CLOSED-END FUND REVIEW

THIRD QUARTER 2019

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THIRD QUARTER 2019 OVERVIEW

Following a positive first and second quarter, the average closed-end fund (CEF) was again positive in the third quarter. The average CEF was up 2.2% for the quarter and is now up 20.1% year-to-date (YTD). It was another broad-based rally with both equity and fixed-income CEFs posting positive returns. For the second quarter in a row, fixed-income CEFs posted the strongest returns. The average fixed-income CEF gained 2.8% for the quarter and is now up 18.9% YTD. Municipal CEFs led the way with a gain of 3.5%, bringing their YTD return to a positive 18.3%. Taxable fixed-income CEFs were up 2.2% and are now up 19.4% for the year. The average equity CEF managed to just barely post a positive return, gaining 0.12% but remains up 19.9% in 2019 (Source: Morningstar. All data is share price total return).

Many factors contributed to the varied performance of the different broad-based categories. As mentioned in prior CEF quarterly commentary pieces, the dovish Federal Reserve (Fed) clearly continues to benefit fixed-income asset classes which in turn helps the performance of many fixed-income categories of the CEF marketplace. Indeed, the Federal Open Market Committee (FOMC) reduced the federal funds rate for the second time this year on September 18th. The BAML 7-12 Year Municipal Index was up 1.37% during the quarter which helped the performance of municipal CEFs. Many taxable fixed-income indices were also positive during the third quarter including the BAML Preferred Index up 3.05%, the BAML High-Yield Bond Index up 1.22%, the S&P/LSTA Leveraged Loan Index up 0.99% and BAML Investment Grade Corporates Index up 3.07%. The strength in the performance of these underlying fixed-income asset classes helped drive the strong quarter for fixed-income CEFs. The more muted performance from equities during the quarter (S&P 500 Index +1.7%, MSCI All-Country World Ex U.S. Index -1.8%) was the primary reason the average equity CEF was up just 0.12% for the third quarter (Source: Bloomberg).

Reflecting another positive quarter for share prices as well as continued demand for high income-oriented investments, the average CEF discount to net asset value (NAV) narrowed during the third quarter to end at 4.20%. As discussed in the second quarter 2019 CEF commentary, https://www.ftportfolios.com/Commentary/Insights/2019/7/22/second-quarter-2019, sentiment for the CEF structure continues to improve given the dovish Fed. Therefore, it is not surprising to see average discounts to NAV narrow from the 5.90% level at which they ended the second quarter and the 9.6% level at which they began the year (Source: Morningstar).

OUTLOOK FOR REMAINDER OF 2019 AND LOOKING AHEAD TO 2020

From my perspective, the outlook for investors who are diversified across favored categories of the CEF marketplace (more on that below) remains a good one. As discussed in the first quarter 2019 CEF commentary https://www.ftportfolios.com/Commentary/Insights/2019/4/24/first-quarter-2019, whether a CEF investor agrees or disagrees with the dovish Fed (and two federal funds rate reductions in 2019), in my opinion, the Fed has created a positive backdrop for the CEF structure and that has clearly helped performance of many categories this year. I continue to believe that investors are more likely to consider investing in CEFs if they believe short-term rates (and therefore leveraged cost for most leveraged funds) are likely to decline. Moreover, according to Charles Schwab, there is approximately $13.6 trillion in negative-yielding bonds around the world at a time when the demand for income remains high. In this global environment of low or negative yields, the 6.83% distribution yield of the average CEF looks particularly attractive on an absolute and relative basis.

As the fourth quarter of 2019 commences, there is the potential for some seasonal, short-term enhanced volatility in the CEF structure due to tax-related selling in individual CEFs in which investors might have a loss. (Tax-loss selling is when investors sell securities to realize losses for tax purposes in order to offset gains within their portfolios.)

While the sting of last year's very difficult fourth quarter (as a result of a global equity correction, flight to safety and tax-loss selling) might still exist for CEF investors, from my perspective the best approach for CEF investors during the traditional season of tax-related volatility is to be prepared to take advantage of any discount widening that might occur in November/December and be a buyer as historically the seasonal weakness late in the fourth quarter turns into seasonal strength during the first quarter.

With the backdrop of a dovish Fed, coupled with our Economic Team's continued forecast of 3% GDP growth for the U.S. economy and a year-end 2019 S&P 500 Index target of 3,250 (and no U.S. recession in 2020), I am making no changes to my belief that the core of diversified CEF investors' portfolios should consist of U.S. equity, senior loan, limited-duration multi-sector fixed-income and municipal CEFs. I also continue to believe Master Limited Partnership (MLP), preferred and CEFs with exposure to European blue-chip stocks are attractive satellite positions in a diversified CEF portfolio. Note that the average preferred CEF ended the third quarter at a premium to NAV of 3.84% (and is up 30.6% YTD) and therefore it is important to pick your spots carefully when selecting individual preferred CEFs (Morningstar).

With average discounts to NAV of 7.53%, coupled with our Economic Team's bullish forecast for U.S. equities and forecast for solid U.S. GDP growth, I continue to believe the backdrop for U.S. equity CEFs remains a good one. With an average distribution yield of 8.22%, U.S. equity CEFs not only provide an attractive income stream but can also potentially provide a growth engine in a portfolio should U.S. equities continue to trend higher (Morningstar).

It was in the CEF commentary piece from exactly one year ago where I advocated investors dollar cost average into municipal CEFs https://www.ftportfolios.com/Commentary/Insights/2018/10/18/third-quarter-2018. Municipal CEFs have performed very well through the first 3 quarters of 2019 with an average gain of 18.3% and given the dovish Fed, average discounts to NAV of 4.44% and attractive tax-free yields on average of 4.07%, municipal CEFs continue to be a category I believe should be part of a diversified CEF portfolio. However, just as I mentioned in the second quarter CEF commentary piece, even though the Fed has become more dovish, I strongly believe it is important to balance the duration risk associated with many leveraged municipal CEFs with shorter duration, credit- sensitive CEF categories including senior loan and limited-duration multi-sector fixed-income CEFs. Indeed, blending categories of CEFs that have different risk characteristics is a way to generate a high-income stream but also create balance in a portfolio (Morningstar).

Senior loan CEFs are up 14.5% YTD and despite the potential for the Fed to reduce the federal funds rate for a third time in 2019 (and therefore reduce the income on floating-rate loans), the fundamentals for the senior loan asset class remains sound. According to S&P, the default rate on the S&P/LSTA Leveraged Loan Index was only 1.29% (as of the end of September) which is still well below the 2.9% historical average. With the backdrop of a low default environment, I continue to believe senior loan CEFs can be a very effective way to generate a high income stream (average distribution yield of 8.32% as of 9/30/19) from a low duration, credit-sensitive asset class. Moreover, when blended with longer-duration municipal CEFs, they can help reduce the duration risk in a portfolio. I would be less inclined to have exposure to senior loan CEFs if our "Macro" call of continued U.S. economic growth in the 3% range was reduced sharply. However, that is not the case and that is why I still believe senior loan CEFs should be included as part of a diversified portfolio of CEFs. Lastly, with average discounts to NAV of 6.72%, valuations of senior loan CEFs remain attractive in my view (Morningstar).

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