Seeking Alpha α

Closed End Funds

CEF Weekly Market Review: When It Rains It Pours

Jan. 29, 2022 7:52 AM ET | AFT, AIF, DFP... | 12 Comments | 24 Likes

Summary

- We review CEF market valuation and performance through the third week of January and highlight recent market action.
- The CEF market had a terrible weak with all sectors finishing in the red and most sector discounts widening substantially.
- We highlight some of the key typical features of CEF drawdowns that investors should be mindful of.
- Credit-sensitive and equity sectors remain expensive, so investors have to pick their spots when allocating in the current market.
- In our view, the tax-exempt CEF sector is beginning to enter an attractive valuations range.
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This article was first released to Systematic Income subscribers and free trials on Jan. 23.

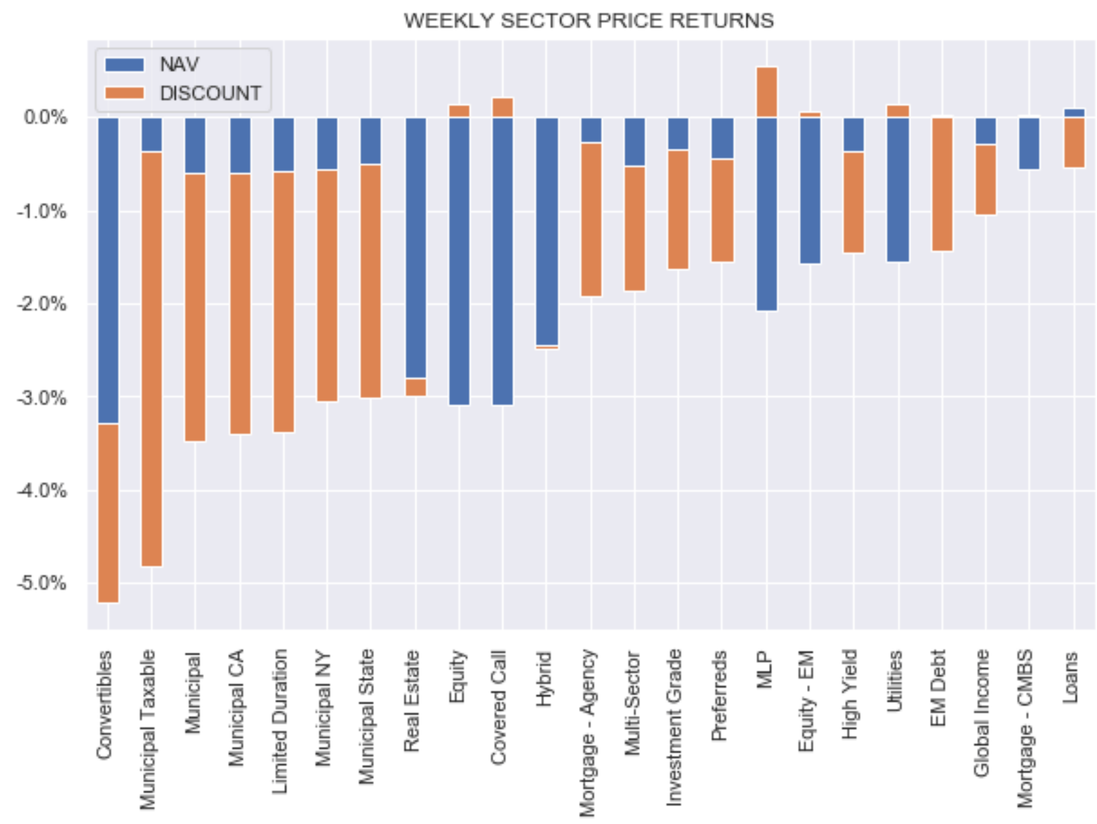
Welcome to another installment of our CEF Market Weekly Review where we discuss CEF market activity from both the bottom-up - highlighting individual fund news and events - as well as top-down - providing an overview of the broader market. We also try to provide some historical context as well as the 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 January. 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 Action

In one of the closing CEF weeklies for the year, we posed the question of whether CEF market performance was going to resemble the flat return period of the second half of 2021 or something worse. So far in this young 2022 the answer appears to be: worse.

It was unquestionably a tough week for the CEF market with all sectors falling in price terms. The worst sectors were Convertibles, not surprising given their Tech focus which was the eye of the storm, and longer-duration sectors like munis. Sectors that held in relatively well were loans (the only sector with a flattish NAV performance for the week), CMBS and non-US bonds.



