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Closed End Funds

CEF Market Weekly Review: Preferreds CEF Managers Struggle To Overcome Sector Tilts

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Summary

- We review CEF market valuation and performance through the second week of February and highlight recent market action.
- It was another down week for the CEF market with about a quarter of sectors now at double-digit losses for the year.
- We discuss how CEF sector tilts can drive fund performance, providing unexpected results for investors.
- We also highlight distribution news and the recent PDI comment debate.
- And review our CEF allocation stance, particularly the lower-duration positions in our Income Portfolios.
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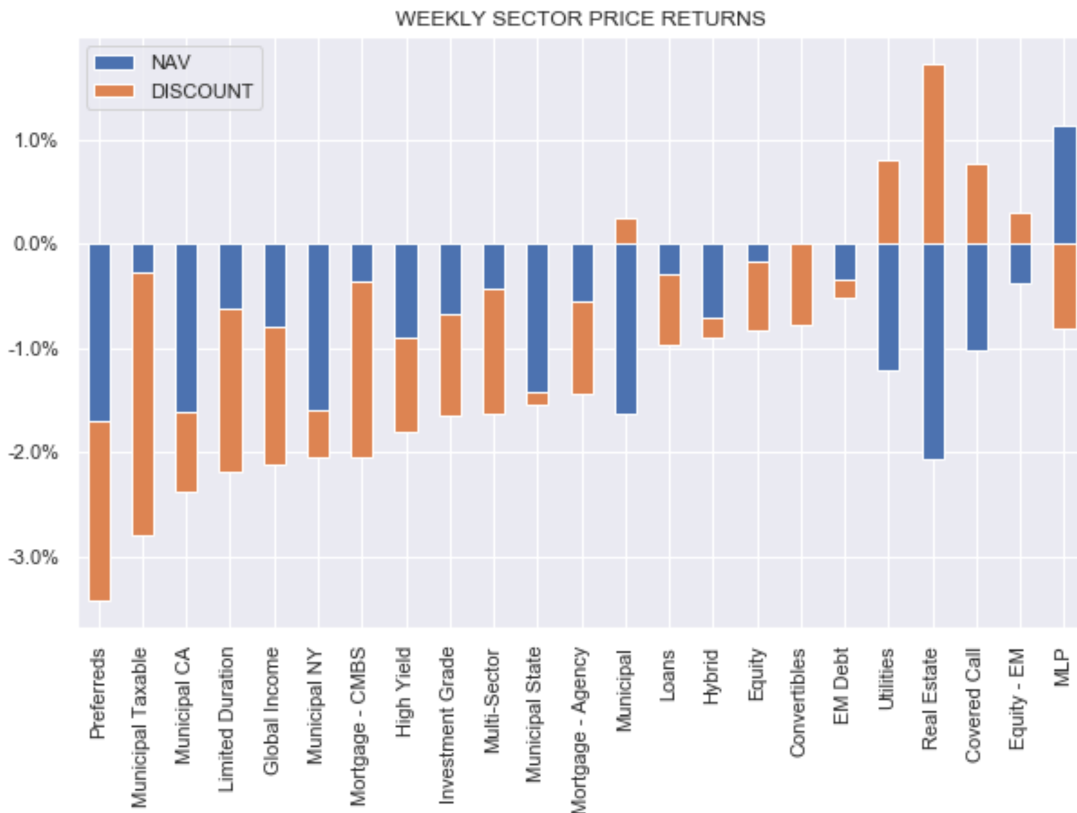
This article was first released to Systematic Income subscribers and free trials on Feb. 12.

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 second 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

It was another tough week for the CEF market with all sectors but one seeing a drop in NAVs and with most sector discounts widening and further exacerbating price losses.



