CEF Weekly Market Review: Treasuries Remain In The Driver's Seat

ADS Analytics

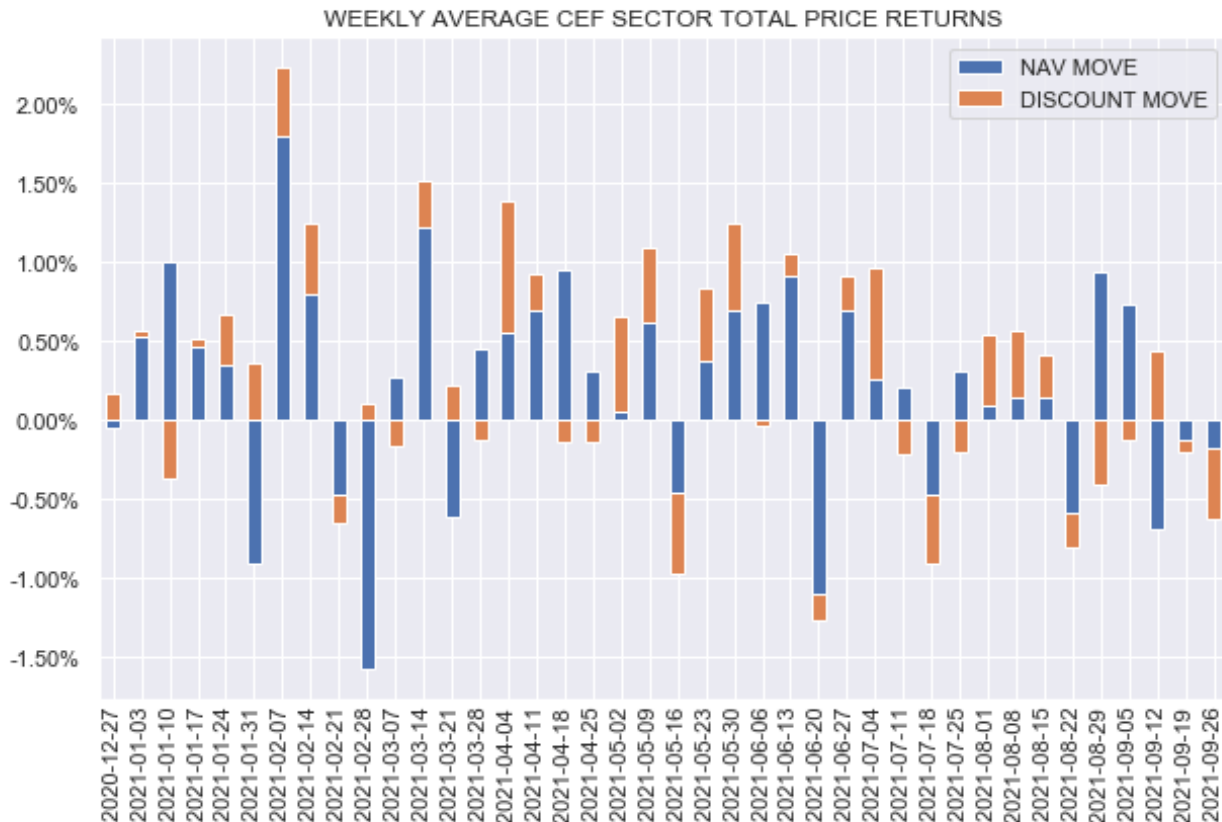
cemagraphics/iStock via Getty Images

This article was first released to Systematic Income subscribers and free trials on 25 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 fourth week of September.