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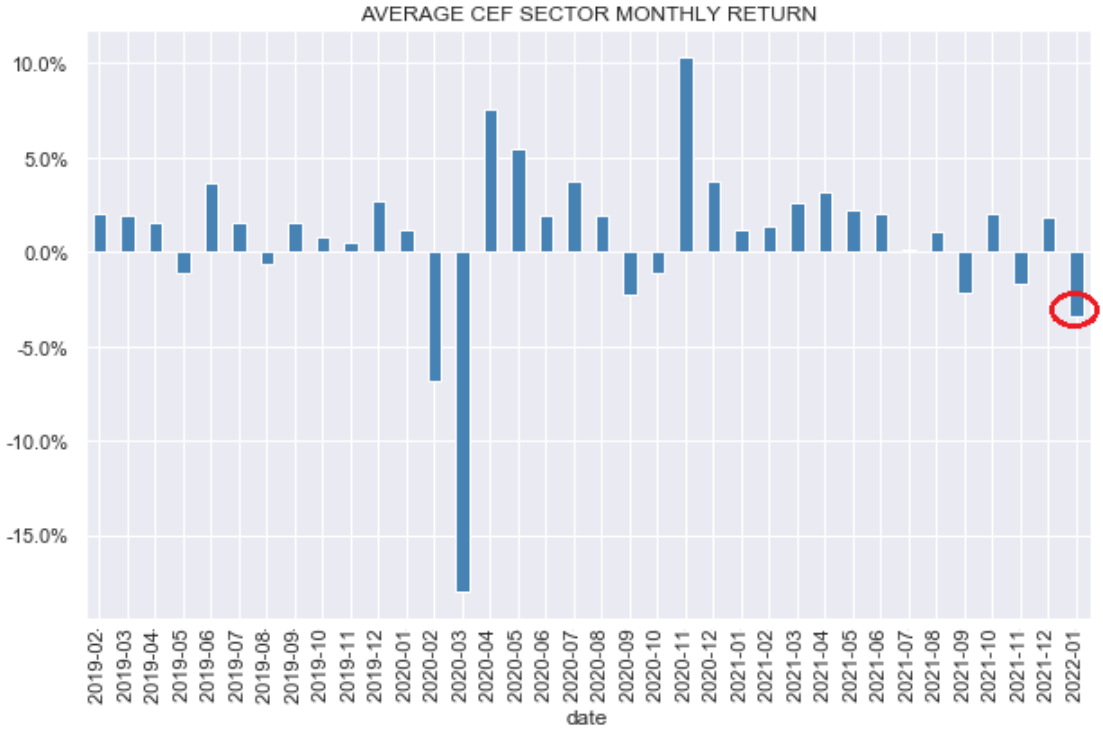
From a monthly perspective, January is shaping up to be the worst month for CEFs since April 2020 at around a -3% total return.



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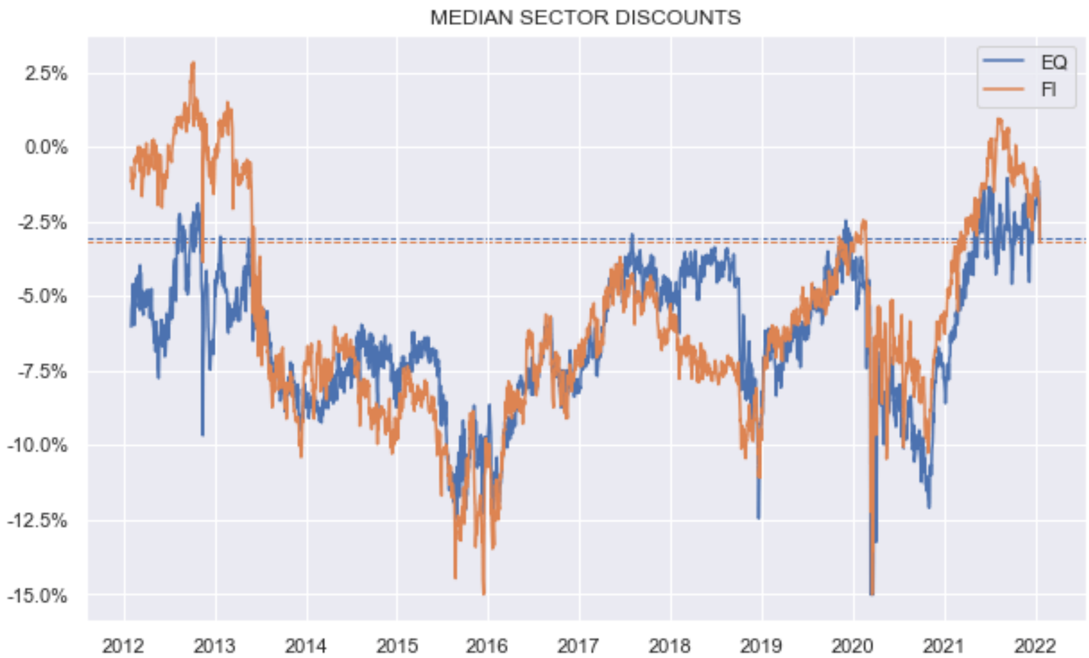
In terms of discounts, fixed-income sector discounts are now trading below their pre-COVID levels, having deflated about 4% since their peak a few months ago. Equity sector discounts have also fallen but are closer to the middle of their range for the past year or so. Overall, discounts are still relatively expensive, going by the price action of the last decade.



