiencies in the market, the crowd doesn't always get this right either. Particularly, if we are in a market crash, we will see intense discounts open up typically.

This is one of the opportunities of CEFs, though it can feel like a punch in the gut during a panic. As prices collapse and you see your portfolio valuation severely impacted. So it can also be identified as a "danger" too. Though also an opportunity in disguise.

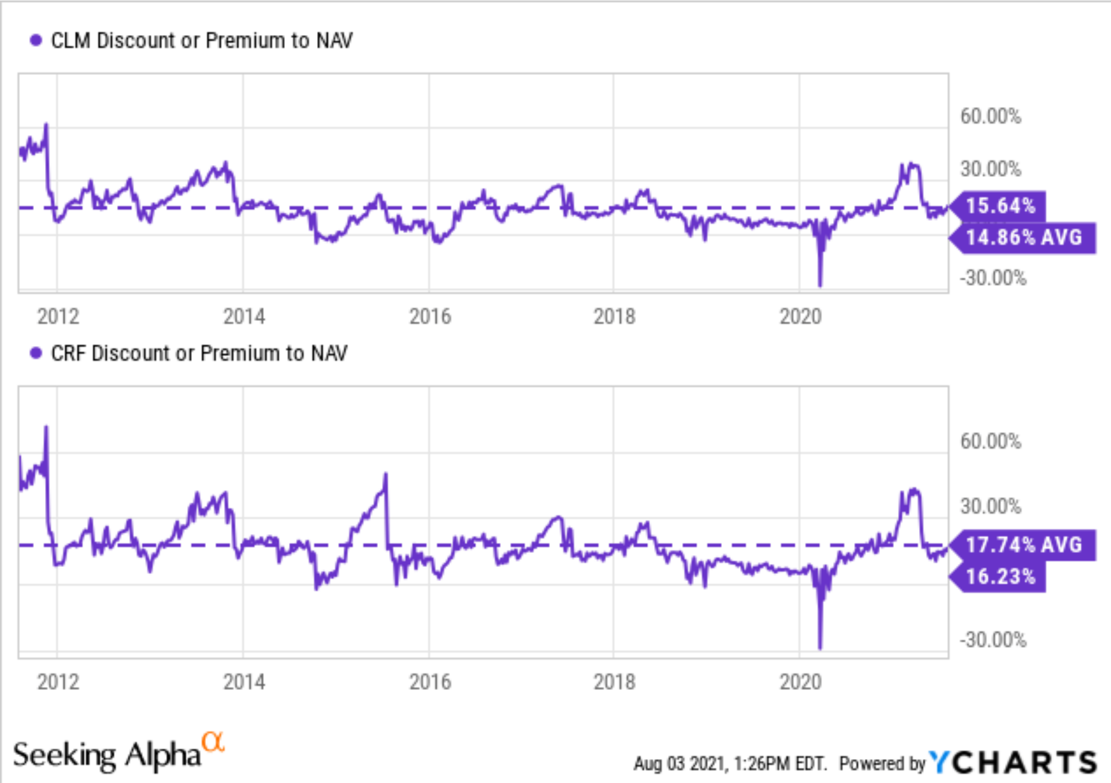
Even with this metric, it is important to consider that other factors could have pushed the fund to a positive or negative z-score. For instance, if a fund just boosted its distribution significantly, that could indicate that investors will probably value that fund to a greater degree. We see this with quite a few of the distributions that target high NAV distribution plans.

The two most famous examples of this are the Cornerstone sister funds, Cornerstone Strategic Value Fund Inc (CLM), and Cornerstone Total Return Fund Inc (CRF). They pay managed distribution plans of 21%, reset annually.



