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Closed End Funds

CEF Weekly Market Review: Market Shrugs Off Treasury Weakness

Oct. 17, 2021 2:38 AM ET | AIF, ARDC, BCAT... | 6 Comments | 1 Like

Summary

- We review CEF market valuation and performance over the first full week of October and highlight recent market events.
- The CEF market took advantage of the rally in stocks and mostly shrugged off the continued rise in Treasury yields.
- We take a look at CEF seasonality dynamics as the tax-loss season is approaching.
- We discuss some of the recent insider trades in BCAT and the key takeaways from the BGH shareholder report update.
- We are focused on three key CEF themes of hybrid allocations, limited duration and cross-credit investment mandates.
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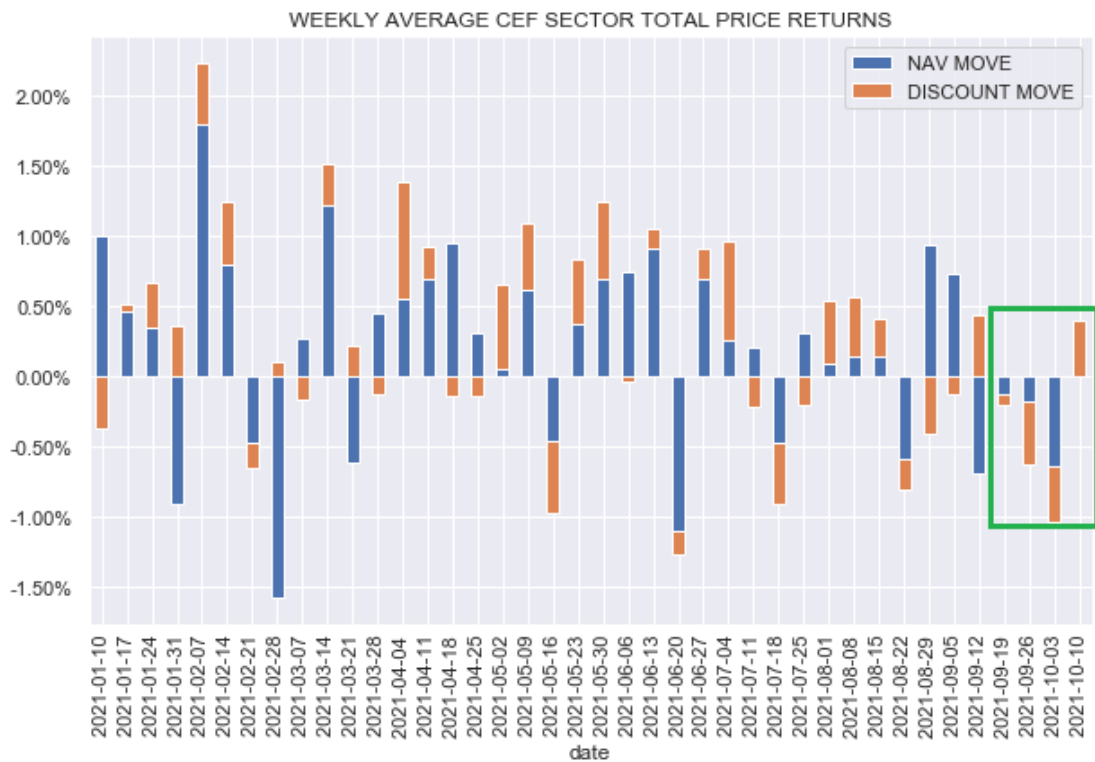
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This article was first released to Systematic Income subscribers and free trials on Oct. 10.

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 first full week of October. Be sure to check out our other weekly updates covering the BDC as well as the preferreds / baby bond markets for perspectives across the broader income space.

