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Demand for CEFs Expected to Increase as Investors Look for Alternative Fixed Income Products

By Jennifer Banzaca

As traditional fixed-income portfolios and allocations are becoming a thing of the past, individual investors are starting looking at alternative fixed income solutions such as closed-end funds.

During the General Session at the Active Investment Company Alliance's (AICAlliance.org)'s Summer Summit on August 13th, Jonathan Browne, a Portfolio Manager at Robinson Capital, said while he has not yet seen a meaningful increase in demand, he anticipates investors moving away from traditional fixed income products and start allocating to the closed-end fund space.

"Over the past two months, average daily trading volumes have remained very consistent. Any increased demand in closed-end funds should move discounts closer to premiums and NAV and we haven't yet seen that," Browne observed. "However, I expect that to change and for closed-end funds to become much more interesting to anyone with traditional fixed income investments."

Browne added that corporate bonds are currently yielding less than 2%, municipal bonds yielding just over one percent, and Treasuries are yielding approximately .5%, it would not take much credit stress or interest rate movement to erode a full year or two worth of income at these levels.

"Because of that, we believe that closed-end funds will see an increase in demand, and quite frankly should play a bigger role in advisors portfolios going forward given they're distributing several hundred basis points more in yield compared to many of the more traditional fixed-income strategies."

The increased demand could lead to new product offerings, Browne added and the demand will be for specific asset classes within the closed-end fund universe.

Another reason demand for CEFs could increase is that the funds have become more investor friendly.

According to Matt Leffler, a Portfolio Manager at RMB Capital Management, the intervention of more activists has caused boards to be much more shareholder friendly, more cognizant of discounts and more cognizant of realizing end-value for the investors.

Leffler also observed that the introduction of term funds that liquidate at a specified time mitigates some of the negative attributes of discount dynamics that put off many investors.

“Over time, fees have trended down and lower, the IPO process has been more advantageous for the end investor. So there are a lot of trends that I think are an indication of a maturation process for the closed-end fund industry that's going to lead to better end investments for the investors,” Leffler added.

Doug Bond, Head of Closed End Funds and a portfolio manager at Cohen & Steers pointed out that one of the inefficiencies found in the closed-end fund market is the disconnect between market price movement and underlying net asset value performance and there have been many different examples of this so far in 2020.

“One area where we think there are interesting shopping opportunities is the convertible group of closed-end funds, where on a year-to-date basis average NAVs were up in excess of 14% and market prices were up 2%. Discounts are close to 13% in that group and the performance on NAV has been very strong and market prices are nowhere near to keeping pace with underlying net asset value performance.”

While the market has seen a great deal of volatility this year, particularly in March 2020 when there was a 27-day period when discounts declined quickly, managers must try to prepare for such periods and try to take advantage.

Edward Keating, a Client Portfolio Manager Lazard Asset Management, noted that he had never seen such a violent move in discounts over such a short period of time, but Lazard’s Discounted Assets team was excited by the volatility.

“Frankly, we need volatility. We need this inefficiency in order to drive alpha for our clients. If discounts are a flatline, that's not very exciting for investors such as ourselves. So this is a period that we're able to take advantage of these discounts and of these inefficiencies,” Keating explained.

In preparing for and dealing with volatile markets, Leffler advised managers to have a well-thought out plan for a wide array of potential outcomes.

“It is impossible to predict when the next downturn or bout of volatility will appear but you can be certain it will come. For my business, historically periods of volatility have been among the best periods for business growth due to our fund’s preparation and portfolio design that lend themselves to outperformance during those periods of uncertainty,” Leffler noted.

It is also important for managers to communicate to investors how volatility will impact the fund.

If our investors are given enough information they can make educated decisions about not just how the portfolio has performed but more importantly what role it is likely to play through future market disruptions and throughout the market cycle. This knowledge not only allows them to build more robust portfolios but can also help frame periods of under- and outperformance thus allowing them to have more confidence that we are providing value,” Leffler said.

on exchanges at prices that may be above or below their NAVs. There is no guarantee that an investor can sell shares at a price greater than or equal to the purchase price, or that a CEF's discount will narrow or be eliminated. Non-listed closed-end funds and business development companies do not offer investors daily liquidity but rather on a quarterly or semi-annual basis, often on a small percentage of share. CEFs often use leverage, which can increase a fund's risk or volatility. The actual amount of distributions may vary with fund performance and other conditions. Past performance is no guarantee for future results.