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Closed End Funds

CEF Quarterly Review January 2022 Interview - Tom Roseen

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Summary

- General investment market performance.
- Expected trends into 2022.
- Interval fund performance.

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CEFA:

Welcome to CEF Insights, your source for closed end fund information and education brought to you by the Closed End Fund Association and available on our website at www.cefa.com. Today we are joined again by Tom Roseen, Head of Research Services with Refinitiv Lipper and author of the Fund Market Insight Report which provides in-depth monthly commentary on the closed end fund market. We're happy to have you with us today Tom.

Tom Roseen:

Hi Diane, great to be here.

CEFA:

Tom, you recently published a report for December 2021 which covers over 600 closed end and interval funds. How did investment markets generally perform in the fourth quarter of 2021 and what was the impact on closed end funds?

Tom Roseen:

Well let's take a little step back. For 2021, equity funds posted their strongest one-year return since 2019, with the average Closed-End Fund returning 11.31% for the year. That includes both fixed income equity funds. And how we break that out, and I'm going to get to the quarter here, but I just wanted to kind of point out how good of a year it was. The one year return for equity funds was about 18.56% as well above what we would normally expect over the long term average is about 10%. And even fixed income funds were able to put about a 5.68% return up on the board. And of course I think normally we expect about 5%. So really both asset classes were doing very well.

Despite the rise in the Omicron variant slowing job growth, I mean it's been okay but again, just analyst expectations. Rising inflation and of course the Fed's late commitment to reducing its asset purchases and probably add some interest rate hikes in 2022. Closed end funds did surprisingly well for the quarter. Overall, if we take a look it's about a 4.18% return. This is again for the quarter that's fixed income and equity together. But breaking these out and taking a little closer look, I like to break them out into our macro groups. I've talked to people about the macro groups and basically it allows us to take a look at kind of equities that are domestic and then world equities and then mixed asset funds. So that's what I'm going to give you here. So for Q4, we saw that domestic equity funds had about a 5.82% return. Very good return for a quarter.

World equity funds didn't do quite as well, about 1.71%. And then we take a look at mixed asset funds. They had about a 1.36%. A little bit of disappointment on the fixed income side. When we take a look at the quarter, world bond funds were down about 0.95%. And then we take a look at the domestic taxable bond funds, they were up 0.54%. And muni bond funds really had a pretty strong quarter considering what was going on, about a 1.38% return. So overall, for the quarter we saw some good numbers and it certainly translated from the market all the way through to the fixed income and equity universe on the closed end fund side as well.

CEFA:

Your data breaks out closed and funds into over 20 classifications. What classifications were the best performing for the month of December and which sector struggled?

Tom Roseen:

Well let's start off with kind of with the big view again. Now first of all, about 90% of all closed end funds did fantastic. They had plus side performance. For the month of December, if we take a look and break it down a little bit closer. We take a look at on a NAV base, 94% of equities and 88% of fixed income funds had returns in the black. And another quick review, on the macro bits that I've given you before. Basically if we take a look at those domestic equity funds for December were up 3.76%. This is the second month in three that they were actually showing plus side returns. World equity funds were up 3.64%. Mixed asset funds, 2.10%. So overall on the equity side did very well. World bond funds actually climbed to the top of the charts for the month of December. World bond funds had a 1.85% return, it's first month in four that they actually beat their domestic and muni brethren. And domestic taxable funds returned about 1.03%. And muni bond funds had a 0.24% return, about.

So, when we're taking a look at that overall, when we want to take a kind of a deep dive, we then get into what's happening in the equity universe by itself. And I'll give you a little bit of light at the end of the tunnel for fixed income as well. But on the equity side, we saw that utility funds came in about 7.46%. So, while techs were falling out of favor, value and income-oriented funds actually did better. And of course, we did see a run in energy funds as well for obvious reasons, gas prices and oil prices went up about 16% for the quarter. But taking a look again, developed market funds had a really good return and this is one of our international categories, developed markets had about a 4.51%. And then we take a look at the diversified equity funds which again is our domestic group, 5.26%. So overall, these three had some very good returns. Taking a look though at the bottom of the group, convertible funds had about a 1.02% return. And sector equity funds lagged a little bit at 2.26%.

