BDC Returns Rally Amid Thorny Third Quarter for Listed Closed-End Funds

By Johnathan Rickman

Diversified portfolios were generally down in the third quarter of this year, with 89% of listed closed-end funds (CEF) trading below their net asset value and only 30% reporting positive total returns, said John Cole Scott, president of Closed-End Fund Advisors (CEFA) and AICA's chairman, on an October 18 call. Listed CEFs holding master limited partnerships (MLP) and real estate investment trust (REIT)/real assets all traded at discounts, with discounts also somewhat wide for publicly traded business development companies (BDC), Scott said in presenting CEFA's Q3 2023 review and outlook of the CEF and BDC universe. CEFA tracks a total of 763 closed-ended management companies. Wide discounts for BDCs belie the sector's "dividend growing story" of +20% growth year to date, Scott said.

But it was a rough quarter overall, with discounts "pervasively wide for essentially everything," with the upshot being that CEFs and BDCs are now a good entry point for longer-term investments, he added.

> "Be thoughtfully active. When a diversified portfolio is beat up, and the methodology isn't broken
> —arguably the forward-looking nature of a diversified CEF portfolio—it's a very good time to be building, growing, and adding to this sector." —
> John Cole Scott

Total Returns

Total returns for the average listed CEF, including BDCs, were up 2.4% during the quarter. They are still up 6% year to date, but about 70% of CEFs posted negative returns in the third quarter amid a rise in discounts.

Winners

Senior loan funds were the clear winner, with 100% posting positive quarterly total returns, averaging +6% for the quarter and trending +14% year to date. MLP funds also performed well, with 93% posting positive total returns, averaging +3% for the quarter and +11% year to date. BDCs were also winners, with 86% posting positive quarterly total returns, averaging +7% for the quarter and +20% year to date.

Losers

Municipal bond funds, REIT/real asset funds, and U.S. and international stock CEFs all posted negative total returns in Q3:

• Muni Bond CEFs: 100% of funds had negative returns, averaging -10% for the quarter and -10% year to date.
• REIT/Real Asset CEFs: 100% of funds had negative returns, averaging -7% for the quarter and -5% year to date.
• U.S. and Intl. Stock CEFs: 91% of funds had negative returns, with mixed averages of -4.5% (Q) and +7.5% (YTD).

NAV

Winners

Net asset value (NAV), a popular subject among CEF investors, didn't always track closely with total returns in the third quarter, but senior loan CEFs and MLP CEFs performed well in this category, too:

• Senior Loan CEFs: +3.5% NAV increase
• MLP CEFs: +2.5% NAV increase
• Preferred Equity: +1% NAV increase

The senior loan sector has been overweight for years, Scott noted on the Q3 call. "I feel that we've finally unfolded the thesis of more durable NAVs [and] growing yields" for senior loan CEFs, while still generating wide discounts for many of them due to the inevitable ebb and flow of pullback, he added.

Losers

Sectors that experienced NAV declines in Q3 were utilities and infrastructure (-9.5%), REIT/real asset (-8%), municipal bonds (-7.5%), and convertible bonds (-5%).

"If you've been in the [convertible bond] sector this year, discounts have been common … [and] … generally wider as well," while still trading relatively well, Scott said.

The combined group of municipal bond, REIT/real asset, and preferred equity funds have been reporting negative total returns on NAV all year, while MLP funds have traded at wide discounts, resulting in mid-level NAV performance.

Yield

Some 6.6% of distributions press releases for CEFs in the third quarter posted positive yield results, averaging +11.3%. Benchmarked against a one-year average for the previous year, positive CEF yields were up 9%.

On the flip side, 6% of distributions press releases reported distribution cuts, averaging -6.9%. That contrasts with the previous year's average of -10.8%, suggesting improving trends in both directions.

These results come against a two-year backdrop of distribution policy changes at CEFs:

• 44% made cuts at an average of -15%.
• 25% made increases at an average of +12%.
• 31% of funds made no distribution policy change.

The good news is that current yields trends are forward-looking:

Taxable bond CEFs are averaging **+10.8%**, debt BDCs are averaging **+10.7%**, equity funds are averaging **+8.5%**, and municipal bond CEFs are averaging **+4.8%**.

The following chart shows projected one- and three-year dividend growth rates for the same four funds:

Fund Type	One-Year Dividend Growth Rate	Three-Year Dividend Growth Rate
Debt BDCs	+12%	+18%
Taxable Bond CEFs	+6%	+10%
Equity CEFs	-2.5%	+12%
Municipal Bond CEFs	-21%	-26%

It's worth noting that municipal bond CEFs are federally tax-free, which means their tax-equivalent yields are roughly 7%-8% for many high-income investors. Further, compared to the previous quarter, REIT/real asset fund yields are up an additional 1%. And while dividends for listed BDCs are growing, they're currently down 40 basis points because their market price is growing faster than their distribution rates.

Yield Growth and Discounts Over Time

For additional perspective, it's instructive to compare where the CEF universe is right now compared to where it was in early 2020. The average CEF right now is showing an indicated yield of 2% higher than the pre-COVID pullback period because NAVs are down and discounts are wide. MLPs are only off 20 basis points, REIT/real assets are up 4.7%, senior loans are up 3.5%, and convertible bonds are up 3.2%.

Since 1998, month-end discounts for the average CEF have only been wider 5% of the time. For equity CEFs and taxable bond funds, those have only been wider 12% and 16% of the time, respectively. For the same 25-year period, municipal CEFs have never been wider, and almost 1% wider than '08/'09 pullback.

This tells us that pricing is currently very steep, with a lot of tailwind optimism for the next 12 months.

Market Size

At the end of Q3, the universe of listed and non-listed CEF and BDC gross assets totaled $706 billion:

• 434 listed CEFs ($315 billion) and 48 listed BDCs ($130 billion)
• 85 interval funds: $85 billion, reflecting 58% of total assets
• 98 tender offer funds: $216 billion
• 81 non-listed BDCs: About $155 billion in gross assets, reflecting 42% of assets

In 2023, there have been no CEF IPOs, three CEF deaths, and 12 mergers.

"We believe we'll get closed-end fund IPOs in the future," said Scott. "I think it's probably going to take a few quarters of settling and creativity to think of what can be done to continue to try and improve the structure," he added. 2023 has been a modest year for mergers, but more are inevitable as fund sponsors look to consolidate expenses, improve liquidity, and make trading easier for large institutions.

John Cole Scott's presentation also covered the impacts of leverage, activism, discount seasonality and tax loss selling, and NAV correlation across different sectors of the CEF and BDC investment universe.

Access the replay of CEFA's Q3 2023 presentation and full slide deck on CEFA's website. CEFA is an income-focused investment firm with an industry-leading database and a suite of model portfolios centered on the listed and non-listed universe of CEFs, BDCs, interval funds, and tender offer funds.

About CEFA

Closed-End Fund Advisors is a fee-based, registered investment advisory firm founded in 1989. CEFA has its headquarters in Richmond, VA. CEFA's primary business is discretionary asset management. As a global manager of managers, we build portfolios for individual and institutional clients, through either direct work with clients or through financial advisors and planners. Visit CEFA's website to learn more.

About AICA

The Active Investment Company Alliance is a trade association committed to educating and engaging investment professionals and investors about closed-ended management companies: listed and non-listed closed-end funds, business development companies, interval funds, and tender offer funds. As the industry's spokesperson, we advocate for our member firms' funds and educate investors about fund structures and specific strategies. Our primary methods of advocacy are through our weekly NAVigator podcasts, hosted by Chuck Jaffe, and events we conduct throughout the year.