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Closed End Funds

CEF Weekly Market Review: Mind Your CEF Expenses

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Summary

- We review CEF market valuation and performance over the third week of November and highlight recent market events.
- The CEF market had an off-week with nearly all sectors delivering lower NAVs and wider discounts.
- The CEF market has clearly downshifted with recent performance more-or-less treading water, in aggregate.
- We discuss why investors should mind the expenses of their CEF holdings and how they can do that.
- We highlight distribution rises from the Allspring funds, recap some of the details of WDI, and touch on our add to DSL across our Income Portfolios.
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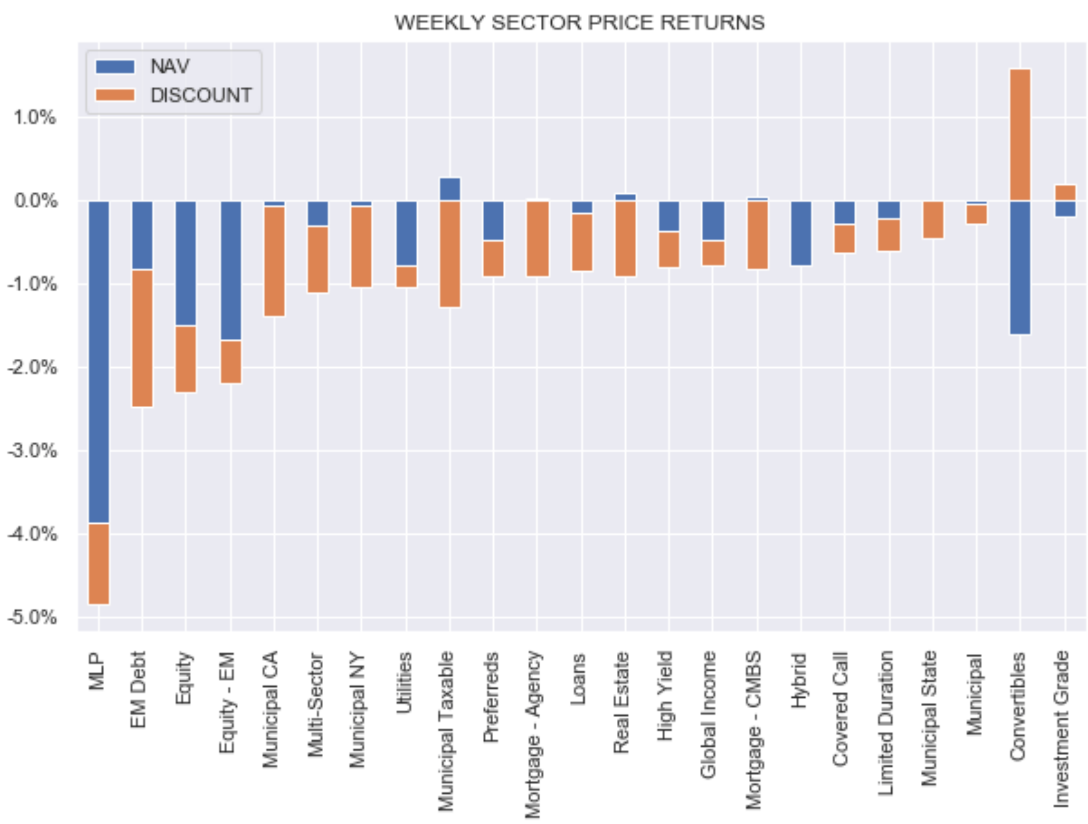
This article was first released to Systematic Income subscribers and free trials on Nov. 21.

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 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.

