

CEF Weekly Market Review: The Attraction Of Shadow High Yielders

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Summary

- We review CEF market valuation and performance through the first week of February and highlight recent market action.
- CEFs started the week on a strong foot however performance petered out quickly and discounts finished flat while the average sector saw a small rise in the NAV.
- We take a look at shadow high-yielders in the tax-exempt space.
- And highlight recent insider buys, coverage news and more.
- I do much more than just articles at Systematic Income: Members get access to model portfolios, regular updates, a chat room, and more. [Learn More »](#)



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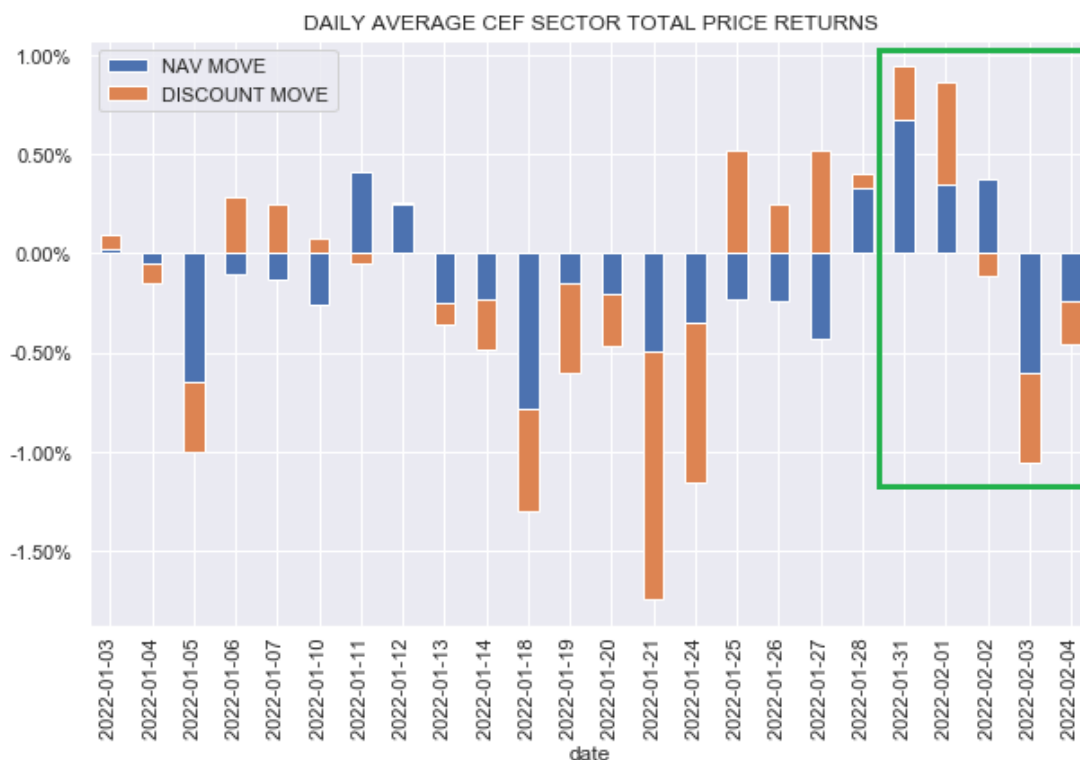
This article was first released to Systematic Income subscribers and free trials on Feb. 6.

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 February. 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.

