Seeking Alpha α

Closed End Funds

CEF Weekly Market Review: What It Means To Be A Bargain

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Summary

- We review CEF market valuation and performance through the fourth week of January and highlight recent market action.
- CEF discounts recovered this week after what looked like retail capitulation and despite NAVs moving lower on the week.
- Investors can sometimes be swayed by the optics of 5-10% discount compression however intelligent bargain hunting requires a few more steps.
- We rotated from terms CEFs to perpetual CEFs this week in our tax-exempt allocation to take advantage of a number of new opportunities.
- We also highlight a number of market developments such as the new PIMCO fund PAXS, preferred CEF sector valuations and more.
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This article was first released to Systematic Income subscribers and free trials on Jan. 29.

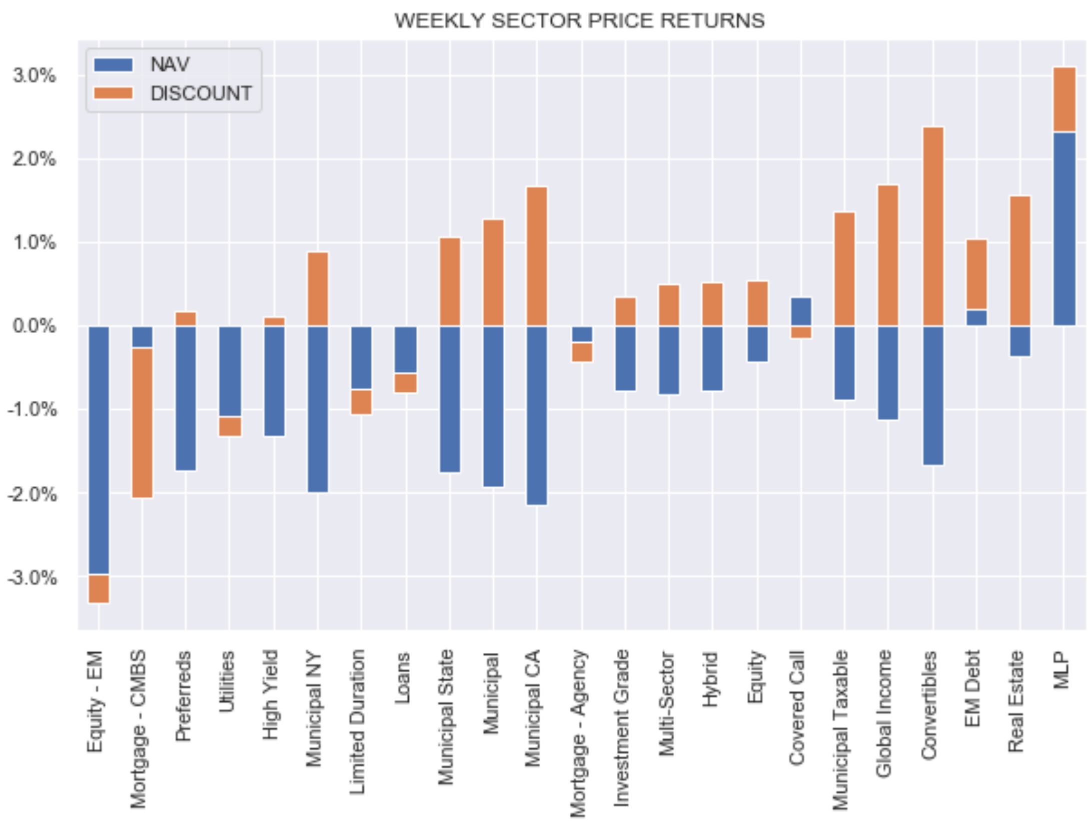
Welcome to another installment of our CEF Market Weekly Review where we discuss CEF market activity from both the bottom-up - highlighting individual fund news and events - as well as top-down - providing an overview of the broader market. We also try to provide some historical context as well as the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

Last week we highlighted the unusual dichotomy in the CEF space where discounts widened substantially but credit spreads remained glued to the floor. This unusual dynamic has partly corrected itself as discounts retraced somewhat and credit spreads leaked wider. Spreads finished 0.36% wider Thursday to Thursday, moving more than 10% from their starting level.

CEF sectors that outperformed in discount terms this week were those that were hit the hardest the previous week - Munis and Convertibles.



