CLOSED-END FUND REVIEW

THIRD QUARTER 2023

JEFF MARGOLIN
Senior Vice President
Closed-End Fund Analyst

THIRD QUARTER 2023 OVERVIEW

Following three consecutive quarters of positive total returns, the average closed-end fund (CEF) posted a negative total return for the third quarter of 2023. Indeed, the average CEF was lower by -3.98% for the quarter and is now up only +0.92% year-to-date as of 9/29/23 (YTD). Equity CEFs were lower by -3.58%, fixed-income CEFs were lower by -4.38%, municipal CEFs were lower by -9.38% and taxable fixed-income CEFs were lower by -0.60%, for the quarter. Equity CEFs are still up on average +3.35% YTD as are taxable fixed-income CEFs which are up +5.27% YTD. Municipal CEFs are lower YTD by an average of -8.08% as are fixed-income CEFs which are lower on average by -0.50%. (Source: Morningstar. All data is share price total return)

During the third quarter, equity CEFs were negatively impacted by the -3.27% total return in the S&P 500 Index. Many taxable fixed-income CEFs were adversely impacted by the negative total returns of several key fixed-income indices during the third quarter as both short and long-term interest rates moved higher. Indeed, the S&P U.S. Aggregate Bond Index was lower by -2.65% during the quarter and the iBoxx USD Liquid Investment Grade Index was lower by -4.28%. Municipal CEFs were negatively impacted by the -3.82% total return in the S&P National AMT-Free Muni Bond Index. One taxable fixed-income CEF category which was positive for the third quarter was senior loan CEFs which were up on average +4.04% and are now up +13.18% YTD. During the third quarter, senior loan CEFs benefitted from the +2.71% total return in the iBoxx USD Liquid Leveraged Loans Index. (Source: S&P Dow Jones Indices)

Average Discounts to Net Asset Value (NAV) Remain Wider Than Historical Averages

As the fourth quarter of 2023 begins, average discounts to NAV for many CEFs remain significantly wider than historical averages. The Federal Reserve (Fed) has yet to indicate that they are finished raising short-term interest rates for this current tightening cycle and from my standpoint, the potential of further short-term interest rate increases continues to create a headwind for many levered CEFs. It is my view the Fed continuing its tightening cycle or potentially continuing its tightening cycle, creates negative sentiment towards the CEF structure as some investors might be hesitant to buy CEFs, as they worry about the potential for leverage cost rising and further distribution reductions.

Average discounts to net asset value (NAV) remained quite wide and widened during the third quarter. The average CEF was at a -9.62% discount to NAV as of 9/29/23 which was wider than the -8.51% average discount they ended the second quarter. Average discounts to NAV continued to remain significantly wider than the -2.18% level from which they ended 2021 and wider than the 10-year average discount to NAV of -5.78%. Average discounts to NAV for equity CEFs ended 3Q23 at -10.16%, wider than the 10-year average discount of -7.07%. Average discounts to NAV for taxable bond CEFs ended 3Q23 at -6.13%, wider than the 10-year average discount of -4.81%. Among these broad categories, the widest discrepancy between current discounts to NAV relative to the long-term average remains in the municipal CEF category where average discounts to NAV ended 3Q23 at -12.93%, wider than the 10-year average discount of -4.86%. (Source: CEFData.com)

While I recognize many CEF investors are frustrated that average discounts to NAV remain wider than historical averages and have yet to narrow so far in 2023, I also continue to firmly believe that these wide average discounts to NAV can potentially create compelling long-term total return opportunities for investors who are disciplined, patient and build diversified CEF portfolios during this period of wide discounts.

Outlook for Remainder of 2023

As the fourth quarter commences, many of the CEF investors I speak with are frustrated with the mixed performance results experienced so far in 2023 and with the fact that average discounts to NAV have yet to narrow. From my standpoint, the biggest headwind for many CEFs continues to be the fact that the Federal Reserve has yet to signal they are finished raising short-term rates and the fact that long-term interest rates continue to trend higher. However, I also believe the Federal Reserve is likely closer to the end than the beginning of its tightening cycle and if they do indeed stop raising short-term rates during the fourth quarter or in early 2024 and if long-term rates begin to stabilize, the backdrop for many CEFs-particularly fixed-income CEFs- could begin to improve. Indeed, bonds have historically performed very well when the Federal Reserve stops raising short-term rates. Bond as represented by the Bloomberg U.S. Aggregate Bond Index have exhibited positive total returns 100% of the time over the 6-month, 1 year, 3 year and 5-year time periods following each of the last seven Fed tightening cycles. (Source: Morningstar Direct)

The solid historical performance that bonds have earned following the end of Fed tightening cycles coupled with the wider than average discounts to NAV available in the secondary market, are two of the primary reasons I continue to advocate that CEF investors remain patient, disciplined and dollar cost average across different categories of the CEF marketplace including but not limited to diversified equity CEFs, municipal CEFs, preferred CEFs, high yield CEF and senior loan CEFs. While there is always the potential for short-term volatility in the financial markets, I believe that CEF investors who focus on the long-term and take advantage of the attractive valuations and compelling distribution rates available in the secondary market, along with building diversified CEF portfolios, will be rewarded.

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