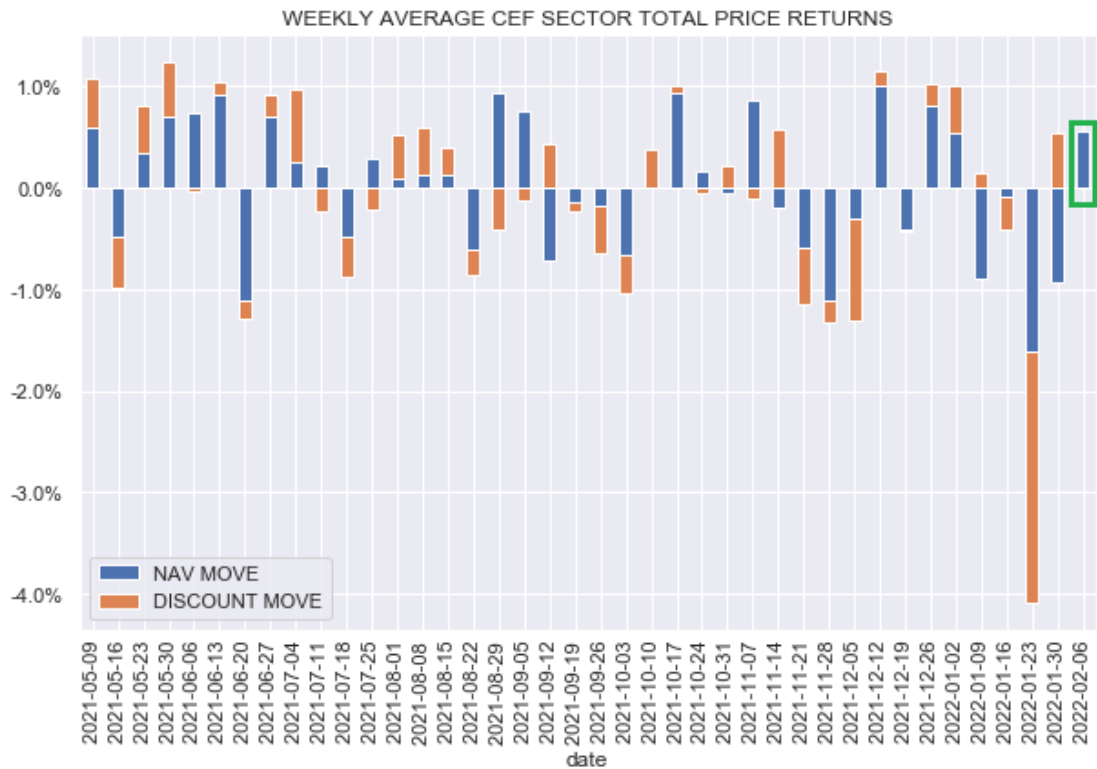
Market Action

At the start of the week it looked like the CEF market could continue its previous week's strength and completely reverse January weakness. However, the rally petered out by the middle of the week with the last three days seeing a sell-off in discounts and the last two days a sell-off in NAVs as well.



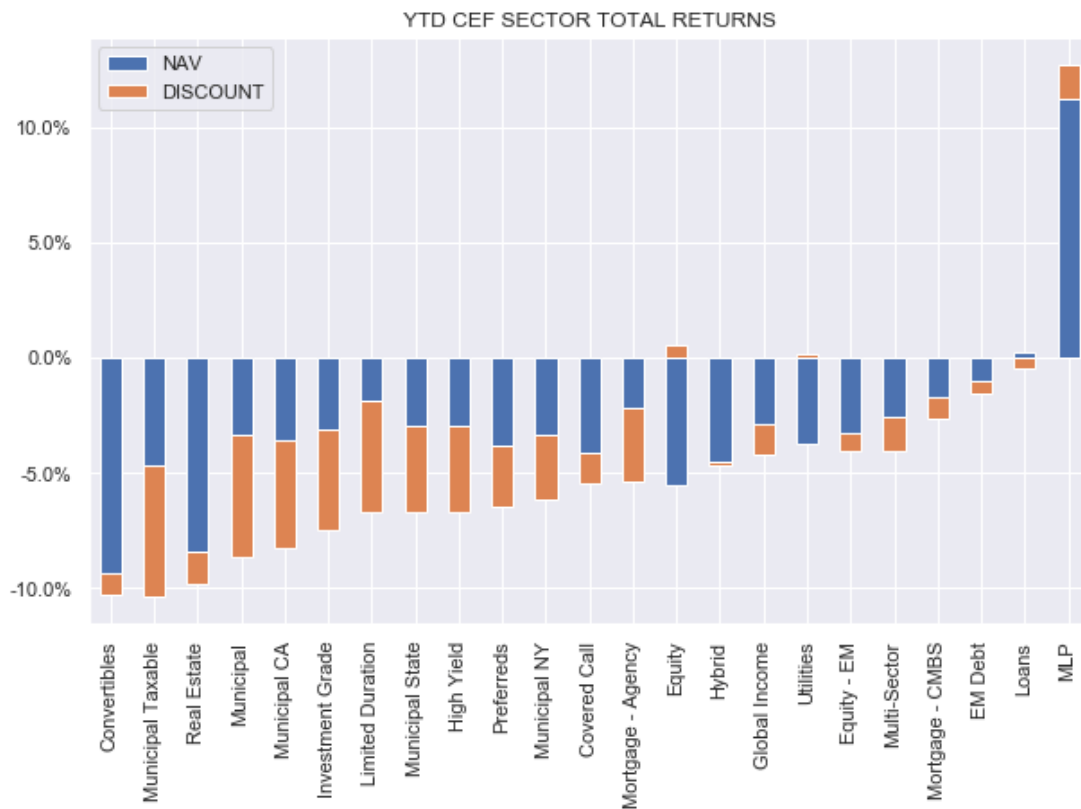
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Overall, it was still a decent week with flat discount performance for the average sector and a small rise in the NAV.