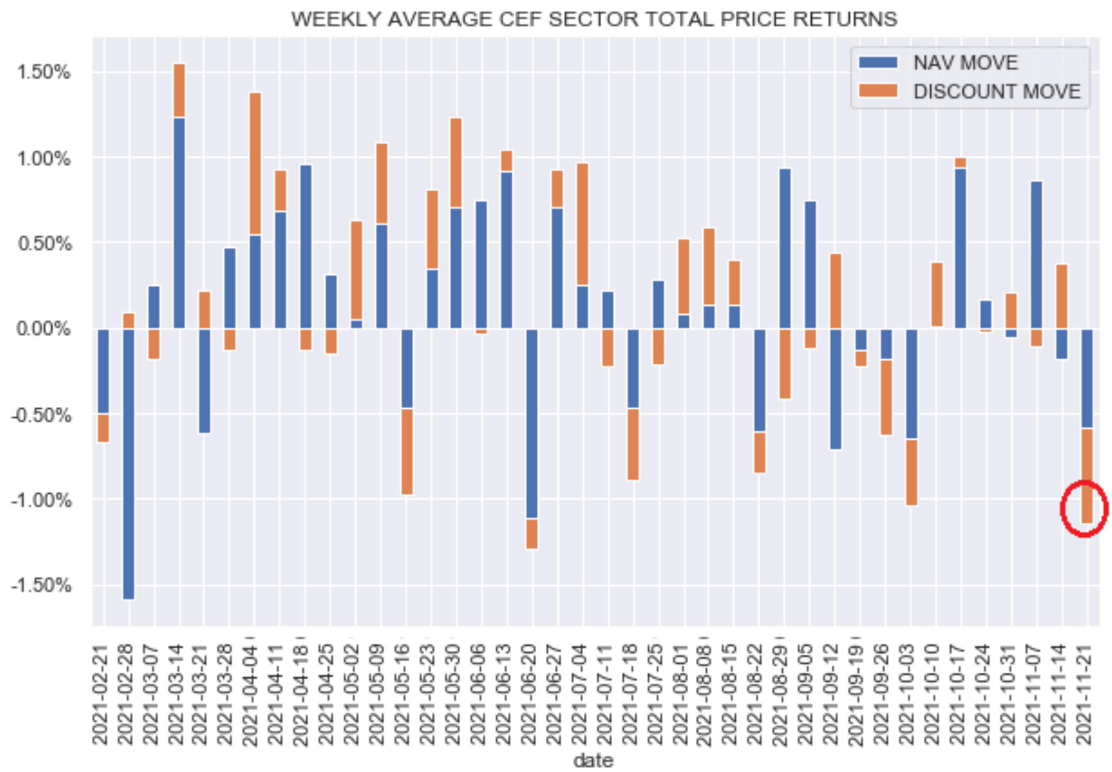
Market Overview

It was a striking week in the CEF space with close to universal weakness. All but three sectors finished with lower NAVs and only two sectors managed a rally in discounts.



Source: Systematic Income

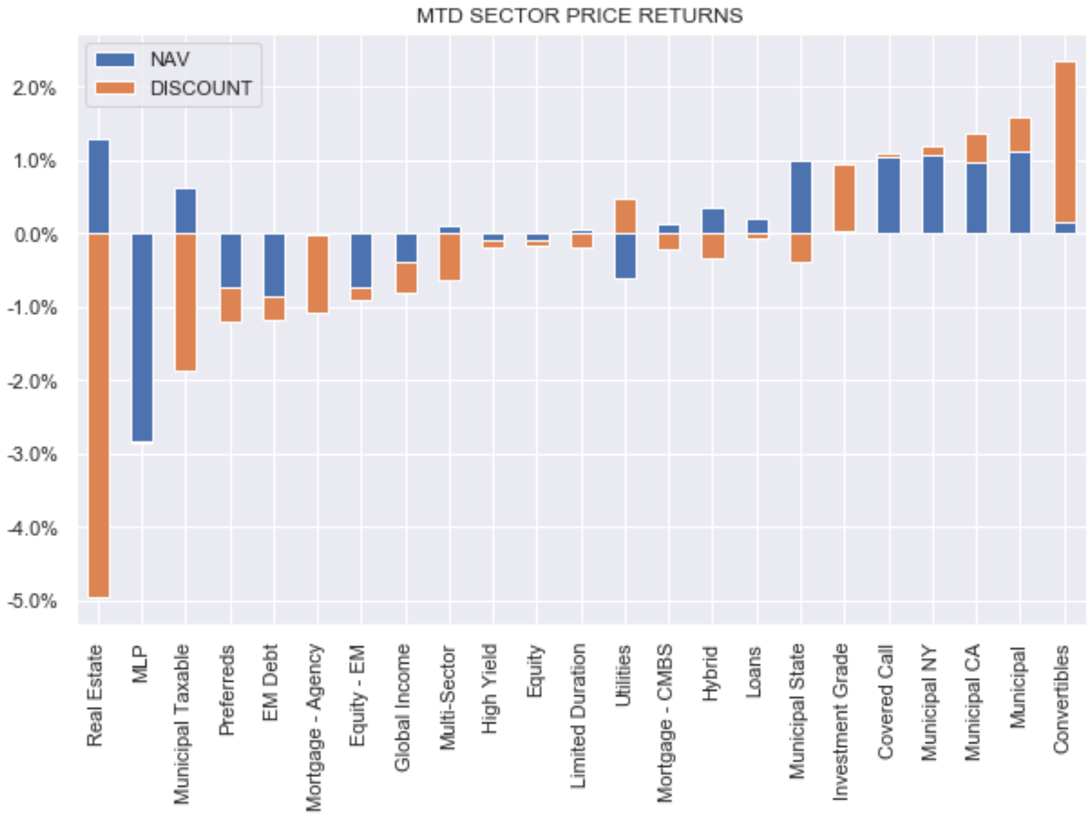
The aggregate return this week was the worst since June and February before that, though it is only a touch worse than a 1% drop.



