CEF Weekly Market Review: Slow And Steady Distributions

ADS Analytics

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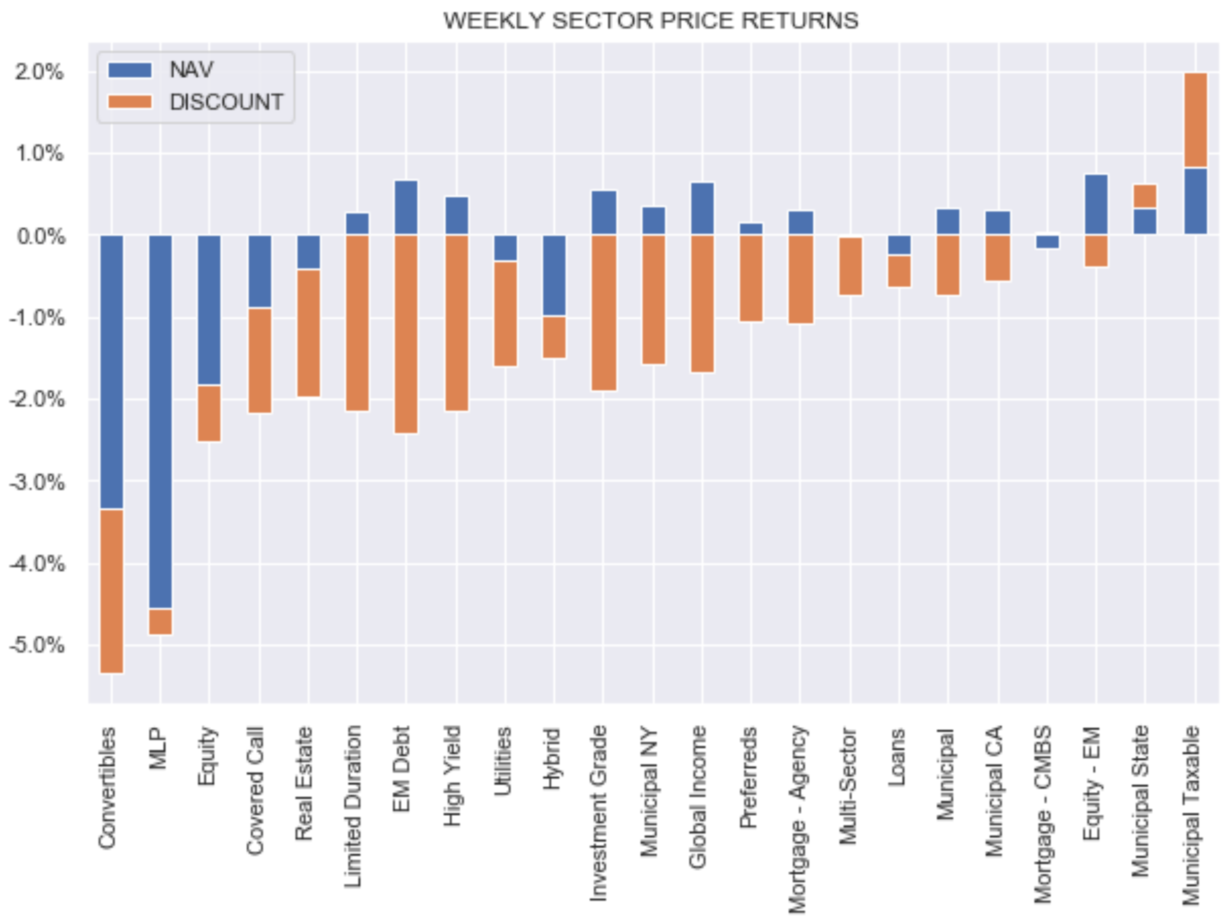
This article was first released to Systematic Income subscribers and free trials on Dec. 5.

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 December. 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.