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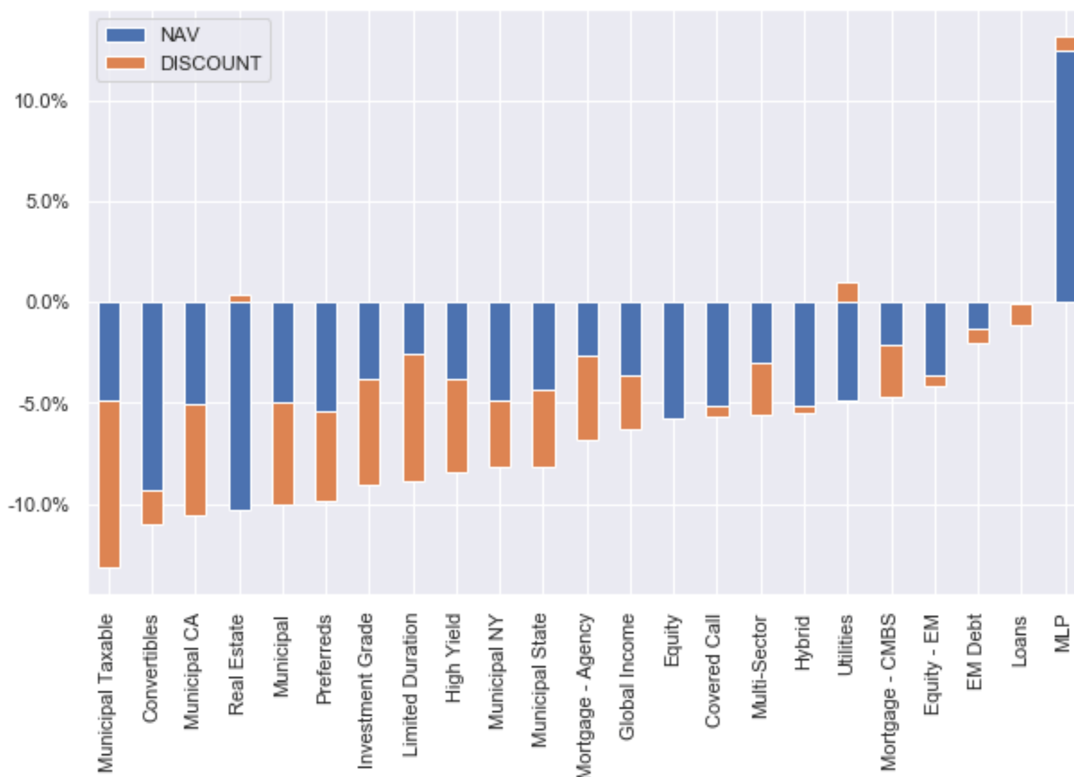
Year-to-date around 6 CEF sectors have losses of more than or around double-digit levels. Tech-heavy and higher-duration sectors have underperformed while shorter-duration sectors like CMBS and loans have outperformed with MLPs leading the charge.



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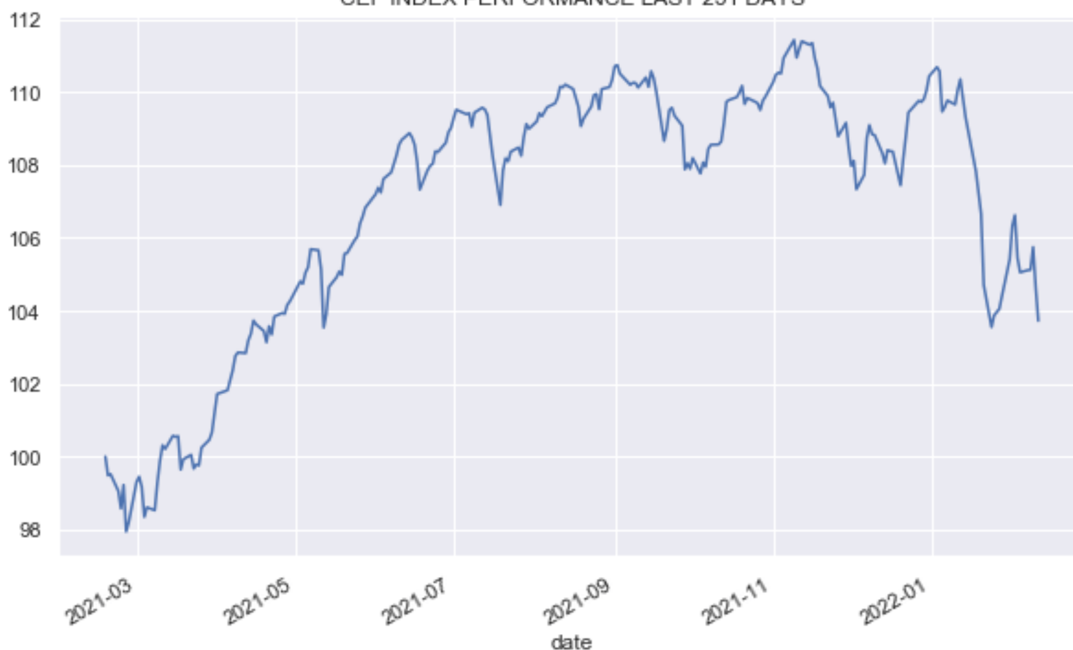
The CEF market has reversed all of its recent recovery and is back to a level last seen around April of last year, essentially having provided no returns for the previous 10 months in aggregate.



