



CEF Weekly Market Review: CEF Market Pushes Through Inflation Scare

Nov. 20, 2021 1:29 PM ET | IHIT, IHTA, JEMD... | 1 Comment | 6 Likes



ADS Analytics

Marketplace Bio

Summary

- We review CEF market valuation and performance over the second week of November and highlight recent market events.
- Discounts mostly rallied this week despite broadly lower NAVs due to rising Treasury yields and lower stocks.
- Tax-exempt funds were supported by the passage of the infrastructure bill.
- We discuss a few common pitfalls in CEF analysis using NCV as an example.
- We also highlight the Delaware fund merger and the recent shareholder report from the Invesco CMBS funds.
- I do much more than just articles at Systematic Income: Members get access to model portfolios, regular updates, a chat room, and more. [Learn More »](#)



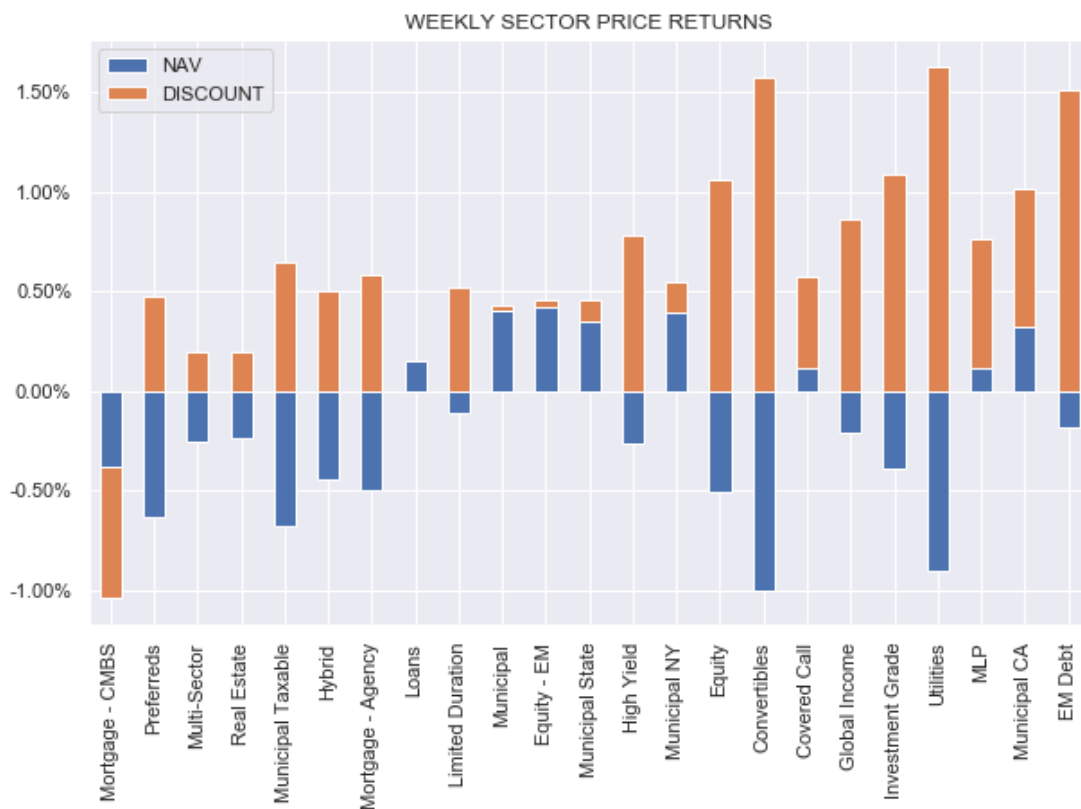
shapecharge/iStock via Getty Images

This article was first released to Systematic Income subscribers and free trials on Nov. 15.

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 second 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

This week was fairly unusual in a few respects. First, while the majority of CEF sectors saw lower NAV returns (blue bars) due to sharply higher Treasury yields and lower stocks, all but one saw tighter or flat discounts (orange bars). This is unusual as discounts are usually procyclical, i.e. discounts also push prices upward when NAVs move higher and vice-versa.



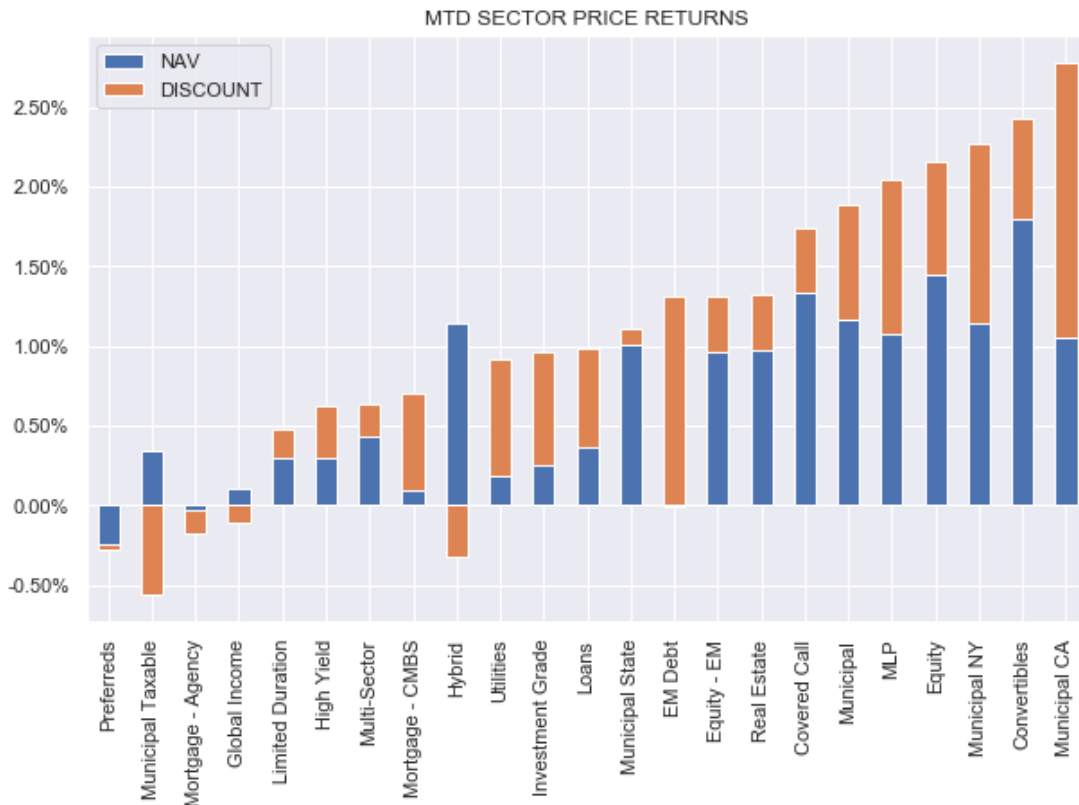
Source: Systematic Income

The second unusual dynamic is the fact that tax-exempt sectors rallied (with both NAVs and discounts contributing to higher prices) despite higher Treasury yields. The key bullish dynamic here is likely the passage of the Infrastructure Investment and Jobs Act which is a credit positive for the muni market. The IIJA is part of a recent one-two punch for the muni market following the aid delivered by the American Rescue Plan earlier.

