

Following Solid December, Municipal CEFs off to Good Start in 2014

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While the average municipal closed-end fund (CEF) was lower by 13.42% on a share price total return basis in 2013 (NAVs were lower by 6.88% on a total return basis) according to Morningstar, performance has improved recently. On September 3, 2013 I wrote a blog piece entitled "[Still out of Favor but with Compelling Yields and Valuations](#)" which discussed that municipal CEFs were still out of favor with investors despite the value in municipal bonds, attractive discounts to NAV and very compelling tax-free yields municipal CEFs offered. The September to November period was a fairly stable one for most municipal CEFs, however by December investors had finally begun to take advantage of the very compelling yields and discounts to NAV. In fact, the First Trust Municipal CEF Index (MNCEFT) was up 2.26% during the month of December. The positive momentum and bargain hunting has continued into 2014 with MNCEFT up 2.24% through 1/8/14 according to Bloomberg. The index closed at 1443 on 1/8/14 which represents its highest closing price since 7/12/13 according to Bloomberg.

While the primary risk in municipal CEFs in my opinion remains duration risk (aka interest rate risk) and investors need to be aware of it, municipal CEFs continue to also have many positive characteristics including average discounts to NAV of 6.20% as of 1/9/14 (a year ago they were at an average premium to NAV of 3.22% according to Morningstar), average distribution yields of 6.37% as of 1/9/14 (a year ago the average distribution yield was 5.17% according to Morningstar) and they continue to benefit from very low leverage cost which should remain low through 2014 given the fact the Federal Reserve has indicated they do not intend to raise the Federal Funds rate until 2015. Furthermore, despite a few high profile municipal bond defaults, such as Detroit's bankruptcy filing, the number of bond issues that defaulted in the S&P Municipal Bond Index actually fell for the third straight year in 2013, according to S&P Dow Jones Indices. The number of defaults in each year were as follows: 2013 (23 issues/0.107% default rate); 2012 (30 issues/0.144% default rate); and 2011 (46 issues/0.227% default rate).

Despite the inherent interest rate risk in municipal CEFs, I continue to believe the positive characteristics discussed above are compelling. Given the sell-off in municipal CEFs which occurred in 2013, I believe the yields and valuations make it worth taking on the interest rate risk as part of a diversified, balanced CEF income portfolio which should also include shorter duration credit sensitive funds such as senior loan funds, limited duration funds, high yield funds and domestic equity funds.

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.

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