

Trump Tantrum Sends Muni Closed-End Fund Discount to 1-Year High 2016-11-18 10:00:00.6 GMT

By **Martin Z. Braun**

(Bloomberg) -- Shareholders of municipal bond closed-end funds who looked at their statements this week are finding out how risky the vehicles can be.

At the beginning of November, AllianceBernstein Holding LP's \$117.5 million California Municipal Income Fund was posting year-to-date returns of 8.7 percent as strong demand for higher-yielding debt boosted shares. Two weeks later, the gains had vanished after Donald Trump's election as U.S. president triggered a bond sell-off.

Pioneer Investment Management Inc.'s \$272 million Municipal High Income Trust had year-to-date returns of 2.66 percent before the election. By Thursday, it had losses of 3.3 percent.

A weighted average of closed-end fund discounts -- which measures the price of the shares compared with the underlying assets -- reached 7.9 percent on Monday, the most since October 2015, according to Ryan Paylor, a portfolio manager at Thomas J. Herzfeld Advisors, Inc. in Miami. While discounts have since bounced back to about 6.3 percent, they could widen further if investors sell securities at a loss to offset capital gains tax liabilities, he said.

"Munis can turn quick in the closed-end fund space," said Paylor. "We think there's going to be even more selling."

Trump's election may make matters worse for closed-end fund shareholders. Both Trump and the Republican controlled congress want to reduce personal and corporate tax rates, which could dampen demand for tax-exempt bonds. At the same time, Trump wants to increase spending on infrastructure, which may boost the supply of debt. Moreover, investors are pricing in a 98 percent probability that the Federal Reserve will raise interest rates next month, which will reduce the value of outstanding fixed-income securities.

"The simple math of interest rates rising is a long duration fund is going to hurt," said Cara Esser, a senior analyst with Morningstar Inc.

Closed-end funds raise a fixed amount of money from shareholders in a public offering, unlike mutual funds, which continually sell and redeem shares. The funds, which borrow short-term and buy higher-yielding long-dated debt, are traded on stock exchanges and can trade at premiums or discounts to their net asset value. Open-end mutual funds trade daily at their net asset value, unlike closed-end funds, whose values can move away from the underlying assets.

"Because they're closed to daily asset flows they can hold stuff that's a little bit less liquid than an open-end fund and then they add leverage on top of that," said Esser. Some closed-end funds are leveraged 20 percent to 30 percent, according to Morningstar.

Through the first three-quarters muni closed-end fund shareholders benefited as U.S. and foreign investors, seeking securities with higher yields than government bonds and less risk than corporate debt, pushed prices higher in the \$3.8 trillion market.

From the beginning of the year, through the end of the third quarter, muni closed-end funds returned 6.29 percent, according to Morningstar. Returns have fallen to 1.06 percent as of Nov. 15.

Typically, closed-end funds borrow at the short-term muni rate, plus a spread of 0.4 percentage point to 0.7 percentage point, said Paylor. Short-term borrowing costs in the muni market spiked to 0.87 percent in October from 0.01 percent at the end of February as investors pulled cash from municipal money-market funds in advance of new rules that required the fund's share prices to fluctuate along with the market.

Short-term yields have since declined to 0.55 percent, though they may rise again once the Fed resumes raising its benchmark overnight lending rate.

As the cost of leverage rose and the municipal yield curve flattened to an almost nine-year low at the end of September, fund managers had to buy longer dated, higher-yielding debt, Paylor said.

"If borrowing costs are going up and you're taking on 20-year risk just to squeeze out an extra small spread, that's just a ton of risk to put on," Paylor said.

Herzfeld sold all of its shares in leveraged municipal closed-end funds by the end of the August, Paylor said. The firm oversees \$300 million.

"I think it will be just as bad for closed-end fund munis if not worse," Paylor said. "The muni market is coming off a much more compressed curve with limited spread, higher leverage costs, and possible changes to tax code that make munis less attractive."

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