Closed-End Fund Discounts: A Master-Class in Nuance

May 13, 2014

We are often asked, “So, your firm buys closed-end funds, do you just buy at a discount and sell at a premium?” After thirteen years in the industry the answer is, “Yes, but all discounts are not created equal”. In this article we hope to address three areas that we believe investors should better understand before venturing into the closed-end fund (CEF) structure. First let’s look at Absolute Discounts vs. Relative Discounts charted over the past two years. An Absolute Discount is the fund’s current Market Price vs. Current Net Asset Value (NAV). CEFA defines a Relative Discount as a fund’s Current Discount/Premium vs. its 90-day Average Discount/Premium. We see Relative Discounts as a way to monitor the momentum and recent relative value of a fund’s Current Discount. For some CEFs trading near their Historical Average Discount level is normal while other CEFs routinely trade with a high level of Discount Volatility. We think that this information is important to comprehend. The graphs below track the Average CEF Discount and the Average CEF Relative Discount, for the approximately 600 closed-end funds, from May 2012 through May 2014.

premium to NAV and since May of 2013, the average fund has been at a discount to NAV. A -9% Average CEF Discount in December 2013 is the widest we have seen in a long time, for a non-crisis environment. However, after reviewing relative discounts, we can see that it is uncommon for the average CEF to be priced more than 1% above, or -2% below its 90 day Average Discount. If your strategy with CEFs is to buy funds that are cheap to themselves and to sell funds that are expensive to themselves, then this data can help you understand the magnitude of the potential relative value you may be able to exploit.

We believe that with CEF based portfolios, you can design an investment allocation based on your personal market outlook and a risk profile, and then use the inefficient nature of the CEF structure to attempt to swap funds at relative highs for funds at relative lows while maintaining similar portfolio exposure. This strategy is called “discount capture” and is often repeatable over time for those investors or financial advisors that are patient and diligent enough to monitor for the changes amongst funds. In addition to discounts, we also think you should be comfortable with both the Board of Director’s dividend policy and the ability of the Fund’s manager to create good performance over time. Just because a fund is cheap, doesn’t mean the discount will narrow due to the Market Price outperforming NAV. The NAV could end up falling towards the market price; in such a case, the discount narrows but investors may not experience positive performance.

What other factors are at play in a closed-end fund’s trading behavior? We think understanding a CEF’s liquidity peaks and valleys as well as its correlation peaks and valleys can help identify a turn in a fund’s discount or premium. The graphs below track Average Daily Liquidity, expressed as Current Market Price multiplied by 30 day Average Trade Volume, and the Average Correlation, of NAV and Market Price over a rolling 90 day period, for the approximately 600 CEFs, from May 2012 through May 2014.

As you can see from the two charts above, correlation levels tend to peak when trade volumes are more than 50% above average. Discounts bottomed out and then turned higher as trade volume subsided during late December of 2013 and into January 2014. This volume spike roughly coincided with the reduction in correlation to NAV over the same period of time.
We suggest investors look at peer funds for swapping ideas, in that they should try to find opportunities where a fund’s discount has narrowed beyond both its peer-group average as well as its 90-day Average Discount. Finding similar funds based on investment allocation or Net Asset Value Total Return can assist one in finding a replacement CEF with some relative value potential based on discount differences from the original holding.

**Benefits of volatility:** As of May 9, 2014 our CEF Universe data shows the Average Equity CEF has a one-year Standard Deviation of 16.6 vs. the Average Bond CEF one-year Standard Deviation of 13.0. Equity NAVs have an avg. one-year Standard Deviation of 13.2 while bond NAV standard deviations average 8.6. This means, in simple terms, that the Average Equity CEF’s Market Price is currently about 25% more volatile than its NAV and, the Average Bond CEF’s Market Price is about 50% more volatile than its respective NAV. We believe the cause of this volatility is due to the sometimes illiquid trading in some CEFs with about 36% of funds trading under $500k a day in Average Liquidity. In addition there is the likelihood of increased irrational trading due to high retail investor ownership in the shares, especially municipal bond CEFs. The average institutional ownership is about 22% for taxable CEFs and only 8% for tax free CEFs. The discount volatility of Bond and Equity CEFs has been similar for the past year at 2.4 and 2.3 respectively. We see this volatility as opportunity for CEF investors to seek the potential to buy at lower prices relative to NAV and sell at potentially higher prices relative to NAV.

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<th>NAV St Dev</th>
<th>Mrt Pr St Dev</th>
<th>St Dev Mkt Pr Increase</th>
<th>Discount St Dev</th>
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<tbody>
<tr>
<td>Equity CEFs</td>
<td>13.2</td>
<td>16.6</td>
<td>+25.8%</td>
<td>2.3</td>
</tr>
<tr>
<td>Bond CEFs</td>
<td>8.6</td>
<td>13.0</td>
<td>+51.2%</td>
<td>2.4</td>
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Lastly, remember buying a CEF is buying exposure to a sector and a portfolio manager’s investment objective. As mentioned before, if you don’t have a reasonable expectation that a fund’s NAV should grow over time, then we suggest you only look at the fund for a short-term Discount Capture strategy. If you are going to do well buying into CEF discounts and taking profit on the reversion to mean then it is possible you have a strong idea why the discount widened. Was it sector concerns? Distribution concerns? Liquidity concerns due the likelihood of creating more capital with a secondary offering or rights offering? Or is it as simple as investors don’t like the manager’s performance results?

On the other side, when a discount narrows aggressively you need to answer a similar list of questions to determine why. Is it a potential tender offer? Is it liquidation, merger, or a dividend increase? Typically, if we make 4-6 months distributions from a discount narrowing situation, we sell or at least cut our exposure in half and look for a similar place to invest the proceeds. Discounts and premiums will always exist for CEFs, in our opinion, due to the nature of having a fixed-capital structure and predominately retail investor base. We suggest investors continue to keep in mind the simple rules of: 1. What is normal for a fund? 2. What is normal for its peers and 3. Why would the discount trend revert to previous levels?

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