Flexing, Not Reaching: A More Flexible Approach for Credit Investments Seeking Yield and Total Return

By Michael Story and Bryan Lazarus, CFA®
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A MORE FLEXIBLE APPROACH FOR CREDIT INVESTMENTS SEEKING YIELD AND TOTAL RETURN

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Years of accommodative central bank policy combined with pandemic-related market dynamics have U.S. Treasury yields hovering near all-time lows. This lower-for-longer environment is likely to persist for years, meaning many bond investors will continue to face challenges in targeting attractive yield in a risk-conscious manner. Following a brief period of spread-widening in early 2020, the ensuing rapid recovery has brought most traditional bond market spreads back to pre-COVID ranges above Treasuries. Coupled with that, market liquidity remains fragile in many sectors, and the potential for volatility remains high.

Nonetheless, attractive opportunities remain across global fixed income markets. Nontraditional sectors in particular may be attractive markets for investors seeking higher yield objectives. We believe investors may want to flex beyond traditional investment vehicles, and traditional parts of the bond market, to access greater yield and total return potential.

One such vehicle that has seen increased adoption in recent years is the interval fund, an unlisted closed-end fund that is offered continuously like an open-end mutual fund, but instead of daily liquidity it offers investors limited liquidity via periodic fund share repurchases typically limited to no more than 5–25 percent of fund assets per stated interval, which is most commonly quarterly.

Interval funds offer less liquidity than traditional open-end funds, and accordingly they may invest more meaningfully in less liquid, more complex, and alternative asset classes.

Among the many potential advantages of interval funds, we highlight three key benefits:

Expanding the opportunity set.
Interval funds offer less liquidity than traditional open-end funds, and accordingly they may invest more meaningfully in less liquid, more complex, and alternative asset classes. These investments may offer investors additional yield and return potential relative to more traditional investments, in exchange for more limited liquidity.

Positioning to be a liquidity provider.
In recent years, the quantity of fixed income assets in daily liquidity U.S. mutual funds and exchange-traded funds (ETFs) has increased significantly, while inventory levels on broker-dealer balance sheets have continued to shrink post 2008. This mismatch has tended to put a premium on liquidity and may create the potential for interval funds to earn incremental yield and return by providing liquidity to the market when it is desperately needed during periods of sharp outflows in a given asset class.

Supporting responsible use of financing. When utilized thoughtfully and responsibly, financing can be a valuable tool to increase yield and return potential. The interval fund structure allows for increased and more flexible use of financing as an additional tool for a fund to potentially provide alpha.

For these reasons, we believe interval funds offer a compelling solution for investors seeking risk-conscious yield. We see opportunities across the fixed income landscape, and in this article we discuss specific examples of how interval funds may provide value in the broad taxable credit, municipal bond, and emerging market debt markets.

ALTERNATIVE CREDIT

In public credit markets currently, yields have broadly declined across asset classes. With investors’ portfolio yield targets likely unchanged, however, many investors are forced to allocate to higher-risk and often lower-credit-quality asset classes in an effort to achieve those targets (see figure 1). For example, to achieve a 5-percent yield in 2006, investors could have simply looked to core fixed income with allocations to U.S. Treasuries, government-guaranteed agency mortgage-backed securities (MBS), and high-quality investment-grade corporate rates. Today, that same hypothetical portfolio likely would yield closer to
As yields across traditional fixed income asset classes have declined ... investors have become increasingly reliant on higher-yielding credit for returns

As of September 30, 2020. Past performance is not a guarantee or reliable indicator of future results.

Source: U.S. Treasuries: Bloomberg data; MBS (mortgage-backed securities): Bloomberg Barclays Fixed Rate MBS Index; IG corps (investment grade corporate bonds): Bloomberg Barclays U.S. Aggregate Credit Index; EM corps (emerging market corporate bonds): J.P. Morgan CEMBI Index; BBB CLOs (collateralized loan obligations): J.P. Morgan CLO 2.0 BBB Index; bank loans: J.P. Morgan Leveraged Loan Index; CMBS (commercial mortgage-backed securities): Bloomberg Barclays CMBS BBB 8.5+ Year Index; HY corps (high yield corporate bonds): Bloomberg Barclays U.S. High Yield Index. It is not possible to invest directly into an unmanaged index.

1.5 percent, so to meet a 5-percent target, meaningful allocations to riskier credit asset classes would be necessary.