Data by YCharts

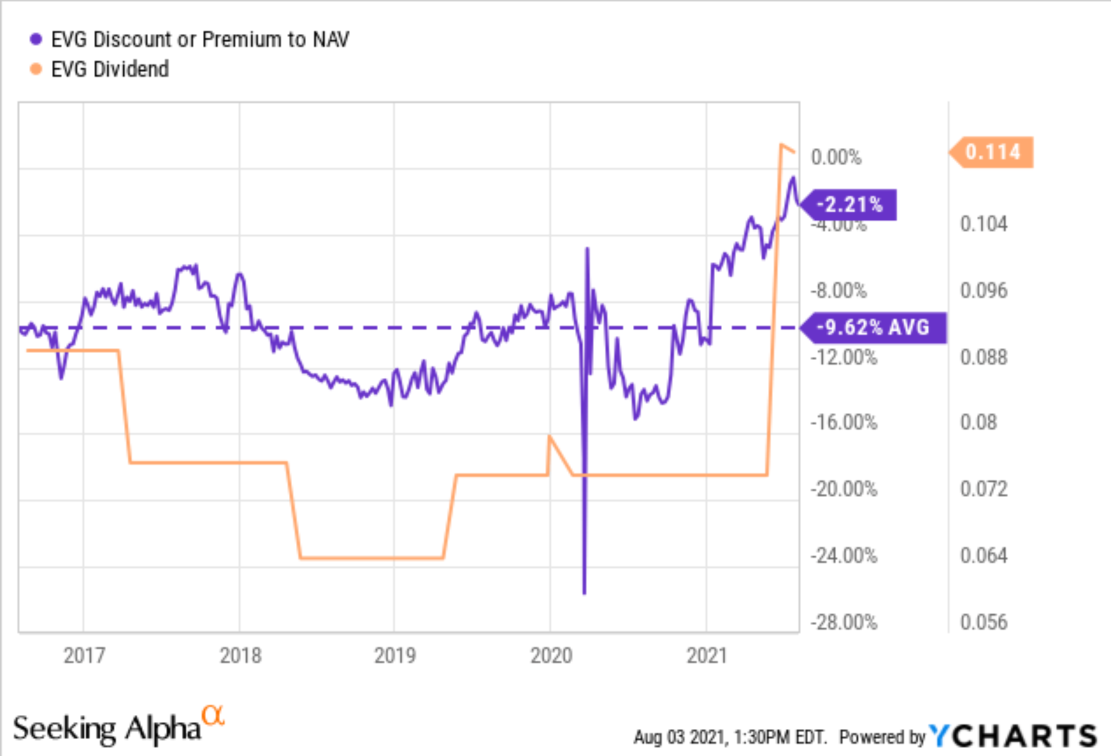
This has resulted in mostly lower distributions every year. If they can't return 21% in a year on a NAV basis, it is quite simple - then the distribution gets trimmed. These funds have been paying this managed plan for years. It has pushed the fund to trade at premiums regularly.



Data by YCharts

In fact, over the last 1 year, their z-scores are now negative due to being below their 52-week average. CLM's 1-year average comes to 19.16% and CRF at 21.45%.

A fund that has recently gone to a managed distribution plan is Eaton Vance's Short Duration Diversified Income Fund (EVG). Due to activist investors pushing the fund to implement changes to approve an advisory change, the fund employed a 10% managed distribution plan. However, they are implementing this a bit differently as it will be a monthly reset. Investors don't typically value that style as highly.



Data by YCharts

With that bump, though - it also coincides with the valuation of the fund being valued higher. Therefore, a deception if one just looked at the 1-year z-score of 1.25 currently. As you need to factor in changing policies within discounts/premiums and z-score valuation metrics. This fund also just finished up a tender offer, which boosted some of the valuations.

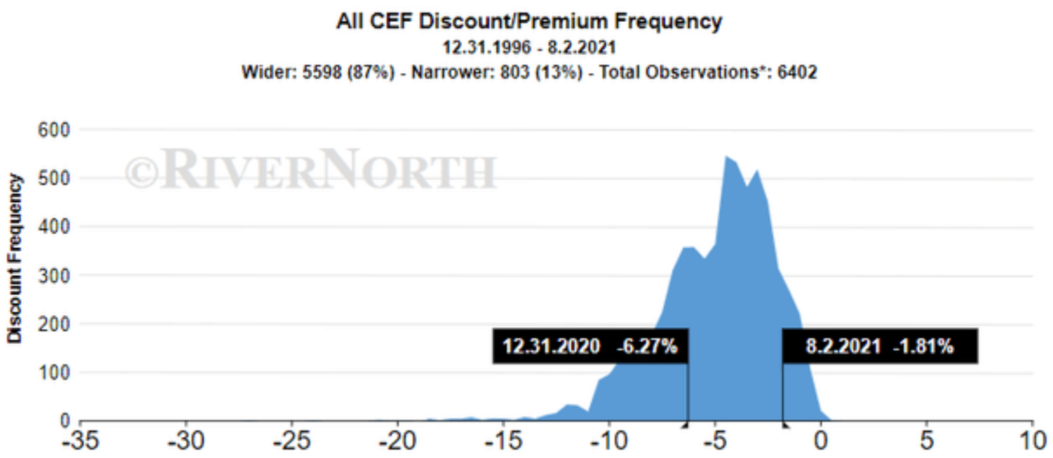
Just because a fund is paying a high distribution doesn't mean that it's one's return. It's important to remember that CEFs can pay out what they want for however long. None of the three here - CLM, CRF, or EVG - are covering their distributions at this time.

