Seeking Alpha α

Closed End Funds

# CEF Report September 2021 | A Broken Record

Sep. 17, 2021 7:00 AM ET | ASGI, BCV, BCV.PA... | 2 Comments | 6 Likes

## Summary


- Discounts widened a bit but remain very tight relative to historical comparisons going back to 1996. Munis are now in line with taxable avg. premiums.
- At this time, a counter-cyclical approach is warranted. I have been advocating rotating from leveraged, junkier, and discount susceptible structures to open-end funds.
- Moving up quality is warranted at this point, but you will be reducing your income substantially by doing so.
- We run through the scenario that is likely to drive discounts, on average, wider.
- Are there any opportunities out there? We find a few but they are scarce today and the upside opportunity is relatively small in comparison to other time periods.
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*(This report was issued to members of Yield Hunting on Sept. 6th.)*

Don't say I didn't warn you.

This post is not meant to scare but to educate.

We were in a similar position right before the pandemic hit and then the stuff hit the fan.

I keep saying it but it can't be said enough, discounts remain near their tights of the last several years and in the top decile of all time. That doesn't mean you run out and sell every closed-end fund ("CEF") but you must be cognizant of the risks today.

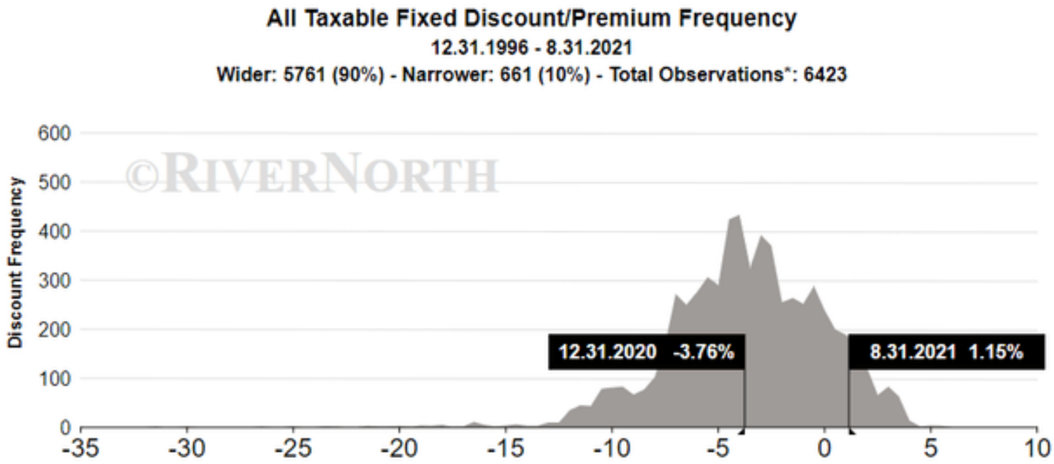
I liken the current environment as a game of chicken. You are in your car driving towards another car with a trajectory of being hit head on. Your car can be thought of as the price trend of your CEF position and the oncoming car is the event that causes the discounts to blow out.