As investors reach into those higher yielding, higher risk credit sectors, they need to be aware of the potential trade-offs in market liquidity. Historically, many investors have been able to target their long-term return objectives by generally staying in liquid equity and fixed income assets without having to incorporate significant illiquidity risk into their portfolios. However, more recently we have seen many investors stretching for yield in relatively illiquid securities within daily liquidity investment vehicles, which could see increased volatility during a market dislocation.

This risk is exacerbated in today’s liquidity-mismatched market, where mutual fund and ETF ownership of corporate bonds has increased from approximately 25 percent in 2008 to close to 50 percent (see figure 2), while dealer inventories in taxable credit have decreased by more than 85 percent over the same period, according to the Federal Reserve Bank of New York.

Taking illiquidity risk may be an effective way to increase yield and return potential, but investors should do so carefully and responsibly in a vehicle that matches the liquidity profile of the investment. Interval funds, for example, could allow portfolio managers the flexibility to more responsibly and selectively invest in less-liquid unique or niche opportunities. These bonds are often in underfollowed markets or not available to the broader buyer base, allowing managers to take advantage of differentiated sourcing capabilities to find potential investments.

Given the current environment of low yields, relatively tight spreads in liquid credit, and potentially volatile equity markets, a flexible approach to credit markets that responsibly expands the investment opportunity set may be of great value to investors. An interval fund could allow portfolio managers the flexibility to more responsibly and selectively invest in less-liquid unique or niche opportunities.

Figure 1

Figure 2

As yields across traditional fixed income asset classes have declined ... investors have become increasingly reliant on higher-yielding credit for returns

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Specifically, such a strategy could target more complexity in the structured finance and real estate markets, special situations, and stressed opportunities in corporate markets, as well as a wide range of opportunities in private credit markets (see table 1).
INTERVAL FUNDS MAY TARGET A BROAD OPPORTUNITY SET ACROSS PUBLIC AND PRIVATE CREDIT SECTORS

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Source: PIMCO

Although many interval funds have focused on single segments of the credit markets, a broader, more flexible approach that invests across the entire fixed income landscape can be beneficial. First, this flexibility would allow the strategy to seek attractive opportunities within a maximum opportunity set across both liquid and less liquid markets. Second, a more diversified portfolio across sectors, geographies, and positioning in capital structures can potentially diversify the portfolio risk away from any particular market beta and potentially foster a more consistent yield and return profile.

Finally, many interval funds allow for increased and/or more flexible use of financing. Although financing also can increase the potential risk of leverage in a portfolio, if used prudently and responsibly, it can provide a way to increase return and yield potential without reaching for yields in riskier credit markets. By incorporating financing as an alpha source, strategies still can increase yield potential while remaining focused on opportunities offering attractive compensation for risk, strong asset coverage, structural seniority, and meaningful lender protections. In an environment such as today’s with interest rates at extreme lows, financing also may be even more attractive given historically low borrowing costs.

**TAX-EFFICIENT CREDIT**

We see a strong value proposition for interval funds focusing on tax-efficient credit. Specifically, we believe interval funds are ideally positioned to take advantage of the unique liquidity dynamics within the municipal bond space, invest more responsibly in the growing universe of less-liquid opportunities, and thoughtfully employ advanced use of financing relative to traditional open-end mutual funds.

First, from a liquidity perspective, the municipal bond market has gone through a transformational shift since the Global Financial Crisis of 2008. Although assets in daily liquidity municipal bond mutual funds have more than doubled since 2008, broker-dealer municipal inventory has declined by more than 80 percent, according to the Federal Reserve. This has created a significant liquidity mismatch in municipals, which has led to periodic dislocations over the past 10 years during which a particular event has driven broad-based selling ranging from $15 billion to $45 billion in outflows, all resulting in muni yields rising 100–150 basis points (bps) as measured by the Bloomberg Barclays Municipal Bond Index (see figure 3). By not being subject to the same degree of sharp outflows typically faced by daily liquidity open-end funds during these periods, an interval fund is well positioned to take advantage of these dislocations and be a coveted liquidity provider, purchasing bonds at depressed prices and elevated yields, creating advantaged yield and total return potential for investors.