Source: Systematic Income

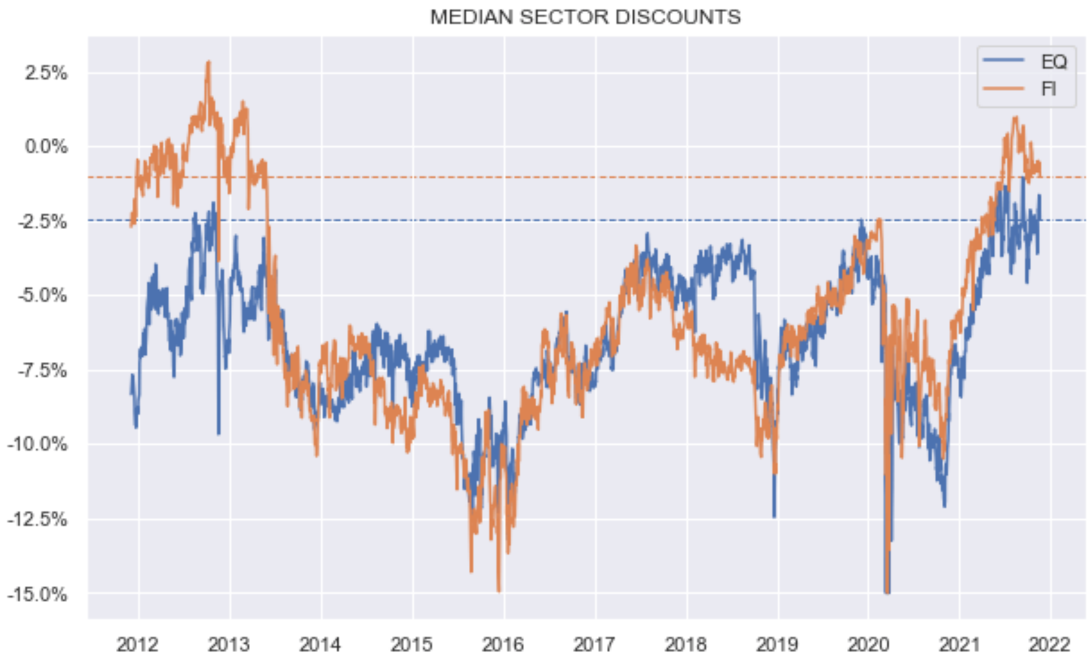
Broad-based weakness, in itself, is not all that rare. What is more unusual is that this weakness has come despite a drop in Treasury yields and mostly stable or mixed performance in broad equity indices with the S&P 500 and the Nasdaq in the green and the Dow and Russell 2000 in the red.

On a month-to-date basis, returns are much more balanced with tax-exempt sectors and convertibles outperforming.