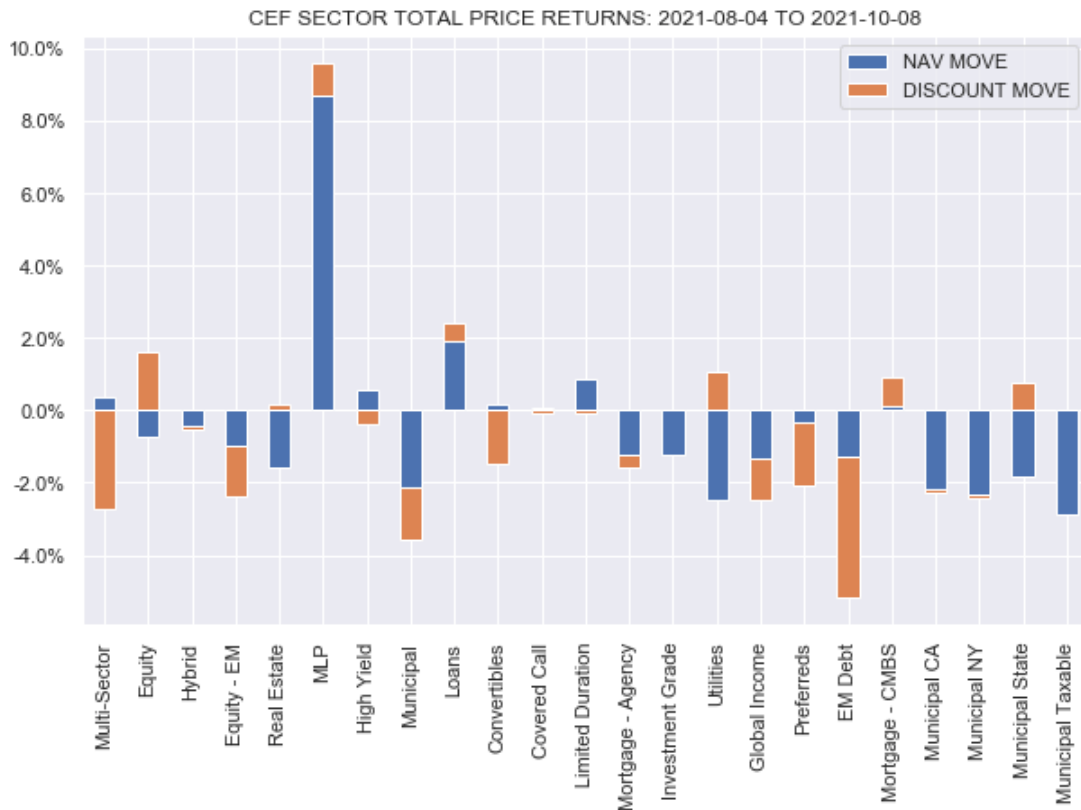
Market Overview

Weakness in CEFs over the last few weeks took a breather this week on the back of a rally in stocks as well as strength in discounts of most CEF sectors. Longer-duration sectors like taxable and tax-exempt munis saw further weakness, however, as Treasury yields continued to rise.



Source: Systematic Income

The 10-year Treasury yield has now risen 0.42% to 1.61% from its recent low in early August. This is how the disaggregated sector price returns look since then. Interestingly, the S&P 500 is basically flat over the same period which provides a good test case of how the different sectors respond to a rise in Treasury yields as the primary market driver.



Source: Systematic Income

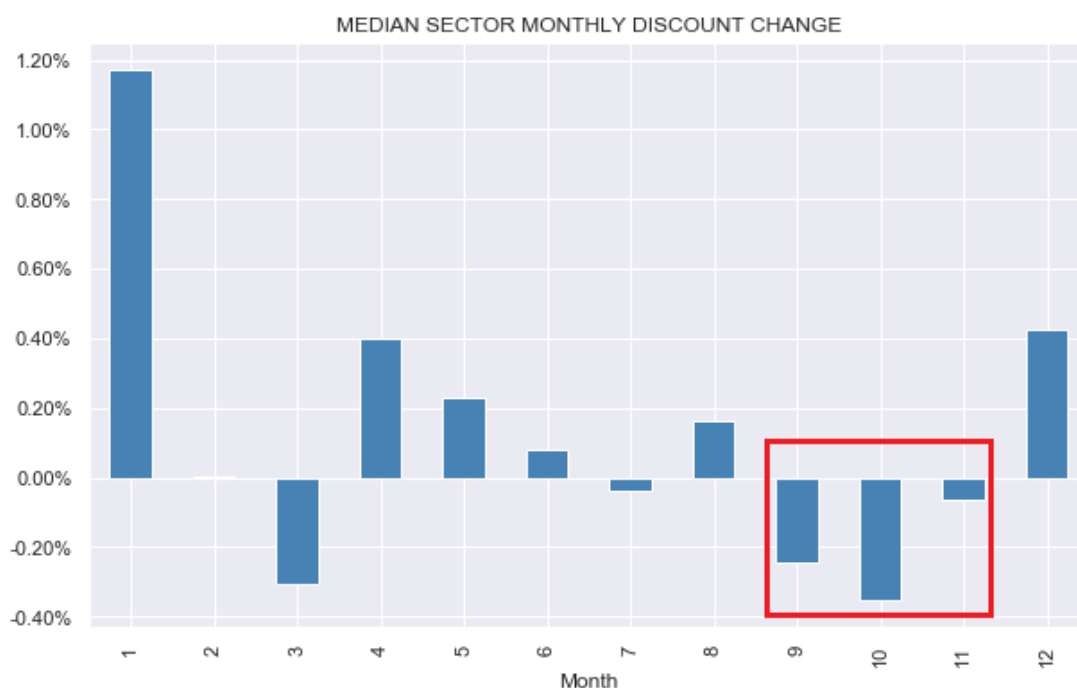
The worst performers in NAV terms are bond sectors with the longest durations such as taxable and tax-exempt munis. Some of the rate-sensitive equity sectors such as utilities and REITs have also underperformed. Sectors with positive NAV returns are MLPs which have taken advantage of the rise in energy prices as well as low-duration sectors such as loans and limited duration CEFs. Discount underperformers have been the two emerging market sectors - likely due to the more hawkish Fed communication as well as the memory of the damage inflicted on EM assets in the last taper tantrum.