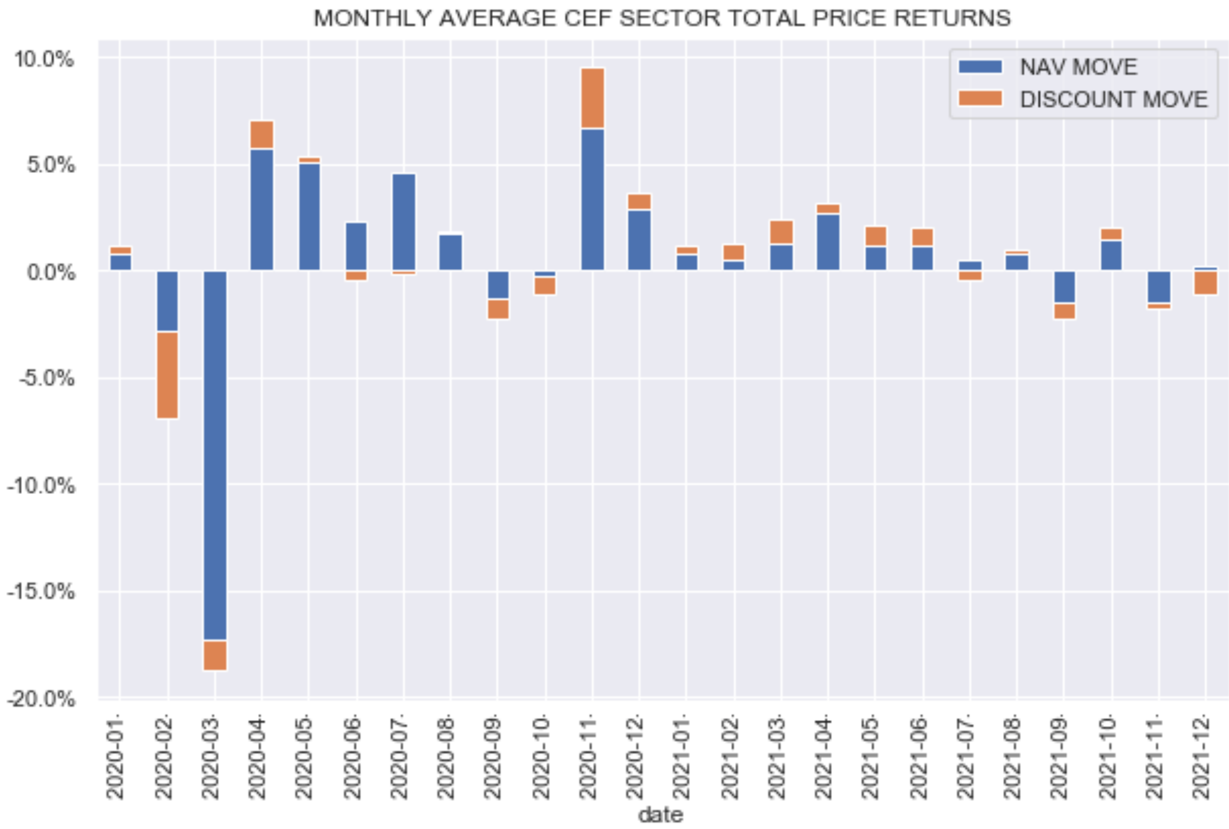
Market Overview

The CEF market continued the recent trend of relative stability in NAVs. Some sectors have certainly come off such as the higher-beta Convertible and MLP sectors however fixed-income sectors have held in quite well due to the drop in Treasury yields. Discounts, on the other hand, continue to move wider - only two sectors, both municipal, registered a rally in discounts on the week.



