

CEF Weekly Market Review: CEF Gains Are A Nice Problem To Have

Sep. 25, 2021 11:18 AM ET | AIF, BGX, BSL... | 2 Comments | 8 Likes

Summary

- We review CEF market valuation and performance over the third week of September and highlight recent market events.
- We discuss a few considerations for investors sitting on large CEF capital gains who are getting nervous.
- And highlight a few market developments such as Blackstone fund distribution rises, FIV termination and more.
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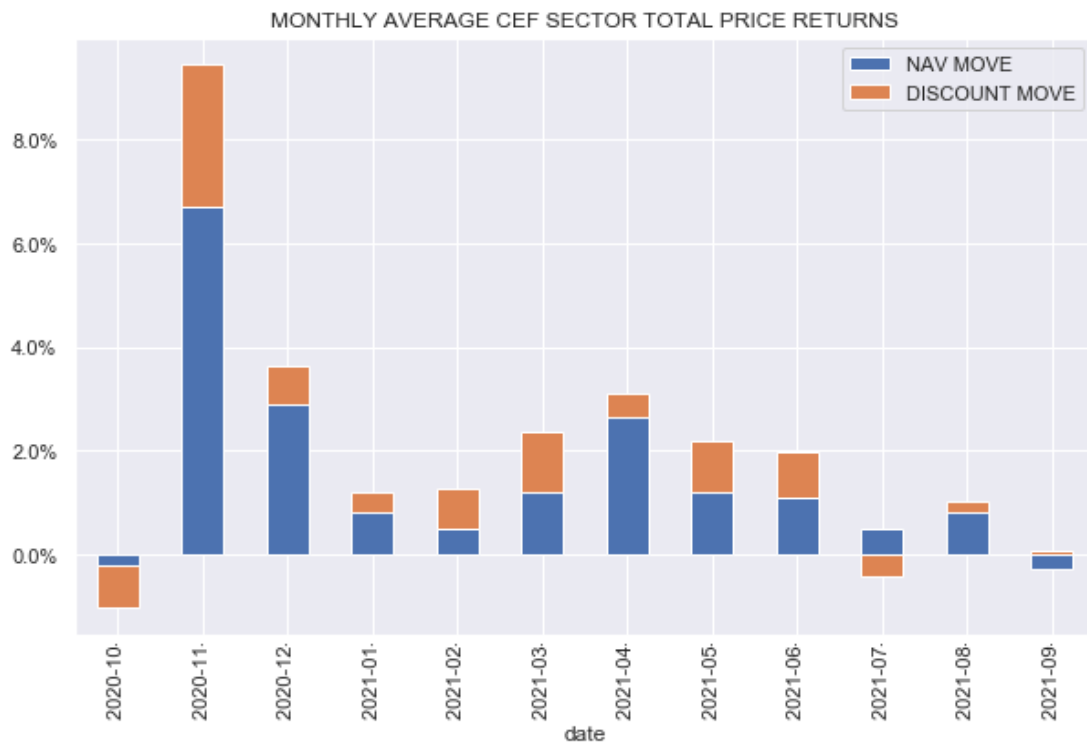
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This article was first released to Systematic Income subscribers and free trials on 19 September.

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 September.

