2Q 2019 Market Insights
Are Closed End Funds Right, Right Now?
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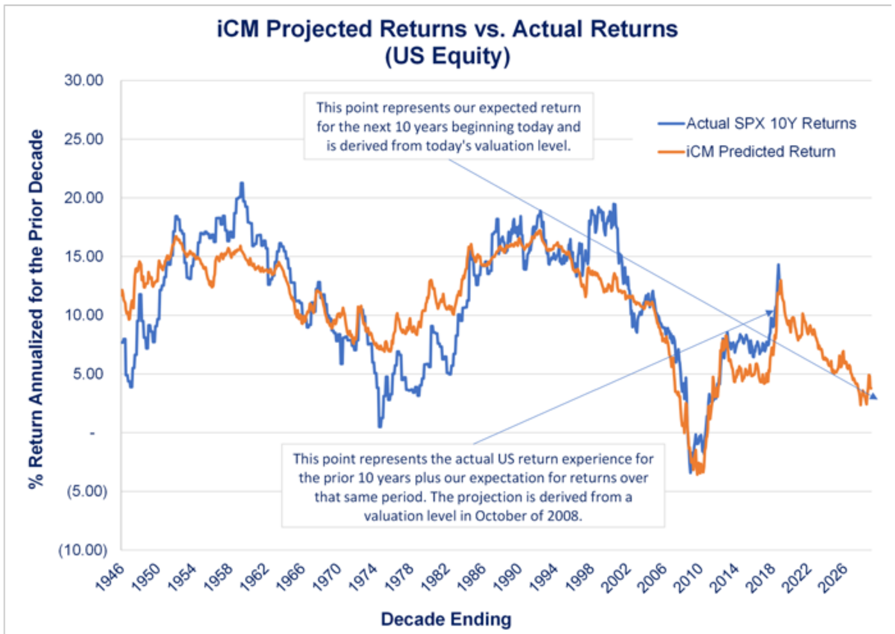
"It is impossible to produce superior performance unless you do something different from the majority." – John Templeton

Since year end, volatility has dissipated, equity markets have rebounded from their difficult 2018, and investor life as we know it has returned to normal. Just three short months ago, investors had an entirely different feeling, as equities declined by 19% during a volatile fourth quarter. Fast forward to today and that has been long forgotten. For the moment, we have a more patient central bank, a government that is open, and a trade war with China that is concluding. Life is good. While we should enjoy it, I can promise you one thing, life won't always be this good. Whether you are an experienced investor or a novice, most realize that a decade of largely uninterrupted gains is probably closer to an interruption than we would like to admit.

Valuations & Returns – US Equities

CHART 1



The blue line represents the actual return achieved by the S&P 500 for the prior 10 years. The orange line represents our prediction for the next 10 years using the same logic. As you will notice, the line ends in 2028, which is derived from today's valuation level. Even though we staggered the lines, the orange line represents the prior 10 years, making the return in 2028 the one caused by today's valuation and covers the period of 2019-2028. The overlapping nature of the lines indicates the strength and overall reliability of the prediction. As we can see from the chart, today's valuation suggests a rather abysmal outlook for US stocks over the next decade, predicting a return of about 3.5% annually.

Source: S&P, FRB, iCM Capital Markets Research

For a while now, we've expressed our concern about the growing level of valuations in the US equity market and the impact we expect this to have on investors over the next decade. Chart 1, which we first introduced last quarter, illustrates this relationship. The chart details our valuation model's prediction of what will happen looking out over ten-year intervals, ending at our next ten-year interval in 2028. On top of that, we've overlaid what has happened historically to provide some perspective around the long-term accuracy of the model. If the model were perfect, the lines would lie right on top of one another. While not perfect, it has been a very good predictor of 10-year returns. As we can see on the chart, two of the worst environments were the decades ending in 2008 and 2009, beginning in 1999 and 2000 respectively. These decades truly were lost, producing a negative return on stocks for ten years. This period was accurately predicted by the model, as it was able to observe the elevated valuations during the internet bubble and translate that into weak returns to come. While our next decade (2019-2028) doesn't look as bleak, it is shaping up to be no great shakes nonetheless, with an expected return on US stocks of about 3.5% per year for the next ten years. At the same time, bond yields remain low by historical standards, hovering between 2.5%-3.5% depending on the degree of risk taken. With the potential for total returns before fees and taxes hovering near 3%, this will surely make for tough sledding for most financial plans, especially those who need to draw an income from their investment portfolios.

