CLOSED-END FUND review

FIRST QUARTER 2014

Jeff Margolin

Senior Vice President, Closed-End Fund Analyst

First Quarter Overview

The first quarter of 2014 was a solid one for most categories of the closed-end fund (CEF) marketplace. As I commented in my quarterly CEF commentary piece from January[1], it was my belief that as 2014 commenced there were as many opportunities which existed in the secondary market for CEF investors as there had been since early 2009 when the credit crisis was beginning to heal. Based on the positive share price total returns which most categories of the CEF marketplace posted during the quarter, investors were clearly anxious to take advantage of them. Indeed, the average CEF was positive by 4.25% for the first quarter on a share price total return basis (according to Morningstar).

Wider than average historical discounts to net asset value (NAV), attractive distributions, further indications from the Federal Reserve that it doesn't intend to raise the federal funds rate until mid-2015 (which keeps leverage cost low for most leveraged funds) and the fact that tax-loss selling season was over, all helped to contribute to bargain hunting during the quarter. Furthermore, a rally in the bond market, coupled with a continued low default environment for credit-sensitive asset classes (including high-yield bonds and senior loans), also helped encourage investors to take advantage of the distributions and discounts available in many fixed-income oriented categories.

While all CEFs were up an average of 4.25% for the quarter, there was a wide variance in the performance by category. As I wrote in my blog on 1/9/14[2] and 3/31/14[3], municipal CEFs had a terrific first quarter after a difficult 2013. According to Morningstar, the average municipal CEF was up 7.92% on a share price total return basis for the quarter. Taxable fixed-income CEFs also had a solid quarter, up on average 4.36% on a share price total return basis (Morningstar). High-yield bond CEFs were up 4.02% for the quarter and senior loan CEFs were up 1.91% (Morningstar) on a share price total return basis. Lastly, the Morningstar universe of equity CEFs was up 1.23% on a share price total return basis and I believe that reflected the somewhat choppy start to the year the major equity indices had during the first quarter.

Why I Still Like Senior Loan CEFs as Part of a Diversified CEF Portfolio

I continue to be an advocate for investors building a diversified CEF portfolio focusing on a select group of categories including primarily domestic equity CEFs, municipal CEFs and credit-sensitive CEFs including senior loan, high-yield bond and limited duration CEFs. Throughout the first quarter, the category that generated the most amount of questions was the senior loan category. Therefore, I want to directly address why I continue to believe senior loan CEFs should be part of a diversified CEF portfolio. I can sum it up with four points:

1. **Average loan price around par:** According to Bloomberg, as of 3/31/14, the S&P Leveraged Loan 100 Index was at 98.40, or just slightly under par. The majority of senior loans are priced at around 100. Despite the fact loan prices are trading around par, I keep hearing from investors that senior loans are in a "bubble." However, to say senior loans are in a "bubble" completely ignores the historical data which clearly shows that in environments in which the economy is growing (as we are now) senior loan prices historically trade around 100. Indeed, the last time the U.S. economy was in a sustained period of economic growth (2003-2006), loan prices traded around par the entire time. According to Bloomberg, the S&P Leveraged Loan 100 Index ended 2003 at 99.89, 2004 at 100.99, 2005 at 100.59 and 2006 at 100.18. It wasn't until the end of 2007 and into 2008 when the credit crisis began that loan prices began to trade meaningfully below par. My point is that as long as the economy continues to grow and the Plow Horse economy (as First Trust's Chief Economist, Brian Wesbury calls it) continues to plow ahead, loan prices should stay around par. Barring a shock to the economy or a recession in 2014 (which our economics team is not calling for), I expect loan prices to stay around par as they historically have in this type of an economic environment.