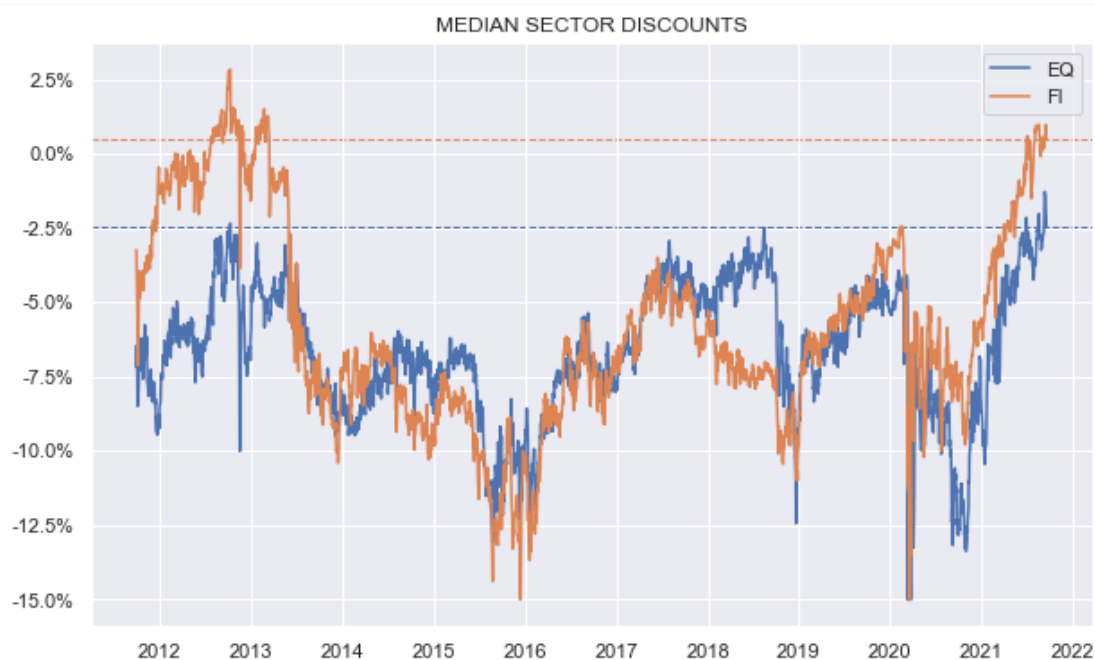
Market Overview

September CEF market returns have, so far, been fairly lackluster with a flat average sector discount and a marginally lower NAV.



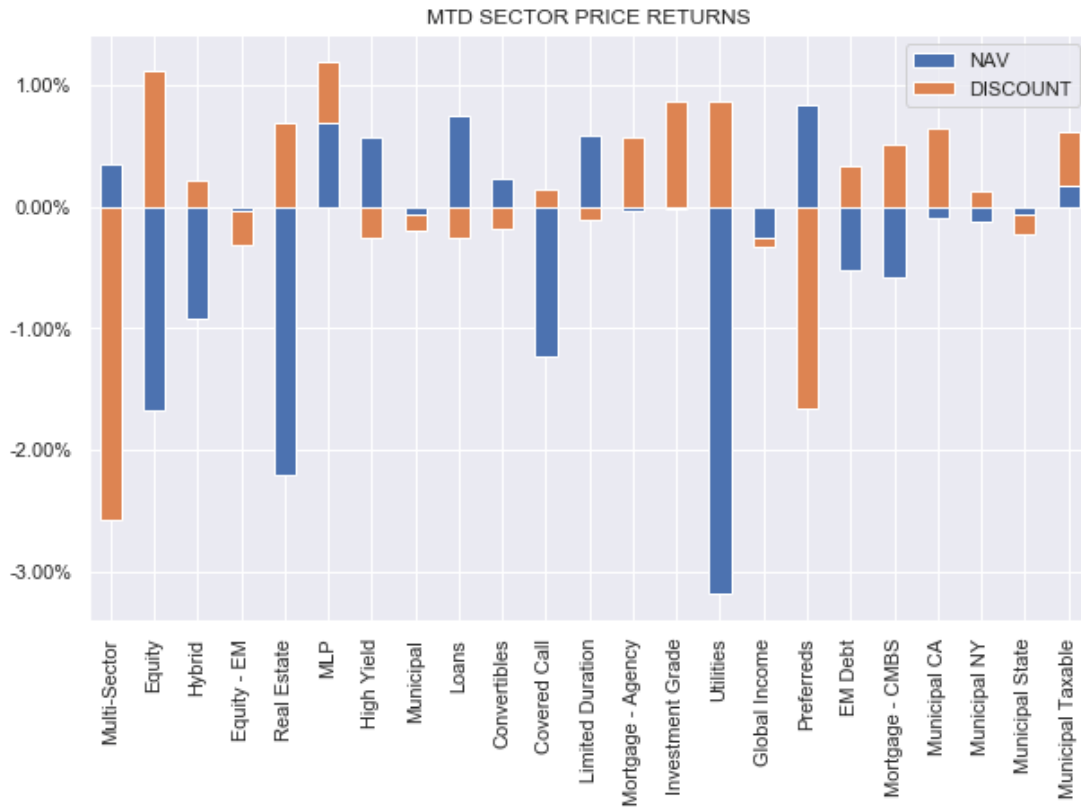
Source: Systematic Income

A stall in discounts over the last three months is a theme we have discussed in prior updates. There are many likely reasons for it but the fact that discounts are now bumping up against historically tight levels is probably not a coincidence.