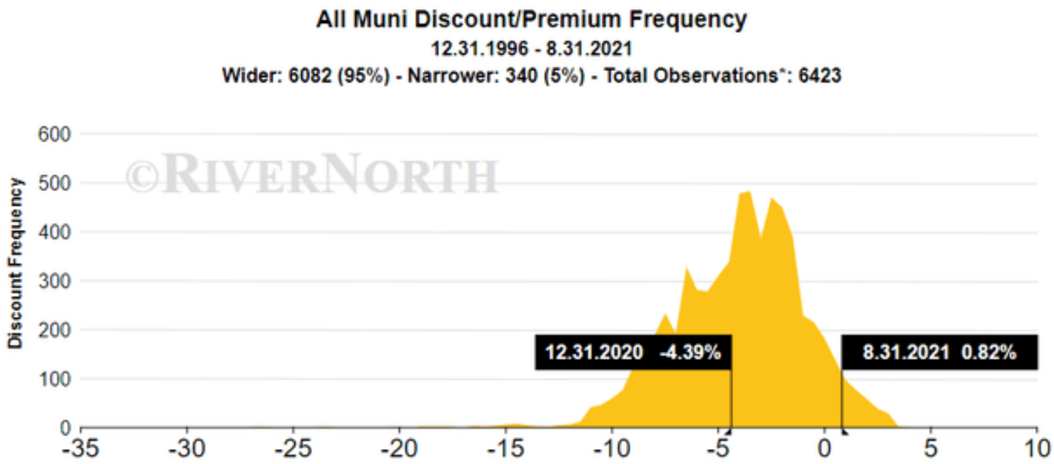
As you drive, the goal is to hold on to the CEF as long as possible without crashing your car. The problem is you can barely see out of your windshield because it is covered in snow. So you are going over your intuition.

Do you play it safe and pull over now and perhaps sacrifice a lot of opportunity? Or do you continue driving collecting those distributions not wanting to give up the gravy train?

The game is made worse by the current interest rate environment. If you pull your car over, you can either go to cash or invest in open-end bond funds like mutual funds or ETFs. In doing so, you cut your income stream by more than 50%. This is causing investors to stay driving a bit longer.

This is what happens when you're on the right side of the distribution - or what I call right tail risk. Most investors have probably heard of left tail risk or the risk of a large draw down from a Black Swan. Right tail risk is the risk in CEFs trading at elevated valuations. When you sit on the right hand side of the distribution, you run the risk of higher declines from a correction, bear market, or recessionary trend.




(Source: RiverNorth)

Right now, munis are in the top 5% of all observations. We've been telling subscribers that we believed that munis would get to a premium sometime this year and it occurred faster than expected in July. Today, the average muni is now trading at a+0.82% premium. Just four months ago they were at a -4% discount.

Taxables have widened a bit in the last month going from the top 7% of all observations and an average premium of +1.8% to +1.15% today.

## A Counter-Cyclical Approach To Investing In CEFs

The juice in the orange has been squeezed. We are now at a point where the risk is all to the downside. But does that mean you sell? No. We take a counter-cyclical approach.

### What is counter-cyclical investing?

We will do a whole separate report on that and go much more in depth and what it means for today. For the purposes of this report, counter-cyclical investing or ("CCI") is a systematic approach to reducing risk as the market cycle advances and underlying fundamentals shift. In essence, a portfolio that is 20% CEFs is a lot more risk late in the cycle and when discounts are gone versus at -10%.

When high-risk assets like non-investment grade, loans, CLOs, and even high yield munis are trading at tight spreads AND the funds themselves are trading at tight discounts, or even premiums, we are exposed to significantly more risk than if spreads are wide and discounts wide.

I have used the Double-Discount strategy a lot. Counter-cyclical investing is the general approach that encompasses the Double-Discount strategy ("DDS"). DDS is fairly simple. We want to buy CEFs when they are trading at double discounts - i.e., that the funds are trading at a discount AND the bonds in the portfolio are trading at a discount to par.

That way we can capture two tailwinds. The first is the discount of the fund closing as it mean reverts towards the long term average. The second is the natural pull towards NAV as the bonds recover and approach maturity, where the borrower recoups the full principal unless the company is in default.

Today, we are at the *opposite* of the Double-Discount environment. Most bonds are trading at a premium to par and the average muni or taxable bond CEF is trading at a premium to NAV (as we illustrated above with the RiverNorth distributions).

If a Double-Discount is what we want to buy, then is the opposite what we need to see to sell?