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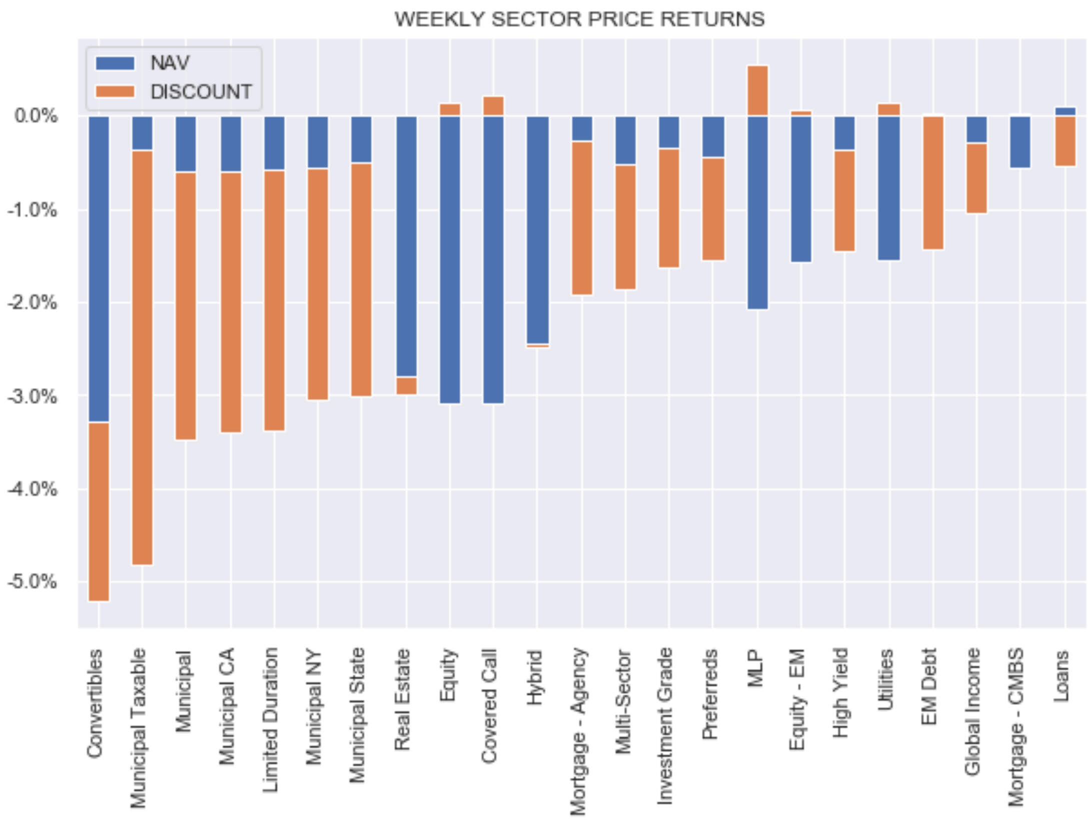
Market Themes

Given the price action last week, it's worth reviewing some of the key dynamics of CEFs drawdowns.

First, higher-quality sectors were not spared from price weakness. Although there was a lot of concern over rising Treasury yields so far this year, longer-term Treasury yields actually fell on the week. Despite this, municipal funds (which typically allocate to very high quality municipal bonds) were among the hardest hit as the following chart shows.



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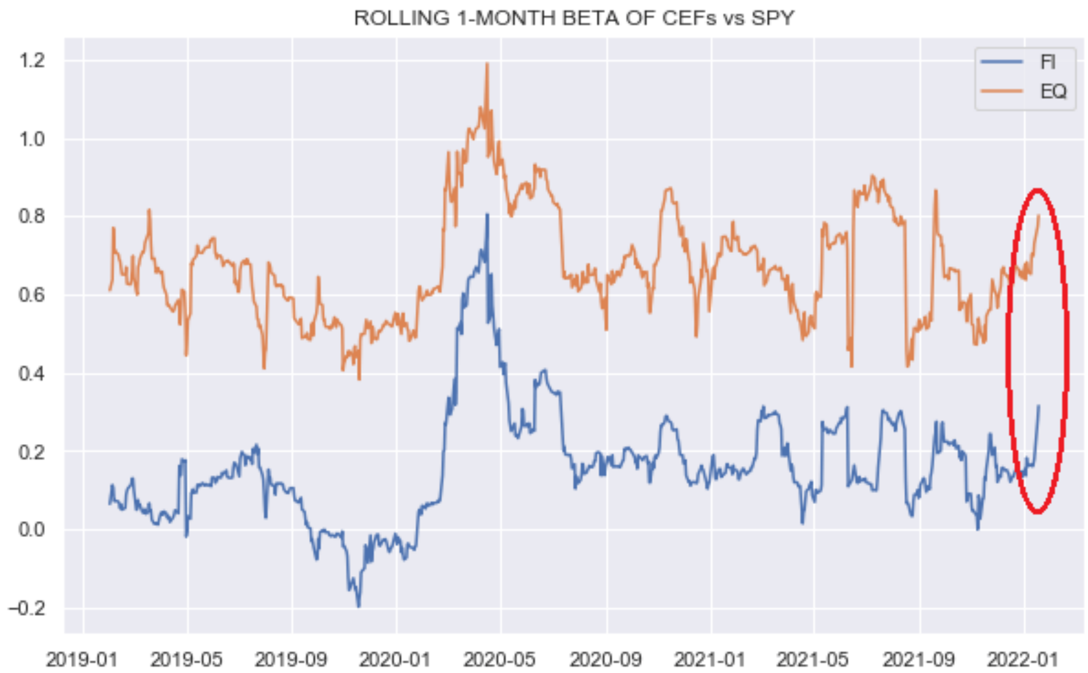
This frequently observed drawdown pattern repeatedly disappoints investors who allocate to higher-quality or lower-duration sectors like municipals or limited duration sectors in expectation that these sectors will outperform during drawdowns. And although the NAVs of these sectors tend to hold up well, their prices are not exactly a shelter in a storm.