Source: Systematic Income

In addition to a stall in discounts, September also brought a drop in the median sector NAV, although credit NAVs have held up better so far than equity sectors as the chart below shows.



Source: Systematic Income

A key concern for CEF investors is that the historical diversification between Treasuries and stocks may decouple, leading to both lower Treasuries and stocks. This is precisely what we have seen so far in September as risk-free rates have edged higher while stocks have come off their recent highs. This type of dynamic is more likely in an environment where the rise in stocks has been driven by the desire and ability of the Fed to keep rates unusually low - arguably, the kind of environment we are living through now. And because yields (and hence the carry of most sector NAVs) are very low, NAVs and discounts don't have to fall a whole lot in order to deliver negative returns to investors. The next year will be a tricky one for CEFs to navigate given these headwinds.

Market Themes

A subscriber posed a question of how to think about unwinding some of the fixed-income CEFs that have had such a great run-up over the past year or more. The uncontroversial view here is that risk-free rates, credit spreads and discounts are all very expensive. As usual there is no right or wrong here. The view that interest rates are "obviously" shooting higher is probably not a great reason to unwind all duration exposure. After all, that seemed to be the consensus when rates were much higher than they are now just a few months ago. The recent unexpectedly low inflation print and the recent drop in rates in the face of previously rising inflation highlights how much uncertainty there is about the path of rates.

It's also important to add that having duration exposure is not all about risk but potential reward as well. A macro-driven market sell-off is very likely to lead to even lower rates so having duration exposure provides a kind of partial hedge of a weaker macro picture. There is also yield curve rolldown which generates additional returns due to the steep yield curve. There are also tax capital gains considerations in taxable accounts. This doesn't mean everyone should hang onto duration like grim death but the point is it's not a one-sided story. That said, it can make sense to trim duration exposure here. There are a [number of different strategies investors can pursue](#). As far as CEFs are concerned, we tend to look at whether or not CEFs are attractive by how much additional excess spread they tend to generate over and above the yields of their underlying portfolios. For lower-quality assets that is on the order of 0.5-2% and for higher-quality CEFs that is close to zero. The chart below shows how much additional portfolio yield a typical high-yield corporate bond CEF can generate through leverage, net of fees.



Source: *Systematic Income*

The point here is that it's hard to get very excited about this kind of additional yield, particularly when investors have to wear the full discount and leverage volatility. It's up to individual investors to gauge the risk/reward on offer – our view is that out of all the key features of CEFs, discounts and leverage are currently unattractive (in aggregate) and active management is attractive.

Of course, it is possible to get active management in ETFs and mutual funds without having to take discount and leverage risk. For investors who look for higher yields than available in open-end funds, there are options in preferreds e.g. mREITs, etc. which have 5-8% yields without explicit leverage and discount risk. At the margin our view remains that it does make sense to lighten the CEF footprint of income portfolios without necessarily sitting in cash – this is pretty much what has been happening in the High Income Portfolio over the last 6 months or so. In short, risk in CEFs is clearly asymmetric right now to the downside but it may take a while to play out.

Market Commentary

In the CEF space, two Blackstone funds - the Blackstone GSO Senior Floating Rate Term Fund ([BSL](#)) and the Blackstone/GSO Long-Short Credit Income Fund ([BGX](#)) raised distributions. This is a second recent raise for BSL which has had a weirdly low distribution rate – about 1% below the sector average despite its lower quality profile (which tends to indicate a relatively higher-yielding underlying portfolio yield). Both funds have sector-beating historical returns and valuations pretty close to the sector average. Both also have very high alpha in the sector. Both still offer decent choices in the loan sector.

| | PORTFOLIO CREDIT QUALITY | | | | | | | | |
|----------------|--------------------------|-----|----|----|-----|-----|-----|-----|----|
| LOANS | IG | AAA | AA | A | BBB | BB | B | CCC | NR |
| SECTOR AVERAGE | 4% | 0% | 0% | 0% | 4% | 19% | 60% | 11% | 5% |
| BSL | 0% | 0% | 0% | 0% | 0% | 4% | 80% | 14% | 2% |

