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On Aug. 6, a $1.8 billion market cap closed-end fund, the AllianceBernstein Income Fund (ACG on the NYSE), tipped its intention to convert to the open-ended form of organization. ACG had traded at $7.46, a 10% discount to net asset value before the announcement. After the happy news, the share price leapt to $7.95, a 4% discount to NAV. The AllianceBernstein demarche was the sixth such value-crystalizing event in the closed-end fund market in the previous four weeks. For all we know, a trend has been born.

Now under way is a survey of the kind of fund in which price and net asset value are usually separate and distinct, in which the number of shares are fixed and the price of those shares is set in the stock market. Closed-end funds comprise a world of their own, and a droopy little world it's been. In preview, we find, there's value in the gloom.

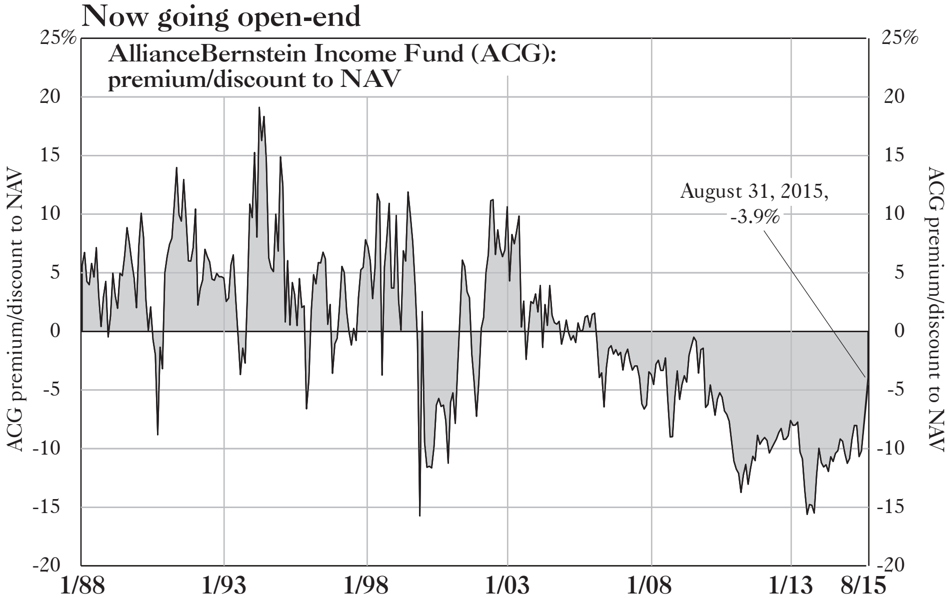
Price is the selling point. Closed-end funds usually sell at some discount to net asset value—4.4% is the long-term average. On Aug. 24, the average discount reached 10.7%, according to Steve O'Neill, portfolio manager of Chicago-based RiverNorth Capital Management, which deals extensively in that class of asset. "Today's discounts," O'Neill tells colleague David Peligal, "are unparalleled outside of the Great Recession. Some may argue that closed-end funds should be cheap—they utilize leverage, often trade like small-cap stocks and levy higher fees. But when you look at history, the market has consistently priced these funds much closer to par value, even when asset-class valuations are fair to rich."

Morningstar counts 562 closed-end funds with a combined market cap of $221 billion. The taxable fixed-income subset comprises 175 funds with a combined $70 billion market cap. On Aug. 24, that credit subset traded at an average discount to NAV of 12.5%. As corporate yields are on the upswing, the prices (and net asset values) of closed-end credit funds have naturally come under pressure. Emerging market funds, too, are on the outs, of course.

"Given market trends right now," says Robert Knapp, founder and chief investment officer of Boston-based Ironsides Partners LLC, "perhaps a discount on credit funds and EM funds is warranted. Discounts do sometimes, in fact, discount events that come. But more often than not, discounts appear because of market sentiment, and market sentiment is usually formed by historical events. In the case of credit funds, they were all on premiums at the beginning of 2013, and then in Q2 the so-called taper tantrum sent NAVs down 10%, and shares from 5% premiums to 10% discounts. The net result was something like a 25% loss from bond funds—things that most retail shareholders thought were safe. And since then, there has not been much of a recovery."

It's axiomatic that leverage makes a good situation better and a bad situation worse. It's also axiomatic that, in a very bad situation, leverage hardly seems to matter; people *will* be bearish. "For example," O'Neill relates,

Now going open-end



source: The Bloomberg

"Western Asset manages four high-yield bond funds, two are levered, two are not, but each fund trades around a 15% discount." Go figure.