Now, some who believe in the great American economy and its long-term strength can quickly dismiss this low expected return, despite the model's impressive track record of prediction. The argument being "what if you are wrong?" To which I would respond, "what if we aren't?" That is, what if this is an accurate depiction of what is to come, or worse? The fact is, most investors own enough of the US market and high growth assets that they will do just fine if we are wrong. That is, if valuations don't matter, if trees do grow to the sun, and if investors always and forever are entitled to a 10% return or better on their equity investments, I believe that the vast majority of folks will fare very well. The question is, are you prepared, or said differently, diversified into assets that will help you if we experience another lost or almost lost decade? The answer to that, in most cases, is probably not.

Over the past few years we've talked about many of the traditional diversifying assets like commodities, international equities and emerging markets stocks and bonds as diversifiers that could potentially help soften the blow if and when this proves to be accurate. Given that we've discussed those at length, we will not mention those any further other than that we continue to believe that all the aforementioned diversifiers, in our opinion, do represent very good alternatives to a weak US equity asset class. The purpose of this quarterly Market Insights is to discuss an alternative to each of these that we believe will prove beneficial in the difficult decade that lies ahead, the closed end fund (CEF) market.

<u>Background & History</u>

For those who are not familiar, closed end funds are baskets of securities, hundreds of individual stocks and bonds, all rolled up in one ticker symbol, much like a mutual fund or exchange traded fund (ETF). The difference comes down to trading and pricing. While mutual funds trade once per day, both ETFs and CEFs trade intraday just like stocks. So, what makes a CEF different than an ETF? When you invest in either a mutual fund or an ETF, $1 worth of assets will generally buy you $1 worth of portfolio. With a CEF, $1 worth of assets can buy you more or less than a $1 worth of portfolio. Let me be clear. We aren't taking about valuations, which can be somewhat subjective. We are talking about the potential to buy a share of a pool of assets and pay less for it than is actually being managed in the pool. This is called trading at discount to net asset value (NAV) or the per share dollar value of what the portfolio manager is managing. This has the potential to add another layer of return to an investment portfolio. We'll come back to this in a moment.

By way of history, CEFs are not new. They predate open ended mutual funds, dating back to the 1860's, and until the advent of the ETF were the only way one could trade multiple securities simultaneously on an intraday basis. They've ebbed and flowed in popularity over the years. They were exceptionally popular in the 1980's and 1990's and were used, among other ways, as a way to trade baskets of securities in one trade intraday, just like a stock. In and around the year 2000, with the continued development and rising popularity of the ETF, they were replaced by the ETF as that preferred trading vehicle.

Much like traditional (open ended) mutual funds, closed end funds are governed by the Investment Company Act of 1940, and as a result meet strict operational standards such as diversification and antifraud requirements. These activities must be supervised by an independent board of directors offering the same investor protections as those offered to investors in mutual funds or exchange traded funds. The market, while not as large as the mutual fund or exchange traded fund market is not small either, with about $275B invested across 520 distinct closed end funds and more than half of those assets in fixed income CEFs.

From a demographic perspective, CEFs remain popular among individual investors. According to the Investment Company Institute, an estimated 3.6mm households owned closed end funds as of the end of 2017. The average age of the household owning closed end funds tended to be slightly older, at 56 years of age, as compared to all US households (51 years) or those owning mutual funds (51 years) or individual stocks (53 years). This age difference is likely related to the elevated level of yield that is common with most CEFs and attractive to those in retirement who may be drawing an income from their investments. In fact, this is confirmed by the 38% of CEF investors who are retired from their occupation vs. just 23% for traditional mutual fund investors.

