Closed-End Fund *Review*

FIRST QUARTER 2018

First Quarter and 2018 Overview

After a year in which the average closed-end fund (CEF) was up 11.37% and managed to earn a positive total return in each of the four quarters, the average CEF declined by 3.80% in the first quarter of 2018. Weakness and volatility in equities (both domestic and international), coupled with an increase in interest rates (both short and long-term), created a difficult environment for many categories of the CEF marketplace. (Source: Morningstar. All data is share price total return.)

Equity CEFs were lower on average by 4.85% for the quarter while fixed-income CEFs were down by an average of 3.18%. Within fixed-income CEFs, municipal funds really felt the sting of the increase in interest rates given the duration risk many of them have. The average municipal CEF was lower by 4.88% during the quarter compared to a decline of only 1.51% for the average taxable fixed-income CEF. The benefit of reducing duration risk and focusing on short-duration, senior loan CEFs proved its worth during the first quarter as the average senior loan CEF gained 2.64%. More on senior loan CEFs below (Source: Morningstar.)

Average discounts to net asset value (NAV) widened during the quarter and ended at 6.40% from the 4.84% at which we began the year. (Source: Morningstar)

Top Inquiries

During the course of any given quarter, we receive many inquiries from investors and advisors regarding our thoughts on several different categories of the CEF marketplace. To that end, I wanted to try something different in this CEF commentary and provide my current thoughts on 4 specific categories about which we received the majority of inquiries during this past quarter.

- **Municipal CEFs:** Readers of prior CEF commentaries are aware that I have been cautious toward long-duration, levered CEFs for quite some time given our Economics team's forecast for both higher short- and long-term interest rates. While not all municipal CEFs employ the use of leverage and have long durations, a significant percentage do. As mentioned in the second paragraph above, this concern about duration risk really played out during the first quarter as the average municipal CEF was lower by 4.88%. Now that we have experienced a nearly 5% sell-off in the share prices of municipal CEFs and average discounts to NAV have widened to 8.58% (Source: Morningstar) as of the end of the first quarter, investors are asking if it is time to get aggressive and buy municipal CEFs. In my view, the sell-off has made the valuations of municipal CEFs more attractive and I believe it has created an opportunity for longer-term CEF investors to slowly dollar-cost average back into municipal CEFs. However, the reason I am not advocating a more aggressive approach at this time and remain somewhat cautious is because our Economics team continues to forecast higher short- and long-term rates for the remainder of the year, and therefore, I think investors need to be aware of the duration risk that is still present in municipal CEFs. I prefer to take a dollar-cost average approach to take advantage of wide discounts to NAV that were created during the sell-off (and provide a bit of a cushion should NAVs move lower again as a result of higher long-term rates) but be prepared to add to positions later in the year should we see another pullback as a result of rates moving higher. Finally, should the Federal Reserve ("Fed") continue to hike short-term rates this year, it will lead to an increase in leverage cost for many municipal CEFs which will likely lead to more distribution cuts.

Jeff Margolin
Senior Vice President, Closed-End Fund Analyst

- **Senior Loan CEFs:** As mentioned above, senior loan CEFs had a solid first quarter and posted an average share price total return of 2.64%. In my view, senior loan CEFs continue to be the most attractive category of the fixed-income CEF marketplace especially in light of our Economics team's forecast for potentially 3 more increases in the federal funds rate in 2018. As a result of the floating-rate nature of the interest on senior loans, duration risk remains low for the senior loan asset class, defaults remain low for senior loans (the default rate on senior loans stood at 1.93% in March, according to S&P Global Market Intelligence) and, according to Morningstar, the average senior loan CEF was at a still attractive 4.65% discount to NAV as of 3/31/2018. Lastly, as LIBOR (London Interbank Offered Rate) continues to trend higher as a result of recent increases in the federal funds rate (and likely will continue to move higher should the Fed raise rates again), I believe we are on the cusp of several senior loan CEFs being in the position to increase distributions—which could provide a positive catalyst for senior loan CEFs.
- **Master Limited Partnership** ("**MLP") CEFs:** MLP CEFs had a very difficult first quarter, declining by an average of 14.54% on a share price total return basis, according to Morningstar. A key reason for the weakness was related to the ruling on March 15th from the Federal Energy Regulatory Commission (FERC) that stated MLPs can no longer recover the cost of income taxes in setting tariffs on interstate pipelines. While the ultimate impact of this ruling may only mean a minimal loss of income for some MLPs, investors were clearly surprised by the ruling and took a "Sell now, ask questions later" mentality and that helped contribute to a double-digit decline for MLP CEFs. The FERC ruling adds an element of uncertainty to the MLP space; however, I think it is important to note that mid-stream MLPs, in particular, continue to have very attractive assets, generate significant cash flow, pay out high distributions and continue to benefit from the energy infrastructure build out in North America. While it will likely continue to be a volatile category, in my view much of the potential downside to the FERC ruling has been priced in and I believe investors should continue to have exposure to MLP CEFs that have significant exposure to the mid-stream oriented MLPs.
- **U.S. Equity CEFs:** With both the S&P 500 Index and the Dow Jones Industrial Average posting their first quarterly losses since the third quarter of 2015 (Source: Forbes), we received inquiries related to whether or not we still favored U.S. equity CEFs. The answer is "Yes". From my perspective, investors looking for income with the potential for capital appreciation should still own U.S. equity CEFs as part of a diversified CEF portfolio. Our Chief Market Strategist continues to expect a double-digit increase in earnings per share for the S&P 500 in 2018 and our Economics team continues to forecast GDP growth of approximately 3.0% for the U.S. economy this year. In my view, the backdrop of double digit EPS growth coupled with an economy growing at 3.0% creates a positive environment for U.S. equities and CEFs with exposure to them.

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