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Closed End Funds

CEF Weekly Market Review: Don't Look At CEFs As A Black Box

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Summary

- We review CEF market valuation and performance over the fourth week of November and highlight recent mark.
- The last full week of November continued the weak trend earlier in the month.
- We highlight funds with potential tax-loss selling risk as well as funds that have remained resilient in the post-Thanksgiving sell-off.
- We discuss the tendency to view CEFs as a black box which makes it difficult to make sensible comments about a fund's future behavior.
- And highlight the price action of the new Nuveen hybrid fund NMAI.
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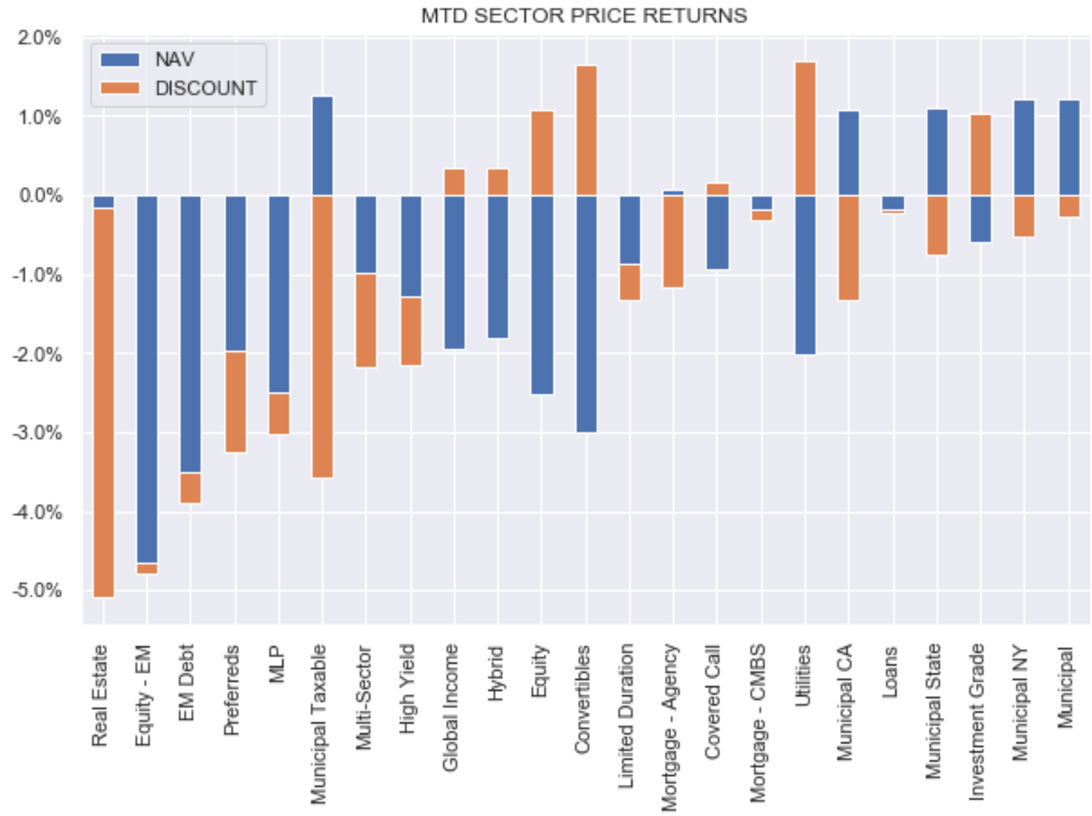
This article was first released to Systematic Income subscribers and free trials on Nov. 29.

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 fourth 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.

