Seeking Tax-Free Income From Closed-End Funds

By John Deysher and Michael Walters

Article Highlights

- Municipal bonds provide tax-free income, but they are subject to interest rate risk and credit risk.
- Closed-end funds can trade at a discount, or premium, to their underlying net asset value.
- Closed-end municipal bond funds should have solid credit ratings, a 10-year record or longer, and low turnover and expense ratios.

Four years ago we wrote an article for the *AAII Journal* highlighting the potential opportunities available in closed-end funds ("Rodney Dangerfield Investing: Closed-End Opportunities," April 2007).

We think now is a good time to revisit the topic, with a focus on municipal bond closed-end funds (CEFs) and their newer cousins, municipal bond exchange-traded funds (ETFs).

Why Consider Municipal Bonds Now?

With most world equity markets near record highs and interest rates near record lows, why consider municipal bonds (aka "munis")? There are several reasons.

First, municipal bonds remain the only game in town for capturing tax-free income. Municipalities must have a way to compete for investor capital, and keeping their interest tax-free (in most cases) accomplishes this. Other vehicles such as IRAs or tax-deferred annuities allow income to accumulate tax-free, but Uncle Sam must be paid upon withdrawal. There are also limits to what you can put in a retirement plan and lockups on annuities.

Next, tax rates are almost certain to rise in the near future, enhancing the appeal of tax-free income. On a tax-adjusted or equivalent-yield basis, municipal bond yields are several percentage points higher than corporates or Treasuries of the same maturity. For example, an eight-year Treasury bond currently yields about 2.5%. A similar high-grade municipal bond of the same maturity might yield 4%. If you live in a high-tax state where your combined tax bracket is 40% and you own a municipal bond issued within your state of residence, the taxable equivalent yield on the municipal bond is 6.6%, over four percentage points higher than the Treasury.

Finally, there are many vehicles investors might choose from to tailor a municipal portfolio to their specific circumstances. Besides actual bonds with different credit ratings and maturities, there are closed- and open-end municipal bond funds and exchange-traded municipal bonds funds (ETFs).

No Free Lunch

While the benefits of owning municipal bonds are clear, there are risks to be aware of.

Interest rate risk is the risk that an uptick in interest rates will result in a decline in a bond's value. Longer-maturity bonds will fall more; shorter-maturity bonds will fall less. If you hold the bond until maturity, you will normally get your principal back, barring any credit issues. Interest rates have been declining for 30 years and are now at historical lows. Many expect interest rates to return to more normal levels, which would hurt bond prices.

Credit risk is the risk of default and the possibility that interest or principal may not be paid according to schedule.

With many municipalities facing budget woes, this is a real possibility, although default rates among municipal bond issuers are very low. You can lower this risk by staying with general obligation or revenue bonds issued by mainstream issuers (not private-purpose entities) with solid credit ratings.

Early call risk is the risk that the issuer can call or redeem your bond before maturity. This often occurs if interest rates fall subsequent to the initial issuance, allowing the municipality to call the older issue and replace it with a new one at lower interest rates. The owner is faced with getting the principal back early and scrambling to invest it on similar terms, which may not be possible. If you buy individual bonds, make sure the bond is not callable at a price below what you pay for it or, if it is, that the interest rate received justifies the risk of an early call. Call provisions are available from your broker.

The Big Three: Basic Differences

Once you have decided that municipal bonds have a place in your portfolio, which vehicle do you chose: individual bonds, bond funds or bond ETFs? If your portfolio is large enough to accommodate several issues for diversification and you know your way around the municipal bond market, individual bonds might make sense. For most others, bond funds (open- and closed-end) or exchange-traded funds may be a better choice. Let's review the latter three.

Open-End Mutual Funds

Most investors are familiar with the structure of an open-end mutual fund. The fund will register with the Securities and Exchange Commission (SEC) under the Investment Company Act of 1940 and issue and redeem shares at net asset value (NAV) on any day the markets are open. (Net asset value is the underlying value of the fund's portfolio.) The share price reflects the net asset value with no premium or discount and, unless the fund closes, any number of shares may be issued.

