Seeking Alpha α

Closed End Funds

Closed-End Funds: A Check-Up On The Preferred Space

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Summary

- Today, we are taking a refreshed look at the preferred closed-end fund space.
- We see that the entire space has become more expensive, yet at the same time, distribution yields have dropped - this is mirroring the broader CEF spaces actions.
- PTA comes up as the best value, though Flaherty & Crumrine's lineup remains the best long-term plays.
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Written by Nick Ackerman, co-produced by Stanford Chemist

Last year we had taken a look at what preferred investments in the closed-end fund space had performed the best historically. It's time to do an update on that subject now that over a year has passed. Additionally, the space has become a bit more attractive, with market volatility rising.

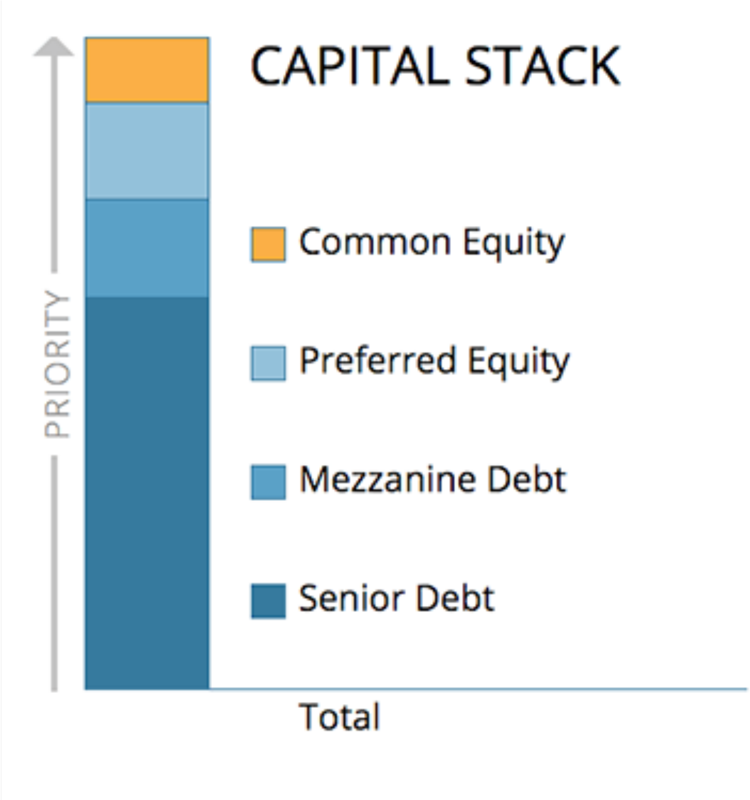
Preferred securities can often reduce investors' volatility in their overall portfolio. In the closed-end fund space, two issues in their structure reduce that volatility dampening benefit. That being said, only one would directly impact the portfolio's actual net asset value or NAV performance.

Characteristics Of Preferred Securities

Preferred shares offer investors a combination of equity and fixed-income features. For the equity similarities, they can trade on a stock exchange throughout the day.

There are several different types of preferred that can be issued. Some can be converted to common shares if they are issued as convertible preferred stocks. For the fixed-income features, they offer a fixed dividend and are tied to par value.

Traditionally, the par value for most publicly traded securities is $25 per share. That being said, they can also be issued in denominations of $50, $100, $1000 or even more for some privately issued offerings. Preferred offerings are also in the middle of the capital stack, which means that they are paid out before investors of common shares in the case of bankruptcy. However, they are paid out after other debts are issued.



(Source - crowd street)

Another common characteristic is that they are largely issued by financial institutions. However, they can be issued by all sorts of companies, even some closed-end funds issue preferred for raising leverage. The primary reason for financial institutions to have issued preferred stock is to help with their capital ratio for regulation purposes. However, with Dodd-Frank, this limited what preferred types could be calculated for Tier 1 capital.

Preferred stock can trade at premiums and discounts. This is due to them being traded throughout the day on an exchange. However, they more traditionally stay near their par value - at whichever level they might be issued at.

Unique Characteristics Of Closed-End Fund Preferred Funds

For those familiar with closed-end funds, you know we will be touching on the discount/premium mechanics at play here. Just like preferred can trade away from par, so to can CEFs. This is the part of their structure that doesn't play a role in the actual NAV performance of the fund. Instead, it can create opportunities for investors.