Current Environment

One of the factors in discounts and premiums is the current market environment. At this time, the broader indexes are at or very near their all-time highs, it seems, throughout most of 2021. Stocks aren't alone either, as CEF's valuations also are becoming quite stretched.

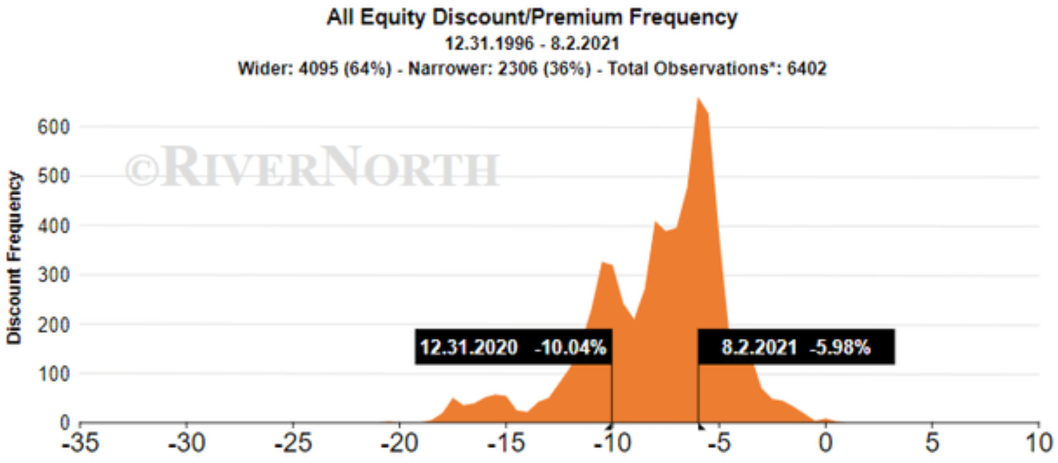
The average discount of all CEFs as of 7/29/2021 comes to 1.97%. To start 2021 off on 01/01/2021, the average was a discount of 6.38%. Exactly 1-year ago from today, on 08/03/2020, the average discount was 7.6%. As we can see, the discount has shrunk across the board materially over the last year.

Looking at RiverNorth's data, we can see that 87% of the time, CEFs have been at wider discounts since 1996. 13% of the time, they've been at narrower discounts.



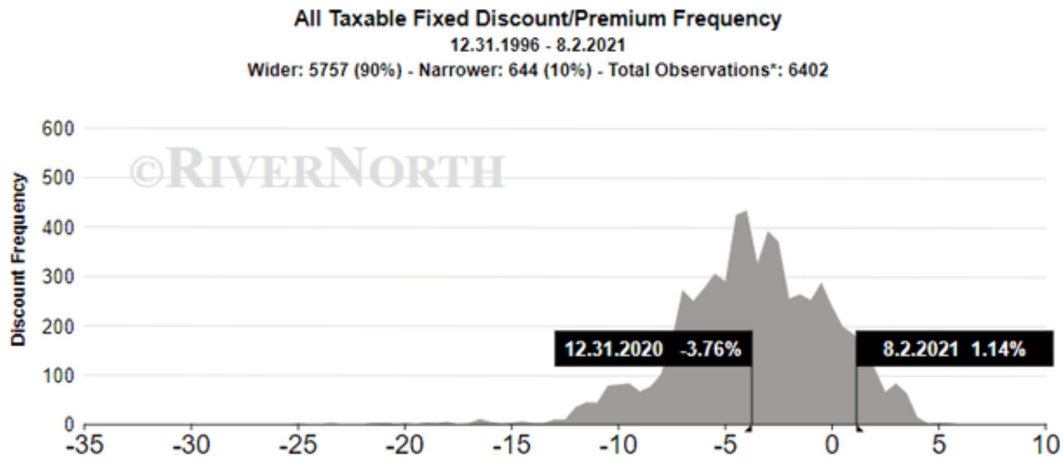
(Source - RiverNorth)