Shareholders pay a percentage of assets (expense ratio) to cover the costs of managing the fund on an active basis. Distributions of realized net capital gains and net investment income must be made by the fund at least annually.

Closed-End Funds

Closed-end funds are slightly different. A finite pool of capital is raised and there is no continual offering of shares. Trades occur on a stock exchange at a market price determined by supply and demand. Excess demand will sometimes cause a closed-end fund to trade at a premium to underlying net asset value, while excess supply may result in the market price trading at a discount to net asset value.

Like open-end funds, most closed-end funds are actively managed, charge an expense ratio, and make distributions at least annually.

Exchange-Traded Funds

Exchange-traded funds (ETFs) represent a hybrid of the open- and closed-end structure. Like both, an ETF is a pool of securities with a dedicated purpose: to mimic a particular index or invest in a specific industry or country. ETFs are often passively managed and have lower expense ratios than open or closed-end funds. Like open-end funds, ETFs can issue an unlimited number of shares. Like closed-end funds, ETFs trade on an exchange where shares are bought or sold throughout the day at net asset value. (For a complete description of ETFs, see "The Individual Investor's Guide to Exchange-Traded Funds" in the October 2010 *AAII Journal*.)

Scrutinizing Closed-End Municipal Bond Funds

In Table 1, we list 50 closed-end national muni bond funds that have been around for at least 10 years and have investment-grade portfolios and where distributions exclude any return of capital (they pay out interest and net realized gains only). Generally, you should review the following in examining closed-end municipal bond funds.

Solid Credit Rating

While one of the attractions of a fund is diversification across many different issues, it's always good to see a high weighted-average credit rating, as defined by Morningstar, of at least BBB– or better. This is considered investment grade and reduces, but doesn't eliminate, the risk of an individual bond defaulting.

10-Year Record or Better

This is long enough to see how a fund does throughout a cycle. Examine how the NAV performance compares to the benchmark. Stock price performance is less important since a manager can't control the premium or discount. However, closed-end fund managers can impact the net asset value via astute security analysis, portfolio management and share buybacks. For example, in Table 1, while the average 10-year NAV annualized rate of return through April 29, 2011, was 5.4%, there was significant variance around that average. The highest annualized return was 7.9% and the lowest was 3.8%.

Premium/Discount History

Review how big the premium or discount to net asset value gets over a several-year period. A significant discount alone is no reason to buy a closed-end fund, but if all else is acceptable, it's better to buy when the discount is at its widest. Likewise, when selling, try to sell when the premium is at its widest. Knowing the historical fluctuations of discounts and premiums will help you do this. While current discounts average 3%–4%, they can widen to 15%–20% during periods of extreme uncertainty, as occurred in late 2008 and early 2009. Those discounts quickly narrowed, however.

Low Turnover

High turnover generates commissions and taxes. We generally prefer low turnover and longer holding periods to capture the true potential of a security. The average turnover of the funds in Table 1 is 18%, meaning the average holding period is slightly greater than five years.