Secondly, CEF beta to stocks rose for both equity and fixed-income funds. This dynamic, in effect, reduces the diversification that CEFs provide over stocks. For instance, during the March 2020 drawdown, fixed-income CEFs went from being uncorrelated to the S&P 500 to trading with a beta of 0.8 to the S&P. This "bonds to the upside, stocks to the downside" dynamic is often pointed to by disappointed CEF investors who expect their fixed-income funds to behave like, well, fixed-income, rather than stocks during periods of stress. The smart alecs in the room are quick to point out that CEFs are actually common shares of investment companies so even if they hold fixed-income assets, they often behave like common shares of other "traditional" companies.



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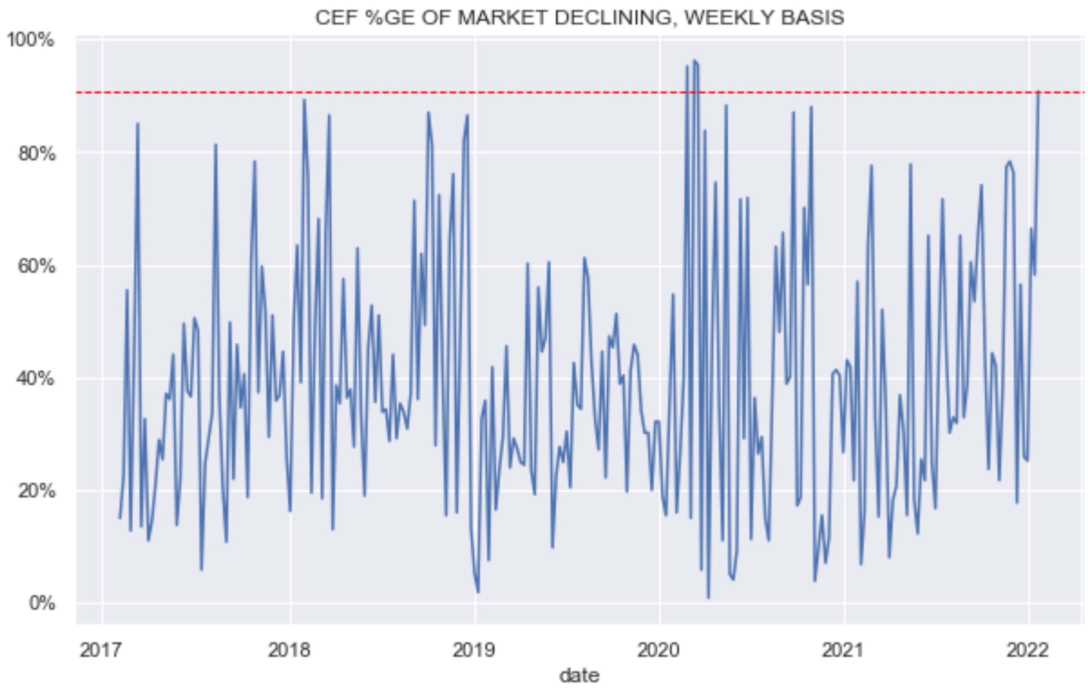
The third typical pattern seen this week, observable in the first chart above, was that fixed-income sector discounts widened more than discounts of equity funds. This is another annoying feature of the CEF market - since one would expect that the harder hit equity sectors (in NAV terms) would also be harder hit from a discount perspective. However, the key point is that the CEF market often trades in a way as to equalize price returns during drawdowns which means that sectors with more modest NAV returns often see worse discount performance. There is no fundamental reason for this to be the case - it could be driven by investors reallocating from higher-quality fixed-income sectors and buying the dip in higher-beta sectors.

Finally, on a weekly basis, more than 90% of the CEF market fell - a "pours when it rains" kind of dynamic. This makes it difficult for investors who run all-CEF portfolios to take advantage of market dislocations since they would likely have few CEF positions that remained unscathed. By contrast, "only" about a three quarters of the preferreds and baby bond markets declined on the week (and the declines were much smaller, on average), leaving investors with more dry powder assets with which to reallocate to newly revealed opportunities.



