Modest Improvement in Many CEF Categories; Potential for Tax-loss Selling

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The wider than average discounts to net asset value (NAV), compelling yields and the recent announcement from the Federal Reserve that it is not going to begin reducing its bond purchasing program known as Quantitative Easing just yet as many market participants had expected as well as their firm commitment to keep short-term interest rates very low at 0-0.25% for a considerable time (likely to 2015) has helped to lead to modest improvement in the share price performance of many fixed-income closed-end funds recently. For example, according to Morningstar, high yield CEFs are up 2.84% in the past month, limited duration CEFs are up 3.46% over the past month and national leveraged municipal CEFs are up 3.77% over the past month (all data is on a share price total return basis). Even with the recent improvement in share price total return performance, the average fixed income closed-end fund (CEF) is lower by 8.87% year-to-date (YTD) while all equity CEFs remain positive YTD on a share price total return basis by 8.70% according to Morningstar.

I believe the fact the Federal Reserve again reiterated that they don't intend to raise the Federal Funds level anytime soon remains a significant positive factor for the CEF structure as roughly 70% of all CEFs employ the use of leverage and of those 70% the overwhelming majority of funds borrow at rates which are pegged off of some short term benchmark. With the Federal Funds rate remaining at 0-0.25% it means leverage cost should also remain very low for the overwhelming majority of funds which are employing the use of leverage and this dynamic helps funds to be able to continue to deliver very high income to shareholders. In fact, partially as a result of this dynamic, the average CEF has a share price distribution yield of 6.75% which is higher than the 1 year average yield of 6.21% and the 3 year average yield of 6.46% according to Morningstar.

In addition to these compelling yields and the fact that leverage cost should remain low for most CEFs until the Fed begins to raise the Federal Funds rate (which may not be until 2015), average discounts to NAV still remain wider than historical averages for most categories of the CEF marketplace. The average discount to NAV for all CEFs according to Morningstar is 6.62%. Much wider than the 1 year average premium to NAV of 0.30%, three year average discount to NAV of 1.42% and 10 year average discount to NAV of 3.43%. Based on the compelling fundamentals, yields and valuations, I continue to advocate CEF investors have diversified exposure to domestic equity CEFs, shorter duration credit sensitive funds such as senior loan, limited duration and high yield CEFs and municipal CEFs. (See blogs from 9/16/13, 9/3/13 and 8/16/13 for more on these categories.)

While the recent reiteration from the Fed that they don't intend to raise the Federal Funds rate anytime soon remains a positive for many CEFs as it keeps leverage cost low and yields, fundamentals and discounts to NAV remain attractive for the categories of the CEF marketplace I continue to favor (see paragraph above), there is the potential for enhanced volatility for many CEFs towards the end of the fourth quarter due to the potential for tax-loss selling. Tax-loss selling is when investors sell securities to realize losses in order to offset gains within their portfolios. Tax-loss selling tends to be more pronounced in CEFs in years when investors have losses to take and when investors have gains in parts of their portfolios they wish to offset. Given the fact that the universe of 189 taxable fixed income CEFs is lower on average by 4.55% YTD on a share price total return basis according to Morningstar and that the universe of 208 municipal CEFs is lower by 12.46% YTD on a share price total return basis according to Morningstar coupled with the fact that it has been a very good year for equities thus far in 2013 (YTD the S&P 500 Index is up 21% according to Bloomberg) means this year could see more tax-loss selling in CEFs than in recent prior years.

While it is hard to know when it will begin and how long it will last, typically tax-loss selling tends to occur from mid-November through mid to late December. Historically, when tax-loss selling is prevalent, discounts to NAV widen. The share price weakness and discount widening from tax-loss selling tends to be a short-lived, technical phenomenon that historically reverses at the beginning of the following year in January and February when discounts to NAV tend to narrow and share prices tend to bounce back as the tax-loss selling is over and investors look to take advantage of the discounts and opportunities that were created during the prior months' tax-loss selling.

I believe tactical and CEF investors who tend to actively trade their CEF positions should have some cash on hand heading into to November and December should we experience weakness and discount widening as a result of tax-loss selling and be prepared to take advantage of the opportunities which present themselves as a result of tax-loss selling. Longer-term CEF investors who tend not to actively trade their positions but rather usually hold during periods of short term volatility should be aware that there could be some short-term volatility and weakness as a result of tax loss selling but also be aware that it tends to be short-lived and historically the short-term weakness associated with tax-loss selling tends to become short-term strength at the beginning of the following year once the tax-loss selling is over and investors seek to take advantage of the opportunities it creates.

All data is through 9/25/13.