Market Themes

'Tis the seasons to discuss the seasonality of CEFs - a topic we [covered](#) in more detail earlier. The key idea here is that as we approach the end of the tax year, investors holding funds with capital losses are more likely to sell them if they need to offset capital gains. The reason this is important for other investors is that this behavior can put pressure on the broader CEF market and potentially open up opportunities for either side-stepping weakness in certain funds or legging into them on tactical weakness.

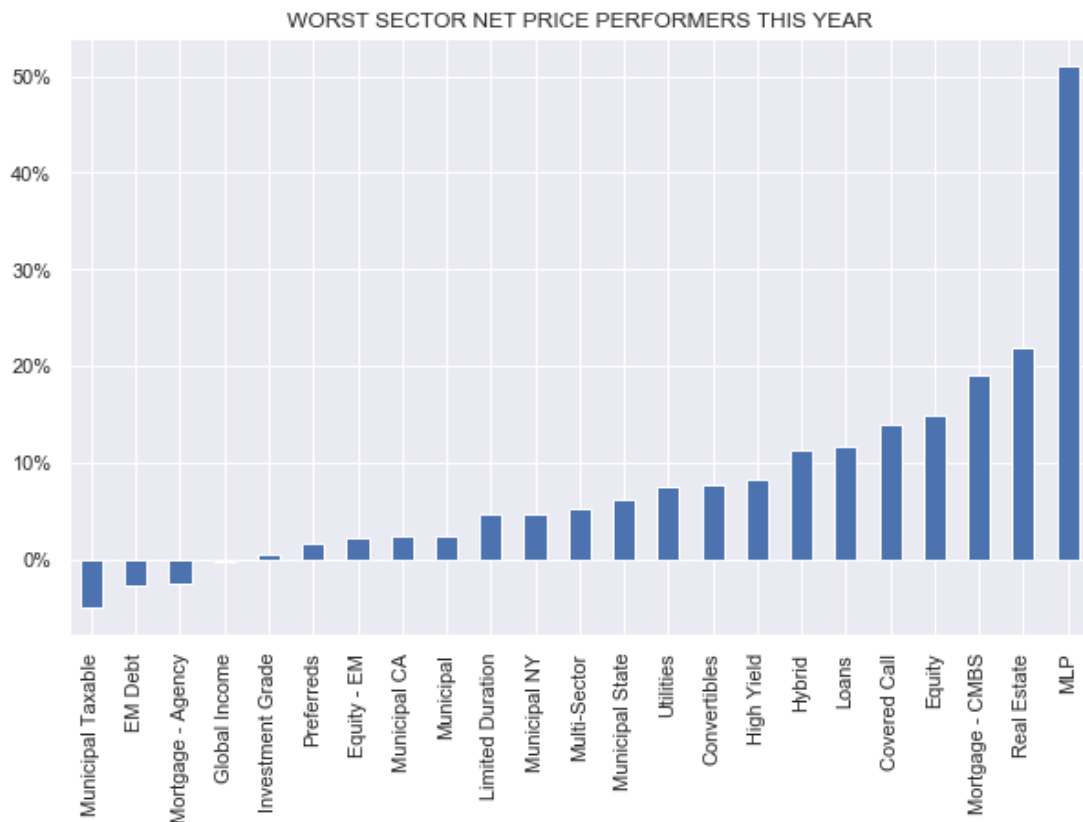
it can be hard to tease out tax-loss harvesting from the broader market moves. For instance, are CEFs down, in aggregate, over past month because the Fed has turned more hawkish and stocks and Treasuries have pushed lower or because of tax-loss harvesting? Probably more former than the latter but it could be a bit of both.

Discount seasonality tends to be weak through the period of Sep-Nov - a potential sign of tax-loss harvesting at the end of the year - but the sample size is small at 20 years so it is far from definitive.



