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Closed End Funds

# CEF Weekly Market Review: Beware Of The Free CEF Lunch

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## Summary


- We review CEF market valuation and performance over the third full week of October and highlight recent market events.
- Equity-linked CEF sectors have been supported by strength in equities while higher-quality fixed-income sectors continue to face the headwind of higher Treasury yields.
- We discuss the apparent "free lunch" in the CEF space of high-quality CEFs with high distribution rates.
- And touch on recent leverage changes as well as news from FMY, HYI, EDF and others.
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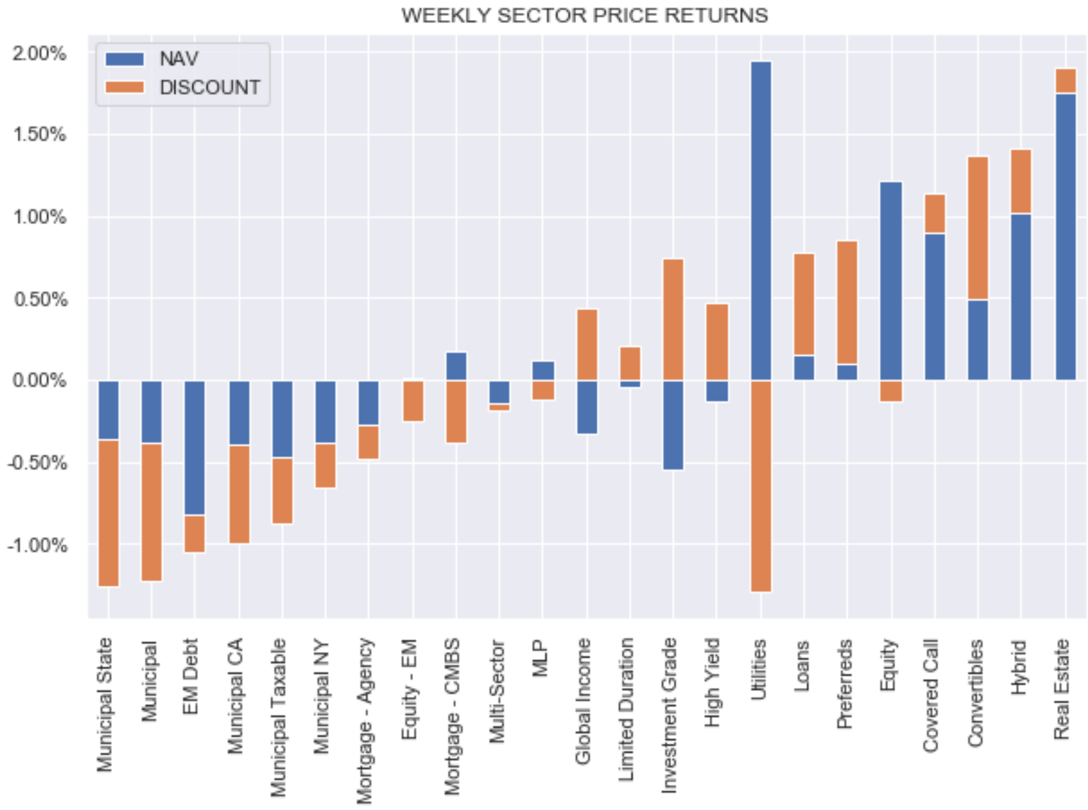
*This article was first released to Systematic Income subscribers and free trials on Oct. 25.*

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 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

