CLOSED-END FUND REVIEW

FIRST QUARTER 2023

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FIRST QUARTER 2023 OVERVIEW

After a positive fourth quarter of 2022 which saw the average closed-end fund (CEF) post a total return of +6.4%, CEFs continued their positive momentum in 1Q23 and rose on average +3.4%. It was a broad rally with total returns of +4.2% for equity CEFs, +3.0% for fixed-income CEFs, +2.7% for municipal CEFs, and +3.2% for taxable fixed-income CEFs. Every category tracked by Morningstar was positive during 1Q23 except for California state specific municipal CEFs (-1.7%) and preferred CEFs (-2.7%). (Source: Morningstar. All data is share price total return)

Equity CEFs benefitted from a +7.5% total return for the S&P 500 Index and a +7.0% total return from the MSCI ACWI ex USA Index for 1Q23. Fixed-income CEFs benefitted from positive total returns from several key fixed-income indices for 1Q23 including a +3.7% for the ICE BofA High Yield Bond Index, a +3.3% return for the Morningstar® LSTA® US Leveraged Loan Index, a +2.6% return for the ICE BofA 7-12 Year US Municipal Securities Index, a +3.0% return for the Bloomberg US Aggregate Bond Index and a +3.0% return for the Bloomberg Global-Aggregate Index. (Source: Bloomberg)

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

Average discounts to NAV stayed stubbornly wide during 1Q23 and ended the quarter at -8.1%. They also ended 4Q22 at -8.1% and remain wider than the 10-year average discount to NAV of -5.6%. Discounts to NAV continue to remain significantly higher than the -2.2% level from which they ended 2021. Average discounts to NAV for equity CEFs ended 1Q23 at -8.5% and are wider than the 10-year average discount of -6.9%. Average discounts to NAV for taxable bond CEFs ended 1Q23 at -6.7% and are wider than the 10-year average discount of -4.7%. Average discounts to NAV for municipal CEFs ended 1Q23 at -9.2% and are wider than the 10-year average discount of -4.6%. (Source: CEFData.com)

While it can be frustrating for CEF investors to see average discounts to NAV remain wider than historical averages, 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 dollar cost average.

Discounts to Narrow?

While it has been rewarding to see performance for many CEFs improve the past two quarters as the equity and credit markets have performed better, many CEF investors continue to be frustrated with the wide discounts to NAV in the secondary market. As I discussed last quarter, the Federal Reserve's (Fed) aggressive tightening cycle, which began in 2022 and has continued this year, has been a major headwind for the CEF structure. It has lifted borrowing cost for leveraged CEFs, which has led to many distribution reductions and helped contribute to the wide discounts to NAV. Furthermore, it is my contention that the Fed aggressively raising short-term rates has created negative sentiment towards the CEF structure which has caused many investors to stay away from the structure as they are concerned about the negative impact of higher borrowing cost.

The good news, from my perspective, is that as the second quarter commences, we are likely closer to the end than the beginning of this aggressive Fed tightening cycle. Should the Fed stop raising short-term interest rates this quarter, I believe the headwind of consistently rising borrowing cost will abate which should lead to a better backdrop for the CEF structure. This, in turn, could begin the process of discounts narrowing as demand increases and sentiment improves for many CEFs. The potential narrowing of discounts to NAV coupled with the still attractive distribution rates available in the secondary market (according to Morningstar, the average CEF had a distribution rate of 8.0% as of 3/31/23), are why I 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.

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