Table 1. Select Closed-End National Municipal Bond Funds

Closed-End Fund (Ticker)	Yield (%)	10-Yr Annualized Return* (%)	Duration (Yrs)	Leverage-Adjusted Duration (Yrs)	Leverage (%)	Average Credit Rating	Total Assets ($ Mil)	Turn-over (%)	Expense Ratio (%)
BlackRock Muni Hldg (MHD)	7.3	7.9	7.6	12.3	38	BBB-	330	31	1.46
BlackRock Muni Hldg II (MUH)	7.0	7.8	7.9	12.4	37	BBB-	240	34	1.43
Amer Muni Income (XAA)	7.6	6.4	15.1	22.8	36	BBB-	120	35	1.24
BlackRock Muni Assets (MUA)	6.7	6.2	7.5	7.8	4	BB+	448	26	0.69
Nuveen Advantage Div II (NXZ)	7.3	6.2	6.7	10.9	38	BBB	633	5	1.30
Invesco Insured Muni Trust (IIM)	6.2	6.1	8.0	12.4	34	BBB+	445	11	1.00
Dreyfus Muni Income (DMF)	6.6	6.1	7.5	11.7	36	BBB	277	22	1.52
Nuveen Advantage Div (NAD)	7.2	6.0	8.5	14.2	40	BBB	855	9	1.18
BlackRock Muni Yield II (MQT)	7.1	5.9	7.9	13.4	41	BBB+	440	22	1.58
Invesco Insured Muni Trust (IMT)	6.5	5.8	7.8	12.1	34	A-	356	9	1.16
Nuveen Quality Muni (NQM)	7.0	5.8	7.5	12.5	39	BBB	801	10	1.32
Nuveen Premier Fund (NPF)	6.8	5.8	6.0	10.4	41	BBB	459	13	1.52
BlackRock Muni Yield (MQY)	7.0	5.8	7.5	12.7	41	BBB+	693	22	1.57
BlackRock Muni Quality II (MUE)	7.2	5.7	7.6	13.0	41	BBB+	470	36	1.43
Nuveen Muni Advantage (NMA)	7.5	5.7	8.9	14.9	40	BBB	952	12	1.39
Invesco Quality Trust (IQT)	7.0	5.7	7.1	11.0	35	BBB	273	15	1.03
BlackRock Muni Quality (MFL)	6.9	5.6	7.5	12.8	41	A	830	34	1.31
BlackRock Muni Insured (MUS)	7.3	5.6	7.4	13.0	42	BBB+	280	40	1.49
BlackRock Muni Yield (MYF)	7.1	5.6	7.9	13.5	41	BBB	296	39	1.38
Invesco Quality Muni (IQM)	6.5	5.6	7.8	11.9	34	BBB	275	14	1.06
Nuveen Insured Opportunity (NIO)	6.4	5.5	6.9	11.5	40	BBB	2,160	8	1.30
BlackRock Muni Enhanced (MEN)	7.0	5.5	7.4	12.5	40	BBB+	500	24	1.58
Nuveen Quality Income (NQU)	7.1	5.5	8.3	13.7	39	BBB	1,180	10	1.28
Duff & Phelps Tax Free (DTF)	5.2	5.4	7.1	10.5	33	BBB	195	13	1.35
Nuveen Premium Insured (NPX)	6.3	5.4	7.9	12.9	39	BBB+	757	9	1.77
BlackRock Strat Muni Trust (BSD)	7.4	5.4	7.7	12.6	39	BBB-	145	29	1.29
Nuveen Premium Income (NPI)	7.1	5.3	7.0	11.9	40	BBB	1,398	10	1.35
MFS Muni Income Trust (MFM)	7.8	5.2	8.3	12.4	30	BB+	370	18	1.52
Nuveen Premium Trust (NPT)	7.3	5.1	8.5	14.2	40	BBB	860	11	1.51
BlackRock Muni Yield (MFT)	6.9	5.1	7.4	12.5	40	BBB+	180	32	1.40
Nuveen Quality Insured (NQI)	6.7	5.1	7.5	12.7	41	BBB+	847	8	1.34
Invesco Quality Income (IQI)	7.1	5.1	6.0	10.0	40	BBB	475	13	1.19
Western Asset Intermed (SBI)	5.2	5.0	5.5	6.7	27	BBB	183	17	1.07
Nuveen Muni Income (NMI)	5.7	5.0	7.9	7.9	0	BBB-	83	9	0.81
Putnam Managed Muni (PMM)	7.6	5.0	7.4	9.9	25	BB+	530	24	1.12
Nuveen Market Opportunity (NMO)	7.8	4.9	9.0	15.5	42	BBB	982	13	1.39
MFS Investment Grade (CXH)	7.4	4.9	9.3	14.0	35	BBB-	160	23	1.36
Invesco Income Oppor Trust (OIB)	7.0	4.9	9.4	10.0	7	BB	122	19	0.83
Western Asset High Inc (MHF)	6.1	4.8	7.6	7.6	0	BB+	157	17	0.75
Nuveen Muni Value (NUV)	5.1	4.8	8.6	8.9	3	BBB	1,853	9	0.63
Invesco Income Oppor Trust (OIA)	6.9	4.8	9.2	9.9	7	BB	134	22	0.83
Nuveen Select Portfolio (NXP)	5.4	4.7	5.6	5.6	0	BBB	224	5	0.32
Invesco Premium Income (PIA)	7.3	4.7	6.5	11.3	42	BBB	227	16	1.44
Nuveen Select Portfolio III (NXR)	4.9	4.6	4.9	5.0	0	BBB	177	5	0.38
Invesco Income Oppor Trust (OIC)	7.0	4.5	9.5	10.2	7	BB	69	23	0.91
Delaware Muni Income (VFL)	4.3	4.4	18.2	18.2	0	BBB	31	32	1.00
Van Kampen Insured Muni (VIM)	7.1	4.4	10.7	18.3	41	BBB	202	30	1.86
Invesco Insured Muni Secs (IMS)	4.3	4.3	9.5	10.0	4	BBB+	94	12	0.65
Nuveen Select Portfolio II (NXQ)	5.3	4.2	6.0	6.0	0	BBB	230	6	0.38
Nuveen Select Maturity (NIM)	4.2	3.8	3.7	3.7	0	BBB	125	9	0.60
Average	**6.6**	**5.4**	**8.0**	**11.6**	**29**		**482**	**18**	**1.19**