With CEFs, they often don't trade at their NAV per share. Hence, that's how a discount or premium can open up in the fund. Historically, the preferred CEF space has traded quite elevated, with most of the "best" trading at premiums regularly. In fact, the average premium for the funds came to 2.7%.

This is different from exchange-traded products [ETFs] that also trade throughout the public exchanges throughout the market day. With ETFs, there is a mechanism keeping the share price and the NAV per share chained together. Discounts and premiums can open up, but it isn't often, and they aren't generally significant.

That's positive with volatility in the CEF space, the fact that it can open up a discount on a fund where you can buy assets for less than their value. On the other hand, CEFs often employ leverage to various degrees. This leverage is a double-edged sword - during rising markets, it works out in an investor's favor. However, during market panics, it often works against an investor as the fund would lose more than it otherwise would.

This can even be compounded in the preferred space due to reduced trading volume. When everyone is heading for the exits, this can leave a limited number of buyers on the opposite side of the trade to absorb the selling. What ultimately happens is a share price becomes quite volatile, and investors end up going lower and lower to unload their shares.

That is why some investors might have been shocked by what we witnessed in March's sell-off; at that time, many preferred prices collapsed. This happened for two primary reasons. The first was that preferred shares typically have lower volume, in general. That means during a sell-off, this balance is easily thrown off. Essentially, they went through a liquidity crisis.

However, margin calls put even more pressure on the selling side of the equation. Since preferred shares (and other fixed-income investments) traditionally hold their value close to par, they became prime targets for liquidating to meet these cash needs.

Performances Over The Last Year

With that out of the way, we can take an updated look to see which preferred funds have been performing the best over the last year. In the previous look, we looked at the longer-term performance between the funds in this space. We used the 5-year annualized total NAV performances. I'll also be including the 5-year performance if it is available.

That's where we found that Flaherty & Crumrine funds had dominated the top of the list. In fact, all 5 of their funds came in the top 5 spots-certainly quite an impressive feat. We also saw that Cohen & Steers funds had performed right behind the F&C funds. That will be an important point worth highlighting in a bit.

The data was collected from CEFConnect and is data as of the 12/02/2021 close.

Name	Ticker	Premium/Discount	Distribution Rate	1-Year NAV	5-Year NAV
JHancock Preferred Income II	(HPF)	5.14%	7.11%	10.49%	7.1%
JHancock Preferred Income	(HPS)	4.40%	7.13%	10.34%	7.1%

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JHancock Preferred Income	(HPI)	1.59%	7.26%	9.14%	6.86%
Flah & Crum Dynamic Pref & Income Fund	(DFP)	2.64%	7.02%	8.75%	9.83%
First Trust Inter Dur Pref & Income Fund	(FPF)	1.93%	6.18%	8.64%	8.37%
Nuveen Pref & Income Opps Fund	(JPC)	-2.28%	6.75%	8.52%	6.33%
Flah&Crum Preferred Securities	(FFC)	3.03%	7.08%	8.46%	10.01%
Flaherty & Crumrine Preferred Income	(PFD)	17.31%	5.88%	8.45%	9.48%
Nuveen Preferred & Income Term Fund	(JPI)	1.38%	6.29%	8.32%	7.47%
Flah&Crum Total Return Fund	(FLC)	1.39%	6.89%	8.21%	9.79%
Flaherty & Crumrine Preferred Income	(PFO)	2.56%	6.48%	7.7%	9.27%

Opp					
Nuveen Preferred and Income 2022 Term	(JPT)	0.12%	5.86%	7.13%	
Cohen & Steers Select Preferred & Inc	(PSF)	7.01%	6.70%	6.1%	8.32%
Cohen & Steers Ltd Duration Pref & Inc	(LDP)	4.87%	6.42%	6.02%	7.54%
Nuveen Pref & Income Securities	(JPS)	-1.77%	6.43%	5.94%	7.57%
COHEN & STEERS TAX-ADV PRD SEC AND INC	(PTA)	-6.19%	6.56%	5.44%	

(Source - CEFConnect, Author Compiled)

Since the original publication, Flaherty & Crumrine posted a distribution announcement. This included cuts across most of their funds heading into 2022. Cohen & Steers also announced cuts for two of their preferred funds but kept PTA the same. This will impact the yields, even being mostly small trims. Always check the latest data before making investing decisions.