Source: Systematic Income

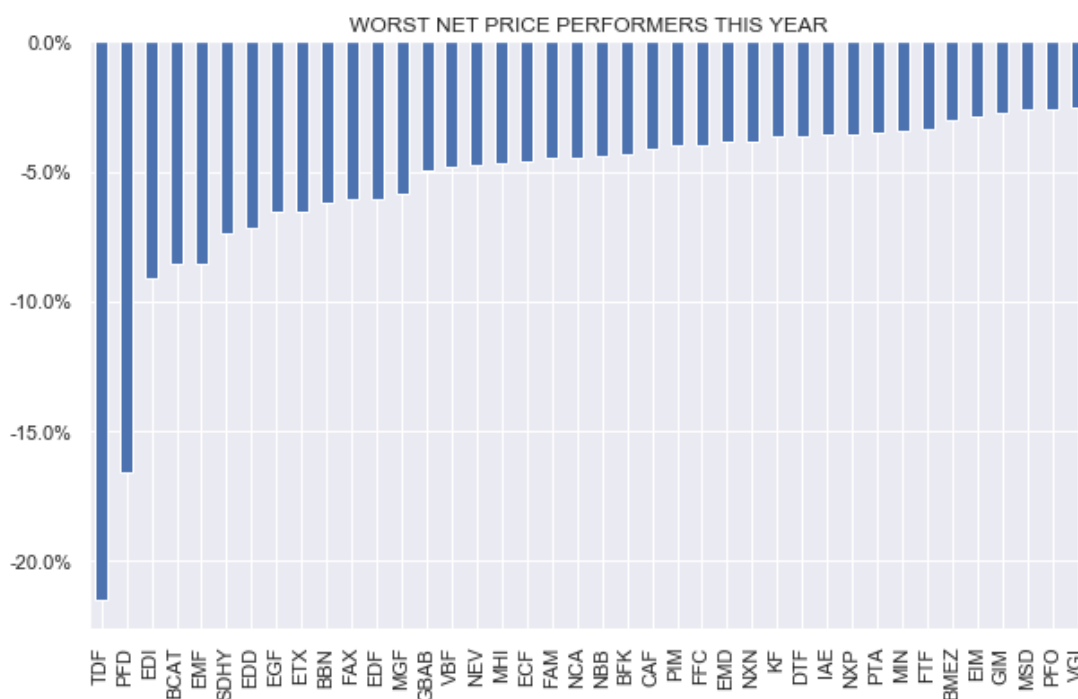
To see which sectors are more likely to experience tax-loss harvesting we can look at sector net price returns (i.e. excluding distributions) year-to-date. Obviously, investors did not all acquire their CEF positions at the start of the year but this breakdown is still helpful.



Source: Systematic Income

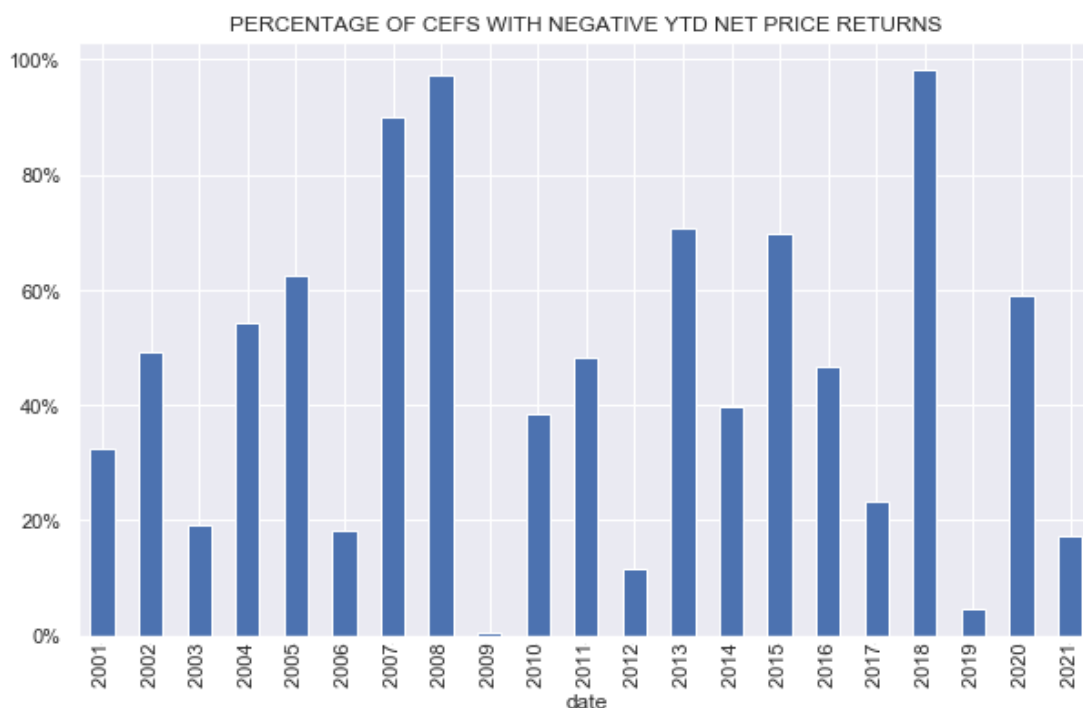
Sectors with negative net price returns are Taxable munis, EM Debt and Agencies and should see more pressure. Some of this (especially in taxable munis and EM funds EDI and EDF) is due to higher rates and premium deflation. Agency CEFs will tend to have negative net price returns because they vastly **overdistribute** relative to their portfolio yields. These sectors are likely to see more pressure from tax-loss harvesting than others for the simple reason that they are likely to have more losses to harvest.

Another way to look at this dynamic is to focus on individual funds. The worst net price performers since the start of the year are the following funds and could see more pressure into year-end.



