Opportunities in Fixed Income CEFs

Michael Hedstrom, director of the Closed-End Fund Association (CEFA), spoke with Chris Kilpatrick, portfolio manager at Western Asset, an independent affiliate of Legg Mason, to discuss his thoughts on the fixed income market, the outlook, and potential opportunities for closed-end fund investors.


Chris Kilpatrick


Michael Hedstrom

The following Q&A recaps the conversation that originally took place as part of CEFA's podcast series on April 12, 2017, which can be heard at CEFA.com.

MH: **Chris, given the recent interest rate hike and that the Fed has signaled plans for a few more rate hikes over the next several quarters, how has this changed your investment strategy and approach in managing your funds?**

CK: Absolutely. We continue to maintain or long-term value approach here at Western Asset. We employ, really, a large and experienced global team of credit analysts that spend a lot of time looking for individual issuer opportunities. Alongside that, we have a pretty deep and experienced team of global credit portfolio managers also trying to exploit sector overweights/underweights, as well as rating category opportunities globally.

Second, we recognize credit markets have had a really strong run here, post the commodity crisis of 2015 which ended in early 2016. While we recognize the lower yield and tighter spreads that we're getting on our spread sectors are certainly more sensitive to changes in interest rates. It certainly hasn't deterred us from looking for opportunities.

Against that backdrop, I'd just like to add that we think rates globally are low. When you look at, for example, the German bond at 20 basis points on a dollar basis, and Japan 10 year bonds even lower than that. We think U.S. rates are somewhat underpinned by some of these lower interest rates globally, and a 2.3% U.S. Treasury bond probably looks okay in that context. We don't expect this big blow-off top in rates, if you will, on longer end portion of the curve.

Lastly, while we do see two additional increases by the Fed, you've recently spoke to my colleague John Bellows, and we do believe that the Fed continues to be data dependent, which is really important. They're focused on inflation expectations, employment data, GDP growth and lastly, global financial conditions. We think that's really important. Especially recently you've seen, certainly, a pickup in the geopolitical risks, whether it's Syria or Russia or North Korea and China, or elections in France. It just seems like there's a lot going on. We think the Fed's data dependent and they're not going do anything to really choke off the expansion that's been going on here in the U.S. post credit crisis.

MH: **With this backdrop, a question that we often get is "what looks good?" With rising rates improving yields on cash and other low-risk assets, will this eventually curb the appetite for yield in higher-risk fixed income sectors? And, Chris, where do you see opportunity for closed-end fund investors?**

CK: Sure. I'll start with our global credit closed-end fund, such as EHI. We're currently overweight, both U.S., as well as emerging market bonds. For emerging markets, we really like the valuations there. They look attractive. Both on a historical basis relative to the developed world, as well as currently. They look attractive based on current valuation. Where we're concerned on emerging markets is, we're certainly cautious or thinking about ... Just some of the protection is politics we've been seeing recently like border taxes or implications from a stronger dollar. These are things that could be negative for emerging markets.

We're seeing several individual opportunities. We like a couple of countries that are emerging from recessions. Overweight countries such as Brazil, Argentina, as well as Russian bonds, currently across our global credit closed-end funds.

Second, we see opportunities in investment grade corporate bonds here in the U.S., as well as in Europe. Specifically, we like financials. We think financials is a nice hedge against rising interest rates in our fixed income portfolios. The reason being is simply that banks tend to be more profitable with higher front end rates. In the U.S., we think banks will benefit additionally just from the shift that's happening now from monetary to fiscal stimulus. That's positive for the banks, as well as a more business friendly regulatory environment should be beneficial, as well.

For Europe, some of the same. We think things could improve there going forward, as well as for their balance sheets, there is still more work to do in Europe with the banks. But, we do feel like the road map is out there for them, then you overlay that with valuations that are currently pretty attractive.

Lastly, we're overweight U.S. below investment grade corporate bonds, especially in our un-levered high-yield portfolios, such as HIO or our levered high-yield portfolios, such as HIX. The market is no longer obviously cheap, as I mentioned previously. We don't think you can go out and just buy systematic or market risk, if you will, for the high-yield market. You know, like an ETF or a passive fund would do. We really think you have to be focused and there are opportunities out there, but you have to be selective.

Some of the sectors that we're currently interested in are sectors where we think management teams continue to focus on improving their balance sheets, and they're less focused on returning cash or paying dividends to their shareholders. Some of these sectors would be energy, as well as metals and mining space.