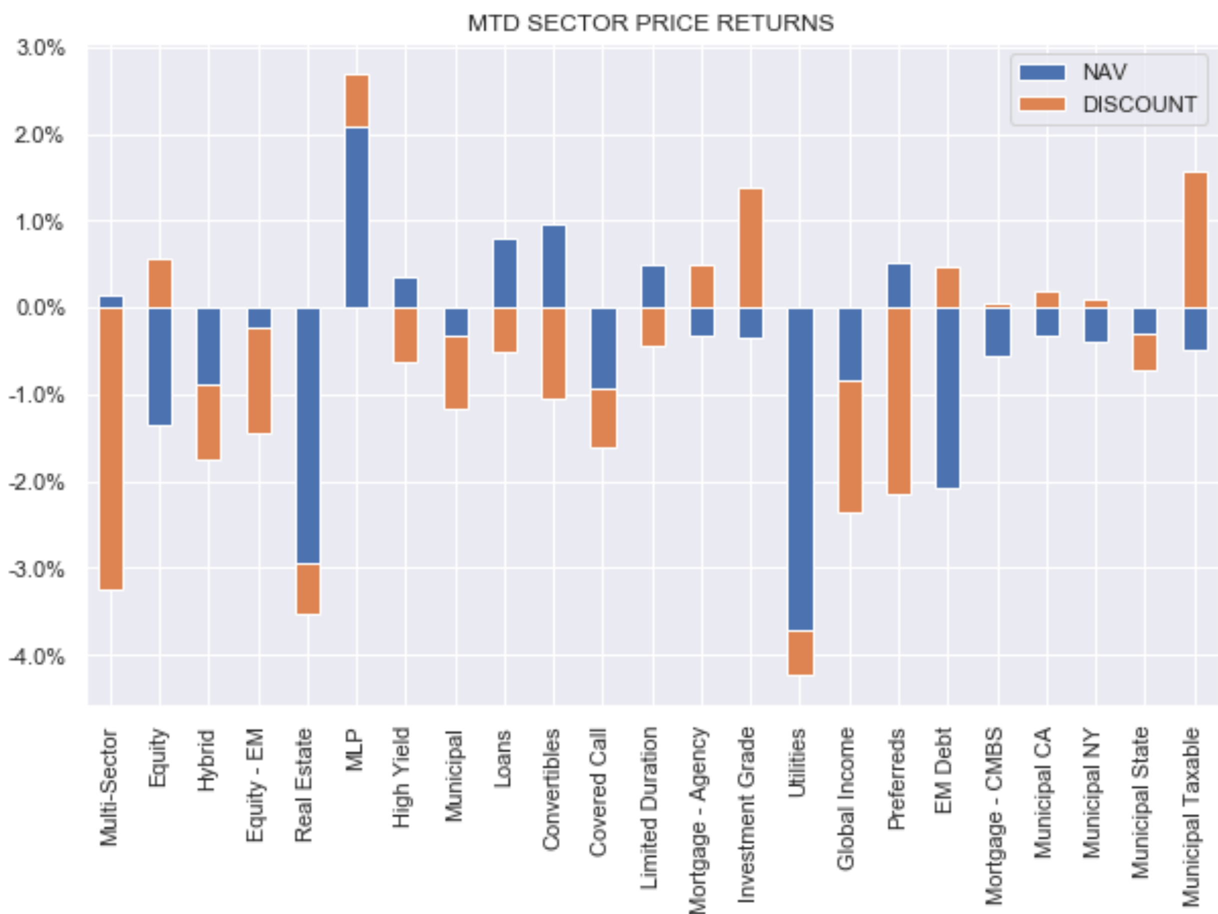
Market Overview

It felt like rough ride at the start of the week for CEFs but by market close on Friday, the net result was actually not that bad with an average CEF sector falling just over half a percent.