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Overall, the average sector price performance is about -5% year-to-date, about evenly split between NAVs and discounts. On an individual basis, only one sector remains in the green year-to-date - MLPs. And only two sectors show stronger discounts. Underperformers are convertible debt given the sell-off in Tech and munis/investment-grade bonds given their longer-duration profile.



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In the closing months of last year we frequently discussed the four-factor pillars of the CEF market: credit spreads, equity prices, Treasury yields and discounts. All four were relatively expensive and, arguably, all were highly correlated. This meant that the risk that all four would weaken at the same time was very high. January of this year showed how much the CEF market was dependent on these four factors when all four reversed their previously strong performance at the same time. In our view, further weakness across all four of these drivers remains a key risk, if not necessarily our base case.

Market Themes

Income investors like to keep a keen eye on fund yields, with a general preference for funds with higher-earning capacity. However, as many investors tend to find out over time, fund distribution rates are not always good proxies for fund earnings. This is why, as one of our investment strategies, we like to focus on, what we call, *shadow high-yielders*.

What we call shadow high-yielding CEFs are those whose earnings yields are in excess of their distribution rates. In other words, these funds earn more in income than they pay out in distributions. Why would this happen?

Few CEFs pay out exactly what they earn. Most CEFs tend to make stable distributions, making changes only infrequently. In fact, this is one reason why CEFs remain popular income investments and also why they often cause some anxiety around distribution declaration dates.

Why would shadow high-yielding funds be attractive - intuition suggests that they should, in fact, be unattractive. A fund that can afford larger distributions but scrimps on them is surely *less* attractive? A closer look at fund dynamics, however, tells us why these funds can be attractive additions to income portfolios.

First, a fund that under-distributes is in a stronger position to raise distributions and increased distributions are often rewarded with discount tightening, driving stronger price returns to boot.

Secondly, CEFs with lower distribution rates tend to trade at wider discounts, all else equal, as the CEF market likes to compress price yields relative to NAV yields. In other words, CEFs with higher distribution rates are often bid up by investors seeking higher distributions and vice-versa. This is why you often see very high-yielding CEFs also trade at very high premiums and why these funds' premiums often collapse when they cut distributions. The PIMCO Global StocksPLUS & Income Fund (PGP) is a poster child for this kind of historic dynamic. The red lines in the chart indicate when the fund made distribution cuts. These are also the dates when the fund's premium fell sharply.



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Wider discounts not only provide an additional margin of safety for the fund's price (funds already trading at wider discounts are at smaller risk of further widening on surprises, all else equal) and they also boost the fund's price yield.

Thirdly, funds that under-distribute are able to use retained earnings to buy additional assets, further boosting earning capacity. In contrast, funds that overdistribute leak value from their NAV which puts pressure on their leverage levels and is more likely to lead to a sale of income-producing assets, further reducing income levels.

Fourthly, shadow high-yielders are also less likely to be forced to use dilutive rights offerings in order to boost NAVs to keep management fees from moving lower with time due to NAV erosion.

In an efficient market, funds with similar income levels would trade at similar valuations, all else equal. However, as many investors are well aware, the CEF market is inefficient in spots. Specifically, it does not appear to "look through" to the funds' income yield and, instead, awards discount valuation based on current yields. This creates an opportunity for discerning investors. Below we highlight some of the shadow high-yielders in the tax-exempt sector that look attractive.