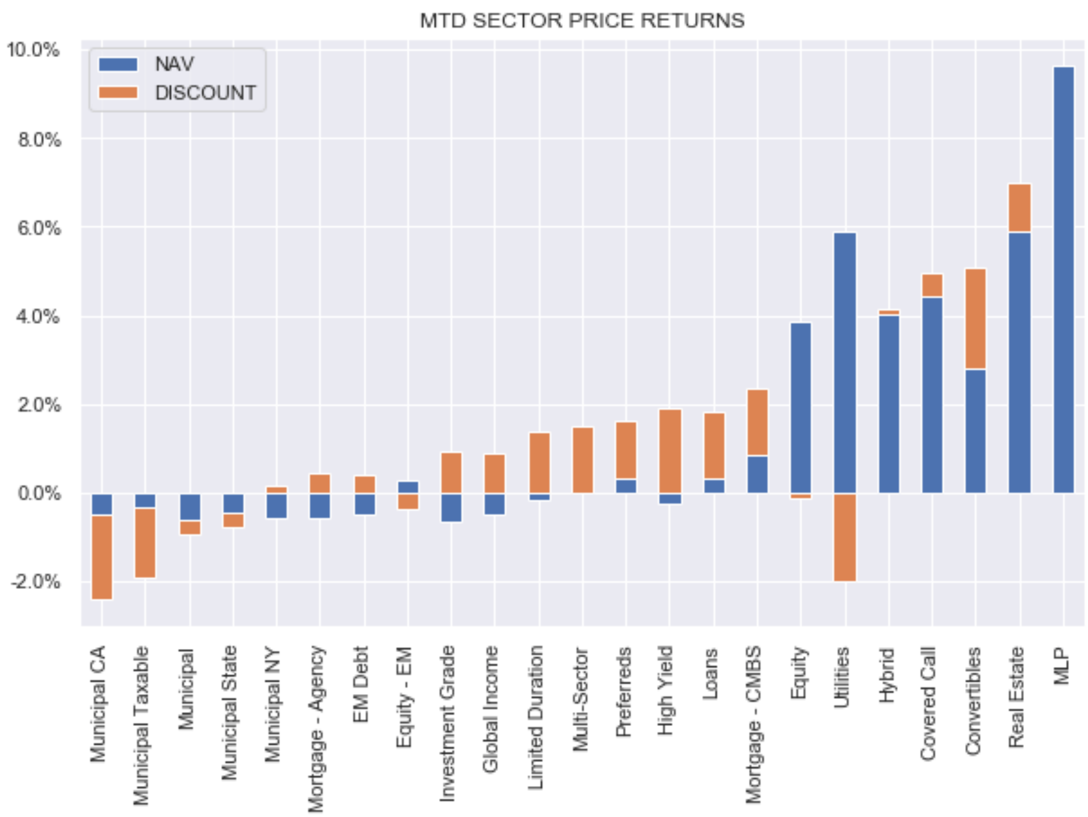
It was a mixed week in the CEF space with higher-quality sectors firmly in the red on both an NAV and discount basis. This week was particularly interesting as it highlighted the pro-cyclical tendency of discounts - widening (i.e. driving lower prices) at the same time as NAVs move lower. We can see this particularly well in the Muni sectors (on the left side of the chart below) where discounts were responsible for most of the price drops in those sectors.




