CLOSED-END FUND REVIEW

SECOND QUARTER 2023

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SECOND QUARTER 2023 OVERVIEW

Following a positive first quarter of 2023 which saw the average closed-end fund (CEF) post a total return of +3.4%, CEFs maintained their positive momentum in the second quarter and rose on average +1.6%. This represents the third consecutive quarter the average CEF posted a positive total return as the average CEF was up +6.4% in the fourth quarter of 2022. The average CEF is now up 5.1% year-to-date (YTD). Most broad categories of the CEF marketplace were positive for the second quarter with equity CEFs up +2.8%, taxable fixed-income CEFs up +2.7% and fixed-income CEFs up +1.0%. Municipal CEFs were lower for the second quarter by an average of -1.3% but remain positive YTD up on average 1.4%. (Source: Morningstar. All data is share price total return)

During the second quarter, equity CEFs benefitted from a +8.7% total return for the S&P 500 Index and a +2.7% total return for the MSCI ACWI ex USA Index. Taxable fixed-income CEFs benefitted from positive total returns from several key fixed-income indices for the second quarter including a +1.6% return for the ICE BofA US High Yield Constrained Index, a +3.2% return for the Morningstar LSTA US Leveraged Loan Index and a +1.2% return for the ICE BofA Fixed Rate Preferred Securities Index. Municipal CEFs were negatively impacted by the -0.6% total return for the ICE BofA 7-12 Year US Municipal Securities Index during the quarter. (Source: Bloomberg)

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

As the second half of 2023 commences, average discounts to NAV for many CEFs remain significantly wider than historical averages. The Federal Reserve (Fed) indicating they might continue to raise short-term interest rates during the second half of the year to help combat high inflation, continues to create a headwind for many leveraged CEFs and I believe is contributing to these wider than average discounts to NAV. I also believe 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 the cost to lever up funds rising.

Average discounts to NAV widened during the second quarter to end the quarter at an average discount of -8.5%. This was slightly wider than the -8.1% average discount they ended the first quarter of 2023. Average discounts to NAV continue to remain significantly wider than the -2.2% level from which they ended 2021 and are also wider than the 10-year average discount to NAV of -5.7%. Average discounts to NAV for equity CEFs ended 2Q23 at -9.3% and are wider than the 10-year average discount of -7.0%. Average discounts to NAV for taxable bond CEFs ended 2Q23 at -5.7% and are wider than the 10-year average discount of -4.9%. 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 2Q23 at -10.9% and are wider than the 10-year average discount of -4.7%. (Source: CEFData.com)

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

Similar Themes

From my standpoint, the last three consecutive quarters have had three similar themes for CEFs including:

1. Steadily improving performance for the broad equity and credit markets which has led to better performance for many CEFs.
2. The Fed continuing its tightening cycle in an effort to combat high inflation.
3. Wider than average discounts to NAV for many CEFs.

It is my view that the Fed is likely closer to the end than the beginning of its tightening cycle and if the Fed does indeed stop raising short-term interest rates (or signal its tightening cycle is over) during the second half of the year, it could have positive implications for many CEFs. I believe the backdrop for the CEF structure would improve and discounts could begin to narrow. Leverage cost would no longer be trending higher which would likely lead to more distribution stability for many CEFs, and I believe more investors will be willing to invest in CEFs if the Fed has indeed stopped raising short-term interest rates.

The potential for discounts to narrow from these wider than average levels, potential ending of the Fed's tightening cycle during the second half of 2023 and still very attractive distribution rates available in the secondary market (according to Morningstar, the average CEF had a distribution rate of 8.0% as of 6/30/23) are why I continue to believe investors should consider utilizing dollar cost averaging across different categories of the CEF marketplace including but not limited to diversified equity CEFs, preferred CEFs, municipal CEFs, below investment grade high-yield CEFs 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.

Past performance is not a guarantee of future results.