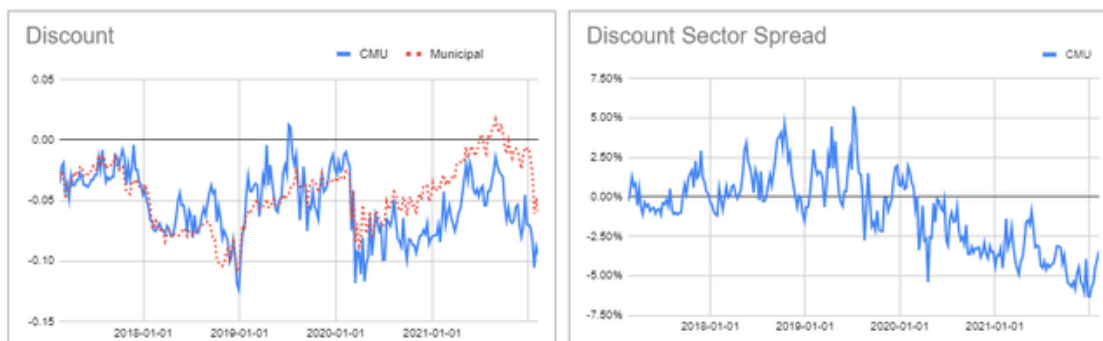
The **Pioneer Municipal High Income Fund (MHI)** is trading at an 11.4% discount and a 4% current yield. The fund's current yield is well below the sector average of 4.82%, however, its income yield is 4.66% which is actually higher than the sector average. The fund has delivered the same performance as the broader sector over the last five years in total NAV terms. Its discount valuation is around 5% wider to the broader sector which is near its 5-year low (observable in the right-hand chart below). The fund has cut its distribution a couple of times over the past year, however, its distribution coverage is currently 116% or about 20% above the sector average.



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The **MFS High Yield Municipal Trust (CMU)** has a focus on the healthcare sector as well as a significant allocation to high-yield and unrated bonds. It is trading at a 9.4% discount and a 4.34% current yield, however, its covered yield is 4.80% or 0.2% above the sector average. The fund just raised its distribution after a few cuts, however, its coverage remains high at 109%.

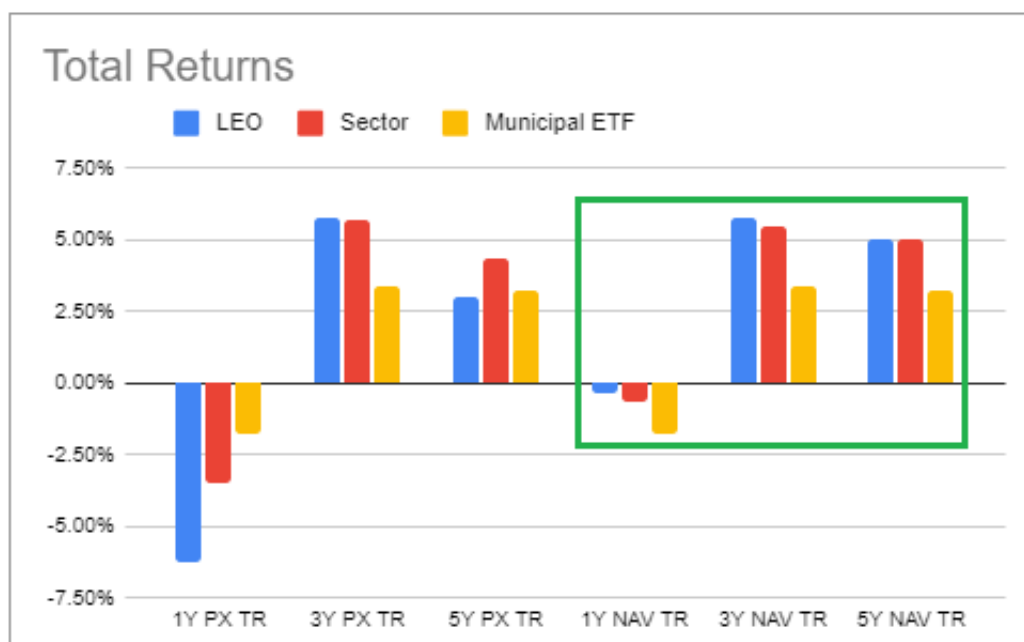
The fund has outperformed the sector over the past year and slightly underperformed over the last five years in total NAV terms. The fund continues to trade cheap to the sector.