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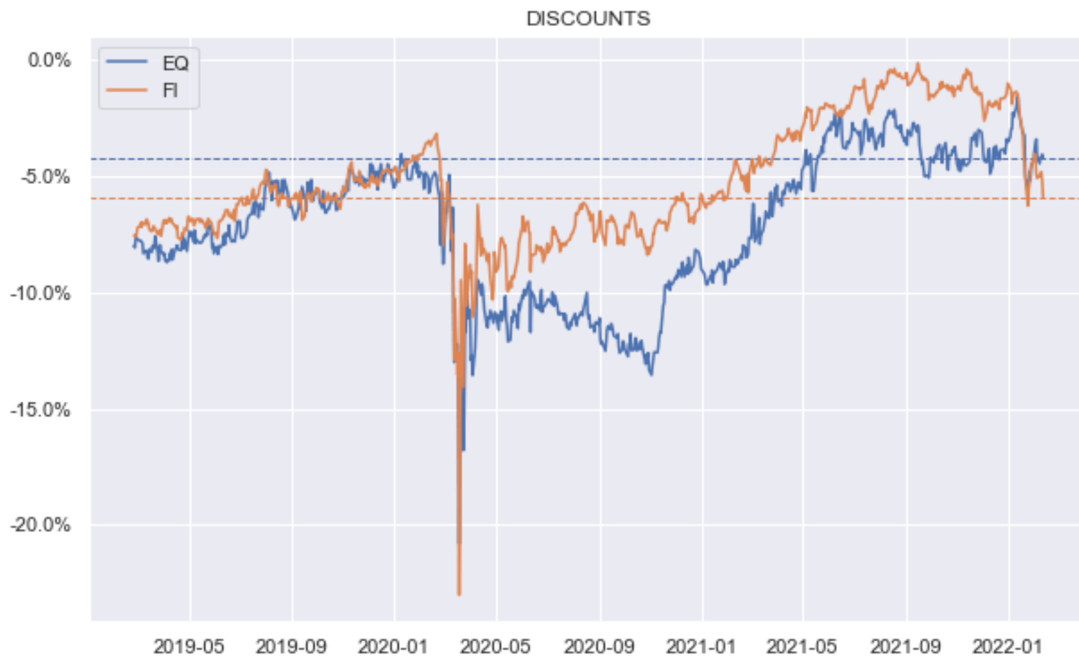
Equity CEF sector discounts have been a bit more resilient in the last week whereas fixed-income fund discounts have pushed back to their wides last seen about a year ago.



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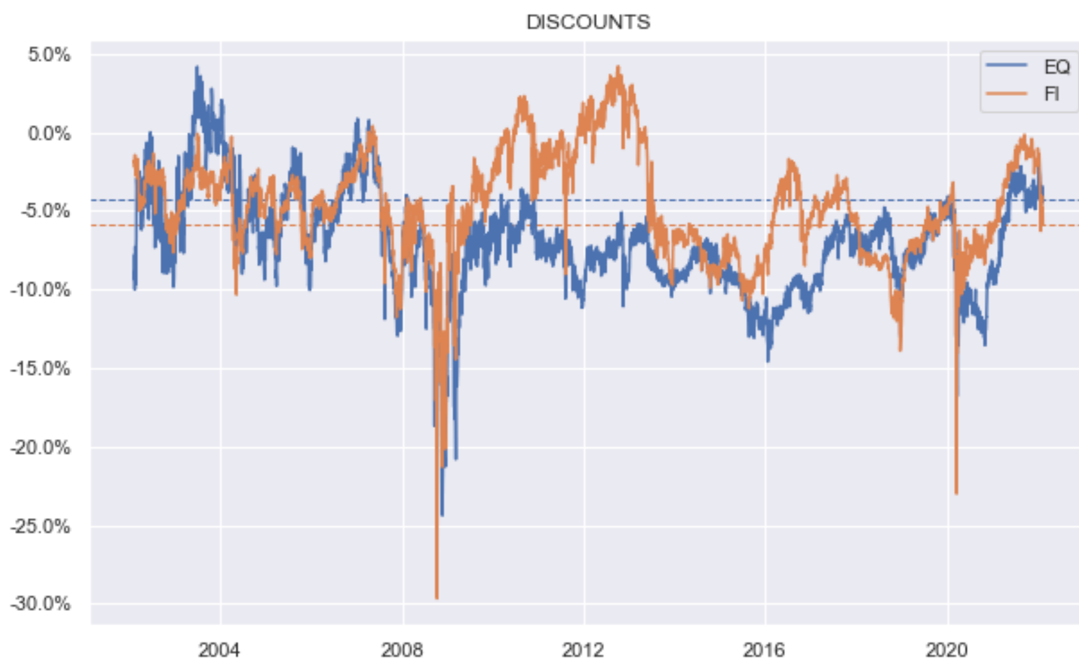
From a longer-term perspective fixed-income discounts look to be in the middle of their historic range while equity discounts remain expensive.



