Closed-End Fund *Review*

FOURTH QUARTER 2017

Fourth Quarter and 2017 Overview

The average closed-end fund (CEF) managed a small gain of 0.18% during the fourth quarter of 2017. With this positive gain for the quarter, the average CEF earned a positive total return in each of the four quarters during 2017. It was a very strong year for the CEF marketplace with the average fund up 11.37% in 2017. This follows another solid year when the average CEF was up 8.59% for 2016. Gains in 2017 were broad based for the year, but the rise in global equity prices helped propel the average equity CEF to a particularly impressive positive return of 16.08%. Fixed-income CEFs benefited from relatively stable long-term interest rates and a low default environment for credit-sensitive securities. Taxable fixed-income CEFs were up on average 10.90% for the year while municipal CEFs were positive by 6.49%. (Source: Morningstar. All data is share price total return throughout this commentary.)

Average discounts to net asset value (NAV) narrowed during the year and ended 2017 at 4.84%. This continues the trend which has lasted several years. For example, average discounts ended 2016 at 6.34% and ended 2015 at 7.86%. As average discounts to NAV have narrowed, going forward I expect more of the potential total return earned by a portfolio of CEFs will come from the distributions they provide (as opposed to meaningful capital appreciation) since there is less room for discount contraction to boost total returns. See below for my 5 CEF Investment Themes for 2018. (Source: Morningstar)

5 CEF Investment Themes for 2018

1. **Focus on equity income CEFs: Both U.S. and Global Equity:** In last year's outlook commentary (https://www.ftportfolios.com/Commentary/Insights/2017/1/27/fourth-quarter-2016), you'll recall two of my three favored categories for 2017 were U.S. equity income CEFs and global equity CEFs. Fueled by rising equity prices (both domestic and international), these two categories did not disappoint in 2017 as U.S. general equity CEFs were positive 16.48% and global equity CEFs were up 26.89% for the year. (Source: Morningstar) With our Economics team forecasting higher U.S. equity prices in 2018 and U.S. GDP growth of approximately 3%, coupled with our chief market strategist continuing to find value in Europe as well as expecting S&P 500 earnings growth of approximately 10% in 2018, I continue to favor both U.S. and global equity CEFs. Indeed, I believe U.S. and global equity CEFs represent two of the categories of the CEF marketplace which I expect to deliver high income but also could potentially provide capital appreciation in 2018.
2. **Focus on shorter-duration fixed-income CEFs:** The third category I favored for 2017 was senior loan CEFs. While some may have been disappointed with the average return of 3.97% delivered in 2017, as 2018 begins it is my view that it is still important to focus on shorter duration fixed-income CEFs including both senior loan and limited duration funds. Our Economics team is forecasting 3 hikes in the federal funds rate in 2018. Couple that with expectations for faster global GDP growth, as well as several central banks reducing quantitative easing measures, and it is likely 2018 could be a year when both short- and long-term rates trend higher, in my opinion. This is precisely why I think, as it relates to fixed-income CEFs, investors should focus on shorter-duration funds or term trust CEFs which still provide attractive income but also help reduce interest rate risk.

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3. **Lighten up on long-duration, leveraged fixed-income CEFs:** As discussed in bullet point 2, our Economics team is forecasting 3 increases in the federal funds rate in 2018. They are also forecasting a year-end rate of 3% for the ten-year U.S. Treasury. If faster U.S. GDP growth as well as faster global GDP growth helps to propel both short- and long-term interest rates higher in 2018, it could make for a challenging environment for leveraged, long-duration fixed-income CEFs. This is why I prefer short-duration fixed-income CEFs as well as term trust CEFs for the majority of a CEF investor's fixed-income exposure in 2018.
4. **Seek out CEFs that are either non-leveraged or have locked in some or all of their leverage cost:** While the majority of CEFs employ the use of leverage with the goal of enhancing income and NAV returns, there is a sliver of the CEF marketplace of non-levered funds and ones which have locked in some or all of their leverage cost. As the Federal Reserve raises the federal funds rate, it has the impact of increasing borrowing cost for the majority of levered funds. While I am not opposed to owning CEFs that utilize leverage (particularly equity income or senior loan CEFs), I do think it will serve investors well in 2018 to increase exposure to non-levered funds or funds that have locked in some or all of their leverage cost if, as expected, the Federal Reserve raises short-term rates.
5. **As average discounts to NAV have narrowed, expect more of the potential total return a diversified portfolio of CEFs provides to come from the distributions:** While I discuss this above, it is worth repeating. The trend in 2015, 2016 and 2017 has been for an overall narrowing of average discounts to NAV. Therefore, as 2018 begins with average discounts to NAV of 4.84%, it likely means more of the potential total return a diversified portfolio of CEFs provides will come from the distributions as opposed to meaningful capital appreciation (as there is less room for discount contraction to boost total returns). This doesn't mean average discounts can't or won't narrow more in 2018 or that investors cannot earn capital appreciation, but rather in my view it is simply less likely for significant discount narrowing to increase capital appreciation. From my standpoint, equity CEFs (both U.S. and global) offer the best potential for capital appreciation as the underlying asset class of equities provides the best opportunity for growth in 2018.

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