"A hallmark of the post-2008 era is that discounts appear and possibly widen but seem to rarely narrow," Knapp observes. "It is fascinating to me how much discount volatility has subsided. Proprietary desks used to trade CEFs (at least in Europe) with regularity and arbitrage funds used to trade them too. Capital has steadily drained from the space. . . ."

To buy a dollar for 90 cents is the kind of opportunity that usually comes with strings attached. In the case of the closed-end bond funds, one could point to three strings at least: the possibility that the credit cycle has turned, an idea which this publication endorses; the looming risk of an aggressively tightening Federal Reserve, about which we continue to entertain doubts; and—an operational point—the difficulty of putting large sums of money to work in a slightly out-of-the-way corner of the capital markets. Big money investors assure us that this latter objection is much exaggerated.

Bill Gross, late of Pimco and now of Janus, is a devotee of the closed-end fund (*Grant's*, April 17). Nowadays, as he relates, he is particularly drawn to the BlackRock Taxable Municipal Bond Trust (BBN on the Big Board), which boasts a market cap of $1.1 billion and trades at a discount to NAV of 9.6%. BBN buys "Build America Bonds," a federally subsidized kind of taxable muni security. Its assets are long dated (as of June 30 duration was 12.1 years) and borrowed-money leverage is high (35.8% of the portfolio). "If you are a believer in a low Fed," says Gross, "the leverage isn't a large negative; in fact, it's what produces the yield." The shares are priced to yield 7.9%.

Higher yields than that are on offer—with strings, of course. DoubleLine Income Solutions (DSL on the New York Stock Exchange) is a closed-end fund in the Jeffrey Gundlach stable. In conversation with *Grant's*, Gundlach called it "the riskiest bond fund that is offered publicly that I manage." Emerging-market debt is its largest asset category, at 43.3% of the portfolio, followed by high-yield corporates (21.2%) and bank loans (10.2%); 85% of the assets are either unrated or rated below investment grade. Leverage from borrowed funds—29.6% of the footings—adds another source of volatility accelerant. DSL is quoted at a 12% discount to NAV and yields 9.9%. "I think it's a pretty good thing if you want to hold your nose and buy risk at this point," says Gundlach. "Certainly, if you're going to own EMB [the emerging markets' dollar-bond exchange-traded fund] or JNK [the speculative-grade corporate ETF], for goodness sake, you're vastly better off owning DSL."

"If" is the operative word. Gundlach himself is bearish on junk bonds over a five-year horizon. He says he believes that interest rates have bottomed. And he has deeper misgivings. What if the world's pleasant, generation-long experience with falling interest rates is over, he asks?

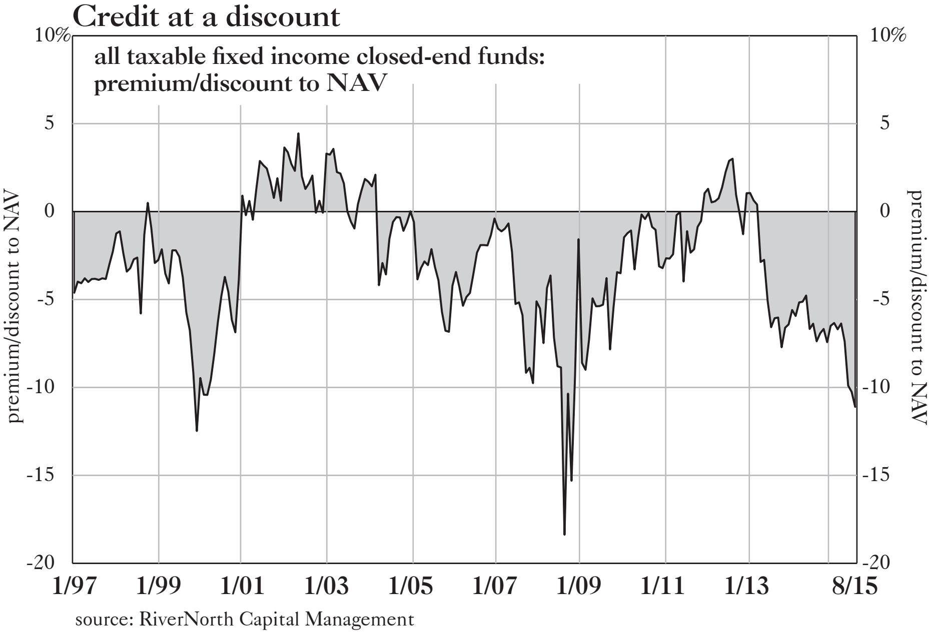
"What if," Gundlach muses, "everything that we think we've learned about the credit market, particularly the lower tiers of the credit market, i.e. the junk bond market, what if all we know has been informed by a single season that has been secularly falling interest rates? What if the default rates that we've come to think we understand, averaging about 4% with a lot of volatility around it, what if that is being suppressed because of the ability of corporations to roll over maturing debt at lower interest rates systematically? What if interest rates are indeed rising? What will happen when corporate America is rolling over its debt at higher interest rates? And what if it's even worse, that spreads are widening, which I think would be the case?" Well, in that case, one would not want to own DSL.