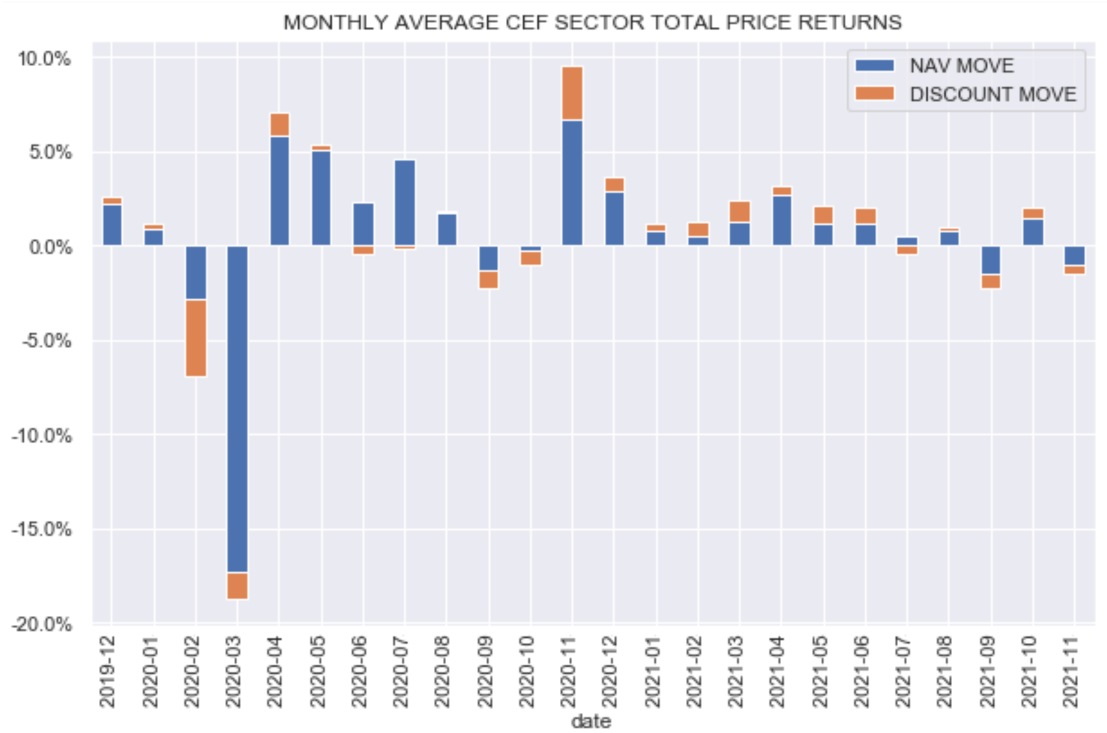
Market Overview

The last full week of November did not deliver any better news for CEF investors than the price action earlier in the month. Only the muni and agency sectors saw positive NAV returns - the result of a drop in Treasury yields. On a month-to-date basis, the picture is not much different with municipal sectors outperforming in NAV and price terms.



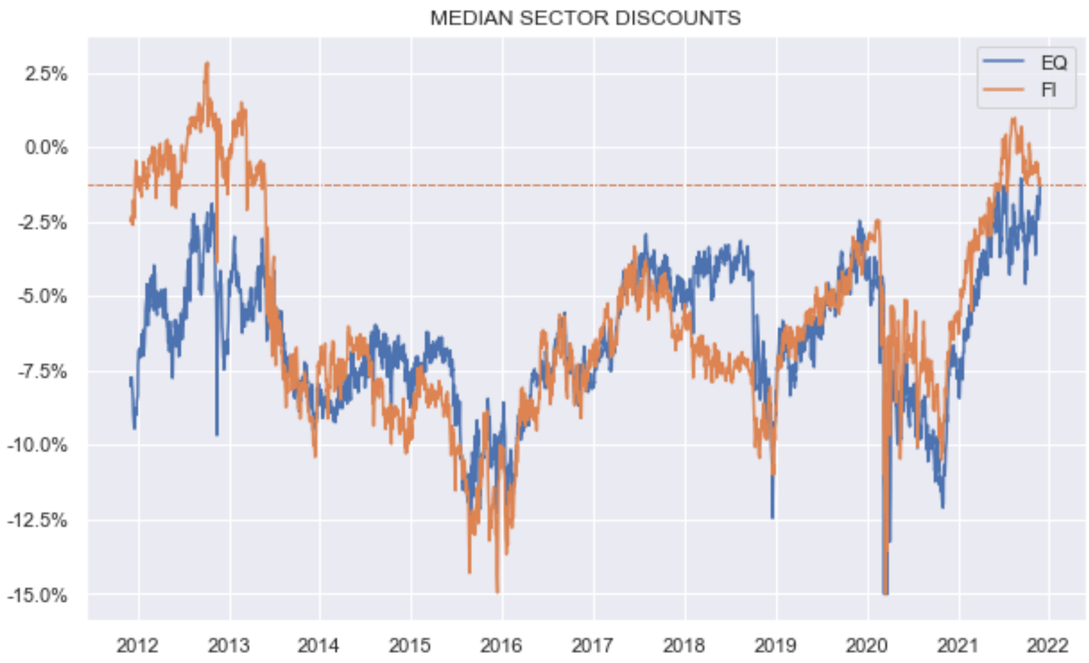
Source: Systematic Income

From a bigger-picture perspective, November is not quite as bad as September for CEFs, though it still looks to be the second worst month over the past year.