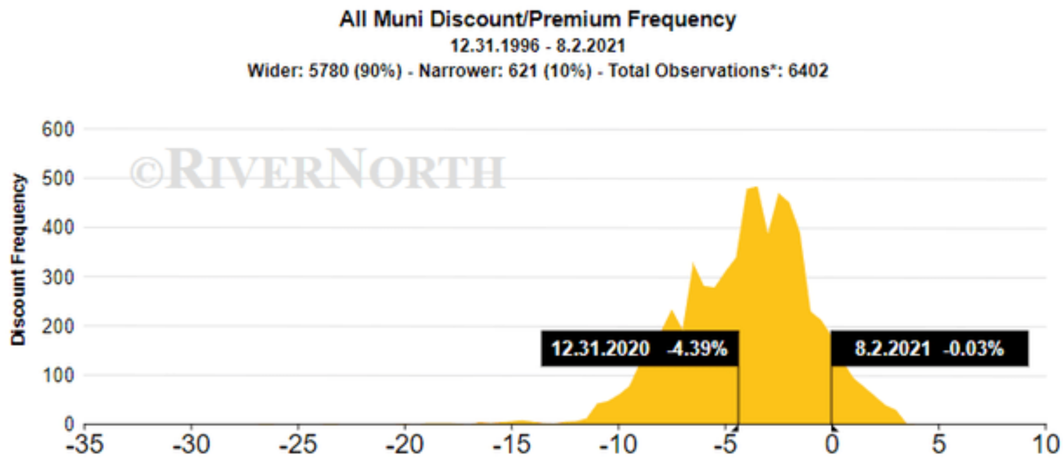
Though this isn't equally distributed across the board. Equity funds are still enjoying some values out there.



(Source - RiverNorth)

When breaking it down further between taxable and muni discount/premium frequencies, we see that they are historically more narrow relative to equity funds, with taxable fixed-income funds trading at an average slight premium. Munis are trading basically at par.





(Source - RiverNorth)

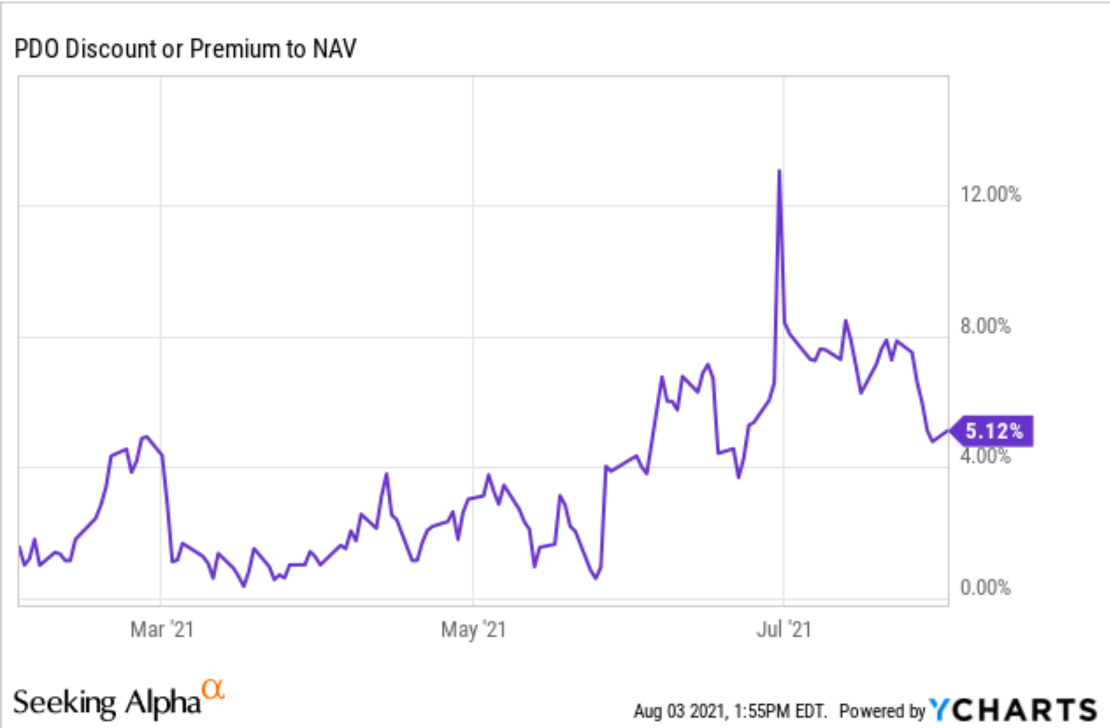
This helps highlight why it has become increasingly difficult to find a "value" in the CEF space. It isn't you - it's just the whole market type of thing.

