Early Thoughts on Tax-Loss Selling Season

Jeff Margolin • Senior Vice President • Closed-End Fund Analyst

With the fourth quarter about a week and a half away, the topic of tax-loss selling and closed-end funds (CEFs) is one that is often on the forefront of CEF investors' minds. Tax-loss selling is when investors sell securities to realize losses in order to offset gains within their portfolios. Tax-loss selling in the CEF structure often is most pronounced from roughly mid-November to the third week of December. It can lead to enhanced volatility and discounts to net asset value (NAV) widening during this period. The share price weakness and discount widening from tax-loss selling tends to be a short-lived, technical phenomenon that historically reverses course at the beginning of the following year when discounts to NAV often narrow and bargain hunters look to take advantage of the discounts and opportunities that were created during the previous quarter's tax-loss selling.

Historically, tax-loss selling is most prominent during years in which the total returns for the majority of CEFs and categories within the CEF structure are lower for the year and therefore CEF investors have losses to take. With the average CEF up 9.65% year-to-date (YTD) through September 19th (according to Morningstar) on a share price total return basis, it has clearly been a positive year for the average CEF in 2014. Moreover, not only is the average CEF return positive by nearly 10% YTD, but it has also been a very broad rally with almost every category of the CEF marketplace positive for the year. Indeed, according to Morningstar, Emerging Markets is the only broad CEF category with a negative share price total return with the 18 CEFs in this category lower on average by 0.77% YTD, as of 9/19/14.

While a lot can change between now and the end of the calendar year, based on the fact that most CEFs have produced positive share price total returns so far in 2014, I believe conditions do not appear likely for there to be a lot of tax-loss selling in the CEF structure this year. However, it is important to state that while the CEF structure might not experience significant tax-loss selling in the fourth quarter, I believe there is still the possibility for some enhanced volatility as investors potentially begin the process of repositioning CEF portfolios ahead of 2015 when the Federal Reserve could finally begin to increase the Federal Funds rate, which has been at 0-0.25% since December of 2008. Also, while this has been a very solid year from a share price total return perspective for most CEFs, it does not mean CEF investors do not have losses in individual CEFs they have owned for more than a year, and therefore could still be candidates for tax-related selling. **Either way, my primary focus as the fourth quarter commences is to continue to be an active proponent of CEF investors utilizing a four part "game plan" focused on adjusting CEF portfolios ahead of the potential increase in the Federal Funds rate that I outlined in this commentary piece from July 24, 2014: Click here to view 7/24/14 commentary.**

Unlike open-end funds, which trade at prices based on a current determination of a fund's net asset value, closed-end funds frequently trade at a discount to their net asset value in the secondary market. Not all closed-end funds invest in income-producing securities and there is no guarantee that a fund's yield will not fall regardless of whether the discount widens. In addition, as an investor's total return will be impacted by the value of the fund's shares, a widening discount will negatively affect total return.

Closed-end funds are subject to various risks, including management's ability to meet a fund's investment objective, and to manage a 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. Certain closed-end funds may employ the use of leverage which increases the volatility of such funds.

All opinions expressed constitute judgments as of the date of release, and are subject to change without notice. There can be no assurance forecasts will be achieved. The information is taken from sources that we believe to be reliable but we do not guarantee its accuracy or completeness.