CURRENT YIELD

Closed-End Bond Funds: A Haven Amid Global Risk

After a good run, they still offer more yield than Treasuries. Nuveen Dividend Advantage Municipal Income and Eaton Vance Municipal Bond are two choices.

By AMEY STONE
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Municipal bonds have been hard to beat lately. With a 4% total return, the average national muni fund has bested every category of bond and diversified stock fund in the past year, according to Morningstar. Consider that they're low risk and that the income is tax-free and they stand out even more.

There's only one problem: As munis have climbed in value, yields have fallen. The average high-rated intermediate term municipal bond yields just 1.6%. After-tax, that's still way better than a 10-year Treasury, but not a lot of income.

One solution to the income dilemma is to buy a closed-end muni fund. Because many of them use leverage (borrowing short-term to buy longer-term bonds) they average 5% yields. The funds typically trade at discounts to net asset value, but those have narrowed substantially in the past year, boosting returns. The average total return in this niche is 11% over the last 12 months, reports Morningstar.

A 5% distribution yield becomes an 8% tax-equivalent yield for investors in a top tax bracket. Investors who go with a state-specific muni fund in a high-tax area enjoy after-tax yields that are even higher. Muni defaults are rare, plus funds are diversified and active managers can avoid deteriorating credit conditions in places like Chicago, Atlantic City, and Puerto Rico.

Like munis generally, the closed-end fund versions aren't cheap right now as a result of strong demand after good performance. At *Barron's*, we like to recommend closed-end funds when they are trading at wider-than-usual discounts. But the average discount is just 2% now compared to 6% a year ago.

That leaves less room for share price gains. But as investors shy from global risk, closed-end muni funds are still a good place to be. The Federal Reserve has indicated it's likely to keep short-term rates lower for longer, a plus for leveraged investments. "Closed-end muni funds have an advantage in that borrowing rates are very low relative to the higher rates of the bonds originally purchased into the fund," says John Miller, who heads muni investing at Nuveen Asset Management, which runs an assortment of muni-related funds.

Muni issuance is likely to rise this quarter, which could be a head wind since it increases supply. But given recent returns, Peter Hayes, head of municipal bond investing at BlackRock, expects demand to continue to outpace supply. "Sustainable demand is one of the tail winds," says Hayes.

Jim Robinson, who runs [Robinson Tax Advantaged Income] (ROBAX), a mutual fund that

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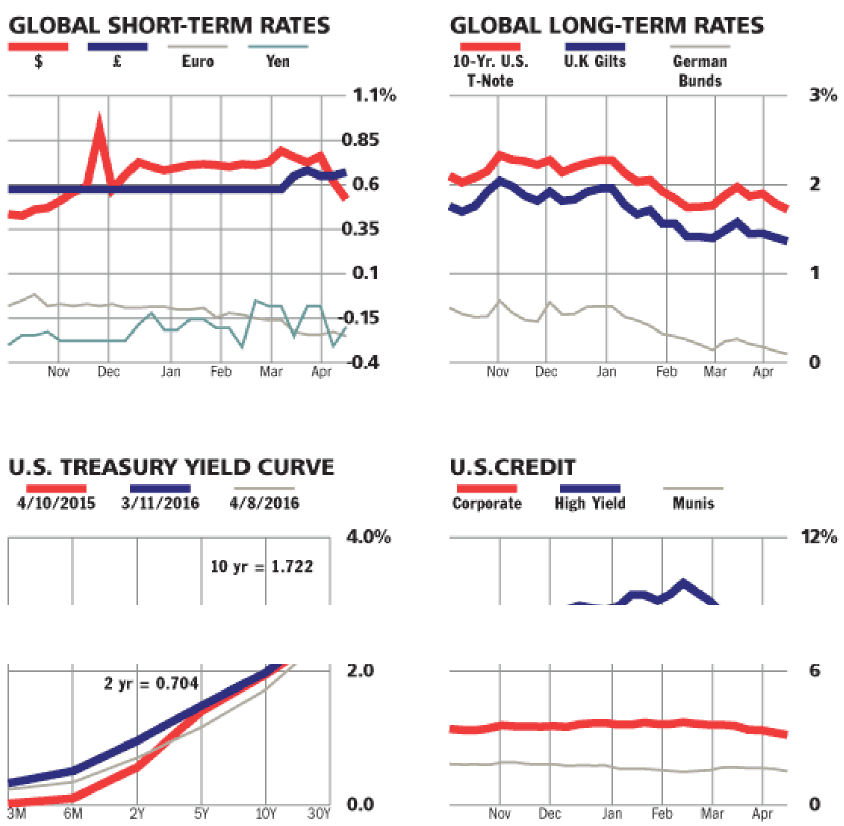
invests in closed-end muni funds, currently sees opportunity in two Nuveen funds. The firm is merging several smaller funds into two larger ones, a move Robinson thinks will eventually narrow the discounts on the survivors. The two, Nuveen Dividend Advantage Municipal Income fund (NVG) and Nuveen Dividend Advantage Municipal Fund 3 (NZF), have relatively wide 9% discounts. He also likes Eaton Vance Municipal Bond (EIM). BlackRock Investment Quality Muni (BKN) is another well-regarded fund.

FOR THOSE WILLING to assume more credit risk for additional yield, high-yield muni funds (which have less default risk than their corporate-bond counterparts) yield 6%, for a better than 9% after-tax yield. Note: Due to their popularity, many trade at a premium, such as Pioneer Muni High Income Advantage (MAV), which has an 11% premium.

There's plenty of rate risk in the average muni closed-end fund. Robinson hedges it by shorting Treasuries. Investors worried about long-term losses can also buy a fund that terminates at its offering price at a set date in the future, such as BlackRock Municipal 2030 Target Term Trust (BTT).

As attractive as closed-end funds can be, Kathy Jones, chief fixed income strategist at Charles Schwab, warns not to go overboard: "Don't put all of your fixed-income assets in them, since they can be illiquid."



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