Characteristics & Risks in Closed End Funds

There are several unique characteristics of closed end funds. We know that CEF's are baskets of securities that look and trade a lot like ETFs. Unlike the ETF, their price can stray above or below what the portfolio manager actually manages, this is called trading at a premium or discount to NAV. In fact, this isn't exactly a true statement. ETFs experience this as well, but the deviations are generally very small.

In addition to unique pricing characteristics, closed end funds are also known for leverage and yield. Generally speaking, it is common to find some leverage used in closed end funds. While this varies from fund to fund, the average across the entirety of the 520 fund universe is about 20%. In fact, at iCM we maintain an active research universe of roughly 485 funds, nearly the entire CEF universe. 130 of these 485 funds (27%) used no leverage at all while 33 funds used between 40-46% leverage.

Leverage generally occurs at two levels, within the fund at the portfolio manager level, and at the client level. At the portfolio manager level, the PM can create leverage by borrowing or by investing in certain securities that intrinsically create leverage (portfolio or structural leverage). This is a fairly common practice within even traditional mutual funds, especially bond funds, but more pronounced in CEF space especially as it relates to enhancing the return and risk of the portfolio. In fact, of the 1451 unique, active bond mutual funds in the Morningstar Universe, 282 of them employ some type of derivative use in their portfolios.

The other way that leverage is created is at the end investor or client level when buying closed end funds below their NAV. Much like when an investor buys a discount bond, by buying at a price below par value, or NAV in this case, the yield, duration, and price movements are amplified.

Using Diversification & Portfolio Structure to Reduce Risk

While the prospect of higher yields and enhanced returns might be enticing, greater participation in closed end funds is limited by a lack of full understanding, as well as the stigma regarding even a small amount of leverage in a portfolio. As stated previously, what few investors realize is that many bond mutual funds employ the same tactics that make investors fearful of participating in closed end funds. What's more, investing in one closed end fund is a much different beast than investing in a diversified portfolio of closed end funds, in the same way that investing in a single stock is not advisable, but investing in hundreds of stocks is commonly accepted to make stock investing much safer. Take for example a single US equity closed end fund that is quite risky and employs 40% leverage (a small number of funds do this as we identified previously). There are two primary risks that should concern us. The first is similar to single stock risk. If an investor owns one stock and chooses poorly, it could result in large losses. With a single CEF, the risk is similar, but not quite as pronounced since the hypothetical

CEF is inherently diversified, itself owning several hundred underlying stocks. While single stock risk isn't the issue, single CEF risk is. What if that fund isn't very good? We would, in this example, have all our eggs in one bad basket. Therefore, owning several CEFs solves this problem.

Additionally, diversification among CEFs solves two other potential issues, portfolio risk and leverage. By owning bonds in greater percentages than stocks, investors can dilute volatility, no matter the source. Own a risky stock investment, you can dilute the volatility with bonds. Own a volatile ETF, CEF or mutual fund, you can likewise reduce that volatility by owning a less volatile bond investment alongside it. So, what have we solved? 1) By owning dozens of individual CEFs, we can reduce single CEF risk (risk of owning one bad CEF) much in the same way as owning multiple stocks can reduce single stock risk. 2) An additional benefit of owning dozens of closed end funds is that the leverage used, in total, should start to converge on the universe average of around 20%, rather than risk selecting one of the few that are highly levered. 3) By structuring the selection of CEFs and focusing our asset allocation on the proper mix of stocks vs. bonds, perhaps even tilting our portfolio more in favor of bonds than we normally would, we can further reduce this risk, much in the same way that building an asset allocation out of mutual funds or ETFs can align portfolio risk with investor risk tolerance.