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This last dynamic highlights another investment belief about the CEF market. Specifically, some investors say that they absolutely love CEF drawdowns because it allows them to reinvest dividends at lower prices and higher yields. And this can make sense. However, there are three issues worth considering. First, CEFs can lock in permanent economic losses if the drawdown also features a deleveraging (more likely in case of a NAV drawdown than just a discount widening).

Secondly, because CEF discounts are pretty highly correlated it usually means that adding additional capital at lower prices means having to sell something else which is also at lower prices. In other words, a portfolio that is all or nearly all allocated to CEFs offers fewer opportunities to reallocate to assets during drawdown because CEFs, even those allocated to very high-quality sectors, also tend to suffer significant drawdowns.

And thirdly, a CEF that has seen its discount widen offers no guarantee that it will bounce right back up. The CEF market is littered with corpses of CEFs that now trade at much wider discounts than did previously and that includes many "blue-chip" PIMCO taxable CEFs - the valuations of these CEFs are very unlikely to move back to previous elevated levels.

Market Commentary

The Nuveen Preferred and Income 2022 Term Fund (JPT) had its shareholders approve the restructure so it will turn into a standard perpetual CEF (from being a 2022 term CEF). The fund will conduct a tender offer at the NAV, allowing investors to exit. It also means that JPT is very likely to increase its leverage - from low 20s to low 30s - where other sector funds are as the following table from our subscriber CEF Tool shows.

PREFERREDS	Lvrg
SECTOR AVERAGE	33.1%
DFP	33.6%
FFC	33.6%
FLC	33.7%
FPF	31.0%
HPF	32.6%
HPI	32.3%
HPS	32.3%
JPC	37.2%
JPI	35.0%
JPS	36.8%
JPT	22.1%
LDP	30.2%
PFD	33.1%
PFO	33.7%
PSF	29.5%

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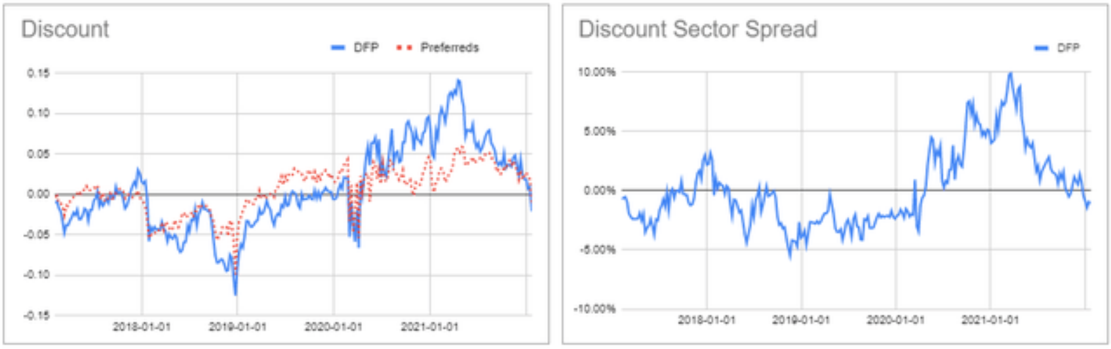
The knock-on effect of this is that we expect the fund to also hike its distribution to be on par with the other Nuveen perpetual funds JPS and JPC. JPT is currently at 5.87% on NAV which should move to around 6.4-6.5% on NAV. Normally, a fund that increases its distribution should also move to a tighter / more expensive discount valuation, however, JPT is already trading at a higher discount valuation than JPS and JPC so once the tender goes through its discount / premium should weaken to converge with the other 2 funds.

Overall, within the sector we continue to like the Cohen & Steers Tax-Advantaged Preferred Securities & Income Fund (PTA), trading at a 6.1% discount (the widest in the preferreds sector) and a 6.6% current yield (roughly in line with the sector average). The fund may be particularly attractive to investors who are worried about higher interest rates as its duration is a very modest 3.7 based on its Q3 disclosure. This is due to its use of interest rate swaps as a way to both lower its duration profile and lock in a fixed-rate cost of its leverage.

For investors willing to entertain a higher level of duration (and, hence, a higher level of income) we like the Flaherty & Crumrine Dynamic Preferred and Income Fund (DFP). In other view, the suite of 5 Flaherty preferreds funds have not been particularly attractive since the end of 2020 due to their excessive valuations. Over the past year, 3 of the 5 funds have delivered a negative total price return with the best Flaherty performer managing to eke out a meager return of just 1% - clearly a disappointment for less patient investors.

The valuation story has now corrected and DFP is trading at a discount of 2.1% and at a wider discount than the sector average as the chart below shows. In our view, DFP is currently the most attractive of the Flaherty preferreds CEFs.



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Tortoise MLP funds TYG, NTG, TTP, NDP, and TPZ have sharply increased distributions (by 35-75%) and adopted managed distribution policies to target distribution rates of 7-10% of NAVs. Separately, and also part and parcel of this discount management effort, they will hold tender offers this year and next for 5% of shares at 98% of NAV for funds trading at discounts wider of 10%.

