Senior Loan CEFs: Big Disparity Between Share Price and NAV Performance in 2013

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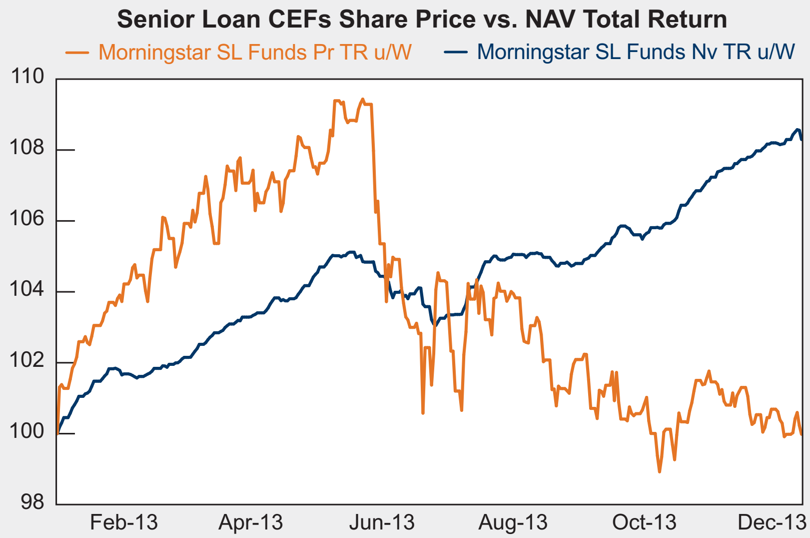

Source: Morningstar. Data from 1/1/13 to 12/13/13. Past performance is no guarantee of future results.

This graph helps to visually articulate the blog post below.

It is a YTD total return graph with the orange line representing the share price total return performance for all senior loan CEFs. The blue line shows the YTD NAV total return performance for all senior loan CEFs.

As you can see, the NAV performance of the universe of senior loan CEFs has been steadily trending higher all year and is up over 8% YTD. You can also see how despite this solid and steady underlying NAV performance for senior loans, in late May/early June the share prices of the universe of senior loan CEFs began to sell off and didn't stabilize until early September.

The wide gap and divergence in performance which began in the Spring/Summer represents the "discount opportunity" that I firmly believe exist in the senior loan CEF category. Senior loan NAVs are performing very well but yet this is not being recognized in the share prices of the same universe of senior loan CEFs. While this significant disparity in YTD performance between share prices and NAVs might be frustrating to investors, ultimately I believe it represents an opportunity, as historically the market does become more efficient and begin to recognize this opportunity.

Following 2012, a year in which the average senior loan closed-end fund (CEF) was up 22.63% on a share price total return basis according to Morningstar, the average senior loan CEF is up a miniscule 0.03% year-to-date (YTD) also on a share price total return basis according to Morningstar as of 12/9/13. However, the slightly positive share price total return earned thus far in 2013 only tells part of the story. While share price total returns are barely positive YTD, underlying net asset value (NAV) performance has been much better. In fact, according to Morningstar, as of 12/9/2013, the average senior loan CEF has a NAV total return of 8.43%. This high single digit NAV total return reflects the positive fundamentals which continue to exist in the senior loan asset class, including a default rate of only 1.48% as of the end of November according to S&P. It also reflects the continued demand investors have for the senior loan asset class given their limited duration risk and compelling income.

Furthermore, while not at a meaningful discount to par, the average loan in the S&P/LSTA Leveraged Loan 100 Index is at a slight discount nonetheless trading at 98.14 as of 12/9/2013 according to Bloomberg. While not necessarily a growth story, historically senior loans have traded right around par in environments in which the economy is growing and interest rates are trending higher such as the 2004-2006 period. Indeed, from 1/2/2004 to 12/31/2006 which was the last time both short and long-term interest rates trended higher, the S&P/LSTA Leveraged Loan 100 Index stayed in a very tight range that entire three year rising interest rate period, hitting a low of 99.82 on 1/2/2004 and a high of 101.32 on 3/18/2005, while distributing compelling income the entire time.

I suspect some of you might be reading this blog thinking to yourself, "Why would I care that NAV performance for the average senior loan CEF is up over 8% YTD? I own my senior loan CEFs at the share price, not the NAV and share prices are barely positive YTD on a total return basis." While of course I recognize that investors in CEFs own them at the share price and not the underlying NAV (as they would an open-end mutual fund), ultimately as I discussed in my **blog from 8/28/2013** entitled "Share Prices Historically Track NAVs," the underlying NAV performance of a CEF is very important as historically share prices have tended to gravitate towards the underlying NAV. While this year might have been frustrating for investors in senior loan CEFs as share prices underperformed NAVs significantly, historically while there are these periods when the marketplace is inefficient and there is a wide disparity between share price and NAV performance, it can also represent a compelling opportunity as share prices historically do track underlying NAVs over time.

As we enter 2014, the underlying fundamentals of senior loans remain strong as mentioned above. Furthermore, as a result of share prices underperforming NAVs by such a significant amount, average discounts to NAV are a significant 6.70% according to Morningstar as of 12/9/2013 and represent some of the most compelling valuations seen in the senior loan CEF category since the summer of 2011 when the U.S. debt was downgraded. In addition to compelling fundamentals and valuations for senior loans and senior loan CEFs, yields also remain compelling. To that end, even with several senior loan CEFs recently reducing distributions as spreads have narrowed, the average senior loan CEF still yields a significant 7.12% as of 12/9/2013 according to Morningstar.

While I recognize that 2013 has been a frustrating year to this point for some investors in senior loan CEFs given the very solid NAV total return performance but yet barely positive share price total return performance, ultimately I think the share price total return performance reflects the fact that many CEFs became out of favor with investors (particularly in the second and third quarters) as the equity markets continued to move higher and investors indiscriminately sold shares of many categories of the CEF marketplace without considering the strength and characteristics of the underlying asset class as was the case with senior loan CEFs. It is my view that eventually the secondary market for CEFs will become more efficient and investors will recognize the compelling valuations, fundamentals and yields which still exist in senior loan CEFs. I continue to believe they should be part of a diversified CEF portfolio which should also include limited duration, high yield, domestic equity and municipal CEFs.