**10-year NAV annualized return through 4/29/2011.*
Sources: Securities and Exchange Commission, Morningstar. Weighted averages used for duration and credit rating.

Table 2. Select National Municipal Bond ETFs

	Yield (%)	Annualized Return* (%)	Duration (Yrs)	Average Credit Rating	Total Assets ($ Mil)	Turn-over (%)	Expense Ratio (%)
S&P Long AMT-Free Muni Bond (MUB)	3.8	3.5	7.5	A	2,000	8	0.25
S&P Short AMT-Free Muni Bond (SUB)	1.3	3.3	2.1	A	410	22	0.25
Barclays High Yield Muni Bond (HYD)	6.3	11.8	9.5	BB	210	18	0.35
Barclays Intermed Muni Bond (ITM)	3.5	3.8	6.5	AA	220	22	0.25
Barclays Long Muni Bond (TFI)	3.6	3.8	9.3	AA	850	9	0.23
Barclays Short Muni Bond (SHM)	1.6	4.0	2.8	AA	1,300	14	0.20

*Returns calculated since each fund's inception.
Weighted averages used for duration and credit rating.
Source: Morningstar.

Constant or Declining Shares Outstanding

We generally aren't excited by closed-end funds that raise capital via rights or secondary offerings. We normally prefer smaller asset bases to larger ones, which can sometimes lead to a lowering of standards to keep the portfolio fully invested. Most of the funds in Table 1 have kept their share base stable for the last several years. Several have repurchased shares in recent years, which if done properly at less than net asset value, can be immediately accretive.

No Returns of Capital

Many funds attempt to attract investors by maintaining an above-average yield funded by a return of capital/principal. Essentially this means giving us our money back, which of course results in a declining net asset value and share price over time.

High Insider Ownership

All closed-end funds file proxies in conjunction with their annual meetings that show insider ownership. The higher the ownership the better.

Low Expense Ratio

Since the expense ratio directly reduces shareholder return, we prefer lower ratios. The average in Table 1 is 1.19%, with a range of 0.32% to 1.86%.