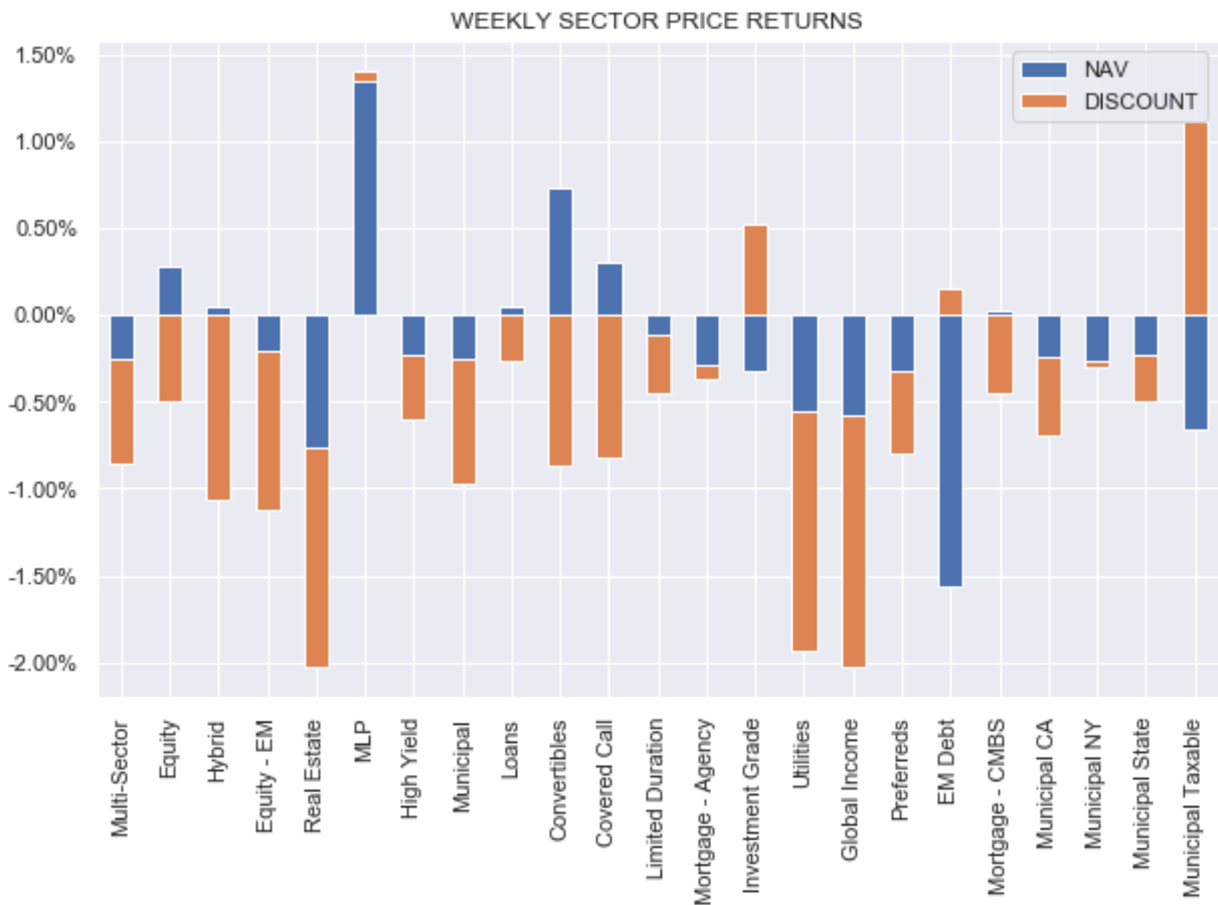
Source: Systematic Income

Month-to-date both Treasuries and stocks are marginally lower which is reflected in a fairly broad weakness across CEFs. What is also notable is that for many sectors the biggest contributor to price weakness was actually the widening in discounts rather than the drop in NAVs. This is not unexpected, particularly for richly valued sectors like preferreds given the market concerns about higher Treasury yields and elevated premiums across many sectors.



