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# Better than zero

Much as the Fed would appear to hope that you starve to death, no self-respecting saver would give the central bank that satisfaction. The subject at hand is an income-producing closed-end fund that holds out a fighting chance (though not, of course, the certainty) of a decent return on one's capital.

Western Asset High Income Opportunity Fund (HIO on the New York Stock Exchange), founded in 1993, invests in junk bonds and pays a distribution yield of 8%, a pickup of 279 basis points over the Bloomberg/Barclays U.S. Corporate High Yield Index's yield-to-worst of 5.21%. Using no leverage, the fund delivered compound annual returns at NAV of 6.14% over the 10 years ended June 30.

To repeat, these are junk bonds, most of them with double-B and single-B names making up 43% and 36% of the portfolio, respectively. At the other extreme ends, bonds rated triple-B and higher add about 14%, those rated triple-C and lower, about 8%. Average duration is a middling 4.4 years, and the annual management fee is 88 basis points.

How does HIO do what it does? Mr. Market lends a helping hand. The shares trade at $4.89, a discount of 8.3% to net asset value. The existence of a discount is scarcely unusual in closed-end funds. Notable in this case is a pending cash tender offer, announced on June 22, the very purpose of which is to narrow the discount.

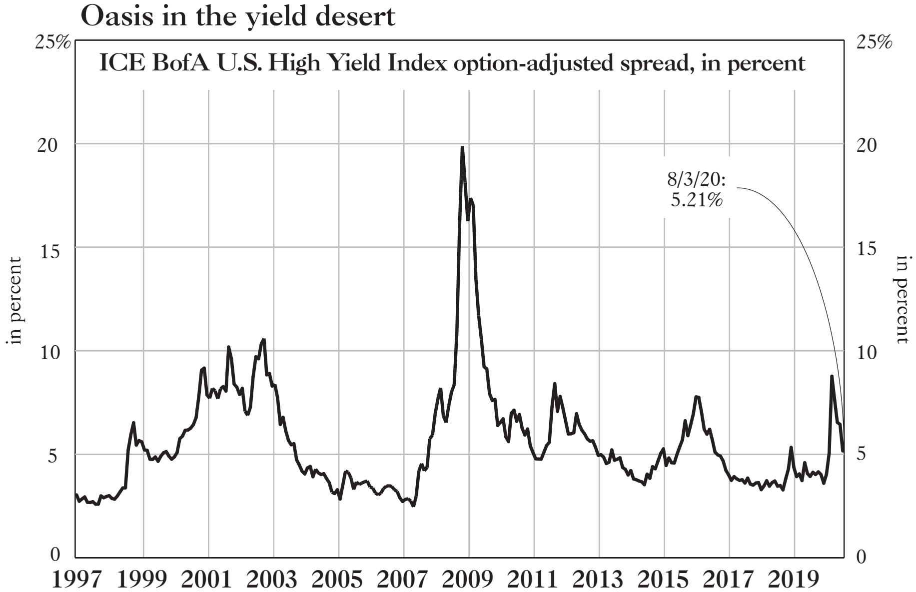
That offer, and those relating to a pair of other closed-end Western Asset income funds, designated EHI and HIX, is the result of a June 22 agreement between Western Asset and Saba Capital Management, L.P. Saba's involvement should come as no surprise to *Grant's* readers and conference-goers.

At the Spring 2018 *Grant's* event—see "A special thing" in the issue dated April 20, 2018—Boaz Weinstein, the founder and chief investment officer of Saba Capital, described the opportunity in a handful of value-laden, under-analyzed and actionable closed-end bond funds trading at discounts to NAV: "a discount that you can actually do something about, that is objective and that, while you sit there, is not dead money, is a really special thing." What does Saba do about those discounts? It presses fund managements to close them by mounting a tender offer.