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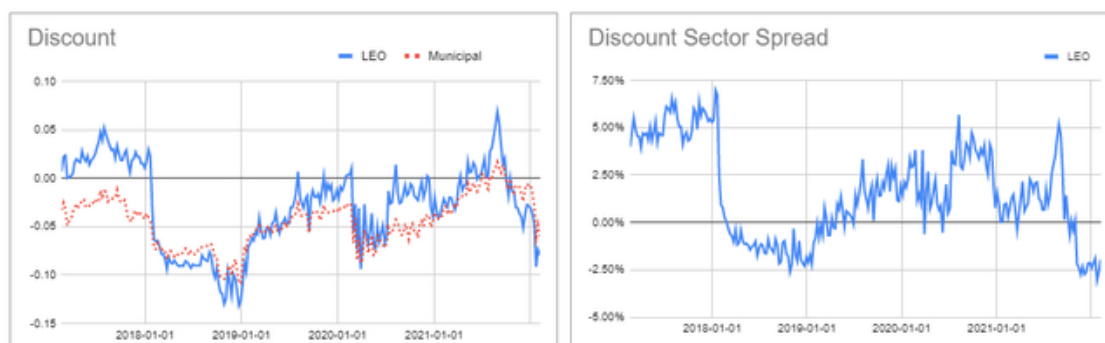
The **BNY Mellon Strategic Municipals Fund (LEO)** also has a higher-yielding focus with top sector allocations to Healthcare and Education sectors. The fund is trading at an 8% discount and a 4.65% current yield. Its covered yield is one of the highest in the sector at 5.4% - well above the sector average of 4.6%. Distribution coverage of 117% leaves quite a bit of margin of safety for its distributions.

The fund has outperformed the sector over the last one and three years in total NAV terms and matched it over the last five years.



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Its discount valuation has recently collapsed and it is trading near its lowest valuation relative to the broader sector over the last five years which looks attractive.

