CEF Discounts Continue Tailwind Trajectory in Q2 2024

Discounts for the universe of closed-end funds (CEF) continued to narrow in the second quarter of 2024 — a trend that continued to make a dent even in the stubbornly inexpensive municipal bond sector, said John Cole Scott, AICA Chairman and President of Closed-End Fund Advisors (CEF Advisors), during his firm's 50th consecutive quarterly research call.

Referencing his firm's 15 Major CEF Sectors Index, Scott said the second quarter of the year saw discounts for the average fund-per-sector-basis narrowing by -0.88% and generating a 1.75% net asset value (NAV) return. The index benchmarks the 100 most liquid funds by 90-day average trading-dollar liquidity in each of the 15 major groupings of funds.

Prices for the average CEF were up 2.63% during the quarter, which Scott described as having "almost the same weighting" to business development companies (BDCs), investment-grade REITs, master limited partnerships, municipal bond funds, and preferreds. Combined with positive yield results, CEFs had a great second quarter overall.

"It's truly a diversified liquid exposure," Scott said. "There's still lots of room for continued recovery … and upside." Those comments came during his presentation of CEF Advisors' Q2 2024 review and outlook of the CEF and BDC universe on July 18, 2024.

CEFData.com tracks $826 billion in fund assets across 787 closed-ended management companies, which include traditional CEFs, BDCs, tender offer funds, and interval funds.

Asset Levels

Traditional listed closed-end funds ended the second quarter of 2024 with about $459 billion in total gross assets across 469 funds. Those results include:

- Equity funds, with about $144 billion across 174 funds.
- Taxable bond funds, coming in at about $83 billion across 133 funds.

- Tax-free municipal bond funds, with about $85 billion across 111 funds.
- BDCs, with $147 billion.

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 continue to far outpace their peers in assets and sector exposure, with Franklin Templeton a potential contender with 29 funds across 16 sectors.

Discounts

Scott said the average traditional CEF ended the quarter at about a -6.2% discount, compared to the 25-year average of -4.9%. "We're roughly in line with the three and five year averages [of -6.4%]," he added.

Looking three years into the future, Scott said he estimates the average discount in the CEF and BDC universe will be closer to -3.75% or -4.25%, basing his forecast on current retail investor behavior, trends to protect discounts and curb activism, and eventual interest rate reductions.

A 25-year snapshot of discount history reveals that discounts were wider than the median about a fourth of the time. "About 76% of the time, discounts were higher … and so we do expect more tailwinds in discounts going forward than headwinds," Scott said.

Digging deeper into the data for Q2 2024, Scott found that:

- Equity CEFs ended the quarter at about a -8.5% discount vs a -5.5% median.
    - Master limited partnerships averaged -9.8%, narrowing by about 2.4%.
    - Covered call funds averaged a -6.3% discount to NAV, narrowing by 1.5%.

- Taxable bond CEFs ended Q@ at a -2.6% discount vs a -3.6% 25-year median.
    - International bond discounts narrowed by 2.8%.
    - Senior loans and preferreds both narrowed by 1.8%.

- Municipal bond funds ended Q2 at a -8.39% discount to NAV, narrowing by 1.6%.
    - 99% of muni CEFs ended the quarter at a discount.

- BDCs (40%) ended Q2 at a premium to NAV, with an average -1.1% discount to NAV vs a 19-year median of -2.97% for the sector.

BDCs

Listed and non-listed BDCs represent 41.5% of the universe of funds that CEFData.com tracks. BDCs in the second quarter of 2024 had total assets of $344 billion in gross assets across 154 funds, including:

- 51 listed BDCs with $147 billion in gross assets.

- 103 non-listed (private) BDCs with $197 billion in gross assets.

Blackstone and Blue Owl continue to be the top BDC sponsors in terms of total assets under management, managing $57.1 billion and $36.6 billion, respectively. Neuberger Berman and Morgan Stanley manage the most funds (11 and 10, respectively), with nine sponsors now managing more than five funds and 16 sponsors managing more than four.

"As the sector grows and diversifies, there are a few players with a lot of assets, and a lot players with medium-sized assets, which is less common with ETFs and open-end funds," Scott noted.

The average BDC loan size is about $8.5 million, with 74% of loans under $25 million per BDC's allocation.

Scott said BDCs continued to trade well in the second quarter, with five new debt-focused BDCs emerging this year. One of those, Kayne Anderson BDC (KBDC), launched on May 22.

NAVs for debt-focused BDCs, traditionally the highest-yielding funds, are at an all-time high, Scott noted. The next earnings season for BDCs begins on July 30, 2024, and is expected to generate strong results.

Municipal Bond Funds

Similar to last quarter, municipal bond funds were 90% positive in price at the end of Q2, and remain "historically very attractive," Scott said.

Municipal bond funds ended the quarter with an average discount of about -8.3%. "Munis look so much better than the last six months, but are still nowhere near expensive … and nowhere near on the recovery," Scott said. (Municipal bond funds ended the first quarter of 2024 at a -9.88% discount, having narrowed by about 2.5%.)

Scott said the level of discounts and leverage in the sector are increasing fund distributions by 41% and boosting overall sector optimism.