Commentary

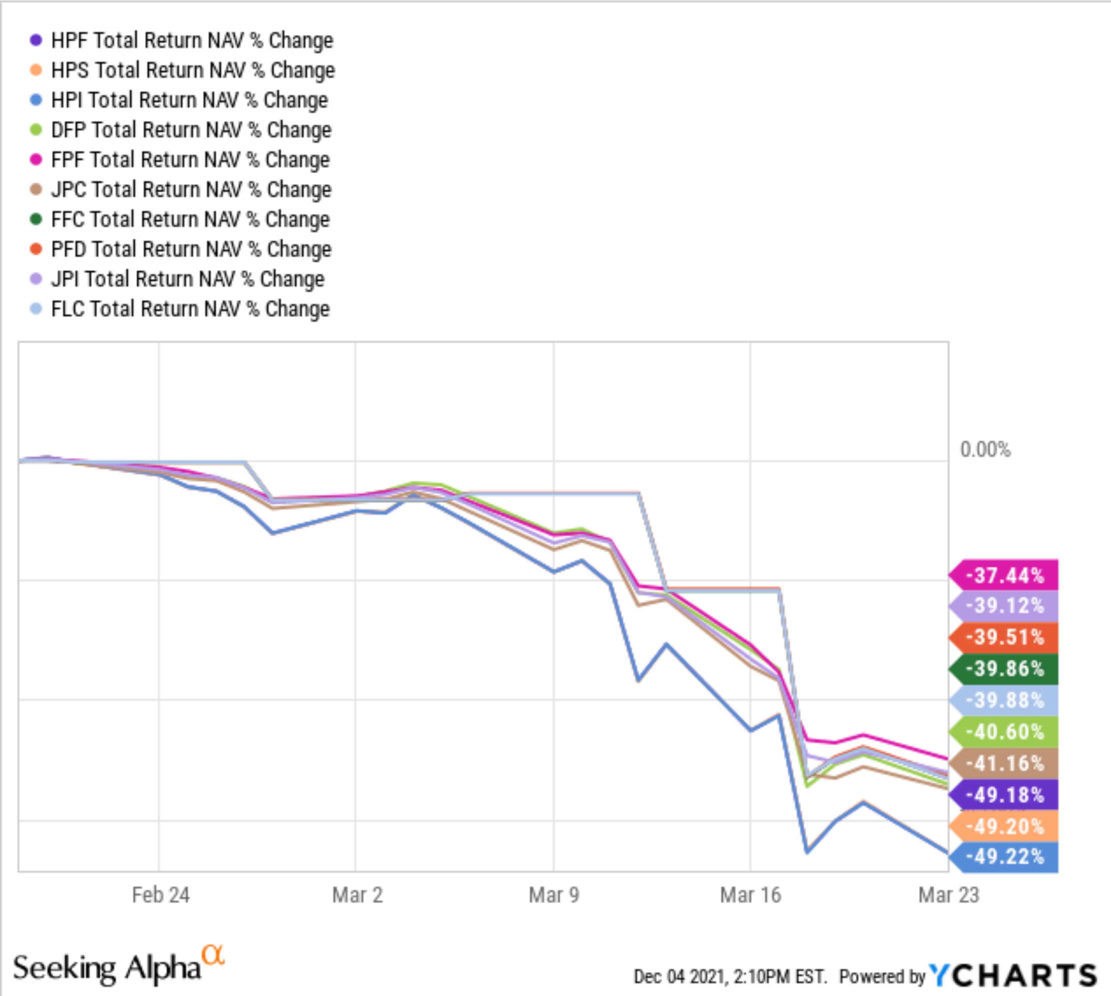
First of all, I would note that most of these funds have a longer history than 5 years. Thus, we can see 5-year data. Based on that, F&C funds still come out on top this year. However, First Trust Intermediate Duration Preferred & Income Fund (FPF) snuck in between the F&C funds and outmaneuvered the C&S funds.

The average yield of the funds here comes to 6.63%. As we mentioned above, the funds' average premium comes to 2.70%. These can be compared with the data as of 10/08/2020. The average premium at that time was 1.92%, and the average distribution yield came to 7.27%.