Source: Systematic Income

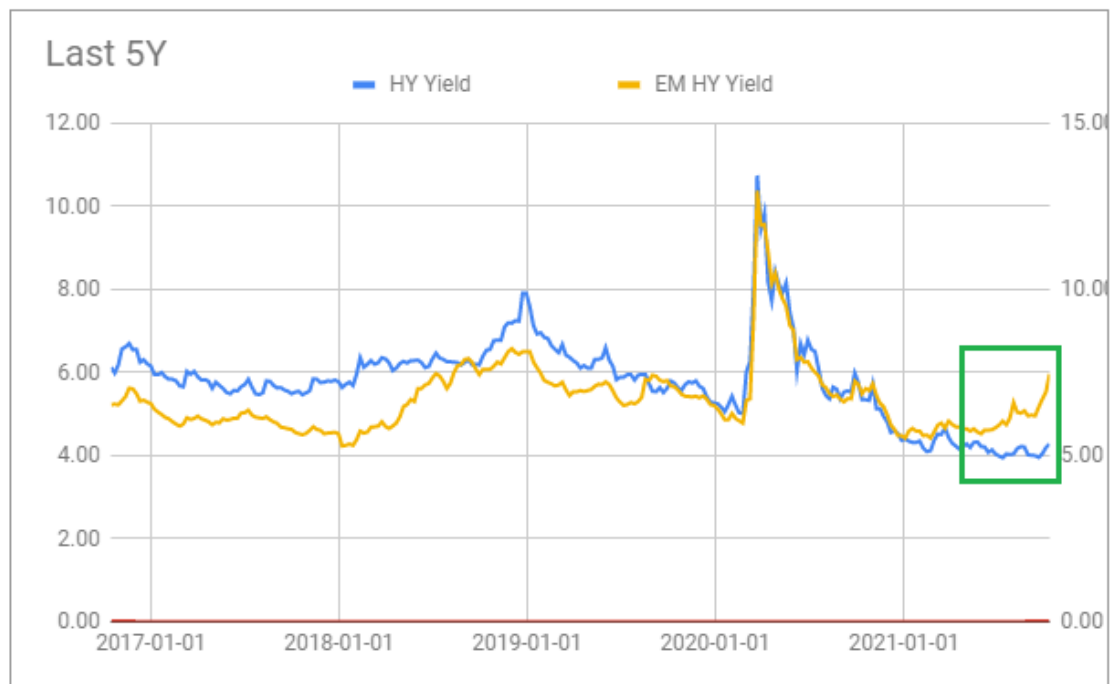
In aggregate, we should expect relatively little tax-loss harvesting this year (if the market holds up) for the simple reason that 2021 has been a very good year for CEFs. The chart below shows that the percentage of CEFs with negative net price returns is less than 20% - the third best performance over this century.



Source: Systematic Income

The other important question is - if tax-loss harvesting is real what do investors do about it? Purely tactical investors may be looking to buy oversold funds in these sectors. More strategic investors, however, also have to decide if the funds and sectors themselves are worth holding for more than purely tactical reasons. For instance, just because agency CEFs may sell off that doesn't make them worth holding.

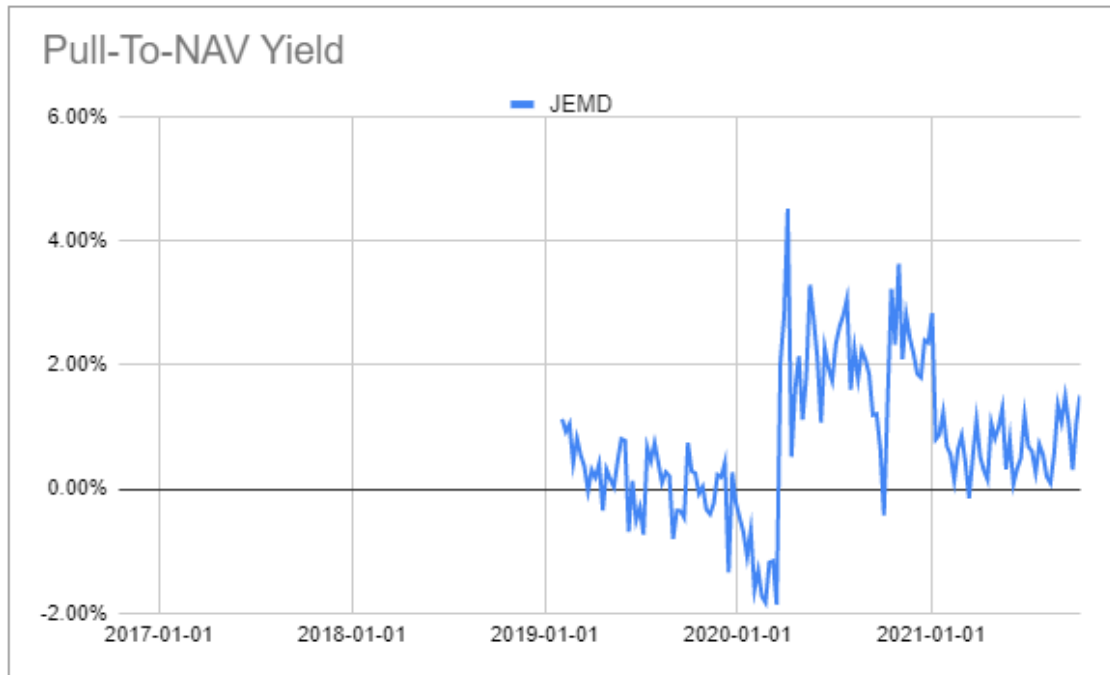
In our view, hard-currency EM debt looks pretty attractive now - high-yield EM debt has diverged from its US counterpart as the following chart shows.