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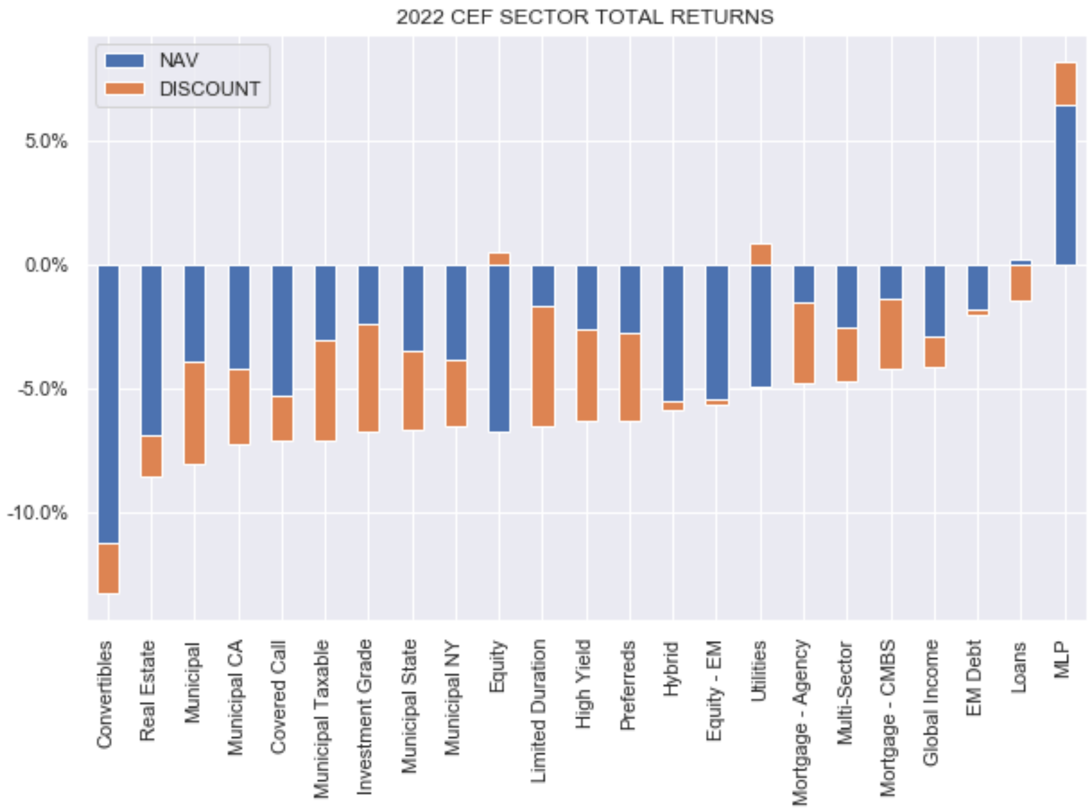
What was also interesting this week was that NAVs continued their steady march lower, this time pushed lower not by stocks or Treasuries but by credit spreads. As we have highlighted previously, all three key drivers of CEF NAVs were trading at expensive levels with each priced close to perfection. A small wobble in one of the legs can destabilize overall performance.

On a year-to-date basis all sectors outside of MLPs remain lower with munis and higher-beta sectors like converts, REITs and covered calls leading the way lower.



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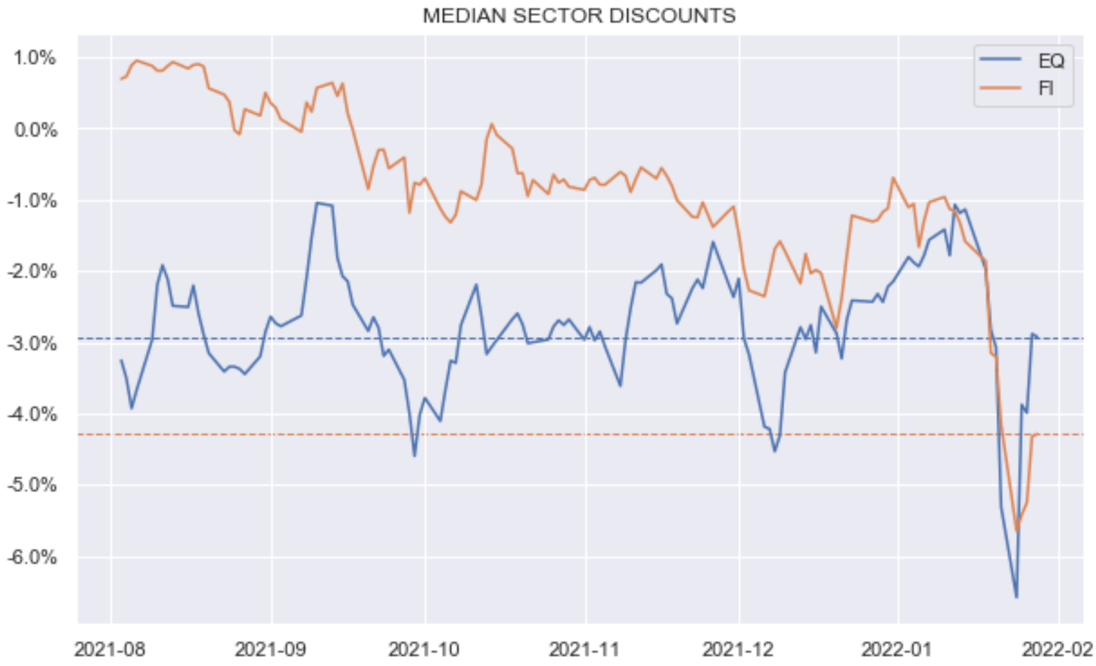
Equity-sector discounts have reversed about two-thirds of their drop while fixed-income sectors reversed less than a third.



