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AICA Panel:

CEF Leverage Continues to Evolve

The use of leverage in closed-end funds (CEF) can enhance a fund's overall returns and continues to evolve, a leadership panel at AICA's 2023 Fall Roundtable said. Having board members who understand leverage and can critique its use is essential to fund management, experts from Edison Holdings, abrdn, and Sumitomo said at the November 15, 2023, event in New York City.

Those comments came during the panel discussion, *Independent Board Members and Lenders to Traditional CEFs*, in which panelists also emphasized the importance of clarity and transparency in 15(c) board reporting.

Leverage

The panel began the discussion on leverage by covering the basics. Shane Klein, Managing Director and General Manager, Head of Financial Institutions Group at Sumitomo Mitsui Banking Corporation (SMBC), said leverage not only enhances a fund's overall return, but it also allows for a fund to be fully invested:

"Roughly 62% of closed-end funds do use some form of leverage according to the ICI," Klein said. "What we've seen over the last few years . . . [is] a massive de-leveraging on the taxable side [and] most of that was on the repo side," he added, noting that repos saw a bigger movement because it's "easier to lever that down."

Klein continued: "In terms of types of funds, muni funds generally employ the most amount of leverage, whereas … equity funds probably tend to do the least amount of leverage."

Klein added that not only are funds merging into each other, some are also merging into BDCs. "Everything's getting grayer now," he added. "I'd say that the movement into private credit, into alternatives, is something that is here to stay."

Tom Hunersen, Director and Board Member, abrdn Global Infrastructure Income Fund, said in the right market environment, leveraging can enhance portfolios. But there's one caveat: It needs to be clear in the prospectus that leverage is part of the fund's overall strategy.

"I think [if it's] well-managed alongside of an effective investment strategy by a portfolio manager, it's accretive," Hunersen said. "I know there's deleveraging going on … [but] in the longer term, as a part of managing a diversified portfolio [that] has a bright path in terms of investment performance, leverage is a good thing."

"It's important to have people on the board who understand leverage, and who understand how to assess lending relationships and hedging structures and debt portfolio management," Hunersen added.

One audience member asked about the calculus for determining whether leverage is generally accretive:

Said Hunersen: "If there is leverage, there's a detailed piece of the management process that directors see regularly, including the cost of it, the structure of it, and all the elements involved. Periodically, let's say maybe it's annually at least, but I'd say more than annually, you can take that leverage and measure the performance of that piece of the puzzle in a generic sense, and establish whether or not it's costing more than it's returning. It's a relatively straightforward thing to establish based on the performance of the overall fund."

"If you're out there with a levered fund and you're promising a levered return, a total return, and it suggests that it will perform better because of the leverage, the board has to have evidence that that's the case," Hunersen added. That's a part of the paper trail that you have to make sure is there."

SMBC's Klein said the use of leverage "generally needs board approval."

"A lot of the managers that we finance have a very thorough process in terms of determining who they want to provide that leverage, and then they … [seek] board approval."

15(c) Board Reporting

The conversation then turned to the 15(c) board-reporting process. This process refers to the Investment Company Act of 1940's mandate that a majority of a fund's independent directors must approve advisory and underwriting contracts. It also calls for the clarification of contract terms, including its advisory fees.

Moritz Sell, who serves as board director and holds other leadership positions for several abrdn funds, described the process of learning about a fund's shareholder base, crucial to such reporting, as mostly "guesswork."

"At the end of the day, it's about performance, and fees, and it's really about relative fee structures and relative performance, performance against benchmarks," he said. "Those are the key things that we're looking at."

Added Hunersen: "15(c) is a big deal in an annual process run by any fund, and one of my concerns is that people don't spend enough time considering who is looking at the 15(c). Do they understand what they're reading?"

"I'm a big fan of having a properly constituted board of trustees who bring the skill sets, the expertise, and the confidence to actually dig into the 15(c) and be able to engage in a productive conversation rather than just going through a box-ticking exercise," he said. "I know it's kind of boring; it's kind of dry. But for people who look at individual closed-end funds, I think one of the factors to look at ... is whether it has a properly constituted, competent, diverse, skilled, experienced board relative to the fund structure and strategy."

To hear more valuable insights from this panel, register to access a replay and review the full agenda of AICA's 2023 Fall Roundtable. The cost of the replay is $30 for access to all nine panels.