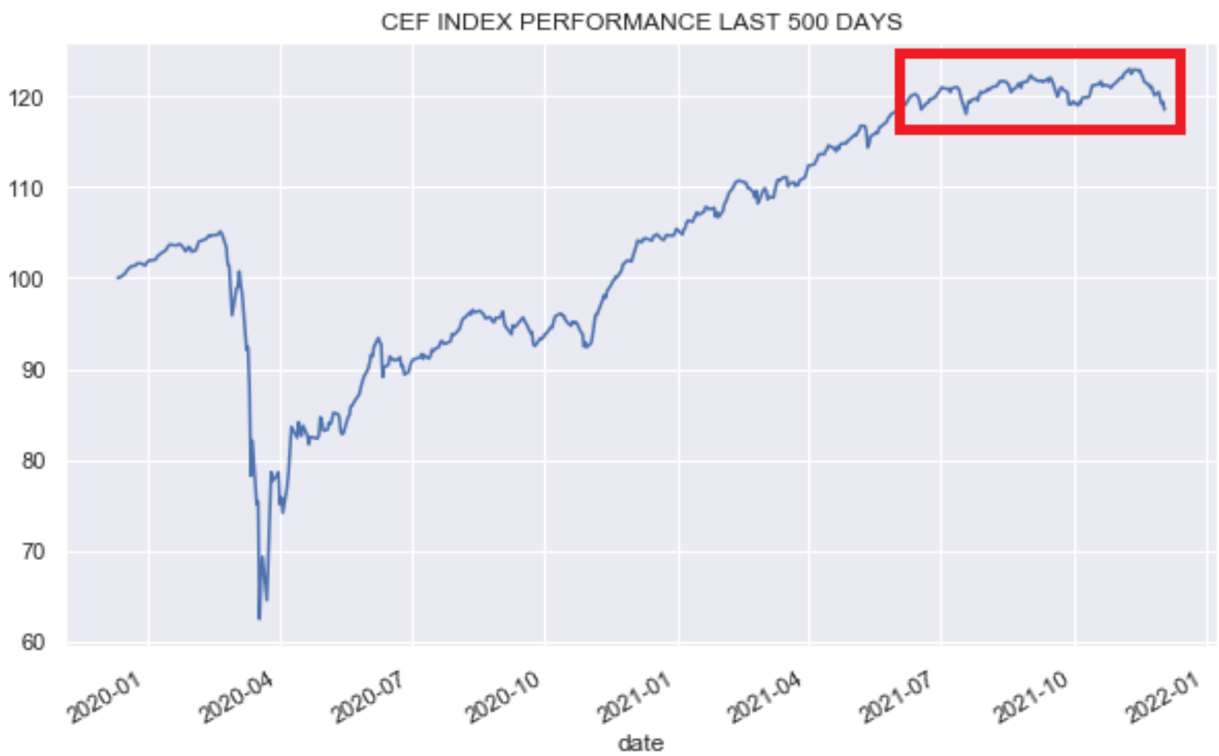
Source: Systematic Income

On a monthly basis November was the third worst month in CEFs since March of last year. December, so far, is only adding to the pain. It has been more than a year since we had two down months in a row in the CEF space.



Source: Systematic Income

The chart below, which plots the performance of the entire CEF market, shows that CEFs, in aggregate, have gone nowhere



Source: Systematic Income

The wobbly three-legged valuation stool of low risk-free rates, tight credit spreads and expensive discounts is clearly exerting its gravitational pull on the market and has gone from being a tailwind to being a headwind in the market. This doesn't mean that investors can't experience positive returns (in line with or even somewhat exceeding the underlying carry of their holdings) but this requires a more considered approach as the everything-rally is long behind us.

Market Themes

One allocation strategy that we like to use on the service is to tilt to funds that are under-distributing somewhat. This may sound counterintuitive since CEFs are typically held for their yield and, all else equal, the higher yield the better.

However, funds that under-distribute have a number of attractive features. First, they tend to trade at cheaper valuations. This is because of the tendency of funds with higher distribution rates to trade at more expensive valuations - this is not a hard-and-fast-rule but the relationship is there.

Secondly, funds that trade at cheaper valuations provide a higher yield to investors through their discount (i.e. the wider the discount, the higher the yield on price, all else equal).

Thirdly, they also benefit from a margin of safety - funds with wider discounts tend to outperform during periods of drawdowns relative to funds that trade at excessive premiums.

Fourthly, funds that underdistribute are also less vulnerable to distribution cuts (and the knock-on impact of premium deflation / discount widening) because they have a cushion with which to protect the distribution. They are also more likely to raise the distribution and benefit from a shift to a higher valuation.

Finally, in our view, investors are not giving up a whole lot by tilting to funds that underdistribute. This is because the retained earnings (earnings that aren't distributed out) remain with the fund and will either drive additional NAV returns from compounding and/or will be paid out as a special distribution anyway.