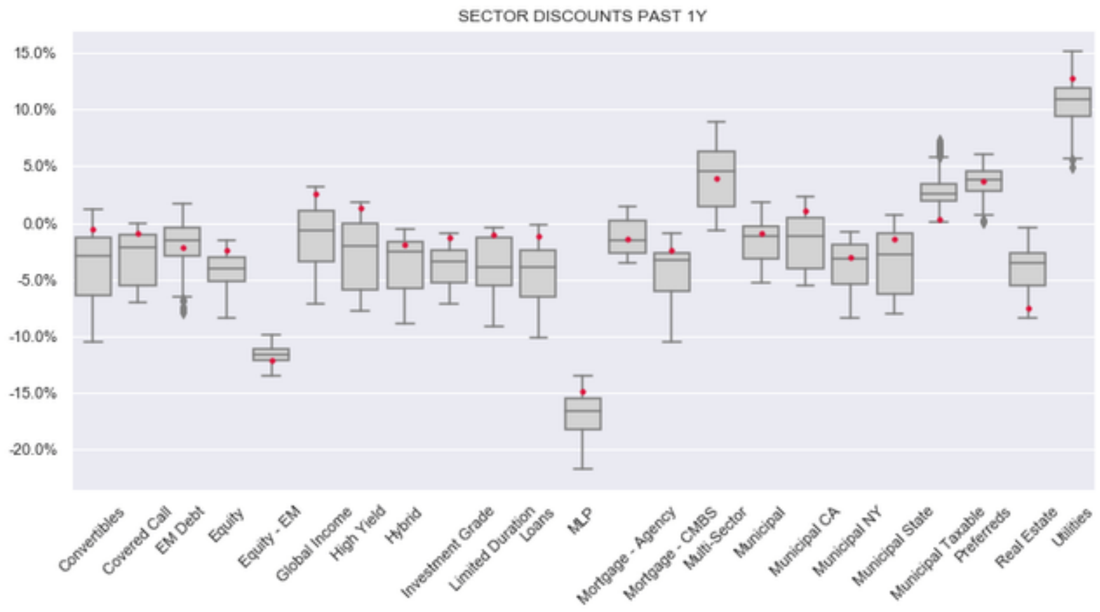
Source: Systematic Income

Fixed-income CEF discounts are trading close to their wides of the last 5 months or so though from a longer-term perspective they are still on the expensive side. The asymmetric risk to CEF prices that we have been highlighting over the last few months is now happening on a number of fronts - through lower NAVs due to wider credit spreads in the last two weeks as well as wider discounts, particularly in fixed-income over the last few months. That said, the moves have, so far, been very benign by historic standards.



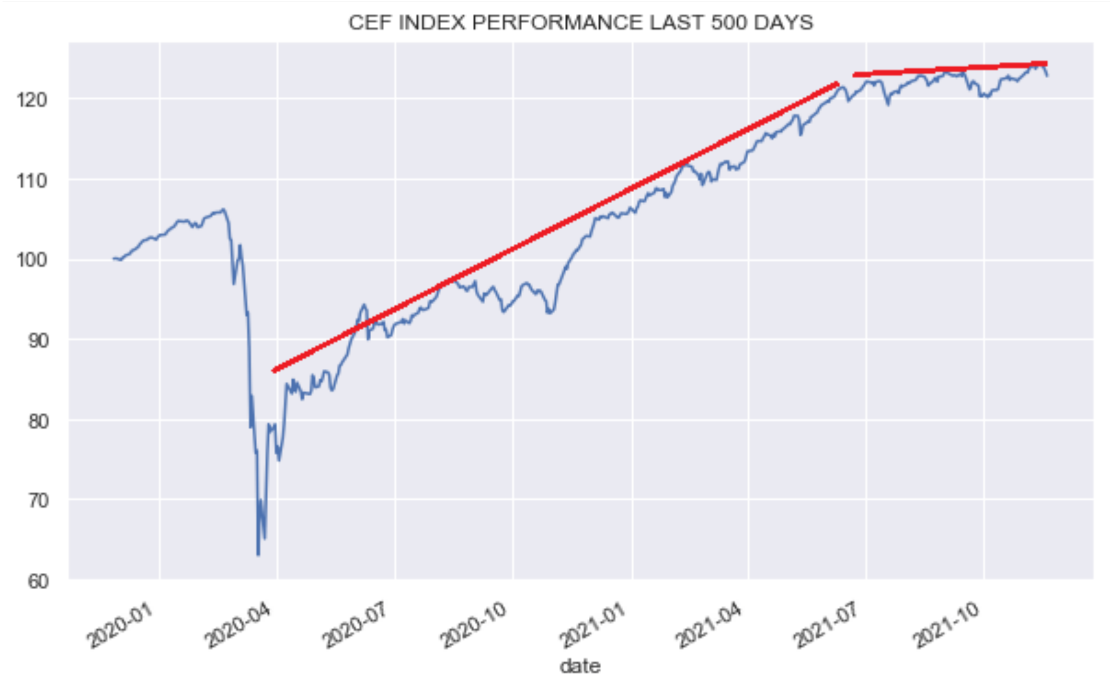
Source: Systematic Income

If we check in on the trading range in discounts of CEF sectors over the past year we see that the municipal taxable and the REITs sectors have seen the largest discount deflations this year. The taxable muni sector is now, arguably, much more fairly priced - the high premium of the sector was a conundrum to us last year.



