# CLOSED-END FUND review

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SECOND QUARTER 2013

**Second Quarter Overview**

Following a quarter in which the average closed-end fund was up 4.31%, the universe of 595 funds was lower by 5.60% on a share price total return basis during the second quarter (both figures from Morningstar). For many funds, most of the weakness occurred during the month of June (when the average fund was lower by 6.09% on a share price total return basis, according to Morningstar). The selling pressure began in May when the yield on the 10-year U.S. Treasury began a very swift move from 1.63% on 5/2/13 all the way to 2.48% by the end of the quarter (Bloomberg). This sharp rise in long-term interest rates not only put pressure on the net asset values (NAVs) of fixed-income funds that have long durations (particularly municipal funds), but also caused funds that don't have long durations to sell off (such as senior loan funds, high-yield funds and limited duration multi-sector bond funds). This was magnified for funds which use leverage. For many quarters, and years for that matter, leading up to May/June 2013, many retail investors were in a "risk off" mode, focusing primarily on fixed-income and high-yielding investments. However, with the equity markets continuing to rise at an impressive pace, coupled with the surge in long-term interest rates, there was a palpable shift in May/June with investors shifting from "risk off" to "risk on." This manifested itself with investors not only selling yield oriented closed-end funds, but also with the significant outflows of money from open-end bond mutual funds. The yield-oriented sectors of the S&P 500, such as utilities, telecommunications, REITs (real estate investment trusts) and MLPs (master limited partnerships) turned out to be the worst performers for the quarter.

The result of the weakness during the second quarter was that average discounts to NAV widened significantly during the quarter, creating many compelling values in the secondary market for closed-end funds, in my view. Indeed, at the end of the second quarter, the average fund was at a discount to NAV of 3.8% (Morningstar). This level is wider than the 1-year average discount to NAV of 0.6%, 3-year average discount to NAV of 1.8% and the 10-year average discount to NAV of 0.7%. During these very volatile periods for the share prices of closed-end funds, there are often 2 key phenomenons which occur and the May/June period encompassed both of them as detailed below:

1. **Share price weakness is more pronounced than NAV weakness and discounts to NAV widen:** One of the unique characteristics of a CEF is that investors buy shares of a fund on a stock exchange as they would any other publicly-traded security. This share price is independent from the underlying NAV of the fund. The NAV for most funds is calculated once a day after the market closes. During periods of enhanced volatility in the CEF marketplace, oftentimes share prices will sell off more severely than the actual weakness occurring in the NAVs of funds and this causes discounts to NAV to widen. While there is no single reason this occurs, it is mostly driven by the fact that CEFs are purchased at a share price on an exchange and are subject to the supply and demand relationship for the fund. When sentiment turns negative (as it did in a meaningful way in May/June), share prices can fall more than underlying NAVs. Furthermore, many CEFs are thinly traded and therefore it does not take a significant amount of added selling pressure to meaningfully move the share prices of many funds. During the second quarter, while share prices were lower on average by 5.60% (as mentioned above), underlying NAVs for the universe of 595 funds were only lower on an average by 4.55% on a NAV total return basis. This data point illustrates that during the quarter, share price weakness was more pronounced than underlying NAV weakness and contributed to the widening of discounts to NAV.
2. **CEFs trade as one asset class even though there are dozens of different CEF categories made up of many different asset classes:** While a CEF is a structure and a way for investors to gain exposure to many different asset classes just like an exchange-traded fund (ETF) or unit investment trust (UIT), there are periods (such as the recent May/June period) when all CEFs seem to trade as one asset class and all trade lower (even though there are dozens of different asset classes spread out throughout the universe of 595 CEFs). This was particularly true during the

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recent period of weakness when many categories of the CEF marketplace were experiencing meaningful share price weakness even though the underlying asset class and NAVs were relatively stable. For example, even though limited duration CEFs do not have meaningful duration risk and were not significantly impacted by the increase in long-term interest rates, the average limited duration CEF had share price total return weakness of 6.4% (Morningstar) during the quarter. NAVs for limited duration funds were only lower by 2.25% (Morningstar) on a total return basis. This is an example of a CEF category selling off in sympathy with other CEF categories even though the underlying asset class that these funds invest in performed much better than the share price weakness would indicate. While it can be frustrating in the short term for investors to see certain categories of the CEF marketplace trade lower even though underlying NAV performance is still holding up well, ultimately I believe over time the market and investors begin to differentiate between the categories of funds which are experiencing *real* NAV weakness with the categories that are *not*.

While it is hard to know exactly why sometimes all CEFs trade as one asset class even though there are many different asset classes throughout the CEF universe, it might be related to the fact that when long-term interest rates moved higher in May/June, investors erroneously assumed that because long-term rates were increasing and many CEFs employ the use of leverage, it must mean that leverage costs were rising for all leveraged funds. However, this is not the case (as most funds' leverage costs are tied to short-term interest rates such as the Federal Funds rate which remains very low) and therefore these funds were not impacted by the increase in long-term rates.

**Outlook & Favored Categories**

While the recent period of broad weakness and discount widening across the closed-end fund universe might be frustrating and surprising for newer investors to this investment structure, it is not the first time CEFs have experienced this sort of volatility in the 100-plus year history they have been trading in the United States. In fact, I believe for patient, long-term investors, some of the best values and opportunities are created during these types of discount-widening periods. Indeed, the last time the broad CEF marketplace experienced this type of weakness and discount widening was in the summer of 2011 when the U.S. debt was downgraded to AA+ from AAA by S&P and investors were also concerned about Greece (see report from 8/10/2011 entitled "Discounts Continue to Widen...Opportunities Abound for Long-Term Investors"). Investors who dollar-cost averaged into the weakness were ultimately rewarded.