Source: Systematic Income Strategic Allocation Tool

Some of this is because of the China spillover, downside risks from the Delta variant and the impact of the macro slowdown on these more cyclical economies but it does look overdone. EM HY leverage is 1.5x lower than in the US so you get paid 1.75% for 1 turn of leverage in EM and just 0.55% in the US. Duration is also fairly low at 4. We covered some of this ground in our last sector [update](#).

It's unfortunate that there are not really HY-focused EM debt CEFs and the ones that sort of focus on the space also hold local-currency debt like EDF and EDI and/or have uninspiring historic alpha. ETFs are a good, lower-beta, way to play in the space with options such as the WisdomTree EM Corporate Bond Fund ([EMCB](#)) or VanEck EM HY Bond Fund ([HYEM](#)). In the CEF space, the Nuveen EM Debt 2022 Target Term Fund ([JEMD](#)) is also worth a look. The fund's PTN yield or the expected tailwind from discount amortization is trading at an attractive 1.5% level.



Source: Systematic Income CEF Tool

Market Commentary

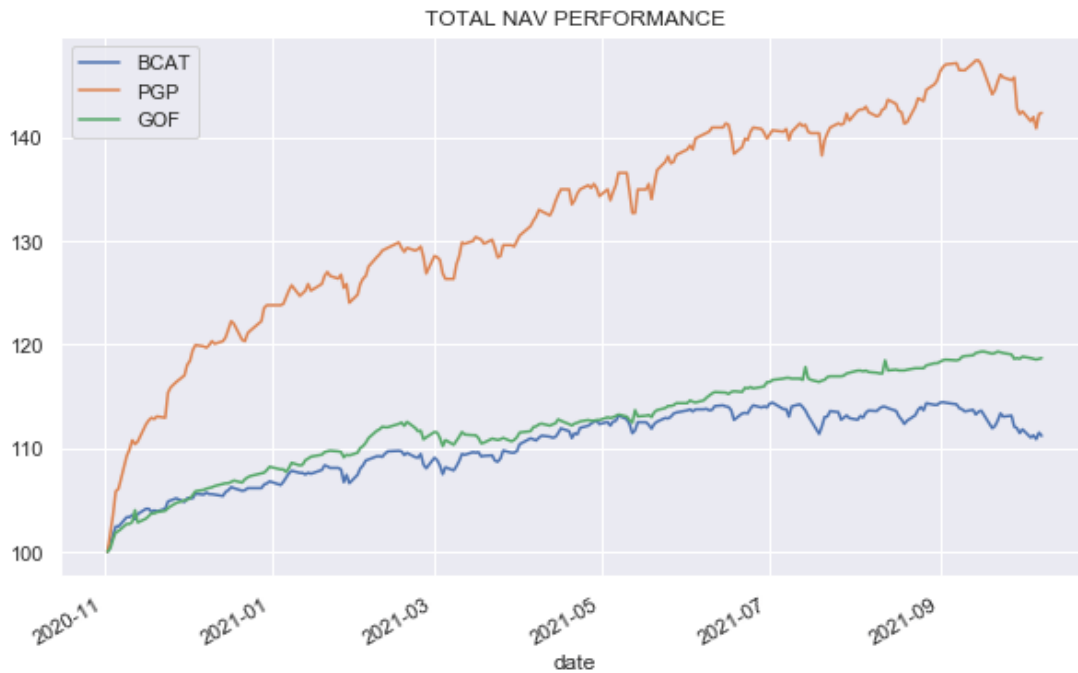
We often like to check in on what CEF insiders are doing using a database on the service that we update on a daily basis. The other week we noticed that two of the three managers of the BlackRock Capital Allocation Trust ([BCAT](#)) have added to their fund holdings. Below is a partial screenshot of the recent transactions. Rick Rieder is BlackRock's CIO of fixed-income and head of global allocation.

