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How the Third Largest Closed-End Fund is Coping With Rising Rates.

Rising interest rates are creating challenges for the Nuveen AMT-Free Municipal Credit Income Fund.

Like other closed-end bond funds, the Nuveen AMT-Free Municipal Credit Income Fund is grappling with the fallout from the Federal Reserve's rate-raising campaign and a roller coaster stock market.

With more than $3.1 billion in assets, the Nuveen AMT-Free Municipal Credit Income Fund is the third largest closed-end fund in the world, according to Lipper Research.

Nuveen's decision a few years ago to expand the fund and revamp its investment focus turned out to be a winner, helping cushion the fund amid rate-hike and stock market turbulence.

Founded in 2002, NVG undertook a significant expansion a few years ago when Nuveen, its parent fund company, merged and combined 18 closed-end bond funds into eight.

Along with an infusion of assets, NVG also was given a new mission to reposition its portfolio to focus on lower-rated municipal bonds.

That strategy has paid off well for NVG, with lower-rated bonds performing handsomely even as their premium-rated cousins have lagged, notes Paul Brennan, a portfolio manager at Nuveen Asset Management, who oversees NVG and other closed-end funds.

"That has been the most positive part of our fund performance," Brennan says. "Over the last number of years, the lower-rated bonds have been the top performers."

Some of NVG's largest holdings are bonds issued by the state of Illinois and Chicago, both of which have struggled in recent years with various budget crises.

Illinois last year resolved a two-year budget standoff that had threatened to implode the state's already shaky finances. And while Chicago faces a $98 million deficit, it is down from $635 million in 2012.

Overall, municipal bonds have proven to be a good bet, with state and local revenues, from taxes to highway tolls, on the rise, Brennan says. In deciding where to invest, NVG draws upon Nuveen's team of 26 or so credit analysts, who keep tabs on the immense, $3.7 trillion municipal bond market and the tens of thousands of government and quasi-government entities that issue the bonds.

(Full disclosure: Nuveen is an advertiser on TheStreet, but did not participate in the preparation of this article.)

"While the news was very dire in Illinois and Chicago, our belief was that there were solutions," Brennan says. "We were getting bonds at distressed levels at the trough of the cycle. We generated very good yields on those bonds."

The NVG's investments in tobacco settlement bonds have also been a bright spot as well, he notes.

Overall, more than 50% of the fund's holdings are now in bonds rated triple-B, the lowest investment grade, or below.

"A lot of our top holdings have been some of our top performers," Brennan notes. "That is the best type of outcome."

However, the Fed's efforts to jack up interest rates have made it more expensive for the fund to do business.

Unlike open-end mutual funds, which make up most of the market, closed-end funds are allowed to borrow and use leverage, which can boost returns.

But with short-term interest rates rising, NVG's cost of borrowing has also gone up, increasing the amount of money the fund owes to creditors and cutting into earnings, according to Brennan.

The increase in long-term rates, in turn, has had a negative impact on the fund's net asset value, with a reduction in the value of its bonds as investors flock to higher-paying newer issues.

NVG has posted annualized returns of 6.6% over the past five years, with a 5.7% annual distribution rate, a key state for investors seeking steady income. But year to date, the fund's net asset value is down 2.5%, according to Lipper Research.

The fund is trading at a 12% discount relative to its net asset value — another feature unique to closed-end funds, which hold a modest but influential niche in the overall fund world, managing roughly $300 billion in assets.

They differ from their far more numerous cousins in the open-end mutual fund world in their fixed capital structure and the fact they are traded on exchanges throughout the day.

This combination creates gaps between the closed-end fund's trading price and the net asset value of its holdings, often allowing investors to buy the stocks and bonds in the portfolio at a significant discount.

A 12% discount effectively means investors can buy a dollar's worth of bonds in NVG's portfolio for 88 cents, with a potential gain if the discount narrows rather than widens.

That's down from a 52-week high of nearly 14% but up from its 52-week average of around 8.6%.

Looking ahead, Nuveen's Brennan sees more of the same when it comes to the main pressure weighing on NVG and other closed-end bond funds.

"We are still looking for the Fed, which is the most important thing to watch, to continue the pace of slow, gradual increases," Brennan says.

That, in turn, could set the stage for more growth in 2019 and continued strong performance by municipal bonds.

"We are seeing more volatility in our space but the underlying fundamentals are pretty solid," Brennan says. "There is still pretty good economic growth and state and local municipalities are performing well."

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