For example, two funds that we have held in our High Income Portfolio that fit the bill are:

- DoubleLine Income Solutions Fund (NYSE:DSL)
- PIMCO Dynamic Income Opportunities Fund (NYSE:PDO)

DSL features a 7.96% distribution rate and a 5.4% discount in a sector where the average fund trades at a 2% premium. The fund's coverage based on the most recent shareholder report was 122%.

PDO features a 7.04% distribution rate and a 2.3% premium. The average premium of the fixed-income taxable PIMCO funds is 10.4%. The fund's 6-month coverage was 145% as of October.

A few days ago both declared special distributions. DSL declared a $0.411 special distribution (2.3% of NAV) and PDO declared a $0.49 special distribution (2.5% of NAV). PDO, in effect, went from having the lowest distribution rate in the PIMCO taxable suite to a rate that is 0.56% above the average fund in the suite.

The mistake that some investors make is to use the distribution rate of a given fund as a proxy for its earnings capacity. This is true in some cases but far from all and it means investors often leave a lot of yield on the table. Funds that underdistribute only look like they are low-earning and discerning investors can pick them up at an attractive valuation which further increases the amount of yield that is passed on to them.

Market Commentary

A new start of the month brings CEF distribution releases.

There were no changes from Nuveen and PIMCO. BlackRock appears to be late with their December announcement. A couple of changes for Eaton Vance funds – a raise for the Senior Income Trust (NYSE:EVF) and a cut for the Short Duration Diversified Income Fund (NYSE:EVG). Annoyingly, EV only list funds without managed distributions in their monthly coverage summary which we follow on the service in the CEF tool and this excludes EVG. EVG coverage has been on the order of 60%.

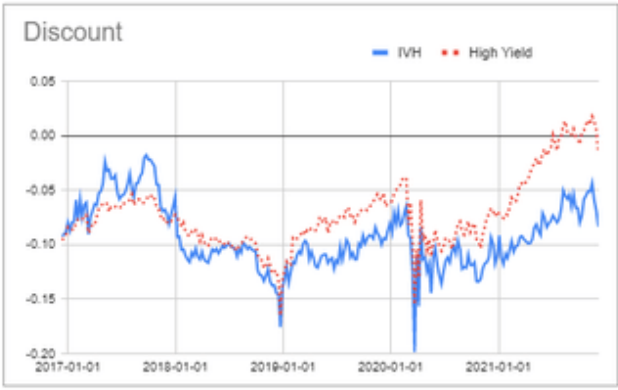
The MDP for EVG is set to 10% of NAV – the NAV has been dropping, hence the continued cuts for the fund. The primary reason the NAV has continued to drop is because of the large overdistribution so this trend is likely to keep going.

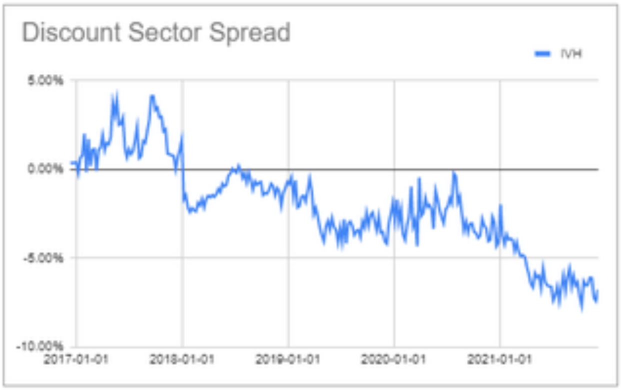
The fund looks like a slam dunk to many investors – a 30% allocation in AAA securities, a double-digit distribution rate and a sub-3 duration – you get quality, yield and low duration all in one package. However, the fund has delivered only a 4.2% total NAV return in the past year which is low as far as CEFs go even for those with low durations and is obviously a far cry from its double-digit distribution rate. Longer-term returns are even further below that level. It's important to remember that investors can’t have all 3 fund features at the same time – an income investment version of the impossible trilemma. For Pioneer funds, the High Income Fund (NYSE:PHT) – a high yield corporate CEF - made a cut and Municipal High Income Opportunities Fund (NYSE:MIO) had a raise. PHT coverage should now be around 106% based on the previous shareholder report with NII at a pretty steady level over the last 3 years.

