CLOSED-END FUND REVIEW

SECOND QUARTER 2022

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SECOND QUARTER 2022 OVERVIEW

After a very difficult first quarter of 2022 for the equity and credit markets (https://www.ftportfolios.com/Commentary/Insights/2022/4/22/closed-end-fund-review---first-quarter-2022) as well as for many closed-end funds (CEFs), the second quarter of 2022 was also a challenging one. Concerns about the potential for a recession in 2022, elevated inflation data as well as rising short- and long-term interest rates contributed to a tough quarter for many asset classes in the second quarter. The total return for the average CEF was -11.2% for the quarter and -17.4% for the year, as of 6/30/22. Every single CEF category tracked by Morningstar posted negative total returns for the quarter and only the master limited partnership (MLP) category was positive year-to-date (YTD), as of 6/30/22, with a return of 11.9%. For the second quarter, equity CEFs returned -14.0%, fixed-income CEFs returned -9.4%, municipal CEFs returned -7.2%, and taxable fixed-income CEFs returned -11.1%.

Equity CEFs were hurt by a -16.1% return for the S&P 500 Index as well as by a -13.7% return for the MSCI All-Country World Ex USA Index in the second quarter. Elevated inflation data helped contribute to rising short- and long-term interest rates which put downward price pressure on several key credit markets during the second quarter. In fact, for the quarter the ICE BofA US High Yield Constrained Index returned -10.0%, the ICE BofA Fixed Rate Preferred Securities Index returned -7.7%, the ICE BofA US Corporate Index returned -6.7%, the S&P/LSTA Leveraged Loan Index returned -4.5% and the ICE BofA 7-12 Year US Municipal Securities Index returned -2.3%. (Source: Bloomberg)

Average Discounts to Net Asset Value (NAV) Continue to Widen

Reflecting the negative sentiment among many investors, average discounts to NAV widened to -5.7% at the end of the second quarter from the -4.7% level they ended the first quarter of 2022. Average discounts to NAV are now wider than the 10-year average discount to NAV of -5.2% and have more than doubled from -2.3% at which they ended 2021. Municipal CEFs ended the second quarter at an average discount to NAV of -5.0% which is wider than the 10-year average discount to NAV of -3.8%. Taxable fixed-income CEFs ended the second quarter at an average discount to NAV of -5.3% which is wider than the 10-year average discount to NAV of -4.1%. Equity CEFs ended the second quarter at an average discount to NAV -6.3% which is slightly narrower than the 10-year average discount to NAV of -6.8%. (Source: CEFdata.com) While in the short-term it can be frustrating for CEF investors to see average discounts to NAV continue to widen, I continue to firmly believe the widening of average discounts can potentially create attractive long-term total return opportunities for investors who dollar cost average and take advantage of the wider than average discounts that currently exist across several categories of the CEF marketplace.

Outlook for the Second Half of 2022

During challenging periods for most categories of CEFs, I think it is important to be reminded that CEFs are an investment structure and not an asset class. As an investment structure, CEFs invest in different asset classes. To that end, the primary reason 2022 has been so difficult for most CEFs is directly related to the data in the second paragraph of this commentary which illustrates the negative total returns many key equity and credit asset classes had in the second quarter (and have experienced YTD). The leverage that many CEFs employ magnifies the NAV losses a CEF will experience during down markets. While I maintain my view that dollar cost averaging and building a diversified portfolio of CEFs during periods when average discounts to NAV are wider than historical averages for many CEFs remains a compelling long-term strategy, ultimately, we likely won't see meaningful improvement in share price performance until the underlying equity and credit markets stabilize and perform better.

Part of the reason it has been such a tough year for the equity markets and credit sensitive fixed-income markets is because many investors fear the U.S. economy is in a recession or that one is imminent in 2022. However, our Economics team does not subscribe to this view and believes a recession is unlikely until late 2023 or 2024 (https://www.ftportfolios.com/Blogs/EconBlog/2022/6/27/were-not-already-in-a-recession). If the U.S. economy does indeed avoid a recession in 2022, I believe we could potentially see a rebound across equity CEFs as well as credit sensitive CEFs including senior loan CEFs, high-yield CEFs and multi-sector fixed-income CEFs which is why I believe this remains a compelling time to take advantage of the weakness many equity oriented and credit sensitive CEFs have experienced in 2022. It is also important to note that defaults for credit sensitive securities remain very low. Indeed, according to S&P Global Market Intelligence as of 5/31/22 the default rate for the S&P/LSTA Leveraged Loan Index was only 0.35% by issuer count.

As it relates to municipal CEFs, my views have not changed from the end of the first quarter. While duration risk remains elevated for leveraged municipal CEFs and there is the likelihood of distribution reductions given the increase in borrowing costs associated with rising short-term rates, valuations have become compelling for investors looking for high tax-free income for the long-duration portion of their municipal holdings. To that end, I think it is prudent to dollar cost average 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 blend the longer duration leveraged municipal CEFs with municipal term CEFs, non-levered municipal CEFs and non-levered municipal exchange traded funds (ETFs) to potentially reduce duration risk in a municipal portfolio.

Lastly, a brief comment as it relates to distribution rates for CEFs. According to Morningstar, as of 6/30/22 the average CEF had a distribution rate of 8.4%. With the Federal Reserve continuing to raise short-term interest rates and therefore borrowing cost rising for the majority of CEFs that employ the use of leverage, I think investors should expect distribution reductions for CEFs that invest in fixed-coupon securities including but not limited to municipal CEFs, high-yield CEFs and preferred CEFs. While there is the potential for distribution reductions for many CEFs during the second half of the year, I would expect distribution rates and the cash flow that CEFs provide to continue to remain quite attractive on an absolute and relative basis to other income-oriented investments. Senior loan CEFs are one category which could benefit from rising short-term rates given the floating-rate interest that senior loans provide.

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

Past performance is not a guarantee of future results.

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