Perceived Quality

Finally, I wanted to take a look at trying to measure a fund based on perceived quality. This isn't really an easy thing to look at since it isn't necessarily measurable. However, what we do know are some obvious signs of this.

For instance, the PIMCO funds typically trade at some lofty premiums. This is across the board of their whole suite of funds for the most part. Part of the reason for this is that the distributions are level or "managed distributions" that are paid at the same rate for a significant period of time. That being said, their coverage has been slipping too due to rates being near 0%.

That being said, it hasn't stopped their newest fund from jumping to a premium. That is even with a lower distribution. PIMCO Dynamic Income Opportunities Fund (PDO) has a distribution yield of 6.59% and quickly began trading at a premium.



Data by YCharts

The assumption that I would take away from here is that investors know that PIMCO has been a quality fixed-income manager in the past. If we look at PIMCO Income Opportunity Fund (PKO), they have ranked number 1 out of 12 peers in the last 10 years. They ranked 2nd out of 19 in the last 5-year period and 6th out of 22 in the last 3 years. Not exactly the top every year but a good track record nonetheless.

I would also mention that it is also competing against some of its sister funds too, such as; PIMCO Income Strategy Fund II (PFN), which comes in 2nd place in the 10-year period, or PIMCO Income Strategy Fund (PFL) that is the 4th best performing in that same period.

Total Return (%) - Reinvested Dividends *Periods greater than 1 Year are annualized.*										
	1 Week	1 Month	3 Month	6 Month	QTD	YTD	1 Year	3 Year	5 Year	10 Year
Price	0.61	-0.41	0.11	10.00	0.08	10.21	20.22	8.61	12.61	11.07
Rank	13 / 26	17 / 26	22 / 25	14 / 24	14 / 26	14 / 23	17 / 23	12 / 22	5 / 19	4 / 12
Peer Group (Mk Pr)	*0.04*	*-0.33*	*3.04*	*10.85*	*-0.33*	*11.88*	*26.48*	*8.30*	*8.69*	*8.33*
NAV	0.04	0.51	3.19	5.36	0.63	6.07	20.31	8.22	10.79	10.37
Rank	22 / 26	17 / 26	10 / 25	13 / 24	19 / 26	13 / 23	9 / 23	6 / 22	2 / 19	1 / 12
Peer Group (NAV)	*0.18*	*0.38*	*2.56*	*5.06*	*0.38*	*5.77*	*17.70*	*7.37*	*8.23*	*8.15*

(Source - CEFData)

Then you have the other side of this equation. The funds that trade at some of the deepest discounts but are rather flawed. At least they are flawed, in my opinion, and deserve to be perceived as lower quality. These are easy to find; you can go to CEFConnect's screener and the only criteria to put in is a discount. You will see several names at the bottom that are worth avoiding.

Though you will also see many energy names that aren't necessarily deserving of the discounts, too, that's where the market inefficiencies are coming in. Now, admittedly, I'm not one to advocate strongly for energy. But some of the energy discounts are quite ridiculous due to past performance.

Name	Ticker	Premium/Discount	Distribution Rate
FOXBY CORP	(OTCPK:FXBY)	-38.04%	0.35%
NexPoint Strategic Opportunities Fund	(NHF)	-35.26%	4.39%
Cushing MLP & Infras Total Return	(SRV)	-25.95%	5.18%
Dividend and Income Fund	(OTCPK:DNIF)	-25.14%	6.77%
Center Coast Brookfield MLP & NRG Inf Fd	(CEN)	-24.97%	7.20%
Salient Midstream & MLP Fund	(SMM)	-24.08%	4.14%
Highland Floating Rate Opportunities Fd	(HFRO)	-23.86%	8.94%
Tortoise Midstream Energy Fund	(NTG)	-23.44%	5.03%
Tortoise Energy	(TYG)	-22.56%	5.03%

Infrastructure Corp.			
NB MLP and Energy Income Fund Inc.	(NML)	-20.98%	4.06%

(Source - CEFConnect)

With the deepest discount, we have FXBY. I see no compelling reason to buy this fund at all. It has less than $13 million in total managed assets and has paid 7 distributions since its inception in 1999. The historical returns have been okay, but due to the size of the fund, it just isn't worth investing in.