The IIJA left a few things out such as the tax-exempt advance refundings as well as Build America Bonds however the two packages provide a solid backing for the municipal market over the longer term. The remaining piece of the puzzle is the tax reform which would make munis even more appealing. On the table is a reduction in a 15% minimum tax for corporations on tax-exempt bond interest and an increase in the \$10k SALT cap to \$80k.

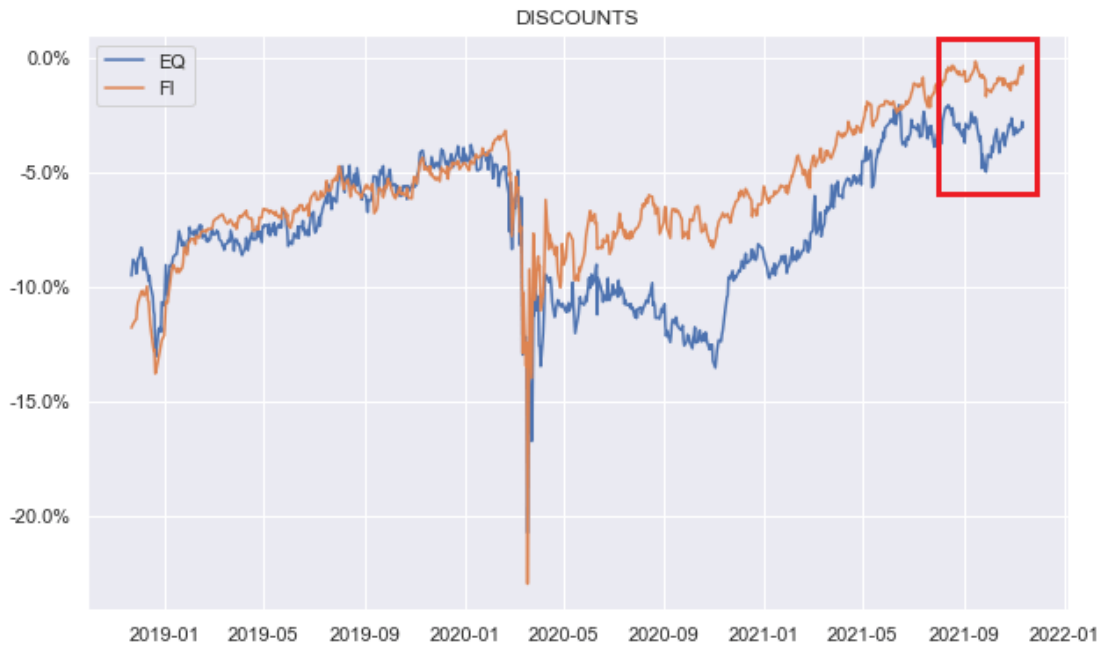
It may not feel like it but on a month-to-date basis Treasury yields are only marginally higher outside of the 3-year point which is 0.10% higher. The 10-year and 30-year yields are only 0.03% and 0.02% higher from the end of October.

This resilience in both CEF discounts as well as Treasury yields may seem surprising given the blaring headlines of the highest 30-year CPI reading. However, we have to keep in mind that core CPI at 4.6% is only marginally above the 4-4.5% year-on-year range it has been in over the last few months.



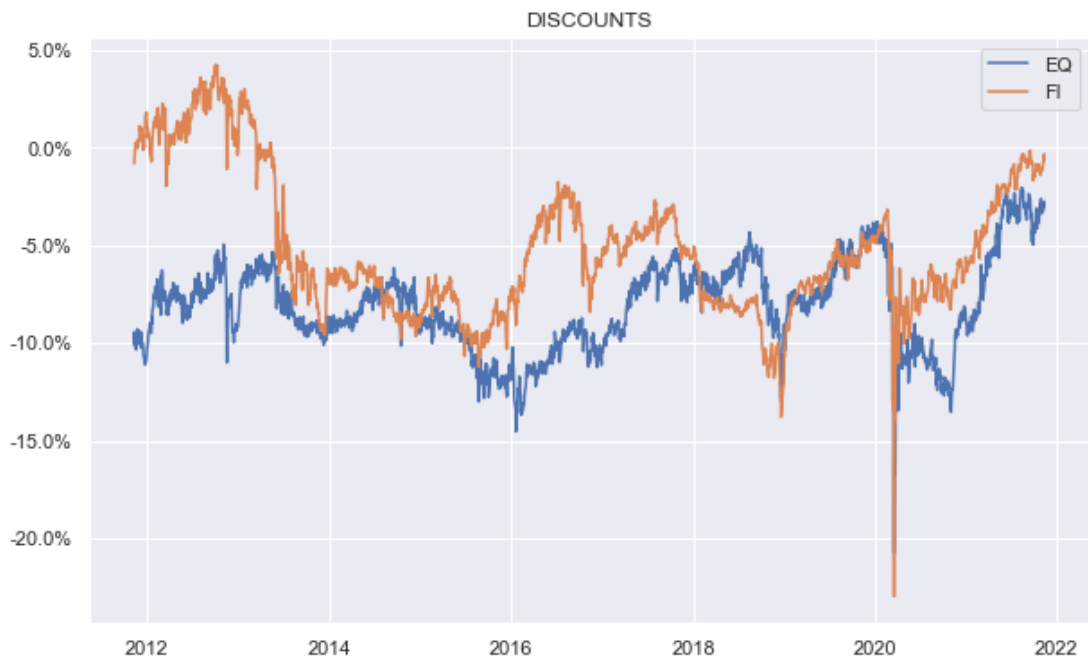
Source: Systematic Income

As far as CEF valuations, Equity and Fixed-income sector discounts have been retracing from their recent dips.



