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BARRON'S MFQ

Good Buys Among Closed-End Muni Funds

Closed-end municipal bond funds have soared recently, but income investors who missed out can still find some opportunity.

By AMEY STONE
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Closed-end municipal bond funds have been smart investments for the past three years. They've returned an average of 12% annually over that time and are up a stunning 16% in the past year alone, according to Morningstar. Going forward, investors are likely to have a tougher time, but there are still some good opportunities if you know where to look.

In early 2015, many investors were worried that interest rates would rise and sold these funds, leading to large discounts. Because closed-end funds offer only a fixed number of shares that are listed on stock exchanges, they can trade at premiums or discounts to the average value of their holdings, known as the net asset value. But as interest rates fell, munis rose and closed-end funds came back into favor. Boosted by leverage (the funds borrow short term to buy longer-term bonds), the funds yield near 5%, on average. That's equivalent to an 8% taxable yield for investors in a top tax bracket, and about twice that of open-end muni funds.

But for all their merits, closed-end muni funds now face some troubling head winds. While this isn't a time to sell, investors who loaded up on the niche may want to scale back—or at least take stock of how their funds stack up against the looming risks.

For starters, valuations are a double concern—for the underlying munis, which yield just 1.7% on average, near historic lows, as well as the closed-end funds themselves. Discounts have disappeared; the average muni closed-end fund is trading at a 1% discount to net asset value, compared with a 7% discount a year ago, reports Morningstar. The best time to buy a fund is when it's trading at a discount, or at least below its average, which most funds aren't.

Those discounts could return—and fast—if interest rates start to rise, compounding losses on the downside the same way they lifted returns on the upside by narrowing. Leverage, too, increases the downside risk should rates rise—not a foregone conclusion, even though the Federal Reserve has indicated it would like to raise interest rates once more this year, probably in December.

Jim Robinson, portfolio manager of Robinson Tax Advantaged Income (ticker: ROBAX), a fund made up of closed-end funds, thinks that closed-end muni funds could handle a rate hike this year without a big spike in the longer-term maturities they typically hold. Still, he warns, "if rates go up 1%, you own a long-duration asset that is just going to get clobbered."

It happened not all that long ago. Leveraged national closed-end muni funds lost an average 13% in price during the so-called taper tantrum in 2013 when Treasury yields spiked to 3% from 1.6%. In contrast, their net asset values fell just 8%, says Sangeeta Marfatia, an analyst with UBS.

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A nearer-term problem: Many closed-end funds are being forced to cut their distributions—about half of them cut last summer, usually by 5% to 10%, estimates Robinson. Morningstar says that distribution rates have fallen to an average of 4.7% in this category, from 5.6% in the past year.

There are two main reasons. First, short-term borrowing costs are rising for the funds that use leverage, mainly due to side effects of money-market reforms that go into effect on Oct. 14. Those higher costs eat into the income a fund can distribute. "The leverage is still adding to earnings, but less than it used to," says Anne Kritzmire, managing director of closed-end funds at Nuveen.

Also eating into income: The long-term munis these funds own, which have high coupons, are maturing or being called, which means that fund managers have to replace them with much lower-yielding bonds. That reinvestment risk "means dividend cuts are going to happen more often than not," says Stifel analyst Alexander Reiss. He cut ratings on 17 muni funds in August partly for this reason.

The underlying muni market has its issues, too. Prices are high (and yields low) due to huge demand from investors for the safe, stable yield. But fund flows are slowing as interest-rate worries increase and many strategists raise concerns about credit quality. Dan Heckman of U.S. Bank Wealth Management, for example, thinks that pension underfunding is a risk.

These are all reasons that investors who have built up big positions in closed-end muni funds should scale back, but not sell outright. With their 5% tax-free yields, "in the bigger picture, if you sell, where else can you go for income?" asks Marfatia. Richard Daskin of RSD Advisors suggests that closed-end funds should be just a small part of a bond portfolio—10% to 20% makes sense.

There are still some funds that look like good buys. We point out a few that have less interest-rate risk, wider discounts, or less leverage—all factors that should insulate them from today's head winds. (See table below.) For example, Invesco Trust for Investment Grade Municipals (VGM) has an attractive 6% discount because it cut its distribution in August, later than many, and the share price took a hit. Nuveen, a leader in muni investing, has the unhedged Nuveen Municipal Value (NUV), as well as two national funds, which are very liquid and have wider-than-average discounts because they are having smaller funds merged into them. Robinson's fund hedges out interest-rate risk, and BlackRock has muni funds that liquidate at NAV at a set date in the future so investors don't have to worry as much about discounts.

Muni Funds With More Yield, Less Risk

These tax-exempt funds have some insulation from head winds facing other closed-end muni funds.

Fund / Ticker	Distribution Rate	3-Yr. Annual Return	Comment
BlackRock Municipal 2030 Target Term Trust / BTT	4.03%	14.95%	Fund terminates at NAV in 2030; trades at 4% discount
Invesco Trust for Investment Grade Municipals / VGM	5.49	10.92	Cut distribution rate and the discount grew to 5.6%
Nuveen Enhanced AMT-Free Municipal Credit Opportunities Fund / NVG	5.74	14.09	Trading at 6.9% discount as it goes through mergers; very liquid
Nuveen Municipal Value Fund / NUV	3.75	9.20	Unleveraged, considered a "stalwart" of the industry
Robinson Tax Advantaged Income / ROBAX	3.32*	N/A	A fund of closed-end funds that hedges out interest-rate risk

*30-day SEC yield. N/A=Not applicable.

Source: Morningstar

Wider discounts in muni closed-end funds may be available later in the year if interest-rate fears rise. But no matter what happens with rates, issues of reinvestment risk and higher funding costs aren't going away, says Reiss. "The time to start thinking about these risks is now, while the sun is still shining," he says.

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