CLOSED-END FUND REVIEW

FOURTH QUARTER 2019

JEFF MARGOLIN

Senior Vice President

Closed-End Fund Analyst

FOURTH QUARTER AND 2019 OVERVIEW

The fourth quarter was another solid one for closed-end funds (CEFs). It capped a very strong year for the secondary CEF marketplace in which CEFs gained, on average, every quarter of the year. The average CEF was up 3.7% during the fourth quarter. Equity CEFs led the way with an average gain of 5.8% as Fixed-Income CEFs rose by 2.5%. Taxable Fixed-Income funds increased 3.7%, while Municipal CEFs were positive by 1.1% for the quarter. (Source: Morningstar. All data is share price total return).

With an average gain of 24.6% for the year, 2019 was the best year for the secondary market of CEFs since 2009 when the average fund increased 39.0%. 2019 was a broad-based rally as Equity, Taxable-Fixed-Income and Municipal CEFs all posted double digit gains. Equity CEFs were up on average 26.9% for the year. Taxable Fixed-Income CEFs were positive on average by 23.9% and Municipal CEFs gained an average of 19.7% (Morningstar).

There were several factors that contributed to the average gains of 24.6%. Equity CEFs benefited from a global equity rally as the S&P 500 Index gained 31.5% in 2019, while the MSCI All-Country World Ex US Index gained 21.5%. Key fixed-income indices (both below investment-grade and investment-grade) all posted strong returns in 2019, which helped boost the performance of many fixed-income CEFs. Indeed, the BofAML High-Yield Bond Index was up 14.4% in 2019 and the S&P/LSTA Leveraged Loan Index gained 8.6%. The BofAML Preferred Index gained 17.7% in 2019, the BofAML Investment Grade Corporate Index added 14.2% and the BofAML 7-12 Year Municipal Index increased 7.8%. (Source: Bloomberg. All index data is total returns.)

In addition to the broad-based strength of many key equity and fixed-income indices, which clearly helped the secondary market of CEFs, was also the fact that average discounts to net asset values (NAVs) narrowed sharply during the year. This discount narrowing helped contribute to the very strong share price total returns earned in 2019. The year began with average discounts to NAVs at a very wide and attractive 9.7%, but they narrowed throughout the year and ended 2019 at 3.8% (Morningstar). The theme of discount narrowing was discussed throughout 2019, including in the First Quarter 2019 CEF Commentary (https://www.ftportfolios.com/Commentary/Insights/2019/4/24/first-quarter-2019) where I outlined the view that the dovish tone expressed by the Federal Reserve (Fed) creates a favorable backdrop for the CEF structure and that discounts would likely continue to narrow throughout 2019.

OUTLOOK FOR 2020

From my viewpoint, as 2020 commences, the backdrop of a strong U.S. economy, coupled with a the Fed that is likely on "hold" for the year, creates a solid environment for diversified CEF investors. First Trust's Economics Team is forecasting the U.S. economy will grow at 2.5%-3.0% in 2020, the S&P 500 Index will hit 3650 by the end of 2020 and the Fed will likely not adjust the federal funds rate. With that as a macro forecast, I continue to advocate that investors have exposure to U.S. equity CEFs. With average discounts to NAV of 8.32%, valuations remain attractive for U.S. equity CEFs (Morningstar). Moreover, as of 12/31/19, the Bloomberg consensus 2020 estimate for EPS growth for the S&P 500 is a strong 9.0%. With average distribution yields of 8.1% (Morningstar), U.S. equity CEFs are poised to provide attractive income but also the potential for growth.

On the fixed-income side of the equation, I continue to be a big advocate of blending asset classes that have different risk characteristics as a tool to potentially reduce overall volatility in a portfolio, create balance but also earn an attractive blended income stream. To that end, I am making no change to the thesis that along with U.S. equity CEFs, senior loan CEFs, limited-duration multi-sector fixed-income CEFs and municipal CEFs should make up the core of a diversified CEF portfolio. I also believe Master Limited Partnerships (MLPs), preferreds and CEFs with exposure to

European blue-chip stocks are attractive satellite positions in a diversified CEF portfolio and can provide compelling income and diversification. Note that the average preferred CEF ended 2019 at a premium to NAV 3.0%, and therefore it is important to pick your spots carefully when selecting individual preferred CEFs (Morningstar).

Coming off a year when senior loan CEFs increased 18.0% and limited-duration CEFs were up 22.8%, I believe the backdrop of a strong U.S. economy should continue to be one which keeps defaults below historical averages for the senior loan asset class. (Morningstar). According to S&P, the S&P/LSTA Leveraged Loan Index default rate ended the year at 1.39%, which remains well below the long-term average of 2.9%. A low default rate, average discounts to NAV of 4.2%, low duration risk and an average distribution yield of 8.5% continue to support the thesis of owning senior loan CEFs. However, senior loans are a credit-sensitive asset class and therefore, while senior loan CEFs have minimal duration risk, they do have credit risk. This is precisely the reason I strongly advocate CEF investors balance the credit risk senior loan CEFs have with exposure to high quality, investment-grade municipal CEFs.

Municipal CEFs had a stellar 2019, rising 19.7%. As 2020 commences, the backdrop of a Fed on hold and significant retail investor demand for municipal bonds is a solid one for municipal CEFs. Tax-free average distribution yields of 4.0% (Morningstar) remain a strong selling point for investors who are seeking attractive tax-free income. The main concern I have regarding municipal CEFs continues to be the duration risk many municipal CEFs have. This is the reason I firmly believe it is important to blend municipal CEFs with fixed-income categories that have minimal to limited duration risk, including senior loan CEFs and limited-duration multi-sector fixed-income CEFs. I believe blending these fixed-income categories is a way to create an appropriate balance in a portfolio as well as earn an attractive income stream.

Lastly, as 2020 begins with average discounts to NAV of 3.8%, I think CEF investors should expect that 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 2020 or that investors cannot earn capital appreciation, but rather in my view it is simply less likely for significant discount narrowing to increase total returns.

First Trust

First Trust Advisors L.P.
1.630.915.6784
www.ftportfolios.com