Source: Systematic Income

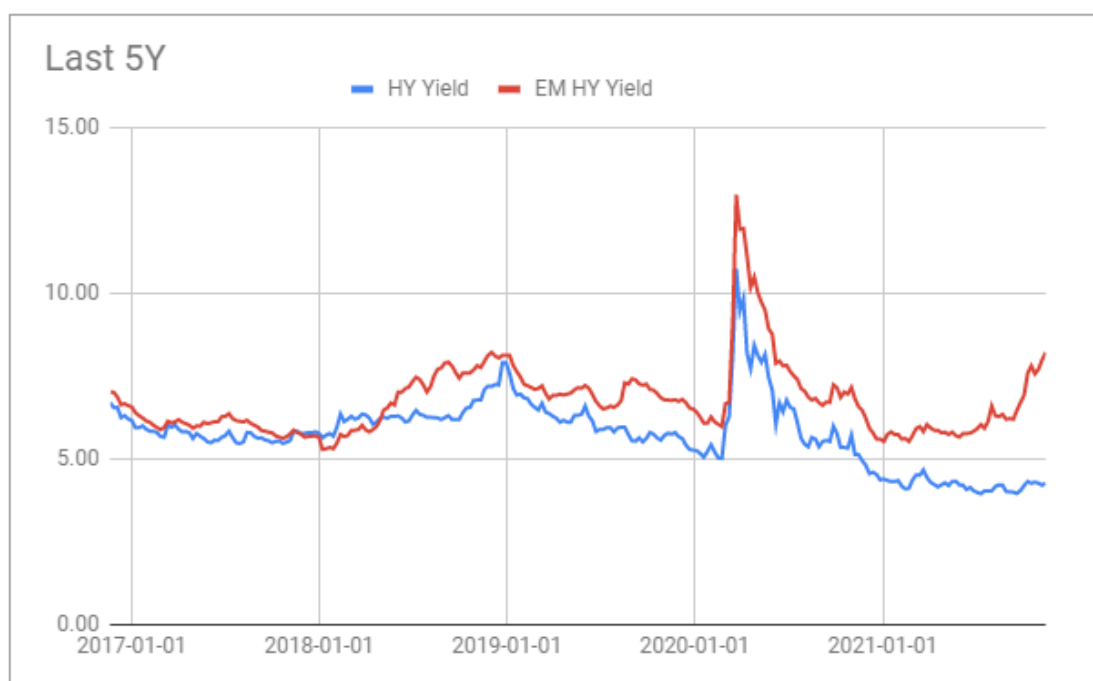
Both asset class discounts are trading not far from their longer-term tight. Fixed-income sectors discounts are staging a second go at breaking through a zero average sector discount while equity sector discounts are attempting to break through their recent 2% discount level.



Source: Systematic Income

Only one sector - MLPs - is trading at a negative 5-year z-score which highlights that the CEF space is more-or-less uniformly expensive. That said, there remain pockets of value in the space, particularly in terms of relative value rotations that we highlighted in earlier articles.

In terms of underlying sectors, we continue to like high-yield Emerging Market debt which has diverged recently from its US counterpart. The likely drivers here are worries about the sustainability of the global recovery, supply chain bottlenecks, slowing Chinese growth and a more hawkish turn by the Fed.



Source: Systematic Income

EM sovereign spreads are around 0.6% wide to long-term averages and spread per turn of leverage of 1.55% is nearly 4x that of the US at 0.4% per turn of leverage - the highest reading since the GFC. For investors worried about taking on duration risk we continue to like the Nuveen EM Debt 2022 Target Term CEF ([JEMD](#)) which has a sub-1 duration, a 4.66% distribution rate and a further 2% tailwind from discount compression into its likely termination next year.

Market Themes

Most income investors don't have the time to do a lot of due diligence in the income space and so rely on third-party analysis to build their portfolios. The trouble is that a lot of CEF analysis suffers from a few common pitfalls. In this section, we use the example of the Virtus AllianzGI Convertible & Income Fund ([NCV](#)) which has recently caught the attention of the fund commentariat.

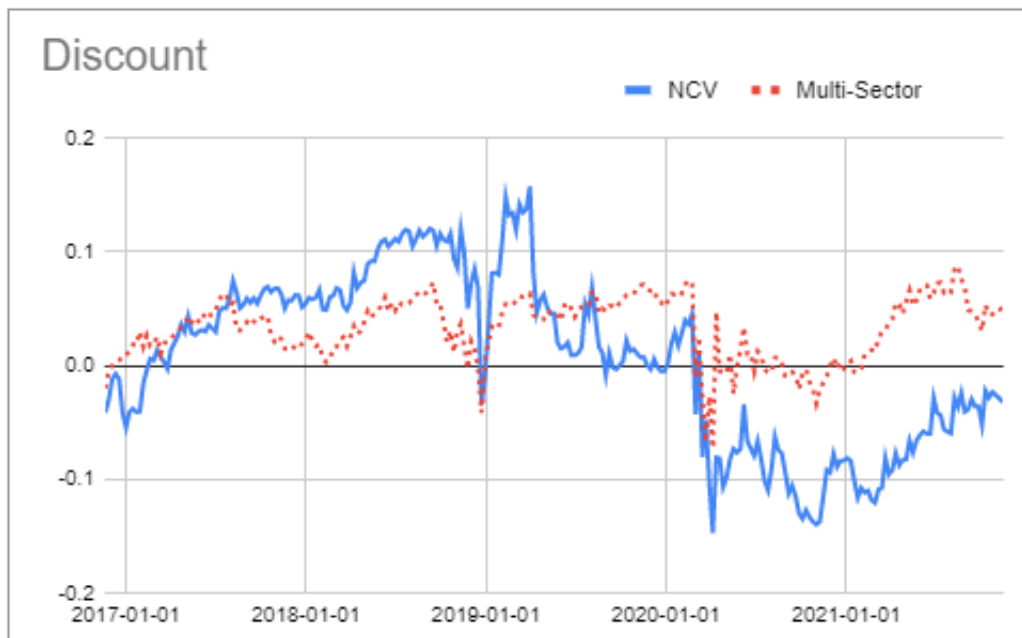
First, and most broadly, a lot of CEF analysis is, what we call, "**snowflake analysis**" which treats CEFs as utterly unique entities with little reference to either their sectors or the broader CEF space. This obviously does investors a disservice since most investors have finite capital and who look to allocate to the most appealing funds within a limited number of available investment strategies. This tendency afflicts not just NCV but the entire CEF space.

