Closed-End Fund *Review*

FOURTH QUARTER 2018

Fourth Quarter and 2018 Overview

The fourth quarter was a very difficult one for the closed-end fund (CEF) marketplace. The average CEF was lower by 8.74% for the three-month period ended on 12/31/18. The sell-off during the fourth quarter helped contribute to what turned out to be an overall negative one for the average CEF in 2018. The average CEF was lower by 10.73% for the year. It was a broad sell-off as, on average, both equity and fixed-income CEFs were lower for the year. Equity CEFs were down 17.94%. Taxable fixed-income funds were weaker by 6.76%, while Municipal CEFs were lower by 5.95% for the year. (Source: Morningstar. All data is share price total return.)

As is often the case, there were many varying factors which impacted the performance of equity and fixed-income CEFs, but clearly the negative performance for most U.S. and international equity indices hurt equity CEFs. Indeed, the MSCI All-Country World Ex US Index was down 16.42% for the year while the S&P 500 Index was lower by 4.39% during 2018. Rising short- and long-term interest rates hurt municipal CEFs, while many credit-sensitive taxable fixed-income CEFs were negatively impacted by investor fears that the global economy was slowing down. The BofAML Global Corporate Index was weaker by 3.46% for the year. (Source: Bloomberg)

Despite the weakness in many credit-sensitive categories including high-yield bonds and senior loans, the data continues to show that the fundamentals remain solid. Illustrating this fact is that Moody's reported that its global speculative-grade default rate stood at a low 2.3% in December which is well below its historical average. In fact, Moody's puts the historical average default rate at around 4.2% since 1983. The default rate on senior loans also remains quite low at 1.56% in December, according to S&P Global Market Intelligence.

Opportunities Abound

While it is often frustrating to have to endure a very challenging year for the secondary market of CEFs, from my standpoint the sell-off and subsequent meaningful widening of average discounts to net asset values (NAVs), has created a very unique and compelling buying opportunity across many different categories. I believe that as 2019 begins and the tax-loss selling season is over, price discovery will take hold and CEF investors will look to take advantage of the significant value which was created during the fourth quarter sell-off and buyers will appear.

Indeed, as 2019 commenced, the average discount to NAV for all CEFs was a very wide and attractive 9.71%. This is more than double the 4.84% at which we began 2018. More importantly, it is more than double the long-term average discount to NAV of 4.70% from 1/1/99-12/31/18. (Source: Morningstar) While average discounts to NAV should only be one important factor when considering investing in CEFs, given our Economic team's recently-released bullish forecast for both the U.S. economy where they are forecasting GDP growth of 3.0% in 2019 and a year-end target of 3,100 for the S&P 500 Index, I believe this remains a very compelling time to take advantage of these wide discounts to NAV.

Categories I Currently Favor

At this point in time, it is easy to find CEFs in the secondary market at discounts to NAV in the high single-digits or even low double-digits. However, from my perspective, the valuation of a CEF (i.e. discount to NAV) should not be the only factor to consider. It is my view that it is also important to invest in CEFs where you believe the fundamentals of the underlying asset class remain sound and are poised to do well given the current macro environment. I also favor blending categories of funds that have different risk characteristics and can therefore create good balance in a portfolio.

Jeff Margolin
Senior Vice President, Closed-End Fund Analyst

For example, I still favor senior loan CEFs right now (as well as limited-duration multi-sector fixed-income CEFs) given their currently low default rate, minimal duration risk, potential for distribution increases (given the recent increase in short-term rates and the floating-rate nature the interest loans pay) as well as the nearly 13% discount to NAV the average senior loan CEF was trading at as 2019 began, according to Morningstar. However, I recognize senior loans are a credit-sensitive asset class and therefore, while senior loan CEFs have minimal duration risk, they do have credit risk. To help offset some of the credit risk of senior loan CEFs, I believe CEF investors should balance them with exposure to high quality, investment-grade municipal CEFs.

Municipal CEFs began 2019 at a very wide and attractive 11.34% average discount to NAV, according to Morningstar, and I believe these very wide discounts already have priced in the potential for interest rates to trend up slightly in 2019. While most municipal CEFs do have meaningful duration risk, many are investment-grade and have much less credit risk. Therefore, when municipal CEFs are blended with senior loan CEFs, I believe it can potentially create an appropriate balance as well as an attractive income stream.

Given our Economic team's 2019 year-end S&P 500 Index forecast of 3100, Bloomberg's 2019 consensus year-over-year earnings growth rate estimate of 7.0% for the S&P 500 Index (as of 1/11/19), and the 9.81% average discount to NAV for U.S. equity CEFs, U.S. equity CEFs are also another broad category of the CEF marketplace I currently favor.

While I believe the core of a diversified CEF portfolio should consist of U.S. equity, senior loan, limited-duration multi-sector fixed-income and municipal CEFs, I also believe there are other categories which can be attractive satellite holdings and have significant value, including master limited partnership CEFs.

Historically, average discounts to NAV of nearly 10% for all CEFs does not last for many months and that is why I believe now is a very opportune time to take advantage of these discounts and build or add to positions in the favored categories mentioned above before average discounts begin to narrow.