Answer: yes

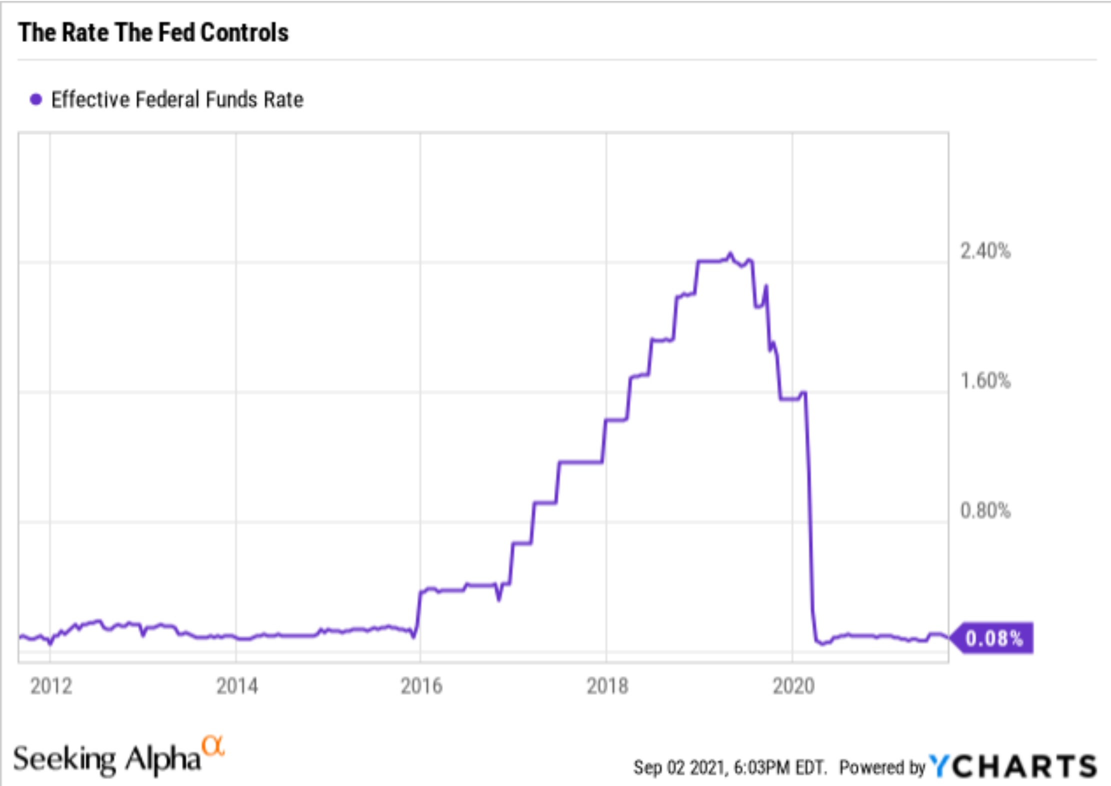
But the answer is really FAR more complex than that. A lot of CEF investors are in them for the income. By swapping out of them, they are shutting off that income stream when they are pulling from their portfolios. More in our follow up report.

## What COULD Drive Discounts Wider?

We do think there are storms on the horizon (October letter title!) that could widen discounts from here. The largest risks for CEF investors are really short-term interest rates, NAV risks, inflation, and deleveraging.