The second way that CEF analysis can go awry is to use the **wrong peer group** when analyzing a given fund. NCV is a great example of this because most analysis that bothers looking at NCV within a peer sector uses the wrong sector. This is either because analysts use the CEFConnect Convertibles sector by default or because they are taken by the "Convertible" in the name of the fund.

As it happens, NCV is 43% in convertible bonds and another 17% in convertible preferreds with the rest in corporate unsecured debt (which is why we have it in the Multisector part of the CEF market). However, much of its preferreds allocation is in busted convertibles which are convertibles in name only and behave like any other preferred stock. The other funds in the CEFConnect Convertibles sector (with the exception of PCF which simply looks like a mistake) have a much higher allocation to convertible securities.

The upshot here is that investors who look at the NAV historic return in the context of the Convertibles sector will be disappointed as NCV has indeed underperformed the sector. But this is a simple category mistake. Because convertibles have strongly outperformed corporate debt and preferreds, NCV has also underperformed more pure-play convertible funds. This doesn't make NCV a "bad" fund - it's just not the business that it is in.

As far as **discount valuation** a lot of commentary will simply look at the NCV discount relative to its own history, suggesting it is rich or cheap on this basis alone. The trouble with type of analysis is that it ignores what the rest of the CEF sector or the rest of the market is doing. This is like discussing a P/E of the stock and ignoring the valuation of the broader equity market. By this metric NCV is quite cheap relative to its history.



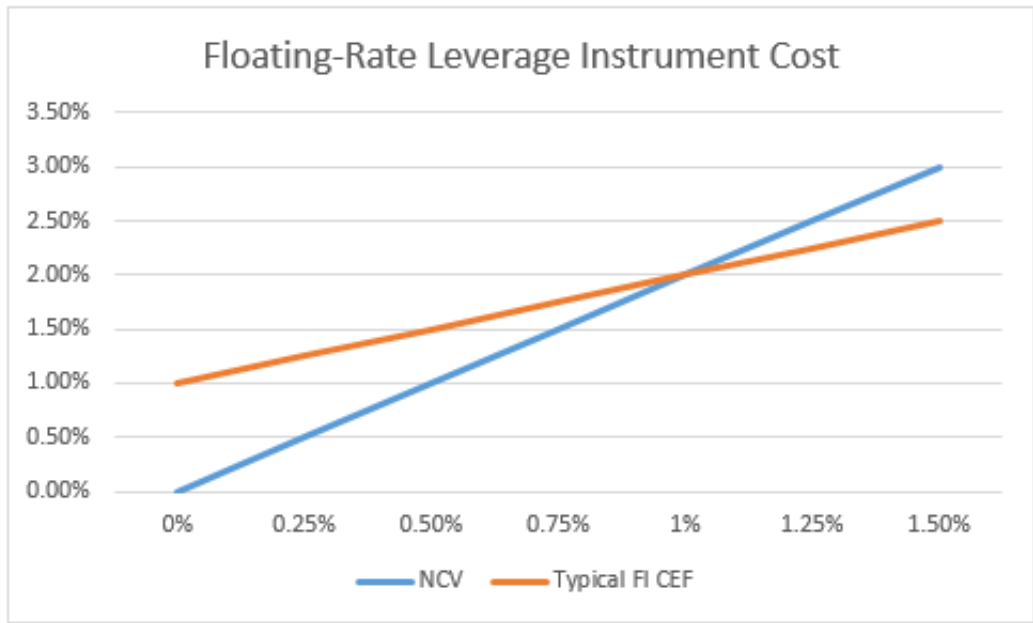
Source: Systematic Income CEF Tool

Another way that **ignoring a broader sector context** can lead investors astray is when discussing the fund's leverage cost. We often hear that a rise in short-term rates will also lead to a rise in the fund's cost of leverage. That's all fine and true but it ignores the key point that the fund's cost of leverage will rise at a much slower pace than the cost of leverage of most other fixed-income CEFs.

The reason for this is two-fold. First, NCV only has 2/3 of its leverage instruments in floating-rate instruments (i.e. auction-rate preferreds or ARPS) with the rest in a fixed-rate preferred. And secondly, the auction-rate preferred coupon is set to 2 x 7-day AA Composite Commercial Paper Rate (a kind of short-term working capital funding for high-quality companies) which will remain below the rate most other floating-rate leverage instruments like credit facilities and repo used by the vast majority of fixed-income CEFs for some time.

Most other fixed-income CEFs are funded via repo or credit facilities at a more-or-less rate of Libor+1%. And because the CP rate will also roughly follow Libor what we need to compare is $2 * x$ (the rate paid by NCV) versus $x + 1\%$ (the rate paid by the vast majority of other fixed-income CEFs) where x stands in for Libor / CP rate for various levels of x .

Khan Academy tells us that it takes an 8th-grader to solve a set of simultaneous equations but we reckon a clever 5th grader can do it as well. In any case what it means is that NCV will enjoy a lower leverage cost on its floating-rate leverage instruments, i.e. ARPS than a typical CEF on its credit facility or repo until Libor moves past 1% or roughly equivalent to 4 hikes by the Fed.



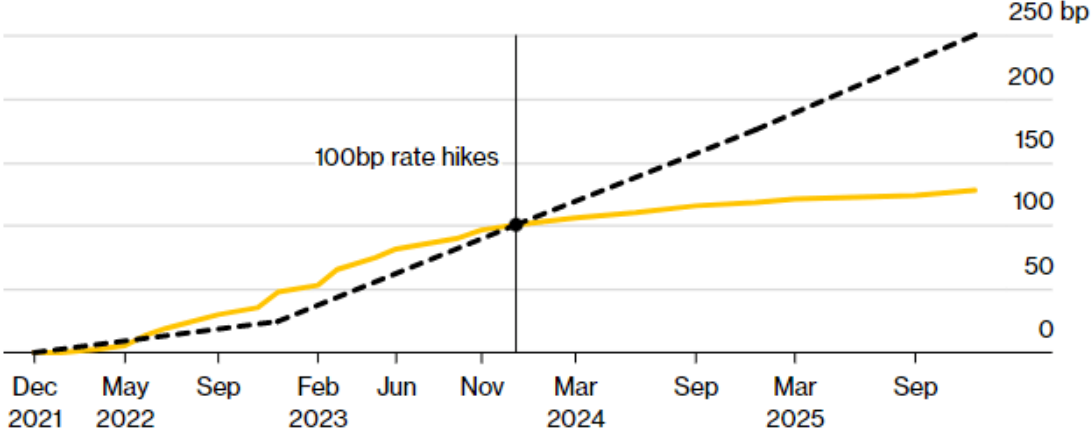
Source: Clever 5th Grader hired by Systematic Income

The market agrees with the Fed that we should see 4 rate hikes only by the end of 2023 which means NCV will enjoy a lower cost of leverage on its floating-rate instruments than the most of the rest of the fixed-income CEFs.

