Closed-End Fund *Review*

THIRD QUARTER 2018

Third Quarter 2018 Overview

The average closed-end fund (CEF) managed a slight gain for the third quarter—up 0.51%, but remains lower on average by 2.12% year-to-date (YTD). Equity CEFs led the way in the quarter with an average gain of 1.52%. U.S. general equity funds were particularly strong, with the average fund up 4.07% for the quarter as they benefitted from the 7.71% total return gain the S&P 500 Index posted during the quarter. Taxable fixed-income CEFs were up on average 1.30% during the quarter. Municipal CEFs continue to be hurt by the rise in both short- and long-term interest rates and finished the quarter with an average loss of 1.30%. The average municipal CEF is now lower by 4.84% YTD. Average discounts to net asset value (NAV) widened during the quarter to 6.57% from the 5.93% average which they had ended the second quarter with. They remain wider than the 4.84% discount the average CEF had as of the end of 2017. (Source: Morningstar and Bloomberg. All data is share price total return.)

U.S. Equity CEFs Excel, Senior Loan CEFs Frustrate

As detailed above, U.S. general equity CEFs posted a very solid quarter as they benefitted from the rise in U.S. equity prices. U.S. equity CEFs continue to be a category of the CEF marketplace that I favor. Valuations among U.S. general equity CEFs remain compelling with the average fund at a 7.60% discount to NAV as of the end of the third quarter. Our Economics team maintains its 3,100 year-end target price for the S&P 500 and the earnings growth rate for U.S. equities remains strong. Indeed, according to Bloomberg, as of 8/10/18 the S&P 500 Index is forecasted to have 23.8% earnings growth in 2018 and 11.3% in 2019.

While U.S. equity CEFs continue to perform well and benefit from the strong U.S. earnings environment and strong U.S. economy, senior loan CEFs have seen their share prices underperform underlying NAV returns, causing average discounts to NAV to widen meaningfully. This has understandably caused frustration among shareholders in senior loan CEFs.

The primary reason I continue to advocate owning senior loan CEFs specifically is because the backdrop for the underlying asset class continues to be a strong one. Indeed, according to S&P, the month of September was the third consecutive month there were no defaults among the S&P/LSTA Leveraged Loan Index. As a result of this, the default rate for senior loans fell to a 10-month low of 1.81% in September. This is down from 1.99% in August. Moreover, according to S&P, loan portfolio managers are now forecasting the senior loan default rate will stay below the long-term average of 3% and end next year (2019) at 2.54%.

Not only is the backdrop for senior loans favorable from a credit standpoint (low defaults) but it continues to be one that has minimal duration risk. Furthermore, the Federal Reserve (Fed) continues to raise short-term rates which creates a positive environment for floating-rate asset classes such as senior loans. Despite this positive environment for senior loans, average discounts to NAV continue to widen for senior loan CEFs as share prices decline or increase less than underlying NAVs.

For example, in the third quarter of 2018 the average senior loan CEF was up 0.78% on a share price total return basis. This performance meaningfully underperformed the 2.14% NAV total return performance for the average senior loan CEF. This is the reason the average senior loan CEF ended the 3Q at a wide 7.4% discount to its NAV. This average discount to NAV is more than double the 3.31% average discount on 12/31/16 and also wider than the average discount to NAV of 5.23% as of 12/31/17.

These wider than average discounts to NAV, coupled with solid fundamentals for senior loans, continue to attract me to the senior loan CEF category. Nevertheless, the obvious question is "Despite this positive backdrop, why have senior loan CEFs underperformed underlying NAVs and not had better share price performance in this

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environment?" While it is difficult to know the precise answer to this question, I do believe it has a lot to do with the disappointment of investors of senior loan CEFs in that their distributions have not been increased meaningfully over the past year as the Fed continues to raise rates. Indeed, several senior loan CEFs even decreased distributions this year and last year as refinancing within the senior loan asset class has reduced income. The distribution reductions are in contrast to the many distribution increases senior loan CEFs had during the last tightening cycle in 2004-2006. The good news, from my perspective, is that toward the end of the third quarter there were several senior loan CEFs that did indeed finally increase their distribution. If we do continue to see more senior loan CEFs increase distributions throughout the rest of 2018 and into 2019, I think it could be a catalyst to get investors interested again in senior loan CEFs.

The discount widening and CEF share price underperformance relative to underlying senior loan CEF NAV performance has been frustrating during a period when the underlying asset class of senior loans continues to perform well and the environment and outlook remains a positive one. While this has been frustrating, I do believe "price discovery" will eventually take hold on the part of market participants/investors and we will see investors recognize the value in senior loan CEFs and buyers will step in.

Outlook for Rest of 2018

As I write this commentary in early October, long-term interest rates continue to rise and equities are going through a minor correction. This has caused average discounts to NAV to widen further, creating even more value and opportunity for long-term CEF investors. With our Economics team continuing to forecast a strong U.S. economy for the next 12-months (3%+ U.S. GDP growth), higher short- and long-term interest rates and higher U.S. equity prices, I believe the core of a CEF portfolio should consist of U.S. equity, senior loan and limited duration CEFs. The sell-off in global equities and long-term bonds in early October has also led to many opportunities for CEF investors to add additional satellite positions in compelling areas including European equity CEFs, Preferred CEFs with an emphasis on fixed-to-float preferreds and MLP CEFs.

As it relates specifically to municipal CEFs, while I remain concerned about duration risk as well as the likelihood of further distribution reductions, I also recognize the average discount to NAV has widened to a very compelling 9.13% for the average municipal CEF. To that end, I think the best approach for municipal CEFs is to slowly dollar cost average into the space over the next 1-4 quarters to take advantage of the recent weakness and discount widening. However, I don't want to get too aggressive just yet for municipal CEFs in case there is tax-loss selling toward the end of the fourth quarter and potentially further downside weakness in early 2019 should rates continue to trend higher. I think municipal CEF investors will be well served to "keep some power dry" and be prepared to add to positions during the first half of 2019.

As the fourth quarter progresses there is the potential for some enhanced volatility due to tax related selling in individual CEFs or categories of CEFs (such as municipal CEFs) that are lower for the year. Tax-loss selling is when investors sell securities to realize losses for tax purposes in order to offset gains within their portfolios. Should we indeed see this volatility and discount widening in CEFs as a result of tax related selling, I expect it to be short lived as historically in January and February of the New Year investors take advantage of the prior quarter's weakness and scoop up the value that was created as a result of the seasonal tax-related weakness.