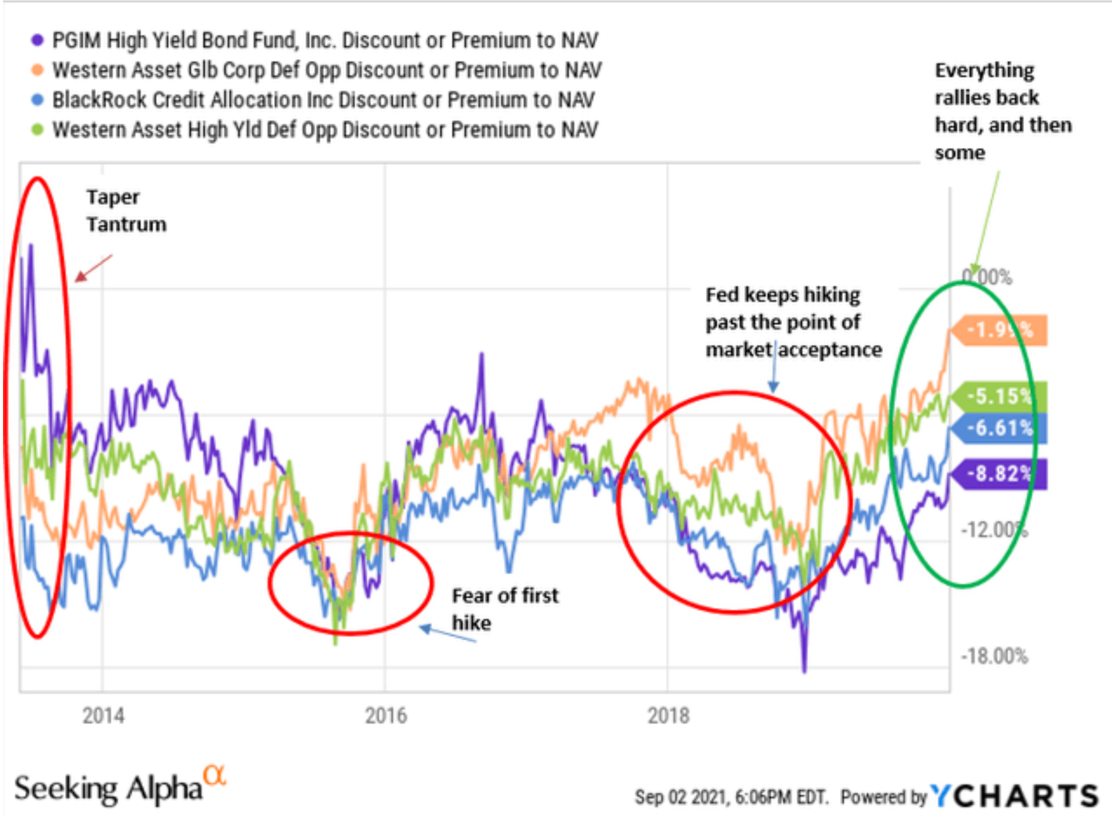
I'm not so worried about deleveraging, and inflation risks are one of the most hotly debated topics in the markets today. However, I don't see a lot of CEF investors selling based on an increase in the inflation rate from 1.8% to 3.0%. Sure, if inflation spikes to mid-to-high single digits that could be a different story but that seems highly unlikely at the moment. In fact, we may see some disinflation in the next 6 months that could drive CEF investment demand further.

The largest risk that CEF investors perceive are short-term rates. You can see that in the last two times that short-term rates were on the rise in the last decade-plus, in 2015 and again in 2017/2018. Each time, the S&P 500 saw at least a pause if not a complete correction and bear market. In the fourth quarter of 2018 when interest rates were on the rise, the S&P 500 fell 20%.




Data by YCharts

What happened to CEFs? We can use a couple of CEFs as proxies for the entire universe. We used four funds, ISD, GDO, BTZ, and HYI as the proxies.




The fear of higher rates is likely going to be the largest driver for wider discounts in the next year. As we approach the end of 2022, investors, especially CEF investors, will start getting anxiety about the increase in rates. Why? An increase in short-term rates, even at a quarter point, will drive up leverage costs.

Leverage costs dropping is what caused so many funds to increase their distributions last year. While that was a much larger drop (you can see that two charts above with the purple line), a small increase in Fed Funds (by a quarter point) could cause some funds to trim distributions. Most CEFs have floating rate borrowing arrangements (funds that use preferreds for leverage mostly have fixed liabilities)

Investors will start preparing for that by selling their CEFs and moving to open-end funds and cash - something we've been advocating for a couple of months now.