What's Priced In

Market expectations match Fed projections for 100bp rate hikes by end-2023

Legend: / Fed dot-plot forecast (dashed line), \ Current (solid line)



Source: Bloomberg

And keep in mind the first point that a third of the fund's leverage will not increase in price at all meaning its overall leverage cost increase will be below the rest of the CEF space for even longer.

Another problem with the typical approach to NCV is it **ignores its sister fund** - appropriately named Virtus AllianzGI Convertible & Income Fund II (NCZ).

On the asset side, the two funds are as identical as is practically possible in the CEF space.

This wasn't always the case, as the following NAV return chart shows; however, since about 2017 the two fund's NAV returns have tracked each other extremely closely.



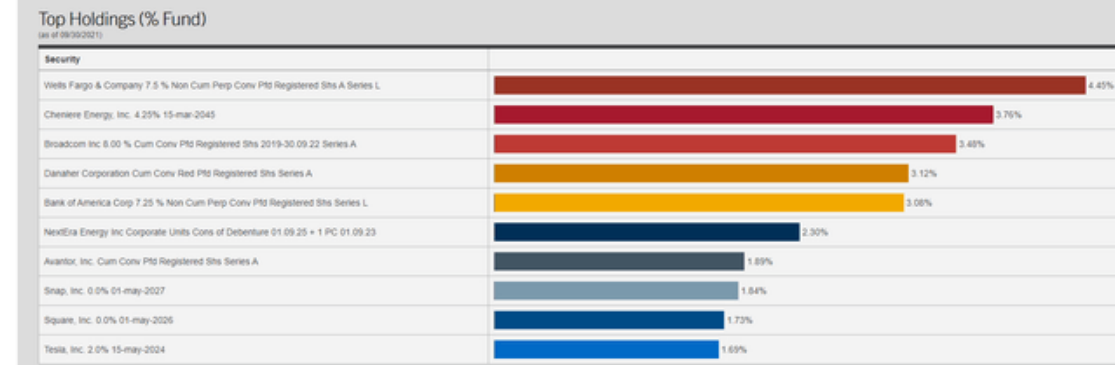
Source: Systematic Income CEF Tool

The 3-month rolling average daily NAV return correlation is pretty much at 100%

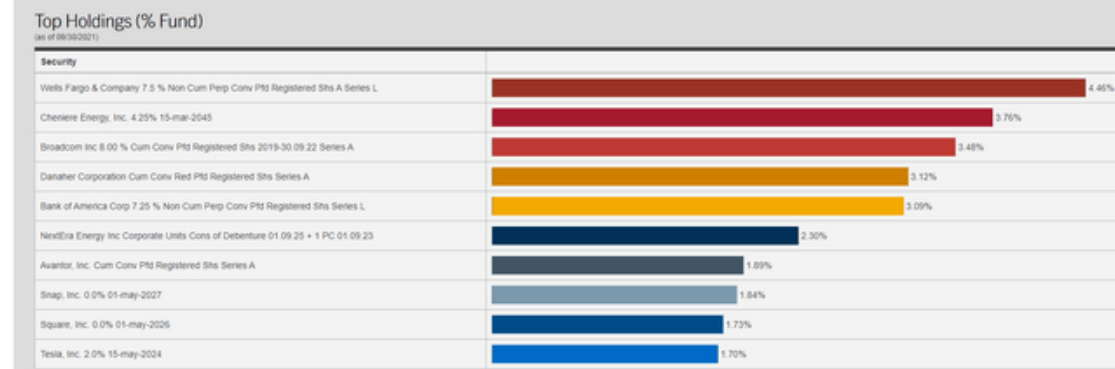


Source: Systematic Income CEF Tool

For fans of "spot the difference" we present the Top Holdings screenshots below for the two funds.



Source: NCV Site



Source: NCZ Site

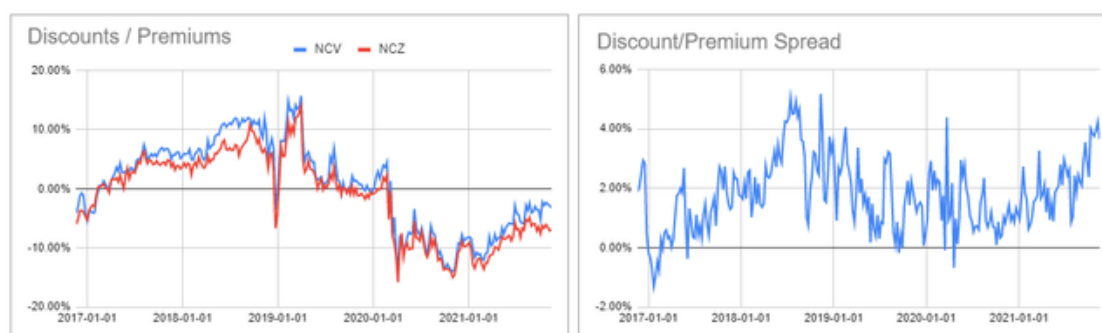
The two funds do have a difference on the liability side with NCV enjoying a somewhat lower weighted-average leverage cost than NCZ.

Liabilities (\$mm)	NCV	NCZ
ARPS	223.28	162.53
\$25-par	100.00	109.00
Loan	28.85	0.00
Total	352.13	271.53

Cost	NCV	NCZ
ARPS	0.12%	0.12%
\$25-par	5.63%	5.50%
Debt	0.53%	0.00%
WA leverage cost	1.72%	2.28%

Source: Systematic Income

This also pretty much explains why NCV has tended to trade at a tighter discount of the two.



Source: Systematic Income CEF Tool

It has also become a bit of a sport to pick on NCV and highlight its **low distribution coverage**. In our view, this misses the whole point of what NCV is trying to achieve. Here are the three most salient factors investors need to know about NCV (and for that matter any fund with a significant convertible debt holding).

1. The largest sector allocation of NCV is *convertible bonds*.
2. Convertible bonds have *ultra-low coupons* for the simple fact that they derive most of their value from the upside conversion.
3. NCV has a fairly *high NAV distribution rate* of 7.87%.

Therefore, it makes little sense to complain about the 50% distribution coverage of NCV. It is simply *not possible* for it to be anywhere near 100% given the set of facts above.

Investors who 1) want a fund with a high distribution and 2) want that fund to have high distribution coverage should absolutely avoid funds with pretty much any convertible bond holdings.

