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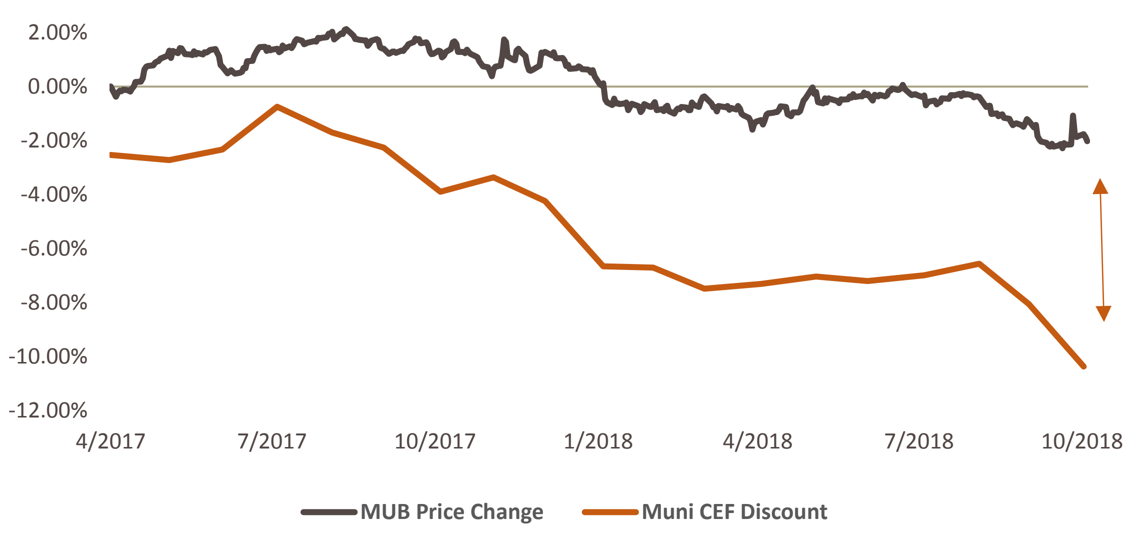
Investment Perspectives – November 2018

Closed-end municipal bond funds are trading at historic discounts to NAV giving investors the opportunity to earn over 5% tax free.

Closed-end mutual funds are unique and get less attention than traditional open-end mutual funds and exchange traded funds. Closed-end funds are sold primarily to retail investors and traded thinly on the open market, which results in prices often departing from the value of the underlying assets. Typically, closed-end funds trade at modest discounts to their net-asset-value (NAV) but occasionally, due to strong selling pressure, funds can trade at very large discounts to NAV. These times of strong selling pressure can present an attractive buying opportunity for investors. The municipal closed-end fund market may be presenting such an opportunity today.

