CLOSED-END FUND REVIEW

FIRST QUARTER 2020

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FIRST QUARTER 2020 OVERVIEW

It was an extremely challenging quarter for the closed-end fund (CEF) marketplace. The average fund was lower by 23.46%. All the broad CEF categories tracked by Morningstar were lower for the quarter. The average equity CEF was lower by 36.24%, taxable fixed-income funds were lower by 23.02%, all fixed-income funds were down by 15.77% and municipal CEFs declined on average 7.25% (source: Morningstar. All performance is based on share price total return).

Concerns about the Coronavirus and the significant negative impact it will have on the global economy led to a severe sell-off across most equity and credit markets.

- The S&P 500 Index declined 19.60% during the first quarter.
- The ICE BofA High-Yield Bond Index declined 13.13%.
- The S&P/LSTA Leveraged Loan Index dropped 13.05%.
- The ICE BofA Preferreds Index was lower by 8.83%.
- The ICE BofA 7-12 Yr Municipal Index declined 0.78%.

The negative performance across many key equity and fixed-income asset classes, the use of leverage by many CEFs and discount widening all helped to contribute to the very challenging quarter for CEFs (source: Bloomberg, as of 3/31/20. Index performance is based on total returns).

Average Discounts to NAV Widen

Average discounts to net asset value (NAV) widened during the first quarter from 3.78% to start the year to 8.82% on 3/31/2020. To help illustrate how volatile the CEF structure was during the first quarter, we note that on 2/20/2020 average discounts to NAV were only 2.59%, but by 3/18/2020 they had widened to 20.42% (Morningstar).

While this is not the first time the CEF structure has exhibited average discounts to NAVs hitting north of 20%, the speed at which discounts widened was striking. Indeed, on March 17th average discounts to NAV were 11.27%. On Wednesday March 18th discounts widened to over 20% (20.42% to be exact). In one day, average discounts to NAV widened almost 10% to over 20%. I looked at the Morningstar database going back 20 years and could not find a day other than March 18th when average discounts to NAV widened by nearly 10% in one day. This helps illustrate just how quick and severe this sell-off has been (Morningstar).

The last time average discounts to NAV were north of 20% was on 11/21/2008, when they were 21.26%. The widest they got during the 2008-2009 financial crisis was 26.82% on 10/10/2008. To help put these numbers in perspective, the average discount to NAV for all CEFs from 1/3/2000—3/31/2020 is 4.65% (Morningstar).

Expect Distribution Reductions

As of 3/31/2020, the average distribution yield for all CEFs was 11.31%. Equity CEFs had an average distribution yield of 18.89%, taxable fixed-income funds were 10.54%, and municipal income funds were at 4.32% (Morningstar). Given the significant NAV declines many CEFs experienced during the first quarter and the fact that many CEFs have had to reduce the amount of leverage they have in order to maintain the appropriate asset coverage ratios, I expect many CEFs will be reducing their distributions this year.

Looking Back at 2008-2009 Financial Crisis

While there is no precise period in history that is comparable to the current period we are going through—which includes a health care crisis, an economic crisis and an oil price war—I do believe it is worthwhile to look back at the 2008-2009 financial crisis to see how CEFs performed coming out of that period. 2008-2009 was very challenging and similar to the current environment in that discounts to NAV widened to over 20%, there was a significant widening of credit spreads and a meaningful equity bear market.

To that end, CEFs performed very well in 2009. The average CEF was higher in 2009 by 39.02%. Equity CEFs were up 42.05%, taxable fixed-income CEFs were up 49.19% and municipal CEFs were up 30.27%. The rally continued into 2010 with the average CEF up 11.96%. Discounts to NAV also narrowed dramatically from 26.82% on October 10, 2008 to only 3.69% by August 10, 2009 (Morningstar).

On January 1, 2009, when we were in the middle of a financial crisis and average discounts to NAV were 12.96%, corporate defaults were increasing, equities were selling off and the unemployment rate was rising, it was difficult to imagine that by the summer of that year the average discount would only be 3.69% and by the end of the year the average CEF would be up 39.02% but that is what occurred (Morningstar). Clearly, price discovery in the CEF marketplace took place in 2009 as the broader economy, equity and credit markets began to recover. Investors did turn to the CEF structure to participate in that recovery.

To be clear, I am not saying that the performance of the secondary market for CEFs is going to mirror exactly what happened after the 2008-2009 financial crisis. However, I am stating the data which shows that once the broader equity and credit markets began to recover, price discovery in the secondary market for CEFs did take hold in a meaningful way and investors took advantage of the wide discounts to NAV, values in both equity and credit markets and bought CEFs, which helped lead to very solid total returns in 2009 and 2010.

It is also worth noting that coming out of the financial crisis in 2009, short-term interest rates and therefore leverage cost for many funds, were very low and created a good backdrop for levered CEFs. The Federal Reserve will also likely be on hold for a considerable period coming out of this crisis which should also create a good backdrop for levered CEFs when the economy begins to recover.

Game Plan for CEF Investors

We are clearly now in a period of extreme volatility in the equity and credit markets that will likely continue until the economy begins to open and social restrictions are eased. I do not know when we will begin to see the broader equity and credit markets stabilize for more than a couple of weeks or when the economy will begin to open. I don't think anyone knows precisely when that will happen. However, I do believe that once that process starts and the economy is again open for business, social restrictions are eased, the VIX declines and credit spreads narrow, investors will again—as they have before as in 2009—take advantage of the wide and attractive discounts to NAV in the secondary market and we could see performance improve for many categories of the CEF marketplace.

While we have seen glimpses of that as the second quarter gets underway, from my perspective I believe CEF investors need to be patient as the equity and credit markets are still very volatile and will likely contine to be volatile until the economy begins to re-open and social restrictions are eased.

I believe the best approach for CEF investors is to dollar-cost average over the coming days and weeks across many different categories of the CEF marketplace to take advantage of the broad weakness, wider than average discounts to NAV and opportunities that I believe are present in many categories including equity CEFs, credit sensitive taxable fixed-income CEFs (including senior loan CEFs, limited duration CEFs, multi-sector fixed-income CEFs as well as higher-quality municipal CEFs and preferred income CEFs).

During the first quarter, we received many inquiries related to the master limited partnership (MLP) category. Given the dramatic price decline in oil, MLP CEFs were hit particularly hard during the quarter and many MLP CEFs had significant distribution reductions. From my standpoint, until the price of oil rebounds and global demand picks up, I expect MLP CEFs will continue to be a very volatile space and each investor must decide if he/she can handle that volatility. I do believe there are pipelines and other energy infrastructure entities that have valuable assets and still have the potential to generate attractive cash flows, but until we see the price of oil rebound and global demand accelerate, I think it is going to be a very volatile category.

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