CLOSED-END FUND REVIEW

FIRST QUARTER 2019

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FIRST QUARTER 2019 OVERVIEW

After a very challenging fourth quarter of 2018 when the average closed-end fund (CEF) was lower by 8.7% and for the year was down 10.7%, CEFs staged a significant rally during the first quarter of 2019. The average fund was up 11.8% for the first quarter. It was a very broad-based rally with Equity CEFs up 14.8%, Taxable Fixed-Income CEFs positive by 11.2% and Municipal CEFs up 9.4%. As discussed in the fourth quarter 2018 CEF commentary (https://www.ftportfolios.com/Commentary/Insights/2019/1/28/fourth-quarter-2018), as tax loss selling ends and the calendar switches to the new year, price discovery takes hold as investors look to take advantage of the meaningful value and discounts to net asset value (NAV) that was created during the fourth quarter sell-off. That is, indeed, what we have seen occur in the first quarter. (Source: Morningstar. All data is share price total return).

As is often the case, there were several varying factors which contributed to the very strong performance many categories of the CEF marketplace produced in the first quarter. Equity funds benefited from the very strong quarter posted by most global equity markets (the S&P 500 Index was up 13.7% and the MSCI All-Country World Ex U.S. Index was up 9.6% in the first quarter). Fixed-Income CEFs benefited from a decline in long-term interest rates, a more dovish outlook from the Federal Reserve (the "Fed") and improvement in the underlying performance of many credit-sensitive asset classes including high-yield (the BAML High-Yield Bond Index was up 7.4%) and senior loans (the S&P/LSTA Leveraged Loan Index was up 4.0% for the quarter). (Source: Bloomberg)

Another important factor which contributed to the strong results delivered in the first quarter was the attractive valuations many CEFs were trading at to start the year. 2019 began with the average CEF at a very wide and compelling 9.6% discount to its NAV. To put that number in perspective, a 9.6% average discount to NAV is more than double the 20-year average of a 4.7% discount to NAV and clearly these inexpensive valuations attracted buyers to CEFs. While average discounts to NAV narrowed to 5.7% as of 3/31/19, they still remain wider than the 20-year long-term historical average. (Source: Morningstar)

STILL FAVOR THE SAME CATEGORIES

Following such a difficult fourth quarter, it was encouraging to see performance improve in a significant manner for many categories of the CEF marketplace as investors pounced on the value during the first quarter. As the second quarter of 2019 commences, I continue to favor and 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 diversified CEF investors should consider master limited partnership (MLP) CEFs, preferred CEFs and funds with exposure to European blue-chip dividend-paying stocks as attractive satellite positions in a portfolio.

One reason I continue to favor U.S. equity, senior loan, limited-duration multi-sector fixed-income and municipal CEFs as core holdings is related to our Economic Team's continued forecast of 3% GDP growth for the U.S. economy and a 3100 year-end price target for the S&P 500 Index. The backdrop of solid U.S. economic growth provides a good environment for U.S. equity CEFs as well as credit-sensitive short-duration CEFs including senior loan and limited-duration multi-sector fixed-income CEFs. Indeed, defaults continue to be very low for credit-sensitive asset classes including senior loans. The default rate on senior loans stood at a low 1.40% in March, according to S&P Global Market Intelligence.

Moreover, discounts to NAV remain attractive for these categories as the average discount to NAV was 9.2% for U.S. general equity CEFs, 8.2% for senior loan CEFs and 10.45% for limited-duration fixed-income CEFs as of 3/31/2019. (Source: Morningstar)

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I continue to believe that when building a portfolio of CEFs it is important to blend categories of funds that have different risk characteristics and can therefore create good balance in a portfolio. To that end, I still favor adding municipal CEFs to a diversified portfolio of CEFs. Most municipal CEFs do take on duration risk and tend to focus primarily on investment-grade securities. Therefore, when municipal CEFs are blended with senior loan CEFs and limited-duration multi-sector fixed-income CEFs, it can potentially create an appropriate balance (as senior loan and limited-duration multi sector fixed-income CEFs tend to have minimal duration risk but do take on higher credit risk) as well as an attractive blended income stream. While average discounts to NAV narrowed from a very wide 11.1% to start the year to 6.3% as of 3/31/19, municipal CEFs still remain attractive in my opinion. (Source: Morningstar)

Lastly, whether you agree or disagree with the much more dovish tone expressed by the Fed during the first quarter, from my standpoint this new dovish tone does create a favorable backdrop for the CEF structure. I state this because it is my opinion that investors will be more inclined to consider investing in CEFs if they believe short-term rates (and therefore borrowing cost for leveraged funds) are likely to be stable. Many CEFs employ the use of leverage and sentiment could improve for leveraged funds as the dovish tone implies that borrowing cost will not be increasing anytime soon. Therefore, it would not surprise me if the discount narrowing we saw in the first quarter continues throughout 2019, as sentiment improves for the CEF structure.

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