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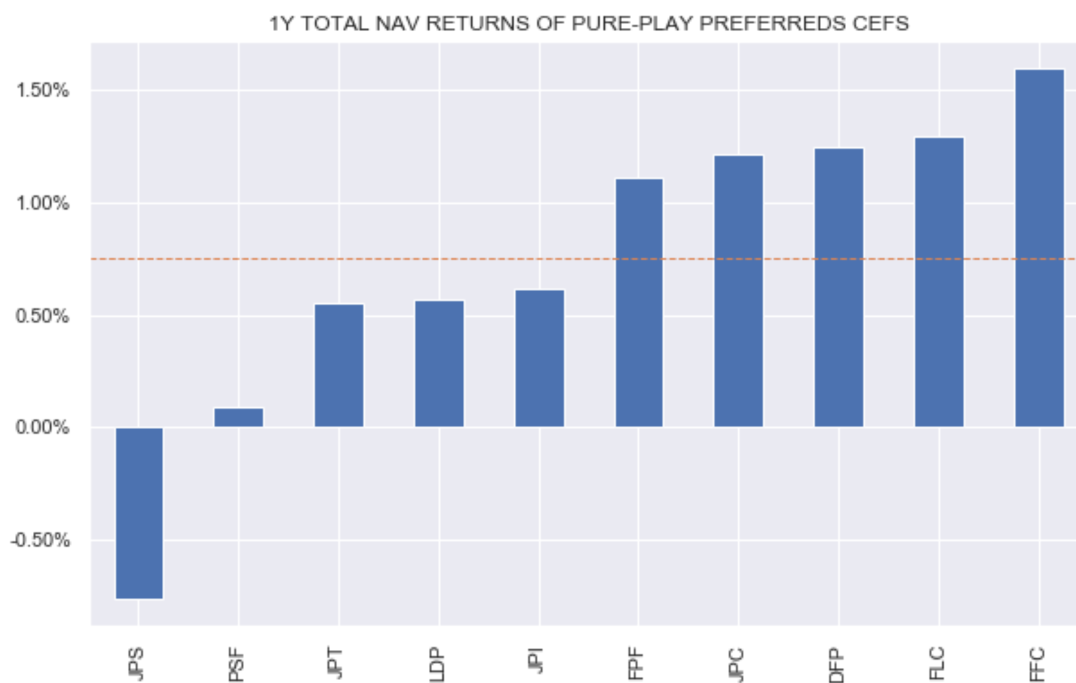
Market Themes

One important concept CEF investors often have to come to grips with is what we call *sector tilts* which is a way to describe the specific allocation choices or mandates of certain funds within whatever sector they allocate. Understanding fund tilts very useful because they do a good job of both explaining a big dose of fund historic returns and they also allow investors to anticipate how a given fund will perform in various future market scenarios.

A good case study here is the preferreds CEF sector because of the higher-quality / financial-sector tilts of its funds. In this section we take a look at the pure-play preferreds funds in the sector and exclude the John Hancock funds as they also allocate to corporate bonds and common equity.

This is how the sector funds have performed over the past year in total NAV terms - the average fund has delivered a total NAV return of about 0.75%.



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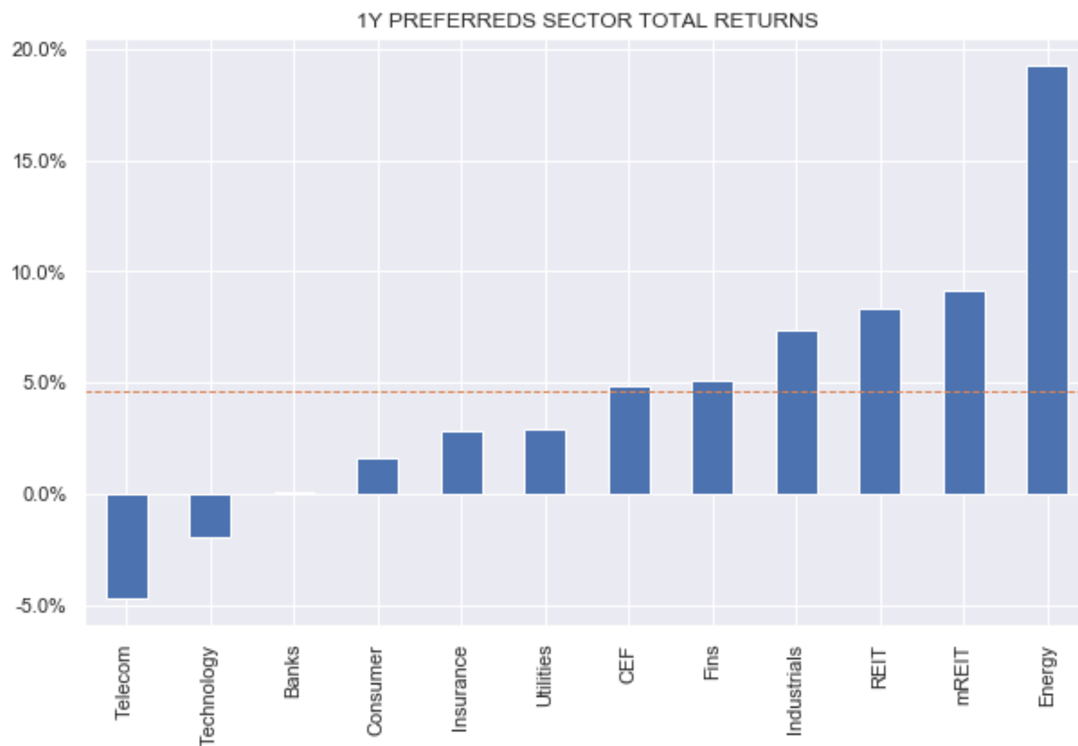
Investors who also allocate to individual preferreds very likely had a different experience - the average exchange-traded preferreds sector has delivered about a 5% total return over the past year (see chart below). And although preferred CEFs hold mostly institutional preferreds while individual investors will typically only hold "25-par" or exchange-traded preferreds the performance outcome is very much the same.