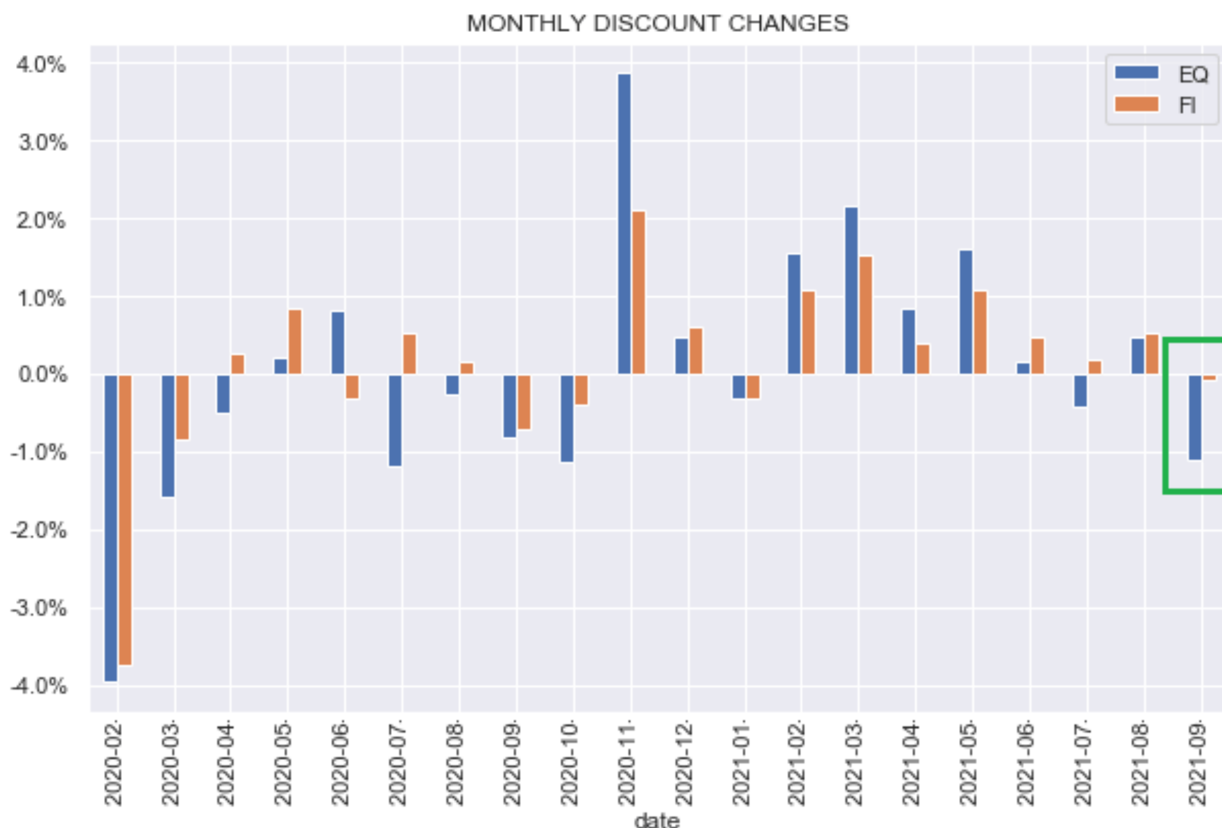
Source: Systematic Income

Recent action in CEFs makes it clear that discounts are much more tightly anchored to the moves in Treasuries rather than stocks. This week is a good case in study where the S&P 500 actually finished the week higher while 10-year Treasury yield were 10bps higher. Only 4 of 23 sectors finished the week with tighter discounts, many of them equity sectors.



Source: Systematic Income

This weakness and underperformance in equity sector discounts in a period of rising stocks highlights that equity CEFs often behave as duration instruments that are, in some periods, tightly coupled to the action in risk-free rates.