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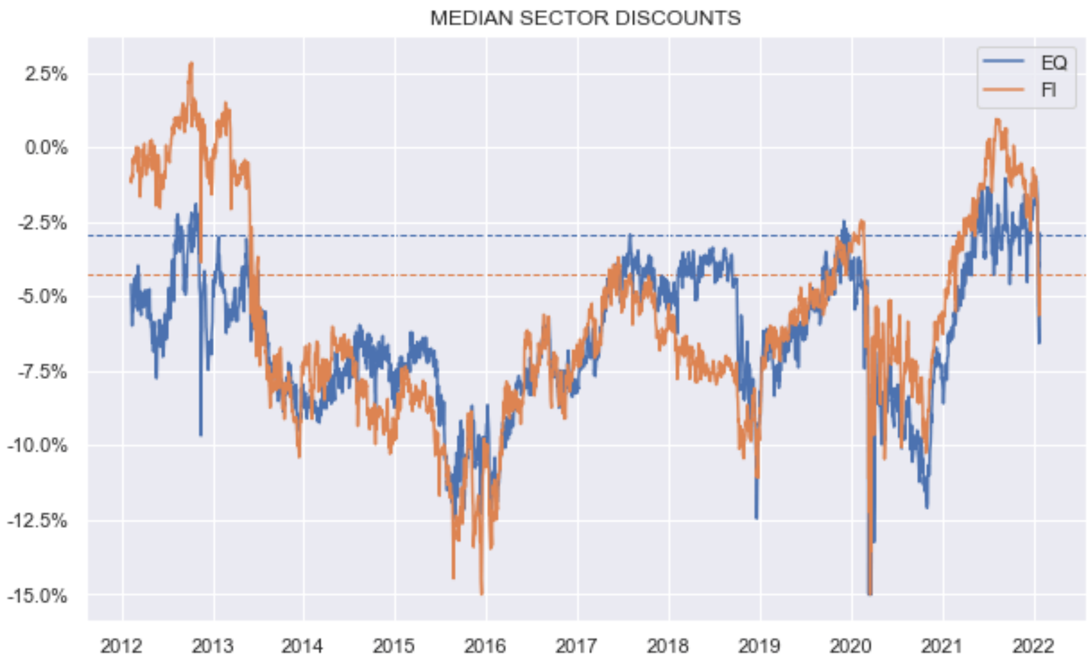
From a longer-term perspective, however, discounts remain pretty expensive, in aggregate.



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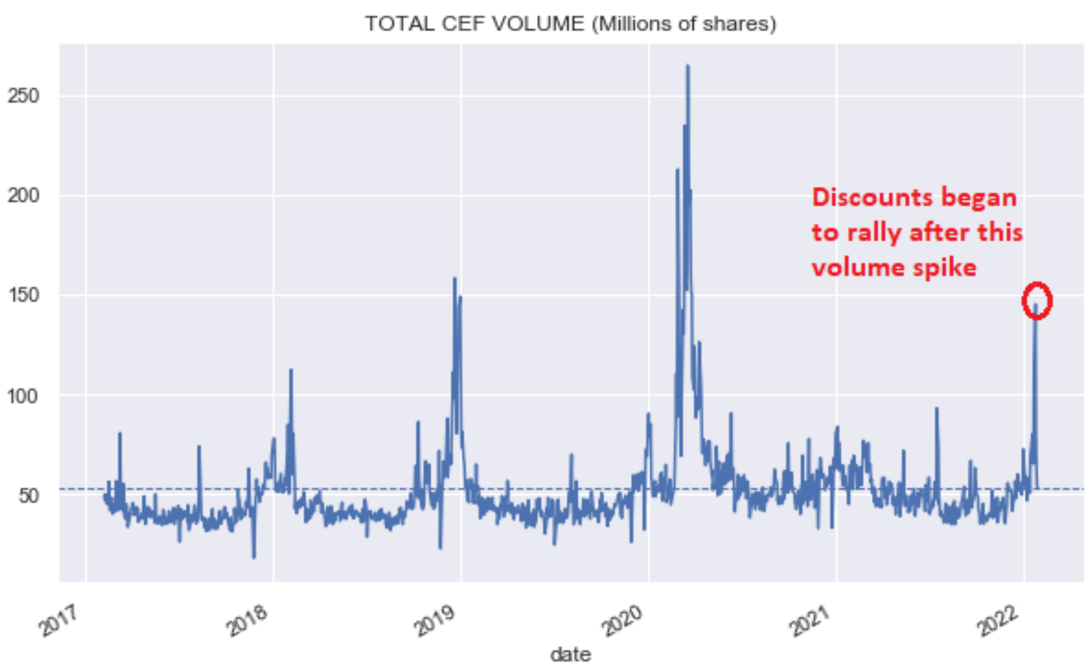
An interesting dynamic this week was that discounts began to rally right after a large spike in CEF volume shown in the chart below. For investors looking to gauge retail capitulation and initiate new positions with a margin of safety, aggregate volumes are important metrics to watch and is something we follow on the service.



