CEF Specialist

How Will Rising Rates Impact Bank-Loan CEFs?

We examine the effect of short-term Treasury yields on these closed-end funds' discounts.

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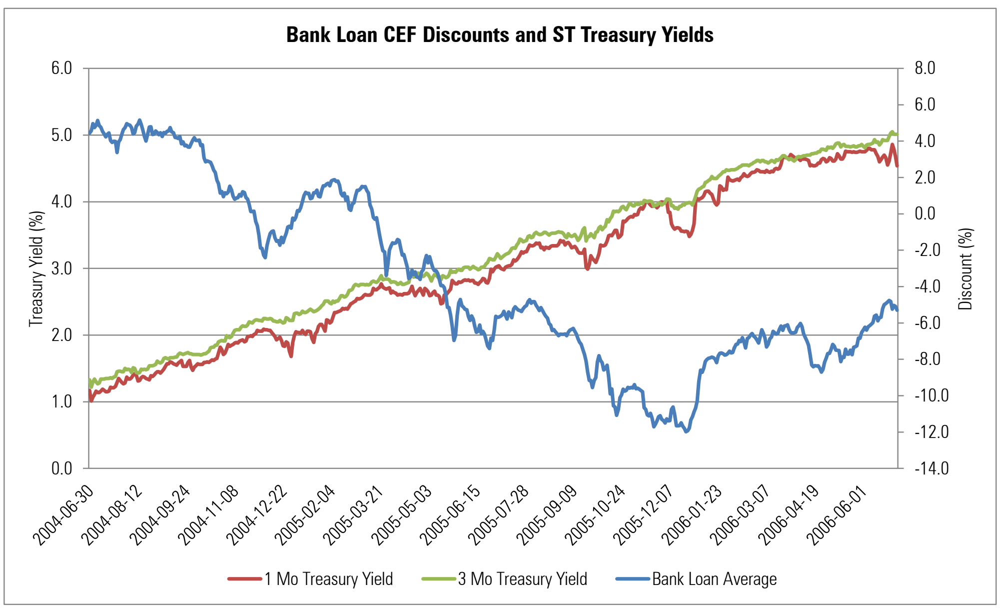
On Wednesday, the Federal Reserve announced that starting in October it would cut back its purchases of agency mortgage-backed securities to $5 billion per month from $10 billion per month and that it will add to longer-term Treasuries at $10 billion per month, down from $15 billion per month. The Fed also noted that it would stop all of its asset purchases at the next meeting if economic indicators point to continued improvement in unemployment and GDP growth and if inflation remains within an acceptable range.

Following the end of quantitative easing, the Fed has not stated plans to raise short-term Treasury rates immediately, but many fund managers believe the market may push rates higher before the Fed makes its first move. Regardless of when the rate hikes begin, investors may want to prepare by investing in funds that stand to benefit from rising rates, including bank-loan funds.

As their name suggests, bank-loan funds buy slices of loans issued by banks, generally to leveraged companies with below-investment-grade credit ratings. The coupons on bank loans reset periodically to a spread over Libor. Because the coupon payments from the fund's underlying holdings change with interest rates, bank-loan funds have extremely short durations. This insulates the funds somewhat from the adverse price movements associated with an increase in short-term interest rates. This also means that funds should be able to pay higher distributions as short-term yields rise. However, because of Libor floors (and a lag in the reset mechanism), it will take some time before bank-loan funds can increase their distributions. An article published last year discusses these issues in detail.