Ticker	Rating	Transaction Date	Reporting Owner	Form	Transaction Type	Direct or Indirect Ownership	Number of Securities Transacted	Number of Securities Owner
BCAT		2021-09-28	Koesterich Russell Jared	4	P-Purchase	D	2,000	31,000
BCAT		2021-09-27	Rieder Richard M	4	P-Purchase	D	1,851	277,645
BCAT		2021-09-27	Rieder Richard M	4	P-Purchase	D	2,988	268,056
BCAT		2021-09-27	Rieder Richard M	4	P-Purchase	D	4,405	273,849
BCAT		2021-09-27	Rieder Richard M	4	P-Purchase	D	1,012	278,657
BCAT		2021-09-27	Rieder Richard M	4	P-Purchase	D	2,354	281,011
BCAT		2021-09-27	Rieder Richard M	4	P-Purchase	D	246	281,257
BCAT		2021-09-27	Rieder Richard M	4	P-Purchase	D	99	281,356
BCAT		2021-09-27	Rieder Richard M	4	P-Purchase	D	1,259	275,794
BCAT		2021-09-27	Rieder Richard M	4	P-Purchase	D	786	282,142
BCAT		2021-09-27	Rieder Richard M	4	P-Purchase	D	694	268,750
BCAT		2021-09-27	Rieder Richard M	4	P-Purchase	D	694	269,444
BCAT		2021-09-27	Rieder Richard M	4	P-Purchase	D	686	274,535
BCAT		2021-09-27	Rieder Richard M	4	P-Purchase	D	1,070	265,068
BCAT		2021-09-24	Rieder Richard M	4	P-Purchase	D	4,939	254,122
BCAT		2021-09-24	Rieder Richard M	4	P-Purchase	D	3,703	234,861
BCAT		2021-09-24	Rieder Richard M	4	P-Purchase	D	741	263,998
BCAT		2021-09-24	Rieder Richard M	4	P-Purchase	D	1,235	263,257
BCAT		2021-09-24	Rieder Richard M	4	P-Purchase	D	2,469	262,022

Source: Systematic Income CEF Tool

BCAT is a hybrid CEF (i.e. holding both equities and bonds) with a multi-sector credit allocation. It is a roughly 40% stock / 60% fixed-income with around 17% of leverage which is somewhat understated because the fund also has exposure to credit via derivatives.

What is odd about the fund is its unusually tepid performance over the past year which is shown in the chart below alongside two other hybrid / multi-sector funds from PIMCO and Guggenheim.



Source: Systematic Income Strategic Allocation Tool

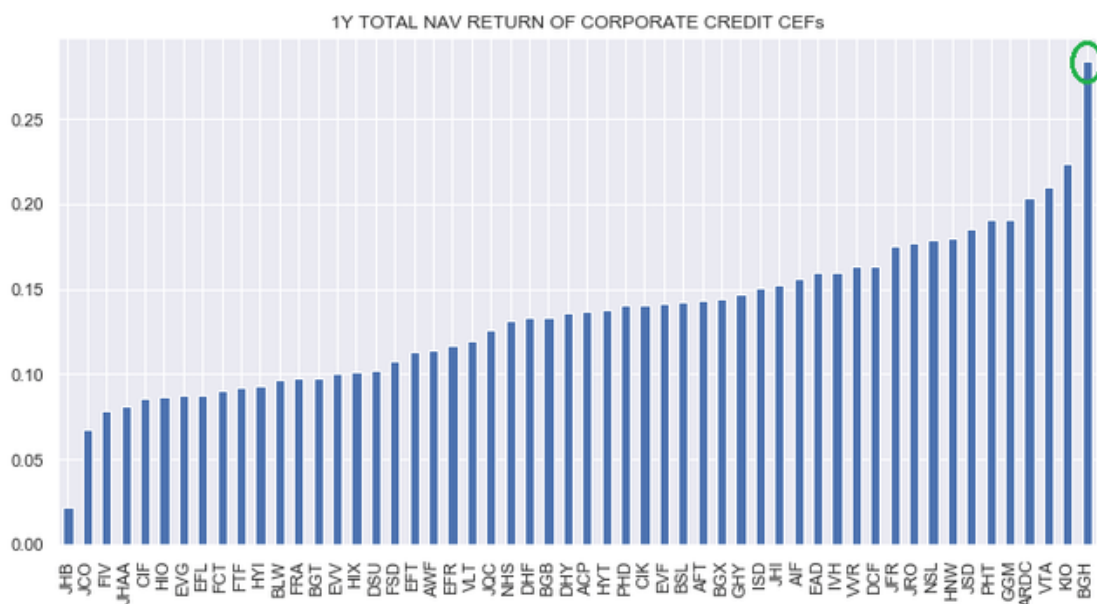
The fund delivered around a 10% total NAV return over the past year which may not sound too bad but is miles off what its exposure suggests it should have delivered. If we simply look at what a 17% leveraged portfolio in SPY / JNK has done over the last year that number is +22% more than twice the performance of BCAT.

It's not obvious what is going in the fund to drive a -12% alpha - perhaps it's equity security selection though their larger holdings have outperformed the broader S&P 500. Maybe it's their options positions of which they have a ton but the net sum of their PL there pretty low. And it's not because they took time to gear up their allocation - their run-up has been consistently slow and, if anything, it slowed down in the second half of the period when it should have accelerated as they built out their portfolio. Quite a few question marks around this one.

