CLOSED-END FUND REVIEW
FOURTH QUARTER 2021

JEFF MARGOLIN
Senior Vice President
Closed-End Fund Analyst

FOURTH QUARTER 2021 AND 2021 OVERVIEW

Following the third quarter, when the average closed-end fund (CEF) returned -1.25%, CEFs rebounded during the fourth quarter with the average CEF returning +2.38%. This helped push the average CEF to return a very solid +16.32% for 2021. It was a broad rally in the fourth quarter with equity CEFs returning an average of +4.77%, fixed-income CEFs returning an average of +0.79%, municipal CEFs returning an average of +0.88% and taxable fixed-income CEFs returning an average of +0.67%.

The full year 2021 results are particularly impressive with the average CEF returning +16.32%. Equity CEFs returned an average of +27.28%, fixed-income CEFs returned an average of +10.01%, municipal CEFs returned an average of +8.10% and taxable fixed-income CEFs returned an average of +11.49%.

For 2021, CEF performance was boosted by a significant narrowing of discounts to net asset value (NAV), more on that below, and very strong performance across the equity markets and key credit sensitive fixed-income indices. Indeed, for the year, equity CEFs benefitted from a 28.68% gain in the S&P 500 Index as well as the 7.82% gain in the MSCI All-Country World Ex US Index (Source: Bloomberg). Many key fixed-income indices also posted strong performance in 2021 and helped the performance of several taxable fixed-income categories of the CEF marketplace. For example, for 2021 the ICE BofA High-Yield Bond Index returned +5.35% and the S&P/LSTA Leveraged Loan Index returned +5.20% (Source: Bloomberg). The solid underlying performance of the senior loan and high-yield markets helped two of our favored fixed-income CEF categories (senior loan and limited-duration) post very strong performance results for 2021. Indeed, for 2021 senior loan CEFs returned an average of +20.67% and limited-duration CEFs returned an average of +13.19%.

Discounts to NAV Narrowed Considerably in 2021

One year ago, this CEF commentary (https://www.ftportfolios.com/Commentary/Insights/2021/1/22/fourth-quarter-2020) had a bolded headline which said "Expect Average Discounts to Narrow in 2021 as Backdrop Remains Positive for CEF Structure." Indeed, we did see average discounts to NAV narrow in 2021 from the -6.47% level in which they ended 2020 to -2.36% on 12/31/2021, and many CEFs did benefit from a positive backdrop. Average discounts to NAV are narrower than the 10-year average discount to NAV of -4.95% (Source: CEFdata.com). The discount narrowing in 2021 helped boost share price total returns, but as 2022 commences with average discounts to NAV in the low single digit range, there is less room for meaningful discount contraction to help total returns. Therefore, I expect more of the potential total return a diversified portfolio of CEFs provides to come from the distributions as opposed to significant capital appreciation.

Outlook for 2022

As 2022 begins, I still believe the overall backdrop for the CEF structure remains positive but there are a couple of key differences to start this year (relative to the start of 2021) that investors need to be aware of. On the positive front, our Economic team is forecasting real GDP to rise at about a 3.0% rate in 2022 (https://www.ftportfolios.com/Commentary/EconomicResearch/2021/12/20/2022-moderate-gdp,-persistent-inflation). Solid growth in the U.S. economy should continue to paint a positive backdrop for credit sensitive fixed-income asset classes including senior loans and help keep defaults very low. Furthermore, our Economic team also believes that a growing U.S. economy and strong corporate profits should also help U.S. equity prices to trend higher. Indeed, they are forecasting a year-end S&P 500 price target of 5,250 (https://www.ftportfolios.com/Commentary/EconomicResearch/2021/12/13/sp-5,250---dow-40,000). Should equity prices continue to move higher in 2022 as our Economic team is forecasting, it should create a positive backdrop for equity oriented CEFs.

Another positive to start 2022 is that we are still in a very low interest rate environment. The low interest rate environment is helpful to the CEF structure as, I believe, with yields on traditional income investments at very low rates, more investors will be looking to the CEF structure to increase yield and cash flow from their portfolios. As of 12/31/2021, the average CEF had a distribution yield of 7.03%, which remains attractive to investors during this time of low interest rates (Source: Morningstar).

From my standpoint, the two primary differences as it relates to the backdrop for the CEF structure at the beginning of 2022 vs. the beginning of 2021 are the fact that average discounts to NAV are narrower now than the start of 2021 (see above) and the likelihood that both short- and long-term interest rates trend up this year. Indeed, our Economic team is forecasting the Federal Reserve (Fed) will raise rates two times this year (https://www.ftportfolios.com/Commentary/EconomicResearch/2022/1/3/welcome-to-2022-the-winds-of-change). Should interest rates trend up in 2022, it could put pressure on CEFs with long durations, and investors need to be aware of duration risk in their fixed-income holdings. However, I believe it is important to note that even if the Fed does raise rates two times (or even three times) and even if the 10-year note yield finishes 2022 at 2.00% as our Economic team is forecasting (https://www.ftportfolios.com/Commentary/EconomicResearch/2021/12/13/sp-5,250---dow-40,000), the overall level of interest rates will still be quite low, and therefore, I expect the demand for the CEF structure to remain quite strong in 2022.

As far as specific CEF categories, I believe the backdrop remains most favorable for U.S. equity CEFs, senior loan CEFs, and limited-duration multi-sector income CEFs. While I also believe municipal CEFs should be part of a diversified CEF portfolio as the yields they provide remain very attractive and I believe they provide important balance to the more credit sensitive senior loan and limited-duration multi-sector income CEFs, it is important to be aware of the interest rate sensitivity and duration risk many municipal CEFs have. While it is impossible to completely eliminate the interest rate risk in municipal CEFs, I do believe investors can potentially reduce the risk by increasing exposure to municipal term CEFs as well as non-levered municipal CEFs.

Source for CEF performance: Morningstar. All performance is based on share price total return.

Past performance is not a guarantee of future results.