Duration

The weighted-average duration of a closed-end muni bond fund indicates how much interest rate risk is embedded in the portfolio. As previously mentioned, interest rates and bond values move in opposite directions with the longest durations fluctuating the most, up or down. For example, if a fund has a duration of eight years, and interest rates rise by one percentage point (100 basis points), the fund's value will fall by 8%. Conversely, if interest rates fall by one percentage point, the bond's value will rise by 8%. If interest rates rise or fall by two percentage points, the bond's price will change by 16%.

Which is better, a long- or short-duration portfolio? It depends on which way you think interest rates are going. If you expect a rise in interest rates, you're better off with a short-duration portfolio that will fall less. If you expect rates to fall, you're better off with a long-duration portfolio, which will rise in value more than a shorter-duration portfolio.

Fund investors should assess this carefully. Holders of individual bonds will normally be paid off at maturity regardless of duration, even if rates go against them in the interim.

However, bond fund owners are more vulnerable to interest rate risks, since there is no moment at which all bonds in the portfolio mature at once. Bonds are constantly maturing, with the proceeds being reinvested to maintain a maturity/duration consistent with the prospectus. The net asset value will fluctuate with interest rates, and the proceeds obtained upon sale may be more or less than the original cost.

At this point in the interest rate cycle, we suggest giving consideration to short-duration funds. In our opinion, investors are not compensated with enough additional yield to justify the risk of longer durations. The weighted-average duration in Table 1 is eight years, which provides an average current yield of 6.6%. However, there are shorter-duration funds that generate only slightly lower yields with comparable expense ratios and quality.

A Word About Leverage

Many municipal bond funds use leverage to enhance their returns. They will often obtain the leverage by issuing adjustable-rate securities (often preferred shares) with dividends that are tied either directly or indirectly to short-term interest rates. Proceeds from the preferred issuance are used to invest in higher-yielding, longer-maturity municipal bonds. The higher interest earned on the long bonds more than offsets the preferred dividends, and the common shareholders pocket the difference with a higher return.

In times of a normal sloping yield curve (lower short-term interest rates, higher long-term interest rates), this formula normally works. However, if the yield curve starts to flatten (short- and long-term rates are similar), or worse, becomes inverted (long-term rates are lower than short-term rates), trouble ensues. The cost of the preferred dividends becomes greater than the interest generated by the longer-maturity bonds. Since the preferred shareholders are always paid before the common shareholders, there may be little left over to pay the common shareholders, who will often liquidate their holdings, causing a rapid price decline.

Even if the yield curve remains upward-sloping, leverage magnifies the risk inherent with a change in interest rates. As mentioned earlier, the longer a fund's duration, the more sensitive it is to a change in interest rates. Adding leverage automatically extends a bond's duration since the owner is getting cash flows back at a slower rate due to the additional cost of the leverage. Thus, a leveraged muni bond portfolio with its longer durations is especially vulnerable to a rise in interest rates.

Table 1 shows that even though the average duration of the funds shown is eight years, the average leverage-adjusted duration is 11.6 years, almost 50% longer. If you invest in a leveraged closed-end muni bond fund, make sure you know what the leverage-adjusted duration is. This dictates how the value of your fund will respond to changes in interest rates.

Are Municipal Bond ETFs a Better Alternative?

In Table 2 we list several well-known national muni bond exchange-traded funds, each of which is designed to mimic a particular municipal bond index. While most have been in existence only two or three years, this is long enough to draw some general conclusions.

- Unlike closed-end muni bond funds, municipal bond ETFs rarely trade at a discount to net asset value. In times of muni bond market distress, when discounts to net asset value widen, closed-end funds should be the vehicle of choice, all other factors (duration, credit rating, etc.) being equal.
- Municipal bond ETFs are non-leveraged, so their duration will be tied to the duration of the underlying bonds and they will normally be less volatile when interest rates fluctuate.
- Table 3 shows that weighted-average durations of ETFs tend to be shorter than those of closed-end funds. If you are seeking a shorter duration to avoid the pain of higher interest rates, municipal bond ETFs provide a greater ability to target this.