The Barings Global Short Duration High Yield Fund (BGH) - a limited duration CEF - released its shareholder report last month. BGH is a fund we have highlighted a few times over the past year as part of the Limited Duration sector [update](#), a [look](#) at higher-yielding CEFs and a cross-credit allocation [theme](#) we have favored.

BGH earned around \$0.1333 of NII per month for the first half of the year versus a distribution of just \$0.1056. The fund's NII price yield (i.e. which we call covered yield sometimes) is 9.29%. That number is enormous relative to what most other credit funds are earning or distributing. This is, in part, due to the fund's lower quality stance with 38% in \leq CCC securities and another 37% in B-rated assets. That puts the fund in one of the lowest quality profiles in the sector.

Another way to gauge the fund's quality stance is by looking at its NAV performance over the last year which is by far the highest in the credit space and is about 2x that of the average credit CEF. This is driven in part by the fund's energy and commodities exposure which takes up about a quarter of the portfolio.



Source: Systematic Income

In this early-to-mid cycle environment with the outlook on defaults being very benign it's probably not a crazy holding for investors looking at higher-yielding options. That said, it's less appealing now given where valuations are than even when we highlighted it earlier. Two additional points worth mentioning about BGH. First, the fund's NII yield is slightly overstated - one way to gauge its portfolio yield is by comparing the fair-value of its securities to their principal. If we do that, we get to a weighted average price of around \$106 and the average maturity is somewhere around 4-5 years so we need to shave off around 1.5% (6% above par / 4 years = per annum 1.5% pull-to-par) from its yield.

The other thing to note is that the fund maintained its NII over the previous year. One reason it was able to do that was because it increased borrowings by around 11%. And the reason it was able to do that was because of NAV growth in its portfolio which caused its leverage to move lower, creating room to boost it by adding borrowings. It's going to be harder to do that going forward due to expensive valuations. The NAV has leveled off a bit over the last 4 months in line with this dynamic. The fund remains a decent option for investors with a constructive market outlook, those who want a relatively low duration profile and who buy into the cross-credit sector theme linked above.

Stance And Takeaways

The three different themes mentioned in this update: hybrid CEFs, short duration and cross-credit allocation are some of the themes that continue to drive our Income Portfolio and are worth serious consideration by income investors.

Low underlying asset yields plus rising Treasury yields are creating a drag on fixed-income CEF NAVs which will make it more difficult for them to sustain their distributions. CEFs that allocate to securities with equity upside can use those gains to either fund distributions or reallocate into income-producing assets, providing more support to fund income. PGP remains an attractive option here for investors with a bullish equity view. Our own stance has been in lower-beta equity-upside holdings such as the Virtus AllianzGI Convertible & Income Fund ([NCV](#)) which has convertible debt and preferreds holdings and has beaten the average PIMCO taxable fund by 5% in NAV terms over the past year.

Short duration options such as JEMD and BGH highlighted above both feature duration below 2 which can allow them to better withstand the rise in Treasuries than the average credit fund, all else equal. We also like the term structure feature of JEMD which provides an additional discount anchor.

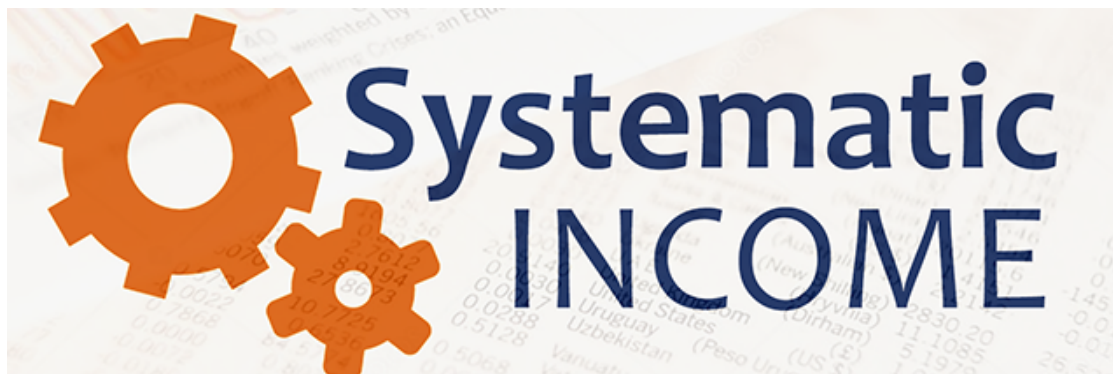
Finally, the cross-credit investment mandate allows fund managers greater freedom in finding attractively-priced securities across bonds, loans, CLO debt, ABS and other sectors in a market that is, frankly, richly priced. This type of investment strategy not only provides a more diversified portfolio but can be a more consistent generator of alpha. In this space we like funds like the Ares Dynamic Credit Allocation Fund ([ARDC](#)) and the Apollo Tactical Income Fund ([AIF](#)), among others.

Check out [Systematic Income](#) and explore our **Income Portfolios**, engineered with both yield and risk management considerations.

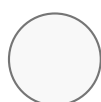
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