Wells Fargo Advisors CEF/ETP Analysis

Closed-end Funds

Return of Capital

Mariana F. Bush, CFA
Head of CEF/ETP Research

Adam Shah, CFA
Research Analyst

Joe Hussain
Research Analyst

Dival Vroom
Research Analyst

August 14, 2017

Summary

» *A closed-end fund returns capital to shareholders when its distribution is sourced from anything other than the underlying portfolio's net investment income or realized capital gains.*

» *Section 19(a) of the Investment Company Act of 1940 requires closed-end funds to provide a written estimate of the tax composition of each declared distribution, if such distribution is sourced from anything other than income. Shareholders should consider these estimates incidentally because they may deviate — sometimes quite substantially — from the actual tax composition on Form 1099-DIV. Instead, we believe investors should focus on the long-term trend of the actual tax composition on the Form 1099-DIV tax documents.*

» *Return of capital is not necessarily undesirable, especially when the portfolio's total return covers its distribution, and the return of capital simply arises as a result of accounting rules. We consider this a constructive return of capital, as opposed to destructive return of capital where a fund distributes more than it achieves in NAV total return.*

Overview

Distributions that are classified as return of capital can be confusing for closed-end fund shareholders. Some investors view the return of capital as negative, which may or may not be justified. In this report we define return of capital, discuss differences between estimated and actual return of capital, constructive and destructive return of capital, and explain how shareholders can anticipate return of capital payments. We also clarify what the estimated tax composition in Section 19(a) Notices does and does not mean for investors. Bear in mind, Wells Fargo Advisors and its affiliates are not tax advisors. Be sure to consult with your own tax advisor before you take any action that may involve tax consequences.

Why Does a Closed-end Fund Return Capital?

Return of capital distributions can occur when there is not enough interest income, dividend income, or realized gains to support the distribution payment for the particular period. Return of capital can be viewed as a distributed realized loss.

Closed-end funds that invest in certain types of asset classes, such as municipal or taxable debt, primarily distribute interest income derived from bonds; only rarely do they distribute capital gains, and almost never return capital. Closed-end funds that do tend to return capital usually pay shareholders a distribution in excess of what they earn from interest and/or dividend income in order to enhance their distribution rate. Funds that

Please see pages 6-7 of this report for Important Disclosures.

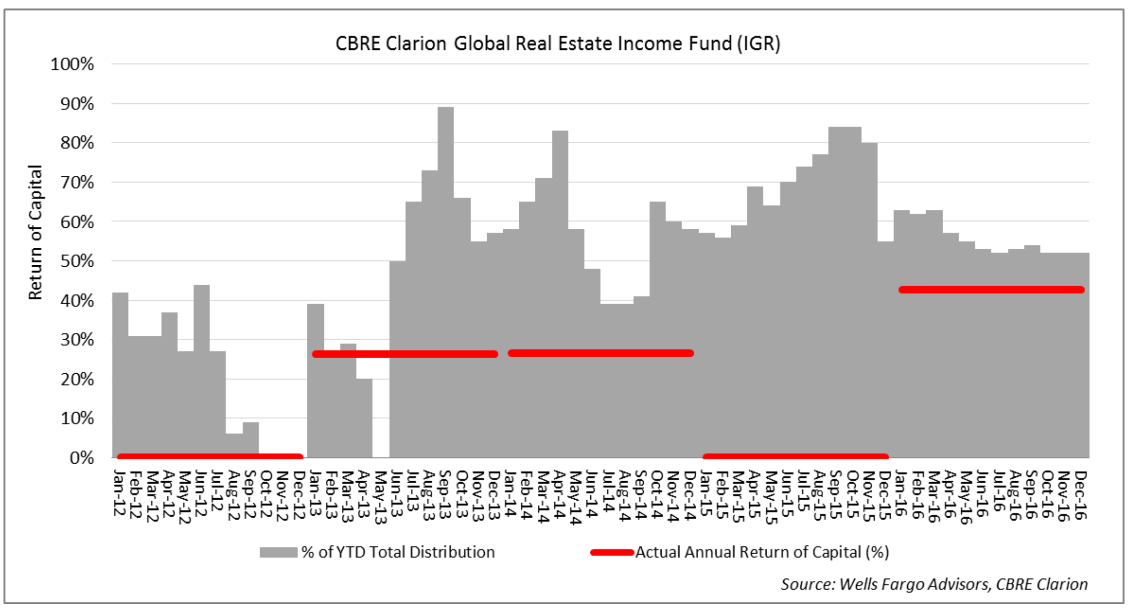
return capital include equity or balanced funds, which may use a level or managed distribution in order to pay out a higher distribution on a regular quarterly or monthly basis.