*Source: Systematic Income*

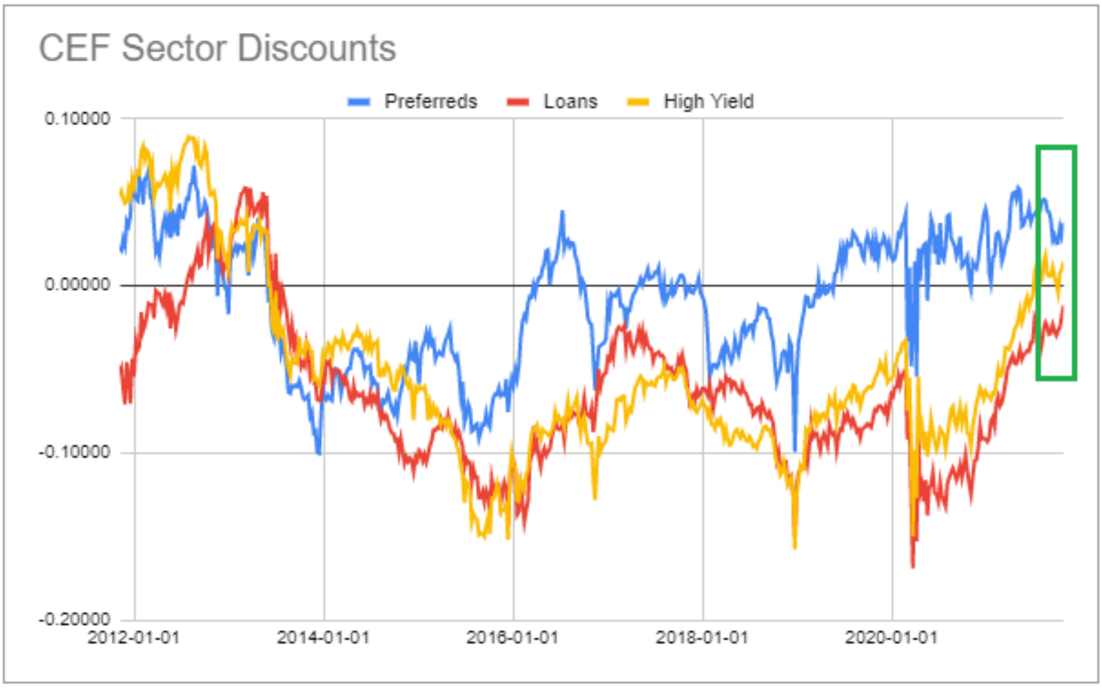
The difficulty for high-quality sectors, as we have discussed in several prior weeklies, is the combination of low Treasury yields (though now not as low as they were just a few weeks ago), expensive discounts and tight credit spreads - the three-legged stool of CEF prices. All three are likely to pose some headwinds for investors. The best case scenario is likely to feature forward returns that are more aligned with underlying portfolio yields of higher-quality sectors which are in the low-single digits.

So far in October, most sectors have registered gains. The chart below shows an interesting dynamic of equity CEF sector price gains driven mostly by higher NAVs (blue bars) due to supportive equities while fixed-income CEF gains (to the extent they exist) have been driven mostly by tighter discounts (orange bars).




*Source: Systematic Income*

Discount valuations of sectors like Preferreds and High-Yield Corporates have retraced some of their weakness in the previous few weeks. The Loan sector valuation has moved to a 7-year record, no doubt, spurred on by the recent rise in Treasury yields and the desire on the part of investors to shorten up on duration.




*Source: Systematic Income CEF Tool*

Surprisingly, the Loan sector valuation has lagged that of the other two sectors which feature much longer durations. This valuation gap will probably continue to close in the coming months, particularly if Treasury yields keep marching higher.

## Market Themes

The CEF space is somewhat unusual, at least relative to the open-end fund (i.e. ETF + mutual fund) market in that the link between distributions and underlying asset yields (i.e. what the fund portfolio actually yields) is fairly weak. In other words, fund managers have wide leeway in the distribution rate of their fund. What this means in practice is that the distribution rate of the CEF can be well above the underlying yield of its portfolio.

In addition to the "yield" (i.e. distribution rate or current yield) of a given CEF, the other key dimension for most investors is its underlying "quality". This is more relevant for credit CEFs i.e. those that hold assets like loans, corporate bonds, ABS, MBS, munis, etc.

The attitude that many CEF investors have is that - well, all I am after is a high "yield" (by which they mean CEF distribution rate, i.e. current yield) so I might as well get the highest quality portfolio I can get for a given yield. A typical strategy here is to find CEFs with the highest "yields" with mostly investment-grade holdings. After all, who wouldn't go for a "safe" fund with a 7%+ "yield"?