Source: Systematic Income

Recent price action in discounts looks interesting. The median fixed-income and equity sector discounts are trading right on top of each other at about a 1% median discount - the same level they were trading at about 5 months ago. However, as the chart below shows, the path to the current level has been very different. Fixed-income sectors made a roundtrip, rising to about a 1% median premium which deflated over the last few months while equity discounts widened but then rallied to their current level.



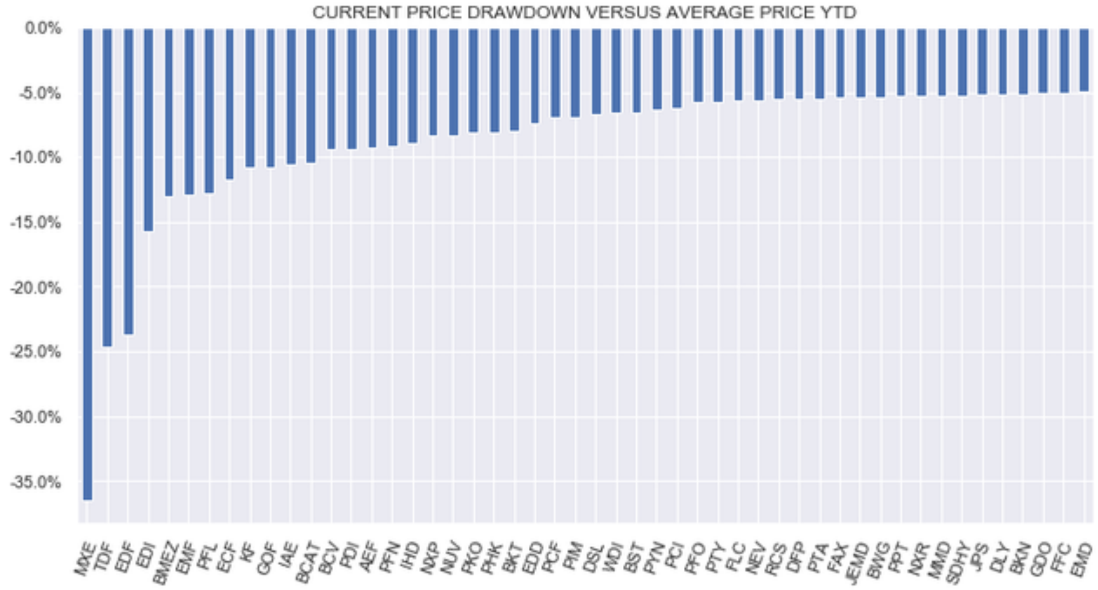
Source: Systematic Income

Also worth noting that the post-Thanksgiving Friday was very unusual. Normally CEF market weakness is associated with higher volumes (in millions of shares in the chart below). A close to 1% drop in the CEF market that we saw on Friday should have delivered volume around twice as high as we saw on Friday.