Closed-end fund managers are sometimes under pressure to increase their fund's distribution rates to improve the fund's valuation or premium/discount. Closed-end funds with a higher net asset value (NAV) distribution rate often trade at higher valuations (i.e., a larger premium or narrower discount) than peers with a lower NAV distribution rate. If a closed-end fund trades at a wide discount, activists may pressure its board to recommend a corporate action such as a repurchase of shares, a tender offer, a conversion to an open-end fund, or in the most extreme case, liquidation, in order to narrow the fund's discount. Accordingly, a fund may increase its distribution in an attempt to avoid a wide discount. The problem arises when the NAV distribution rate is too aggressive relative to the longer-term expected total return of the portfolio, and capital is returned in order to support the excessive distribution rate.

Estimated vs. Actual Return of Capital

If a closed-end fund estimates that a given regular distribution is sourced from anything other than net income, the closed-end fund is required by regulation to send out a Section 19(a) Notice to shareholders stating how much of such distribution is *estimated* to be made up of net income, capital gains, or return of capital. The amount contained in the Section 19(a) Notice is ***only an estimate*** and should be treated as such. Closed-end funds publish the *actual* tax composition for the calendar-year distribution on a Form 1099-DIV tax document. Investors should consider the tax composition in the Section 19(a) Notices incidentally since in many cases such estimate does not match the actual composition of the distribution. This is because there can be significant discrepancies between (1) the estimated return of capital for a given monthly or quarterly distribution on such notices, and (2) the actual classification on Form 1099-DIV for the calendar-year distribution.

An example of these variances can be seen in the case of the CBRE Clarion Global Real Estate Income Fund (IGR) in the chart below. In 2014, the monthly estimated year-to-date portion of return of capital (grey bars) varied from 39% to 83%; however, the *actual* return of capital as a percentage of 2014's total distribution (red lines) was only 27%. Similarly, in 2015 the 19(a) Notices warned about the possible presence of return of capital, but the actual classification at year-end did not include any. In 2016, IGR returned capital — under 43% of its annual distribution — but less than the monthly YTD (year-to-date) estimates suggested throughout the year, which ranged between 52% and 63%. Note that the opposite is also possible — a fund may not issue any 19(a) Notices throughout the year, but a portion of the distribution could still end up being categorized as return of capital after year-end.



Other examples of a significant discrepancy between the estimated and the actual tax composition of distributions are two Eaton Vance closed-end funds that are deliberately managed to produce more tax-efficient distributions — the Eaton Vance Tax-Managed Buy-Write Income Fund (ETB) and the Eaton Vance Tax-Managed Buy-Write Opportunities Fund (ETV). In fact, both include "tax-managed" in their name which means in pursuing their objectives, the funds evaluate returns on an after-tax basis. The table on the left lists the *estimates* for the monthly distributions declared in March 2016 and the year-to-date distribution as well as the *actual* composition for the 2016 calendar year. In the case of ETB, the estimate for the monthly distribution suggested a substantial portion of return of capital (84%). However, the actual amount for the calendar year ended up being much less (49%). Similarly, for ETV, the actual amount of return of capital was much less than what the estimate had suggested.

Tax Composition of Distributions	Estimate March 2016	Actual 1Q2016	Actual 2016
Eaton Vance Tax-Managed Buy-Write Income Fund (ETB)			
Income	16%	15%	14%
Gains	0%	0%	37%
Return of Capital	84%	85%	49%
Eaton Vance Tax-Managed Buy-Write Opportunities Fund (ETV)			
Income	10%	8%	9%
Gains	0%	0%	33%
Return of Capital	90%	92%	58%

Source: Eaton Vance 19(a) notices and 1099s, Wells Fargo Advisors

Some investors might assume that towards the end of the year, a closed-end fund's estimate of its distribution's tax composition – especially the estimate for its year-to-date distribution — will converge towards the actual breakdown. However, the Nuveen Real Estate Income Fund (JRS) and the Nuveen S&P 500 Dynamic Overwrite Fund (SPXX) are good examples that illustrate that the December estimate for the tax composition for the annual distributions was quite different from the actual tax composition. See the table on the right. For example, JRS estimated in December 2016 that 50% of the year-to-date distribution would be treated as return of capital. However, for the 2016 calendar year, the entire distribution ended up being treated for tax purposes as income and none of it as return of capital. Similarly, the estimate provided in December 2016 for the tax composition of SPXX's annual distribution was quite different from the actual breakdown.