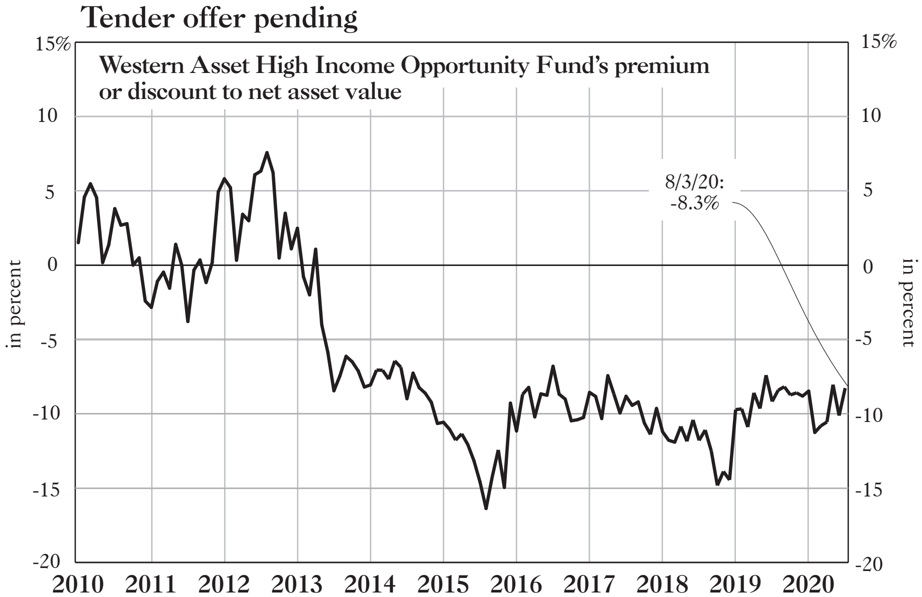
Specific to HIO, its board authorized a cash tender offer for up to 25% of the fund's 127 million outstanding shares at a price equal to 99.5% of HIO's NAV per share on the business day immediately following the expiration date of the offer. While Western Asset has yet to announce the start date for the tender, we do know that it will not expire prior to Nov. 13, 2020.

Since Mr. Market tries to keep up with the news, the HIO discount to NAV has shrunk by 2.3 percentage points since the June 22 announcement, to the aforementioned 8.3%; that compares to an average discount over the past seven years of 9.97%. Not that a discount is invariable. From 2010 through 2012, the shares commanded a premium. Then came the 2013 taper tantrum (in which the Fed dared to suggest it might withdraw its stimulus) and, with it, the discount that persists to this day.

**Oasis in the yield desert**




source: Federal Reserve Bank of St. Louis




source: The Bloomberg

When analyzing closed-end funds, particularly those with beguiling distribution yields, the stability and composition of those distributions are all important. What you don't want to see, as Matthew Blume, a portfolio manager at Pekin Hardy Strauss Wealth Management, tells colleague Harrison Waddill, "is that a huge chunk of the distributions are coming from return of capital. I've seen some closed-end funds where half of your income is your own capital coming back to you. When you see a fund that is having to really fill in the gap between current income and distributions with return of capital, that is a little bit of an alarming thing, and you have to pay close attention to that."

As for HIO, in the six months through March 31, it generated 17 cents in net income per share while paying out 19 cents per share. Management estimates that 88% of the distributions were sourced from net investment income and 12% from return of capital (a footnote explains that the actual source of current fiscal-year distributions will be revealed after the close of that year). Over the past three years, with the exception of 2017, net investment income covered distributions, and in those outlying 12 months, net investment income delivered all but a penny of the 37-cent-per-share dividend.

Compare and contrast two other high-yield closed-end funds. First Trust High Income Long/Short Fund (ticker: FSD) estimates that 31.26% of its most recent distribution is a return of capital. That follows three years of similarly high returns, as dividends, of the stockholders' own money. Like HIO, FSD is unleveraged.

Wells Fargo Income Opportunities Fund (ticker: EAD), too, is prone to returning capital in the shape of distributions. More than 18% of the most recent dividend will derive from a return of capital, management estimates, as it did in greater or lesser degrees in each of the prior three years. Unlike HIO and FSD, EAD is leveraged.

"Today," an HIO spokesman tells Waddill, "we are seeing market yields in the 5% to 6% range while the fund is paying out just under 8%. Many securities in the fund are held at attractive yields relative to the current environment, but the fund is reinvesting at lower prevailing rates as bonds mature or are called away, putting downward pressure on the income-generating profile of the fund. If prevailing rates remain low, the income distributed to shareholders may come down over time, but it will remain our goal to keep the distribution stable and consistent, even if the overall path is lower, by supplementing income with total return."

"HIO is a bit of an outlier," Waddill notes. "Of those funds having Lipper classifications, only nine answer to the description of unlevered high-yield closed-ends funds, compared with the 42 funds in the 'leveraged high-yield fund' category. And within that unlevered category, HIO is the only one with more than $500 million in total assets. High yield is risky enough without the addition of leverage."

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