Second, our team's looking to identify some rising star candidates. We're looking for bonds where we feel maybe the agencies have been overly punitive. They were too quick to downgrade them during the last cycle. Or, overweight. A couple of issuers. One would be DaVita, it's a dialysis provider here in the states. It was actually upgraded recently. Another one is Hilton Hotels. They have a stable business and a management team that we think really wants to get back to investment grade. The last one I'll mention, a company called Park Aerospace, it's one of the global aircraft leasing companies. We think that these are all good, not just income opportunities for our closed-end fund shareholders, but also longer term capital appreciation stories that we have across our funds right now.

MH: **Speaking of income, most closed-end funds are designed and built for income. Another common question advisors and investors often have is, "what's going on with my distributions?" This is a key outcome for many closed-end fund investors, particularly over the long run. How should investors evaluate distributions? Do any of your funds use a managed distribution approach and, if so, why?**

CK: Sure. All our distributions are really a function of the income that's available for distribution to shareholders. We're a little bit beholden to the market. As markets rally, we tend to reinvest at lower yields. That does tend to pressure income. When markets sell off, however, we increase the income available to shareholders, because we're reinvesting at higher rates, or as we're trading the portfolio we're reinvesting it at higher yields.

This is really true for all managers. You kind of get what's given to you in terms of opportunities out there for general yield opportunities. We look at our distributions relative to other credit closed-end funds, just to make sure our payouts look attractive relative to those other funds.

Lastly, the comment I'd like to make is, we also look at our distributions relative to some of the passive opportunities, which we think is really important. When shareholders have a lot of opportunities to, for example, buy an ETF. We want to make sure our funds look attractive relative to those. For example, HIO, our un-levered high yield portfolio, currently has a payout of distribution of just over 7% —7.1% versus the ETFs out there are currently distributing about 5.6%. That's currently the payout there. As well as the global high-yield index, is also currently trading in the mid- to high- fives range. Pretty significant pickup in yield relative to some of the other opportunities if you go with the Western Asset opportunity.

MH: **Let's talk about leverage. Income from closed-end funds may be potentially enhanced by the use of leverage. Nearly three quarters of the closed-end fund universe uses leverage. With short term interest rates heading higher, leverage costs are also increasing. Chris, how do you use leverage to generate additional income, and is using leverage an effective tool in this environment?**

CK: In our levered closed-end funds, you're accurate. We have seen an increase in our cost of financing. It's been marginal, but it's noticeable, and it certainly does reduce income available to shareholders. It's something that we're really focused on.

We do use leverage in our levered Closed-End Funds. We continue to actively manage that leverage. What we like to do is dial it up when we see more opportunities, and then we like to reduce leverage when we think the market's ahead of itself, and there's maybe not enough concern from investors. That's when it's time to de-lever your funds and be a little more cautious. I'd say the use of leverage is more dictated by the opportunities we're seeing in below investment grade, as well as other spread products available for shareholders.

Where are we right now? We're kind of in the middle of that range. We have the ability to take up leverage and add exposure if we see some opportunities from maybe some of the geopolitical events cause volatility to go higher. We see some more opportunities. We can increase leverage and take advantage of those opportunities. If things continue to rally, and we continue to post such strong performance, we could look to reduce our leverage and de-lever the funds going forward.

MH: Another thing I'd just like to get your thoughts on is, as most of our listeners know, closed-end funds have two values — the Net Asset Value, or NAV, and the market price, and the difference is the premium or discount. Can you talk a little bit about what you're seeing related to the trends in the level of discounts and premiums? And, are all discounts good?

CK: I think, as an investor, we all like to buy things at a discount, so in general I'd say discounts are beneficial. I want to frame that with a couple of other things. One is that, as an investor we understand that you also want a stable stream of income with these funds. It's important to do everything you can to maintain that stability of income. We also understand that over time, there needs to be some sort of path to narrow that discount, right? Said another way, we'd like our shareholders to benefit from the capital appreciation in the funds. Those are the way we'd balance the discount vs. price and NAV questions.

One additional tool that we at Western have and we have used this in the past, is that if discounts become too large or we see an obvious opportunity to retire shares, our board has approved a buy back across our credit closed-end funds. We do have the ability to use that tool to purchase our own shares in the secondary and retire them. Again, we have used that in the past when those opportunities have appeared.

You can find more insight from Western Asset on their website at westernasset.com, as well as information about their closed-end funds on the Legg Mason website at leggmason.com. Information is also available on CEFA.com – your comprehensive resource for education, data, and timely insight on closed-end funds.