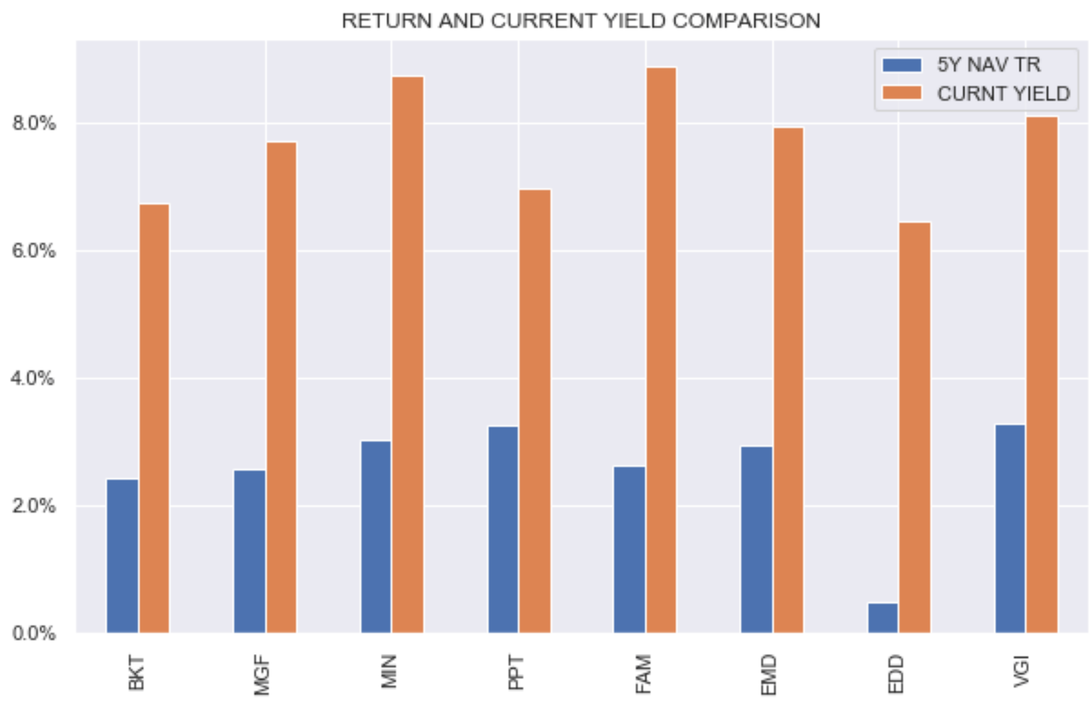
The trouble with this strategy is that it can lead to disappointing returns on investor capital for the simple reason that higher-quality assets don't actually generate particularly high yields - at least not anywhere close to the current yields of these funds.

To illustrate this point let's take a look at CEFs with a higher than 50% investment-grade allocation ("IG" on the y-axis) and an above 6% current yield (on the x-axis) in the chart below. The key point is that funds in the upper-right quadrant, i.e. those with both a very high quality allocation and high current yield will likely struggle to deliver returns anywhere near their current yields.


*Source: Systematic Income*

To illustrate how this works let's pick out a number of funds towards the upper right quadrant and compare the 5-year total NAV returns to their current yields. We used 5-year returns for 2 reasons. First, 10-year Treasury yields were about what they are now 5 years ago which controls for any large duration impact. And secondly, it's a decent balance between the short and long-end returns, capturing enough of a historic track record without being so long as to be irrelevant for current discussion.

The chart below shows how the current yields (orange bars) of these funds stack up to their 5-year total NAV returns (blue bars). It is clear from the chart that the actual NAV returns generated by these funds are well below their "yields". This is not particularly surprising for the simple reason mentioned above that the higher quality allocation of these funds makes it difficult for them to generate high NAV returns since high-quality assets also tend to have low yields.

