Nuveen's Meyers Explains Leverage In Closed-End Funds In The Virus Economy

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Chuck Jaffe, in The NAVigator podcast, interviewed Bill Meyers, head of the closed-end business-development group at Nuveen Inc. Read the Q & A below as Bill and Chuck discuss how leverage works in closed-end funds and the types of leverage and rules governing it, because leveraged funds – and their potential to blow up fast when facing trouble – could scare off nervous investors during volatile times.


Bill Meyers

The podcast can be found on AICA's website by clicking here: https://aicalliance.org/alliance-content/pod-cast/

CHUCK JAFFE: Bill Meyers, senior managing director at Nuveen is here today. We're discussing leverage right now on The NAVigator. Welcome to The NAVigator, where we talk about all-weather active investing and plotting a course to financial success with the help of closed-end funds. The NAVigator is brought to you by the Active Investment Company Alliance. A unique industry organization that represents all facets of the closed-end fund industry, from users and investors to fund sponsors and creators. If you're looking for excellence beyond indexing, The NAVigator's going to point you in the right direction. Joining me today for The NAVigator, it's Bill Meyers, head of the closed-end fund business-development group at Nuveen. Nuveen, which has roughly a trillion dollars under management, and we are looking at closed-end funds and leverage. But before we do, just a reminder, you can go to Nuveen.com for more information. If you go to Nuveen.com/Closed-End-Funds, you will get information directly relevant to you as a closed-end investor. They're on Twitter @NuveenINV. And to learn more about closed-end fund investing, check out the Active Investment Company Alliance website, AICAlliance.com. Bill Meyers, welcome to Money Life.

BILL MEYERS: Thanks for having me, Chuck. It's always a pleasure being on The NAVigator with you.

CHUCK JAFFE: We are talking today about leverage, because in all of the craziness that has been going on and moving the markets, well, we've also seen a little bit of craziness that has widened discounts, changed discounts, etcetera. And it has closed-end fund investors concerned about leverage. So let's kind of help people understand how leverage works in closed-end funds. The types of leverage, and then the risks that come along with it.

BILL MEYERS: Great. Chuck, thanks for having me. The closed-end fund universe I'd like to discuss a little bit before talking specifically about the types of leverage. Right now the closed-end fund universe has about 280 billion dollars in assets under management. About two thirds of that is fixed-income type of assets. And then if you think about the closed-end universe, about two thirds of the assets under management are from leveraged products. So leverage is a pretty important component of closed-end funds within the market. Now to your specific question with respect to types of leverage, closed-end funds can have two types of leverage. One is debt leverage, the other is equity leverage. The debt leverage, think of that as borrowing; some type of note, a line of credit, commercial paper. It shows up on the fund's balance sheet as a liability. So again, it comes above where the common shares are in terms of the hierarchy in the credit. Another form of leverage is equity leverage. Think of it as a preferred shares. Again, it's senior to common shareholders, but it's a preferred share that's issued as a form of leverage. So those are the two general types of leverage for closed-end funds. And each are governed by different types of rules.

CHUCK JAFFE: Let's talk about the rules. Because the rules are kind of important so that an investor's not surprised.

BILL MEYERS: Yeah, and the rules are really important. Think of the rules, there's different masters of leverage with respects to the rules. One of the masters are the regulators. The regulators put certain limits on how much leverage can be used for closed-end funds. Closed-end funds are governed by The Investment Company Act of 1940. The 40 Act puts limitations to how much leverage you can use in either form. If you have borrowing leverage, you can have no more than 33% of your total fund assets derived from the borrow. If you have preferred share leverage or equity share leverage, it can comprise no more than 50% of the fund assets. Let's talk about the definition of 33 and 50. If a fund has 100 million dollars in total assets under management, the debt leverage has to have three times asset coverage or 300%, and the inverse of that is 33%. So no more than 33% of that 100 million, or 33 million, can come from the debt. Preferred shares, there's more latitude on that. So the preferred shares can comprise up to 50% or 50 million of that 100 million total assets under management. Those are the rules that The 40 Act puts on top of that. But there's other masters involved. There's counter-parties that provide the leverage. So if you're borrowing from a commercial or an investment bank, they might have certain restrictions that might be more onerous than The 40 Act. So you need to be mindful of some of the restrictions the counter-parties have. Also, institutional investors might be buying some of the preferred shares or the debt, so they might not want as much leverage in the fund. So the fund sponsors need to be mindful of them. The final constraint that there is on leverage would be rating agencies. So a lot of the debt or preferred shares are rated by the rating agencies. And the rating agencies might have certain coverage restrictions as it relates to position sizes, diversification, absolute amount of debt, and so on. So those are the thresholds and the rules that govern just how much debt can be issued by a closed-end fund.

CHUCK JAFFE: Everybody hears leverage, thinks leverage exacerbates risks, makes things more risky. Explain how leverage and the risk equation works in closed-end funds, so that folks understand that leverage does not mean you're getting wild here.