Source: Systematic Income

The big picture for CEF investors is that the performance slope of the broader market has downshifted considerably. The CEF market had a sharp run-up coming out of the COVID drawdown and has now subsided to a nearly flat line.



Source: Systematic Income

The combination of fixed-income yields at historically low yields, discounts near historically tight levels and the Fed, seemingly, a few quarters away from hiking rates and driving up CEF leverage costs, creates a tricky environment to navigate for CEF investors.

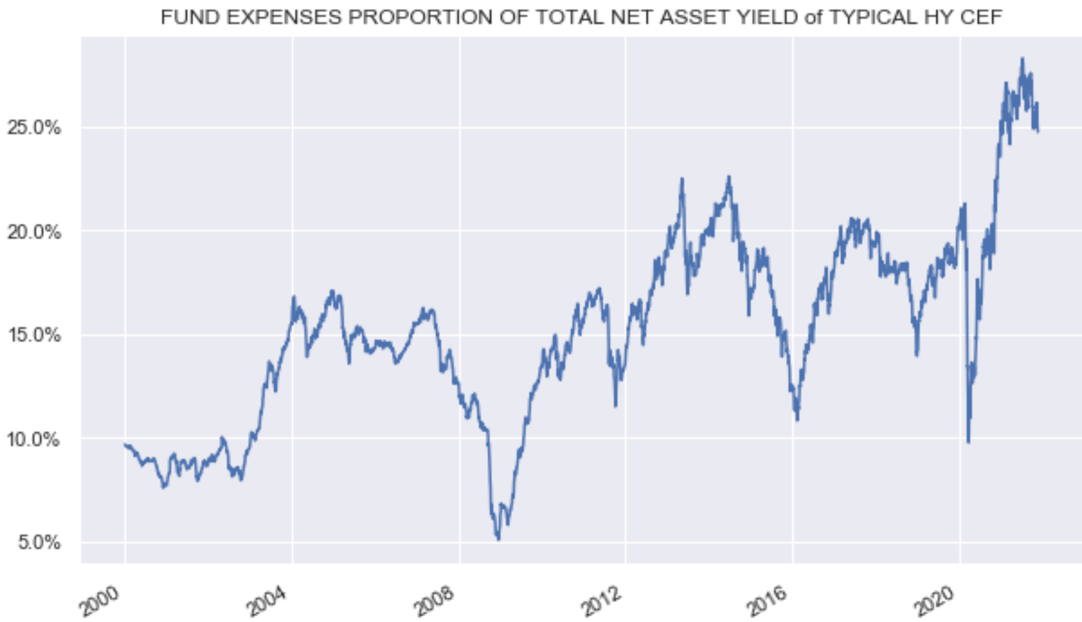
Market Themes

Just like investors are told to be mindful of their expenses in retirement - "a penny saved is a penny earned" - investors should be as mindful of the expenses of their investment holdings.

This is particularly the case for two reasons. First, overall yields have fallen over the last decade whether you look at corporate bonds, US Treasuries, floating-rate products like loans, etc. This is at the same time that fund fees have remained fixed and, have even risen for more recently launched funds.

Source: FRED

If we combine these two dynamics we see that fund expenses (the sum of management fees and leverage costs) have risen as a percentage of the underlying portfolio yield.