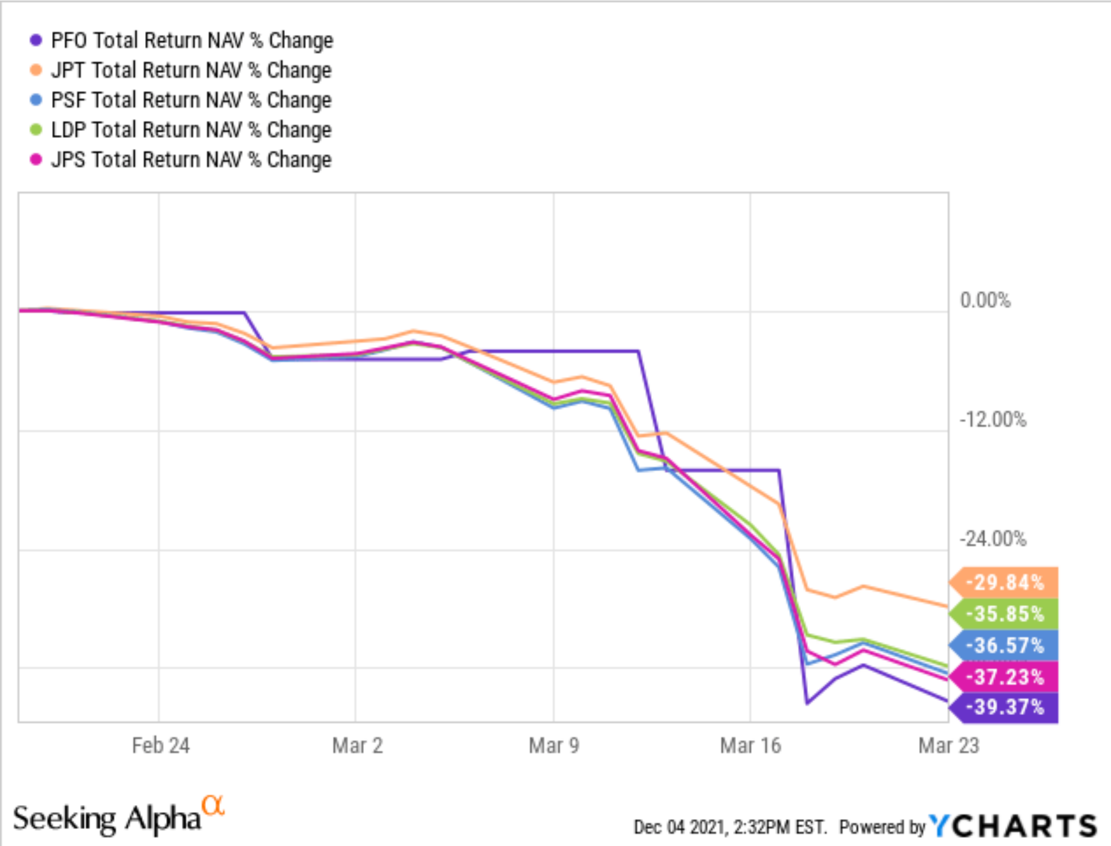
That isn't a large leap but is consistent with what we've seen across the entire CEF space throughout the last year.

The other broad note I'd make is that John Hancock's Funds have now been performing much better on a NAV basis. However, that seems to be related to the fact that they are rebounding from the 2020's market crash.

The graphs below take the preferred we are looking at above and shows their performance from February 19th, 2020, to March 23rd, 2020. That marks the peak to trough of last year's COVID-induced crash. We can see that John Hancock Preferred Income (HPI), Preferred Income III (HPS) and Preferred Income II (HPF) were the bottom three performers. The next closest performance to that was the Nuveen Preferred & Income Fund (JPI).



Data by YCharts



Data by YCharts

We can also see that the best performing funds during that time came from C&S. That was Cohen & Steers Select Preferred & Income Fund (PSF) and Cohen & Steers Limited Duration Preferred & Income Fund (LDP). That can explain some of why they are the laggard at this time when they hadn't been rebounding as much as the others.