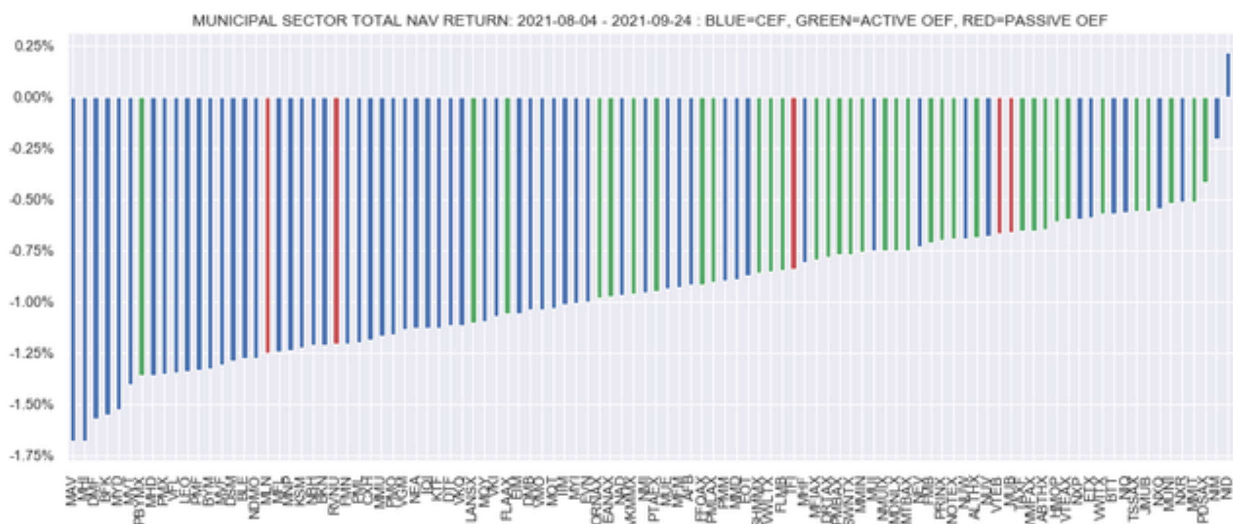
Source: Systematic Income

Market Themes

The price action in Treasuries highlights two obvious headwinds for the CEF market - low underlying yields and leverage. Low underlying yields makes it difficult for a CEF to generate significant excess yields for investors through the use of leverage, particularly for the higher-quality sectors as management fees and leverage expenses eat away a significant chunk of the yield on leveraged assets. And secondly, leverage, obviously, increases the exposure investors carry to changes in interest rates.

The fairly busy chart below highlights the tax-exempt fund total NAV returns since 4-August when 10-year Treasuries hit their recent low of 1.19% rising to 1.47% by the end of this week. Blue bars are CEFs, green bars are actively-managed mutual funds and ETFs and red bars are passive ETFs. CEFs tend to be leveraged funds while mutual

funds and ETFs tend to be unleveraged.



Source: Systematic Income

We shouldn't be surprised by the outcome that CEFs, being typically leveraged funds, are going to underperform unleveraged funds in a period of rising rates. It is interesting to note that a few of the CEFs on the right-hand side of the chart are actually unleveraged such as Nuveen Select Tax-Free Income Portfolio 3 (NYSE:NXR), Nuveen Select Tax-Free Income Portfolio 2 (NYSE:NXQ) and Nuveen Select Tax-Free Income Portfolio (NYSE:NXP).

The point here is not that investors should avoid CEF exposure or get out of any duration risk when Treasury yields are low. Rather, it can be helpful in thinking about CEFs as a bundle of features, some of which are available elsewhere.

In our view, there are a number of different reasons to own CEFs such as leverage, active management, discounts and a stable asset base. The value of these features is not constant but rises and falls as the market environment changes. Leverage is particularly useful when underlying asset valuations are very attractive, underlying yields are high and leverage cost is low. Discounts add additional yield when they are wide and take away yield when they switch to

premiums. Active management can drive additional returns or sidestep certain market risks but active management is also available in other investment vehicles such as mutual funds and some ETFs. A stable asset base in CEFs reduces cash drag and avoids the feast-and-famine cycle familiar to mutual fund managers. ETFs also benefit from a more stable asset base as much ETF trading takes place in the secondary market (where investors trade the ETF with each other - a feature mutual funds don't have) and the trading of underlying securities is done by the creation / redemption mechanism which eases the burden on ETF managers.

The upshot here is that rather than thinking of fund they should hold, investors can think about which bundle of features they would rather hold at any one time. In other words, a focus on feature bundles can distill the allocation process more than the focus on funds.

