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Increasing Retirement Income and Expected Returns Using Closed-End Funds

By Jim Robinson, CEO/CIO of Robinson Capital

The aging of the Baby Boom generation coupled with historic low interest rates has created an income challenge for many retirees. The first Baby Boomers turned 65 years ago, and they have been retiring at the rate of 10,000 per day ever since. The last of the Baby Boomers turn 65 in the year 2030. In other words, the demand for income-oriented investments will only get greater in the coming years. Investors in traditional stocks and bonds will have a difficult time generating sufficient cash flow in the current sub 2% yield environment. The right solution for many of these current and soon-to-be retirees might be found in the high yielding universe of closed-end mutual funds.

What is a Closed-End Mutual Fund?

Let's start by acknowledging that the name "closed-end mutual fund" is probably the worst ever for a financial security. It connotes mysteriousness and illiquidity, even though closed-end funds are no less transparent than open-end mutual funds and in many ways are more liquid. Closed-end mutual funds have actually been around longer than their open-ended brethren. Most investors are familiar with an open-end mutual fund structure—it redeems and creates shares on a daily basis—it is "open" to new and departing investors. Those shares are always priced at the net asset value of the fund whether the investor is buying or selling. Closed-end funds usually raise all of their capital at the onset of the fund. The shares are not redeemable from the fund nor are new shares typically created—it is "closed" to new and departing investors. Instead, most closed-end funds are listed on a recognized stock exchange—their shares can be bought and sold throughout the trading day on that exchange. The price per share will be determined by the market, similar to a listed stock, and that price may or may not be equal to the fund's underlying net asset value.

Benefits of the Closed-End Fund Structure

Closed-end mutual funds have a number of attractive qualities due to the nature of the structure. The most obvious one is the complete lack of contributions and withdrawals that the manager need worry about. The retail nature of mutual funds usually results in the largest cash inflows occurring as markets are peaking, and the largest withdrawals occurring when markets are bottoming. Invariably it forces fund managers to buy at high valuations and sell at low valuations—pretty much the exact opposite of the "buy low, sell high" adage. The closed-end fund manager doesn't have to worry about such activities as the fund's assets are "closed" to new and departing capital. This feature also allows closed-end funds to maintain lower fund expenses as there is no overhead expense related to creating and redeeming shares. The manager can remain fully invested if so desired. In fact, the manager can be over-invested as closed-end funds are allowed, by law, to use up to 50% leverage. Allowable leverage is calculated as a percentage of the fund's total assets—50% leverage means that an investor gets $2 of market exposure for every $1 dollar invested. There are a variety of investment vehicles used to effect that leverage, but most of them are tied to short-term interest rates. Since the yield curve is positively sloped (i.e. longer investments have higher yields than short investments) 90% of the time, this is almost always a positive carry trade as the cost of leverage is much lower than the investment yields the manager can access with that borrowed money. This is precisely how most closed-end fund managers are able to generate above market yields.

What Asset Classes are Available for the Closed-End Fund Investor?

Investors can access a wide array of asset classes through closed-end mutual funds. The bias tends to be toward more income-oriented asset classes, but one can still find the occasional growth asset class. One of the largest asset classes offered in the closed-end fund structure is municipal bonds. There are over 80 national municipal bond closed-end funds and nearly another 60 funds that focus on the municipal bonds of 18 specific states. In taxable asset classes one can find senior bank loan funds, preferred stock funds, domestic and global corporate bond funds, mortgage-backed securities funds, emerging market bond funds, infrastructure funds, master limited partnership (MLP) funds, precious metals funds, miner funds, natural resources funds, real estate investment trusts (REIT) funds, domestic and global high dividend income funds, covered call funds, growth and income balanced funds and convertible bond funds. In total, there are over 300 listed taxable closed-end funds and nearly 150 tax-exempt closed-end funds.

An investor could build a well-diversified balanced portfolio, targeted to most any benchmark across the risk spectrum, using just closed-end funds. The only notable asset classes missing from the closed-end fund palette are small-cap stocks (both domestic and global) and US Treasuries. In both instances one can find other funds with exposures to those asset classes, but it’s rare to find funds dedicated exclusively to those asset classes since small-cap stocks typically have low-to-no dividend yield and US Treasuries don’t yield enough for traditional taxable bond investors.

One could argue that for a number of less liquid asset classes the closed-end fund structure is the most desired vehicle. Many of the fixed income asset classes, such as senior bank loans, municipal bonds, high yield corporate bonds, non-agency mortgage backed securities, preferred stocks and convertible bonds are best offered in a structure that is immune to a sudden barrage of redemptions. All of the investors of the closed-end fund structure benefit from this feature as the manager, unlike the open-end fund manager, is not forced to hold cash or lower yielding more liquid securities such as US Treasuries, to meet those redemptions, nor is he forced to find bids for less liquid securities in difficult market environments.

What’s not to like about Closed-End Funds?

