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Intra-Sector Fund Swapping: A Strategy for Unlocking Value Through Closed-End Funds

During times of lingering inflation, engaging in intra-sector swapping of actively managed, taxable fixed income closed-end funds (CEFs) can potentially improve portfolio value while making good use of the CEF structure, says Active Investment Company Alliance Chairman John Cole Scott.

The strategy — moving money from a successful fund that is at or near a premium to one selling at a discount within the same fund company — can provide investors with almost the same level of credit exposure but with far less dollars, Scott said on the September 9, 2024, NAVigator Podcast.

He notes that while swaps are a taxable event, investors functionally profit from the move. “If you own the funds on the premium list, you should be excited; you’ve outperformed the average fund on a premium expansion and it’s the best time to sell because you over-won. It’s a chance to take the profits and not change the asset allocation and even the manager.”

With fixed income CEFs performing well in the current rate environment, the average fund has been trading close to net asset value (NAV)[1], which means many investors may be holding onto funds at narrow discounts or small-to-medium premiums.

The Lowdown on Discounts

The NAV of any closed-end fund is based on the sum of the market value of a fund’s holdings and minus any liabilities. When the market price of a fund is beating the NAV, the fund’s discount is said to be “narrowing,” whereas the opposite scenario creates a “widening” discount.

Premiums occur when a market has more buyers than sellers and shares sell at a price higher than NAV. Discounts, by contrast, result from an excess of sellers in the market when shares sell below the NAV.

While pervasive discounts can frustrate some investors, they are a feature enjoyed by many long-term investors in the universe of CEFs.

How It Works

So, if you're not making a tax-loss sale and trying to match gains with losses, what's the point of swapping out a premium fund for a discounted fund? In the show notes to the podcast, Scott provides 10 examples of potential benefits from fund swaps, most of which are from the same peer group, and all of the swaps are from the same fund sponsor.

Scott looked at 10 different managers that currently have more than one fund in the same sector. He then collected average data for high-yielding premium funds and discounted funds that displayed a roughly 15% average wider discount for about the same allocation.

"With almost the same six-month and one-year NAV total return for these 10 funds, and you're getting essentially almost the same total credit exposure but with 15% less dollars, which is to me very powerful," Scott said on the podcast. "Basically, if you have $100,000 in 10 funds and you sell them at NAV, you'll gain $115,000 of new fund exposure through the complete swap."

In one of the examples that Scott researched, he found that ISD, the PGIM High Yield Bond Fund, currently trades at a -2% discount, while SDHY, which has almost the same asset allocation, sells at a -10% discount. This means investors stand to gain 8% more assets to rotate into SDHY, the PGIM Short Duration High Yield Opportunities Fund. In some instances, the asset exposure gained from intra-sector fund swapping can range between 30% and 60%.[2]

In addition, looking at the three-year estimated discount downside, it is -5.5% for SDHY and -12.5% for ISD. For the funds in the comparison, this averages about 10% lower than the previous discount low. In addition, looking at the three-year estimated discount downside, it's -5.5% for SDHY and -12.5% for ISD. For the funds in this comparison, the average is about 10% lower than the previous discount low for "discount" funds vs "premium" funds.[2]

"When markets hit a bumpy patch and discounts expand after a narrowing stretch, we see a much more downside volatility on things the higher they live above net asset value," said Scott. "We've seen things go from a 20-30% premium down to a 10% plus discount in less than a week, just from market dividend and other craziness."

Listen to the September 9, 2024, NAVigator Podcast and review current and deeper data on each fund Scott mentions in the podcast and show notes (PDF) at CEFData.com.

References

[1]Closed-End Fund Advisors, 2Q 2024 Closed-End Fund & BDC Review and Outlook (PDF)

[2]September 9, 2024, NAVigator Podcast Show Notes (PDF)

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