## What Are NAVs Doing?

My largest concern for CEFs are the NAV trends. Most sectors on the bond side seem to be getting sluggish and in some cases, rolling over. When discounts are wide and NAVs go from a long-term uptrend to rolling over, I am not all that concerned. However, when that happens while valuations are rich, you tend to get the newbie CEF investors selling quickly.

Right now, CEF demand is probably near an all-time high and we're seeing a lot of new funds being launched. This could temper some of the selling a bit as investors are hunting for yield anywhere they can find it. It is amazing that fixed income open-end funds that are "multi-sector" or "total return" are still attracting capital since their future returns are going to be extremely low.

| CEF Sub-Sector | Avg Yield | Avg Disc | 1M Pr | 1M NAV | Disc Ret | 3M Pr | 3M NAV | Disc Ret | 6M Pr | 6M NAV | Disc Ret | 1yr Pr | 1yr NAV | Disc Ret |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Asian Equity Funds | 8.9% | -10.6% | 1.6% | 0.2% | 1.3% | 0.2% | -0.3% | 0.5% | 3.3% | 2.6% | 0.7% | 34.6% | 26.6% | 7.9% |
| Collateralized Loan Obligation | 9.9% | 6.7% | 3.5% | 0.0% | 3.5% | 0.3% | 4.4% | -4.0% | 15.6% | 12.3% | 3.3% | 71.5% | 71.0% | 0.5% |
| Commodities Fund | 0.0% | -2.1% | -2.7% | -2.9% | 0.2% | -10.5% | -7.8% | -2.7% | -2.7% | -1.2% | -1.5% | -11.8% | -8.8% | -3.0% |
| Convertible Funds | 7.6% | -3.2% | 2.8% | 2.7% | 0.0% | 6.1% | 6.6% | -0.5% | 9.4% | 5.4% | 4.0% | 41.6% | 30.2% | 11.4% |
| Covered Call Funds | 6.5% | -0.5% | 2.7% | 1.9% | 0.8% | 5.2% | 5.0% | 0.3% | 18.8% | 13.8% | 5.1% | 40.3% | 28.9% | 11.4% |
| Emerging Market Equity | 5.5% | -9.6% | 0.8% | 0.9% | -0.1% | -6.6% | -4.4% | -2.2% | -2.3% | -2.8% | 0.5% | 29.3% | 23.5% | 5.9% |
| Emerging Market Income | 7.8% | -1.3% | 0.8% | 1.9% | -1.1% | 1.6% | 1.1% | 0.5% | 5.9% | 5.2% | 0.7% | 19.9% | 8.6% | 11.3% |
| Energy Natural Resources Funds | 5.7% | -10.3% | 2.4% | 0.9% | 1.5% | -3.6% | -3.3% | -0.4% | 12.8% | 10.1% | 2.7% | 49.1% | 36.8% | 12.3% |
| Equity Tax Advantage Funds | 6.0% | -3.7% | 4.3% | 2.3% | 2.0% | 5.9% | 3.9% | 2.0% | 22.2% | 16.1% | 6.1% | 48.2% | 35.8% | 12.4% |
| Finance Funds | 6.8% | 3.0% | 4.5% | 1.4% | 3.1% | -0.1% | 0.4% | -0.5% | 13.1% | 8.6% | 4.5% | 65.7% | 53.5% | 12.1% |
| General Equity Funds | 6.6% | -5.6% | 4.3% | 2.5% | 1.7% | 4.7% | 3.7% | 0.9% | 14.1% | 13.6% | 0.5% | 41.4% | 37.2% | 4.2% |
