CLOSED-END FUND REVIEW

FIRST QUARTER 2022

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FIRST QUARTER 2022 OVERVIEW

After a year in which the average closed-end fund (CEF) returned an impressive +16.32% (https://www.ftportfolios.com/Commentary/Insights/2022/1/19/fourth-quarter-2021), many CEFs struggled during the first quarter of 2022. Indeed, the first quarter of 2022 was a challenging one for the equity and credit markets as well as for the CEF structure. Rising short- and long-term interest rates coupled with geopolitical concerns helped contribute to a difficult quarter for many asset classes in 1Q22. The total return for the average CEF was -6.99% for the quarter. It was a broad decline as equity CEFs returned -0.45%, fixed-income CEFs returned -10.51%, municipal CEFs returned -13.27% and taxable fixed-income CEFs returned -8.39%. It was a challenge to identify categories of the CEF marketplace that posted positive total returns during the first quarter but Master Limited Partnership (MLP) CEFs returned +23.25% for the quarter and commodity CEFs were also positive for the quarter gaining +10.65%.

Equity CEFs were hurt by a -4.60% total return in the S&P 500 Index as well as by a -5.44% total return in the MSCI All-Country World Ex US Index. Rising interest rates across the curve during the 1Q22 put pressure on several key credit markets as indicated by the negative total returns for many fixed-income indices. Indeed, for the 1Q22 the ICE BofA Investment Grade Corporates Index total return was -7.74%, the ICE BofA Preferreds Index returned -6.72%, the ICE BofA 7-12 Yr. Municipal Index returned -6.29%, and the ICE BofA High-Yield Bond Index returned -4.50%. The best performing of the major bond indices was the S&P/LSTA Leveraged Loan Index, posting a negative return of just -0.10% for 1Q22. (Source: Bloomberg)

Sell-off Has Created Opportunities; Dollar Cost Averaging May be Approach to Take

While it can be challenging to endure difficult quarters for CEFs, ultimately I believe the weakness and widening of discounts may create many compelling long-term opportunities for investors. As is often the case, when both the equity and credit markets go through a period of enhanced volatility (as was the case during 1Q22), many CEFs may see their share prices sell-off more than their underlying net asset values (NAVs) which causes discounts to NAV to widen. This is precisely what occurred during the first quarter. Indeed, average discounts to NAV widened meaningfully during 1Q22 to -4.72% from the -2.30% at the end of 2021. Average discounts to NAV are now only slightly narrower than the long-term 10-year average of -5.05%. (Source: CEFdata.com)

Perhaps, the primary reason I believe investors should consider taking advantage of the recent weakness as well as the widening of discounts to NAV, is because our Economics Team still maintains a positive view on the U.S. economy and U.S. equity markets. Indeed, the Team is forecasting real GDP growth of around 2.5% in 2022, (https://www.ftportfolios.com/Commentary/EconomicResearch/2022/1/27/real-gdp-grew-at-a-6.9percent-annual-rate-in-q4) and year-end equity forecasts of 5,250 for the S&P 500 Index and 40,000 for the Dow Jones Industrial Average (https://www.ftportfolios.com/Commentary/EconomicResearch/2022/2/22/sticking-to-our-targets,-for-now). Should the U.S. economy indeed grow in the 2.5% range this year, and should equities begin to trend higher, I would expect both equity oriented CEFs as well as credit sensitive CEFs to benefit from that positive macro environment.

It is important to note that while many credit sensitive CEFs declined during the first quarter, defaults remain very low for both the high-yield and senior loan asset classes. In fact, according to Moody's Investors Service the trailing 12-month global speculative-grade default rate was only 2.0% at the end of February. This default rate is well below the long-term average of 4.1%. Default rates remain even lower for senior loans. Indeed, according to S&P, as of the end of February, the default rate for the S&P/LSTA Leveraged Loan Index was at a 10-year low of 0.19% by principal amount.

Given our positive macro outlook for the U.S. economy, low default environment and the fact that discounts to NAV for many CEFs have widened to levels which are near historical averages or wider than historical averages, I believe this is a compelling time to consider dollar cost averaging across many categories of the CEF marketplace that were hit hard during the first quarter including (but not limited to) U.S. equity CEFs, senior loan CEFs, limited duration CEFs and high-yield CEFs.

As it relates to municipal CEFs, the sharp increase in interest rates, use of leverage for most municipal CEFs and widening of discounts all helped contribute to a very difficult quarter for the category. Indeed, the sell-off in the first quarter has led to the average municipal CEF trading at a -4.83% discount to its NAV which is wider than its 10-year average of -3.61%. (Source: CEFdata.com) While duration risk remains elevated for leveraged municipal CEFs and there is the expectation of distribution reductions given the increase in borrowing cost associated with rising short-term rates, I believe valuations have become compelling for investors looking for high tax-free income potential for the long-duration portion of their municipal holdings. To that end, I think it is prudent to consider dollar cost averaging in the municipal CEF space over the next several months to take advantage of the wider than average discounts to NAV and compelling tax-free income. I also think investors should consider blending the longer duration leveraged municipal CEFs with municipal term CEFs, non-levered municipal CEFs and non-levered municipal exchange-traded funds to potentially reduce duration risk in a municipal portfolio.

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

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