Again, all of them positive, all of them are looking really good. Turning our attention to the fixed income side in knowing that we saw about a nine basis point increase in yields, 10 year yields to about 1.52% this month. And investors stayed in search of yield. So for the first month in four, we saw emerging market hard currency debt actually outperformed all of the categories, up 2.19%. So very spectacular return for one month period. High yield funds leveraged return about 1.95%, global income up about 1.72%. And at the bottom we had our Pennsylvania municipal bond fund classification up only 0.06% and US mortgage funds up about 0.07%. So really the investor was in search of yield and willing to put risk on to gain that yield for the month of December.

CEFA:

Is this a change from what you saw earlier in the fourth quarter?

Tom Roseen:

It is. So actually from the third quarter. So the big change basically was that we didn't have negative returns. If you look back to Q3 we did have really kind of some hard times in September, October and people were very worried about the Delta variant, its rise rather than focusing on the Omicron variant. And we had concerns with China. For instance, China Evergrande was worried about some bankruptcy and what type of ripple impact that might have on the real estate markets. And of course, the Fed kept interest rates and their bond purchases unchanged but people anticipated that they would have interest rate hikes and probably start reducing their bond purchases. Let me give you an example, September our returns for equity is about 1.64%, in bonds and these were minus, and bonds were down about 0.39%. So really a much better quarter for Q4.

CEFA:

Do you expect these trends to continue as we start the new year?

Tom Roseen:

I do. Inflation is on the rise so I think what we're going to see is again, foot off the pedal and we've seen it off and on over the last several months. Stay at home stocks did very well for a while and they fell out of favor for a while. But really with the Fed saying that they expect to raise interest rates soon, many people are saying that could be as early as March. I think that we're going to see investors focus on income orientation as far as getting interest plays out of there. And they're also going to look for out of favor issues. And for instance I think we'll see a little bit more play in the overseas stocks and maybe even some of the areas that were not doing so well at the beginning of the quarter. For instance, financial services that actually benefit from rises in interest rates. So yeah, I think we're going to see the same thing that's been occurring over the last month or so.

CEFA:

The way closed end funds trade in relation to their net asset value is an important consideration for many investors. Did you see any specific trends in premium discount behavior for December?

Tom Roseen:

Yeah, we didn't see the big moves that some people might expect at end of year. We did see some in equities, the big change in equities. But from the numbers I'm going to show you here, not that big of a thing. The median discount for all closed end funds again, we focus on the median because the average is skewed by some of the big discounts and the big premiums out there. So the median discount for all closed end funds narrowed or improved by about 37 basis points for December to 2.03%. That is much better than the 12 month moving average of 3.29%. And when I say much, again, I guess 3.29% versus 2.03% is not a lot to write home about but certainly it's very low. And it's something that we've been keeping an eye on. The median discount for all equity funds actually widened a little bit, by 29 basis points, to 5.22%.

And even that might have been that tax loss harvesting kind of the end of the year sale that I was talking about. So we did see a little climb there. But again, 29 basis points, 5.22%, very respectful. But we saw the median discount for all fixed income closed end funds narrowed by about 26 basis points to 1.30%. That's the lowest that we've seen since August 2021. But again, not too many months ago, but that's when it was at a minus 0.95%. So again, on the fixed income side, not a lot of changes. On the equity side we did see what I would expect, some climbing or widening of discounts just for various reasons of doing tax loss harvesting and getting winners. So some of those winners and those losers so they can avoid some tax allocations.

CEFA:

How do current premiums and discounts compare to their historical averages?