PHT dropped around 3.5% on the day and is down 19% since its September peak (13% since its November peak). The discount is around 5% now and is wider of the sector average. Allocation is slightly lower quality than the sector average and historic returns are a bit above the sector average. The combination of a below-average valuation and above-average returns in the sector makes for an attractive combination. Distribution rate is 8.29%.

Source: Systematic Income CEF Tool

The Delaware Ivy High Income Opportunities Fund (NYSE:IVH) – another HY corporate fund - raised its distribution to $0.08 from $0.07. As we have discussed previously, NII has been running well north of its previous distribution at around $0.087 so even with the rise to $0.08 coverage is still above 100%. NII has been decreasing annually so that cushion may go away over the next year or so, however. The discount is unusually wide at around 8.4% vs. sector median of around 1.6% and historical 5Y NAV returns are above the sector average. The valuation and coverage provide a good margin of safety. Current distribution rate is 7.11%.

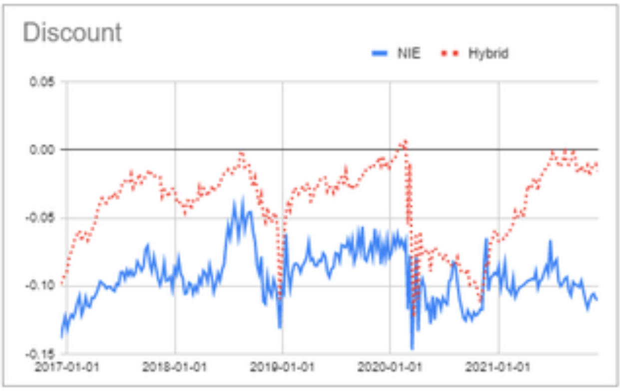


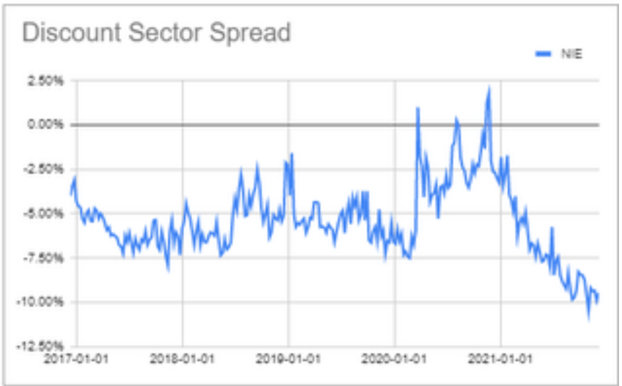


Source: Systematic Income CEF Tool

In the hybrid sector, a fund that looks interesting is the AllianzGI Equity & Convertible Income Fund (NYSE:NIE) – an equity / convertible debt fund. This is a very high beta fund with a negative level of NII, so it's really for investors who like holding stocks / converts in CEF wrappers and don't mind a non-existent NII.