Since CEFs use leverage, a fund that reflected this "average" preferreds sector profile should have delivered around a 6% return after fees in total NAV terms - so what explains this large lag across the entire population?

The key point is that preferreds CEFs have a higher-quality allocation profile, focusing primarily on Bank and Insurance sectors with allocations to these sectors of around 70-80%. These securities also tend to feature lower coupons and as we discussed in our Preferreds Weekly, lower-coupon securities have been hit particularly hard over the last few months. As the preferreds sector performance chart below shows these two sectors have lagged the broader sector. And while a number of CEFs in the sector actively manage their duration profile it hasn't entirely saved them from the rise in yields.



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The key point here is that the managers of preferreds CEFs are not "bad managers" - they are simply constrained by their allocation mandate. Their higher-quality allocation profile makes it very difficult for them to escape unscathed when their sector tilts underperform. The CEF performance chart also makes it clear that whatever alpha the managers delivered over the past year was not large enough to escape the gravitational pull of their broader allocation profile.

The first key takeaway for investors is that CEF allocation tilts will tend to drive fund performance and can be very difficult to escape by even the best managers. The second takeaway is that a "safer" allocation profile that the preferreds CEFs boast relative to the broader market can be misleading - since it is the higher-quality preferreds that have been hit hardest recently given their longer-duration profile.

Now that the 10Y Treasury yield has backed up close to 2%, higher-quality preferreds are trading at yields north of 5% and preferreds CEF premiums have deflated into discounts, we have a more favorable view on this CEF sector. This is especially so since credit spreads remain relatively tight and the higher-quality holdings of these funds should hold up better if we do have sharp credit spread widening this year.

Within the sector we view the Flaherty & Crumrine Preferred Securities Income Fund (FFC) as the most attractive pick. It is trading at the widest discount relative to the 4 other Flaherty preferred CEFs - the comparison with (DFP) is shown below. This is unusual as the fund has the lowest fee in the suite and, as it has a similar allocation to the other funds, normally trades at an elevated premium. Obvious risks to the sector remain a further messy back-up in Treasury yields as well as a rise in leverage cost with the market now expecting around 7 hikes this year. Next week we will review what that means for fund income levels over 2022.

Systematic Income CEF Tool

Market Commentary

There was not a ton of movement on the CEF distribution front for February - PIMCO, BlackRock, Guggenheim and Nuveen had no changes. Eaton Vance had one cut for (EVG) - a limited duration fund, which is overdue as the fund has been running around 50% coverage. Invesco cut the tax-exempt (IQI) to a level where its coverage is now 103% which lowers the risk of future cuts.

In the tax-exempt sector, (CMU), (MHI), (EVN), (MYD) look like decent options here with the first two having more of a high-yield / unrated bond flavour. With the 10Y Treasury zooming briefly past 2% the broader yield environment is obviously as important as discount valuation so some consolidation beyond a widely expected level of 2% makes sense before piling into the tax-exempt space in our view.

The Nuveen Dynamic Municipal Opportunities Fund (NDMO) came up on the chat. NDMO has an unrated bond focus and, importantly, a different distribution policy from Nuveen's other muni funds which they call a "monthly managed distribution". Under this policy the fund distributes expected long-term capital gains. This explains why the fund's distribution rate is very high and way above the fund's net income. The net result is that the fund distributes a lot of ROC to fill the gap in the absence of capital gains.

The fund's performance is not particularly stellar - it's 1Y total NAV return is -3.4% - a touch worse than the broader sector. Within the high-yield / unrated space we continue to favor the Nuveen Municipal Credit Opportunities Fund (NMCO) which has a lower fee, a similar valuation and a higher 1Y total NAV return.

There was a comment discussion in our recent CEF Weekly in response to our wondering-out-loud why the PIMCO Dynamic Opportunities Fund (PDI) continues to find so much support despite having posted the worst 3Y total NAV returns in the PIMCO taxable credit suite (i.e. ex-RCS), sharing the highest fee and trading at a premium that does not scream cheap.