Source: Systematic Income

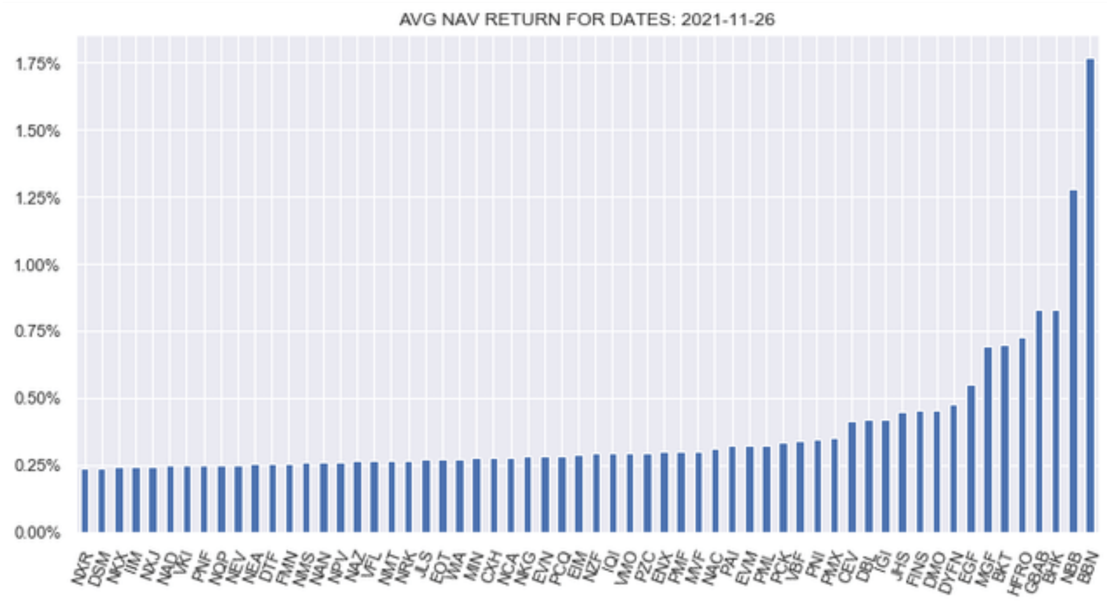
The unusually low volume is likely due to many people taking Friday off for the long weekend. It is not clear, however, if that caused the drawdown in the market to be more or less than what we saw. If the drawdown was heavier due to lower liquidity than it would have been otherwise, then we should see a bounceback in CEF prices in the coming days as liquidity returns.

As we are in tax-loss season, it's also worth checking up on funds that may be under pressure in the coming weeks. The chart below shows the price drawdown of funds relative to their average price through the year. Investors who are eyeing any of these funds may want to watch them carefully in case we see further weakness from tax-loss selling. Funds that we are watching as potential further adds here are Nuveen Emerging Markets Debt 2022 Target Term Fund (NYSE:JEMD), DoubleLine Income Solutions Fund (NYSE:DSL), Cohen & Steers Tax-Advantaged Preferred Securities & Income Fund (NYSE:PTA) and Western Asset Diversified Income Fund (NYSE:WDI).



Source: Systematic Income

Finally, it's worth checking in on funds that remained relatively resilient during the Friday drawdown. It's little surprise that higher-quality fixed-income funds did well. Most of the funds in the chart below are investment-grade focused municipal funds which is not a surprise given the action in Treasuries.



Source: Systematic Income CEF Tool

One downside of higher-quality municipal funds is their relatively long durations. A few funds outside of this space that saw NAV gains on Friday and have a lower duration profile that we like are the following:

- Nuveen Mortgage and Income Fund (JLS) with primarily MBS and ABS holdings and about a third of the portfolio in investment-grade securities, trading at a 4.76% distribution rate and a 6.1% discount.
- Western Asset Mortgage Opportunity Fund (DMO), trading at a 8.44% distribution rate and a 3.5% premium. We would wait for a better entry point for this fund - an overdue distribution trim could be just the catalyst here.
- Invesco High Income 2024 Target Term Fund (IHTA), trading at a 4.94% distribution rate and a 0.9% premium.

Market Themes

One of the things we see fairly often is that investors (and many commentators) tend to treat CEFs as a black box. This has the obvious disadvantage that viewing a fund as a black box makes it difficult to make sensible comments about its future performance since we can only use the past as a guide.

Three recent reader comments are worth highlighting in the context of the Nuveen EM Debt 2022 Target Term Fund. Our view has been that, among a few other funds, JEMD offers a low duration (about 1.7 on a leverage-adjusted basis) and a relatively high-yielding portfolio with an additional tailwind due to potential discount compression - for a total estimated base case return into its Dec-2022 termination of around 7%.

However, a few investors had a different view which we discuss in this section. The main point is that some investors treat the CEF as a black box which prevents them from having the right intuition about it mechanics.

One complaint is that JEMD is not attractive because it **underperformed "just about everything"**. The key point here is that it doesn't make a ton of sense to compare a very low duration fund to the rest of the market because the rest of the market is not low duration. It's like complaining that 3-month Treasury bills have underperformed 10Y Treasuries in the last 3 years, while ignoring that yields have fallen sharply since then and provided a large boost for securities with a longer duration profile.

The point is that a low duration fund will act like a lower-beta holding, all else equal, in all market environments, both on the upside and the downside. This means that in a period of strong returns, these lower-beta options will underperform. Often, investors want the full upside without any of the downside but that's not how markets work.

