

CEF Weekly Market Review: A Wobble Of The Three-Legged Stool

[ADS Analytics](#)

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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 last week of September.

Market Overview

September was not a great month for CEF returns with only two sectors finishing in the green: MLPs and Loans.

Source: Systematic Income

If we break down price returns into moves in NAVs and discounts, we see that only 4 sectors managed to generate positive total NAV returns while only 6 sectors saw discount tightening. Outside of MLPs, shorter-duration fixed-income sectors such as Loans and Limited Duration sectors outperformed in NAV terms while the more rate-sensitive equity sectors like REITs and Utilities underperformed.

Source: Systematic Income

This pro-cyclicality of CEF returns is a key feature of the space. When NAVs drop, discounts tend to drop as well, exacerbating negative returns. The chart below shows monthly average sector price returns disaggregated into NAV and discount moves. All five months where the average CEF sector NAV was lower also saw wider discounts. This is the double-whammy behavior that is par for the course for CEFs and is something that can exacerbate drawdowns and make it difficult to reallocate the capital in CEFs into more attractive opportunities elsewhere.

Source: Systematic Income

The aggregate moves in discounts have been fairly benign with the median fixed-income and equity sectors coming off only around 2-3% from their recent peaks. Although that is a welcome development for value hunters, true bargains are not yet in sight.

Source: Systematic Income

The bird's eye view of the broader CEF market is that total returns have flatlined i.e. the carry produced by the space is just about offset by lower prices on the back of weaker stocks, higher Treasury yields and wider discounts. These three legs of the CEF market stool, so to speak, have reversed and are creating a drag on the space.

Source: Systematic Income

One potential impact of the CEF market rolling over is that capital gains may be harder to come by for funds with managed distribution

policies that rely on them. For example, Cohen & Steers preferreds funds ([LDP](#)) and ([PSF](#)) have MDPs with fixed distributions that source them from both income and capital gains. Distributing capital gains isn't ideal for fixed-income funds in the best of times since it reduces the amount of income-producing assets in the portfolio. It's possible that the funds will make up for this through alpha but that's far from guaranteed – intuitively, in an expensive market there should be less alpha on offer as volatility is low and yields are compressed across the quality spectrum. This doesn't necessarily mean a distribution cut as the funds' MDPs are designed to be longer-term rather than month-to-month but it does mean that NAV drag will be exacerbated which is something we have discussed a few times. Ultimately, that's not a sustainable position from a distribution perspective for CEFs but it can take time to play out.

Market Themes

September was a tough month for the broader market. If we look at the market performance through the usual 60/40 perspective using the SPDR S&P 500 ETF ([SPY](#)) and the iShares 20+ Year Treasury Bond ETF ([TLT](#)) as proxies for stocks and bonds we see that the September return of this portfolio was one of the worst in the last 5 years, nearly exceeding the COVID market shock of March 2020. The key difference is that while broader market moves in September were much more benign than they were in March of 2020, the key difference was that both stocks and Treasuries fell in September unlike in March of 2020 when Treasuries rallied strongly.

Source: Systematic Income

In fact the number of days over the rolling 3 months where Treasuries and stocks fell on the same day has been fairly elevated

as the following chart shows.

Source: Systematic Income

The way we think about the co-movement between stocks and Treasuries is by looking at the driver of market volatility. If that driver is a macro slowdown or shock then Treasuries tend to rally while stocks move lower, providing diversification to portfolios. However, if the cause of the market volatility is due to inflation or a monetary policy mistake, then Treasuries tend to move lower with stocks, providing no diversification to portfolios.

It looks like this latter scenario is what happened in September as the Fed signaled a more hawkish stance by bringing forward the median dot into 2022 and suggesting that the taper would begin in November versus the previous consensus of early 2022. This lack-of-diversification dynamic poses a continued risk to CEF portfolios which typically have exposure to both bonds and stocks, particularly in a period of elevated valuations in both asset classes as well as discounts that remain historically expensive.

