Closed-End Funds: Attractive Yields and NAV Discounts with CEFX

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With yield more difficult to find in today's interest rate environment, closed-end funds represent a unique opportunity to enhance the income profile of a portfolio. Adding to the appeal, many closed-end funds are currently trading at notable discounts to their net asset values (NAVs). The S-Network Composite Closed-End Fund Index (CEFX) exemplifies these benefits with a yield of 8.42% and a weighted-average discount of 9.9% to NAVs as of November 6. This piece discusses key considerations when investing in closed-end funds and the benefits of the construction of CEFX, which is the underlying index for the Invesco CEF Income Composite ETF (PCEF) and the ETRACS 1.5X Closed-End Fund ETN (CEFD).

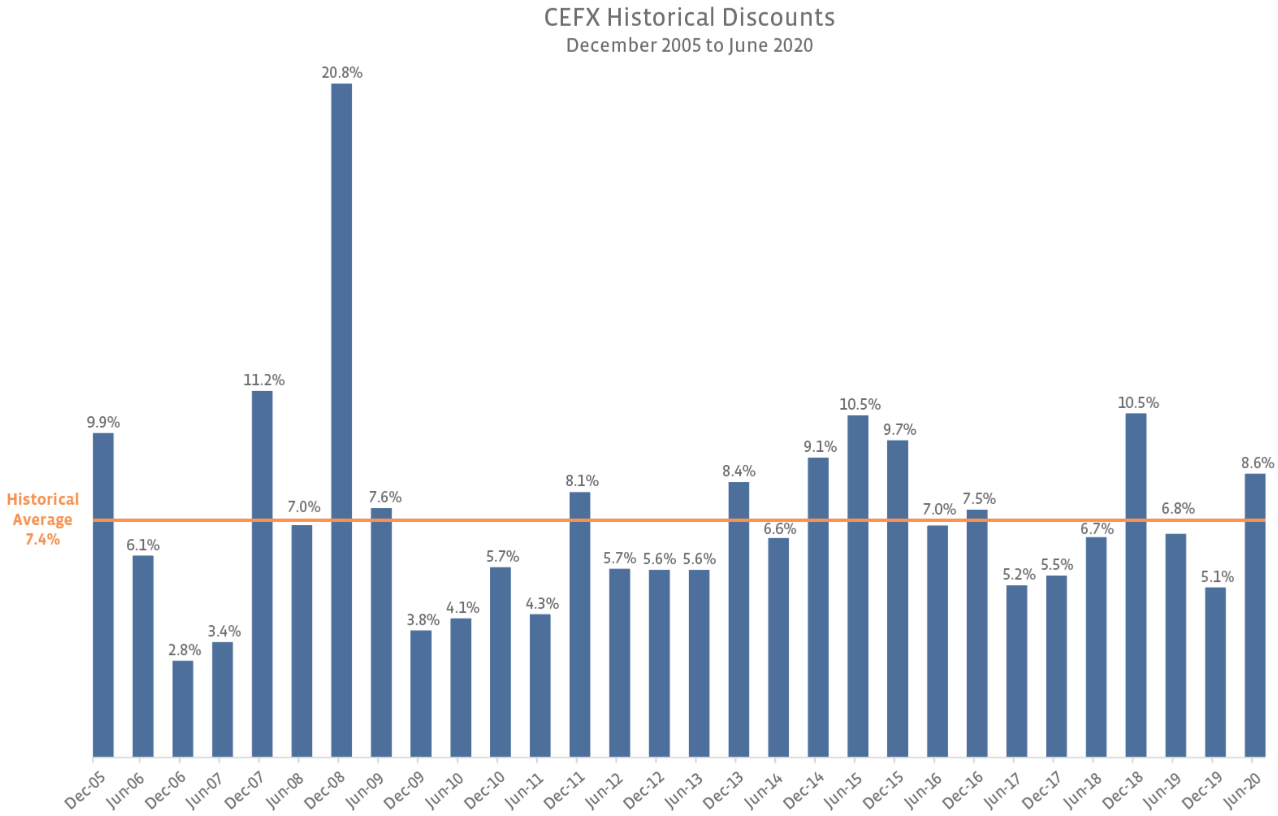
An Overview of Closed-End Funds.