And in fact, JEMD, outperformed all other EM Debt CEFs and all but one limited duration CEF in the past year in total NAV terms which is the right peer group for this type of fund. The reason it didn't also outperform on a price basis is precisely because it is a term CEF and so its discount will be better anchored than the broader market which is actually a big plus for investors who are worried about significant widening in discounts too.

Investors often lump two different concepts into duration but it's worth disaggregating them. Specifically, there is interest rate duration and credit spread duration. A 5-year bond will have, roughly speaking, 5-year interest rate and credit spread duration. On the other hand, a 5-year loan will have very little interest rate duration and a 5-year credit spread duration.

In other words, the 5-year bond and 5-year loan have a similar sensitivity to changes in credit spreads while only the bond is sensitive to changes in interest rates. However, a 1-year bond will have only a marginally higher interest-rate sensitivity than the loan but a much lower credit spread sensitivity. In this sense, it is a superior product for investors who want to minimize both interest rate and credit spread duration i.e. those worried that either interest rates or credit spreads could move substantially higher.

The point here is that because JEMD primarily holds bonds that are about a year away from maturity (there are some exceptions) it provides both low interest rate and credit spread duration. This is one reason why it's never going to shoot the lights out but it has clear benefits as well. Treating the fund as a black box credit CEF isn't going to give investors the right intuition about how it is likely to behave in different market environments.

The second complaint is that the fund had a roughly 5% NAV drawdown already and it **could very well have another 5% drawdown** next year or more which would more than wipe out the 3.5% discount amortization tailwind into the termination. It is obviously possible for the fund to have another 5% NAV drawdown in the next year but let's try to understand what that would entail.

The fund's current unleveraged duration is about 1.3 which means that for its NAV to show a 5% drop the fund's portfolio yield needs to rise by about 3%. In a year's time the fund's unleveraged duration will be about 0.3 which means that for the fund to see another 5% drop in its NAV, the fund's portfolio yield needs to rise by 12% rather than 3%. That's not impossible but that's clearly a much higher hurdle to clear.

This highlights that, as time goes on, the duration of short-dated bonds drops much quicker in relative terms than the duration of longer-dated bonds. In this case, time is very much on the side of investors. Obviously, there could be defaults in the portfolio which could ding the NAV but that's true of all below investment-grade funds. Our estimate above is actually conservative (i.e. the fund's duration is likely to be even lower) because many of its holdings will have matured in a year's time. It is conceivable the fund may replace those matured assets but it's unlikely for a term CEF. In this example viewing the fund as a black box misses the key point about how duration evolves over time.

A final complaint was that the portfolio was "**10% Turkey**". Again, let's dig into what this means. The 10% refers to the proportion of the overall asset portfolio that is linked to Turkey. This is comprised of 2.7% Turkey government bonds, 1% of Turkey industrials and the rest in Turkish banks. So, obviously, there is a bit of diversification there already and the impression that the entire 10% is all in government bonds is not correct.

Of course, if the country defaults, the banks are going to be in trouble so the diversification is not massive but it's not zero either. At the same time we should keep a sense of proportion - Turkey government debt is about 40% of GDP versus 128% for the US. The banks are also forbidden from being short the USD - which is what caused the previous crisis and hard-currency corporate issuers have to demonstrate sufficient hard-currency earnings in order to be allowed to issue hard-currency debt. This means that despite the currency issues, it's not going to be the currency that will bring down the banking or the corporate sector.

Also, we need to put the 10% in context of the fund's relatively low leverage of about 22%. A 10% proportion of the portfolio equates to 12.8% of the fund's NAV for JEMD. A more typical CEF with 35% of leverage would have its 10% allocation equate to 15.4% of the NAV. In effect, the 10% for JEMD is larger than it looks relative to 10% of a more typical CEF. That said, it is true that the fund's Turkey allocation is not small and we would certainly prefer it to be smaller. This last example demonstrates how a headline allocation figure does not necessarily give investors the right context for making an investment decision.

It's important to stress that JEMD is not for everyone. Ultimately, investors have to pick and choose which risk factors they like and which they don't like. JEMD offers investors a relatively low duration (both interest rate and credit spread duration), a measure of discount control via its term structure as well as a potential tailwind of 3.5% over the next year through discount compression, relatively low leverage for a credit CEF and a decent underlying yield of about 4-5%. On the other side of the ledger is a relatively chunky and low-quality Emerging Market debt allocation.