This is the top-down approach. Saba Capital Management, founded in 2009 by the derivatives-cum-chess-cum-poker wunderkind Boaz Weinstein, addresses the question from the bottom up. A new fund, the Saba Fixed Income Closed-End Opportunity Fund, is set to begin operations on Oct. 1. Its objective is to profit by the prospective closing of these fetchingly deep discounts. It will concentrate especially in credit-related funds. Do you, like Gundlach (and *Grant's*) worry that credit quality is deteriorating and interest rates are rising? If you are a qualified investor, you may choose to participate in share classes that provide hedging against either or both risks, credit and interest rate.

The conscientious management of a deeply discounted closed-end fund will try to do something to close the discount. And if it should neglect to take action, an enterprising shareholder may remind it. Knapp, an investor in Pimco Dynamic Credit Income Fund (PCI on the NYSE), recently mounted a proxy contest to force action to close a particularly yawning discount to NAV in those shares. He failed in the vote, though he may yet succeed in the wider cause of shareholder (and management) education.

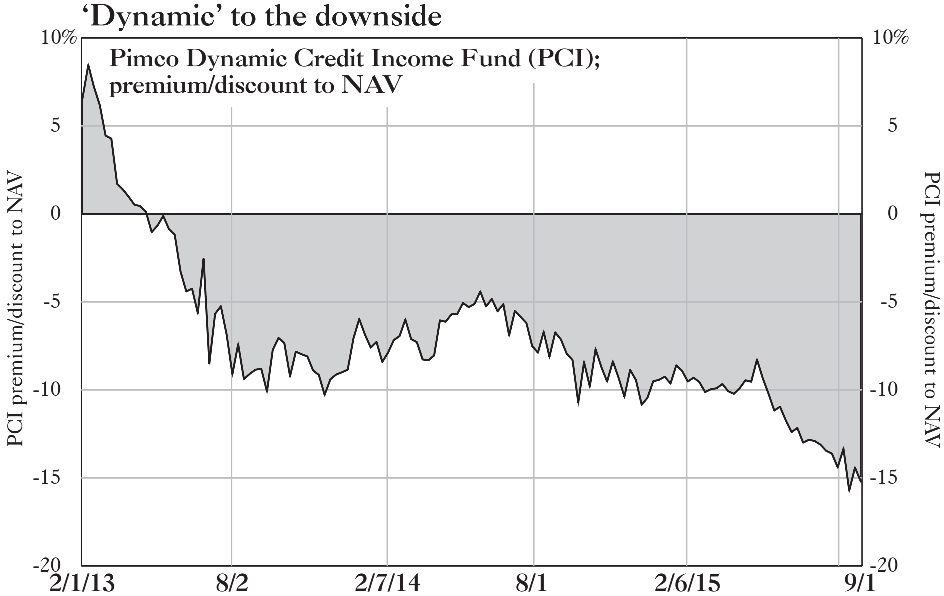
PCI, with a $2.6 billion market cap,

Credit at a discount



source: RiverNorth Capital Management

'Dynamic' to the downside



source: The Bloomberg

is the largest taxable closed-end bond fund. It trades at $18.73 a share, 25% below its $25 a share 2013 IPO price and at a 15.4% discount to NAV. Its portfolio of corporate bonds is 44.4% leveraged; the indicated divided yield is 10.5%. From a formative 8.5% premium to NAV, the share plunged within six months of the launch to an 8% discount. Was this what Mr. and Mrs. Income Seeker had signed up for? It was not. "Discount widening," Peligal observes, "eliminated the entire NAV return. This is why discounts are wide—the investor experience has been poor, even when NAV performance has been all right (6% annualized in this case). The sad reality is that many of these fund managers don't want to buy in their shares since their fees are often tied not to performance but to NAV. So while shops like Pimco continue to enjoy fees despite the discount, investors grumble—and eventually, sell."