Here is a holdings screenshot of its Convertibles allocation with the coupon levels highlighted. The most common coupon is zero with the average probably somewhere around 1%. The fund is not trying to punish investors who want high coverage - that's pretty much what the convertible debt sector looks like.

Schedule of Investments

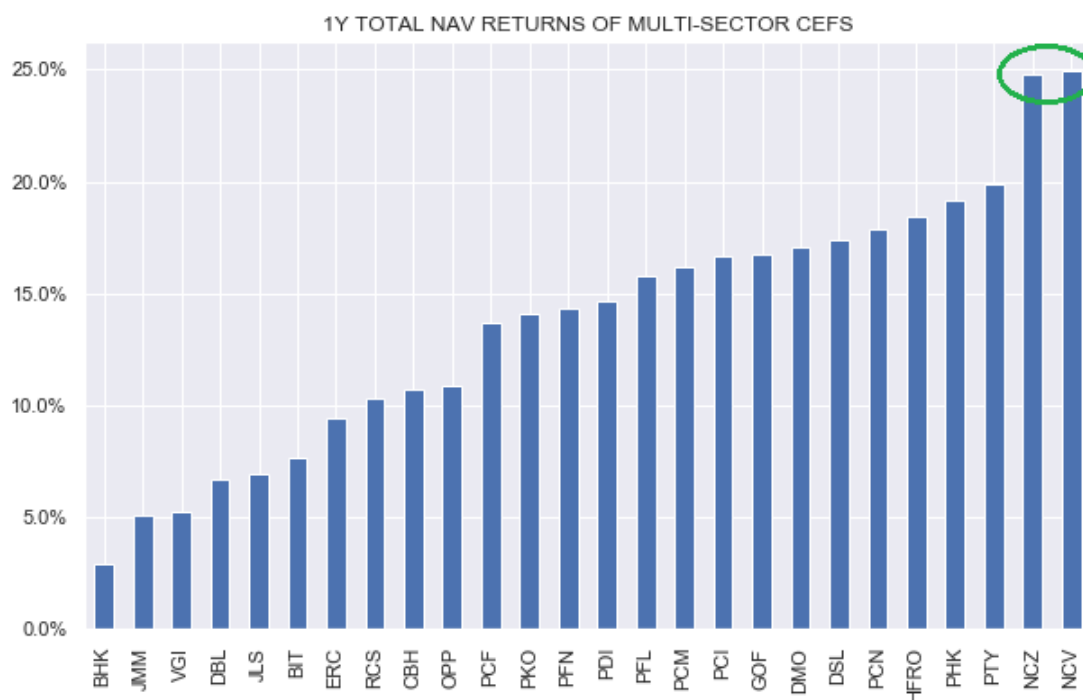
Virtus AllianzGI Convertible & Income Fund

May 31, 2021 (unaudited)

	Principal Amount (000s)	Value		Principal Amount (000s)	Value
CONVERTIBLE BONDS & NOTES—48.6%					
Airlines—1.4%					
JetBlue Airways Corp.,			zero coupon, 3/1/26	\$2,665	\$ 2,427,815
0.50%, 4/1/26 (a)(c)	\$ 5,235	\$ 5,703,532	zero coupon, 3/1/28	3,785	3,277,916
Southwest Airlines Co.,			Sunrun, Inc.,		
1.25%, 5/1/25	4,140	7,048,350	zero coupon, 2/1/26 (a)(c)	700	570,920
		<u>12,751,882</u>			<u>6,276,651</u>
Apparel & Textiles—0.9%					
Iconix Brand Group, Inc.,			Entertainment—1.4%		
5.75%, 8/15/23 (k)	14,740	7,860,945	DraftKings, Inc.,		
Auto Manufacturers—2.7%					
Ford Motor Co.,			zero coupon, 3/15/28 (a)(c)	6,165	5,610,150
zero coupon, 3/15/26 (a)(c)	8,390	9,224,995	Vail Resorts, Inc.,		
NIO, Inc. (a)(c),			zero coupon, 1/1/26 (a)(c)	6,875	7,313,281
zero coupon, 2/1/26	2,010	1,740,660			<u>12,923,431</u>
0.50%, 2/1/27	3,355	2,823,233	Equity Real Estate Investment Trusts (REITs)—0.9%		
Tesla, Inc.,			Bubblebrook Hotel Trust,		
2.00%, 5/15/24	1,060	10,653,000	1.75%, 12/15/26	3,620	3,982,000
		<u>24,441,888</u>	Two Harbors Investment Corp.,		
Banks—1.4%					
BoFA Finance LLC,			6.25%, 1/15/22	3,975	4,034,625
0.125%, 9/1/22	5,970	7,008,780			<u>8,016,625</u>
JPMorgan Chase Bank N.A.,			Healthcare-Products—0.8%		
0.125%, 1/1/23 (a)(c)(m)	5,220	5,702,850	Insulet Corp.,		
		<u>12,711,630</u>	0.375%, 9/1/26	3,265	4,381,222
Biotechnology—1.2%					
BridgeBio Pharma, Inc.,			NonoString Technologies, Inc.,		
2.25%, 2/1/29 (a)(c)	3,125	2,909,879	2.625%, 3/1/25	2,275	3,200,697
Exact Sciences Corp.,					<u>7,581,919</u>
0.375%, 3/1/28	5,125	5,893,750	Healthcare-Services—1.4%		
Halozyme Therapeutics, Inc.,			Oak Street Health, Inc.,		
0.25%, 3/1/27 (a)(c)	2,435	2,170,194	zero coupon, 3/15/26 (a)(c)	5,840	6,011,550
		<u>10,973,823</u>	Teladoc Health, Inc.,		
Building Materials—1.1%					
Patrick Industries, Inc.,			1.25%, 6/1/27 (a)(c)	6,315	6,654,431
1.00%, 2/1/23	8,820	10,357,987			<u>12,665,981</u>
Commercial Services—2.2%					
Alarm.com Holdings, Inc.,			Internet—11.4%		
zero coupon, 1/15/26 (a)(c)	3,150	2,866,500	21Vianet Group, Inc.,		
Chegg, Inc.,			zero coupon, 2/1/26 (a)(c)	3,075	2,606,063
zero coupon, 9/1/26 (a)(c)	4,915	4,951,862	Airbnb, Inc.,		
Shift4 Payments, Inc.,			zero coupon, 3/15/26 (a)(c)	7,940	7,400,080
zero coupon, 12/15/25 (a)(c)	2,615	3,530,381	Booking Holdings, Inc.,		
Square, Inc.,			0.75%, 5/1/25 (m)	3,120	4,587,960
zero coupon, 5/1/26 (a)(c)	8,400	9,140,250	Etsy, Inc.,		
		<u>20,488,993</u>	0.125%, 9/1/27 (a)(c)	2,595	3,005,010
Energy-Alternate Sources—0.7%					
Enphase Energy, Inc. (a)(c)			Expedia Group, Inc.,		
zero coupon, 3/1/26			zero coupon, 2/15/26 (a)(c)(m)	5,005	5,518,012
zero coupon, 3/1/28			FuboTV, Inc.,		
Sunrun, Inc.,			3.25%, 2/15/26 (a)(c)	7,405	6,507,144
zero coupon, 2/1/26 (a)(c)			Magnite, Inc.,		
			0.25%, 3/15/26 (a)(c)	4,905	4,175,626
			Match Group Financeco 2, Inc.,		
			0.25%, 6/15/26 (a)(c)	2,155	2,714,601