The biggest drawback to closed-end funds is their propensity to persistently trade at prices that are below, or at a discount to their true net asset value. This phenomenon, which typically occurs within several months after the fund’s initial public offering, is known as the “closed-end fund puzzle”. This persistent discount appears to violate even the weakest form of efficient market theory which states the price of a publicly traded asset reflects all known public information. Numerous academic papers have been written on this topic. The literature ranges from irrational explanations based on investor sentiment and market imperfections to rational causes such as expenses, taxes, etc. Our research has found that most closed-end funds’ discounts are actually some combination of both rational and irrational factors. Our focus has been to isolate and value the readily identifiable and quantifiable rational factors. Once accounting for the rational factors, the residual discount or premium represents the sum of the irrational factors and a potential arbitrage opportunity.

An investor willing to do the necessary research can identify those closed-end fund discounts that truly represent a savings and avoid the ones that do not. Specifically, the investor can turn the one big drawback of closed-end funds—the chronic discount the funds frequently trade at relative to their underlying net asset value—into a positive.

Implications for Generating Retirement Income

An investor willing to do the research will likely be able to identify closed-end funds across a variety of asset classes trading at true discounts of 5%-10% relative to the funds' underlying net asset values. Those discounts, coupled with the inherent leverage utilized in most closed-end funds, could dramatically increase the amount of fixed income a retiree is able to generate in an investment portfolio. The typical closed-end fund utilizes 30%-40% in leverage. On average, that means for every $1 invested the shareholder is getting exposure to $1.50 in investment exposure. If the fund is purchased at a 10% discount the shareholder is now getting $1.65 in investment exposure. Consider the retiree interested in investing $1 million in utility stocks as a source of dividend income generation. One option would be to purchase a utility stock exchange traded fund such as XLU. That fund is currently yielding 3.45%. It would generate $34,500 a year in dividend income for the retiree. An alternative would be to buy one of the utility closed-end funds that are currently trading at discounts of 10% or more. Those funds are yielding nearly twice the amount of the ETF because of the leverage and discount. The retiree's $1 million investment would now be generating more than $65,000 per year.

Of course, leverage is a double-edged sword and should be used cautiously. The most conservative of income-oriented investors should focus on shorter-duration asset classes where the use of leverage is less impactful on the overall volatility. One such asset class would be senior bank loans. The rates on the underlying loan portfolio are usually pegged to a spread over the 1-month or 3-month LIBOR rate. As those rates increase or decrease (subject to any index floors that may exist), so do the rates on the loan portfolio. Likewise, the leverage utilized in a closed-end fund is also frequently pegged to a spread over short-term interest rates. If no index floors exist in the loan portfolio, a 0.25% increase in short term interest rates would cause the cost of leverage to go up by that amount but would also cause the yields on the underlying loan portfolio to go up by the same amount. In this instance the use of leverage is considerably less scary. Open-ended mutual funds that invest in syndicated bank loan portfolios are currently yielding 4%-5%. Senior bank loan closed-end funds are yielding 7%-8% and are trading at 10%+ discounts. We have found a number of firms/portfolio management teams that offer both open-end and closed-end senior bank loan funds. In general, the senior bank loan closed-end funds have consistently provided dividend yields approximately 1.50% more than their open-end fund counterparts offered by the same firm. That difference, compounded over ten years, could be worth an extra 25% or more to the retiree, or it could simply mean earning an extra $15,000 per year on that $1 million investment.

Most retirement income investors may be perfectly content to stop at this point with the satisfaction of having increased the income generating ability of their portfolio by 2% or more through the use of closed-end funds as opposed to individual securities, exchange traded funds or open-ended mutual funds. For those investors looking to enhance those returns further there are additional strategies that can add considerably more value to those annualized returns.

Unlocking the Value of Irrational Closed-End Fund Discounts

We utilize a large toolkit of techniques to unlock the value of irrational discounts in closed-end funds. Many of these techniques may be beyond the practical means available to an individual investor or financial consultant, but several can probably be utilized with some effectiveness by most.

Historically, our techniques for unlocking the value of premiums and discounts have allowed us to consistently monetize at least half of the current level of irrational discount in the subsequent 12 months. We believe a diligent investor should be able to enhance a portfolio of closed-end funds' returns by an additional 1%-3% when performing the necessary due diligence.

Conclusion

Most closed-end funds invest in higher yielding asset classes which make them a natural fit for investors seeking to maximize their retirement income. The "closed" structure lends itself to investing in less liquid securities because the fund manager need not worry about ongoing contributions and withdrawals. The ability to use leverage, particularly given today's low borrowing costs, makes the funds that much more attractive to yield buyers. The fact many closed-end funds trade at prices irrationally lower than their true value only enhances their relative attractiveness. Investors willing to do a little research can reasonably expect to improve their current portfolio's yield by 2% or more. Investors interested in taking a more active portfolio management role can likely enhance that return even more once they understand the nuances of the closed-end fund market.