Structural Alpha in Public Credit Allocations

CITY OF LONDON
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Planning For The Next Stage of The Credit Cycle

Allocators planning their response to widening spreads in public credit can enhance expected returns by changing the structure of their beta exposure. A basket of listed Closed-end Funds provides liquid beta with embedded structural alpha.

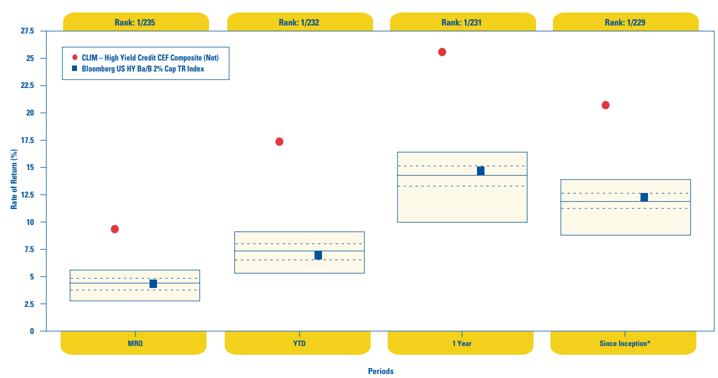
Typically, discounts to NAV at which closed-end funds trade widen in sympathy with credit spreads. This historically has provided an excellent entry point for beta allocations, with high-confidence alpha derived from CEF-specific factors.

Structural Alpha

These factors represent a concrete starting point for a CEF sleeve to enhance returns versus a passive allocation. They also complement other active manager selections. They include:

- The mathematical tailwind from purchasing cashflows below par value, which mechanically generates excess carry.
- The non-subjective yield enhancement generated by Term structures – CEFs which self-liquidate at NAV a fixed date in the future. These generate a Gross Redemption Yield from the pull-to-par of the CEF security, above and beyond that of the underlying credit portfolio.
- Generalised reversion of discounts to NAV, which exhibit reliable cyclicality over time.

City of London's US High Yield Credit CEF Composite, below, demonstrates the allocation impact.



**The universe includes all funds classified as eVestment US High Yield Fixed Income. 95.1% of the universe has been updated through Quarter 3 2024 as at November 12, 2024. CLIM pays a subscription fee to eVestment Alliance for the use of their rankings and charts. Inception October 2022. Net returns reflect an investment management fee of 0.5% per annum. Periods over one year are annualized. Past performance is no guarantee of future results.*

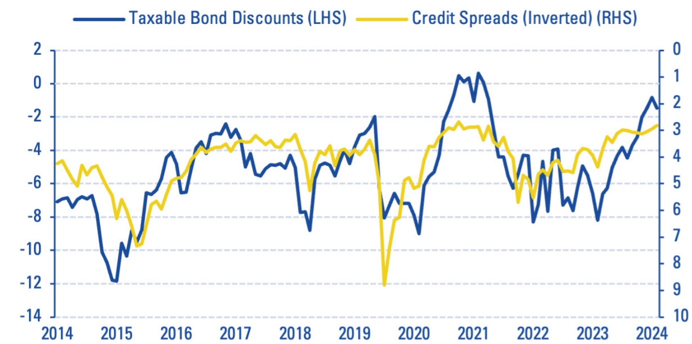
Source: eVestment, Bloomberg

Liquid Implementation

The US universe of credit closed-end funds is both sizeable (over $60bn) and liquid (over $75m/day). CEF Mandates are primarily high yield and leveraged loan. The majority of CEF sponsors are blue-chip fixed-income managers. The underlying exposure of a portfolio of CEFs will typically be extremely diversified and exhibit low tracking error. It will therefore offer quasi-passive index beta to public credit markets. Excess returns are derived from CEF-specific factors, not active share.

Same Credit Risk, Bigger Spread

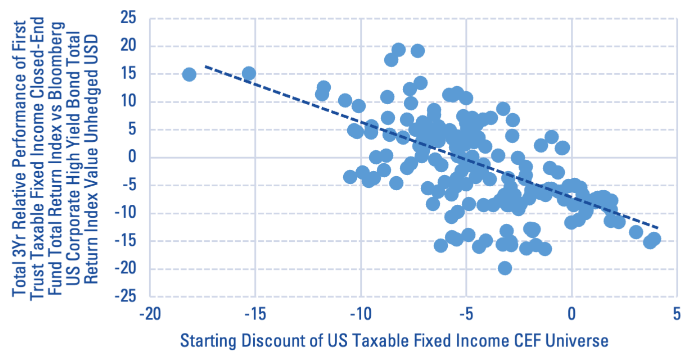
The chart below shows the relationship between high-yield credit spreads and the simple average discount of the US-listed taxable bond CEF universe. There is an observable correlation between widening credit spreads and the propensity of closed-end funds to exhibit higher risk premia. This occurs without any increase in underlying default risk.



Wide Starting Discounts Give High Confidence of Outperformance

The chart below illustrates the three-year relative performance of the universe of taxable bond closed-end funds vs. the Bloomberg US HY TR index from 2006 to 2021 (the longest dataset available).

It indicates that from average starting discounts over 10% underperformance is infrequent relative to periods of outperformance and smaller in absolute quantum.



Summary

Allocators seeking to differentiate their exposure to public credit can consider CEFs.

- An actively-selected portfolio of CEFs offers quasi-passive index beta to public credit.
- Non-subjective tailwinds from structural factors give high-confidence alpha expectations.
- Benefit from "enhanced spread" impact from discounted entry to dislocated underlying spreads.
- On-market liquidity enables active management of risk factors.

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The High Yield Credit Closed-End Fund Composite incepted and was created in October 2022, and is a fixed income composite managed by CLIM. The investment objective is income, with capital appreciation as a secondary objective. The strategy focuses on generating income through investment in below investment grade credit. The strategy does not employ hedging or leverage at the fund level. The Composite employs listed funds, including closed-end funds and ETFs. The strategy is measured against the Bloomberg US High Yield Ba/B 2% Cap TR Index. Fixed income securities issued by municipalities of the United States are typically issued by or on behalf of states, territories and possessions of the United States, the District of Columbia and their political subdivisions, agencies or instrumentalities as well as private and public-private enterprises to obtain funds for a wide range of public facilities including housing projects, industrial projects, hospitals, schools, mass transportation, stadiums, waterworks and sewer systems and highways. The municipal securities market is fragmented, with significant variations in economic conditions, credit quality, and supply-demand fundamentals. Public information in the municipal market is also less available than in other markets, increasing the difficulty of evaluating and valuing securities. Events affecting municipalities and related bond issuers that are distressed or otherwise financially challenged, such as a default or a restructuring by a large municipality, may cause a sell-off in the municipal market as related news headlines will negatively impact municipal bond pricing. Municipal securities risks include the ability of the issuer to repay the obligation, the relative lack of information about certain issuers of municipal securities, and the possibility of future legislative changes which could affect the market for and value of municipal securities. Debt securities, such as bonds, in involve interest rate risk, credit risk, extension risk, and prepayment risk, among other things. The market value of bonds and other fixed income securities changes in response to interest rate changes and other factors. Interest rate risk is the risk that prices of bonds and other fixed-income securities will increase as interest rates fall and decrease as interest rates rise. Credit risk refers to the possibility that the issuer of a debt security (i.e., the borrower) will not be able to make principal and interest payments when due.

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 US High Yield Ba/B 2% Cap TR Index is a rules-based, market-value-weighted index engineered to measure publicly issued non-investment 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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