While many investors are familiar with exchange-traded or open-ended funds, closed-end funds (CEFs) are another popular investment vehicle that come with their own unique set of considerations. CEFs are 40-Act mutual funds that trade on recognized stock exchanges, but, unlike their open-ended peers, CEFs are closed to fresh contributions and redemptions. This gives CEFs an advantage over exchange-traded and open-ended funds, as they are not required to hold cash in reserve in case of redemption activity. Additionally, they can invest in less-liquid securities, which, in the case of bonds held to maturity, can provide insulation from market turbulence. The majority of CEFs are actively managed. Active portfolio managers may employ proprietary investment strategies aimed at enhancing yield or returns. Many CEFs also borrow against their assets in order to further increase yields. As of the end of 2019, these funds held approximately $278 billion in assets, roughly 60% of which pursue yield-oriented strategies such as fixed income and covered call writing, emphasizing the important role that high-income CEF strategies play in the broader market.

Understanding CEFX and its Advantaged Approach.

The most unique characteristic of CEFX lies in its 100% closed-end fund exposure. As a composite index, CEFX includes every US-listed CEF with at least $100 million in total assets that meets its selection criteria. Further screens are applied to define criteria for liquidity, management fee and discount/premium to NAV. Currently, there are 129 CEFs in the index. Importantly, CEFs with high management fees are excluded, using thresholds of 1.5% for new additions and 2% for existing constituents. This keeps the management fees from meaningfully exceeding industry norms. Unlike most indexes, which weight constituents based on their market capitalizations, CEFX weights its constituents based on their total net assets. Since most CEFs trade at a discount to NAV, this weighting methodology produces a more accurate representation of the holdings while a traditional market cap weighting could favor CEFs selling at premiums or rich relative valuations. Taken together, the index rules applied to the selection of constituent funds provides beneficial risk mitigation.

CEFX also builds a smart beta component into its weighting methodology. Simply put, weights are adjusted at quarterly rebalancings to give the CEFs with the highest discounts the highest weights and to reduce the weights of CEFs trading at a premium to NAV. This is a technique often used by professional CEF investors, because CEFs trading at a discount tend to revert to the mean in time. In turbulent markets, the discounts tend to widen, and when market stability is restored, the discounts tend to narrow. Buying yield-oriented funds at a discount increases the yield on their market prices and can provide additional returns when discounts narrow. Through its smart beta weighting process, CEFX is engineered to take advantage of these discounts. The chart on the following page shows the historical weighted-average discount of CEFX constituents. As of November 6, the average discount had widened to 9.9%, demonstrating an opportunity for investors to capture attractive income while capitalizing on NAV discounts.