Table 3. Comparison of Municipal Bond Funds

	Expense Ratio (%)	Yield (%)	Total Return (%)	Duration (Yrs)	Turnover (%)
Short-Term ETFs (2)	0.22	1.4	3.7	2.4	18
Short-term CEFs (2)	0.38	5.1	4.4	5.5	6
Long-term ETFs (3)	0.22	3.6	3.7	7.8	13
Long-term CEFs (48)	1.19	6.6	5.4	8.0	18

- Municipal bond ETFs appear to offer comparable returns at a lower cost. The average expense ratio for the ETFs in Table 2 is about 0.26% vs. 1.19% for the CEFs in Table 1. However, as can be seen in Table 3, the closed-end fund returns aren't dramatically better.

Conclusion

For individuals in high tax brackets in search of tax-free income from a diversified portfolio, closed-end muni bond funds and muni bond ETFs make sense as alternatives to individual bonds. They are fairly liquid and may be purchased through normal brokerage firms. Each provides investors with a wide array of choices regarding dura-

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More Information on Closed-End Funds

The following websites are useful for researching closed-end funds.

CEF Connect
www.cefconnect.com
Features a closed-end fund screener, education center and other tools.

Closed-End Fund Association
www.cefa.com
Offers useful information on various closed-end fund categories, distributions, leverage and performance.

Closed-End Fund Forum From Capital Link
www.closedendfundforum.com
Provides fund statistics, industry reports, information on events, interviews and conferences.

Morningstar
www.morningstar.com
Offers a large amount of free information on a variety of closed-end funds and ETFs.

QuantumOnline.com
www.quantumonline.com
Offers multiple listings of closed-end funds, real estate investment trusts (REITs), master limited partnerships (MLPs), royalty trusts, ETFs and other investment vehicles. Although registration is required, the website won't bother you with unwanted promotional emails.

that will provide above-normal returns. When investing in such potentially volatile stocks, it is very important to have a system in place that gets you out of a trade with only a minimal loss, while allowing the winners to ride until their momentum burns out. As the tech bubble of the late 1990s and the financial crisis of 2008–2009 showed, momentum strategies can crash back to earth very quickly, with potentially devastating consequences for investors.

As always, keep in mind that screening is only the first step in the investment process. The stocks passing this or any other screen do not represent a "recommended" or "buy" list. Before making any investment decisions, it is important to perform sufficient due diligence to identify those stocks that match your investing tolerances and constraints. ➤

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tion, credit ratings and leverage.

Closed-end funds can often be purchased at a discount to net asset value during periods of market turmoil, providing the opportunity for additional gains. ETFs rarely trade at such discounts. They often offer similar benefits to closed-end muni bond funds, but at a much lower cost.

However, there are risks—including interest rate risk, the impact of which is magnified with a leveraged or a long-duration portfolio. Credit risk also exists and, while rare, muni bond defaults could happen in today's world. Even if a default happens outside your portfolio, the negative psychology could impact the value of your fund. While investing in closed-end funds and ETFs is very convenient, make sure you know the risks. ➤

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differences in yield between what you earn on Treasuries versus corporates, Treasuries versus high yield, Treasuries versus emerging market bonds, etc.) last seen before Lehman Brothers collapsed.

Be Preemptive

Even though the tug of war between bond bulls and bond bears continues, be preemptive if you are worried about higher rates. Shorten your duration; buy fixed-to-float or CPI-based individual bonds. Bond fund investors should rebalance from long-term funds to intermediate funds. If you cannot stand taking your profits from long-term funds, then buy an equal amount of ultra-short-term bond funds to barbell your long-term bond fund portfolio, thereby shortening your duration.

Floating-rate bond funds have a place in your portfolio, but the pile into them has been breathtaking; buy only on a pullback. Remember, these are bonds with call dates and final maturity dates. These are not some high-tech or biotech shares whose next big product will appear to make price appreciation limitless.

There are multiple strong cross currents and undertows in the bond market tug of war taking place. Don't let your portfolio be a casualty. Be a proactive bond investor. ➤

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