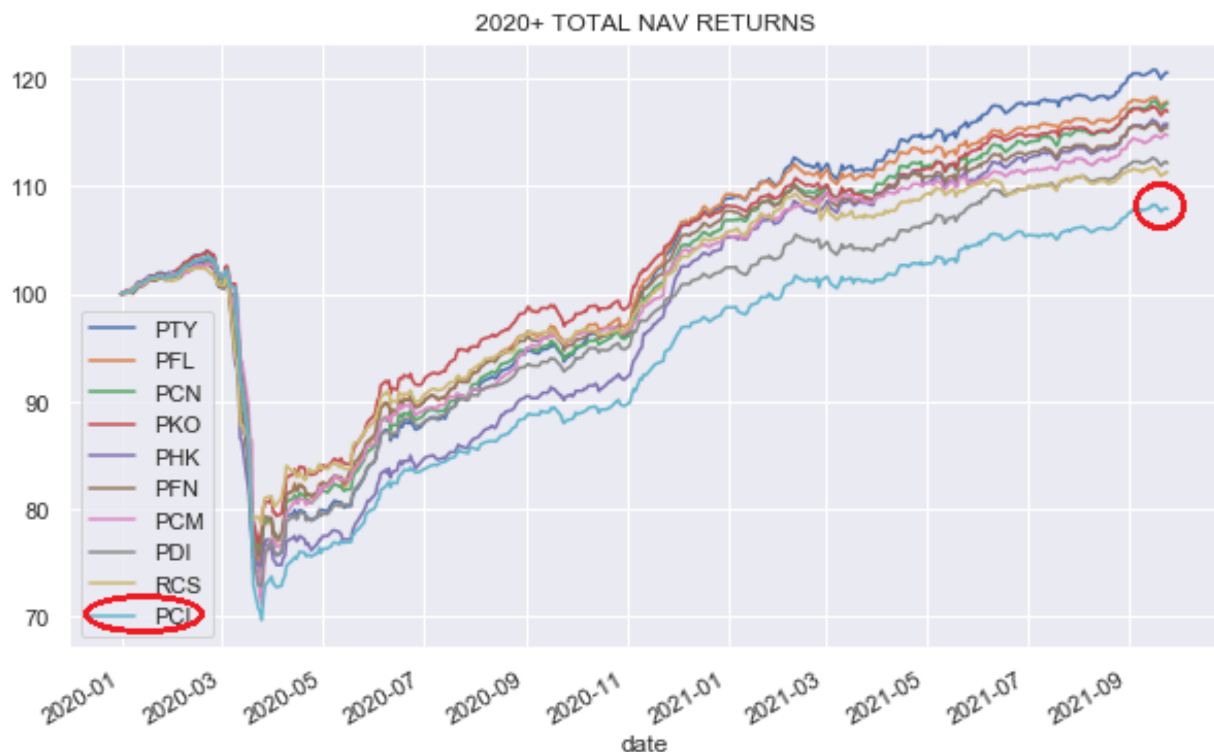
In our view, the value of CEF leverage is not very high right now given funds are not able to drive much additional yield, especially in higher-quality sectors where underlying yields are very low. Instead, leverage simply exposes investors to increased duration risk in a period of unusually low yields. Aggregate discount valuations are at historically expensive levels and, in aggregate, don't add additional yield or likely provide much more upside. A stable asset base and active management can both be obtained in ETFs, though, to be fair, the number of fixed-income active ETFs is not as high as the number of fixed-income CEFs and the ones that do exist typically have a short track record.

Market Commentary

There was a question on the service about the apparent underperformance of the PIMCO Dynamic Income Fund (PDI) lately. Our view here is that this is driven simply by the premium

convergence between PDI and PCI as the two are merging. The fact that PDI has tended to trade at a significantly higher premium than PCI never made much sense as the funds shared the same fees and a similar strategy. If anything, PCI should have traded at a premium to PDI as it has tended to have higher leverage.

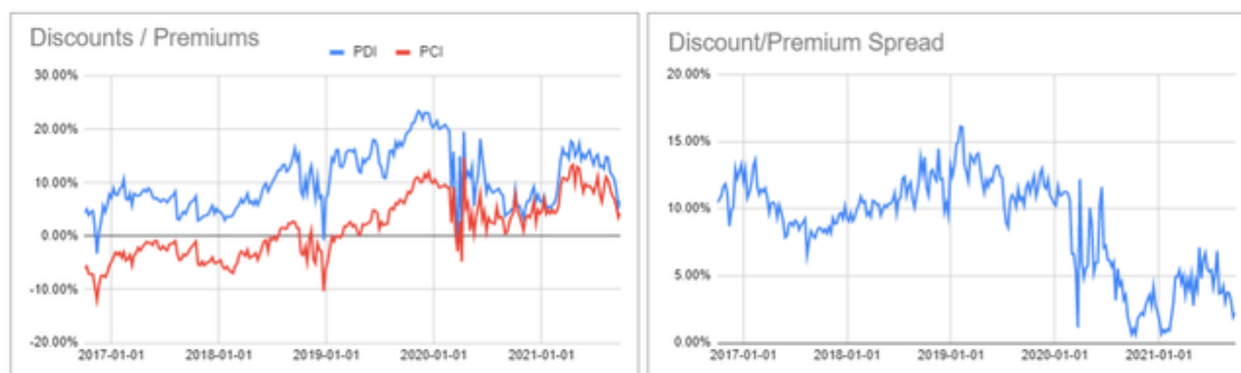
You could argue that because PCI traded much closer to a soft leverage cap of 50% than PDI, it was actually more vulnerable to a deleveraging (and hence, arguably, lower long-term returns) and therefore deserved a lower premium. This is pretty much what played out in 2020 and why PCI NAV returns have lagged the taxable suite post-2020.