It's worth summarizing the discussion here as well because it is clear that many investors share a number of misconceptions about the fund.

The arguments for favoring PDI are *in italics* with our responses in plain font:

PDI is a large fund which allows management great flexibility in asset allocation

Other PIMCO CEFs are also large if not as large as PDI. We could even argue that being a smaller fund can provide more flexibility than being a large fund. For example, a large fund is not going to look at a great $10m opportunity because it will be a rounding error in its performance. Plus, any forced deleveraging is going to be easier to navigate for a smaller fund - a larger fund will be forced to take a bigger haircut on selling a larger amount of assets, causing it to potentially lock in larger economic losses for investors.

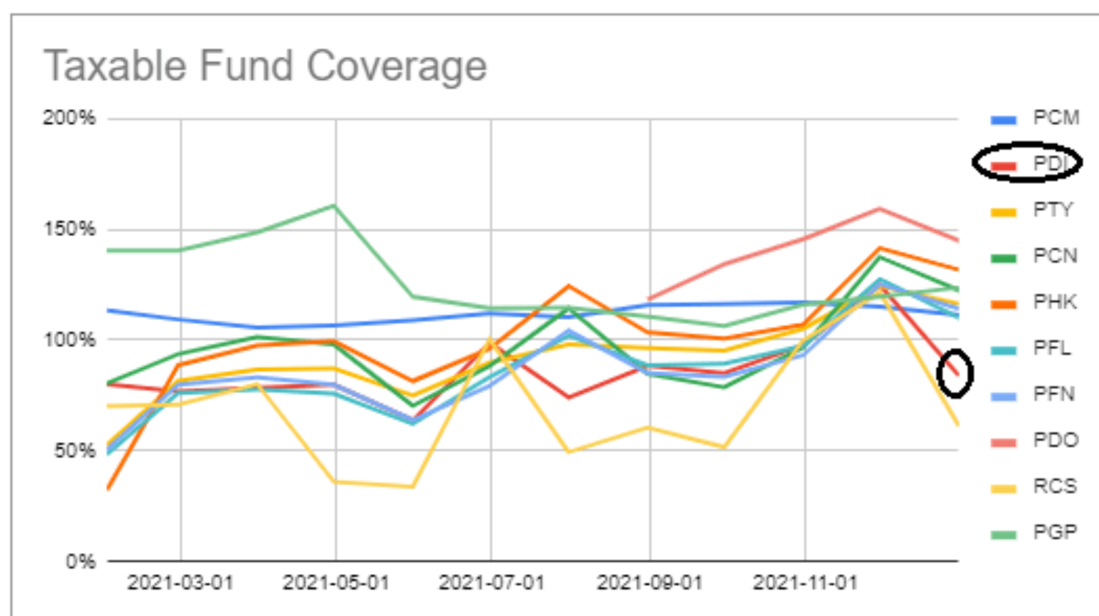
PDI distribution is net of fees so the fees don't really matter.

We always find this comment very puzzling. We wonder how the same people think of salary tax-witholdings because their salaries are deposited in their bank account net of expected taxes. Do taxes still not matter to them because the salary they see in their bank account is "net of taxes"?

Presumably when people say "well, fees don't matter because distributions are net of fees" what they mean is that the fund company doesn't send them a separate bill in the mail saying "Dear Investor, your fund shares have accrued a fee of $745.23 in the last quarter - please send your payment to … ". It's great that investors don't get bills like that but that doesn't mean that investors don't actually end up paying for the fees - they are still taken out of the fund's NAV.

PIMCO publishes UNII for their CEFs which shows whether distributions are covered.

This is true but it's nothing to do with PDI specifically. Furthermore, PDI has the second lowest 6-month rolling distribution coverage in the taxable suite and tends to be on the lower end of these funds.



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No ROC is ever paid

Yes, Virginia, PIMCO does pay ROC pretty regularly on its funds and has paid it on PDI. If all you do is look at the monthly reports you will miss this because the monthlies use a different reporting treatment.