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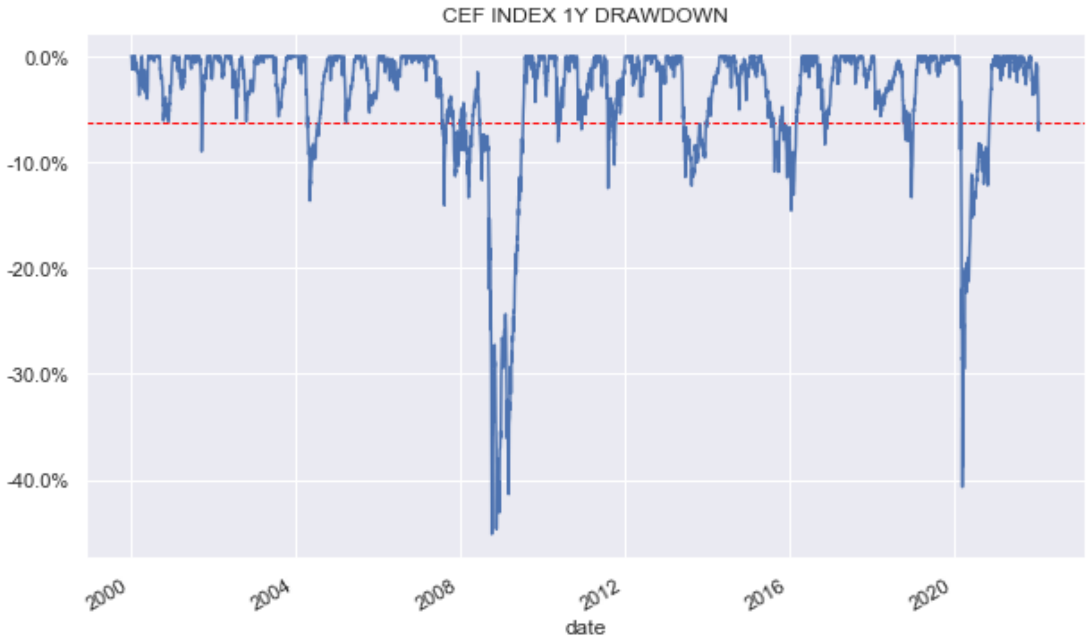
In terms of overall price drawdowns - this latest CEF market drop is not particularly unusual as the following chart shows. The CEF market sees similar 5-7% or larger drawdowns about every 12-18 months.



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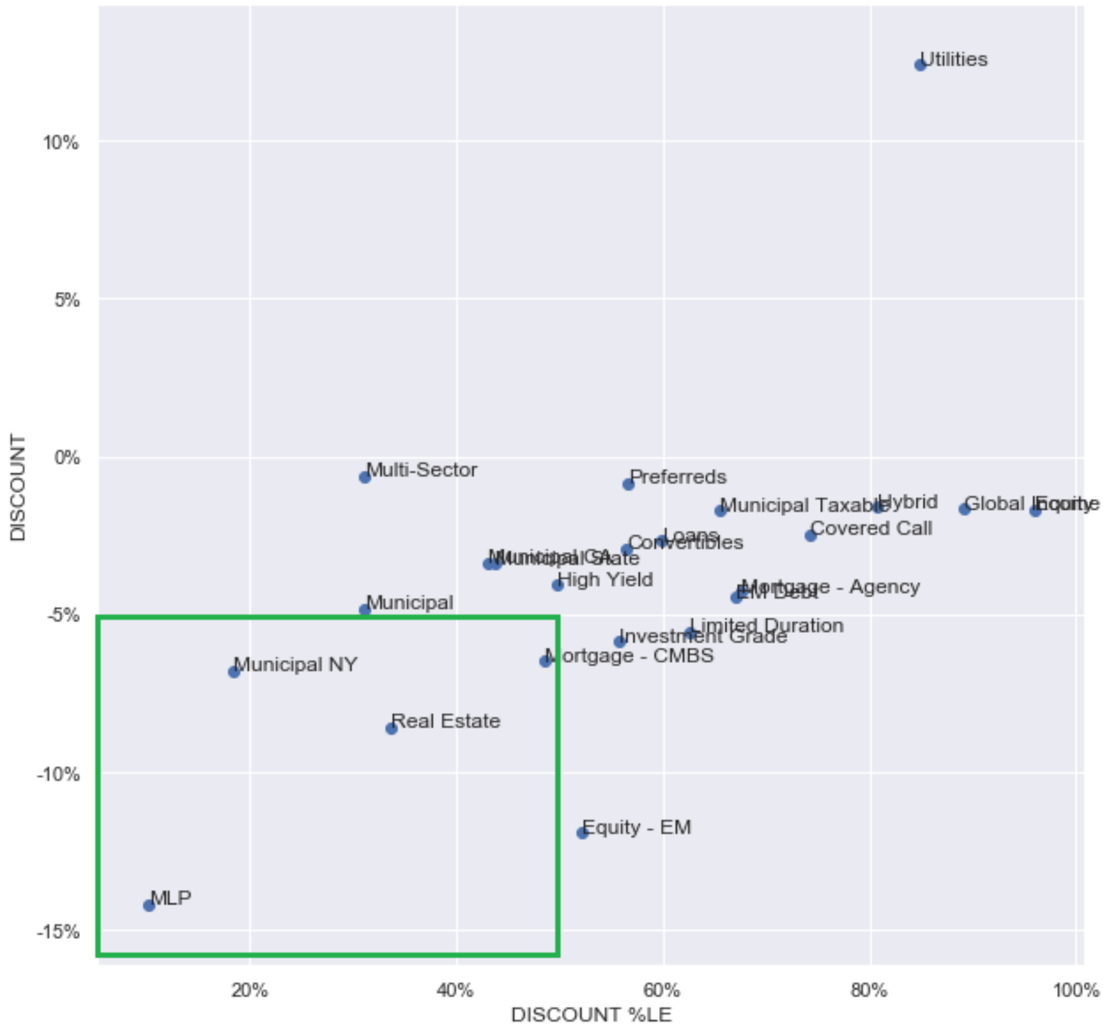
In terms of sector valuation, the following chart shows both absolute sector discounts (y-axis) and relative valuation (x-axis). A 50% discount percentile means the sector has had a wider discount half the time in the last 5 years. What the chart shows is that there are very few sectors with average discounts above 5% and having a discount percentile below 50% (i.e. below their median value in the last 5 years).