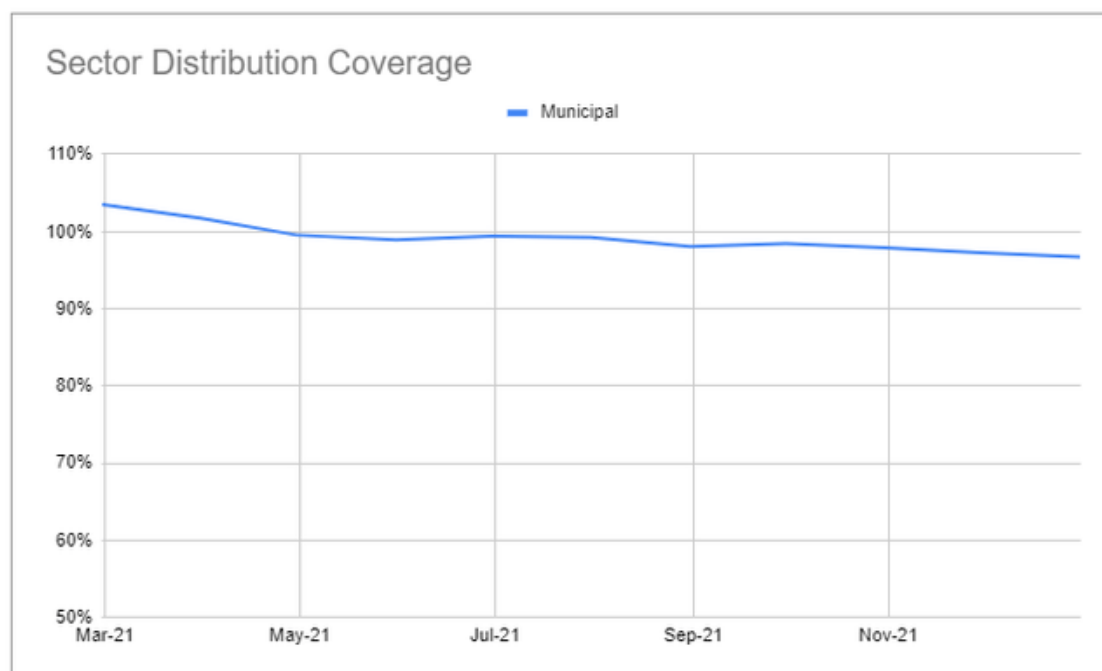


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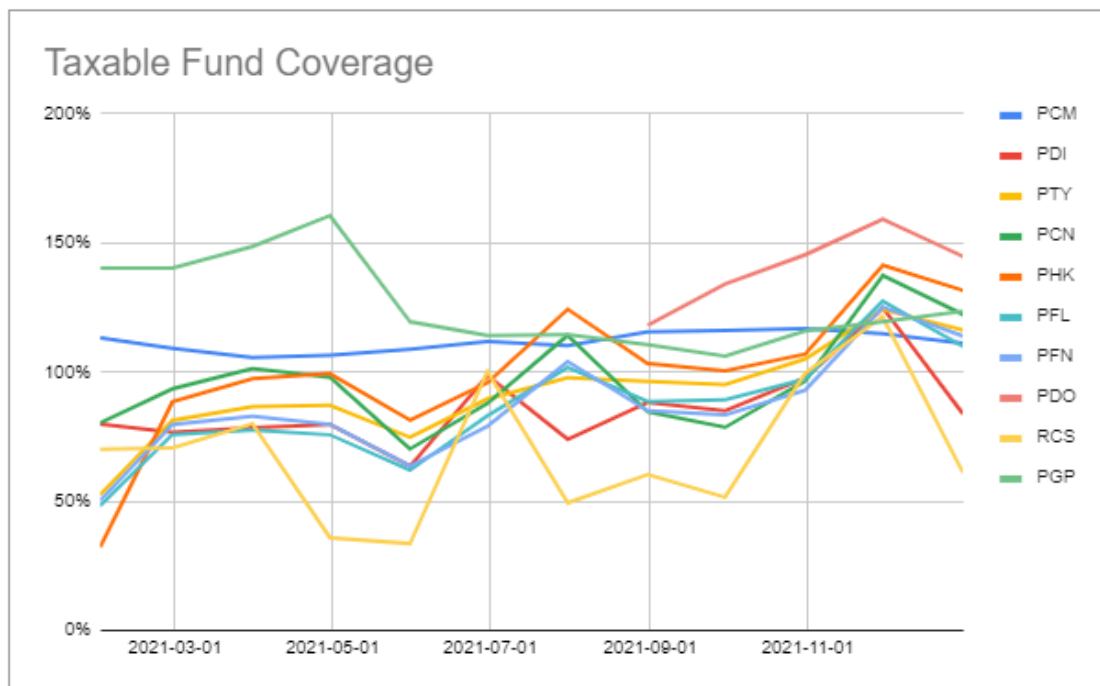
Market Commentary

We updated CEF distribution coverage on the service for December. A number of BlackRock and Eaton Vance credit CEFs saw a bump in coverage. Given coverage rose across both floating-rate and fixed-rate funds it is more likely due to a previous bump in borrowings. We wouldn't expect significant rises in loan CEF coverage until Libor moves north of around 1% given the presence of Libor floors on the asset side of the balance sheet. In fact, we should see a drop in loan CEF coverage at first which should then reverse itself as the Fed moves past 3-4 hikes.

Most Nuveen and BlackRock Muni fund coverage numbers moved lower (PIMCO numbers were a bit more stable). This is a trend we are likely to see over the coming year which will be supercharged by higher leverage costs as the Fed kicks off policy tightening. We wouldn't be surprised to see Muni CEF distribution cuts as soon as the Fed makes its first hike. This might lead to some additional opportunities to acquire funds in the sector though investor conviction may be tested as cuts begin.



In the PIMCO taxable suite all funds ex-PGP showed a drop in 6-month rolling coverage though coverage in all but two is still above 100%. RCS coverage moved back to its usual mid-double digit level after flying a bit too close to the sun in the previous two months. PDO UNII remains in positive territory even after the recent special distribution and we expect it to start climbing higher in the coming months.