Tax Composition of Distributions December 2016	Estimate	Actual
Nuveen Real Estate Income Fund (JRS)		
Income	50%	100%
Gains	50%	0%
Return of Capital	0%	0%
Nuveen S&P 500 Dynamic Overwrite Fund (SPXX)		
Income	21%	87%
Gains	55%	0%
Return of Capital	24%	13%

Source: Nuveen 19(a) notices and 1099s, Wells Fargo Advisors

In our view, focusing on the actual — not the estimated — tax composition of the distribution for the entire calendar year is a best practice. Investors would be better served by paying less attention to estimates throughout a given year. We believe, ideally, having an understanding of the tax composition over several years is more sensible because in some cases the tax composition may vary from the norm in a given year or more. One such example is the Nuveen Energy MLP Total Return Fund (JMF) as shown in the table on the left. Following higher-than-usual portfolio turnover in 2012 and 2013 resulting in

Tax Composition of Distributions	Actual (as of November 30)				
	2012	2013	2014	2015	2016
Nuveen Energy MLP Total Return Fund (JMF)					
Income	0%	91%	9%	0%	0%
Gains	0%	0%	0%	0%	0%
Return of Capital	100%	9%	91%	100%	100%
Turnover	45%	39%	6%	18%	28%

Source: Nuveen 1099s, Wells Fargo Advisors realized capital gains[1], the actual tax composition of the annual distribution was no longer entirely return of capital, which is more typical for a master limited partnership (MLP) portfolio.[2] Thus, one normally would expect JMF's distribution to be return of capital, but certain market conditions and/or portfolio actions — higher turnover than usual in this case — may change the typical tax composition of its distribution.

In our view, investors should focus on the actual tax composition of the annual distributions over yearly periods as provided on Form 1099-DIV tax documents. This is illustrated by ☑☑ in the table below. On the other hand, the least reliable method would be to focus on the estimates of the tax composition for the most recently declared distribution. This approach is described by ☒☒ in the table.

To which tax composition should investors pay attention?	Actual DIV-1099	Estimate 19(a) notice
Trend of several years of annual distributions	☑☑	
Most recent calendar year distribution	☑	
Year-to-date distribution		☒
Current monthly/quarterly distribution		☒☒

☑☑ = Best practice, ☑ = Acceptable, ☒ = Not ideal, ☒☒ = Least reliable practice

Destructive vs. Constructive Return of Capital

We differentiate between what we consider constructive and destructive returns of capital. A closed-end fund's return of capital distribution that arises from complex accounting rules as a result of a reasonable managed distribution policy in an attempt to maintain a narrower discount may be constructive. In contrast, destructive return of capital distributions tends to erode NAV over time.

Destructive. The following hypothetical example should clarify when a closed-end fund returns capital in a destructive manner. If a closed-end fund were to distribute 15% of NAV but "produces" only 5% in NAV total return on an annualized basis, then its NAV will erode over time as the 5% "earnings" rate is too low to replenish assets paid out at the 15% NAV distribution rate. One may compare this scenario to a funnel where the volume of the liquid that is flowing out of it (NAV distribution rate) exceeds the volume that is flowing into the funnel (NAV total return). Eventually, the volume of the liquid inside the funnel (NAV) will decrease.