Source: NCV

The point of a CEF with a significant convertible debt holding is in the upside it can achieve in a reflationary environment where higher interest rates could limit the gains of the more traditional fixed-income funds. This is what the 1-year total NAV return picture looks like for the two funds in the sector - an environment we would describe as reflationary. And on a price basis they are not 1 and 2 but 2 and 3.



Source: Systematic Income

So why not hold more pure-play convertible funds? Well, that's certainly possible but we like these two funds for three reasons. First, they offer additional alpha from relative value rotations. Secondly, they do actually have significantly higher NII than more pure-play convertible CEFs which is something. And thirdly, they have a more robust leverage profile as preferreds cannot force a fund to deleverage unlike a repo or credit facility. These two funds did not deleverage at all in 2020 unlike a number of their competitors like the DoubleLine and PIMCO funds.

In short, NCV is a good case study for how some investors can end up with a wrong end of the stick from the analysis they may come across. We continue to hold NCZ in our High Income Portfolio - a recent rotation from NCV.

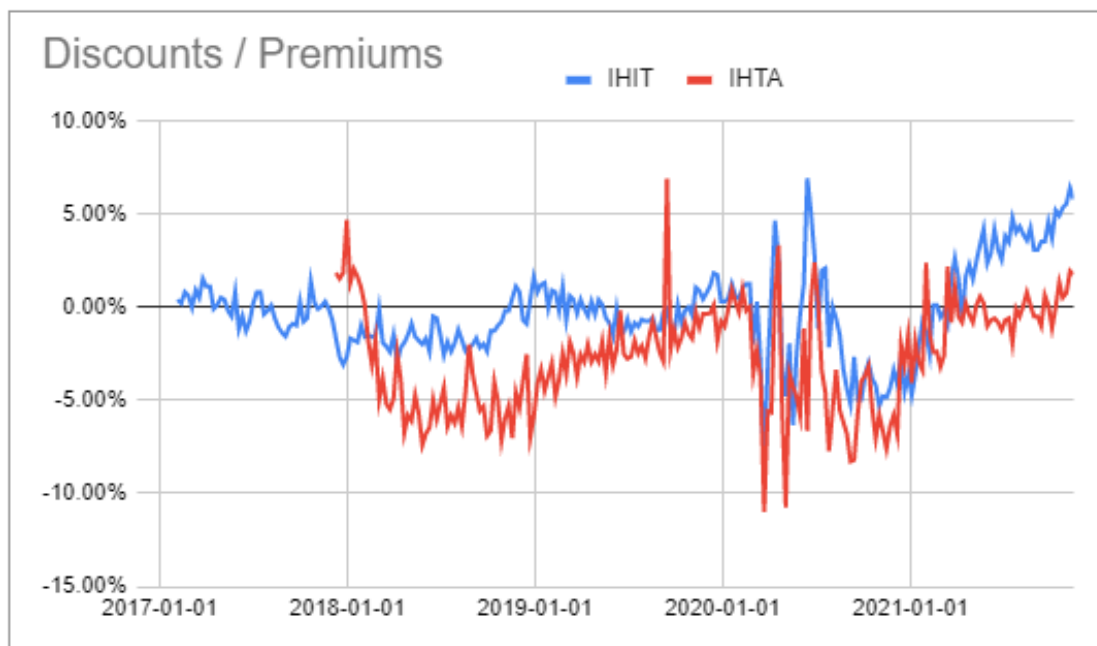
Market Commentary

Invesco CMBS Target Term CEFs, High Income 2023 Target Term Fund (IHIT) and High Income 2024 Target Term Fund (IHTA), released shareholder reports covering the semi-annual period ending in August. NII increased 7.4% and 10% for IHTA and IHIT respectively in annualized terms over the previous year. NAV NII yields are 7.03% and 5.90% for IHIT and IHTA which is not something we would expect since IHIT is a 2023 term fund and IHTA is a 2024 term fund.

Because IHTA holds longer-term securities it should have a higher NAV NII yield all else equal. It's possible that this is due to IHTA holding more cash (also a weird issue since we would expect IHIT to hold more cash, if anything, as it's closer to termination). Coverage is high at 125% and 119% so it's a bit odd they decided to cut a few months ago – perhaps they don't see the increase in NII as sustainable.

Both funds also partially hedge their repo exposure (and also hold floating-rate assets) which means they won't be impacted as much when short-term rates finally get off the floor.