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Market Themes

We are hearing breathless reports from the usual commentariat about bargain prices in the CEF space with the John Hancock Investors Trust (JHI) as an example. Let's dig into this fund as a case study to see how investors can evaluate whether a given fund is actually a bargain or not.

The valuation of JHI has come off around 9% from its peak at the end of 2021 - its 5-year history looks like the following.

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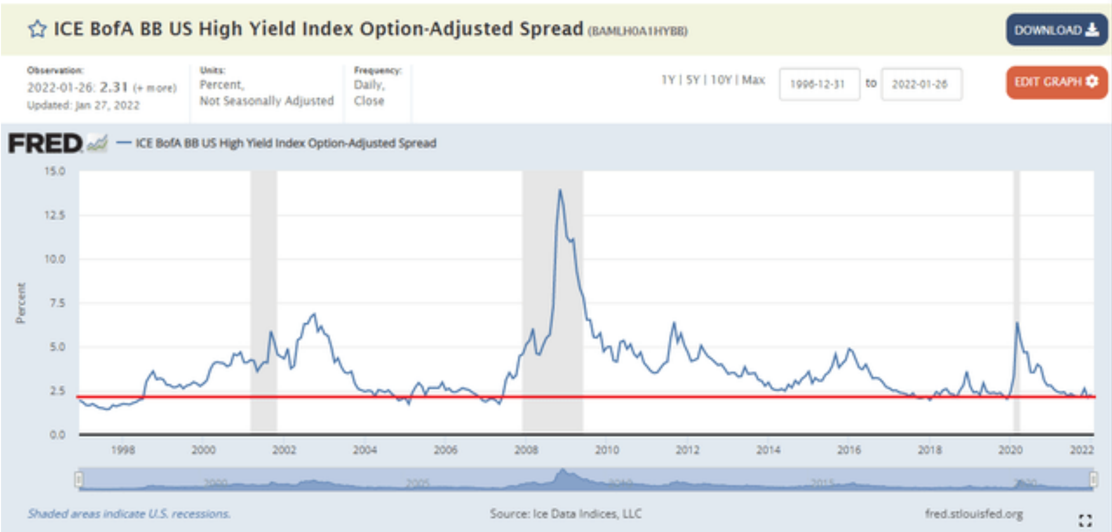
The chart makes it clear that the fund's discount briefly shot up to an unsustainable premium which has now completely deflated. Even on this very rudimentary observation that does not seem like an obvious bargain.

More quantitatively, on a 5-year basis the fund's discount is at a 0.3 z-score (i.e. a third of a standard deviation above the average). Perhaps more intuitively, it is at a 71st discount percentile (i.e. it is more expensive than 71% of days in the last 5 years). Calling JHI a bargain today is sort of like buying something at a 20%-off sale after it has been marked up 30%. The fact that an expensive premium has deflated to being only marginally expensive does not make it cheap. When evaluating potential "bargains" there are four key things for investors to be aware of. First, a lot of credit CEF discount commentary misses the obvious point that credit funds like JHI also hold assets whose valuation should be analyzed in addition to the fund's discount to see whether it's attractively valued *in aggregate*.

The fund's credit-quality sweet spot is in BB-rated corporate debt. Let's take a look at a metric of BB credit spreads over time in the chart below. What the chart shows is that BB-rated debt has only been more expensive briefly in 2005, 2007 and at the close of the 20th century - earlier data is not available.



FRED

Focusing exclusively on the discount while ignoring underlying valuations is the difference between buying a house in 2006 at a 5% discount and buying one in 2010 at a 0% discount. It might feel good to snag that 5% discount but we'd rather pay full market price if it's half of its 2010 level. Secondly, when thinking about discounts we should also consider how the fund is trading relative to the sector. Much of the commentariat involves looking at absolute discount levels, ignoring the fact that most CEFs have many other similar alternatives with capable managers.

This is how the fund stacks up to its sector (the High-Yield sector is the correct sector for comparison - CEFConnect bizarrely slots JHI into the Investment-Grade sector despite over 75% of the portfolio being below investment-grade).

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What the left-hand chart shows is that the fund's valuation has tended to trade in line with the broader sector and the right hand chart shows that the fund is actually trading at a tighter discount than the sector currently and is roughly in line with its 5-year valuation range versus the sector. Neither chart screams a bargain.

Thirdly, we have to consider something else which is that underlying credit yields have fallen over time which makes today's 5% discount actually expensive relative to a 5% discount 5-10 years ago.

