

# CEF Weekly Market Review: Key Hazards To Watch Out For

[ADS Analytics](#)

franckreporter/iStock via Getty Images

*This article was first released to Systematic Income subscribers and free trials on 22-August.*

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 third week of August.

## Market Overview

The moves in the CEF market in the third week of August mirrored those of major asset classes - fixed-income CEF sectors finished flat or higher, in line with Treasuries, while equity sectors finished mostly in the red, in line with lower stocks. Over August, the overall picture is upbeat outside of MLPs and EM Equities as tighter discounts pushed prices higher in aggregate.

*Source: Systematic Income*

Both fixed-income and equity discounts continue to trade near their decade tights, having stabilized after a relentless run-up over the last 18 months.

*Source: Systematic Income*

On a year-to-date basis, there is wide variation in returns across sectors. Higher-quality sectors such as agencies, munis and investment-grade bonds clock in at lower returns due to a rise in Treasury yields since the start of the year, relatively tight credit spreads which had much less room to rally through the year and relatively low carry. Top-performing sectors like MLPs, REITs and CMBS fall squarely in the hardest hit sectors by the pandemic and were the sector to bounce back the most.

*Source: Systematic Income*

Since 2020, however, MLP remains the worst-performing sector with CMBS at a slightly negative total return and REITs with decent returns but in sixth place. This dynamic highlights that investors should think of CEF allocations as a "through-the-cycle" investment that can be highly sensitive to market dislocations which can lock in economic losses through deleveraging.

## **Market Themes**

CEF investors who like to read market commentary or who want to do additional due diligence on potential allocations have a lot of analysis at their disposal. However, as with anything, it is important to avoid some of the hazards that can do more harm than good.

One such common hazard is what we call the "**snowflake theory of CEF investing**" where CEFs are discussed individually, without reference to other potential choices or the broader sector. The reality is that CEFs exist in a competitive ecology with similar constraints, strategies and tools. The case is even stronger across funds of a

given issuer. For example, the chart below shows the NAV return correlation matrix of the preferreds CEF sector with red highlighting very similar funds and green relatively dissimilar funds.

*Source: Systematic Income*

Few investors who follow the space will be surprised that the highlighted Flaherty suite of 5 funds are incredibly similar. This means that discussing one fund in the suite, without providing context for the broader suite doesn't make a ton of sense. The question that investors ought to ask is - why this fund over the rest in the suite or the broader sector?

Another hazard for investors to watch out for is "**rear-view mirror analysis**" - for example, discussing fund coverage metrics without providing context for how fund income has changed since the last shareholder report. The problem is that shareholder reports are only provided semi-annually and even then with a significant delay. Many funds publish borrowings information on a monthly basis which will signal whether they have increased or decreased their income-generating asset base. Fund leverage cost is also linked to short-term rates which, until recently, were relatively volatile, delivered regular headwinds or tailwinds to fund income levels and will do so again once short-term rates move off their zero bound.

A final hazard we'll touch on here (though it's far from a complete list) is what we call "**stuff I made up**". These are comments or views that stem from a misunderstanding of market mechanics. One such comment is that rising Fed policy rates typically boost the incomes of fixed-income funds. This is obviously wrong as short-term rates either have no impact on the fixed coupon securities typically held by these funds (hence the term fixed-income) or they actually decrease fund income levels through a rise in leverage cost as leverage

instruments are usually tied to short-term rates such as Libor which are tightly linked to the Fed policy rate.

Keeping an eye on these three hazards is likely to result in a smoother and more enjoyable journey for CEF investors.

## Market Commentary

We came across a recent [survey](#) of 2020 defaults in the Muni space by VanEck. They count 83 new defaults in 2020 which sounds like a lot but in the context of an average of 58, it's not too bad particularly since only one sector - the healthcare sector - is primarily responsible for the rise. This robust behaviour of the High-Yield muni space outside of one sector suggests that it's a part of the market investors should consider. The High-Yield/unrated sub-sector doesn't pay as well as it did last year or even earlier in the year but the differential to investment-grade munis is still large. High-Yield muni yield-to-worst is at 2.95% vs. 0.94% for the broader, primarily, Investment-Grade space, according to Nuveen. Muni CEFs that allocate primarily to IG bonds (the vast majority) top up that 0.94% yield by extending duration so on the one hand they are able to deliver a marginally higher yield but at the cost of taking on more duration risk. We will shortly be doing an update on the sector to highlight some options.

We updated 13F filings for CEFs across a group of institutional investors that tend to play in the CEF space. These quarterly filings disclose individual holdings of institutional investors. The table below is sorted by the number of positions (i.e. not size of the position just whether a position exists) across these investors with funds toward the top of the table held by a larger number of these investors. Most of the holdings are in funds which earn our high quantitative ratings which makes sense as these investors often adopt a similar ranking

approach.

*Source: Systematic Income CEF Tool*

Some of the 4-star rated funds worth highlighting are the Nuveen AMT-Free Quality Muni Income Fund ([NEA](#)), BlackRock MuniHoldings Fund ([MHD](#)), and the BlackRock MuniYield Quality Fund III ([MYI](#)) in the muni space plus the Apollo Tactical Income Fund ([AIF](#)) that we recently added to the High Income Portfolio.

Three of four Wells Fargo CEFs raised distributions ([EAD](#), [ERC](#), [ERH](#)) in accordance with their 12-month trailing NAV calculation. This suite of funds was discussed a [few times](#), specifically that distribution hikes should be expected for the next while. [EOD](#) made a cut because of the change in its MDP policy from 10% to 9% of the trailing-12 month NAV. EAD remains a decent choice in the credit CEF space, trading at a 2% discount - about 3% wider than the median High-Yield fund - with strong absolute and risk-adjusted returns and a rising distribution tailwind.

## **Stance and Takeaways**

In the current market environment we like a number of niche sectors which can help diversify income portfolios such as legacy non-agency RMBS, CMBS and CLO Debt. These parts of the CEF space can be overlooked as there are few funds focusing on these sectors. In CMBS we like the Invesco High Income 2024 Target Term Fund ([IHTA](#)), trading at a 5% current yield and a flat discount. CLO Debt offers only a single dedicated fund - the Eagle Point Income Co. ([EIC](#)), trading at a 8.16% current yield and an estimated 1% premium (the fund does not publish daily NAVs). In the legacy non-agency RMBS space, the pickings are slim. We are watching the Western

Asset Mortgage Defined Opportunity Fund ([DMO](#)) and the PIMCO Dynamic Income Opportunities Fund ([PDO](#)) which has a third of its portfolio in the sector.