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Exit From Leveraged-Credit Funds Seen as Sign of Things to Come

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When you use borrowed money to make a bet, you can win big and you can lose big, as some investors in closed-end debt funds are finding out right now.

Shares of such funds are plunging way below the value of their underlying assets, with the biggest discounts since the U.S. financial crisis. Traders seem to just want to get this stuff off their books, even at a painful price.

At best, these funds are just a small corner of the $39 trillion U.S. debt market and their suffering is perhaps a temporary phenomenon that doesn't reflect broader problems. At worst, it's a harbinger of a more significant selloff ahead in debt markets that have swelled to unprecedented sizes on the heels of the Federal Reserve's stimulus.

"The bigger fish to fry is now in U.S. credit markets," wrote Credit Suisse Group AG analyst Sean Shepley in a July 30 report. The steep decline in credit closed-end fund shares is "a signal both of underlying credit market illiquidity and also of end investor risk aversion."

Closed-end funds raise cash through initial public offerings and then lock up investor money in return for regular dividend payments. Managers use the money to buy assets, typically with leverage, which magnifies gains and losses. If investor want to get out of their investments, they need to sell their shares to others on exchanges.

Trim Time

It's getting hard to do that now for a decent price when it comes to funds that own assets such as high-yield bonds, preferred securities and government debt, at least relative to how the less-traded underlying assets are being valued.

For example, traders are taking a 15 percent discount to sell shares of the $1.3 billion BlackRock Corporate High Yield Fund relative to its assets' value, and an almost 11 percent haircut on John Hancock Preferred Income Fund II shares, data compiled by Bloomberg show.

The discount on the share prices of these funds has grown to the widest levels ever, with the exception of the period after souring U.S. mortgage values spurred the collapse of Lehman Brothers Holdings Inc., according to the Credit Suisse report.

So does this matter for the broader market? Credit Suisse analysts say they're paying attention because the declines are across the board with these funds, and come at a time of some real angst.

Getting Squeezed

First, the Fed is considering raising interest rates this year from about zero, where they've been since 2008. That means investors may start earning more on safer assets and may no longer feel as compelled to pile into risky securities for returns.

Second, natural resources from oil to copper have been getting decimated this month, with the Bloomberg Commodity Index down to lowest level in more than a decade. That's led to even bigger losses for energy, metal and minings companies, which have to pay back record amounts of debt incurred over the past few years.

Given this backdrop, traders aren't too keen on holding shares of funds that can reap amplified returns and losses and can act a bit like black boxes. And they're paying dearly to get out now before the pain possibly deepens.