Interval funds are also well equipped to take advantage of the increasing complexity across the municipal market amid greater issuance of 144A and unrated bonds in recent years (see figure 4). With its limited repurchase structure, an interval fund can meaningfully invest in these less-liquid bonds, which include unrated, smaller, and/or reverse-inquiry investments, among other less-liquid positions. These investments may offer higher yields and more attractive risk-adjusted return potential than traditional, more liquid municipal bonds, in exchange for more limited liquidity.
Finally, interval funds may have potentially advantaged access to leverage financing. Many traditional muni strategies employ financing using weekly tender option bond financing, but this approach presents the risk of being forced to unwind or refinance these positions in times of market stress, as in 2008. Interval funds, in contrast, can utilize term financing through the issuance of preferred shares, a tool typically used by listed closed-end funds. Although financing generally may lead to additional volatility, the use of preferred shares may reduce the risk of forced unwinding or refinancing in periods of market stress, and also provide further opportunity for a fund to be a liquidity provider to the market by increasing those proceeds in bonds being offered to the market by forced sellers.

**EMERGING MARKET DEBT**

In many ways the interval fund may be an ideal construct for emerging market (EM) debt investors. The benefits of being a liquidity provider—as is the case with an interval fund—versus a liquidity taker can be momentous in this asset class. Moreover, the vast majority of the EM opportunity set may not be available to investment portfolios that seek daily liquidity. For both of these reasons, we believe the interval fund structure offers a strong value proposition within the EM debt space.

The significant presence of inconsistent “tourist capital” in many EM investment portfolios often combines with thin trading volumes, resulting in excessive price movement beyond what appears justified by fundamentals. We believe technicals have greater impact on pricing than they should, and yet this same dynamic is the bedrock of the attractive premium typically offered by EM debt.

We’ve observed this dynamic to be even more extreme with bonds issued by EM corporations. Coverage by investment banks can be sparse, and bid-ask spreads tend to be wider and can evaporate with each new market shock.

Broadly speaking, these markets are less mature and less efficient than their developed counterparts. An interval fund may allow investors to capitalize on these market inefficiencies: The costs borne by erratic capital moving through the daily liquidity investment complex represent meaningful benefits that could accrue to patient capital housed in an interval fund.

One of the most peculiar anomalies about emerging markets is that investors tend to crowd into a tiny corner of the opportunity set. Emerging bond markets are now nearly two-thirds the size of the U.S. bond market (the world’s largest); this translates into about $26 trillion in EM bonds outstanding, yet the vast majority of investors focus on just the most liquid $1 trillion–$2 trillion, leaving the rest unconsidered and untouched (according to J.P. Morgan and the Bank for International Settlements). This concentration by investors is so intense that the Bank for International Settlements found in a recent study that once a country gains inclusion into mainstream bond benchmarks, which most daily liquidity mutual funds track, that country’s bonds become more correlated with other benchmark-included bonds. In other words, the country’s idiosyncratic features no
As one looks beyond traditional forms of debt into investments such as unregistered loans and privately originated lending arrangements, the potential benefits of interval funds shine further. Although the private credit wave has washed across the United States and Europe, it has barely touched emerging markets. Yet, there are many credit-worthy borrowers in EM who don’t have access to international bond markets and are willing to pay attractive yields to access new forms of capital. Their balance sheets may be far stronger than borrowers who issue listed bonds, and the structure of the loan may offer additional investor protections. Granted, this form of debt is far less liquid than listed bonds, but by giving up some liquidity, investors stand to gain significant yield, reduce some risks, and embed more attractive idiosyncratic factors into their portfolios.

Ironically, this approach is the opposite of what more liquidity-minded EM strategies often do: They tend to move down in quality and take on significant default risk in their stretch for yield, ending up with highly concentrated positions in lower quality frontier markets that are often at the mercy of global factors such as commodity prices, risk sentiment, or International Monetary Fund bailouts.

By giving up daily liquidity in an interval fund, EM investors can move up the quality spectrum into investment-grade-rated issuers (thereby significantly reducing default risk), potentially earn substantially more yield, and avoid many of the market inefficiencies driven by the persistent demand for liquidity.

CONCLUSION
Interval funds and other alternative investment vehicles present a compelling value proposition for investors. In today’s low-interest-rate environment, interval funds provide an opportunity for investors to access increased yield and return potential in a risk-conscious manner. Interval funds offer critical flexibility to expand the opportunity set, to be positioned as a liquidity provider, and responsibly employ financing, thereby potentially providing increased value for investors aiming to meet their objectives.

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Disclosures:
All investments contain risk and may lose value. Interval funds can invest in both traditional securities and more speculative securities which may contain significant uncertainties. There is no guarantee that any investment strategy or product will achieve its objectives, generate profits or avoid losses. Investors should carefully consider an interval fund’s investment objectives, risks, strategies and fees. An interval fund’s investment portfolio is subject to management fees. There are no assurances that interval funds will achieve their investment objectives. Investors should review the interval fund’s prospectus for a more complete description of the risks to which an interval fund is subject.

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