| Global Equity | 6.5% | -5.7% | 2.7% | 2.0% | 0.7% | 3.9% | 2.3% | 1.6% | 16.9% | 10.8% | 6.1% | 46.1% | 32.3% | 13.8% |
| Global Income Funds | 11.0% | 2.0% | -0.1% | 0.8% | -0.9% | 2.2% | 0.6% | 1.6% | 5.0% | 1.6% | 3.4% | 16.0% | 6.4% | 9.6% |
| Global Real Estate, REIT & Real Asse | 6.5% | -3.9% | 4.4% | 3.4% | 1.0% | 7.1% | 7.3% | -0.3% | 27.7% | 25.1% | 2.6% | 52.5% | 38.5% | 14.0% |
| Healthcare/Biotech | 6.1% | -1.9% | 3.2% | 2.2% | 1.0% | 9.3% | 10.1% | -0.8% | 15.2% | 14.0% | 1.2% | 36.2% | 26.8% | 9.4% |
| High Yield Bond Funds | 7.3% | -0.2% | 0.9% | 0.8% | 0.1% | 3.2% | 1.7% | 1.5% | 10.2% | 4.2% | 6.0% | 24.6% | 13.9% | 10.8% |
| Hybrid / Balanced Funds | 7.6% | -2.2% | 2.7% | 2.4% | 0.3% | 3.9% | 4.0% | -0.1% | 13.6% | 10.1% | 3.5% | 42.0% | 28.4% | 13.6% |
| Investment Grade Bond | 6.1% | 2.1% | -2.6% | 0.4% | -3.0% | 0.8% | 2.5% | -1.7% | 5.5% | 4.1% | 1.4% | 13.2% | 9.9% | 3.2% |
| Limited Duration Bond Funds | 8.2% | 1.0% | 1.5% | 0.9% | 0.6% | 4.8% | 1.4% | 3.4% | 9.1% | 3.0% | 6.1% | 24.6% | 10.7% | 13.9% |
| Loan Participation | 6.7% | -3.6% | 2.1% | 1.3% | 0.7% | 3.1% | 2.1% | 1.0% | 8.8% | 4.6% | 4.3% | 29.2% | 15.8% | 13.4% |
| Misc. Non US Equity Funds | 5.9% | -12.2% | 2.4% | 2.2% | 0.2% | 2.7% | 2.8% | -0.1% | 16.8% | 13.9% | 3.0% | 48.0% | 39.6% | 8.5% |
| MLP Funds | 5.8% | -16.4% | 2.8% | 1.8% | 1.0% | -2.6% | -2.3% | -0.3% | 19.0% | 17.2% | 1.8% | 78.7% | 59.1% | 19.6% |
| Mortgage Bond Funds | 7.2% | 0.6% | -0.7% | 0.3% | -1.0% | 2.1% | 2.1% | -0.1% | 7.5% | 3.9% | 3.6% | 20.1% | 12.9% | 7.2% |
| Multisector Bond Funds | 7.8% | 3.9% | -1.0% | 1.0% | -2.0% | 1.4% | 2.9% | -1.5% | 7.4% | 5.9% | 1.5% | 23.0% | 16.2% | 6.8% |
| Muni High Yield | 4.6% | -0.8% | -1.3% | -0.7% | -0.5% | 1.4% | 1.5% | -0.2% | 9.4% | 6.2% | 3.2% | 17.7% | 12.3% | 5.3% |
| Preferred Equity | 6.3% | 4.8% | -0.5% | 0.8% | -1.3% | 3.0% | 2.9% | 0.0% | 11.4% | 8.7% | 2.7% | 20.8% | 16.9% | 4.0% |
| Single State Munis | 3.9% | -0.7% | -0.9% | -0.8% | -0.1% | 2.3% | 0.9% | 1.4% | 8.9% | 4.3% | 4.7% | 12.6% | 6.5% | 6.1% |
| Tax-Free Nationals | 4.1% | 1.3% | -0.1% | -0.7% | 0.6% | 3.2% | 1.1% | 2.1% | 9.3% | 4.7% | 4.6% | 15.6% | 8.1% | 7.5% |
| US Government Bond Funds | 4.4% | -5.8% | -0.6% | 0.0% | -0.6% | 2.5% | 3.1% | -0.6% | 8.4% | 6.2% | 2.2% | 11.9% | 8.2% | 3.7% |
| Utilities Funds | 6.5% | 9.1% | 2.9% | 2.6% | 0.3% | 3.5% | 3.8% | -0.3% | 16.6% | 18.8% | -2.2% | 32.0% | 26.2% | 5.7% |

