

Update on Municipal Closed-End Funds

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Despite a wider than historical current average discount to NAV of 4.91% (as of June 24, 2013 according to Morningstar); attractive average yields of 6.63% (Morningstar) for national leveraged funds; and the fact that within the past couple of weeks the Fed clearly stated it is not raising short-term interest rates anytime soon, the market has yet to see meaningful buying in the municipal CEF category. One of the main reasons we continue to see volatility among municipal CEFs, in my opinion, is related to the factors currently negatively impacting the underlying municipal bond market.

Right now both open-end municipal bond mutual funds and municipal ETFs are dealing with significant outflows from investors. While the municipal bond market is an enormous market—with over one million bonds outstanding—many of these bonds don't trade every day. Nevertheless, open-end mutual funds are forced to sell meaningful amounts of individual bonds to meet redemptions. As there are not a lot of muni bond buyers in the market currently, fund managers are forced to mark down the price of the bonds, thereby making them more attractive for investors to purchase. The result of some of this illiquidity in the underlying municipal bond market is that municipal bond prices have declined—even more than U.S. Treasuries—on some days (as on 6-24-13).

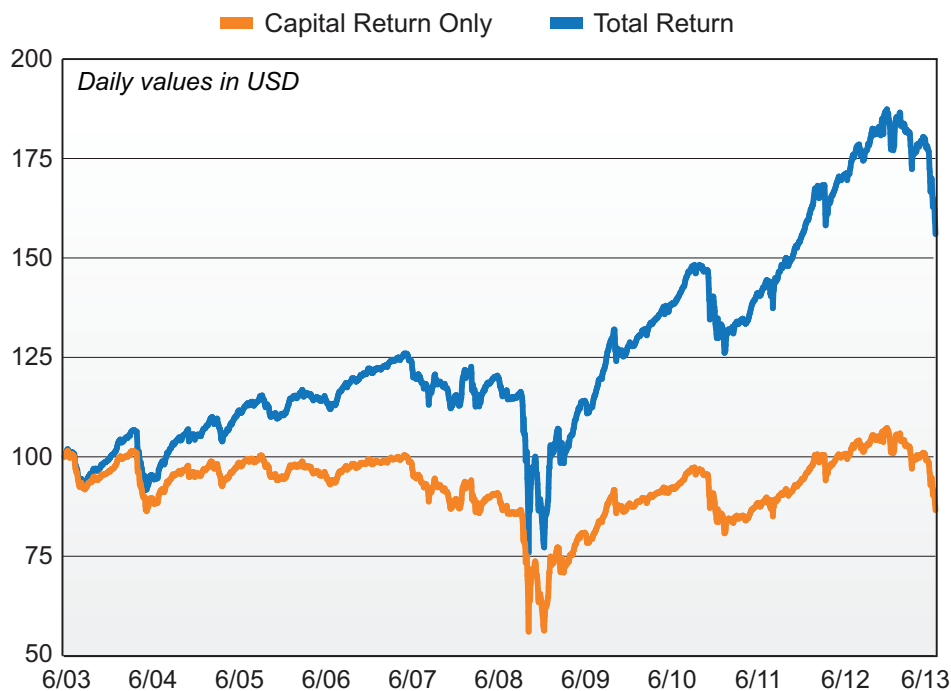
As a result of the weakness in the underlying municipal market, yields on municipal bonds have become very attractive when compared to yields for U.S. Treasuries. For example, according to bondsonline.com, the average yield on a 20-year AA-rated municipal bond is 4.34%, as of 6-24-13. To put that in perspective (assuming the bond does not fall into default or is called), if an investor in the 28% tax bracket bought an individual AA-rated municipal bond and held it to maturity, that investor would lock in a taxable equivalent yield and return of 6.03%. Bear in mind, the 30-year U.S. Treasury currently yields 3.53%, as of 6-24-13.

While there continues to be redemptions in the municipal bond market, historically when yields in individual bonds get to these levels (relative to Treasuries and even corporates), it has attracted interest from retail and/or institutional “cross-over” buyers, which in turn has historically firmed up the market. (The definition of an institutional “cross-over” buyer is an institutional manager who generally only buys taxable bonds because they usually yield more than tax-exempt municipal bonds. However, at times, the institutional managers will “cross-over” to the tax-exempt municipal bond market when yields on municipal bonds rise above taxable bonds and credit quality is comparable, or even better.)

Lastly, during these periods of increased volatility in municipal closed-end funds, it is important to remember the significant and compelling distributions funds continue to make. Indeed, as the chart below clearly shows, the compounding impact of distributions adding up over time is a significant contributor to the historical total return of municipal closed-end funds. “Capital Return Only” shows the price performance of municipal CEFs over the past 10-years ended 6-24-13 and “Total Return” shows municipal CEFs including distributions over the same period.

The chart is for illustrative purposes only and not indicative of any investment. Past performance is no guarantee of future results. An index cannot be purchased directly by investors. Closed-end funds are subject to various risks, including management's ability to meet the fund's investment objective, and to manage the fund's portfolio when the underlying securities are redeemed or sold, during periods of market turmoil and as investors' perceptions regarding the funds or their underlying investments change. Unlike open-end funds, which trade at prices based on a current determination of the fund's net asset value, closed-end funds frequently trade at a discount to their net asset value in the secondary market. Certain closed-end funds may employ the use of leverage which increases the volatility of such funds.

Municipal CEF Returns



Source: Morningstar. Data 6/2/03 through 6/24/13.