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THIRD QUARTER 2020 OVERVIEW

Building on the 15.04% positive total returns earned during the second quarter of 2020, closed-end funds (CEFs) continued their positive momentum during the third quarter. Indeed, the average CEF was positive by 3.27% during the third quarter. Despite two solid back-to-back quarters for CEFs, the average CEF remains lower by 9.00% year-to-date (YTD). (Source: Morningstar. All performance is based on share price total return) While the average CEF remains lower for the year, it is important not to lose sight of the remarkable rally many CEFs have staged since the third week of March. To that end, the First Trust Composite Closed-end Fund Total Return Index (UPCEFT) is up 48.20% from 3/18/20 to 9/30/20 (Source: Bloomberg).

It was a broad rally for CEFs during the third quarter with fixed-income funds leading the way. Fixed-income CEFs were up 4.31% for the quarter with taxable fixed-income funds positive by 4.84% and municipal CEFs gaining an average of 3.69%. Equity CEFs were up an average of 0.96%. Within the universe of equity CEFs, U.S. equity CEFs were particularly strong rising 6.90% for the quarter (Morningstar). Fixed-income CEFs benefitted from the solid performance achieved by several key fixed-income indices. The ICE BofA High-Yield Bond Index was up 4.70% during the third quarter. The S&P/LSTA Leveraged Loan Index increased 4.14% for the quarter. The ICE BofA Preferred Index was up 4.90%. The ICE BofA 7-12 Yr. Municipal Index rose 1.19% and the Bloomberg Barclays Global-Aggregate Index increased by 2.66%. The S&P 500 Index increased 8.93% for the quarter which clearly helped the U.S. equity category (Bloomberg).

Discounts to Net Asset Values (NAVs) Remain Wide, Creating Frustration and Opportunity

In several conversations with CEF investors during the third quarter, many of them expressed frustration that average discounts to NAVs for many CEFs remained much wider than historical averages and they were surprised discounts hadn't narrowed more since the extreme levels experienced in March. To that end, as of 9/30/20, the average CEF was at an 8.63% discount to NAV which remains far wider than the 20-year average discount to NAV of 4.09%. History teaches us that when discounts widen to double-digit levels, the process of average discounts narrowing closer to the long-term average of 4% (or even narrowing less than 4%) can take 12+ months, but I believe the process has begun. Bear in mind at one point in March (March 18 to be exact), average discounts to NAV had reached 21.59% (CEFdata.com).

It doesn't happen in a straight line, but eventually investors recognize the value that exists in the secondary market for CEFs and takes advantage of those opportunities which ultimately leads to discount narrowing. For example, on 10/10/2008 during the financial crisis, average discounts to NAV had widened to 27.33%. As the equity and credit markets stabilized and then rallied in 2009, discounts narrowed to only 2.47% just a year later on 10/9/2009. By August 10th of 2010, the average CEF was at a premium to NAV of 0.45%. In October of 2008, when average discounts to NAV were over 27%, it was hard to imagine that just a year later average discounts to NAV would only be 2.47% and that less than 2 years later the average CEF would be at a premium to its NAV—but that is precisely what occurred (CEFdata.com).

While not quite as extreme as the financial crisis example from 2008, a more recent example of the discount narrowing process occurred from late 2018 to early 2020. On 12/21/2018, average discounts to NAV had reached 11.49%. Again, the discount-narrowing process took time, but by February 5th of 2020, average discounts to NAV had narrowed considerably to only 2.97%. I do not know precisely when we will see average discounts narrow to the long-term average of 4% and I don't expect it to occur in a straight line. However, given the very positive backdrop that exists for the CEF structure, I do believe the process has begun and it would not surprise me if roughly 12 months from now discounts had narrowed closer to the long-term average of 4%. In the meantime, from my perspective, this remains an opportune time to own and build portfolios of CEFs trading at more inexpensive valuations relative to historical averages. Investors can potentially enhance yields in their portfolios by owning CEFs at discounts to NAV and boost total returns should discounts continue to narrow over the next 12 months (CEFdata.com).

Outlook for Remainder of 2020 and Looking Ahead to 2021

It is important to note that as the fourth quarter gets underway there is the potential for tax-loss selling in the CEF structure later in November and December. Tax-loss selling is when investors sell securities to realize losses for tax purposes in order to offset gains within their portfolios. With the average CEF lower by 9.00% YTD, we could see some tax-loss selling this quarter. Should we see this volatility and discount widening in CEFs as a result of tax-related selling, I would view it as a buying opportunity since I expect selling to be short lived (as historically in January and February of the following year investors take advantage of the prior quarter's weakness and scoop up the value that was created as a result of the seasonal tax-related weakness).

I continue to firmly believe the best approach for CEF investors is to dollar-cost average over the coming days and weeks across many different categories of the CEF marketplace. From my standpoint, attractive opportunities are currently present in many categories including equity CEFs, credit-sensitive taxable fixed-income CEFs (including senior loan CEFs, high-yield CEFs, limited duration CEFs and multi-sector CEFs) and investment-grade municipal CEFs. Average discounts to NAV remain wider than historical averages, the Federal Reserve (the Fed) is very accommodative and the global economy is beginning to open up again after it was shut down as a result of the Coronavirus.

The average CEF has a distribution yield of 7.62% (Morningstar, as of 9/30/20). With the Fed keeping short-term rates near 0% for at least the next couple of years, yields on many traditional fixed-income asset classes (including certificates of deposit and U.S. Treasuries) will also likely remain very low. Therefore, the high distribution yields CEFs provide will likely become all that much more attractive on an absolute and relative basis as investors look to increase yield in their portfolios. I believe in an era of very low global interest rates, demand for the CEF structure will increase and discounts to NAV will narrow as more investors are willing to invest in CEFs as they look for the potential to generate cash flow from their portfolios.

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