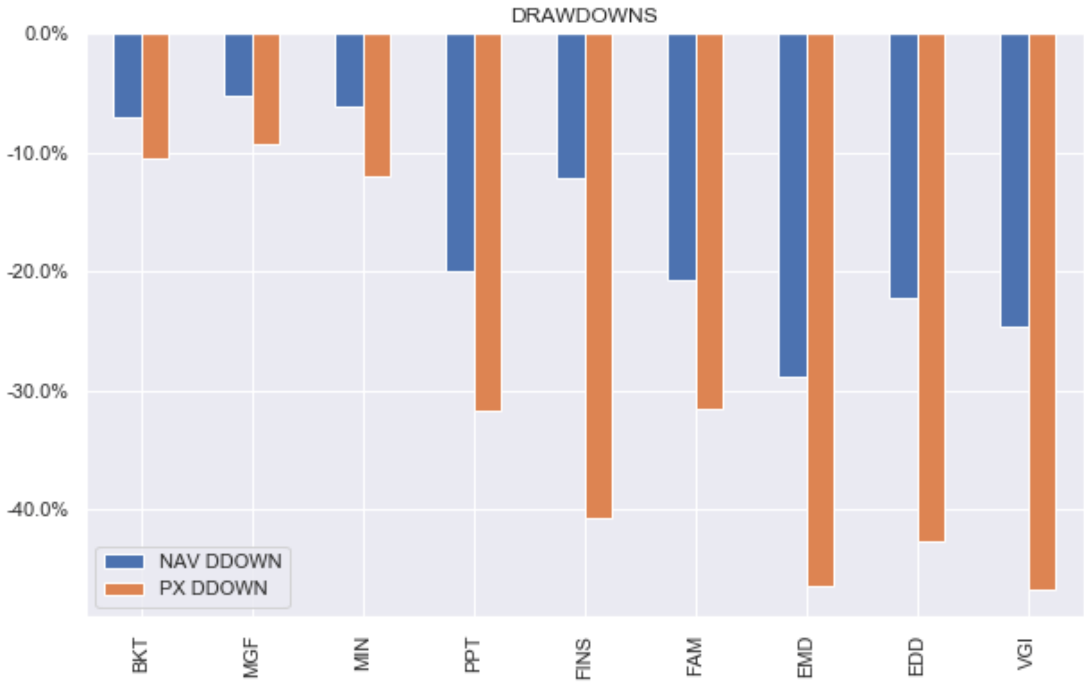


*Source: Systematic Income*

More broadly, there are significant challenges to the high-quality CEF model in the current market environment. First, high management fees are starting to take a big chunk of underlying yields. With AA-rated taxable bond yields at around 2% and CEF fund fees in the range of 0.8-1% it means fees will eat up close to half of the underlying yield.

And secondly, leverage is not going to save the day here since the cost of leverage for taxable credit CEFs is around 1%, which after management fees, is bumping right against the 2% yield of AA bonds, leaving little if anything to investors.

Investors who are betting on high-quality portfolios having low volatility / drawdowns may be disappointed since discounts will typically widen significantly even for high-quality portfolio CEFs. The chart below shows that price drawdowns in 2020 were well above the NAV drawdowns of these funds.