MLP funds continue to trade at some of the widest discounts in the MLP space. This is a big change from a few years ago when the sector tended to trade at a premium. This was explained at the time by the fact that the C-Corp funds had a lot of deferred tax liabilities (from the funds receiving ROC payments over the years) which should really be added back to NAVs (i.e. making NAVs higher) to make them more comparable to RICs - the more typical structure of CEFs. That's gone out the window now either because of poor returns over the last 5 years or so (which don't give rise to DTLs) or because assets that generated DTLs were sold down and their tax liabilities were realized or because people realized that MLP CEFs are prone to periodic bouts of deleveraging due to the very high volatility of its assets.

The two Apollo loan / credit CEFs AIF and AFT decreased distributions - reversing the increase in the middle of last year. Coverage is now closer to 100% though still a bit below based on the previous semi-annual report. The reversal could possibly be a function of four things - a simple normalization closer to a 100% coverage (though this doesn't explain why the previous hike took place), a rotation into higher-quality securities (could make sense given how stretched valuations were at the end of 2021), a decrease in leverage or a pre-emptive move based on the expectation of the March Fed policy hike.

The funds source their financing via a credit facility at a rate of Libor + 0.875%. 3-month Libor has already risen from its trough of around 0.12% in mid-2021 to around double that in expectation of the Fed hike so the fund's cost of financing has already increase (and hence, its NII has already decreased slightly).

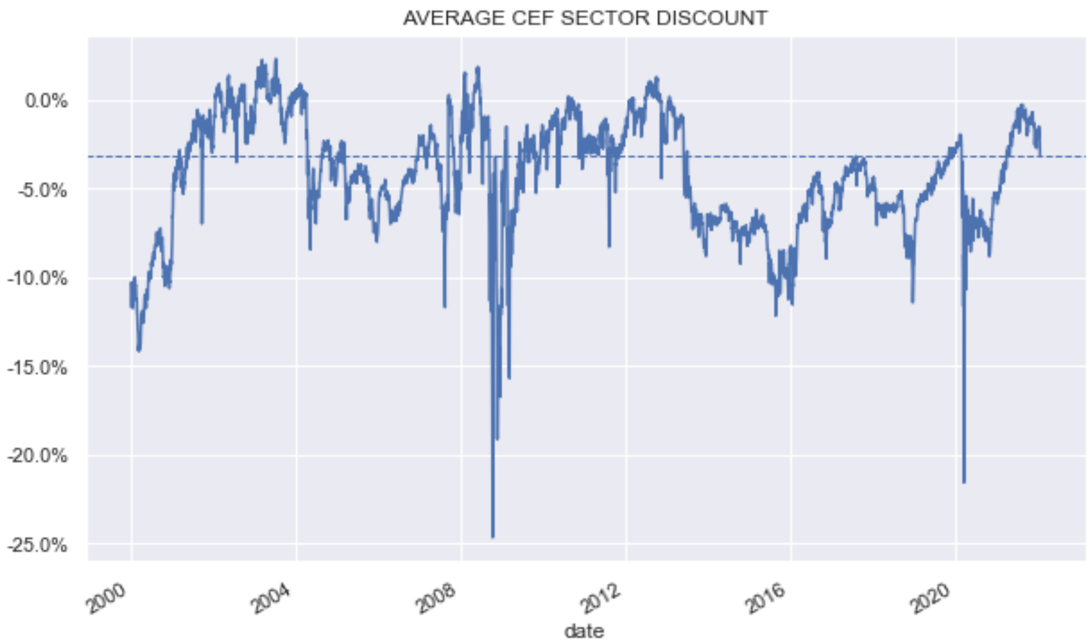
Further rate hikes will push Libor even higher, driving NII lower. The fund has the following comment in its report which is quite telling: "To the extent that the Fund makes investments in Senior Loans or other debt instruments structured with LIBOR floors, the Fund will not realize additional income if rates increase to levels below the LIBOR floor but the Fund's cost of financing is expected to increase, resulting in the potential for a decrease in the level of income available for dividends or distributions made by the Fund." This is worth keeping in mind for investors who expect higher NII from loan CEFs on the day of the first hike.

Glancing at the holdings, the median floor looks to be around 0.75% so NII will move lower until Libor moves above 0.75% so for the first couple of hikes we should see income move lower. AIF remains in the High Income Portfolio at a 6.6% current yield and a 6.4% discount.

Stance & Takeaways

We have been complaining about both expensive CEF valuations and expensive underlying asset valuations all through the second half of 2021, so a CEF market drawdown is not unwelcome.

That said, from an allocation perspective, there are three things worth nothing. First, the broader CEF market valuation is not blindingly cheap as the following chart shows.