Not that matters are hopeless, far from it. Term trusts, of which two dozen are in existence, are closed-end funds that liquidate on a date certain. As the clock winds down, the manager sells the portfolio and returns net asset value to the owners. Blackstone/GSO Senior Floating Rate Term Fund (BSL on the NYSE), which started in May 2010, is one such specimen. BSL, a $245 million market-cap owner of first-lien bank loans, liquidates in 2020. It trades at a 9% discount and has an indicated yield of 6.7%. The shares have traded at a discount since the end of 2013, when investors collectively arrived at the conclusion that interest rates would stay lower for longer. A reduced dividend was the consequence. Indeed, in this zero-percent world, most loan funds, at one time or another, have had to slash their dividend, thereby triggering the retail "sell" button.

Another example of the type (albeit one with a longer running time) is the Blackstone/GSO Strategic Credit Fund (BGB on the NYSE). BGB, a $655 million market-cap company, started in September 2012 and chiefly invests in first-lien loans and high-yield bonds. The discount to NAV is 16%, the indicated yield is 8.6%, leverage is 36% and liquidation is slated for 2027.

Fine print in the legal documents constitutes another source of value in the closed-end marketplace. The Deutsche High Income Trust (KHI on the NYSE), an investor in corporate bonds, makes for an interesting example. KHI, with a $128 million market cap, a long operating history (it came into the world in 1988), and a characteristically deep discount of share price to NAV (12.7%), is quoted at an indicated yield of 7.5%. It happens that the fund is required to weigh a conversion to open-end status from closed-end status if a certain depth of discount to NAV persists beyond a certain period of time—specifically, if the average discount to net asset value exceeds 10% based on the last trading day in each week during the 12 calendar week run-up to year end. If such conditions are met, the question of whether to convert is put up for a shareholder vote.

"Interestingly," Peligal reports, "the requirement was triggered at the end of last year. Long story short, a vote to allow investors to redeem shares at NAV narrowly failed on June 30, despite KHI's 12% discount to NAV. But, really, what's your downside here, that is beyond the big exogenous risks that the downside of the credit cycle may hold? All you need is maybe 10% more institutional ownership. So if the discount doesn't converge, you have this built-in mechanism to actually get back the full NAV. And if the discount does converge by the end of the year, then you have a nice short-term gain. One should note that Saba Capital Management is the largest holder of KHI and has been recently adding to its position."

We close with a financial journey to formerly communist Romania and to one of the biggest closed-end funds in the world, Fondul Proprietatea SA. The Bloomberg ticker is FP RO on the Bucharest exchange; American investors will gravitate to the London-listed GDR, ticker FP/LI. Here, too, is a hopeful marker.

"Fondul," Peligal relates, "which is managed by Franklin Templeton, trades at a discount to NAV of greater than 30%. It's a $2 billion market enterprise that seems to be heading in the right direction. We're attracted to the situation for many reasons"—here Peligal speaks for himself and his editor. "One, we like the assets, as it's basically the infrastructure portfolio of Romania. You've got power generation, hydro generation, an electricity distribution grid, ports, airports, integrated oil and gas, etc. Two, we like the fact that Elliott Management owns 19% of the company and, contrary to stereotype, seems to have an okay working relationship with Franklin Templeton. There's no doubt that Elliott is, shall we say, an attentive and detail-minded shareholder, but they're also imaginative and creative in finding ways to build value. Three, management is doing the right things to narrow the discount, which ranged as high as 60% in mid-2011.

"The all-time low for the discount was 21%, which occurred in April of this year, right before the GDR listing in London," Peligal continues. "Why did the discount narrow? The company has been selling assets and giving back cash. As more of the unlisted assets become listed on a stock exchange, you then have a see-through price, and the discount to NAV becomes more difficult to justify. In 2016, Hidroelectrica SA, a power producer that also happens to be one of the largest components of the portfolio, will, hopefully, go public. It's about 17% of the NAV, according to Franklin Templeton's NAV. If that event occurs, and Franklin Templeton will have to play a big part in that, in terms of holding the hands of management and working with the government and the bankers, that could take another 17% of this fund and kick it into the listed camp. While Romania has issues—corporate governance could use some improvement—we think the discount to NAV can continue to narrow, possibly to 15% or so."

From our lips to Franklin Templeton's ears.

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