CEF Weekly Market Review: CEF Hedges Often Promise More Than They Deliver

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 first week of November. 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

The first week of November was quite striking because all CEF sectors delivered NAV gains, in large part, due to higher stocks as well as a strong rally in Treasuries and despite a slight weakening in credit spreads.

Source: Systematic Income

All sector NAV returns finishing in the green happened only one other time in the past year though it was not uncommon in 2019-2020.

Source: Systematic Income

What was also interesting is that the majority of sector discounts actually widened. Tax-exempt sectors benefited from the rally in Treasuries, however, other higher-quality sectors like taxable munis and agencies saw wider discounts. It is certainly possible that these two sectors may be suffering from tax-loss selling as they are the worst performers so far this year on a price (ex-distribution) basis. Given the general strength in the CEF market this year and the mild negative returns of the worst performance we don't expect tax-loss selling to dominate price action into year-end outside of a handful of funds.

Source: Systematic Income

Market Themes

The strong uptrend in the CEF market alongside, what are undoubtedly, expensive valuations across both underlying assets and discounts, has prompted many investors to consider taking some chips off the table in order to protect gains from any potential fallout over the medium term.

One strategy that investors turn to is hedges. There are many traditional forms that hedges can take such as options and futures. However, the more tempting options for income investors familiar with the fund space are funds that offer income portfolios with a hedge overlay. The pitch for these funds is that they allow investors participate in the underlying income asset but also benefit from the hedge held by the fund - a kind of "have your cake and eat it too" investment option which is often too tempting to pass up.

Obviously, everyone's mileage with hedges and hedged funds will vary and investors should take into account their own experience, situation and views but, generally speaking, we don't recommend hedges on the service for strategic investors for a few reasons.

First, it's important to realize that investors who hold a given asset plus a hedge or a fund with an embedded hedge are not actually getting a free lunch. Ultimately, the cost of the hedge will exert a drag on portfolio performance. Option-based hedges are priced in the market in such a way as to exceed the actual market probability of a given outcome (think of how the cost of insurance exceeds the actuarial likelihood of a certain type of event) so investors who hedge away a certain market scenario are also writing off the risk premium that they earn by taking the risk of underlying assets whether it's corporate default risk in bonds and loans or earnings / market risk in stocks.

Secondly, investors who hold hedged funds in their portfolio end up paying fees on both the underlying asset and the hedge. This doubling up of fees means they will tend to underperform unless their market timing is impeccable. Inverse ETFs also have a negative compounding effect which exerts another kind of performance drag.

Thirdly, there is typically a basis between the underlying asset (e.g. CEF) and the hedge. For instance, a muni CEF hedged with a short Treasury position or an inverse Treasury ETF ignores the biggest drivers of muni CEF prices which is its discount (with muni credit spreads being not far behind, particularly for high-yield / unrated bonds).

Fourthly, based on anecdotal evidence we have seen on our service, most income investors approach hedging from a rear-view mirror / portfolio pain perspective i.e. when their positions have already accrued significant losses rather than from an anticipatory perspective. This means that they will tend to put on hedges at the worst times - when most of the losses have already been accumulated and mean reversion is more likely than not.

Source: Systematic Income

An example of a fund that claims to provide an embedded hedge to inflation, rising interest rates and interest rate volatility is the Quadratic Interest Rate Volatility and Inflation Hedge ETF (NYSEARCA:IVOL) which we had a skeptical take on about a year ago. The fund looks great on paper - 4-6% yield, risk-free holdings, and a hedge against inflation, volatility and rising rates.

Inflation and inflation expectations have clearly risen strongly this year, regardless at which index you look.

Source: YCharts

The 10Y Treasury yield has risen about 0.50% since the start of the year.

Source: FRED

And interest rate volatility has increased due to the recent rollercoaster ride in Treasury yields over the past few months. This combination of factors is precisely what IVOL claims to benefit from.

And so given this supportive environment IVOL should have killed it. Instead it delivered a performance of around 1.5% and underperformed its benchmark by about 4% this year.

Source: Systematic Income

We are not cherry-picking dates here. The fund has underperformed its benchmark over the past 1-year (rather than just year-to-date) as well as since inception in 2019 - both periods which should have been incredibly supportive.

We won't rehash here why we had a skeptical take on the fund last year but the key takeaway is that it is important for investors to understand the key underlying dynamics of funds offering an embedded hedge to make sure it can actually deliver on its premise. This is not to say that all hedged funds will underperform in a supportive market environment but rather that marketing can often get ahead of a given fund's capability.

In our view there are better strategies for most investors to dial down exposure rather than go with a hedge or a hedged fund.

One strategy is to rotate from CEF to ETFs or Preferreds. This reduces the implicit leverage of the position as well as avoids the biggest drive of CEF price drawdowns - discounts. Another strategy is to tilt to term CEFs which boast not only stronger discount control but typically a lower duration profile as well. A third strategy is to move up in quality either by allocating to funds in the same sector that have a stronger credit profile or to allocate to a higher quality sector such as munis or investment-grade corporates over loans or high-yield corporate.