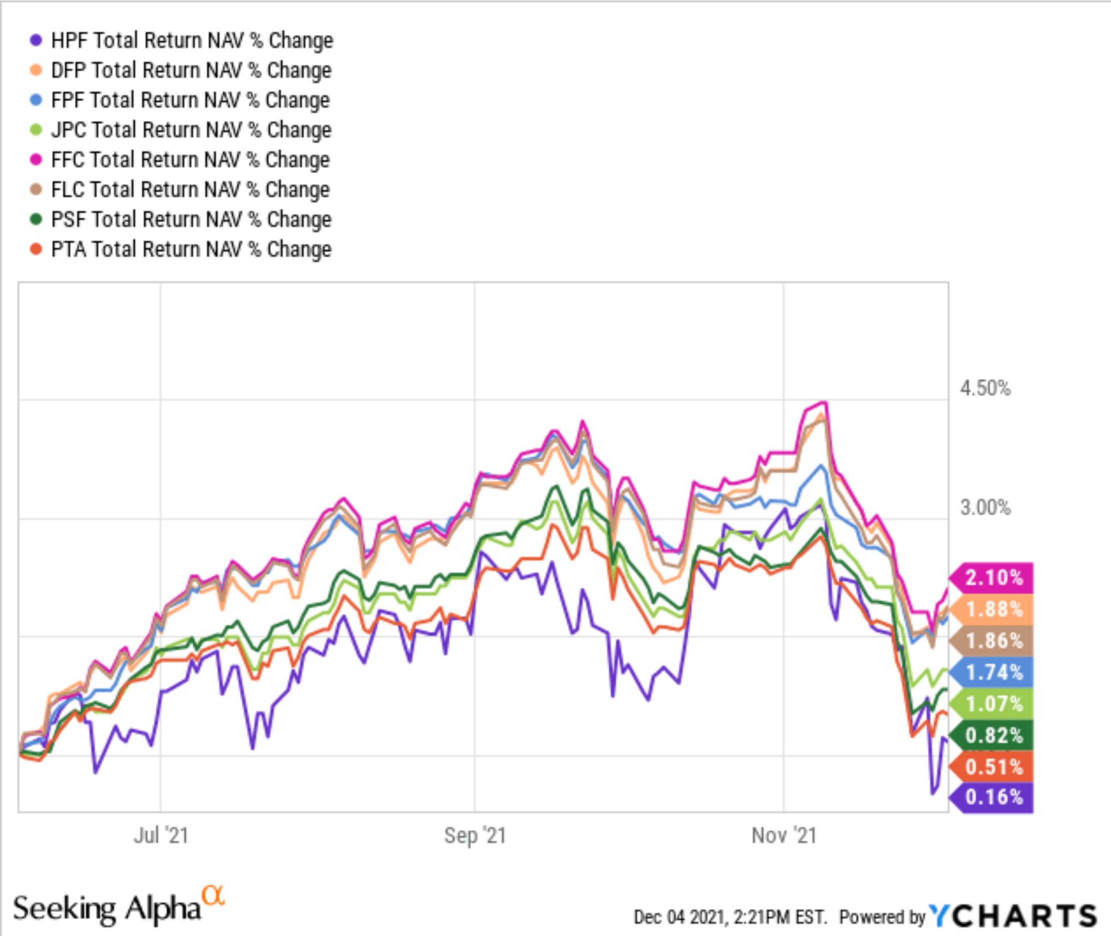
A Discussion On PTA

Bringing up the rear over the last year has been the C&S funds. In particular, we have Cohen & Steers Tax-Advantaged Preferred Securities & Income Fund (PTA). This has been a fund I've been covering regularly since its launch and one I've been adding to recently. This is the latest addition to this group of CEFs, so it might be a bit disconcerting to see it performing the worst. It might not be all that it first appears, though.

We can see that PTA is clearly the fund with the most considerable discount across the space. Only two others, Nuveen Preferred & Income Opportunities Fund (JPC) and Nuveen Preferred & Income Securities Fund (JPS), come in at a discount. Even that, they are relatively shallow. Nothing compares to the over 6% PTA discount at the moment.

However, one might say that since it is the worst-performing, that is a good reason for it to be down there. Since the fund launched at the end of 2020, it is reasonable to assume that they hadn't ramped up their portfolio entirely. They would have had a portion of their portfolio in cash and still be adding leverage. This is a topic we discussed as a follow-up from our initial coverage of PTA.

If we look at the last 6 months' performance on a total NAV return basis, we see that PTA still comes in near the bottom. However, it isn't the bottom, and it isn't so far off from the rest of the random selection of peers that I included.