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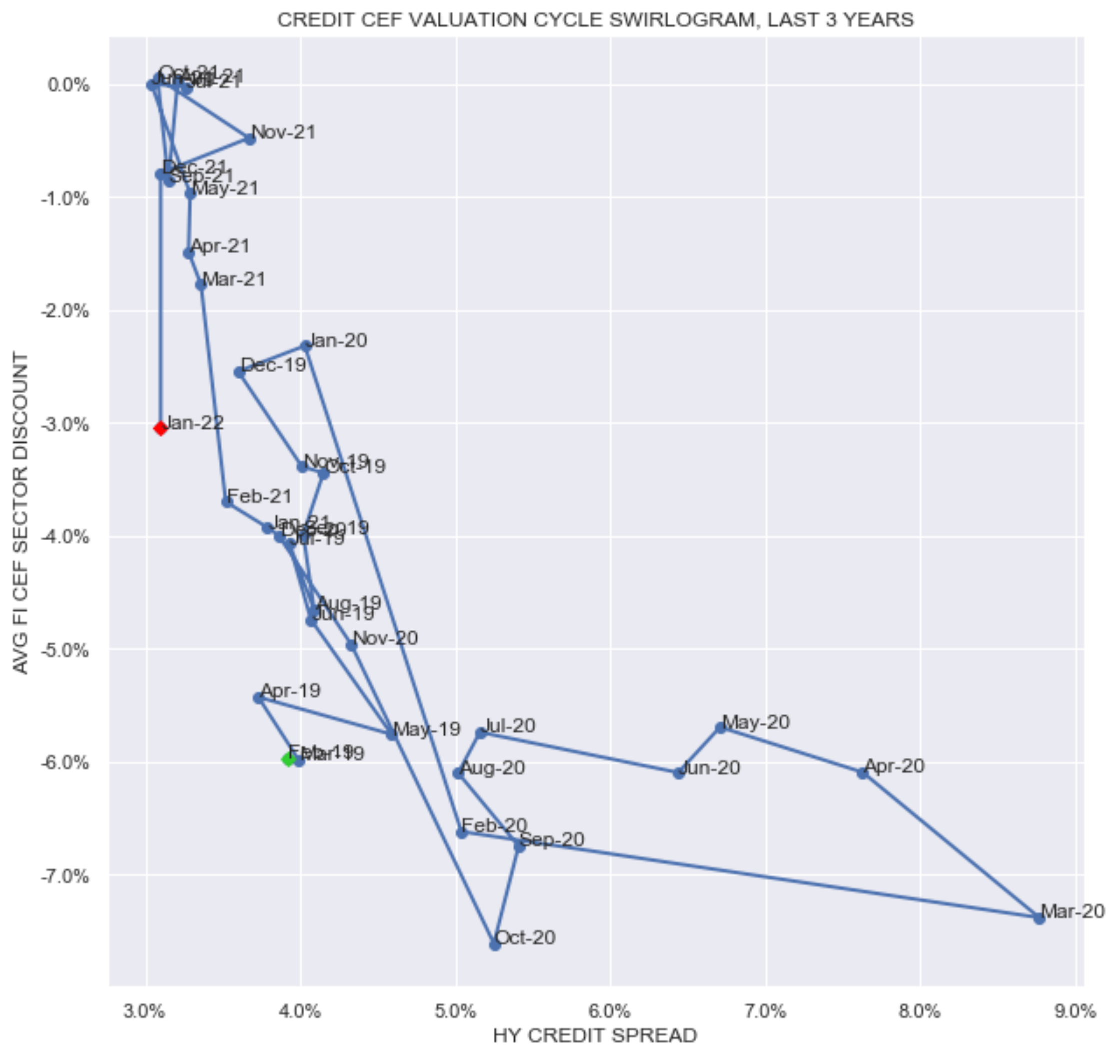
Secondly, while discounts have indeed come off their nosebleed levels, underlying asset valuations have not. As the following chart shows, credit spreads remain stubbornly expensive, near their tights of the last 3 years and not far from their record tights.



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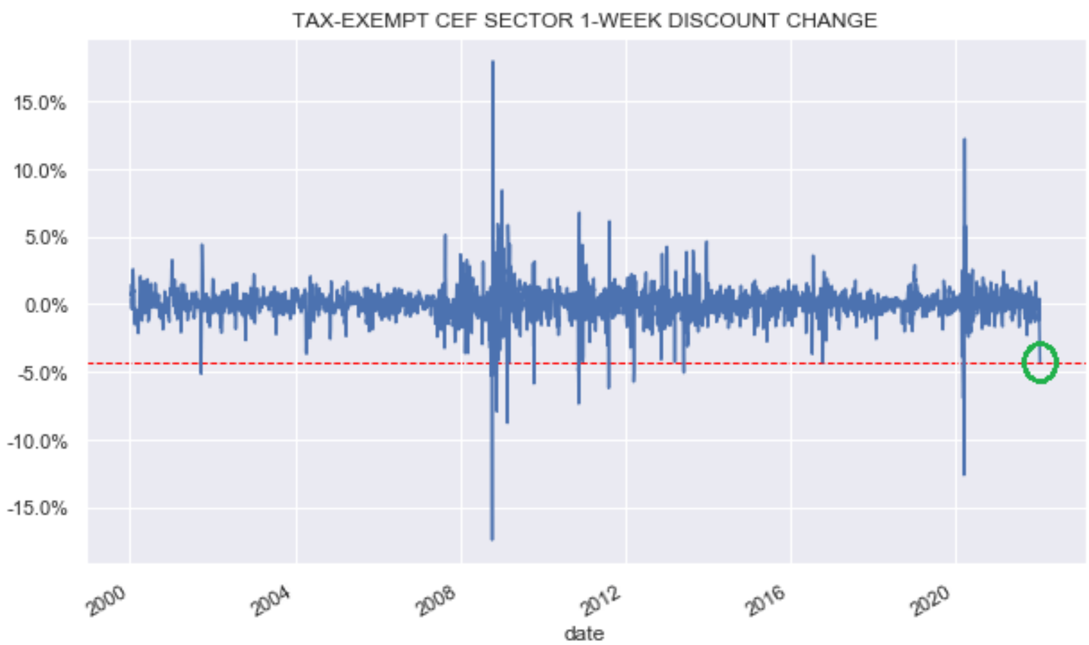
Thirdly, lower-quality / higher-beta sector valuations have not budged a whole lot. For example, high-yield and loan CEF sector valuations remain historically expensive as are many of the equity sectors (see the discount sector valuation table above).

