Still out of Favor but with Compelling Yields and Valuations

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It's not earth shattering news to state that over the past three months investors have lost interest in having exposure to higher quality, yield-oriented municipal bonds and preferred securities. This is clearly epitomized by the significant outflows in these two asset classes from both open-end funds and exchange-traded funds (ETFs) that have occurred over the past three months as well as the significant discount widening both of these closed-end fund (CEF) categories have experienced. The shift out of these two asset classes was primarily due to the significant move higher in long term interest rates (which put pressure on both of these asset classes) as well as investors becoming more enamored with equities. My concern about higher interest rates as well as my attraction to the compelling fundamentals and valuations among domestic equities and senior loans is the reason I have had the highest conviction level in domestic equity CEFs and senior loan CEFs since January 2012. However, given the sell-off in individual municipal bonds and preferreds, as well as municipal CEFs and preferred CEFs, I believe investors should give both of these asset classes and categories of the CEF marketplace another look given the very compelling yields available on a relative and absolute basis.

The compelling yields available in these two categories of the CEF marketplace alone would not be enough to warrant investor attention as I believe yield is only one consideration CEF investors should focus on when investing in a CEF or portfolio of CEFs. However, when the compelling yields are accompanied with wider than average discounts to NAV, likelihood of distribution stability, value in the underlying asset class, very low leverage cost and the likelihood they stay low for a considerable time given the fact the Fed has indicated they don't intend to increase the Federal Funds rate anytime soon, and given that the funds are earning these very high yields from primarily investment grade securities, then I think these two categories do indeed warrant investor attention.

Now I can imagine there are some investors reading this who are saying to themselves, "Why would I want exposure to these asset classes given the interest rate risk they have and given the likelihood interest rates are going to move higher?" Yes, there is interest rate risk in the municipal and preferred asset classes (particularly in longer duration municipals and preferreds), however there is also no guarantee that interest rates move much higher over the next few quarters (long term rates have already moved significantly higher this year) and there are different risks associated with other asset classes as well. For example, as much as I like senior loan, limited duration and high yield CEFs (See blog from 8/16/13) they have higher credit risk which is the risk that the issuer of the underlying loans and/or high yield bonds default. Of course with equities there are risks as well, such as companies not growing earnings per share at a fast enough rate causing investors to sell shares and prices to move lower. The point is, there are different types of risks associated with different asset classes and at this point in time given the big sell-off in municipal bonds and preferreds, I believe that yields and valuations have become compelling enough that investors should consider them despite the inherent interest rate risk. Here is data to support this belief.

Municipal bonds have historically yielded 85-90% of comparable U.S. Treasuries. However, given the recent sell-off in municipal bonds, high quality municipal bonds actually yield more than U.S. Treasuries on most parts of the yield curve despite the fact that the interest on municipal bonds is federally tax free. For example, according to bondsonline.com as of 8/30/13, the 10-year U.S. Treasury yielded 2.77%. 10-year A rated municipal bonds yielded 3.81% which is a taxable equivalent yield (TEY) for someone in the 28% federal tax bracket of 5.29% and 6.31% for someone in the 39.6% tax bracket. Even more compelling than this is the value and yields available in municipal bonds compared to U.S. corporate bonds. For example, according to bondsonline.com, 20 year A rated corporate bonds yield on average 4.88%. By comparison 20 year A rated municipal bonds yield on average 5.20%. Bear in mind that historically municipal bonds only yield roughly 75% of comparable corporate bonds. A 5.20% yield is a TEY for someone in the 28% federal tax bracket of 7.22% and 8.61% for someone in the 39.6% tax bracket. According to Morningstar as of 8/30/13 the average municipal CEF yielded 6.54%. Three months ago the average yield was 5.67% and six months ago it was 5.34%. A 6.54% yield is a TEY for someone in the 28% federal tax bracket of 9.08% and 10.83% for someone in the 39.6% tax bracket.

Not only do I believe the data above indicates real value in the underlying asset class of municipal bonds based on the very compelling yields compared to U.S. Treasuries and corporate bonds but there is also value in municipal CEFs based on the historically wide discounts to NAV presently available (See blog from 8/8/13). For example, according to Morningstar as of 8/30/13 the average municipal CEF was at a discount to NAV of 5.5%. Just 6 months ago the average municipal CEF was at a 0.48% premium to NAV according to Morningstar.

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Looking at the outflows from preferred ETFs, discount widening among preferred CEFs as well as examining weakness in several individual preferreds the past three months, it is apparent this is another high yielding asset class that has become out of favor with investors. However, given the recent weakness among preferreds and preferred CEFs as well as the high yields available in this asset class, I believe this too is an asset class and category of the CEF marketplace that investors should take another look at.

According to epreferreds.com, the PreferredsOnline Index (a compilation of current yields for all preferred stocks with active prices) yields 6.41% as of 8/31/13. It yielded 6.00% at the end of June 2013. According to Morningstar and First Trust calculations as of 8/30/13 the average preferred CEF yielded 8.49%. Three months ago the yield was 7.39% and six months ago the yield was 7.28%. Not only have yields moved higher the past few months but discounts to NAV among preferred CEFs have also widened significantly over this short time period. Indeed, according to Morningstar the average discount to NAV among the universe of 17 preferred CEFs was 6.94% as of 8/30/13. Just three months ago it was only an average discount to NAV of 1.27% and six months ago it was an average 1.37% premium to NAV.

In summary, the areas of the CEF marketplace in which I continue to have the highest conviction level remain domestic equity CEFs and senior loan CEFs. However, while there is interest rate risk and credit risk in the municipal bond and preferred asset classes (as well as municipal CEFs and preferred CEFs) there are different risks in other asset classes as well, and given the meaningful sell-off in these two asset classes, I believe the yields as well as the valuations have become compelling enough that it is worth taking on the risks in order to earn these compelling yields as part of diversified income portfolio. These yields are particularly compelling in light of the very low inflation environment we remain in (still well below the Federal Reserve's 2% target) and considering the Fed is unlikely to raise the Federal Funds rate anytime soon (which should help to keep leverage cost very low for leveraged CEFs). Recent outflow data suggest these 2 asset classes remain out of favor despite these very compelling yields. However, that could change as investors begin to recognize just how high yields have become recently and how valuations have also become attractive.

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