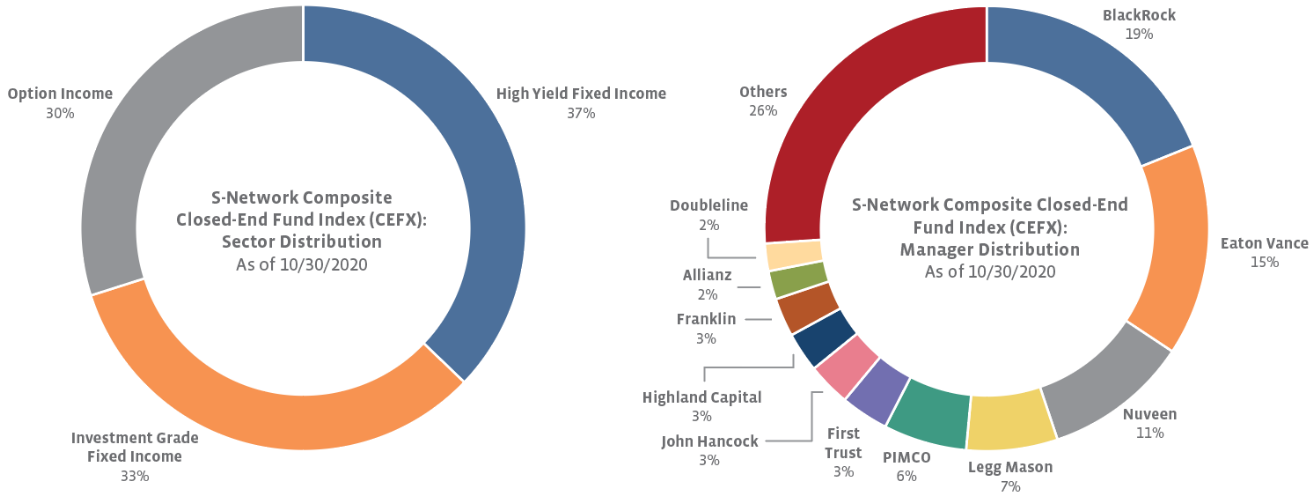
Historical average represents the average of the data points shown.
Source: S-Network Global Indexes, Bloomberg as of June 30, 2020

Additionally, CEFX avoids high levels of turnover, which can negatively impact index performance, by employing buffers on total assets and liquidity at its quarterly reconstitutions. For example, a CEFX constituent must have $100 million in AUM to be selected for inclusion in the index, but once in the index, the constituent would be removed if its AUM fell below $75 million. Liquidity buffers are particularly important given the limited liquidity of CEFs. As a result of these measures, CEFX has maintained very low turnover rates throughout its history, thereby mitigating performance drag.

Diversification Benefits.

With hundreds of CEFs available to investors, the benefit of an index-based CEF investment strategy is that it alleviates the required research and the single-security risk of choosing an individual CEF to purchase. By including funds from 43 separate management companies, including many of the most prominent names in the asset management industry like BlackRock, Eaton Vance, and Nuveen, CEFX represents beneficial diversification. Each manager employs their own unique investment strategy, insulating the index from potential one-off management missteps. Further enhancing diversification, included in CEFX are 45 funds that specialize in investment-grade fixed income, 52 funds that specialize in high-yield fixed income, and 32 funds that pursue option income or covered call strategies, as seen in the chart on the following page. Included in this diversified investment mix are certain high-yielding instruments that fit well into the CEF structure, such as bank loans, emerging-market bonds and, in the case of option income CEFs, global stocks. The diversification of CEFX substantially mitigates individual CEF risk.

CEFX Provides Diversification Among Managers and Strategies



Source: S-Network Global Indexes as of October 30, 2020

The Case for CEFX.

The overall architecture of CEFX uses custom rules-based indexing technology to capitalize on the advantages inherent in CEFs while diminishing the impact of potential drawbacks, such as high fees or premiums to NAVs. Accordingly, CEFX has a complex methodology, but the end result has proven beneficial as evidenced by long-term outperformance of CEFX relative to broader fixed income. Over the trailing 5 years, CEFX has outperformed the Barclays US Aggregate Bond Index (LBUSTRUU) by over 1,700 basis points on a total-return basis through November 6. Additionally, CEFX currently offers a yield of approximately 8.42% in an environment where high yields are persistently hard to attain. For context, the ten-year US Treasury yield of 0.82% as of November 6 sits 124 basis points below its five-year average, emphasizing the dearth of income opportunities in today's market environment.

Given its high income potential, advantaged construction, diversification benefits, and smart beta exposure to elevated CEF discounts, CEFX represents a unique, sophisticated index for the CEF space. Going forward, investors can benefit from elevated yields and steep discounts to NAV captured by the index.

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