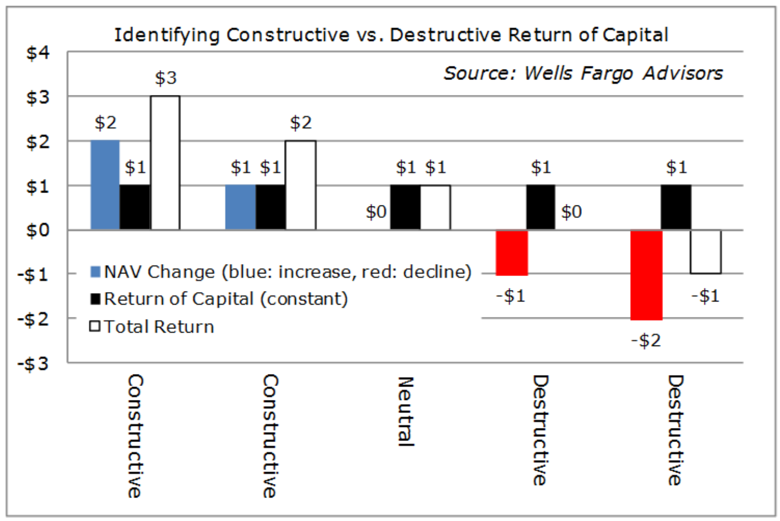
Constructive. Another example — a simplistic two-position portfolio starting with equal weights in stocks A and B — will seek to clarify when a closed-end fund returns capital in a constructive way. For illustrative purposes, let's assume the price of stock A rises, and stock B falls in price. The portfolio manager may decide to hold stock A because she thinks that it will continue to rise, and decides to sell stock B expecting its price to continue to decline. Furthermore, this hypothetical closed-end fund pays a distribution, but neither of the two stocks paid any dividends (and there is no interest income from bonds). The manager did not realize any capital gain — short or long — during our hypothetical holding period. Only a capital loss was realized. In this example, the distribution would be treated as return of capital and, if the price of stock A rises by a greater amount than stock B's price decline — and the total return exceeds the distribution — the NAV would appreciate. Thus, we have a closed-end fund with a rising NAV and with a non-taxable[3] distribution. In other words, we have a desirable situation — a case of a constructive return of capital.

[1] The realized capital gains were reclassified as income because of earnings and profit accounting. In other words, the portfolio received profits, but there were technically no earnings because the underlying MLPs returned capital.
[2] Remember that the underlying MLP holdings usually return capital, and this tax designation is then passed-through to the shareholders of the closed-end fund.
[3] Note that return of capital is not taxable, but the holder would need to adjust the position's cost basis by the amount of capital returned during the holding period.

It is also possible that a closed-end fund may take advantage of previous tax-loss carry forwards to offset current realized capital gains, creating a more tax-advantageous distribution — a return of capital. In the aftermath of 2008, for example, a number of closed-end funds sheltered subsequent years' distributions with capital loss carry forwards.

How does one know if capital returned was constructive or destructive?

Unfortunately, fund sponsors do not designate if capital returned was constructive or destructive, nor are they required to do so. Still, one can get a sense by observing how the NAV changed relative to the amount of capital returned during that period. Ideally, the NAV should remain stable or increase while capital is returned for a given period. It is more sensible to use a longer period for this assessment — a period of only a few months or quarters is too short, in our opinion. In other words, the amount of the distribution should not exceed the long-term NAV total return (distribution plus change in NAV.)



The chart to the right illustrates various hypothetical scenarios where the return of capital distribution remains constant at $1 per share (black bars), but the total return (white bars) varies. For example, the second set of bars illustrates a simplified scenario where the return of capital was $1 per share and during the holding period the NAV increased by $1. In other words, the total return ($2) exceeded the amount of returned capital ($1). We would consider this return of capital to be constructive. In contrast, the last set of bars in the same chart illustrates a scenario where the total return (-$1) is less than the amount of returned capital ($1), which resulted in an erosion in NAV (-$2). We would consider this to be a destructive return of capital.

Anticipating Return of Capital Distributions

Whether constructive or destructive, historical return of capital distributions may not necessarily identify if a closed-end fund is likely to return capital in a constructive or destructive manner in the future. The best way to help avoid an eroding NAV is to evaluate the level of the closed-end fund's NAV distribution rate given the expected return for its underlying assets. Returning to the idea of the funnel, when the rate of outflow is below the historical rate of inflow, the funnel is more likely to remain filled. In the closed-end fund world, we favor a closed-end fund with an NAV distribution rate that does not exceed the expected total return of its NAV.

Conclusion

Return of capital is not always detrimental to shareholders. The process of identifying future destructive return of capital is an art, not a science. We favor NAV distribution rates that are reasonable given the expected return of the closed-end fund's underlying assets or strategy. In our view, investors should not be guided by the required estimates of the tax composition of the most recently declared distribution in Section 19(a) Notices. Instead, investors should focus on the multi-year trend of the actual tax composition of annual distributions in order to better anticipate the tax composition of future distributions. In concept, requiring closed-end funds to publish information regarding the tax composition of distributions is useful. However, such information needs to be presented in a way that is meaningful to investors.

IMPORTANT DISCLOSURES

Disclosure information . . . For important disclosure information, please contact:
Wells Fargo Advisors Attn: Advisory Services (Disclosure Information)
One North Jefferson, St. Louis, MO 63103 Or call phone (888) 410-9203
Please remember to specify the issuer(s) with respect to which you would like to receive disclosure information.