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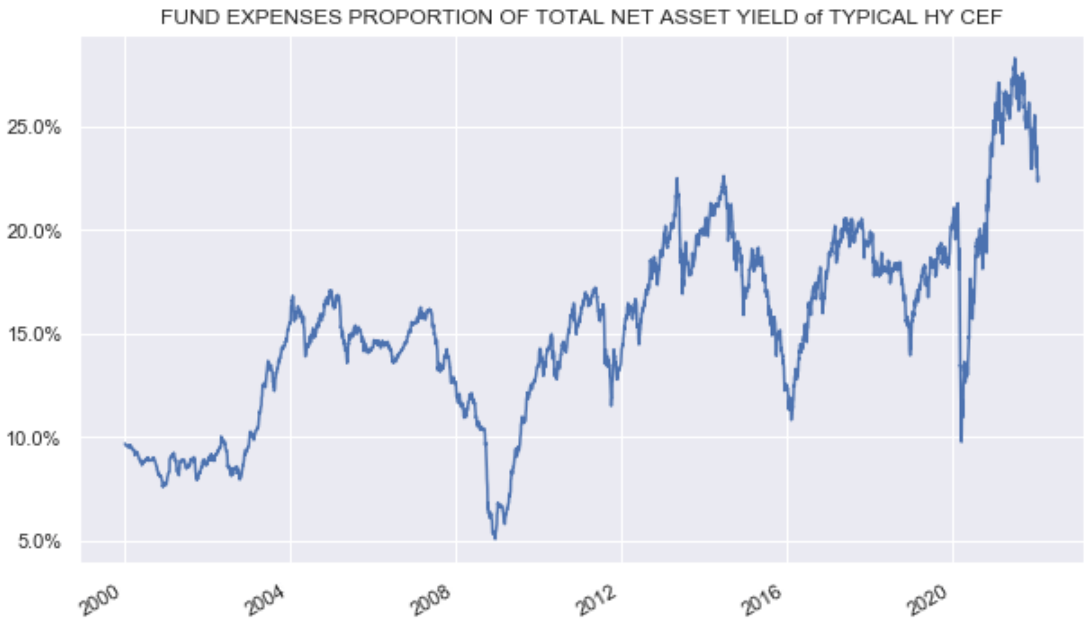
This is because the fund's management fee is fixed and it takes up a bigger chunk of the underlying fund's income (since yields are lower today) which means on a fair-value basis the fund's discount should be wider today i.e. a discount of 5% 5 years ago is equivalent to a discount of, say, 8-10% today.



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Finally, on a fair-value basis, it's important to take into account the fund's fee and its historic alpha. On these two metrics JHI looks pretty strong though not the strongest in the sector.

The key takeaway here is that investors should look through short-term moves in a fund's discount. Rather they should evaluate a fund's discount relative to its sector, take into account the valuation of the assets the fund holds, consider how much excess yield the fund generates and how this has changed over time and consider its other features such as fees and historic alpha. This isn't a trivial process but who said investing was easy.

Market Commentary

The PIMCO Access Income Fund (PAXS) - the new REIT-focused PIMCO fund which we discussed earlier, started trading around $20. Given its high fee and term structure, it will look compelling closer to $19.30 or so given where the PDO discount is trading.

In the PIMCO space, people really continue to be obsessed with (PDI) despite 1) its underperformance over the last 3 years by 3% per annum versus other credit-focused PIMCO taxable NAVs (it's the worst-performing credit-focused PIMCO fund in that period), 2) highest fee in the sector, 3) valuation that is just not cheap - there are 4 taxable funds with lower premiums.

The valuation point is particularly important because discounts are a function of fees (as well as alpha though we can argue that because PDI is managed by the same people who manage all the other taxable PIMCO funds, it's not going to have any more alpha than any of the other fund in the suite).

In the preferreds CEF sector funds trading at decent discounts are (FPF) from First Trust, (JPC) and (JPS) from Nuveen, and (PSF) and (PTA) from Cohen. That FPF, JPS and JPC trade at wider discounts in the sector is not an obvious opportunity in our view.

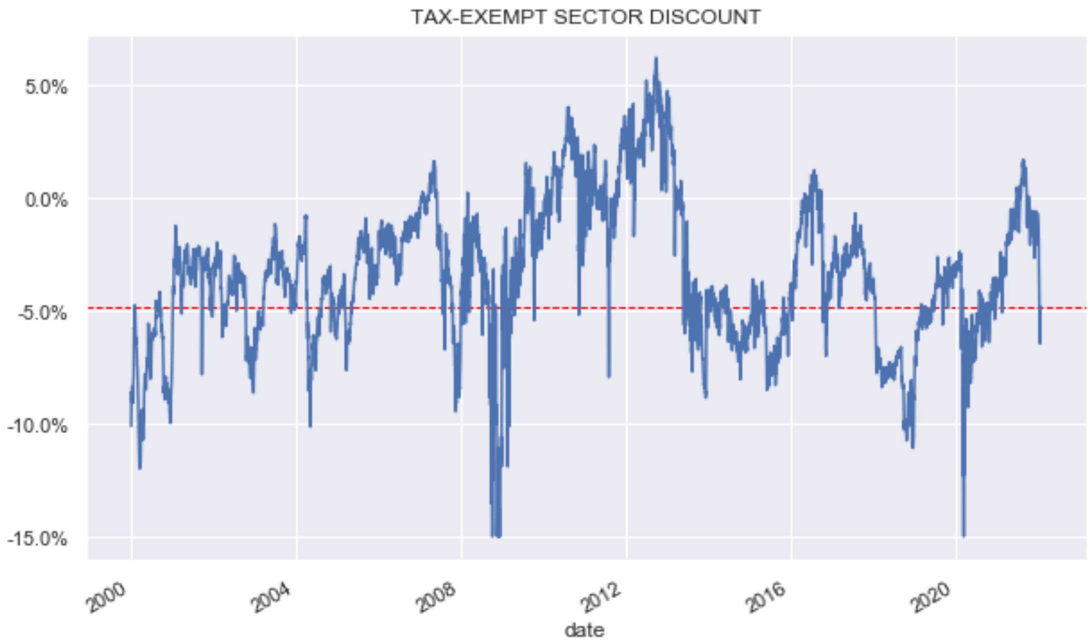
Recall that a key driver of longer-term CEF performance is how a CEF handles its leverage. First Trust and Nuveen preferreds CEFs have strict leverage caps of around 40% which means they are going to (and did in March of 2020) deleverage pretty quickly during significant drawdowns. And because fixed-income markets tend to be mean-reverting, a fund that is quicker to deleverage will end up selling low and buying back high, locking in economic losses in the process. This means these funds *should* trade at wider discounts than the broader sector.