BILL MEYERS: Leverage does not mean you're getting wild, but there is elevated risk with respect to leverage within closed-end funds. So the risks I look at, the main risks are two-fold. One is there's more volatility in the fund NAV. The second is there's more volatility in terms of how much income that the fund might pay out to common shareholders. So tackling each one by one, the NAV volatility. I had mentioned earlier that the leverage on the balance sheet of the fund is as fixed dollar amount. So whether it's borrowing leverage or a preferred share leverage, both forms of leverage come senior to common shareholders. So any appreciation or depreciation of that 100 million dollar fund that I used for example, is going to be born entirely by the common shareholders. So they're going to have a more volatile underlying NAV because of the leverage. It can be good in markets that are moving higher. Because if you borrow and invest in an asset class, and that asset class moves sharply higher, that's all going to be enjoyed by the common shareholders. But the converse can happen as well. And if that asset class depreciates sharply, that's also going to be born entirely by the common shareholders. So again, there's more volatility of the underlying NAV for common shareholders than there would be otherwise if there's no leverage. The other type of risk is more income volatility. So the cost of leverage is generally tied to a short-term benchmark index. The proceeds from the leverage are invested in a longer-term asset class typically. So there's generally a spread between what the portfolio is earning and what the cost of leverage is incurring for the fund. So for example, on muni funds, which again, are dominated by leverage products. The SIFMA index, which is a short-term muni benchmark and a reference rate for a lot of leverage, right now that's 21 basis points. The leverage cost to that is a certain spread to that 21 basis points, but there's a fair amount of incremental income given the steepness of the muni yield curve right now given how low short-term rates are. On the taxable leverage funds, the benchmark on that is typically the three-month LIBOR rate. This morning LIBOR was at 84 basis points. Again, the asset classes are typically earning a fair amount more than 84 basis points. So that spread between the portfolio's earning and what the cost of leverage serves to increase, what dividends would otherwise be to common shareholders. Now in a period where the short-term rates are moving higher, that can squeeze the fund's income and it can increase the cost of the fund because the leverage expenses is increasing, so that might otherwise reduce what the dividends would have been to common shareholders. But right now we're seeing a steepness in the yield curve. We're seen the likelihood of short rates being low for a longer period of time. So there's right now a decent amount of spread available for leverage funds right now, and the possibility of the dividends being higher than they would otherwise be. But that said, Chuck, they're both still risks. And we certainly experienced a lot of that NAV volatility risk this past month toward the tail end of March when the asset values were falling very sharply, very quickly. And that caused some issues for leverage and closed-end funds given how rapidly the market's fell.

CHUCK JAFFE: Now we've had this kind of incredible stress test. And look, the market may test us again, and I actually expect it to do that. But at this point, somebody should be able to look at their closed-end funds, or any closed-end fund that they're considering that uses leverage, and say, "I've got a pretty good recent exemplar for what could happen and might happen. And if I'm not prepared for what this fund just went through, I don't want to buy it to go through what it could go through next." Is that a pretty safe way for somebody who maybe didn't get caught up in closed-end funds, or is nervous about getting back in because of some of the leverage, is that a good way to look at it? Or is there more to it than that?

BILL MEYERS: Well, I think that's a good start. I think investors need to be mindful of leverage in closed-end funds given the risks there are. But there's a lot of information about leverage, both educationally, and there's information on CEF.com and the website. I know Nuveen has a lot of information about just leverage, how it is, how it works. But there's also specific fund-level information about leverage. Just how leveraged is a fund? Is it 28% levered? Is it only 20% leverage? So there's a continuum of leverage that exists for funds out there, and some funds are more highly levered than others. So if someone's concerned about volatility, they might want to stay away from a more highly levered fund. At Nuveen we look at leverage as a long-term component of closed-end funds. We look at leverage as a strategic feature, that may be in one given market cycle, might not be helpful. But over the course of many market cycles, we look at leverage as an important strategic ingredient in a closed-end fund.

CHUCK JAFFE: Bill, great stuff. Thanks so much for chatting with me about it.

BILL MEYERS: Great, Chuck. It's always great to be on with you, and I appreciate the forum.

CHUCK JAFFE: The NAVigator is a joint production of the Active Investment Company Alliance and Money Life with Chuck Jaffe. I am Chuck Jaffe, you can learn more about my work and my show at MoneyLifeShow.com. To learn more about closed-end funds and business-development companies, go to AICAlliance.org, the website for the Active Investment Company Alliance. They're on Facebook and LinkedIn @AICAllaince. Thanks to my guest Bill Meyers, head of the closed-end fund business-development group at Nuveen. Which is online at Nuveen.com and Twitter @NuveenINV. The NAVigator podcast is available every Friday, please subscribe where you find all of your favorite podcasts. We hope you'll join us again next week. And until then, stay safe everybody.

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