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Last month the High Yield CEF Ivy High Income Opportunities Fund (IVH) cut its distribution to \$0.07 from \$0.08 which we said didn't make a ton of sense. So here it is with a hike to \$0.078. With NII around \$0.08 there is more room for the distribution to grow however we wouldn't be surprised if distributions are all over the place. It's not clear what they are trying to achieve there, but it may be an interesting fund to acquire after a cut if it's followed by the typical selling by disappointed investors. The fund remains pretty attractive at a 8.7% discount (vs. 3.3% sector average) with sector-beating historic NAV returns.

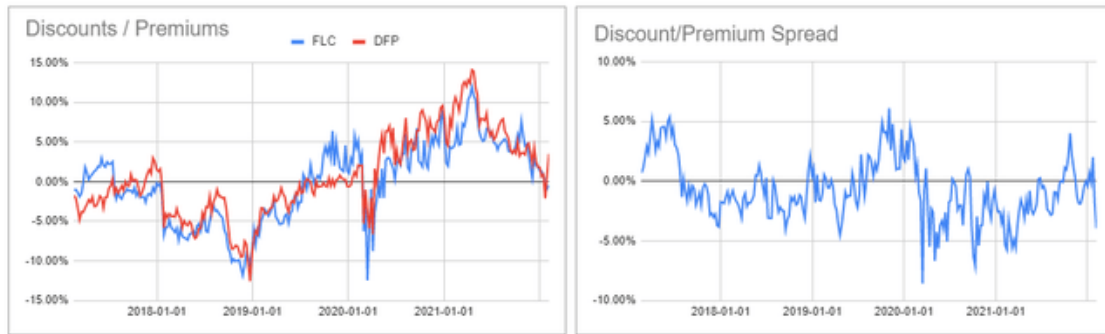
There have been a few chunky insider CEF purchases recently - possibly linked to the timing of bonuses. For example, in the tax-exempt space, it's worth highlighting purchases by Peter Hayes – head of BlackRock Munis – who bought 20k shares in (MHD) and 10k shares in (BTT). Both are 4-starred funds in the sector in our service CEF Tool and so are decent choices.

Ticker	Rating	Transaction Date	Reporting Owner	Form	Transaction Type	Direct or Indirect Ownership	Number of Securities Transacted	Number of Securities Owned
ARDC	★★★★	2022-01-26	Shaw John Joseph	4	P-Purchase	I	26,000	60,002
EDF	★★★	2022-01-24	CRAIGE JAMES E	4	P-Purchase	D	20,000	58,522
EDF	★★★	2022-01-24	CRAIGE JAMES E	4	P-Purchase	D	20,100	38,522
MHD	★★★★	2022-01-21	Hayes Peter	4	P-Purchase	D	20,000	20,000
BTT	★★★★	2022-01-21	Hayes Peter	4	P-Purchase	D	10,000	20,100

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It's worth noting also that insider disclosures may not always contain as much information as we would like them to. Insiders are often constrained in what they can buy (as they would have to disclose all, not just insider, trades to their employers and it would be awkward for Peter Hayes to buy a ton of PIMCO muni CEFs, for instance, even if he wanted to). Plus, the timing can be tricky – buying in January can be really a function of putting bonus cash to work rather than any special conviction. Muni yields have come off a bit and so have muni CEF discounts so it's certainly a better time to buy than it has been for some time.