I also think it is vital during these periods of volatility to be reminded of the importance of the significant and compelling distributions CEFs make as it relates to the total return performance of funds over time. Indeed, according to Morningstar over the past 10 years ended 6/28/2013, the average cumulative share price capital return (which excludes distributions) for the universe of CEFs was only 5.95% (or an annualized 0.58%). However, when you factor in the distributions CEFs distribute and look at the average cumulative share price total return, the number is a much more impressive 79.19% (or an annualized 6.01%). These data points illustrate the importance of distributions compounding year after year and how significantly they contribute to the share price total return performance of CEFs. After all, the majority of CEFs have as their primary investment objective the goal of distributing current income.

As the second half of the year commences, I continue to believe the overall back drop for diversified CEF investors remains a good one. Indeed, I think one of the key comments from the recent Federal Reserve meeting that appears to have been overlooked by investors is that the Fed intends to continue to keep the Federal Funds rate at the extremely low level of 0-0.25% for an extended period of time. This is particularly important as it relates to the CEF structure as roughly 70% of all CEFs employ the use of leverage. Most funds' leverage costs are pegged off of short-term interest rates and therefore, with the Fed likely keeping rates at 0-0.25% for an extended period of time, many funds will continue to have low leverage/borrowing costs, which is a positive factor, in my opinion. Furthermore, with the average CEF trading at a wider discount to NAV than historical averages, coupled with the very attractive average yield of 6.57% (Morningstar, 6/28/13), I believe investors will look to take advantage of these compelling valuations and yields. Even though long-term interest rates did trend up in the second quarter, we are still in an overall low interest rate environment and an average yield of 6.57% is still attractive on both an absolute and relative basis, particularly in light of the very low inflation we continue to experience.

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Another positive for credit-sensitive funds (such as high-yield and senior loan funds) remains the very low default rate. In fact, Moody's reported that the global speculative-grade default rate stood at 2.8% in June, no change from May. Moody's is forecasting a default rate of 3.2% for December 2013. The rate stood at 3.1% a year ago. The historical average for the default rate on speculative-grade debt has been approximately 4.7% since 1983. The U.S. speculative-grade default rate stood at 2.9% in June, no change from May. The rate stood at 3.3% a year ago. The default rate on senior loans stood at 1.49% in June, down slightly from 1.50% in May, according to Standard & Poor's LCD. Leveraged loan managers expect the default rate to be in the vicinity of 1.8% in December. The historical average is 3.3%.

While I believe the overall backdrop remains a favorable one for diversified CEF investors and the recent weakness has created many compelling opportunities in the secondary market, the volatility (particularly in longer duration fixed-income funds such as municipal funds) does illustrate the interest rate risk which does exist in certain funds. While I believe municipal CEFs do have compelling characteristics such as average tax-free yields of 5.98% from primarily investment-grade bonds (Morningstar), average discounts to NAV of 3.0% (Morningstar), and continue to benefit from low leverage cost, I also continue to actively advocate investors diversify into less interest-rate sensitive areas such as domestic equity funds and credit-sensitive funds (such as senior loan, high-yield and limited duration multi-sector funds), along with maintaining some exposure to municipal funds given the compelling tax-free yields they provide.

Since January of 2012 (see CEF commentary from 1/18/2012) I have had the highest conviction level in domestic equity funds and senior loan funds and that is still the case as the second half of 2013 begins. Based on the First Trust Economic team's view that the U.S. economy will continue to grow this year at a moderate rate, coupled with our Chief Market Strategist's view that domestic equities remain undervalued based on the potential for continued earnings growth in the S&P 500 over the next 12-months (as well as the fact that the S&P 500 continues to trade at a market multiple which is below its historical average), I continue to favor the underlying asset class of domestic equities. Furthermore, the Morningstar universe of 113 domestic equity funds trades at an average discount to NAV of 3.0%, which is wider than its 10-year average of a 0.05% premium to NAV.

On the fixed-income side of the equation, I continue to have the highest conviction level in senior loan CEFs. While the Morningstar universe of 24 senior loan CEFs was lower by 2.59% on a share price total return basis during the second quarter, the category is still up 15.01% on a share price total return basis over the past one year (Morningstar). Underlying NAVs for senior loan funds were only lower by 0.03% on a NAV total return basis (Morningstar). My positive thesis for advocating investors have exposure to senior loan CEFs is as follows:

1. Defaults continue to remain low: The default rate on senior loans stood at 1.49% in June, down slightly from 1.50% in May, according to Standard & Poor's LCD. This is significantly below the historical average of 3.3%.
2. Senior loans remain one of few fixed-income asset classes below par: As of 6/28/13, the S&P LSTA U.S. Leveraged Loan 100 Index was at 97.13 (par is 100) (Bloomberg). While not a huge discount to par, it is at a discount nonetheless when most other fixed-income oriented asset classes are at premiums to par. Furthermore, historically when interest rates trend higher, senior loans trade right around this par level as there is not a lot of duration risk due to the floating-rate nature of the interest on the loans. Indeed, the last time interest rates trended higher from 2004-2006 was when the Federal Reserve increased interest rates from 1% to 5.25% and long-term rates trended up as well. This index stayed in an extremely tight range with a low of 99.82 on 1/2/04 and a high of 101.32 on 3/18/05, according to Bloomberg.
3. Yields remain compelling: Average senior loan CEF has a distribution yield of 7.01% (as of 6/28/13, according to Morningstar). This average yield is particularly compelling in light of the limited duration risk the underlying asset class of senior loans have.

As always, due to the fact that closed-end funds can exhibit periods of high volatility, investors are encouraged to maintain a long-term time horizon and exposure to different types of funds.

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