Bond Case Briefs

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How Municipal Bond Dividend Cuts Impact NAV Performance And Investor Sentiment.

Last year, we penned an article about why we thought Municipal bond CEFs were about to suffer numerous and painful distribution cuts. The key data that suggested the cuts to our firm was a downward move in average Relative UNII (underdistributed net investment income) from +23% to -18% in only seven months. For more detail, you can read the article on our blog under the December 2012 section.

What is UNII? UNII is a balance sheet item for a closed-end fund that helps account for retained or overpaid income distributions. Relative UNII is calculated as the funds UNII balance divided into the amount of one-year income-only yield. We have used this data point to normalize our UNII analysis for the past 6 years. We believe it allows for better fund-to-fund comparisons. Our firm's primary research is based on comparing various data on CEFs to peer-group data and to themselves over time. In fact, UNII was the data point we wanted access to when we originally created our CEF Universe report in early 2008.

CEF Advisors argues that the direction of UNII over time is more important, than if for example, the balance is reported as +$0.10 per share vs. -$0.10 per share. To read an earlier article on UNII and UNII trend, please visit our blog under the March 2013 section. This data point trending down, suggested that Muni funds, as a group, were pulling from all available UNII to meet their dividend policies until forced to make a dividend change. Earnings coverage for these funds was maintained at about 98%, without a significant number of National Muni Bond CEF dividend cuts during the same time period, averaging only 2 dividend cuts a month.

What is Earnings coverage? It is the average earnings of the fund dividend by the current distribution amount (net investment income is the primary source for most muni bond funds). It is then adjusted to cover the same time period. For example, if average earnings covered a three month time period at the fund, we would compare it in percentage terms to three months' worth of distributions.

We suspected these funds would pull UNII to meet their dividend policies for as long as possible. If and when they ran out, we believed that Fund's board of directors would have to start adjusting distributions downward to meet the manager's investment results and market expectations. Two factors contributed to the timing of when we expected the dividend changes to occur.

First, we noticed for the first time since we tracked the data in 2009, that a few National Muni Bond CEFs were reporting some of their distributions as return of capital (ROC). RoC is a somewhat common occurrence for equity CEFs, and has pockets of acceptable reporting for taxable bond CEFs. However, to our understanding, has been historically absent from the municipal bond sector. In our opinion, this was the distress at the fund level that suggested UNII balances had generally been eroded and that cuts should be coming. We covered return of capital in an article posted to our bog in the October 2013 section.

Second, we noticed that 45, or almost half of national muni CEFs were expected to announce their next distribution amounts in the next week. All but 7 National Muni funds were expected to announce their next dividend amount during the month of December. Almost a third (30%) of those funds ended up reducing their distribution levels by an average of -6% according to fund press releases that week. This meant that for every dollar that investors were expecting of income, they would end up receiving on average $0.94 going forward. This was the first round of widely painful dividend cuts to muni bond CEF investors.

The Aftermath? In January 2014 we thought it would be interesting to see how discounts and performance had been impacted by the stress and market reaction to the December 2012 dividend cuts. In our experience the more homogeneous the data analyzed, the easier it is to see what is actually going on and to filter out some of the noise caused by outside, sometimes unknown factors. We searched for a core group of CEF national municipal bond funds that were highly similar to each other. We started with the 101 non-Build America Bond National Muni Bond CEFs. We required Leverage over 20% of assets, Liquidity over $333 per day, Average Duration between 6-16, Rated Bonds averaging A or AA (investment grade, no BBB or BB). This reduced the list down to 56 core funds. Making things easy, all but one of these funds existed in November of 2012 (and met the same screening metrics). We used our CEF Universe data to produce these results (CEFuniverse.com) with a summary table below.

This group of example funds had a relative movement of -8.24% to NAV as seen in the dramatic widening of the discount during 2013. With both discount widening and net asset values falling, the average yield increased to 6.8% (even with dividend cuts lowering distribution levels). Not all funds cut, but of the 97 National Muni CEFs in existence on November 30, 2012, about 48% of Muni CEFs reduce their yield by an average of -6.5% during the year.

As seen in the next above, Municipal CEF's that cut distributions had a 1 year average NAV TR of -8.85%% and the muni CEFs with increases have an average 1 year NAV TR of -5.81% over the same time period, even beating the average fund with no changes of -7.00% NAV TR. This does suggest that for the muni funds forced to make dividend changes in the past year, it had a negative impact on the investment portfolio.

I believe it also refutes the sometimes held belief that dividend cuts don't hurt investors in the long run. The thought that, NAV performance will make up for the difference in yield. The current average discount for the muni CEFs without a cut is -3.8% and for those with a cut it is -6.98%. This suggests the market is giving CEFs with cuts a relative -3% extra discount simply because they had to cut the distribution vs. other factors impacting the fund's pricing.

Remember from the first table above, that muni CEF yields are up. However, funds that cut have NAV yield up 7% and those that maintained or increased their distributions have seen an average 17% increase. This shows a 10% extra relative yield boost for successfully avoiding dividend cuts.

To our firm, it is clear that some fund managers were forced into income only vs. NAV total return investment decisions. This can be seen as the CEFs that had to cut distributions lagged by -3% to funds that increased and -1.3% to funds that maintained levels. The Market (through average discounts) is now asking funds that cut for -3.5% more of a relative discount for funds that cut their dividend levels.

We think this is why it is important to track NAV total return, UNII trend and Earnings Coverage levels especially for muni bond closed-end funds. We would also argue that if you add discount analysis you will have the tools to maintain a municipal bond portfolio. For our clients, we seek to find good performing NAV's, avoid dividend cuts. Selling CEFs that are expensive and buying when they are rationally cheap vs. just cheap. You will have a chance at better portfolio (NAV) total return, better market perception (discounts) and more forward looking cash flow (yield). With the thought that bonds are no longer capital appreciation vehicles we think covering all three bases is crucial.

You should experience more day-to-day price volatility (in CEFs), but we believe you can have better principal performance (the value of the holdings) and more consistent stable tax-free income. Municipal bonds are not for every investor and usually not for a majority of their assets. However, we think, though clearly biased, a well-educated investor or advisor can better use CEFs to meet this objective than other potential option. Many funds report portfolio and financial data monthly and there are about 100 national muni bond CEFs and 100 state specific funds to choose from. This gives you more choices (a third of all CEFs) than in any other closed-end fund sector. Good luck, and best wishes.

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