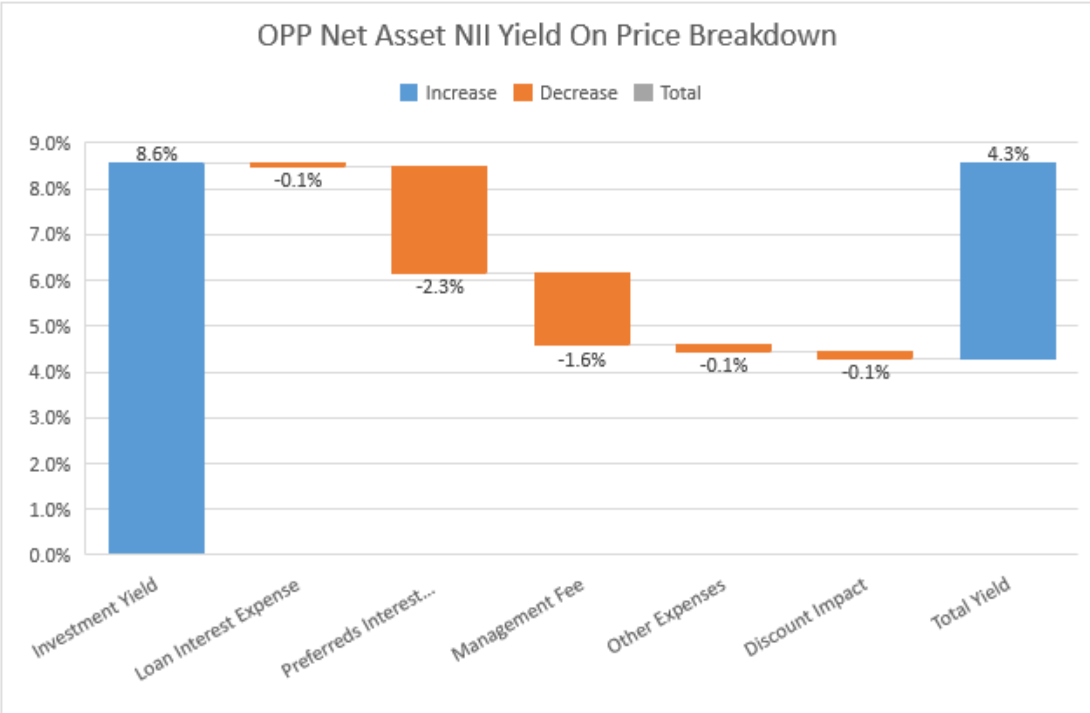


Source: Systematic Income

And the second reason investors ought to be mindful of fund fees is that leverage costs for the majority of funds that use leverage are set to rise because most CEF leverage costs are tied to short-term rates. The market currently expects the Fed to start hiking around mid-year and complete two hikes by next year, raising leverage costs by 0.5%.

Our favorite tool for analyzing fund expenses is a simple dis-aggregation of the fund's total underlying yield. As an example, we use the RiverNorth/DoubleLine Strategic Opportunity Fund (OPP). We use this fund because, as readers of our Preferreds Weekly are aware, it has recently issued a new series of preferreds. We take this opportunity to calculate what the fund's yield profile would be with the preferreds as part of its capital structure, in addition to the existing $21m loan and Series A (OPP.PA) preferred issued earlier.

Our starting point is a total investment yield on net assets of 8.6% which is simply the fund's total investment income of $17.1m for the previous year, adjusted by the new ~$60m of proceeds from the preferreds which should take us to around $20.3m. Our denominator is the net asset number of around $237m. In other words, we should expect the fund to generate NII of 8.6% on its NAV.



Source: Systematic Income

We then subtract the fund's expenses, starting with loan interest of Libor + 0.95% on $21m, followed by the two preferreds - the 4.375% Series A and the 4.75% Series B (OPP.PB) on $60m each, a management fee of 1% on total assets as well as sundry expenses. Finally, in order to convert the resulting net NII NAV yield to a net NII price yield, we take into account the fund's 3% premium which marginally lowers the yield also.

At the end of this process, we are left with a yield on price of 4.3%. This number is the amount of net investment income the fund generates on the fund's share price.

This dis-aggregation process highlights two interesting things. First, half of the fund's underlying income goes to pay for its expenses, which, as CEFs go, is on the higher side for fixed-income funds. And secondly, the yield on the preferreds is actually higher than the NII yield of the common shares which certainly seems the wrong way around, particularly in the fixed-income space.

Of course, none of this stops OPP from having a distribution rate of 12.66%, however, this has little bearing on what the fund's actual NII looks like. It's also important to highlight that the fund's total annualized NAV return is around 4.6% since 2000 - which is not only very low in the sector but is obviously a far cry from its very high distribution rate and much more in line with its NII.

The key takeaway here is that this yield dis-aggregation process can inform investors of how much of the total underlying yield is passed down to them - this figure is about 50% for OPP once the new preferred comes on board. And secondly, it can provide a better measure of total forward NAV returns than a fund's distribution rate, particularly for fixed-income focused funds. A better understanding of how the "sausage is made" can put investors on a solid footing in making their CEF allocations.