Something else to keep in mind with respect to the Nuveen funds is that they are higher-quality. This means they have a lower underlying yield which should also push their discount wider since the fees take out a bigger chunk of the yield the funds can generate.

The Cohen funds don't have leverage caps but they do hedge their duration exposure quite aggressively (Nuveen funds do as well but to a lower extent). This also means their underlying yield capacity is smaller, however, they should outperform if longer-term rates keep climbing.

Stance And Takeaways

This week we took advantage of the widening in tax-exempt CEF discounts prior to their bouncebacks. In our view the range of 5-10% discounts offers an attractive entry point in the sector as the following chart shows.



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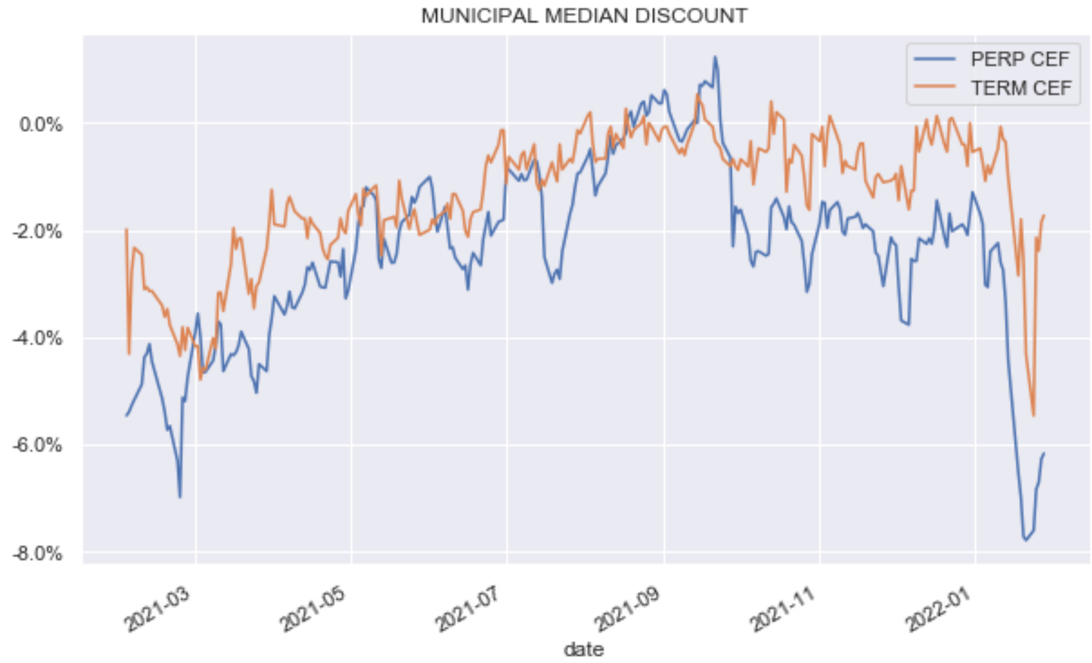
Specifically, we rotated from our term CEF allocations to perpetual CEF allocations within the sector. Tax-exempt term CEF discounts held in very well as we expected and as the following chart shows.



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This allowed us to improve the yield profile of our tax-exempt allocation by being able to reallocate capital from a more resilient part of the portfolio. This highlights that investors can continue to be invested in the market while maintaining a margin of safety which can also allow them to take advantage of specific opportunities.

In the sector we rotated into the MFS High Yield Municipal Trust (CMU), the Eaton Vance Municipal Trust (EVN) and the Blackrock MuniYield Quality Fund III (MYI) - all historic outperformers which were also trading cheap to the broader sector.

Elsewhere, we closed out our (JPI) / (PTA) preferreds CEF switch. The discount differential of the pair had compressed to 5.1% from 10.2%. At the time of the close-out JPI was trading at a 1% discount (it has rallied a bit since then) which we consider attractive due to its term profile.

In the broader CEF space, we highlighted the Blackstone Strategic Credit Fund (BGB) at a 9% discount which looked attractive to us. The discount has rallied a few percentage points since then but remains attractive in our view. The fund boasts the highest distribution coverage in the sector at a very high 130% which suggests that it is more likely than not to raise its distribution . This should cause its discount to rally versus the sector. Currently, the fund's discount looks unusually wide relative to the sector.