Risk Considerations

Closed-End Funds are actively managed and can employ a number of investment strategies in pursuit of the fund's objectives. Some strategies may increase the overall risk of the fund and there is no assurance that any investment strategy will be successful or that the fund will achieve its intended objective. Closed-end funds are subject to different risks, volatility and fees and expenses. These funds invest in many types of instruments, such as domestic and foreign securities, emerging markets, equity and fixed income securities, government, mortgage and corporate securities, bonds and loans, taxable and municipal bonds, among others. In addition, closed-end funds can invest in complex investments such as alternative investments, commodities and derivatives. Many closed-end funds can leverage their assets (through derivatives or borrowing money to buy additional assets) to enhance yields. Leverage is a speculative technique that exposes a portfolio to increased risk of loss, may cause fluctuations in the market value of the fund's portfolio which could have a disproportionately large effect on the fund's NAV or cause the NAV of the fund generally to decline faster than it would otherwise. The use of leverage and other risks are more fully described in each closed-end fund's prospectus under the heading "Risk Factors."

Equity securities are subject to market risk which means their value may fluctuate in response to general economic and market conditions and the perception of individual issuers.

A fund that concentrates its investment in energy-related Master Limited Partnerships (MLPs) is subject to the risks of investing in MLPs and the energy sector. Investment in securities of MLPs involves certain risks which differ from an investment in the securities of a corporation. Holders of MLP units have limited control and voting rights on matters affecting the partnership. In addition, there are certain tax risks associated with an investment in MLP units and conflicts of interest may exist between common unitholders and the general partner, including those arising from incentive distribution payments. MLPs may be sensitive to price changes in oil, natural gas, etc., regulatory risk, and rising interest rates. A change in the current tax law regarding MLPs could result in the MLP being treated as a corporation for federal income tax purposes which would reduce the amount of cash flows distributed by the MLP. Other risks include the volatility associated with the use of leverage; volatility of the commodities markets; market risks; supply and demand; natural and man-made catastrophes; competition; liquidity; market price discount from NAV and other material risks.

There are special risks associated with an investment in real estate, including the possible illiquidity of the underlying property, credit risk, interest rate fluctuations and the impact of varied economic conditions.

A covered call writing (selling) strategy involves special risks. In return for receiving the covered call premium, the fund gives up the opportunity to benefit from any potential increase in the value of the index above the exercise price of the option. However, the fund will continue to be subject to the risk of the decline in the value of the index. Because index options are settled in cash, the Fund cannot provide in advance for its potential settlement obligations by acquiring and holding the underlying securities. Successful options strategies may require the anticipation of future movements in securities prices, interest rates and other economic factors. No assurance can be given that such judgments will be correct.

There is no guarantee any tax-managed strategy will be successful or will not be changed or eliminated because of legislation or regulation.

The sources of closed-end fund distributions can include portfolio income, capital gains/losses, and/or return of capital. The final determination of tax characteristics of each CEF's distributions will occur after the end of the year, at which time it will be reported to the shareholders. Distributions are not guaranteed and are subject to change or elimination.

This communication is not an offer to sell or solicitation of offers to buy any securities mentioned herein. This report is not a complete analysis of every material fact in respect to any fund or fund type. The opinions expressed here reflect the judgment of the author as of the date of the report and are subject to change without notice. Statistical information has been obtained from sources believed to be reliable but its accuracy is not guaranteed. Wells Fargo Advisors does not render legal, accounting or tax advice. Please consult your tax or legal advisors before taking any action that may have tax consequences.

Wells Fargo Advisors is registered with the U.S. Securities Exchange Commission and the Financial Industry Regulatory Authority, but is not licensed or registered with any financial services regulatory authority outside of the U.S. Non-U.S. residents who maintain U.S.-based financial services account(s) with Wells Fargo Advisors may not be afforded certain protections conferred by legislation and regulations in their country of residence in respect of any investments, investment transactions or communications made with Wells Fargo Advisors.

Additional information available upon request. Past performance is not a guide to future performance. The material contained herein has been prepared from sources and data we believe to be reliable but we make no guarantee as to its accuracy or completeness. This material is published solely for informational purposes and is not an offer to buy or sell or a solicitation of an offer to buy or sell any security or investment product. Opinions and estimates are as of a certain date and subject to change without notice.

Wells Fargo Advisors is a trade name used by Wells Fargo Clearing Services, LLC and Wells Fargo Advisors Financial Network, LLC, Members SIPC, separate registered broker-dealers and non-bank affiliates of Wells Fargo & Company.