Source: Systematic Income

However, that would require unusual foresight from the CEF market and so is unlikely to explain the dynamics. Most likely the higher PDI premium is explained by investors looking at the stronger historical NAV returns of PDI without realizing that those stronger returns

include the period when PCI followed a different strategy and so were not useful indicators of relative performance going forward. So now that the two funds are merging their premiums are converging with the premium of PDI being pulled lower toward PCI.



Source: Systematic Income CEF Tool

The Nuveen Preferred and Income 2022 Term Fund (JPT) is asking shareholders to approve a conversion to a perpetual fund. If approved, the fund will run a tender offer at 100% of NAV – providing the same opportunity to exit at NAV had it terminated. If less than $70m of assets remain the fund will terminate, otherwise it will become a perpetual fund.

In a normal market environment where funds are trading at discounts investors would want to allow the conversion (to keep fund in existence) and then tender at NAV to monetize the discount compression. However, current times are not very normal and only one fund in the sector is trading wider than a 0.3% discount with the average sector discount trading at a premium.

Source: Systematic Income

If this situation continues, investors may be better off not tendering since the fund's discount would then likely rally towards the sector average premium. Nuveen coverage numbers were updated for August in our CEF Investor Tool. Nuveen muni funds saw marginally lower coverage overall which is something we should expect in the medium term. The four preferred funds also saw lower coverage – this could be a dividend timing issue or it could be that the inevitable rotations into lower-coupon preferreds are making it harder for the funds to keep income at high levels despite their increased borrowing levels. This is a theme that will play out in the sector over the next year or two. It seems unlikely the sector will be able to maintain income levels as further NAV gains are likely limited given where yields are which will make it harder for the funds to add borrowings to increase income. Ongoing redemptions will also push the funds into lower-coupon securities, further limiting income. This is an ongoing slow-motion transformation of the sector.

The DTF Tax Free Income Fund (DTF) cut its already low distribution by a quarter so it now features a very low 2.67% yield - well below the sector average of 4.33%. Based on the last shareholder report, the cut looks overly large as it leaves the fund with a 108% distribution coverage. The fund's holdings don't look particularly low income – the majority of holdings are in 5% coupon munis, leverage is on par with the sector and fees are below average. Where it falls down seems to be in its leverage cost which it sources via SIFMA+1.25% preferreds.

