BDC, Muni Bond Fund Discounts Continue Recovery in Q1 2024

Average discounts for traditional closed-end funds (CEFs) narrowed during the first quarter of 2024, with municipal bond funds and business development companies (BDCs) rallying yet remaining attractive, said John Cole Scott, AICA Chairman and President of Closed-End Fund Advisors (CEF Advisors), during his firm's 49th consecutive quarterly research call.

"BDCs have continued to recover well, showing their relatively tightest performance since 2014, and very rarely have been narrower on a year average," Scott said, referencing BDC's average discount (-2.47%) for the quarter. Those comments came during his presentation of CEF Advisors' Q1 2024 review and outlook of the CEF and BDC universe on April 24, 2024.

Referencing his firm's [15 Major CEF Sectors Index], Scott said the first quarter of the year was a "very powerful" one performance-wise, with discounts for the average fund-per-sector-basis narrowing by 3.65% and generating a "solid" +4.6% net asset value (NAV) return for an overweight credit experience for investors. The index benchmarks the seven most liquid funds by 90-day average trading-dollar liquidity in each of the 15 major groupings of funds and includes many of the types of funds Scott covered on the Q1 call.

Scott also noted that 13(D) and 13(G) filings were up dramatically during the quarter — 436 versus 98 on average per quarter — which he attributed to new, very active investors in the traditional CEF space. Year to date, there were five IPOs: 1 traditional equity CEF and 4 very large, direct-listed, debt-focused BDCs, with average assets of $1.8 billion.

[CEFData.com] tracks $790 billion in fund assets across 780+ closed-ended management companies, which include traditional CEFs, BDCs, tender offer funds, and interval funds.

Asset Levels

Traditional listed closed-end funds ended the first quarter of 2024 with about $311 billion in total gross assets across roughly

423 funds. Those results include:

- Equity funds, with $142 billion across 181 funds
- Taxable bond funds, coming in at $81 billion across 131 funds
- Tax-free municipal bond funds, with $86 billion across 111 funds

Nuveen led the pack in total gross assets, ending the quarter with $54 billion in 45 CEFs across 18 different sectors. BlackRock had the most funds, with $48 billion in 51 CEFs across 22 peer groups. Both firms far outpace their peers in assets and sector exposure.

Discounts

Scott said the average traditional CEF ended the quarter at about a -6.5% discount, compared to the 25-year average of -4.5%. Those results aren't as extreme as 2023's end-of-year average of -9.5%, but discounts remain attractive historically speaking, Scott said.

"Ninety-one percent of closed-end funds were positive on the quarter on a market price basis, but only 76% on a net asset value basis," Scott said of CEF total returns in Q1. He added that the dispersion of average discounts across different CEF sectors is likely to remain wide this year in light of presidential politics and the continuing interest rate drama. Looking at 25 years of discount data, Scott noted that CEF discounts have been wider than they are now only 18% of the time.

Equity CEFs

Equity CEFs, including BDCs and municipal bond funds, ended Q1 at about a -6.9% discount versus a long-term -6% average. Highlights (discount levels to NAV) within the grouping include:

- Master limited partnership (MLP) funds: -10.0%, narrowing by about 2%
- Real estate investment trust (REIT) real asset funds: -5.7%, narrowing by about 4%

Equity CEFs have indicated 7.7% yield on average.

Taxable Bond Funds

Taxable bond funds, levelling at a -3.4% discount, also recovered in Q1 2024 to their 25-year averages, Scott said. Some sector highlights include:

- Senior loan funds: -4%, narrowing by about 3.6%
- Convertible bond funds: -2%, narrowing by about 4%

Taxable bond CEFs have indicated 10.1% yield on average.

Municipal Bond Funds

Municipal bond funds ended the quarter

at a -9.88% discount, narrowing by about 2.5%. Looking at 25 years of discount data, Scott noted that discounts for the sector have been wider than they are now only 5% of the time. "This will drive the future of the closed-end fund pricing of the muni sector," Scott said. "The long-term average continues to be about -3.5%, and while I do think it will take longer to heal than previous balances … there are a lot of tax-driven investors who will flock to this sector once interest rates stop rising steadily."

Parsing through the data, Scott said it was notable that while 90% of municipal bond funds were positive in price, 57% had a negative total return relative to NAV.