Source: *Systematic Income CEF Investor Tool*

It's rare to be able to forecast CEF distribution changes with accuracy outside of funds with managed distribution policies. However, investors can increase this likelihood by, among other ways, positioning across funds with this kind of mismatch between distribution rate and underlying assets. This is the kind of dynamic that allowed us to benefit from recent hikes in the Apollo Tactical Income Fund ([AIF](#)) and the Eagle Point Income Co. ([EIC](#)).

Speaking of EIC which allocates primarily to CLO debt, the fund reported August NAV with a half a percent rise. The NAV has been rising steadily in the fund which is due to both historical underdistributing (until recently) and general credit spread compression. Both factors are unlikely to keep driving NAVs higher as credit spreads are pretty tight already and the fund's distribution has risen 50% from six months ago.

The fund had a few things going for it – 1) high single digit discount – trading well wider of the loan CEF sector, 2) underdistribution (and hence a likely hike with likely discount compression to follow), 3) niche market segment – providing some diversification relative to the rest of the CEF space, 4) a kind of information alpha – the fund doesn't disclose daily NAVs unlike the rest of the market, leaving investors who only use CEFConnect at a disadvantage, 5) attractive pricing for the risk – BB CLO tranches have been trading north of 7% in yield terms versus about 5% for the broader loan market despite having stronger underlying assets (CLO rules limit the amount of CCC loans in the CLO portfolios) and not having to take first loss portfolio risk, and 6) floating-rate assets which should drive income higher whenever the Fed starts to hike policy rates (the key detail here is that CLO debt typically has zero Libor floors unlike loans which have floors ranging from 0 to 1%). This last point means that CLO debt investors benefit immediately from the first Fed hike while loan investors will see a lower beta in higher income from the first Fed hike).

Drivers 1 and 2 are no longer there as the distribution hikes have led to the discount compressing to around zero. Drivers 3, 4, 5 and 6 are still there, however, so on balance it's still an attractive hold. An issue that bears watching here is the fund's new preferred (yet to be priced) which would drive the fund's income lower.

The First Trust Senior Floating Rate 2022 Target Term Fund ([FIV](#)) is going to terminate in December. Term CEF terminations are always nice to see. Big picture, term CEFs are the "have your cake and eat it" kind of proposition because you get the benefits of CEFs such as leverage and active management but retain a measure of discount control that you have in open-end funds.

Shareholders approved the GPM/GGM into Guggenheim Strategic Opportunities Fund (GOF) merger with the acquired fund shareholders possibly getting some premium uplift as GOF is trading at a much higher premium.

MLP CEF Kayne Anderson Energy Infrastructure Fund (KYN) is taking over the Fiduciary / Claymore Energy Infrastructure Fund (FMO) in a Pan Am sort of deal. Recall that FMO fell on its face and not just because of the 2020 crash when it had a 90% drawdown, remaining about $\frac{3}{4}$ below its pre-COVID level, but because of the deferred tax accounting issue when it shaved another 30% off the NAV, sparking lawsuits. The merger caps what is likely to have been the worst-run ever of any CEF.

A few Franklin Templeton CEFs reported quarterly income figures. The BrandywineGLOBAL Global Income Opportunities Fund (BWG) – a global bond fund – saw its income tick up slightly. Current coverage is 92% with a current yield of 7.57% and a 7.6% discount. Allocation is split-IG with roughly half BBBs and rest in BBs and B with some exposure to EM currencies. Duration is on the higher side at 8. Discount is the widest in the Global Income sector at 7.7% and historical NAV performance is a bit higher than the median.

The Western Asset Global Corporate Defined Opportunity Fund (GDO) saw its income hold steady versus the previous quarter. Current coverage is 86% with current yield at 6.55%. Allocation is $\frac{2}{3}$ in IG bonds with duration about 6.5. The discount is pretty tight though not much tighter than the average and due to its term structure it's attractive in the IG sector. Historical NAV return is above sector average. Both funds remains relatively attractive in their sectors.

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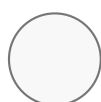
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