‘Distribution Coverage Ratios’ Give Clues On Potential Payout Cuts

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Chuck Jaffe, in this episode of The NAVigator podcast interviewed Roxanna Islam, associate director of research for Alerian and S-Network Global Indexes. Read the Q & A below as Roxanna discusses why her firm's indexes of closed-end funds show particularly high yields right now, but suggests that investors keep an eye on distribution coverage ratios – which look at whether a fund's earnings can cover its payouts – to identify issues where distribution cuts are more likely in the future.

Roxanna Islam

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

CHUCK JAFFE: Roxanna Islam, associate director of research for Alerian is here, and we’re talking closed-end fund distributions 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 will point you in the right direction. And today it's pointing me in the direction of Roxanna Islam, she is associate director of research for Alerian and S-Network Global Indexes. Now they may be best known for their indexes of master limited partnerships, but they also do indexes of closed-end funds, and you can learn more at AlerianAndSnet.com. So in other words it's Alerian, the word 'and', snet, no dashes, no spaces, no dots, no hyphens, dot com. And of course if you're looking for more direction on closed-end funds, business-development companies, interval funds and more, check out the Active Investment Company Alliance website at AICAlliance.org. Roxanna Islam, thanks for joining me on The NAVigator.

ROXANNA ISLAM: Hey Chuck, thanks for having me.

CHUCK JAFFE: Let's start with just a little bit of background. Because people are most familiar with Alerian for its indexes on master limited partnerships, but you guys not only have closed-end fund indexes, but the distribution rates, if somebody's looking for yields, you guys are killing it. So explain what's going on, how you've got your indexes on closed-end funds with these high yields and what do people need to understand about that?

ROXANNA ISLAM: Yeah, so within our Alerian and S-Network Index universe we have several income-oriented indexes that we like to look at. Besides our MLP indexes, our closed-end fund indexes are actually returning to highest yield of distribution rates like you mentioned. So we actually have a few closed-end fund indexes, but the main one we typically look at is the S-Network Composite Closed-End Fund Index, which is ticker CEFX. And before we dive in, I think a basic idea for everyone to keep in mind is the structure of closed-end funds. These are exempt from corporate taxes on the condition that they pass through net investment income to shareholders, which is why these instruments are often so appealing to investors looking for yield. And most closed-end funds actually pay these distributions monthly compared to traditional fixed-income instruments which may pay coupons semi-annually. But when you're looking at these distributions or distribution rates, I think it's really important to know how to interpret these distributions and recognize where they come from. And it's interesting, especially now given the current economic environment, that people want distributions because they're supposed to be stable, but that technically isn't always the case.

CHUCK JAFFE: How should people be looking at distributions to try to figure out if they're stable? Because yeah, consistency is what people want most when it comes to their income.

ROXANNA ISLAM: I guess to start with, but this may be too high level for a lot of listeners, but I think it's important to also remember that distribution rate is different from the actual distribution. So the best way to remember this is that it's a ratio with the distribution as the numerator and the price, the NAV as the denominator, and that ratio is constantly changing as the price and NAV change daily. For example, our index is yielding over 10% in early 2020 when the market crashed and prices took a hit, and now it's averaging closer to 6-7% yield simply because prices have recovered from pandemic lows and not because distributions are significantly lower. So that is first of all important to realize why distribution rates are high and recognize that high distribution rates may not always be sustainable. So within the context of closed-end funds, I think the downside for many is that the distributions are so different for equity and fixed-income funds that it may be hard to interpret them, and I would say that fixed-income distributions are somewhat simpler to understand than equity distributions. So with fixed-income funds most of the time we can just look at a ratio called the distribution coverage ratio, which looks at whether earnings can help support the fund's distribution. And a lot of times this is as simple as realizing that if the earnings are greater than distribution, the coverage ratio will be over 100%, whereas a fund with earnings below distribution will have a coverage ratio of below 100%. If that distribution ratio is below 100%, the fund may have more risk of cutting its distributions, although there's several other factors that you can look at. Another one for example is the fund's undistributed net investment income, which is the total balance of available funds outside of current earnings that the fund can use for its distributions. And if you compare this to the monthly distribution it can give you an approximation of how many months can be covered by that balance.

CHUCK JAFFE: You guys are building indexes, so your decision making is never, hey, I like this ratio or I dislike this ratio, it's more about people understanding. But where an investor, an individual investor might look at a closed-end fund and say, "Oh, I see some vulnerability here. What the distribution rate is telling me we could see changes in distribution." You guys at Alerian and S Global, because you're building an index, are really agnostic to the rate. It's more about making sure everything is covered, correct?

ROXANNA ISLAM: Yeah, that's correct.

CHUCK JAFFE: As a result, if somebody is looking in this space, they should be maybe looking more carefully. Like that difference between "I want to go with an index" versus "I want to pick an individual issue" is going to be something that might be a case where when I want to pick my funds very specifically I'm looking at the distribution ratio, when I'm looking at the index, I want to be in the entire space. Correct?

ROXANNA ISLAM: Yeah, that's correct. But I think a lot of those issues with the distribution rate is resolved by using the index or an index-linked product. So for example, just using our index CEFX, we have over 125 closed-end fund constituents, and it's allocated about a third each to equity option income, high-yield fixed income, and investment grade fixed income, and also diversified across 40 or so of the top closed-end fund managers. So if a manager or a few funds decides to make a cut, it ultimately won't affect the index distribution rate as much because it's an average of these funds that are in the index. And so I think that can help a lot of investors with the ease and simplicity, especially when you consider all these factors that are involved when interpreting closed-end fund distributions.

CHUCK JAFFE: You talked about how the index is made up of different components, the equity option income, and high-yield fixed income, and investment grade fixed income, but when it comes to distribution should people be looking at fixed income versus equity differently? Is there a significant difference behind how the different types of funds perform?

ROXANNA ISLAM: You know, not really. It depends on the economic environment, that's why we have the diversity of those three segments within that index. And something that I touched on earlier was that these fixed-income distributions are a bit more straightforward, and on an equity side it's arguably a lot more difficult and a lot more complicated. So with these equity closed-end funds, a lot of these expect to earn a large portion of their return through capital gains rather than dividends or interest. So if they will use a managed distribution policy, which it tends to forecast capital appreciation for the entire year, and then they'd use that estimate to make the regular monthly and/or quarterly distribution payments. So on one hand those equity funds do provide stable cashflows similar to a fixed-income fund, but it does come with the risk that the fund may overestimate the unrealized capital gain and start returning capital to you instead.

CHUCK JAFFE: Well, Roxanna, it's been really interesting. There's a lot of great stuff here, thanks so much for joining me to talk about it on The NAVigator.

ROXANNA ISLAM: Thanks for having me, Chuck.

CHUCK JAFFE: The NAVigator is a joint production of the Active Investment Company Alliance and Money Life with Chuck Jaffe. And that's me, I'm Chuck Jaffe, and you can check out my show on your favorite podcast app or at MoneyLifeShow.com. To learn more about interval funds, 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 @AICAlliance. Thanks to my guest, Roxanna Islam, associate director of research for Alerian and S-Network Global Indexes. Learn more about her, the firm and its indexes at AlerianAndSnet.com. The NAVigator podcast is new every Friday, we hope you will subscribe and join us again next week. And until then, happy investing everybody.

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