And while interest rates may be higher than they were three years ago, muni funds continue to generate attractive yields — something that should drive interest from family offices and high earners, Scott said. At the end of the quarter, munis generated market price yields of +5.0%, or tax-equivalent yields of between +8.8% and +9.1%, Scott noted for very high-income investors, emphasizing the correlation between higher yields and wide discounts.

Municipal bond CEFs have a 5% average yield for the quarter, using about 31% total leverage. However, muni funds were down -0.6% year to date on a NAV total return basis, Scott said.

Muni liquidity was up on a one-year basis at +30%, but down dramatically on the quarter at -31%, which Scott was "not surprising" due to the traditional fourth-quarter tax-loss trading frenzy.

Dividends for munis spiked during the quarter — far more than in other sectors — following last year's rash of cuts. Scott said the Q1 results reflect "defense for proxy season by overpaying the distributions in excess of expected earnings."

BDCs

BDCs had total assets of $319 billion in gross assets across 147 funds, including:

- 50 listed BDCs with $142 billion in gross assets
- 97 non-listed (private) BDCs with $177 billion in gross assets

Of the 15,000 portfolio companies in the combined universe of listed and non-listed BDCs, five sponsors control 53% of all BDC assets: Blackstone, Blue Owl, Ares, FS/KKR, and Golub Capital. The average BDC loan size is about $8.7 million, with 73% of loans under $25 million per BDC's allocation.

Speaking to the Q1 extended recovery of debt-focused BDCs, Scott noted that 70% had positive returns on a market price basis, with 59% trading at a discount and 41% trading at a premium with an average discount of -1.64% to NAV. That result compares with debt BDCs' 19-year average discount of -3.64%, Scott said. In the past year, BDC discounts have narrowed over 9% and have a one-year total return of 27.7%.

BDCs on average remained the most volatile sector in comparing market price versus NAV. Scott noted that the BDC structure, and the private nature of BDC holdings, allows for only four NAVs per year.

BDCs have an indicated yield of about 10.4% and use about 51% total leverage on average.

Interval and Tender Offer Funds

The interval and tender offer fund space continued to expand, with the number of interval funds rising to 94, with about $89 billion in assets across the sector. That's a sizable jump from just five years ago when there were 68 active interval funds.

At the end of Q1 2024, there were 212 tender offer funds with $249 billion in assets under management. Of those, 115 are non-BDC tender offer funds with $72 billion in assets. The bulk of exposure in the sector overall focuses on venture/private equity and fund of funds.
During the call, Scott lauded the sector's growth, diversification of asset classes and sectors, and management.

Yields, Dividends, and Distributions

The average fund as measured by CEF Advisors' 15-sector index ended the quarter at 9.5% forward-looking yield, and their one-year dividend growth is about 7%, Scott said. Total returns for the average fund, on a market price basis, were up 8.3% for the quarter, with about 4.5% based on NAV and about 3.5% due to discount narrowing.

Senior loan funds showed the most liquidity increase on a one-year basis (+60%) but were flat (+1%) during the quarter.

There were more increases than decreases in CEF and BDC distribution during the quarter, 131 versus 35, but Scott said the spike in the former resulted from "fake" increases based on section 19(a) notices for municipal bond funds. "This doesn't mean you can't benefit from it," Scott said. "When a discount is 10, 12, 14, 15 — we're fine overpaying us the dividend — but you have to go back and reinvest a piece of that or you cannot be retired for 40 years and survive," he added.

Activism

Activism continued to be a big focus of the CEF universe in Q1, with the top five activists consisting of Bulldog Investors/

SPE, City of London, Karpus Investment Management, Saba Capital Management, and SIT Investment Associates. At the end of 2023, activists had $5.1 billion at work, rising to $19.8 billion when combined with the movement's followers.

At the end of 1Q 2024, activists had $6.2 billion at work, rising to $21.1 billion when combined with the movement's followers. In the first two weeks of January alone, Saba raised over $1 billion in net new 13D filings, Scott noted.

Access the replay of [CEFA's Q1 2024 presentation and full slide deck] at CEF Advisors' website. CEFA is an income-focused investment firm with an industry-leading database and a suite of portfolios centered on the listed and non-listed universe of CEFs, BDCs, interval funds, and tender offer funds.

About CEF Advisors

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About AICA

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