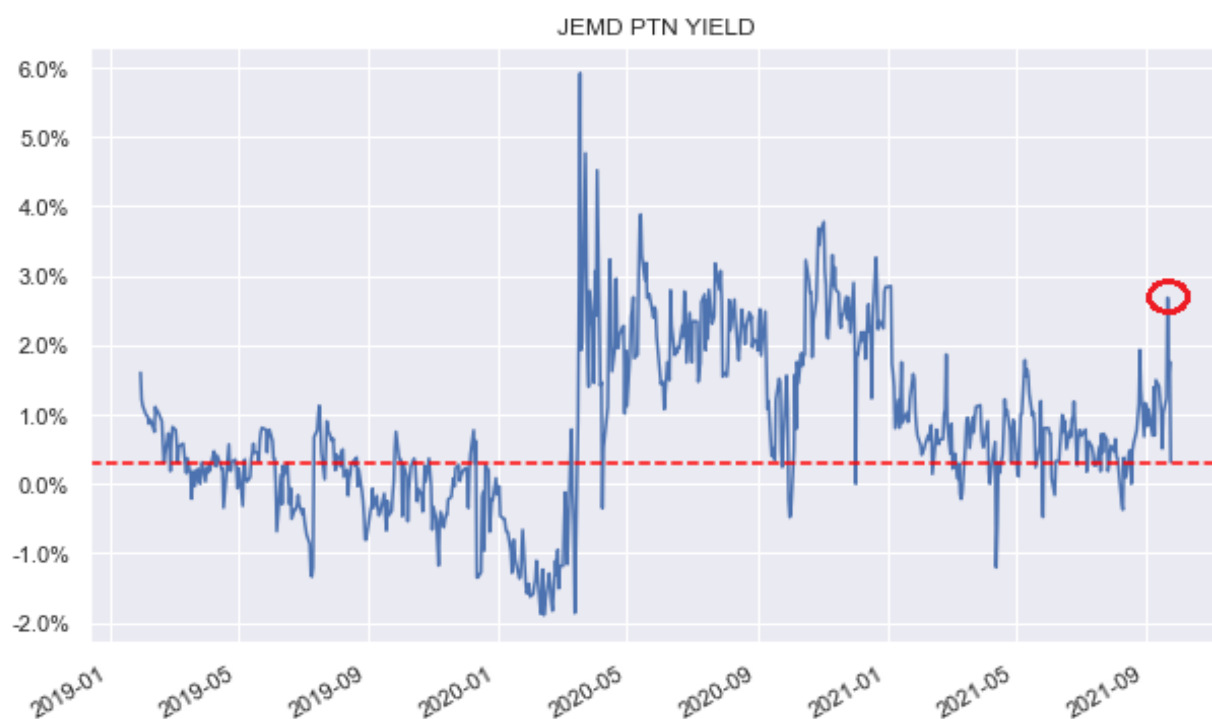
As we discussed in an earlier article, there are two main types of leverage instruments used by muni funds: tender option bonds and muni preferreds. These are different from leverage instruments used by taxable funds such as repo and credit facilities because they are also tax-exempt, allowing them to have much lower interest rates than taxable leverage instruments like repo and credit facilities. Tender option bonds tend to be cheaper than preferreds because TOB lenders can pull their cash back at a very quick notice, in effect, making them 1-week maturity instruments. Preferreds holders, on the other hand, are stuck and can't get it out at short notice which gives the borrowers more freedom to manoeuvre. DTF uses only preferreds in its capital structure and those preferreds seem to be very expensive. For example, Nuveen funds also use preferreds but they pay around half of the DTF level across their 3 types of muni preferreds. With muni yields sub-1% (longer-term muni yields are higher), it's hard to generate a lot of excess income when you are paying north of 1.25% on the debt. The fund's 5y total NAV return looks to be the lowest in the sector at 3.1% versus 4.4% sector average so its very wide discount of around 8% is probably deserved.

Western Asset CEFs declared distributions for the next 3 months with only the Western Asset Managed Municipals Portfolio (MMU)

being dinged but even there by not very much. Allocating to funds that declare distributions over several months is one strategy investors can use to mitigate the risk of cuts.

Speaking of managing distribution exposure, the Nuveen Credit Strategies Income Fund (JQC) adopted a level distribution policy of $0.0385 or a current yield of about 7.2%. Nuveen has a number of different flavors of managed distribution policies – a level distribution policy is the type that most investors are familiar with which tries to keep the distribution steady. Allocating to funds with MDPs is another way to mitigate unexpected distribution changes. We track funds with different flavors of MDPs in out CEF Tool.

There was an exchange about the Nuveen EM Debt 2022 Target Term Fund (JEMD) on the service. It's a fund worth watching – when we highlighted it on the service it fell 1.6% causing it to pop out to a 2.7% PTN Yield (the additional annual return tailwind into its termination).



Source: Systematic Income

Nuveen has been good about honouring the term fund concept so getting out at NAV is pretty likely in their term funds.

The fund does hold an Evergrande bond. Current prices on their dollar bonds seem to be around 30%. At that level it makes up around 0.6% of the portfolio with the downside on net assets being around 0.7% due to leverage. In reality the downside is probably much less because corporate bonds don't go to zero. Historical HY bond recoveries are around 40% - higher than the current price. Of course, this is a Chinese bond but the legal framework is US-based so is worth something.

In any case, it's important to keep things in perspective – at a 3% discount the fund has 3% upside with very high probability (Nuveen has been good about honouring term CEF terminations or, alternatively, providing an ability to tender) while the Evergrande downside in the worst case for the portfolio is 0.70%. That's not counting the carry on the fund which is around 4-5% over the next year into the termination. This gets us to a range of likely returns to its end-2022 termination date of 7.20% (-0.7% + 3% PTN Yield + 5% Carry) to 8% (assuming there is a bit of upside on the Evergrande position) with very little duration exposure. That doesn't seem too bad. At the current discount valuation that range has compressed and doesn't look as attractive but it's a fund worth watching because its discount does jump wider occasionally.