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Closed-end days

"When I first started investing in closed-end funds in the mid-1970s," recalls Phil Goldstein, co-founder of Saddle Brook, N.J.-based Bulldog Investors, "they were plain vanilla, closed-end funds like Tri-Continental Corp. or the Salomon Brothers Fund trading at 25% discounts. You don't see that anymore. Today, the wide discounts to NAV might be in the mid-teens. Typically, discounts tend to widen in bear markets—especially, the fixed-income funds. If you go back to October 2008, there were probably about 200 muni funds, and I would say that half of them were trading at over a 20% discount. Yes, it was a fairly short period of time, but it was all about liquidity. So just sell it—who cares what the price is or what the underlying value is. So it ebbs and flows—there's nothing new about it."

Now unfolding is a two-chapter analysis of closed-end funds; you are reading Chapter 1. It features Deutsche High Income Opportunities Fund (DHG) and Eaton Vance Municipal Bond Fund (EIM). Also appearing in a supporting role is Montgomery Street Income Securities (MTS—all three names are listed on the Big Board). We have some constructive things to say about the lot.

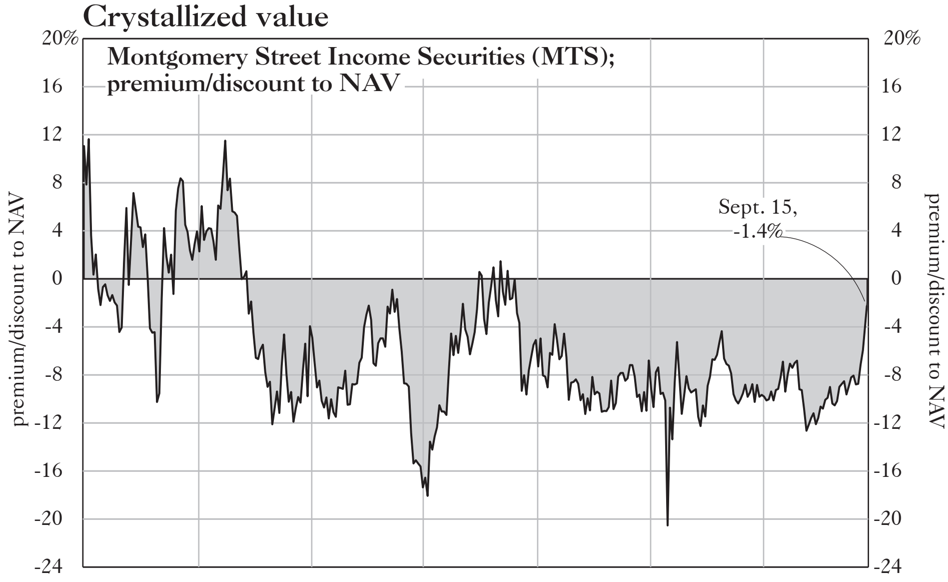
Just as Goldstein suggests, nothing is ever exactly unprecedented in the world of closed-end funds. What is slightly novel today is the trend to close persistent discounts to NAV through winding up or switching to open-end status; either method forces the convergence of price per share to NAV per share. "Of course," notes colleague David Peligal, "these conversions and liquidations do not occur out of the goodness of management's heart. While it's not unheard of for a management to decide all by itself to do right by the shareholders, usually, if you scratch the surface, you find that the catalyst is pressure from below—or rather from above, if you believe, as some of us do, that the stockholders for whom the directors supposedly work, are the high and mighty ones."

"Thus," Peligal proceeds, "on Sept. 3, Montgomery Street announced that its board had approved the liquidation of the fund, if that would be all right with the stockholders; a special meeting would be held by the end of the year. Forty-two-year-old MTS has traded at a discount to NAV for most of the past 21 years. Before the Sept. 3 news, the discount had stood at more than 6%. It is 1.4% today. What led to the sea change at the board? Karpus Investment Management is a 23.2% owner of MTS, and 1607 Capital Partners is a 15.2% owner. Each investor has long experience with closed-end funds. Maybe they had something to do with sowing the seeds of shareholder enlightenment."

On now to DHG, the Deutsche High Opportunities Income Fund, a $212 million market-cap outfit that is trading—still—at an 8.1% discount to NAV. "Still" is the word, because DHG on July 10 disclosed what would seem to be a value-crystalizing event (it was one of many funds to take such a step in the past two months—see *Grant's*, Sept. 4). A press release announced that the board was inviting the stockholders to approve the dissolution and liquidation of the fund at the 2015 annual meeting, to be held on Sept. 30. The winding-up date, which would be set by the board, would in no case be longer than 30 months after Sept. 30, should the shareholders give their blessing.