Data by YCharts

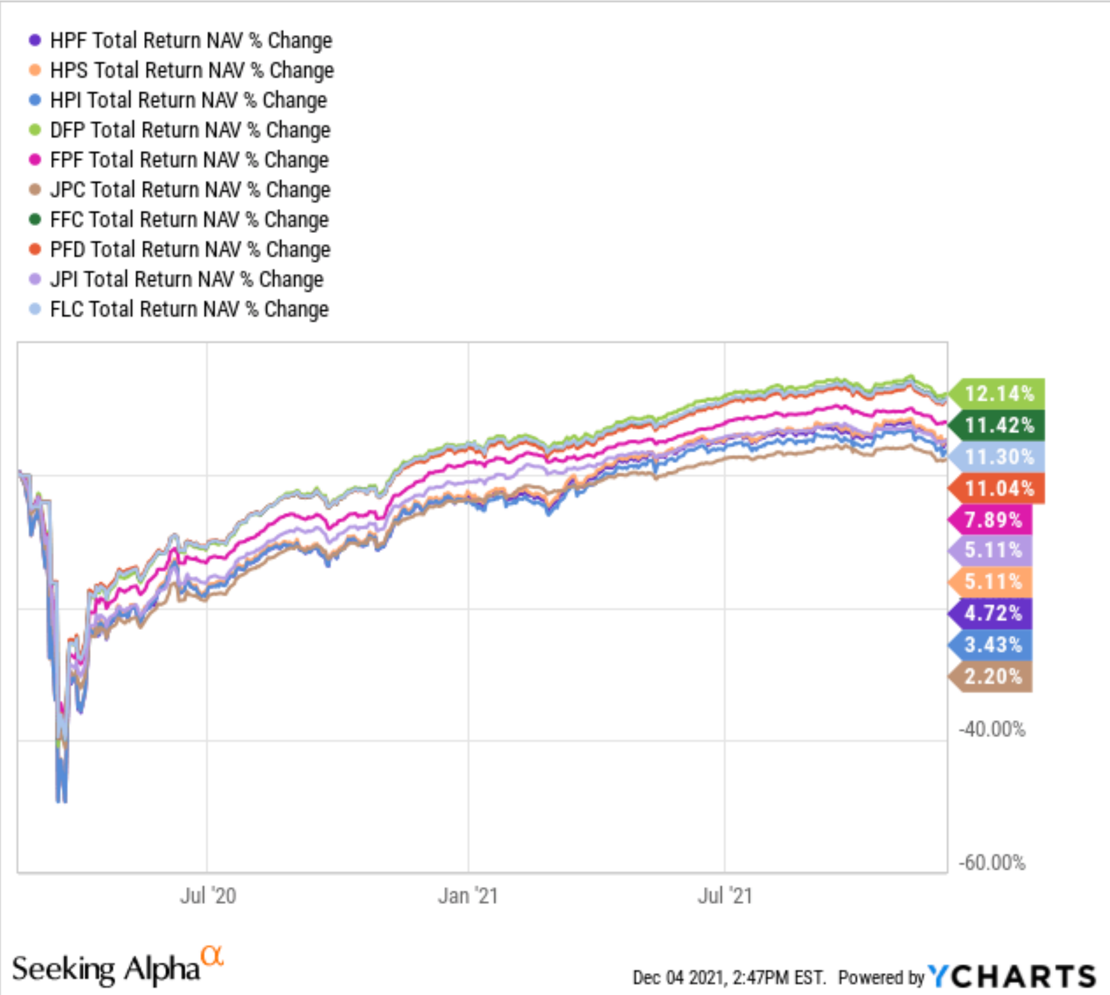
As I mentioned above, the space can be quite highly leveraged. The average effective leverage of the group comes to 32.23%. This is because they are traditionally safer assets that, in normal market environments, don't pose large risks.

However, in particular, one fund utilizes an abnormally low amount of leverage. That is Nuveen Preferred and Income 2022 Term Fund (JPT). Due to the expectation that the fund will be liquidated on March 1st, 2022, they will have been unwinding their leverage.

When excluding that fund, the average leverage amount comes to 32.59%. PTA utilizes leverage at 32.5%. So it is right near the average of its peer group. Carrying the highest leverage is JPS, JPC and JPI. Then it is PFO, FLC, and DFP. Those six funds all carry higher leverage than PTA. That can explain some of the underperformance on a couple of the funds. The rest is just going to come down to portfolio composition.

Regardless, I'd have to give the best value on this list to PTA at this time. The discount is significantly lower than the rest of the space. As we touched on above, the C&S funds held up the best relative to the rest of the group during March 2020. Holding up the best was JPT, but again, that's because they have reduced leverage as a term fund.

Taking a look at the full list again, the graphs below represent the performance from February 19th, 2020, to December 3rd, 2021. This gives us a look at the funds from their previous peak in 2020 to the latest data.