Tom Roseen:

Well this is where I think it'll open up some people's eyes. If I go back 12 months and of course that's 1/29/2021, not 12/31, that'd be 13 months. But if I take a look at the time period of 1/29/2021 and compared to the numbers I just kind of recited to you again. We saw that all funds, this again closed end funds, both the equity and fixed income were at a discount of 7.29%. Whereas I just told you on 12/31 of the 2.03%, equity funds were at 10.13% now they're at 5.22%. In fixed income we're at 6.13%, they're now at 1.30%. So quite a change. And if I take a look at the number of funds traded at premium on 1/29/21, 85, on 12/31/2021 it was 159. So almost twice as much as we had a year ago. So really there's been an improvement and it's pretty much stuck around.

CEFA:

Which sector you saw the greatest change?

Tom Roseen:

Basically if we take a look at some of the big changes that we saw out there. When we take a look at our world income closed end funds, so the largest widening of the closed end funds macro group, and I'm going to give to you macro group classifications here. 136 basis points to 2.30%. Remember I told you it was a widening. So to jump to 2.30% is not too alarming to anybody. Now on the equity side, the domestic equity group actually saw the largest narrowing of discounts, 98 basis points to 1.99%. Now that's among some of the lowest numbers we've seen in a while.

CEFA:

Tom, economic growth has been good and interest rates remain low but there are concerns about inflation and a shift in Federal Reserve policy. Are there sectors among closed end funds where investors may find particular opportunities given where those funds are trading relative to their historical averages and how do you see the direction of the markets?

Tom Roseen:

So we had a spectacular run up as I just described. And this is kind of a foot off the pedal for tech stocks and stay at home stocks. They underwent some pressure at the year-end as people were changing. And we got a little of that back mid-month in December as well. But investor's focus has shifted and really is turning towards value plays. And I'm going to call it income issues or income focused issues that could basically help returns, total return. But if we take a look at it, remember I was telling you financial services actually do better as interest rates rise. They're able to raise some of their rates and they earn a little more money. Utility funds certainly could have a benefit. Sector equity funds are on their own. Sector equity funds for the year only returned about 14.12%.

I say only. With some of the big numbers we saw that's a low number. And utility funds only did about 17.12%. So they were the relative laggards of the equity universe. But we take a look at the world equity funds and I think most people will be paying attention in the space. Global equity funds did okay, 13.04%. But developed market funds were only returning about 8.22% for the year. And emerging market funds basically only had about 6.99%. So they have some opportunity to try to catch up to some of the returns as the normalization of returns on the domestic equity side kind of come in play. And of course we're going to keep our eyes on materials. We've had a material shortage. We think that there's going to be some extra benefit as materials start to loosen up a little bit, more demand, that could be a play.

On the fixed income side, one of the areas that I've been telling people is inflation protected to take a look at and also loan participation funds. Now that was a big winner, 8.24% for the year. Doesn't sound a lot but again remember the fixed income side. So it was one of the top performers for the one year period. But again, with the inflation on the rise, rising interest rate probability, this might be something you can keep an eye on. But one of the out of favor issues, actually two is both corporate debt, triple B rated closed end funds and corporate debt triple B rated leverage funds. They had a 0.15% minus and positive 3.61% of returns for the one year period. So they were a little bit laggards. And of course, I've already mentioned the idea that maybe if you're willing to put some risk on the table, you could take a look at emerging market hard currency debt funds. They were down 1.86% for the one year period. But again, that's not for the faint of heart. And there is a lot of volatility in that space as well.

CEFA:

If the Federal Reserve does begin to have less accommodative policy including raising interest rates, how would you expect this to impact closed end funds?

Tom Roseen:

There are kind of two issues here. It all depends with the speed of the changes. If it's slow and steady, well telegraphed, which so far it has been. We don't know when the first rate hike's going to be. But I could see money being made up in interest rates. So interest payments that will offset the losses that we have from that inverse relationship as interest rates rise. The value of our bonds or our mutual funds will decline a little bit so it could be a push. If it's aggressive I think some people are going to keep a really close eye on longer dated or high duration securities. So that will be a concern. The other issue that I think people are trying to pay attention to is the interest rates and how the higher interest rates are going to impact leverage.