Selected Per Share Data for the Year or Period Ended^:	Net Asset Value Beginning of Year or Period[a]	Net Investment Income (Loss)[b]	Net Realized/ Unrealized Gain (Loss)	Total	From Net Investment Income	From Net Realized Capital Gains	Tax Basis Return of Capital
PCM Fund, Inc.							
06/30/2021	$ 8.47	$ 0.97	$ 1.04	$ 2.01	$ (0.96)	$ 0.00	$ 0.00
06/30/2020	10.19	0.86	(1.62)	(0.76)	(0.95)	0.00	(0.01)
06/30/2019	10.23	0.69	0.23	0.92	(0.96)	0.00	0.00
06/30/2018	10.15	0.88	0.18	1.06	(0.98)	0.00	0.00
06/30/2017	9.71	0.98	0.92	1.90	(1.46)	0.00	0.00
PIMCO Global StocksPLUS® & Income Fund							
06/30/2021	$ 7.47	$ 0.95	$ 2.85	$ 3.80	$ (0.83)	$ 0.00	$ 0.00
06/30/2020	9.89	1.10	(2.42)	(1.32)	(0.85)	0.00	(0.25)
06/30/2019	10.50	1.11	(0.34)	0.77	(1.20)	0.00	(0.18)
06/30/2018	11.18	1.09	(0.16)	0.93	(1.43)	0.00	(0.18)
06/30/2017	9.76	1.15	2.14	3.29	(1.67)	0.00	(0.20)
PIMCO Income Opportunity Fund							
06/30/2021	$ 21.12	$ 2.02	$ 2.88	$ 4.90	$ (1.95)	$ 0.00	$ (0.33)
06/30/2020	24.83	2.26	(3.87)	(1.61)	(2.28)	(0.16)	0.00
06/30/2019	25.06	1.99	0.28	2.27	(2.65)	0.00	0.00
06/30/2018	25.17	2.18	(0.01)	2.17	(2.28)	0.00	0.00
06/30/2017	22.59	2.28	2.92	5.20	(2.56)	0.00	(0.06)
PIMCO Strategic Income Fund, Inc.							
06/30/2021	$ 5.94	$ 0.58	$ 0.64	$ 1.22	$ (0.41)	$ 0.00	$ (0.20)
06/30/2020	7.12	0.74	(1.20)	(0.46)	(0.49)	0.00	(0.23)
06/30/2019	7.32	0.60	0.03	0.63	(0.61)	0.00	(0.22)
06/30/2018[f]	7.75	0.77	(0.34)	0.43	(0.86)	0.00	0.00
06/30/2017[f]	7.89	0.70	0.08	0.78	(0.80)	0.00	(0.12)
PIMCO Dynamic Credit and Mortgage Income Fund (Consolidated)							
06/30/2021	$ 18.16	$ 1.97	$ 2.45	$ 4.42	$ (1.83)	$ 0.00	$ (0.26)
06/30/2020	23.58	2.11	(5.06)	(2.95)	(2.39)	0.00	(0.15)
06/30/2019	23.74	1.88	0.28	2.16	(2.32)	0.00	0.00
06/30/2018	22.91	1.95	0.85	2.80	(1.97)	0.00	0.00
06/30/2017	20.43	1.62	3.46	5.08	(2.60)	0.00	0.00
PIMCO Dynamic Income Fund (Consolidated)							
06/30/2021	$ 22.59	$ 2.51	$ 2.57	$ 5.08	$ (2.52)	$ 0.00	$ (0.13)
06/30/2020	28.29	2.92	(5.80)	(2.88)	(3.07)	0.00	0.00
06/30/2019	28.98	2.73	(0.37)	2.36	(3.15)	0.00	0.00
06/30/2018	28.32	2.95	0.18	3.13	(2.65)	0.00	0.00
06/30/2017	26.56	2.60	3.18	5.78	(4.10)	0.00	0.00

PIMCO

Now the funny thing about PIMCO CEFs, and something that makes them very unusual, is that PIMCO themselves admit upfront (albeit in the footnotes that nearly everyone skips) that a part of the distributions that is reported as ordinary income is functionally return of capital.

> A significant portion of a Fund's monthly distributions may be sourced from the Fund's derivative transactions. Some or all of these transactions, such as paired swap transactions, may also generate capital losses without corresponding offsetting capital gains, such that portions of the Fund's distributions recognized as ordinary income for tax purposes may be **economically similar to a taxable return of capital** when considered together with such capital losses. Please see the Funds' most recent shareholder report for more details.

The premium is not unreasonably high

"Not unreasonably high" is a slippery-enough concept as to be just about meaningless. We could easily argue PDI premium is "unreasonably high" given its 1) highest fee in the suite, and 2) lowest return over the last 3 years within the taxable FI suite. Comparing the fund's premium to its historic level is a basic mistake and is why so many people were pounding the table in 2021 that the (PTY) premium north of 30-40% was not "unreasonably high" - it has since fallen to 13%.

PDI features a highly experienced team

Taxable PIMCO CEFs are all managed by the same people so they all benefit from the same team

PDI has a non-agency RMBS allocation which has performed well.

All of the PIMCO CEFs have a sizable non-agency allocation - PCM has a higher one.

PDI has 36% in 0-1Y assets which gives it plenty of liquidity in picking up assets if rates zoom up.

This is just wrong - this figure includes all the rows in the fund's positions spreadsheet, some of which, like repo, are liabilities rather than assets. The cash borrowed via repo is invested in longer-term holdings. In short, if you actually look through the asset-side of the positions spreadsheet you will find very few sub-1Y assets, nevermind the 36%.