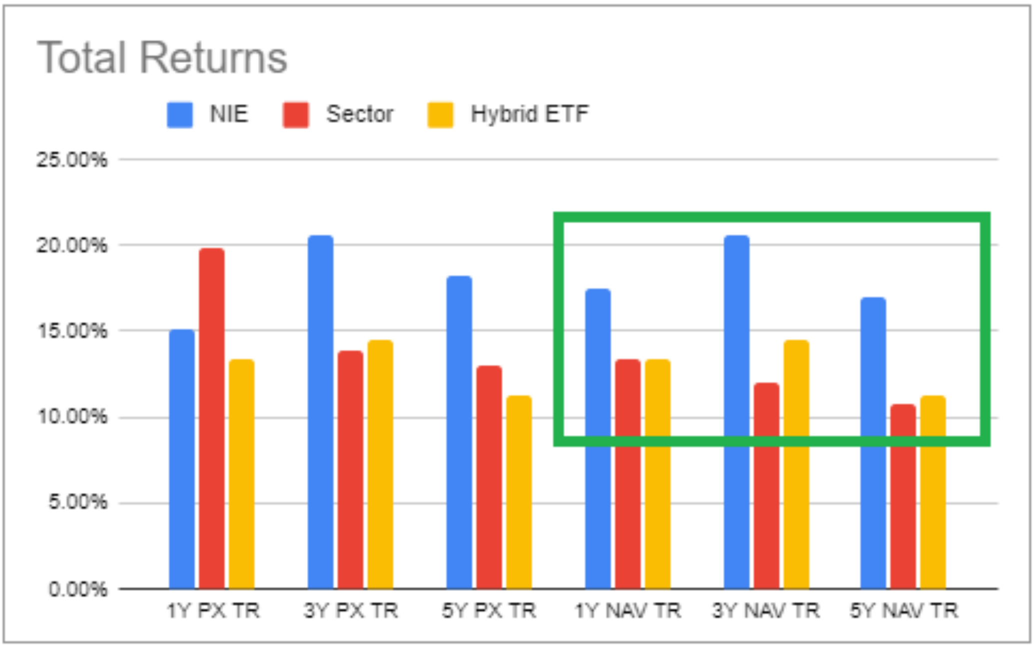
The 11.3% discount is a -0.9 5Y Z-score and the DSSP is zero, i.e. the fund has never been cheaper to its sector in the last 5 years than now.





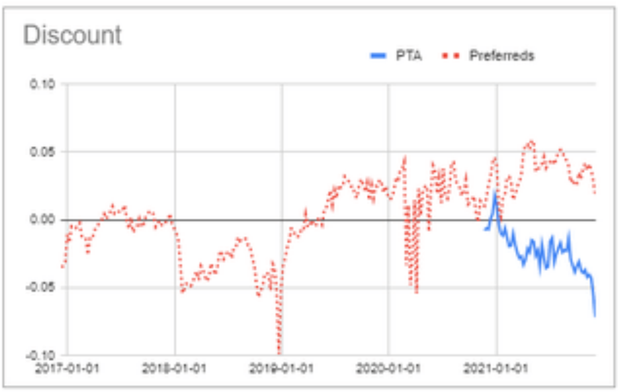
Source: Systematic Income CEF Tool

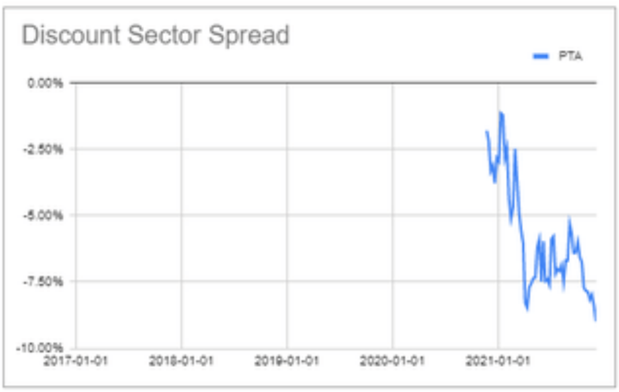
5Y historical total NAV return is more than 2x that of the Hybrid sector and even above that of the Convertibles sector.



Source: Systematic Income CEF Tool

The Cohen & Steers Tax-Advantaged Preferred Securities and Income Fund (NYSE:[PTA](PTA)) – a preferreds fund - is the usual odd man out in the sector with a 7.2% discount versus an average premium of 1.8%. The fund has clearly been a victim of tax-loss selling so investors should time their allocations carefully as we could see more weakness into year-end. The fund trades at a 6.63% distribution rate and has matched the other 2 Cohen & Steers preferreds funds closely in NAV performance. The duration of the fund is relatively low at 3.7 which reflects its use of interest rate swaps to lower its duration profile. The fund's quality profile is fairly high with 80% of holdings rated BB or above.





Source: Systematic Income CEF Tool

Recent market weakness as well as tax-loss selling is opening up some opportunities for investors to start off the new year on a firmer income footing.