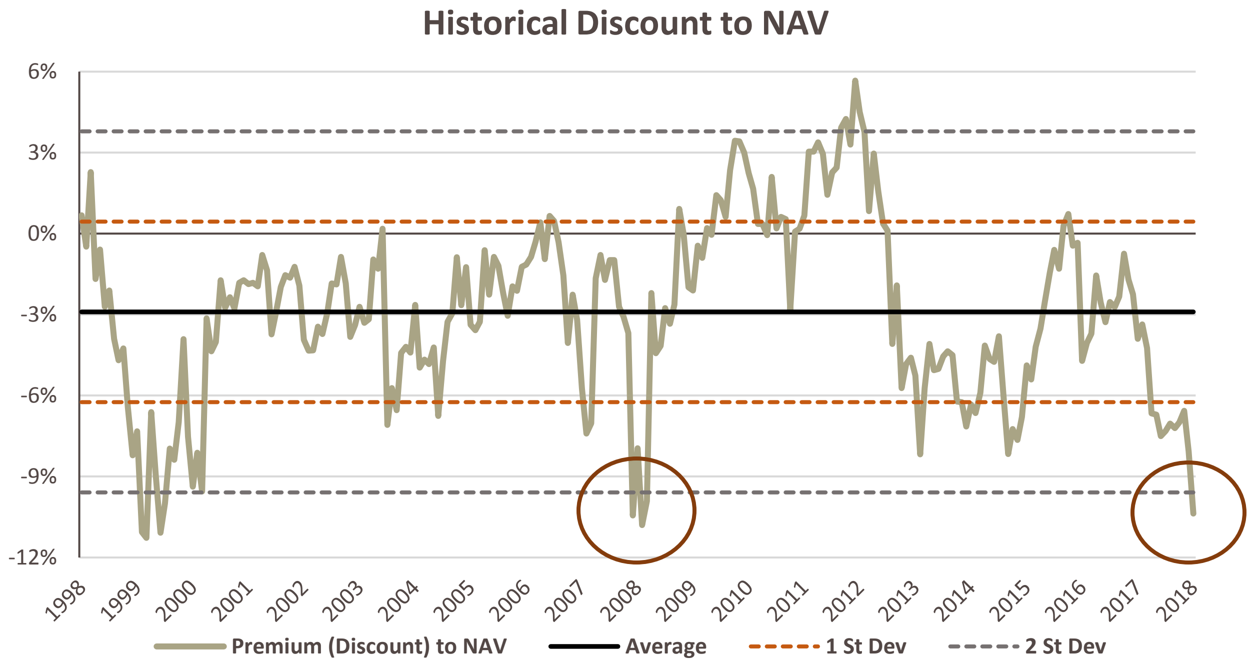
In 2018 muni closed-end funds have seen their discount to NAV widen significantly. We believe the widening discounts are attributable to three main causes: (1) rising long term interest rates, (2) concerns about funds reducing dividends and (3) tax loss selling.

Muni Bond Market & Closed-End Fund Discounts



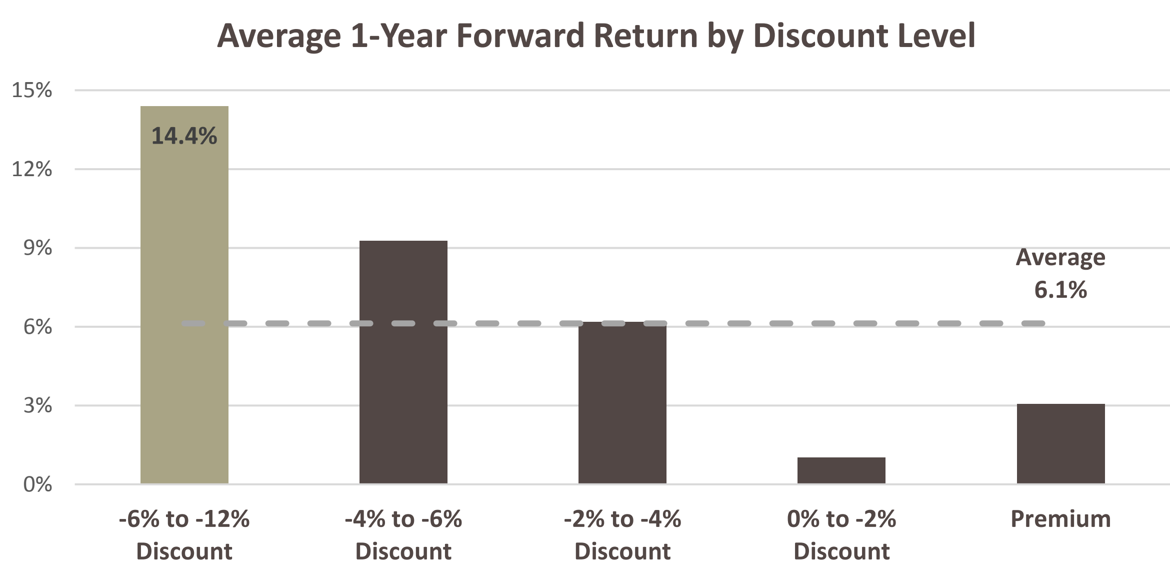
Source: Bloomberg. Analysis by 6 Meridian. Muni CEF discount is average discount to NAV across universe of 85 national municipal closed-end funds

The combination of these three factors has resulted in municipal closed-end funds trading at discounts to NAV that have rarely been seen other than during times of extreme financial stress. Discounts today are over 2 standard deviations below their normal levels. This level of discount resembles the discounts available during the depth of the 2008 financial crisis.