(Source: Alpha Gen Capital) *[Should be enlargeable]*

In the last month, only tax-free munis, single state tax-free munis, high yield munis, and government sectors are down on NAV. But more recently, the trends in NAVs has been poor with many plateauing towards flat. This makes sense as credit spreads are already at their tights and further gains from spreads coming in are likely going to be tough to come by.

## Are There Any Opportunities Out There?

I would continue to focus on relative discount opportunities that materialize on a day-to-day basis. Unfortunately, this type of investing is far more labor intensive. You can't just buy-and-hold and expect to produce alpha. For example, one of my favorite funds to trade is **TCW Strategic Income (TSI)**, buying when the discount is near -4% and selling when it gets back to par. In the last 18 months, I've done this a few times and then for most of 2021, it has remained at roughly a -2% to -3% discount.

In addition to the Core, where I do very little trading, this is what I'm typically doing to produce alpha in my income portfolio. Others do this in preferred stocks or baby bonds or even BDCs. That's fine. But it takes work.

For the tactical investors, check in with my Morning Notes. They will identify which funds have a small window of opportunity. But right now, there are so few funds trading at a -5% or greater discount that it's absurd.

My favorite ideas (buy-and-hold):

- **Bancroft Fund (BCV)**: A safer way to play the tech trade. Discount is back to near -7% and the NAV is inflecting higher. Just remember, this is an equity lite portfolio so it will bounce around a lot. In the meantime, you collect a nice 4.1% yield with upside should the tech trade/growth do well.

- **Vertical Capital (VCIF)**: This is a mortgage fund that used to be an open-end fund but converted to a CEF. The yield is not supported by the earnings but that is okay. Just watch the NAV for stability. The discount is near -10% and the yield 8.90%.

- **Morgan Stanley Emerging Markets Debt (MSD)**: This fund pays only 4.6% but trades at an -8.6% discount. The NAV is moving higher and the dollar has been weak in the last month which is supportive of the underlying valuations.

- **Morgan Stanley EM Domestic Debt (EDD)**: This is a similar fund but buys only local currency debt. Little more risk here but as such so is the reward with the yield over 6% and the discount at -8.5%. I like this play for a one-year hold at least as I think the dollar will weaken.

- **PIMCO Energy And Tactical Credit Opps (NRGX)**: This is an energy play from a hybrid positioning, meaning both debt and equity holdings. The shares trade at a -16% discount but that is mostly because PIMCO refuses to play the yield to juice the returns game. In other words, they pay what they earn instead of using ROC to game the yield and induce demand for the shares.

- **Aberdeen Standard Global Infrastructure Income (ASGI)**: Most investors think this is a debt fund but it downs primarily equities from the utilities and infrastructure (industrials/materials/cyclicals) sector. No leverage in the fund and it pays over 6%. The NAV has been on a roll lately as well and the discount has widened to over -10.5%. I added to this one heavily last week. The one risk is if rates move materially higher.

## Concluding Thoughts

The key is to be careful here. You don't want to get caught up in the FOMO and think that these securities are going to go up forever. The equity markets seem to move higher relentlessly. While I am overweight to stocks here, I am also in my accumulation phase and not dependent on the money. My time horizon is a lot longer than many.

The entry price - the price when you buy - is everything in markets. The opportunities today are relatively small as well as being few and far between. We have made the case that rotating to open-end funds that have slightly lower yields but no leverage risk and no discount risk makes sense here, even for more income-oriented investors. Nothing has changed in that regard.

YIELD HUNTING
ALTERNATIVE INCOME INVESTMENTS

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