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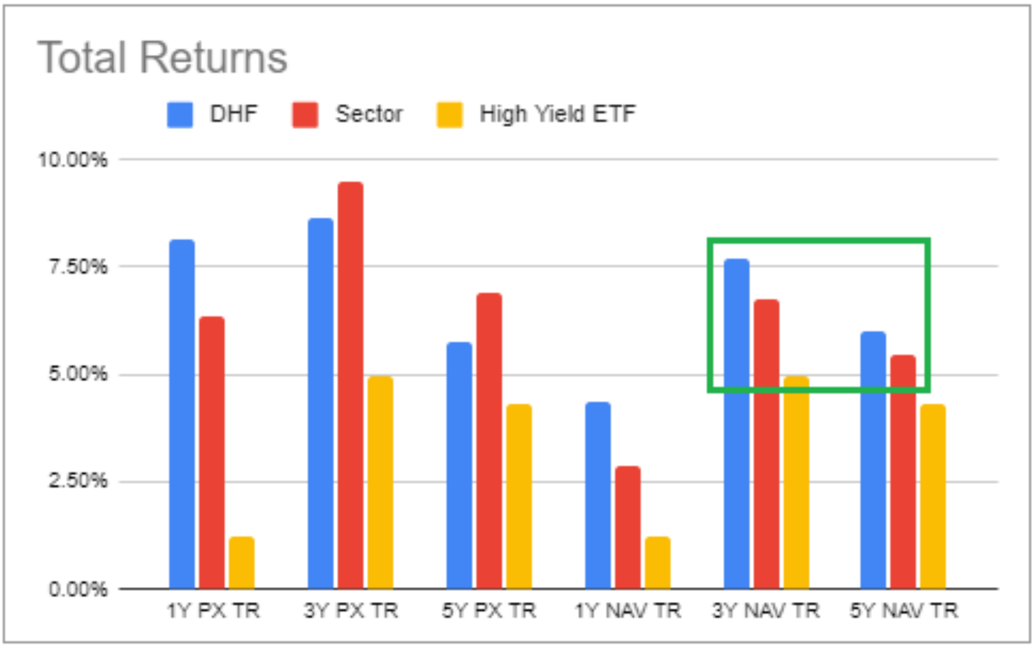
The BNY Mellon High Yield Strategies Fund (DHF) in the High Yield sector remains interesting at a 7.6% discount and a 7.6% current yield as well. The fund has outperformed the sector in NAV terms over various periods.



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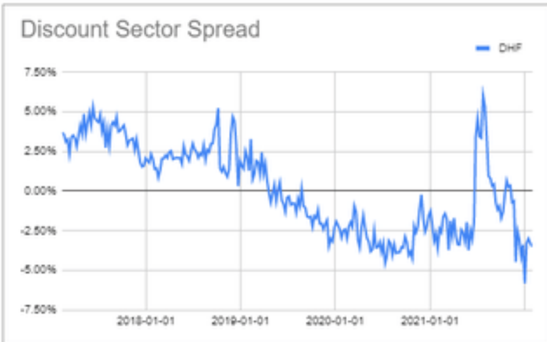
And it is trading cheap to the sector at the moment.



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The Nuveen EM Debt 2022 Target Term Fund (JEMD) remains compelling here as well with a 3.5% discount. Its total NAV return is -0.4% and total price return is flat in the past month which is pretty strong as far as bond funds go despite its lower quality EM debt holdings. By contrast, muni CEF prices are off 7% and HY sector funds are off 5.5% over the same period. We have made the point a few times before that the fund's very low duration and term structure should make it relatively resilient.

In the PIMCO taxable suite (PDO) looks attractive at a 2.6% discount. And it is also worth keeping an eye on (PFN) at a 1.3% premium. The fund's relatively low fee (0.83% management fee on total assets versus 1.15% of PDO) means its 1.3% premium valuation is, arguably, more attractive than the PDO discount. The fund's recent cut means it is likely to maintain its distribution for some time. It may also be attractive for investors who want a lower-leverage fund - its 34% leverage is not low by credit CEF standards but it is the lowest leverage among taxable PIMCO funds.

In the High-Yield CEF sector, the Western Asset High Yield Defined Opportunity Fund (HYI) remains an interesting option as an unleveraged term fund. HYI is trading at a slightly wider discount to the broader sector of around 4.5% which always makes term funds a great choice. The idea is that if the fund terminates (in 2025 in case of HYI) then you get a 4.5% tailwind into the termination (i.e., 1.2% per annum) which you wouldn't get with perpetual funds and if the fund turns into a perpetual fund (even without giving investors a tender offer at NAV) then there shouldn't be much more downside to the discount because it's already trading at the sector discount average. The fund has underperformed the sector over the last 3 years (6% versus 7.4% CAGR) however you would expect that as it's unleveraged. A fund like HYI would not be all that attractive if credit spreads were very wide in which case you would want to go for a leveraged fund however spreads are pretty tight i.e. expensive so it offers a decent margin of safety at an attractive valuation for a term fund.

Our overall CEF allocation strategy remains relatively cautious given the combination of discounts that, despite the recent pullback, remain historically expensive as well as credit spreads that remain near historically expensive levels as well.

With this backdrop we maintain a four-pronged strategy: 1) nibbling assets or rotating between assets now in the chance that the market simply makes a reversal back, 2) buying higher-quality attractively valued assets whose underlying valuations aren't going to blow out a whole lot even if credit spreads start widening out, 3) buying credit assets with unusually large discounts to provide an even larger margin of safety if credit spreads start to widen out, 4) reallocating from assets that haven't reacted (e.g. preferreds / bonds) to those that have moved out to attractive valuations.

Overall, we are taking advantage of current opportunities; however, we remain patient for even more attractive valuations in the months ahead as the Fed kicks off its hiking campaign and the macro cycle nears maturity.

This article was written by

Author of **Systematic Income**
Income investing across BDCs, CEFs, ETFs, preferreds, baby bonds and more.

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