Furthermore, PDI doesn't borrow cash to keep it as "liquidity" - that wouldn't make any sense. It's like trying to take out a mortgage a year before you buy the house to maintain "house liquidity" - the mortgage has to be secured by the house today and so does repo. If PDI borrows billions in repo and, for some incredibly bizarre reason, simply keeps the cash on its balance sheet you would see the cash there and you don't.

Stance And Takeaways

Our CEF view over the past year has been that the four key drivers of CEF performance: Treasury yields, credit spreads, equities and discounts were all at unusually expensive levels, particularly, in the second half of 2021.

As we waited for these drivers to play out we moderated out CEF allocation across the High Income Portfolio, reducing CEF exposure by 20% (i.e. 58% of the portfolio down to 38% of the portfolio).

So far we have seen positive moves across all four of these performance drivers with stocks deflating, the 10Y Treasury yield moving briefly north of 2% this week, credit spreads widening around 0.45% from 3% and discounts now more fairly valued with the median CEF sector 5Y z-score a touch below zero.

SECTOR	Discount	Discount %le	3M Discount %le	1Y Z	5Y Z
	VALUATION				
MEDIAN	-4.97%	50%	24%	-1.69	-0.12
CONVERTIBLES	-2.52%	59%	51%	-0.01	0.95
COVERED CALL	-1.26%	82%	52%	0.47	1.13
EM DEBT	-5.02%	62%	29%	-1.82	-0.35
EQUITY	-2.52%	92%	39%	0.84	1.50
EQUITY - EM	-12.25%	50%	46%	-1.02	-0.23
GLOBAL INCOME	-3.12%	82%	16%	-1.55	1.06
HIGH YIELD	-4.97%	46%	16%	-1.69	0.53
HYBRID	-1.59%	81%	45%	0.15	0.74
INVESTMENT GRADE	-6.84%	44%	11%	-2.67	-0.63
LIMITED DURATION	-6.96%	50%	4%	-2.31	0.27
LOANS	-2.28%	62%	39%	0.45	1.43
MLP	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]

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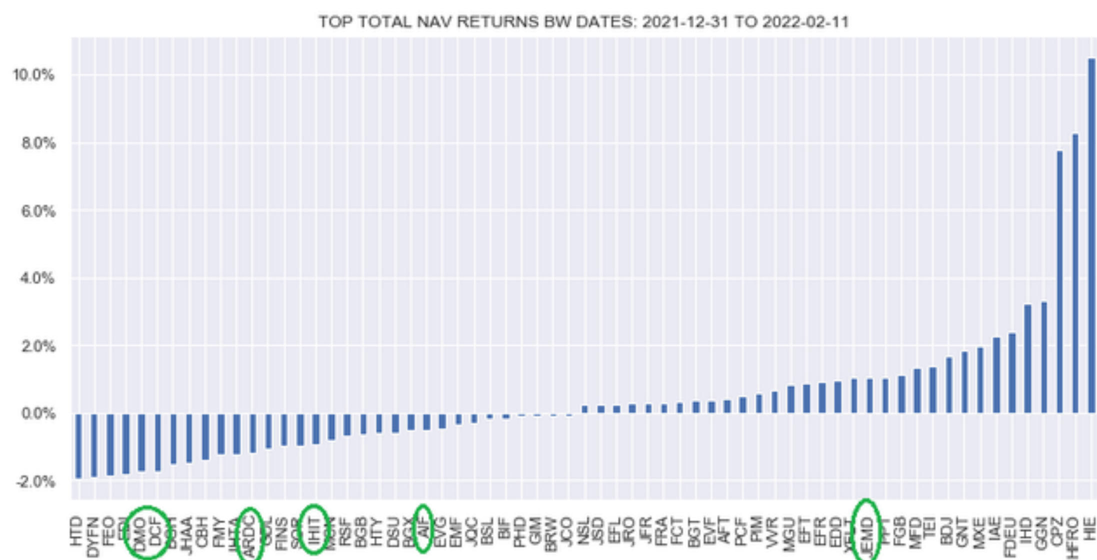
In aggregate, CEFs are more reasonably valued today than they have been for over a year, however, reasonably valued is not the same as cheap so we are looking for further weakness in the space before committing *new capital* to the sector.

However, *within* our CEF allocation we continue to see decent opportunities.

We continue to have a preference for funds with a modest duration profile. Specifically, we continue to have significant allocations to loan funds such as (AIF) and (ARDC) as well as (EIC) - a primarily CLO mezz fund.

We also like niche sector fund with significant floating-rate exposure such as (IHIT) and (DMO) as well as short-maturity funds like (JEMD).

We have continued to favor these funds for quite some time and hold most of them across our Income Portfolios. The chart below shows the top-performing funds since the end of last year in total NAV terms (top performing fund is on the far right etc.), excluding the MLP sector for clarity. The mentioned funds are highlighted in green. We expect these funds to hold up well if Treasury yields continue their march upwards.



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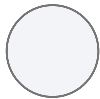

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