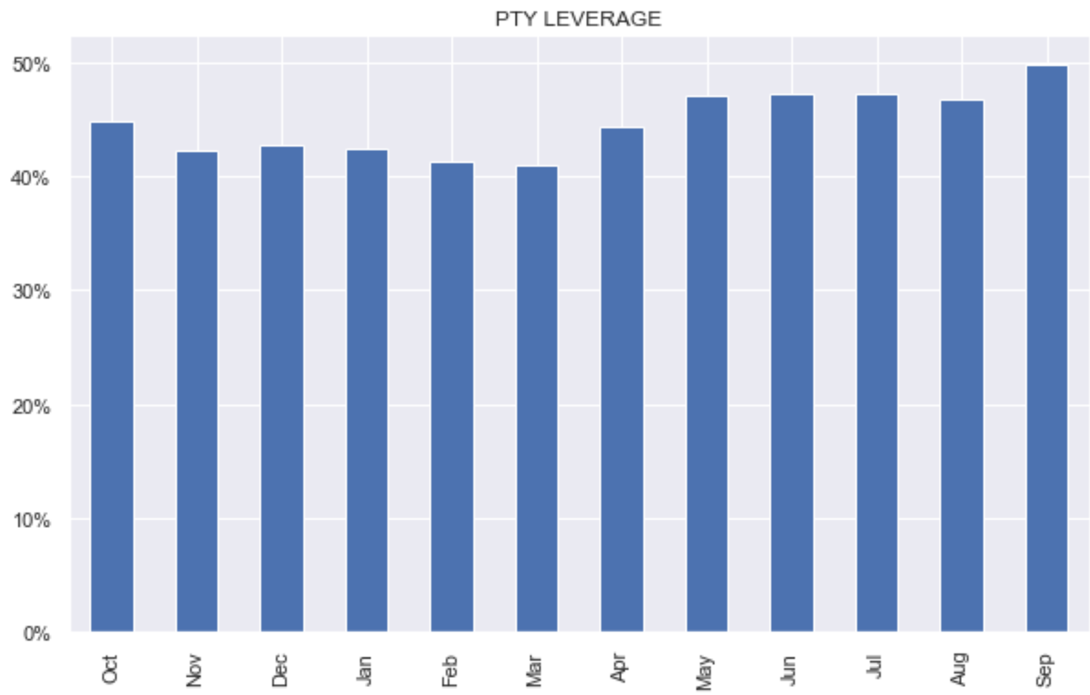

*Source: Systematic Income*

Are there good reasons for holding high-quality portfolio CEFs? Sure, particularly for investors who think that Treasury yields will move lower or those who believe a given management team will deliver significant alpha or where a given fund is trading at an unusually cheap valuation. However, in most situations, investors should think twice before going for the "free lunch" offered by CEFs with high current yields and high-quality portfolios.

## Market Commentary

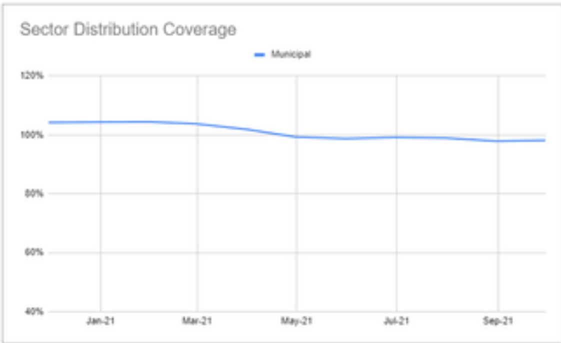
The primarily CLO Debt-focused Eagle Point Income Co. (EIC) issued their new preferreds at 5% which we covered in more detail elsewhere. From the perspective of CEF common shareholders it's not an obvious win because income (at least GAAP income) is not going to increase by much. EIC earns around 7.67% on its unleveraged portfolio in GAAP terms (= total income / total assets) but has expenses on total assets (ex-interest costs) of 2.37%. So after a 5% financing cost you are left with just 0.3% on new assets in exchange for a big increase in leverage from 21% to 35% which doesn't feel like a slam dunk. EIC also deleveraged in 2020 at a lower leverage level than now so it doesn't inspire a ton of confidence that it's not going to do that again if we see another market drawdown.

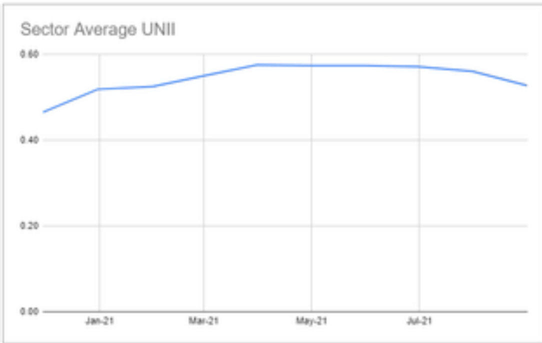
We updated CEF leverage changes for September on the service for those funds that have monthly disclosures. The Nuveen Credit Opportunities 2022 Target Term Fund (JCO) fully deleveraged, presumably on its way to the June-2022 termination. It has something around a 4% yield into the likely termination for essentially no duration risk (including its unannualized PTN Yield of 0.7%) which isn't too bad in the current yield environment.Nuveen and Flaherty preferreds funds added borrowings - a trend we highlighted earlier - while the John Hancock funds saw borrowings fall. PIMCO added borrowings, reversing the drop last month so that the average taxable leverage now looks to be at a record high of around 43.5%. The PIMCO Corporate & Income Opportunity Fund (PTY) leverage is right around 50% - its trajectory is shown below.