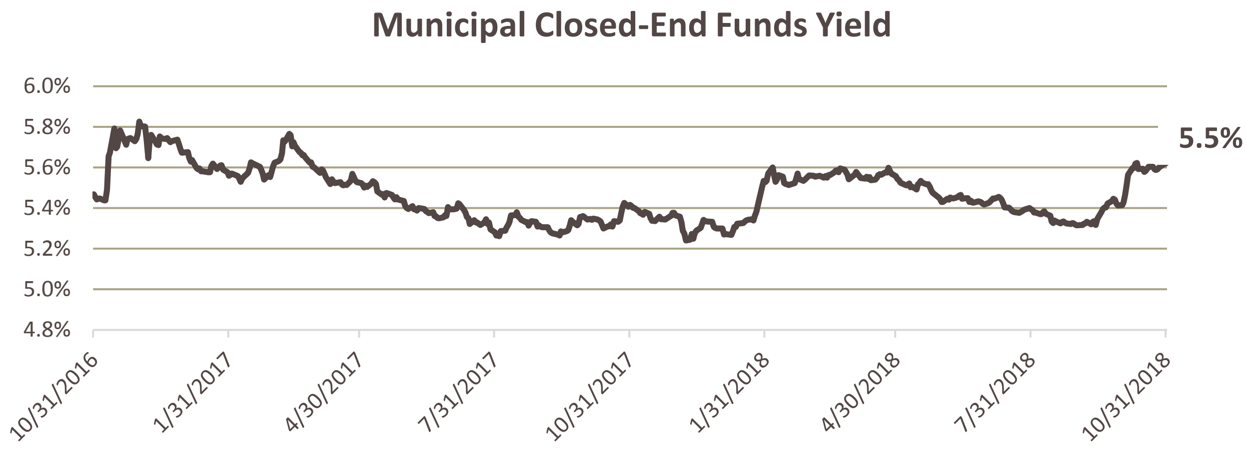
Source: Bloomberg. Analysis by 6 Meridian. Average discount to NAV across universe of 85 national municipal closed-end funds.

History has shown that buying funds when they are trading at larger than normal discounts to NAV typically results in outsized returns. In the chart below, we show the breakdown of various levels of NAV discounts and the subsequent 12-month average return. When discounts were between 6% and 12% (today they are at 11%) the average forward one-year returns were above 14% which is over twice as high as the long run average. Over the 20-year measurement period one-year returns were negative only twice when starting from discount levels greater than 6%.



Source: Bloomberg. Analysis by 6 Meridian. Average 1-year forward total return across universe of 85 national municipal closed-end funds.

Currently investors can own a diversified portfolio of municipal bonds that have a yield of around 5.5% tax free. This would compare to a taxable equivalent yield of around 8.7%.



Source: Bloomberg. 12-Month yield on S-Network Municipal Bond Closed-End Fund Index.

The story is not without risks. Closed-end funds use a modest amount of leverage when they invest (typically between $0.30 - $0.40 of borrowings for every $1.00 of equity). This leverage can magnify losses when the asset values decline, and the cost of the leverage is linked to short-term interest rates which have been rising. Discounts are currently wide on a historic basis, but that doesn't mean they can't get wider. Rising interest rates will most likely continue to be a headwind both for funding costs and potentially for the value of the assets that the funds own. Considering all these risks, we believe that current discount levels provide an adequate level of compensation and there is an opportunity to earn good returns going forward.

Please contact your advisor for ideas on how to implement this investment strategy.

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