Two other funds that aren't worth investing in are NHF and HFRO. They continually make the list as deeply discounted funds, but that doesn't mean they are worth owning. Both have problems with perceived self-dealing. In this case, it means that it can create fees on fees situation. The manager just happens to be the same on both funds as well.

25.6% of the fund as of Q2 2021 included two other NexPoint managed entities.

TOP 10 EXPOSURES*

Investment	Equity	Debt	Preferred	Total
NexPoint Real Estate Finance[3]	15.6%	-	-	15.6%
VineBrook Homes[4]	11.8%	-	-	11.8%
NexPoint Storage Partners	10.0%	-	-	10.0%
Cityplace Tower[4]	8.8%	-	-	8.8%
Terrestar Corporation	4.6%	2.9%	-	7.5%
Specialty Financial Products	5.8%	-	-	5.8%
SAFStor Inc.[4]	4.6%	-	-	4.6%
Metro Goldwyn Mayer	4.4%	-	-	4.4%
IQHQ Inc.[5]	3.2%	-	-	3.2%
Greenbrier CLO	3.0%	-	-	3.0%

(Source - NHF Fact Sheet)

NexPoint Real Estate Finance's (NREF) president is the same manager that runs NHF.

For HFRO, they are a bit more diversified but still have NREF in their portfolio as well. We can also see they have a huge concentration in Creek Pine Holdings. This is a private holding, but it is also interesting that HFRO holds it along with NHF and NexPoint Real Estate Strategies Fund (a non-publicly traded interval fund) also managed by the same manager.

TOP 10 EXPOSURES[2]*

Investment	Equity	Debt	Preferred	Total
Creek Pine Holdings, LLC	23.7%	-	-	23.7%
SAFStor[3]	11.2%	-	-	11.2%
NexPoint Real Estate Finance[4]	8.2%	-	-	8.2%
Metro Goldwyn Mayer, Inc.	6.2%	-	-	6.2%
EDS Legacy Partners	0.2%	-	4.5%	4.7%
IQHQ	3.6%	-	-	3.6%
CCS Medical	0.1%	2.8%	-	2.9%
Grayson CLO	2.7%	-	-	2.7%
NEXLS LLC	2.1%	-	-	2.1%
SFR WLIF III, LC[3]	2.1%	-	-	2.1%

(Source - HFRO Fact Sheet)

HFRO is also looking to convert to a diversified holding company. That doesn't make it a potentially better position, just one that is more complicated and less transparent. Therefore, a great representation that it is still best to be avoided.

Conclusion

Discounts and premiums are not all created equal. Sometimes there is a perceived quality to a fund that allows it to trade at discounts or premiums regularly. Discounts/premiums are just one metric to check. Funds at the largest discounts don't make them a buy; funds at the largest premiums also don't necessarily make them a sell.

It all means there is still more digging to do before knowing if a fund is worth buying or not. A big difference can come in a policy change that can impact the fund going forward materially.

The current environment for CEFs is historically narrow. That is making it harder to find better values, but it is also a function of the environment we are currently trading in. More broadly, the major indexes are continuing higher. This can last for a long time, and not being invested at all could be a missed opportunity.

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This article was written by

Nick Ackerman

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Additional disclosure: This article was originally published to members of the CEF/ETF Income Laboratory on August 3rd, 2021.

Comments (12)

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M

MM1966

Yesterday, 8:29 PM

Comments (736) | + Follow

CEF as an asset class for the most part are not worth investing in. They have very high management fees being active. Here are the only advantages they offer with why is a fake:

1) Leverage-double edge sword, great on way up, opposite on way down (look at performance during COVID break, M-Apr 2020). The leverage interest rate is significantly better than you would get on margin but leverage can be obtained in many ways including levered ETFs.
2) Dividends- Dividends are not an investment critieria as thousands of empirical work in finance has shown. Retired or others wanting dividends can "create" dividends at whatever frequency they desire by selling their investments. Mistakenly this is called "reducing" investments. Guess how the CEF are creating dividends often. Look at tech last 10 years. Most don't offer dividends. Compare owning a FB, GOOG, list goes on and selling to create dividends vs owning a CEF with dividends. An overwhelming majority of CEF have underperformed indices as expected partially due to ridiculous fees. An index can be had for at most 20 bps. Most CEF have expenses over 1% and can get crazy over 2%.
3) Active management- It just doesn't work. Read Bogle (Vanguard), Malkiel (Random Walk down Wall Street). How about tens of thousands of empirical work on this very subject? Look at allocation to active vs. passive over last 10-15 years. Straight up for passive. Straight down for active. You are lucky to find 1% of active funds that beat their respect index on 10 year basis. Once you throw in taxes (below) almost none.
4) Taxes-Any active strategy is tax inefficient due to turnover hence capital gains, often short term which is not at lower rate.
5) Discounts- My grocery store has sale on xyz. Is it a discount if it is always on sale? Discounts increase dividend yield because it is on higher NAV. This is marginal unless you have a large discount. For discounts to help they need to narrow. Big bet given everything else listed. Discounts can narrow and it turns out that the Z score is completely arbitrary, whose very calculation is arbitrary being dependent on time window chosen. A one year Z score is very different than a 3 month. There is no

window chosen. A one year Z score is very different than a 3 month. There is no confirmation of Z score giving outperformance on forward looking basis (out of sample). The empirical work showing outperformance has been challeged because the Z score time window chosen is one that gives this result. Change time window and nada.
6) Delayed transparency like most active funds making it of limited use- You don't even know what you own. If mandate is broad it could be anything: technology weight reduced, financials increased.

I can list 15 other things. If you own CEF, compare for same investment with low cost indices and calculate your underperformance for same risk, asset class exposure, etc. over longer investment horizon.

Reply Like

Nick Ackerman Yesterday, 8:32 PM

Contributor Premium Marketplace Comments (10.19K) | + Follow

Author's Reply @MM1966 sounds like you should write your own article. Thanks for your thoughts!

Reply Like

Income4ever aka Cyclenut Yesterday, 7:36 PM

Premium Comments (1.55K) | + Follow

Intresting information and insights,
One observation I've made is that for many many funds, particularly fixed income Cefs the discounts have closed significantly since covid cliff dive and they are not seemingly returning to historical norms any time soon.
Especially for the many quality funds that were trading at a discount.
Conversely, many premium funds seem to be enjoying increased premiums at the same time.

Reply Like (1)

Nick Ackerman Yesterday, 8:06 PM

Contributor Premium Marketplace Comments (10.19K) | + Follow

Author's Reply @Income4ever aka Cyclenut that is certainly what has been happening! Thank you for adding to the discussion and sharing your input, as always!

Reply Like

B **Bemylov** Yesterday, 7:15 PM

Comments (573) | + Follow

Professor Nick. You need to write book on CEFs

Reply Like (1)

Nick Ackerman Yesterday, 7:21 PM

Contributor Premium Marketplace Comments (10.19K) | + Follow

Author's Reply @Bemylov thank you! A book seems a daunting task! Though I appreciate the kind words, thanks again.

Reply Like

Income4ever aka Cyclenut Yesterday, 7:37 PM

Premium Comments (1.55K) | + Follow

@Nick Ackerman
Just think Nick, write a book and appear on all the morning news shows hawking it :))

Reply Like (1)

Nick Ackerman Yesterday, 8:07 PM

Contributor Premium Marketplace Comments (10.19K) | + Follow

Author's Reply @Income4ever aka Cyclenut maybe not a bad plan then! hah *(edited)*

Reply Like

Steve Fischer Yesterday, 5:06 PM

Comments (753) | + Follow

I didn’t see mention of SMM salient. It has most of the better mlps but it has one investment in a private energy concern which has thrown off cautious investors . Even if that were worth 0 it would still sell at a discount. I had a bad experience with FMO where they suddenly pulled a tax adjustment which cut $2-3 per share. I’m long smm but like even better SMLP and Bkep both of which sell at a small fraction of their net worth.

Reply Like (1)

Nick Ackerman Yesterday, 6:13 PM

Contributor Premium Marketplace Comments (10.19K) | + Follow

Author's Reply @Steve Fischer thank you for your input!

Reply Like (1)

RiskStrategies Yesterday, 4:45 PM

Premium Marketplace Comments (288) | + Follow

OK, this article is exactly what I need to drill down into the CEF underworld. I really appreciate you taking the time to go over CEF basics - Thanks!

Reply Like (7)

Nick Ackerman

Yesterday, 6:13 PM

Contributor Premium Marketplace Comments (10.19K) | + Follow

Author's Reply @RiskStrategies glad to help out! Thanks for reading!

Reply Like