Interval and Tender Offer Funds

Interval funds continue to grow in popularity, building a larger basket of assets in Q2. There are 104 interval funds with $98 billion in total assets under management (compared to that of listed CEFs of $311 billion across 417 funds per CEFData.com). Scott said he expected the interval fund sector to keep growing, saying the sector was on pace to reach 115 by the end of the year.

The bulk of exposure in the sector focuses on global credit, loans/structured credit, and fund of funds.

Tender Offer Funds, a type of non-listed CEF, totaled 115 in number at the end of the quarter, with $74 billion in managed assets. These funds have most of their exposure in BDCs, private equity, hedge funds, and fund of funds.

Yield and Performance

Returning to his firm's [15 Major CEF Sectors Index](), Scott said the second quarter of the year saw the average listed fund generate a 10.1% blended yield, providing a significant boost to the market dollars in a portfolio. Diving deeper into the numbers, Scott found that:

- Equity CEFs generated an 8.2% yield, with 13% leverage.
- Taxable bond CEFs generated a 10% yield, with 25% leverage.
- Municipal bond funds CEFs generated a 5.7% yield, with 31% leverage.
    - The average cost of leverage is 4.9%
    - This is a 9% tax-equivalent yield for high income investors.
    - The average duration is 11 years.
- Debt BDCs generated a 10.4% yield, with 50% leverage.

Leverage costs rose slightly across the sector, ticking up between 5.5% to 6.9%, with about $73 billion in total CEF leverage.

The one-year dividend growth rate stood at 15% at the end of Q2, resulting from what Scott referred to as an ongoing spate of "fake yields" due to sponsors' efforts to narrow discounts and fight activism.

Prices for the average CEF were up 2.63% during the quarter, with 81% of CEFs positive on their market price total return. This compares with the S&P 500 Equal Weight Index, which was off -2.6% in the second quarter but up 5% year to date.

Activism

Activism was again a big focus of the CEF universe in Q2, 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 the quarter, activists had $6.6 billion at work, rising to $22.2 billion when combined with the movement's followers.

During the call, Scott noted how Saba Capital continues to put "intense pressure" on dividend sustainability and the durability of many funds and sectors in the listed universe of CEFs and BDCs. (Not just their battle with BlackRock, but with other funds managed by Nuveen and Franklin Templeton.) "Many funds are now overpaying at levels that defy logic" as a result, he said. Scott said this should prompt more investors to reinvest those dollars.

"The good news is the size and might and level of concern and discomfort in the boardrooms and the decision tree to IPO closed-end funds will create a better future discount program for the entire U.S. market, that is, roughly 85% of the universe of closed-end funds — and that's a positive thing," Scott said.

Scott also noted that Pershing CEO Bill Ackman has a CEF IPO in the offing, describing it as a "clone" of Ackman's U.K. fund. Initially touted as the largest IPO ever at $25 billion, Ackman has since nudged that down to $10 billion, with sources saying that inflows have already begun. Scott called the IPO promising but added it's hard to see a near-term sustainable premium common for the fund.

He also noted a new effort to tamp down on activism: a proposal from the NYSE to remove annual meetings. "Please voice your concern to the SEC as we believe investors large and small should have a vote when needed," Scott said.

Take Action

Looking ahead, Scott noted the importance of tax-loss swapping, encouraging advisors to look at the marginal rate and estimated dividend classification to better inform asset allocation and fund selection decisions for clients and themselves.

Scott elaborated on this further in a July 26, 2024, interview with Chuck Jaffe on the NAVigator Podcast: "Just in the last month we rotated out of BDCs and muni funds for net neutral taxation to our taxable clients while keeping the asset allocation in the dividends and sturdy terms — and a very useful thing — we've done that over nine times in the last three years for many of our larger clients," he said. "I think that's the beauty of a closed-end fund investor, the discount tailwind and the ability to rotate during the market day."

Register to hear a replay of CEF Advisors' Q2 2024 review and outlook and to download the slide presentation. The next quarterly call is scheduled to take place sometime in October.

The next Active Investment Company Alliance roundtable conference will take place in New York City on November 13, 2024. Please join us!

About CEF Advisors

Closed-End Fund Advisors is a SEC registered, fee-based registered investment advisory firm founded in 1989 with headquarters in Richmond, VA. If you're looking for specialists in closed-end funds, look no further than CEF Advisors. For over 35 years, we've lived at the crossroads of

CEF investing, research, and advocacy. We're dedicated to making investment decisions based on the freshest, most accurate information, hand-compiled by our data team. Whether you're looking for a fee-based registered investment advisor, searching for CEFs, BDCs, and interval funds or seeking detailed information to make your own data-driven investment decisions, trust CEF Advisors to deliver outstanding results. Visit CEFAdvisors.com to learn more.

About AICA

The Active Investment Company Alliance is a trade association founded in 2019 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 balanced spokesperson, we advocate for our member firms' funds, institutional investors, and seek to educate investors, and the advisors that serve them, about fund structures and specific strategies. Our primary methods of advocacy are through our weekly NAVigator podcasts hosted by Chuck Jaffe, video interviews with Jane King, articles, and events we conduct throughout the year.