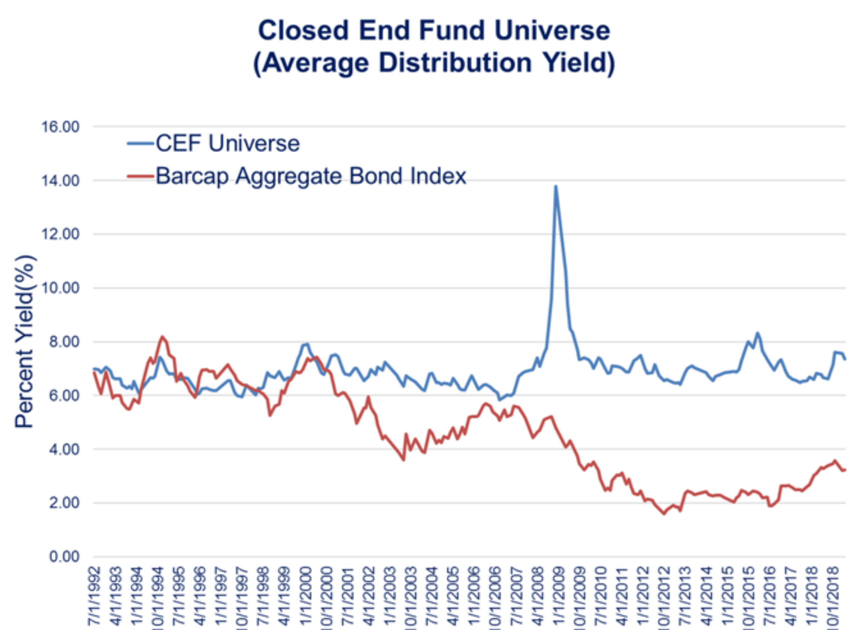
Opportunities in CEF

Thus far, we've provided a bit of background knowledge on CEFs, as well as discussed their primary risks along with ways to account for and ultimately reduce those risks. But why should we care? As I stated in my introductory remarks, our research has shown that we are likely headed for a protracted period of low returns from US equities. CEFs fit neatly into this niche as a diversifier that has the potential to solve this problem.

Most strategies create return through two building blocks, income and capital gains. Buying discount closed end funds gives investors the potential to add a third building block, plus provides a head start in the income category. By purchasing closed end funds at a discount to NAV, an investor can enhance their underlying yield much

Closed End Fund Historical Yield

CHART 2



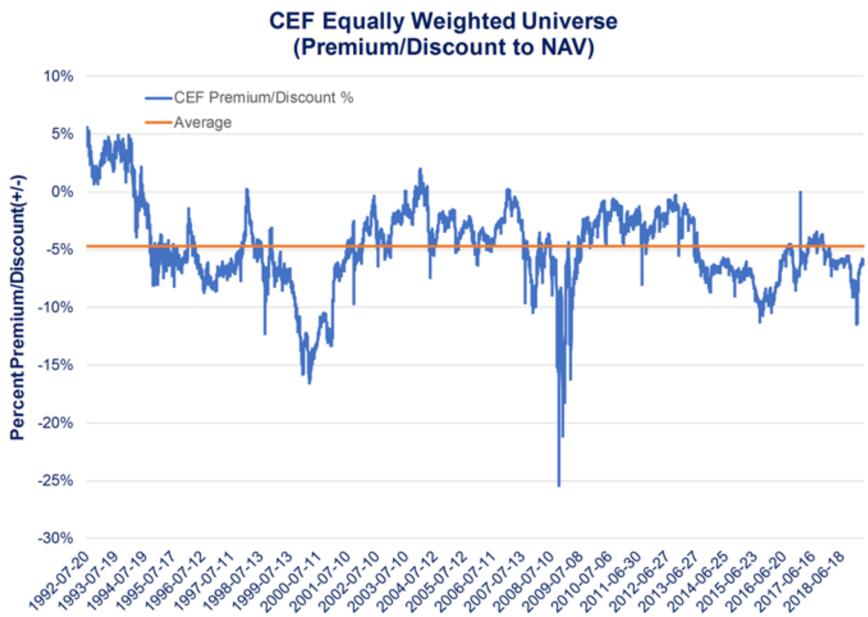
Traditionally, most asset classes create return through two building blocks, income and capital gain, CEFs have the potential to add a third, the discount closing back to NAV. The potential for discount closing along with yields that are nearly double those found in the broader bond market make closed end funds a potential solution to a lengthy low return environment.