Exhibit 1
Bank Loan CEF Discounts and Short-Term Treasury Yields

Source: Morningstar



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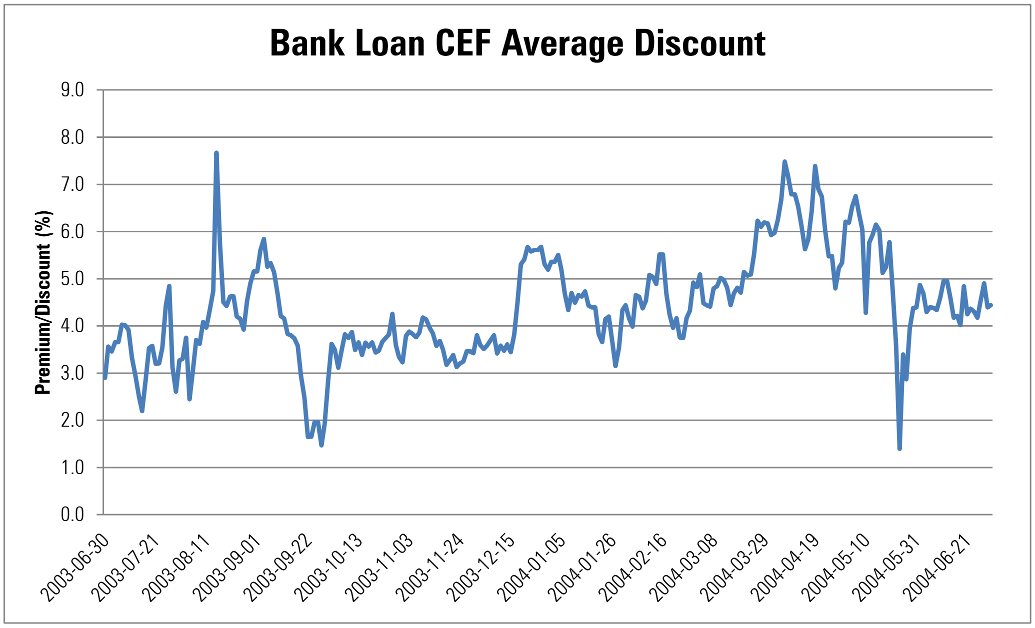
Those issues aside, bank loans are often prized for their relative insensitivity to rising bond yields, and, as a result, investors might expect bank-loan closed-end fund share prices to benefit from an uptick in short-term rates, creating narrower discounts or wider premiums. But history suggests that this might not be the case. The most recent Fed rate hike occurred between June 2004 and June 2006. The chart above overlays the average bank-loan CEF's discount with one- and three-month Treasury yields during that period.

Exhibit 2
Bank Loan CEFs Average Historical Discount

Source: Morningstar



This graph above shows that bank-loan CEFs saw premiums dissipate fairly quickly, falling to a 12%-plus average discount by the end of 2005. The discount eroded a bit by the end of June 2006, most likely because some investors thought the sell-off was overdone and valuations enticed them to buy.

While this may seem counterintuitive, investors pushed the premiums fairly high during the year leading up to the rate hike (see the graph below). The anticipation of an increase in short-term yields was enough to push premiums quite high at times, though the average premium remained within a reasonable band during that period. Once rates started to rise, however, investor sentiment cooled dramatically. Why this happened is a good question (for which there isn't a clear answer). When long-term bond yields rise, funds holding these bonds can invest in longer-maturity and higher-yielding fixed-rate bonds. Investors may have been enticed by those higher yields, but the yield curve significantly flattened between June 2004 and June 2006. In fact, by June 30, 2006, the one-month Treasury yield was 4.5% and the 30-year Treasury yield was 5.2%. It's hard to believe bank-loan funds were significantly less attractive when the yield differential between very short and very long maturities narrowed to less than 100 basis points.

Perhaps investors wanted more equity exposure because rising rates usually indicate an improving economy and a growing stock market. During the two-year rate hike, the S&P 500 Index gained a total of 11%. Not bad, but hardly a rip-roaring success.

So, what's an investor to do with this data? Not much, really. How investors will react to rising rates this time around is anyone's guess. Over the trailing 12 months ended Sept. 10, 2014, the average bank-loan CEF's discount has widened considerably, to 7.7% from 2.9%. Meanwhile open-end bank-loan mutual funds and exchange-traded funds lost nearly $4.9 billion in net outflows for the year to date ended August 2014. It's interesting that investors aren't clamoring for bank-loan funds as we inch closer to the end of quantitative easing and a much-anticipated rate hike.

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Predicting interest-rate movements and how the market will react is an impossible task. Long-term investors, however, can use history and patience to scoop up shares of good funds at great prices. As of Sept. 10, six bank-loan CEFs had one-year z-scores below negative 2, indicating undervaluation relative to historical trading patterns and seven loan funds had six-month z-scores below negative 2. Now is the time to evaluate whether bank loans can play a role in your diversified portfolio, create a watchlist, and wait for attractive opportunities.

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