And when we take a look at leverage, obviously funds borrow money and then what they want to do is borrow a very low rate and then put it back to work for a higher rate. This may stop them or maybe curtail a little bit of that use. Again, we don't know, we don't know how fast it's going to go. But today, it's not closed, but today I heard that we jumped to 1.8% on the ten year treasury which we haven't seen by the way since around January. I'm going to say between the 17th and the 21st of 2020. So interest rates are obviously on the rise. We've seen some of the biggest jumps in rates that we've seen again almost two years of time. So I think people are going to be keeping a really close eye on that.

CEFA:

Tom, you also follow interval funds which typically offer limited quarterly liquidity to investors. How have interval funds generally performed in the fourth quarter of 2021?

Tom Roseen:

Well, they kind of underperformed this time. In almost all of the quarters that we've reviewed this, the interval funds were kind of a I think an outperformer at many times. But we saw that, for instance, in the real estate space there was about 35 interval funds, about eight conventional closed end funds. And they underperformed a bit for -- taking a look at the three month period of time, again, not anything that really to say was bad. The average interval fund returned about 6.07% but the average conventional closed end fund had about a 12.64% return. So almost a doubling. Now keep in mind you're comparing 35 funds to 8 funds. That's not really a good comparison. We did see that in sector equity, we saw that general bond funds and in high yield funds that the interval funds actually did outperform sometimes only marginally but they did outperform. For example, sector equity funds had a 2.98% for the average interval fund. Whereas the average closed end conventional fund had 2.66%.

We're talking about 20 basis points benefit towards the interval side. Loan participation funds was about a push, 58 basis points versus 63. And then we saw that on the income and preferred stock area they actually underperformed quite significantly, about 30 basis points or 0.30% return versus 1.96%. So overall, there was a little bit of a change in the leadership. But again these are the reasons we invest in these on a long-term basis. It's not necessarily for a quarter to quarter type of return that we're looking at. We're looking at longer time periods. Illiquid securities, and not all illiquid, but more illiquid securities. And it gives them plenty of time to actually recover.

CEFA:

What asset classes or investments strategies do you believe offer the most interesting opportunities for interval fund investors in the current market?

Tom Roseen:

So certainly as we take a look at it, like I was saying the real estate and preferred stock underperformed this time and general bond and high yield outperformed and loan participation were neutral. But when we take a look at some of the offerings that are out there, basically general bond funds, the real estate funds and the sector equity funds I think have the biggest opportunities to jump into. They have the most offerings. And as we take a look actually, when we're taking a look at like new fund offerings and truly when we're looking at the new funds the majority of them actually are interval funds. I said in my most recent segment that we had about 37 new funds that came out and out of those 37 new funds that came out, we saw that 24 of them were interval funds.

So certainly the fund families, our understanding that they can offer a different product. Again, less liquid and I think we always have to make sure everybody knows that. Often the refunding or the opportunity to sell your securities are quarterly, often it's between 5% and 10% of the assets under management. So if you need to get out, it's not a good time to get out. But certainly the area that we are talking about, the general bond and real estate and sector equity have had the biggest offering and give people a sampling of different vehicles that they can go into and have a bigger set rather than have just one or two offerings.

Some of these have, the general bond, real estate and sector equity have the largest offerings. Let me give you an example here so the rambling makes sense. General bond funds, there are 45 offerings in interval closed end fund space where there are only 23 on the conventional closed end fund space. So these are where you could probably find some good deals. But again, caveat emptor, they may be difficult to sell if you need to get out of them quickly and raise cash quickly.

CEFA:

Tom, thank you so much for taking the time to join us today.

Tom Roseen:

Diane, it was my pleasure. Thanks for having me.

CEFA:

And we want to thank you for tuning in to another CEF Insights podcast.

This article was written by

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