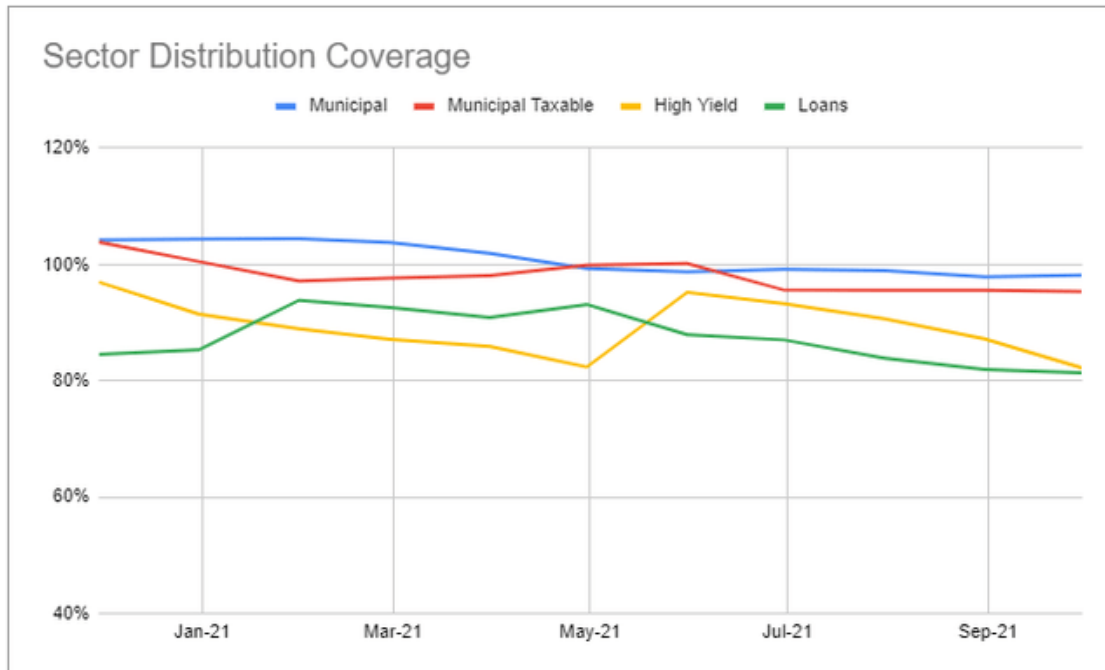
Both funds delivered 1Y price returns of around 33% which puts the PIMCO fixed-income taxable funds to shame (which only managed an average of around 23% - on a NAV basis the two groups are roughly similar). The funds have been part of the High Income Portfolio since inception with IHTA as the current pick due to the more attractive valuation.



Source: Systematic Income CEF Tool

We updated BlackRock CEF distribution coverage for September - BlackRock tends to be late in posting numbers for all their funds. Both taxable and muni coverage generally ticked lower.

We track coverage and UNII numbers for over 100 CEFs across four fund families which disclose their numbers on a monthly basis. The chart below aggregates coverage (typically defined as 3-month rolling distribution coverage) and doesn't inspire a lot of confidence.



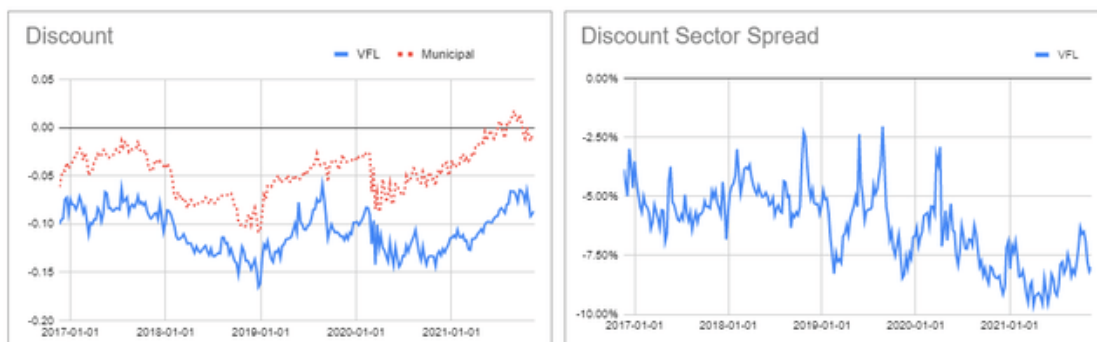
Source: Systematic Income CEF Tool

It's not exactly falling off a cliff but all 4 major sectors are lower now than when they started the year. Part of this is due to a few distribution hikes but the general trend lower is also likely due to a couple of trends that should be playing out in the medium term - deleveraging associated with NAV erosion (due to overdistribution vs. portfolio yields) and a forced rotation into lower-coupon securities.

Something else on the radar is the eventual Fed policy rate hike which would increase the cost of the vast majority of CEFs and immediately hit coverage. Investors who prize distribution stability should be looking at funds with rate hedges, fixed-rate leverage instruments, unleveraged funds or funds with floating-rate assets which could offset the rise in cost on the liability side of the balance sheet. We will be highlighting these funds in due course on the service.

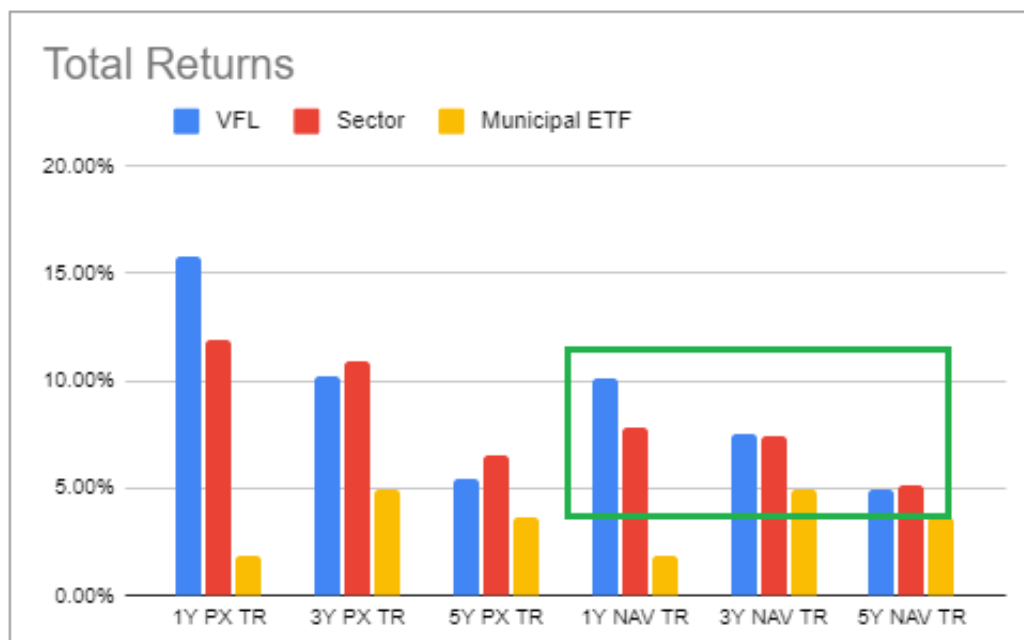
Three Delaware muni CEFs are merging – (VCF), (VMM) into (VFL). All are trading at mid-to-high single digit discounts which is likely due to the lack of Delaware / Macquarie brand name cachet.

This is a comparative discount chart of VFL relative to the sector.



Source: Systematic Income CEF Tool

VFL 5Y total NAV returns have just about matched the sector (and slightly beaten on a 3Y basis).



Source: Systematic Income CEF Tool