CITY OF LONDON
Investment Management Company Limited

Increasing Exposure to Public Credit?

August 2023

Using Closed-End Funds to Enhance and Diversify a Credit Allocation.

A sleeve of Closed-End Funds (CEFs) within a public credit allocation can be used to increase portfolio returns and diversify sources of alpha. Generally, performance can be improved, and downside mitigated through purchasing assets at significant discounts to their Net Asset Value (NAV).

The combination of discounts and high distributions results in higher carry than simply owning the underlying credits. The effect of high cashflows purchased below par value is a mathematical tailwind to return.

The blend of a 15% discount and a 12% distribution for example means investors could enhance returns by receiving a portion of the discounted CEF at NAV when distributions are paid out.

A 15% discount equates to a return of 1/0.85 or 17.6% for each distribution.

Overall, this therefore generates an additional 17.6% x 12%, or 2.1% of alpha per year.

There are also further levers we can rely on to augment this. These include self-liquidating term trusts which offer an exit at NAV at a fixed point in the future. At the time of this article's publication there is a wave of activism driving excess returns, where Boards may be pressured to close discounts to NAV. These complement the robust source of alpha that is discounts, which exhibit natural cyclicality over time.

Example – A 2027 Term Closed-End Fund (Security A)

- Current Distribution of Security A – (10.02%)
- Current Discount of Security A – (12.80%)

– Security A's Discount and Distribution Alpha = 1.47%

In this example the combination of the discount and the high distribution provides a tailwind of 1.47% per annum to the underlying return.

In addition, Security A has a **term structure** meaning it will liquidate in 2027 at NAV. You can calculate a Gross Redemption Yield (GRY) from the pull-to-par effect from its current discount of 12.80% to parity over this time period (July 2023 to 2027).

– GRY to Term Date – (2.94%)

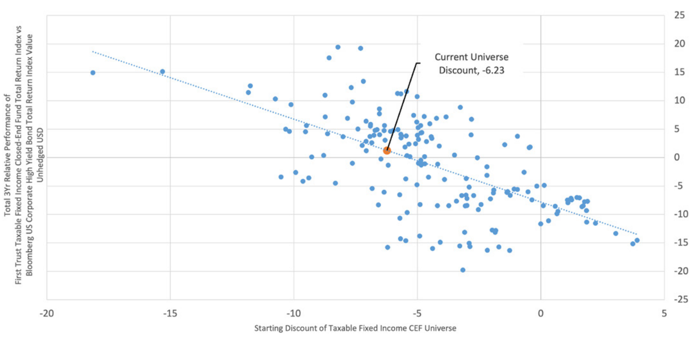
We can therefore infer an alpha effect of >440bps per annum (294bps + 147bps) from the combination of a steeply discounted cashflow and the pull-to-par of the CEF. Whilst the latter may be back-end-loaded toward the end of the fund's life, it is often recognised by the market some way in advance.

This more than outweighs the active expense ratio that is often an excuse to prefer passive "tracking" of the index.

City of London specialises in capturing Alpha from discounts. Relative value capture from discount volatility is a core competence, and the persistence of the opportunity within public credit CEFs is something we believe merits a structural allocation. It offers a concrete starting point for closed-end funds to potentially outperform a passive allocation and can be complementary to existing active manager allocations. Often, we will invest in the same active managers but at an attractive discount to the very similar portfolios in their mutual funds.

The chart below illustrates the three-year relative performance of the universe of taxable bond closed-end funds vs the Bloomberg US Corporate HY TR Index from 2006 to 2020 (the longest dataset available).

This indicates that from current universe average starting discounts (as at 30th June 2023), underperformance is infrequent relative to periods of outperformance and smaller in absolute quantum.



TXCEFT Index – First Trust Taxable Fixed Income Closed-End Fund Total Return Index
LF98TRUU Index – Bloomberg US Corporate High Yield Bond Total Return Index Value Unhedged USD
Average Discount – CLIM Closely Followed Taxable CEF Universe
Please see "Disclosures" for important information.

Source: Bloomberg, CLIM

What's the Catch?

Closed-end funds are listed on exchanges, and whilst this provides liquidity it also increases mark-to-market volatility. However, the ability to flexibly allocate or reduce risk T+2 can be valuable in return.

Further, CEFs often employ internal leverage which can amplify returns in either direction. In 2022, this was a factor in relative underperformance. In due course we anticipate that it will be a driver in the other direction.

Summary

We believe allocators considering an increased risk budget to public credit can look to closed-end funds as return enhancers and risk diversifiers. Expected outperformance and listed liquidity can be seen to balance a degree of increased volatility versus other components of an overall allocation.

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The CLIM Taxable Closed-End Fund Investment Universe consists of over 125 U.S. listed closed-end funds with a market cap over \$50bn. The First Trust Taxable Fixed Income Closed-End Fund Index is capitalization weighted and designed to provide a broad representation of the taxable fixed income closed-end fund universe. The taxable fixed income closed-end fund market is comprised of the following sectors; high yield corporate, senior loan, global income, emerging market income, multi-sector, government, convertible, and mortgage funds. The Bloomberg USD High-Yield Corporate Bond Index is a rules-based, market-value-weighted index engineered to measure publicly issued non-invest¬ment grade USD fixed-rate, taxable and corporate bonds. To be included in the index, a security must have a minimum par amount of \$250 million and have a minimum maturity of 1 year at rebalancing. Emerging market debt is excluded.

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