What this sums up to, in our view, is that now is not the time to focus on the credit-heavy or equity sectors. However, tax-exempt sectors are beginning to look attractive. This conclusion may seem bizarre given one of the consensus risks facing the market is precisely the risk of higher interest rates and their knock-on impact on longer-duration assets like tax-exempt bonds.

However, in our view, there is a natural escape valve to longer-term yields which is that 1) we don't expect the Fed to be able to hike rates anywhere near current levels of inflation of 5-7% (depending on core or headline) without triggering a recession and 2) we expect the yield curve to invert in a recession. Neither one of these views is particularly controversial but putting them together does mean that there is a limit as to how high longer-term rates can rise without causing them to fall back lower. In short, once the 10-year Treasury yield moves past an area of 2-2.25% (it closed at 1.75% this week) we would much rather be taking duration risk than a large amount of credit or equity risk.

In terms of valuation, the tax-exempt space was among the hardest hit on the week. The chart below shows a weekly change in the discount, highlighting that there have been only 5 times that the sector's discount widened around 5% or more over the week over the last decade.



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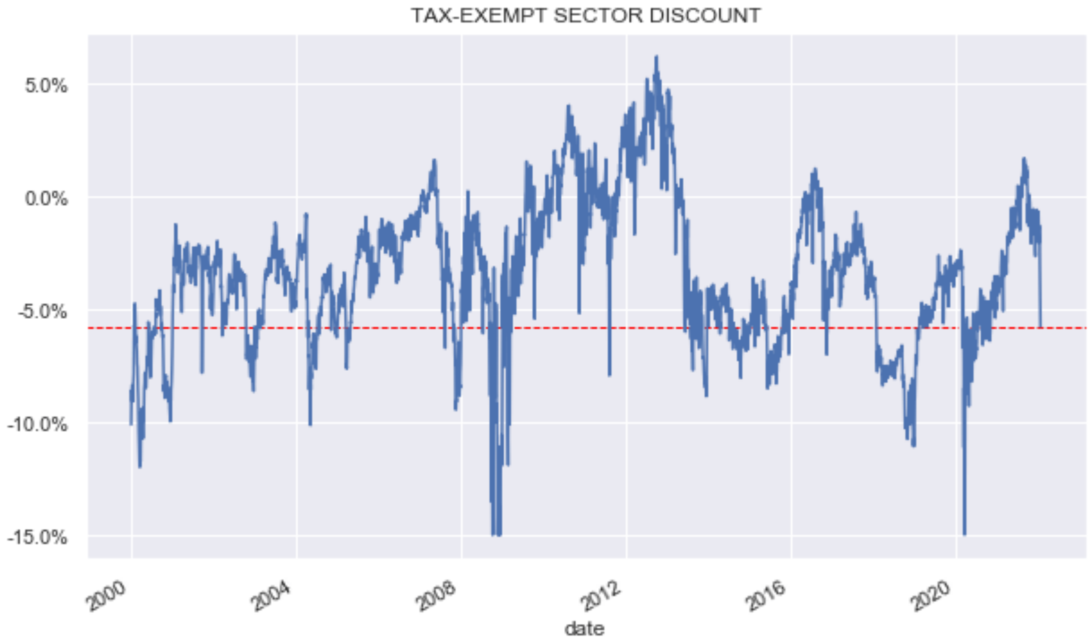
The sector's discount has now moved to trade pretty close to its historically cheap range of 5-10%.



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Our allocation to the sector in our Municipal Income Portfolio has benefited from a significant overweight of open-end funds and term CEFs, both of which didn't move a whole lot over the week, in contrast to the broader CEF sector which sold off around 5%.

Funds that are we are watching to add are the Nuveen Quality Municipal Income Fund (NAD), trading at a 8.2% discount and a 4.9% current yield and the Eaton Vance Municipal Income Trust (EVN), trading at a 8.7% discount and a 4.52% current yield. It is worth nothing, of course, that Treasury yields could very well continue to move higher and tax-exempt sector price action could remain weak. However, starting to add marginally to these funds, particularly using capital from parts of the portfolio that have remained much more resilient can make sense.

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This article was written by

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