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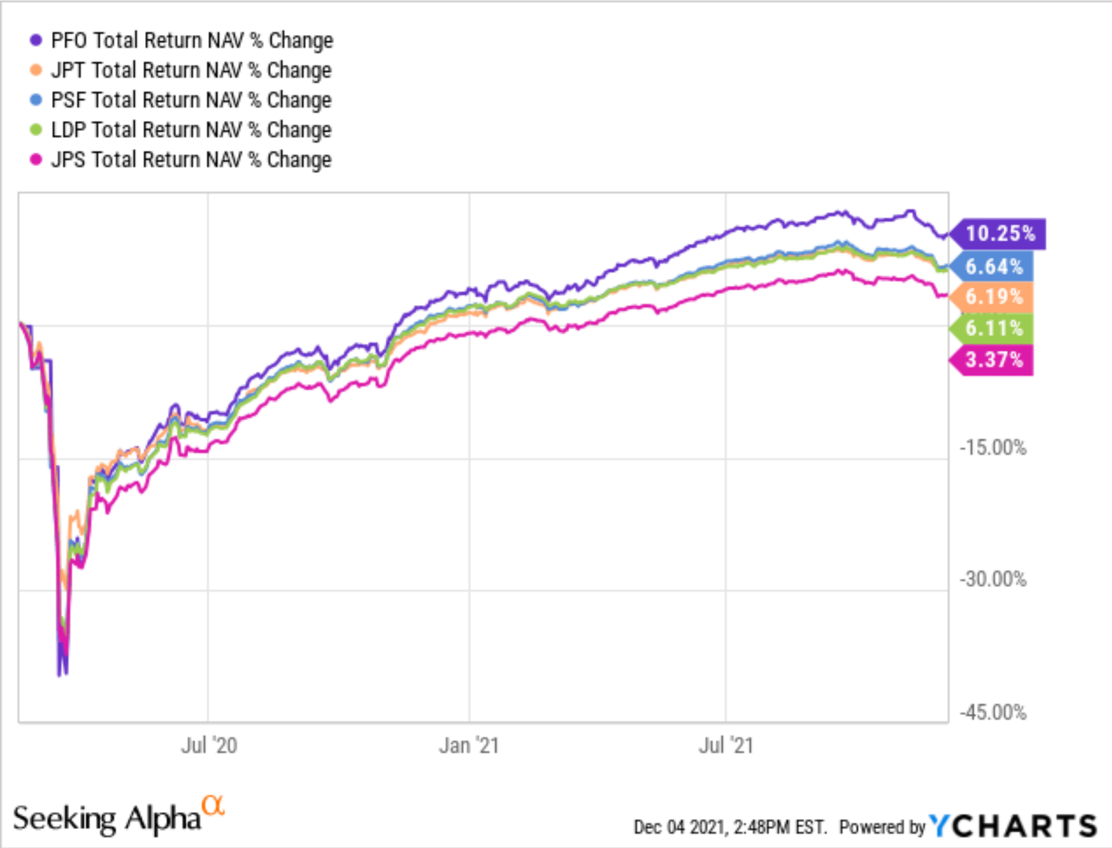

Data by YCharts

This is how we confirm that despite the three John Hancock funds leading the way, most of this is just making up for lost ground last year. They are amongst the bottom performers still due to their significantly more material declines in the crash.

The only funds outpacing them to the bottom are JPS and JPC, which isn't a good look for Nuveen as these are their perpetual structure preferred. Not the JPT that is carrying significantly less leverage. Unfortunately, as a Nuveen fan more broadly, they've shown to be some of the weaker funds in the preferred space, along with John Hancock.

Conclusion

John Hancock's preferred funds have been leading the way in performance this year; however, that could do with making up for more lost ground during last year's panic selling. After going through this list, it would appear that PTA remains one of the better buys due to valuation. I've been putting my money where my mouth is too, and I've been buying recently.

Though I continue to hold Flaherty & Crumrine Preferred Income Opportunity Fund (PFO) at this time, it is on the lower end of the F&C lineup in regards to the premium level.

If I were looking to sell a position, it would definitely be Flaherty & Crumrine Preferred & Income Fund (PFD). That fund has gone to an astronomical premium, and clearly, there are better values at this time. One might consider investing in Flaherty & Crumrine Total Return Fund (FLC) as the lowest premium from the F&C lineup if they didn't want to leave the F&C exposure.