The shareholders are almost certain to say yea. What they have not done yet is

Crystallized value



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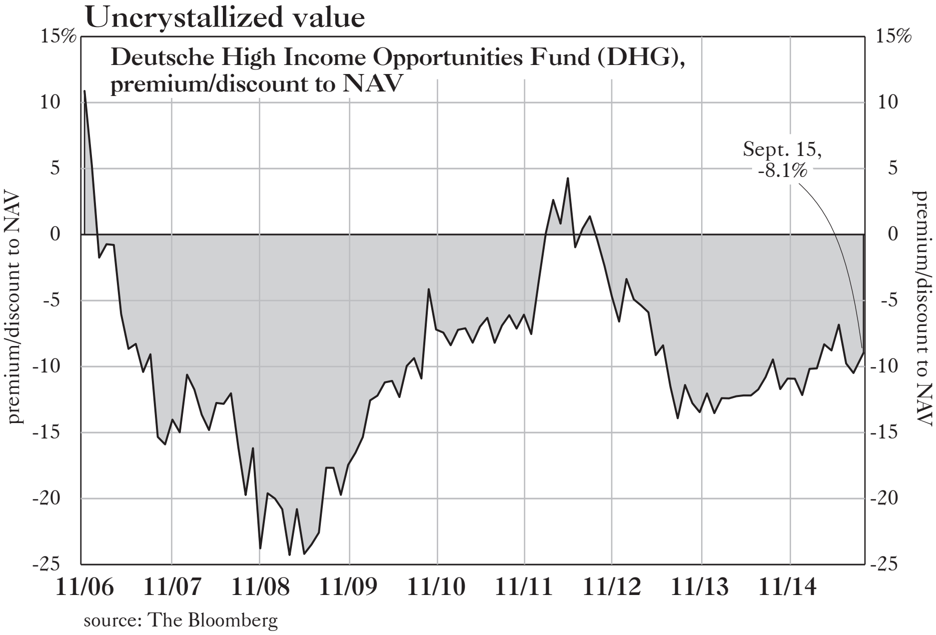

celebrate: DHG's discount to NAV is just about where it was on July 10. Perhaps the market is assuming that it will take all of the allotted 2½ years to liquidate, or that the assets will explode before they can be sold. As of June 30, 48% of the portfolio was rated BB, 37% B and 5% CCC. If you are bearish on junk bonds, you are necessarily more bearish on a package of leveraged junk bonds; the Deutsche fund is levered by 30%. Or, another possible explanation of the persistence of the pre-July 10 discount, it may just be that little DHG has fallen through the analytical cracks.

A great deal turns on the time to liquidation—the more expeditious, the better, of course. Peligal sought counsel from the man with 40 years on the job and who happens to be an 8.8% owner of DHG's shares. "Assuming average performance," says Goldstein, "worst case is an investor should outperform on a risk-adjusted basis by at least 2% per annum. And, yes, it could liquidate sooner, which would boost the IRR. Maybe that is just not enough to excite risk-averse investors, especially in this market environment." One should also note that Saba Capital Management, led by Boaz Weinstein, is the largest holder of DHG, with an 11.5% stake, and that Saba added to its position last month. Also noteworthy is that DHG's board of directors recently extended the fund's existing share repurchase program for an additional 12-month period. "The Fund," remarks DHG's Sept. 11 press release, "may continue to purchase an aggregate of up to 5% of the Fund's outstanding shares of common stock in open-market transactions over the period from Dec. 1, 2015, to Nov. 30, 2016, when the Fund's shares trade at a discount to NAV."

The Eaton Vance Municipal fund, the next order of business, delivers tax-exempt monthly income from a leveraged investment-grade portfolio. EIM, dating from August 2002, has an $844 million market cap and trades at a 9.8% discount to NAV, much deeper than its historical average discount of 2.4%. The aforementioned Karpus, headquartered in the Rochester, N.Y., suburb of Pittsford, owns 4.7% of EIM. Daniel Lippincott, paid-up subscriber to *Grant's* and senior tax-sensitive manager of Karpus (he kindly brought the idea to our attention), observes that the Eaton Vance fund is one of the few high-quality, closed-end funds extant: 10.8% of the portfolio is rated AAA, 69.8% AA, 16.2% A and 2.7% BBB with 0.5% in the netherworld below BBB.

If diversification is your style, EIM is your fund. The portfolio houses 190 individual muni bonds spread out across a variety of states, local governments and revenue streams. No one position is greater than 2.4% of the total. Detroits, Puerto Ricos and Jefferson Counties there will be, but they will do no existential harm to the fund as long as they come singly, rather than in flocks. "While waiting for the discount to narrow," says Lippincott, "you collect 6.2% tax-free current yield (10.95% taxable equivalent at the highest 43.4% marginal federal income-tax bracket). This type of yield is tough if not impossible to find in this environment." Ah, yes, the environment. The prospect of a two-way market in interest rates is one that many young bond buyers are unfamiliar with. "While I believe much of the rate hike worries are priced into the discount of the fund," Lippincott goes on, "this fear could persist and the discount could stay wide for an extended time. Even though this fund does use leverage more efficiently than many other funds, if the yield curve were to flatten, you could see cuts to the distribution."

For a leveraged fund—EIM uses borrowed money equivalent to 40% of its assets—a flattening yield curve would be especially unwelcome. Peligal asked Lippincott about the inner workings of the leverage. "EIM uses tender option bonds (TOB) to borrow from tax-exempt money market funds and then uses the proceeds to buy high-quality municipal bonds with longer maturities," Lippincott replied. "Current yield is enhanced as long as the floating rate paid to the money market fund is less than the yield received on the long-term bond purchased by the fund. Since TOBs allow the fund to pass tax-free income through to the lender, borrowing costs are minimized when compared to alternative forms of leverage such as debt.

"What actually happens," our reader went on, "is (1) The fund deposits a high-quality muni bond into a trust; (2) The trust issues two securities—a floater that is bought by a money market fund and a residual that entitles the fund to the difference between the rate on the bond in the trust and the rate paid on the floater; and (3) The fund receives the cash that the money market fund pays for the floater and invests it in longer-dated municipals. The main advantage of this vehicle is that tax-free interest is passed through, thus lowering borrowing costs."

Unleveraged, medium-term, high-grade munis priced to yield 6% would be ever so much better, of course. Then, again, they are unavailable these days. EIM is available. One takes the world as it is.

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