*Source: Systematic Income*

Nuveen and PIMCO CEF coverage was updated for September as well. Nuveen Muni coverage ticked lower for most funds - a trend we see across the broader sector as well as shown in the two charts below.

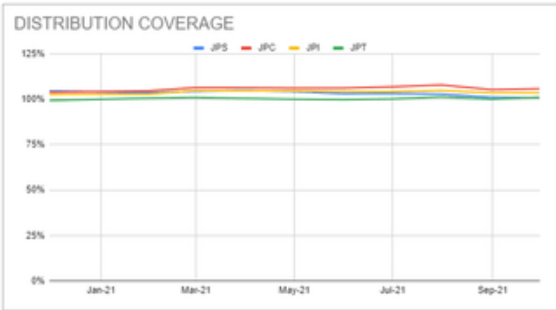


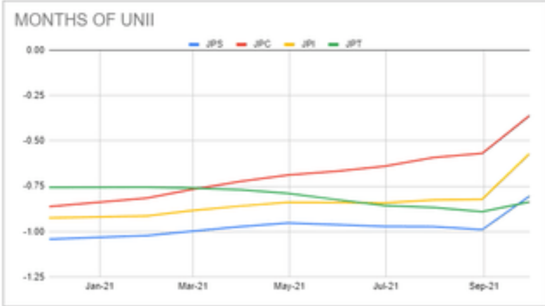




*Source: Systematic Income CEF Tool*

At the current level of bond prices, there is going to be less room to add additional borrowings – if anything we are likely to see very modest deleveraging in the medium term in the Muni sector. Plus, as discussed in the recent Muni write-up, CEFs will be slowly forced to rotate from high coupon to lower coupon bonds which will pressure income and coverage levels.

Elsewhere, Nuveen preferreds fund coverage mostly ticked up - an expected trend given their borrowings trajectory. This suite likely has the least distribution vulnerability in the sector.




*Source: Systematic Income CEF Tool*

The Western Asset HY Defined Opportunity Fund (HYI) is out with quarterly financials – NII fell about 4% from the previous quarter (it fell about the same in the previous quarter as well) for a NAV NII yield of 6.08%.

The fund has been in the Core Income Portfolio because of its 1) term structure which provides a kind of discount anchor as well as a performance tailwind upon termination and 2) lack of leverage. With the fund moving out to a small premium the tailwind is no longer there but the discount anchor and lack of leverage are still risk-mitigating features.

That said, it's a bit less appealing here given the second quarterly drop in NII, plus the fact that a further increase in premium will become a headwind for performance into the termination.

In short, it's worth considering rotation options here. What's interesting about a fund like HYI is that its term structure and lack of leverage makes it look like an actively-managed ETF which also feature discount control (even better than that of term CEFs), lack of leverage and active management. The advantage of actively-managed HY corporate ETFs is that their fees are usually a lot lower, e.g. they average about half the fees of HYI if we get rid of one outlier. Plus, over the last 3 years most of them have actually beaten HYI in NAV terms (HYI is still well ahead in price terms due to discount compression). It's worth considering something like JPHY, FDHY or PHYL in the actively-managed ETF space – FDHY looks especially interesting here.

Other HY corporate ETFs to consider are the passive fallen-angel ETFs, especially FALN. These ETFs buy up bonds that have been downgraded into high-yield from investment-grade. That may sound like a dumb strategy but actually it's a very good one since 1) you end up holding fairly high quality debt relative to the broader HY space and 2) you take advantage of some of the artificial selling pressure where investors with IG-only mandates have to get rid of the bonds that have been downgraded. The two funds here have seen fantastic returns and are worth a look, especially in this part of the credit cycle of tight credit spreads, likely higher Libor at some point (putting pressure on CEF leverage costs) and tight discounts.