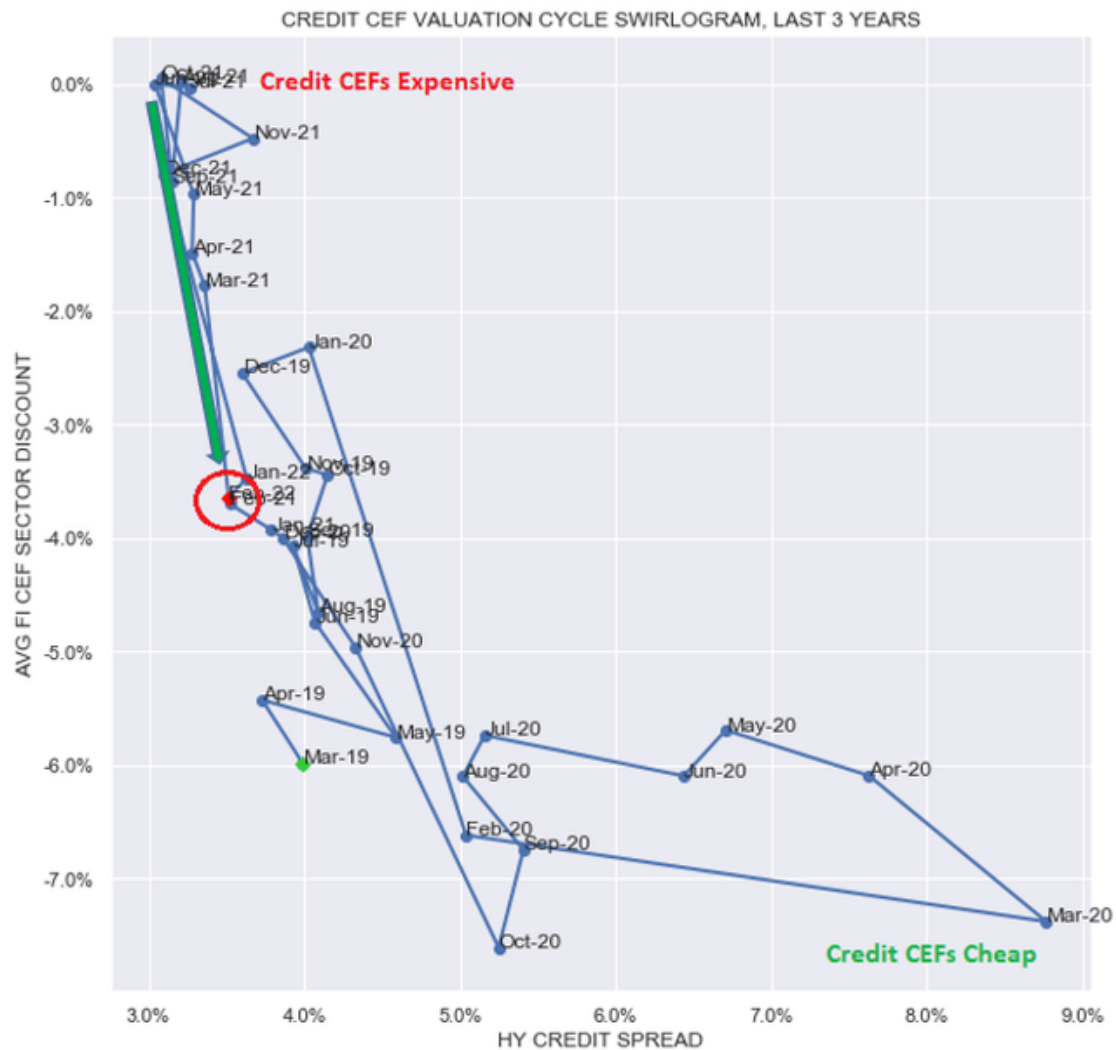
In the relative value space, we recently highlighted the Flaherty & Crumrine Dynamic Preferred and Income Fund (DFP) when it moved out to a 2% discount. At the moment, its sister fund the Total Return Fund (FLC) with a very similar allocation and historic NAV returns looks somewhat more attractive at a small discount. The right-hand chart shows the discount/premium differential between the two funds, highlighting that the DFP/FLC valuation is in the FLC favor at the moment in historical terms.



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Stance & Takeaways

This week we watched credit spreads leak wider to align with the recent widening in CEF discounts. The broader credit CEF picture looks more attractive than it has in some time as the following chart shows - the green arrow shows the move since the end of 2021 as both credit spreads and credit CEF discounts widened since then.



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We have not added to credit CEFs for a while in expectation that high-yield credit spreads would move wider. A move past a level of 4-4.5% in spreads would make the space more attractive in our view, particularly if it is matched with further discount weakness. At the same time it's worth highlighting a couple of relatively low duration funds like the Nuveen Mortgage and Income Fund ([JLS](#)), trading at a 10.2% discount and 5.1% current yield as a higher-quality option and the Western Asset Diversified Income Fund ([WDI](#)) as a lower-quality option, trading at an 8.8% discount and an 8.1% current yield.

mentioned in this article.

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