Market Commentary

This week saw the usual marginal increases in the Wells Fargo (soon to be Allspring) CEFs with distribution increases in the Income Opportunities Fund ([EAD](#)), Multi-Sector Income Fund ([ERC](#)) and the Utilities and High Income Fund ([ERH](#)). As lower NAV months fall out of the 12-month lookback window, distributions will continue to rise over the coming months. This is the dynamic we [highlighted](#) about a year ago with the view that the funds' discounts would outperform the sector and compress closer to the sector average which is what has happened in all three cases - the performance of the EAD discount versus the sector is shown below.

Source: Systematic Income CEF Tool

Funds with managed distribution policies can provide a measure of predictability in how their distributions perform which can be appealing to many investors. We continue to see EAD as an attractive choice in the High Yield CEF sector, having sector-beating historic NAV returns, a wider than average discount and an above average distribution rate of 8.08%.

There was a lot of BlackRock CEF news this week. The BlackRock Taxable Muni Bond Trust ([BBN](#)) is adopting a managed distribution plan. Looks like the next distribution will be \$0.1229 or about 5% above the previous rate. BBN coverage has been around 92% with UNII moving steadily lower. Coverage will drop to around 87% after this raise. Moving to managed distribution plans or MDPs has been a trend in the fixed-income CEF space which is a positive for investors who prize distribution predictability. We highlight funds with MDPs in our CEF Investor Tool on the service. Separately, BlackRock is proposing to merge two of its tax-exempt funds: the MuniHoldings Investment Quality Fund ([MFL](#)) into the Municipal Income Fund ([MUI](#)). Both funds are pretty similar investment-grade focused funds – discounts are very close so no obvious merger alpha play there.

BlackRock is also proposing to merge three CA tax-exempt CEFs: the MuniYield California Fund ([MYC](#)) and the MuniYield California Quality Fund ([MCA](#)) into the MuniHoldings California Quality Fund ([MUC](#)). MYC has already rallied a bit on the news with its discount compressing around 2%. It is still trading at a 5.8% discount versus discounts of 1-2% for the other 2 funds. This suggests that for investors who are already in CA tax-exempt funds for tax reasons MYC looks attractive here.

What's also interesting is that MCA and MUC are roughly 2x larger

than MYC so the discount of the resulting fund should gravitate closer to the 1-2% level. The reason you want to look at relative sizes of the merging funds is because they matter for the fair-value discount of the final merged fund. The view that a 10% discount fund merging with a 1% discount fund has 9% of "alpha" is naïve - imagine the 10% discount fund is a \$1bn fund and the 1% discount fund is a \$50m fund. The merged fund is going to be basically the old 10% discount fund so why would it move to a 1% discount just because it got an insignificant amount of new assets?

In this case, the sizes work in MYC favour since it's trading at a wider discount and it's smaller than the other funds. However, from a fair-value perspective it will still exert some gravitational pull on the merged fund discount. That said, investors should be careful going all in on CEF merger "arbitrage" here since volatility in Muni funds can be high so it may be easy enough to pick up the 3% in relative discount tightening but see the fund drop 3% or more for other reasons so this discount compression trade is probably really for investors who have core holdings of CA munis anyway. BlackRock is also renewing its CEF repurchase programs. Lots of funds have these - not just BlackRock. They are nice to have in that they give the fund a way to support its shares during market drawdowns. That said the total approved amounts are around 5% of outstanding shares and actual purchases tend to run below this low level anyway. Funds don't really like buying back their shares as that reduces fund assets and hence fees even though it can be a no-brainer for shareholders during drawdowns as it supports prices and generates NAV-accretion gains.

Stance And Takeaways

We remain focused on funds with floating-rate profiles, niche sectors and a consistent historic alpha as a way to mitigate the low-yield

environment. On the higher-yielding side these include the loan-focused KKR Income Opportunities Fund ([KIO](#)), trading at a 3.8% discount and a 7.69% distribution rate, the convertible bond and high-yield debt Virtus AllianzGI Convertible Income Fund II ([NCZ](#)), trading at a 7.6% discount and a 8.6% distribution rate, the CLO Debt-focused Eagle Point Income Co ([EIC](#)), trading at a 8.2% distribution rate and an estimated flat discount and the CMBS focused Invesco High Income 2024 Target Term Fund ([IHTA](#)), trading at a 1% discount and a 4.99% distribution rate.