Source: Bloomberg

like buying a discount bond amplifies your yield to maturity. If a 10-year bond has a yield of 5% at par ($100), the YTM and, correspondingly the return to the client, if held to maturity is 5%. If you purchase that same bond but pay $90, the YTM becomes 6.37%. The YTM was amplified by acquiring the bond at a discount. As you can see in Chart 2 on the prior page, if nothing else, closed end funds have certainly been a great income producer with the yield ranging from just under 6% to a peak of nearly 14% during the financial crisis. Today, the yield is approximately 7%, a bit better than the historical average. To lend some perspective this is about 2.3% better than the Barcap Aggregate Bond Index over the same time period and 4.1% better as of March 2019. Second, as assets appreciate, CEFs rise and fall in value along with their underlying investments and will generally participate in these gains. Finally, in addition to creating a yield advantage, buying discounted closed end funds can potentially create that third building block we mentioned a moment ago, the discount reverting toward NAV. How likely is this? At an individual closed end fund level, discount reversion can be fairly random. However, at a universe level, the premium and discount to NAV are a very reliable mean reverting series, as seen in Chart 3. Acquiring a diversified portfolio of closed end funds not only can act as a diversifier and risk mitigator, as we discussed previously, but also as a way to capture the mean reverting nature of discounts at a broad universe level, potentially adding another element to return.

Closed End Fund Discounts

CHART 3



CEFs are issued in the same manner as individual stock, through an initial public offering. The offering is subscribed to by a variety of investors who, buy the fund directly from the fund company and, ultimately provide the source of assets that the portfolio manager will manage. This will be the only transaction between the public and the fund company. All buying and selling afterward will occur in the secondary market between individual investors. Therefore, a buyer needs to find a seller on an exchange just like a stock transaction in a brokerage account making supply and demand a factor in CEF pricing. In the case of a hot closed end fund where there are many buyers and few sellers, the demand might push the price above what the portfolio manager is managing, the portfolio is trading at a “premium to NAV”. Conversely, times of panic or stress can cause CEFs to sell for less than the portfolio manager is managing, a “discount to NAV”, offering investors the opportunity to acquire $1 of assets by paying less than $1.

Source: Bloomberg

Conclusion

Since late 2018 when stocks declined by nearly 20% from peak to trough, markets have calmed, and things have returned to normal. Unfortunately, that has left us in an environment where US stocks are as overvalued as we've seen them in quite some time. Correspondingly, our expectation for return from them is in the very low single digits for the next decade, presenting a problem for most financial plans. As we've discussed in prior Market Insights, diversifying assets like emerging markets equities, international equities, and commodities remain attractively priced and are viable potential solutions to this long-term dilemma. We would add CEFs to this short list. The CEF share class and pricing structure allows them to price below their net asset value, creating an opportunity for additional gains along with elevated yields. Risk mitigation, particularly with regard to leverage, is a legitimate concern that can be addressed through portfolio structure and diversification. When combined, the result is a systematic approach to CEF selection and risk management that shares many of the elements that we use in our own CEF portfolio management strategy. This next decade will likely present us with some unique headwinds. We remain ever vigilant and uniquely suited to meet and successfully navigate these challenges. Thank you, as always, for your trust and confidence.

Sources: ICI, 2018 Investment Company Fact Book

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