Ultimately there is a balance on offer - the first set of attractive factors is not possible without the less attractive allocation factors. Investors who don't want the fund's quality profile have to trade away something on the other side as well. This is true of the choices investors have to make across their broader CEF portfolio. For example, a higher quality allocation will also come with either a much longer duration profile and/or a much lower yield. The task of portfolio allocation is in choosing between these different competing options.

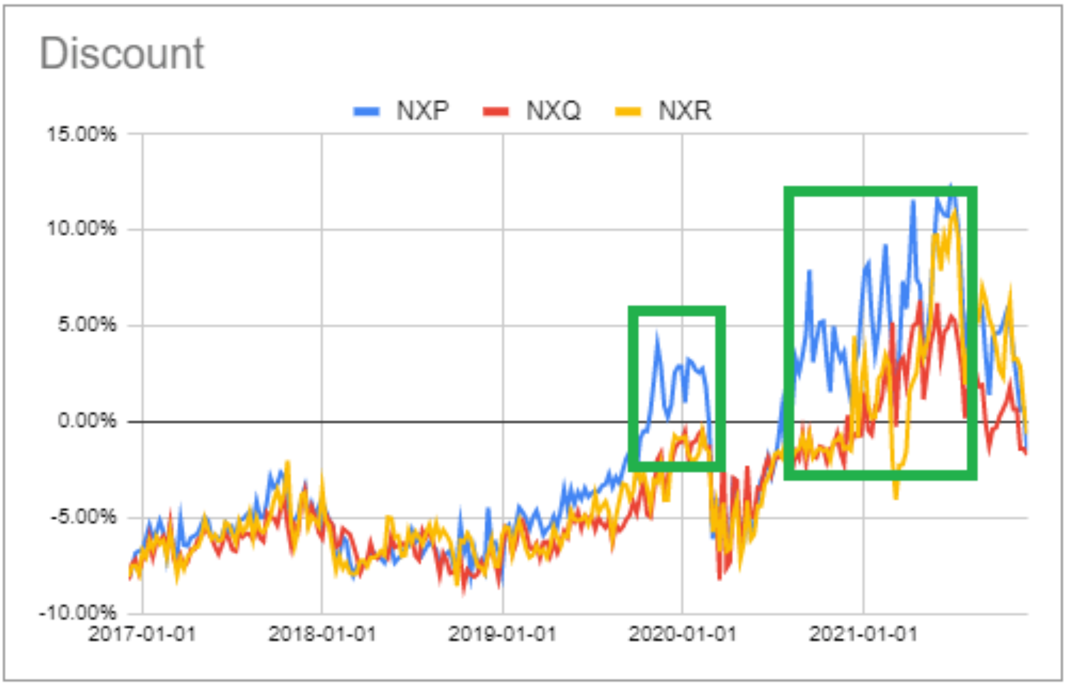
Market Commentary

Nuveen is merging three of its Hybrid CEFs (JTA, JTD, JDD) into the Nuveen Multi-Asset Income Fund (NMAI). The three funds were trading around a 8% discount which is quite a bit wider than the 1.9% discount average in the sector. The average 5Y NAV return of the three funds was also above the sector average.

For investors looking to keep things simple and hold both equities and fixed-income in an unleveraged wrapper with a decent discount and historic track record you could do a lot worse than these three merging funds. NMAI kicked off around $19.35 in initial trading which didn't make a ton of sense because that meant its discount was only 3.25% versus discounts of around 8% of the merging funds.

The fact that the fund subsequently dropped by another 6% was not a surprise. Oddly enough, it was basically flat during the sharp Friday drop while the rest of the sector fell about 1%. The fund's current discount appears to be around 10% which is very attractive both relative to the sector as well as relative to the merging funds. We would be cautious in acquiring a full allocation as we don't fully trust the fund's NAV which appears to be above its initial level of $20 from about a week ago which doesn't correspond well to the rest of the Hybrid sector. We wouldn't be surprised to see the NAV corrected lower by around 2-3% in the next few days.

Elsewhere for Nuveen, three basically identical unleveraged tax-exempt funds are due to merge: NXPQ and NXR into NXP. Something that we found odd and commented on was the fact that the funds' discounts did not reflect the fact that these were pretty much fungible funds.



Source: Systematic Income CEF Tool