CLOSED-END FUND REVIEW

Jeff Margolin | Senior Vice President, Closed-End Fund Analyst

SECOND QUARTER 2024 OVERVIEW

Following the very strong first quarter of 2024 which saw the average closed-end fund (CEF) return +5.86%, CEFs continued their solid momentum during the second quarter. Indeed, the average CEF returned +2.69% for the second quarter and is now up on average +8.71% year-to-date (YTD) through the end of the second quarter. Similar to the first quarter, it was a broad rally with equity CEFs up +2.82%, taxable fixed-income CEFs up +2.24% and municipal CEFs increasing +2.81%. With the exception of the emerging market equity category (lower by -0.96%) and the real estate category (lower by -0.33%), every category tracked by Morningstar posted a positive total return for the second quarter of 2024. For the second consecutive quarter, master limited partnership (MLP) CEFs were the best performing category returning on average +8.93%. (Source: Morningstar. All data is share price total return)

During the second quarter, equity CEFs benefitted from the +4.28% gain in the S&P 500 and the +1.17% gain in the MSCI ACWI ex USA Index. Taxable fixed-income CEFs benefitted from strong returns in several key fixed income indices including the +1.09% return in the ICE BofA US High Yield Constrained Index and the +1.90% return in the Morningstar LSTA Leveraged Loan Index. MLP CEFs benefited from the +3.28% gain in the Alerian MLP Index. (Source: Bloomberg)

Discounts to Net Asset Value continue to narrow

During the second quarter of 2024, average discounts to net asset value (NAV) for CEFs continued to narrow for many CEFs. Indeed, average discounts NAV narrowed during the second quarter to -6.47% from the -7.60% level they ended on 3/28/2024. They ended 2023 at -9.66%. Despite the noticeable narrowing of discounts to NAV so far YTD, average discounts still remain wider than the 10-year average discount of -6.00%. (Source: CEFData.com) While it remains encouraging to see average discounts to NAV continue to narrow, average discounts remain wider than historical averages and I reiterate my view that these wide average discounts to NAV can potentially create compelling long-term total return opportunities for investors who are patient and take advantage of these discounts to NAV. It is my view that if the Federal Reserve (Fed) is finished raising short-term interest rates for this cycle and potentially reduces short-term interest rates in 2024 or during the first half of 2025, I believe we could continue to see average discounts to NAV narrow meaningfully in 2024 and 2025, particularly in longer duration fixed income CEFs, including municipal and preferred CEFs.

Average discounts to NAV for equity CEFs narrowed during 2Q24 to -8.47% from the -9.49% level they ended 1Q24. Average discounts to NAV for equity CEFs are wider than the 10-year average discount of -7.35%. Average discounts to NAV for taxable bond CEFs narrowed during 2Q24 to -2.37% from the -3.19% level they ended 1Q24. Average discounts to NAV for taxable bond CEFs are narrower than the 10-year average discount of -4.92%. Among these broad categories, the widest discrepancy between current discounts to NAV relative to the long-term average remains in the municipal CEF category where average discounts to NAV ended 2Q24 at -8.26%. While average discounts for municipal CEFs did narrow during 2Q24 from the -9.87% level they ended 1Q24, they still remain far wider than the 10-year average discount of -5.19%. (Source: CEFData.com)

Outlook for second half of 2024

As the second half of 2024 commences, it is my view that the backdrop for diversified CEF investors remains a good one as valuations remain compelling (average CEF continues to trade at wider than average historical discounts), the Fed could begin reducing short-term interest rates this year or during the first half of 2025 which would lower borrowing cost for levered CEFs, the U.S. economy continues to grow and distribution rates remain attractive. Indeed, as of the end of the 2Q the average CEF had a distribution rate of 8.38%. The average distribution rate for equity CEFs was 8.55%, taxable fixed-income CEFs average was 10.04% and the average municipal CEF distribution rate was 5.63%. (Source: Morningstar).

As it relates to distributions and CEFs, it is important for investors to know that the composition of a distribution from a CEF can consist of different components such as net investment income earned by a fund, short-term or long-term capital gains and return of capital (ROC). I note this because there has recently been a trend of CEFs increasing their distributions but funding the increases by returning capital. Indeed, according to the Investment Company Institute (ICI) during 2022 of the $16.7 billion in total CEF distributions, 72% were classified as income distributions (Income distributions are paid from interest and dividends that the fund earns on its investments in securities), 17% was a ROC and 11% was capital gains distributions. However, in 2023 the percent of ROC increased. Indeed, according to the Investment Company Institute (ICI) during 2023 of the $16.3 billion in total CEF distributions, 67% were classified as income distributions, 20% was a ROC and 13% was capital gains distributions. We won't receive the ICI 2024 data until the spring of 2025 but if the trend continues I would not at all be surprised if the 20% ROC number we saw in 2023 continues to trend higher in 2024.

As I stated last quarter, it has been very encouraging to see CEF investors who were dollar cost averaging during the challenging periods of 2022 and 2023 benefit from the discipline of having purchased CEFs when average discounts to NAV were high single and low double-digit levels as average total return performance for many CEFs have been quite strong during 4Q23, 1Q24 and 2Q24. I continue to advocate CEF investors to remain disciplined and to take advantage of the wide average discounts to NAV by dollar cost averaging across several different categories of the CEF marketplace. I continue to believe valuations remain compelling for many CEFs as many trade at discounts to NAV which are wider than their historical averages. Moreover, if the Fed begins cutting interest rates later this year or during the first half of 2025, I believe the backdrop for many CEFs- particularly leveraged fixed income CEFs including municipal and preferred CEFs- would continue to improve throughout 2024/2025 and discounts will likely continue to narrow. I continue to believe this remains a compelling time for CEF investors to dollar cost average across many categories including but not limited to diversified equity CEFs, municipal CEFs, preferred CEFs, and high yield CEFs.

Source for CEF performance: Morningstar. All performance is based on share price total return.

Past performance is not a guarantee of future results.