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First Trust Advisors L.P.
1-630-915-6784
www.ftportfolios.com

[1] http://www.ftportfolios.com/Commentary/Insights/2014/1/22/fourth-quarter-2013
[2] http://www.ftportfolios.com/Commentary/Insights/2014/1/9/following-solid-december,-municipal-cefs-off-to-good-start-in-2014
[3] http://www.ftportfolios.com/Commentary/Insights/2014/3/31/year-to-date-performance-of-municipal-closed-end-funds-shows-the-importance-of-balance

2. **Senior Loan CEFs at wider than average historical discounts to NAV:** While senior loan prices are trading on average right around par (as they historically do in an environment in which the economy is growing), senior loan CEFs are currently trading at wider than average historical discounts to NAV and therefore I believe represent a compelling opportunity. Indeed, as of 3/31/14, the average senior loan CEF was at a 5.32% discount to its NAV (Morningstar). This is a far more inexpensive valuation than they were trading at one year ago when the average senior loan CEF was at a 4.22% premium to its NAV and also more inexpensive than the 1.64% premium to NAV they were trading at 3 years ago.
3. **Defaults remain very low:** Senior loans are loans which have been made to below investment-grade companies. It's my view that anytime an investor invests in a credit-sensitive asset class (such as senior loans or high-yield corporate bonds for example), the default rate should be an important consideration. To that end, the default rate for senior loans remains significantly below its historical average. The default rate on senior loans stood at 1.02% in March, down from 1.16% in February, according to Standard & Poor's LCD. Leveraged loan portfolio managers expect the default rate to be in the vicinity of 1.90% by the end of 2014, well below the historical average of around 3.20%.
4. **Distribution rates on Senior Loan CEFs remain attractive:** While there have been some distribution reductions for senior loan CEFs recently, the distribution rates for senior loan CEFs remain very attractive, especially when considering the limited duration risk the underlying asset class of senior loans has owing to the floating-rate nature of the interest senior loans pay. In fact, as of 3/31/14, the average senior loan CEF had a distribution rate of 6.80% (Morningstar). This is higher than the average distribution rate of 6.56% from one year ago and also higher than the average distribution rate of 6.31% from three years ago (Morningstar).

What could change my positive view of the senior loan asset class and senior loan CEFs? Should the U.S. economy suffer a significant slowdown and roll into a recession in 2014, which our economics team is not forecasting, I would be less inclined to want to have exposure to a credit-sensitive asset class such as senior loans. These conditions would most likely trigger a sharp increase in the default rate. However, with the U.S. economy still growing, senior loan prices staying steady around par, a low default rate for senior loans, distribution rates averaging 6.80% for senior loan CEFs and discounts to NAV much wider than historical averages, I believe senior loan CEFs should be included in a diversified portfolio of CEFs.

Backdrop for Favored Categories Remains Positive as the Second Quarter Commences

Even with the solid start to the year for many categories of the CEF marketplace, I still find valuations and distribution rates very compelling as underlying NAVs for many CEFs (particularly fixed-income funds) have also performed well, which has helped to keep discounts to NAV wide and attractive. Indeed, while average discounts to NAV for all CEFs have narrowed slightly since the end of 2013 (from 7.33% to 6.68% as of 3/31/14, according to Morningstar), they are still wider than where they were a year ago when discounts were 1.83% and three years ago at 2.53% (Morningstar).

Furthermore, average distribution rates remain very compelling at 6.58% (as of 3/31/14 according to Morningstar) compared to the average of 6.16% from one year ago as the theme of CEFs benefiting from low leverage cost remains very much intact. I see distributions for most CEFs likely remaining stable in 2014 as the majority of CEFs continue to earn a generous spread between leverage costs and the rates they can earn on borrowed proceeds. With the Fed unlikely to raise the Federal Funds rate until mid-2015 (based on what it has communicated to investors), this positive backdrop for the CEF structure remains in place.

In short, while many categories of the CEF marketplace are off to a good start in 2014, as the second quarter commences there still remains many compelling opportunities available in the secondary market for CEF investors as average discounts to NAV remain wide, distributions remain high and fundamentals for asset classes I favor (including domestic equities, senior loans, high-yield corporate bonds and municipal bonds) remain sound.

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