Finally, investors worried about the rise in interest rates and their potential impact on their portfolios should have a look at I Bonds. The Treasury Series I Savings Bonds or I Bonds for short have shown up on people's radar recently because of the high recent coupons due to the spike in inflation indices. The annualized rate (for the next semi-annual period) for the latest issued bonds is 7.12% which is basically the last semi-annual change in the CPI-U index of 3.56%. Overall these are pretty attractive for a number of reasons. It's worth comparing them to TIPS to see why.

A lot of people think TIPS are a slam dunk because you get paid inflation while holding risk-free securities which misses a lot of the picture. First, TIPS are long duration securities so if rates and inflation jump, TIPS can actually drop in price despite higher inflation simply due to combination of higher rates and high duration. I Bonds have no duration - they are like CDs in this sense and are basically par instruments.

Secondly, TIPS have a symmetric response to inflation - inflation causes the principal to adjust higher and deflation causes it to adjust lower. I Bonds have a zero inflation floor - you can't earn less than zero (barring the early sale penalty).

Thirdly, TIPS are securities traded in the market and thus prone to the usual market volatility - TIPS typically underperform nominal

Treasuries because of their lower liquidity when adjusted for the inflation impact. I Bonds aren't traded and hence don't suffer from any liquidity issues relative to nominal Treasuries.

Fourthly, TIPS trade at a negative real yield i.e. the 10Y real yield is -0.96% so your actual yield will be -0.96% plus whatever inflation happens to be over the next 10 years. In other words, because nominal yields have fallen so much, with TIPS you are about 1% in a hole before you add inflation to the return. I Bonds start you off with zero not -1% so you get a head start relative to TIPS.

There are some downsides too: 1) you can only buy a small amount - $10k electronically and another $5k via your federal taxes per calendar year (presumably you can double this up with your significant other and you should be able to buy into the same initial 7.12% first period in January also), 2) you have to hold for at least a year and there is a 3-month interest penalty if you sell it back to the government within 5 years, 3) the high current optical rates are unlikely to last beyond the next semi-annual accrual period - theoretically you can earn a zero coupon for all subsequent periods after the first if inflation is zero. This is pretty unlikely but not impossible. These are relatively small downsides vs. the positive factors described earlier.

Market Commentary

The 4 Virtus AllianzGI funds released their latest shareholder report covering the period of Feb-Aug. The two more interesting funds: the Virtus AllianzGI Convertible & Income Fund (NYSE:NCV) and the Convertible & Income Fund II (NYSE:NCZ) don't look amazing from a NII perspective. Annualized NII fell 30-35% from the previous year and coverage looks to be closer to 50%.

That said, the drop in NII looks very odd to us. The two funds have not changed their borrowings i.e. they have not deleveraged and their sector allocation looks to be pretty similar to the previous year. It's possible that they may have rotated into lower-coupon converts which has pressured NII.

It's important to keep two things in perspective though. First, the two funds are funded to a significant extent with fixed-rate borrowings so their NII will not be dinged as much once Libor rises unlike that of the vast majority of other credit CEFs which rely on repo / credit facilities for their borrowings.

And secondly, one way to manage the risk of rising rates is to allocate to reflationary / "growthy" kinds of assets in the credit space. NCV and NCZ tick this box by having a partial convertible allocation without being full-tilt convertible funds i.e. still having a decent amount of underlying income (pure convertible funds struggle to generate any appreciable income because convertible bonds tend to be issued at coupons around 0-2%).

So for instance the two funds have generated 1Y NAV returns of 34% versus an average of 20% for more pure-play fixed-income PIMCO taxable funds. Obviously, this comes at the cost of a fairly high beta but the two funds did not deleverage in 2020 (unlike many of their PIMCO counterparts) due to their more robust preferreds financing and so did not lock in any losses which makes their higher-beta nature more palatable for CEF investors.

Other funds that allocate to convertible debt like CHI and CHY are more heavily allocated to convertible bonds - about 60% vs. <50% for NCV and NCZ. This also means that they have a lower NAV NII - about 3% vs. closer to 4% for NCV and NCZ. They also trade at a more expensive valuation. And their higher convertible allocation hasn't resulted in a higher NAV return over the past year.

We have recently rotated into NCZ from NCV due to its historic cheapness versus NCV as the two charts below show.

Source: Systematic Income CEF Tool

It is also worth highlighting that the higher beta nature of these funds allows investors to reallocate the gains in these funds into additional income-producing securities (particularly if they do not want their portfolios to become more heavily allocated to these funds). This kind of additional indirect income potential of these funds during market uptrends is an often-overlooked feature. And as we highlighted above this pair of funds can deliver additional alpha opportunities through relative value rotations.