Market Commentary

Wells-Fargo (now Allspring) CEFs did their usual distribution hikes. Recall that these are in line with their managed distribution policies which are based on a 12-month NAV lookback, something we discussed earlier, just as the funds were about to embark on a series of distribution rises which is ongoing. As the lower NAVs from 12 months ago fall out of the lookback window, the funds will keep raising their distributions. Allocating to CEFs with formulaic MDPs is one way to mitigate the risk of distribution surprises.

The funds have also authorized 10% share repurchases in 2022. Many funds have repurchase programs in place - their existence doesn't mean they are actually implemented. That said, it's nice to have since a fund that can repurchase its shares and does so not only supports its price (through a drawdown presumably) but it can also generate additional value through NAV accretion by buying shares at a discount and then retiring the underlying assets at the NAV. Within this suite, the Income Opportunities Fund (EAD) remains in our High Income Portfolio due to superior historic returns, attractive valuation, and a predictable distribution policy.

The **Western Asset Diversified Income Fund** (WDI) - a multi-sector credit fund - is a fund we have recently added to our CEF Investor Tool. It has a 1.10% fee which is quite steep in the credit space. Unfortunately, the trend in CEFs has been to increase fees - you can see this trend in the PIMCO CEFs that started off around 0.6-0.8% a few decades ago and their more recent funds are at 1.15% (PDO, PCI, PDI). This is obviously at the same time as overall yields have moved lower which means that CEF management fees have eaten up an increasing share of fund income.

In any case, WDI is also a term CEF with an expected termination date in 2033. The fund is trading at a 5.5% discount which translates to about a 0.47% Pull-to-NAV or PTN Yield i.e. the annual headwind you get from discount compressing to zero by the termination date. This is a best-case scenario as the board can extend termination for 2 years and, obviously, shareholders can always vote to get rid of the termination and turn the fund into a perpetual fund.

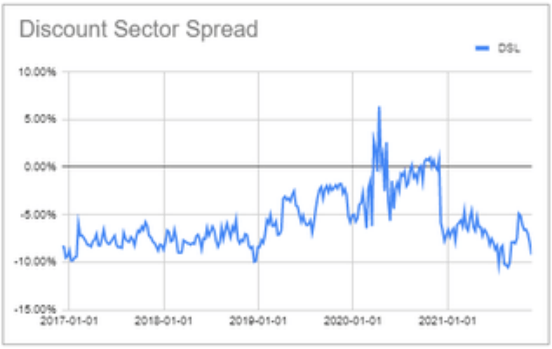
A 0.47% PTN Yield is on the high side in the space with the average PTN Yield near zero. WDI will be run at 20-30% leverage with some CLO holdings so it should be on the higher-yielding side in the Multi-Sector space plus the PTN Yield tailwind. So far it looks OK at its valuation which is about 9% wider of the sector average. Its duration is expected to be on the low side initially according to the fact sheet.

It's too early to gauge performance as it's still holding quite a bit of cash and doesn't appear to use leverage. NAV at $19.78 is not far from the $20 IPO of this summer. Holders are probably disappointed with the price performance which is down close to 6% since the IPO and so maybe dumping it. It could be worth picking up some if this keeps going.

This week we marginally added to the **DoubleLine Income Solutions Fund** (DSL) - a Multi-Sector CEF in our Portfolios. The fund is overweight EM debt with a 40% allocation - an asset class which is unusually cheap relative to US High Yield debt - something we also highlighted in the previous weekly. The rest of the fund is in HY corporates, CMBS, CLOs, and other fixed-income securities. The fund's duration is on the shorter side at 3.6.

The fund has put up very strong returns in the past year with a total NAV return of 15.2% - about 2.5% above the sector average and stronger than the majority of the PIMCO taxable funds despite its EM overweight.

At the same time, valuation relative to the sector has lagged with DSL trading close to 10% wider of the sector average.



Source: Systematic Income CEF Tool

Stance And Takeaways

The CEF market has entered a tricky phase with prospective returns unlikely to match what investors have gotten used to over the last year-and-a-half. That said, we continue to find value in the space, particularly among some of the more niche fixed-income sectors, funds with a consistent level of alpha generation, funds with a reflationary profile such as a partial convertible debt allocation as well as relative value rotation opportunities - all of which should continue to drive returns over the medium term.