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WSJ: Sizing Up Discounted Muni Closed-End Bond Funds.

Some municipal closed-end bond funds, including Michigan-specific funds, are trading at appealing discounts following interest-rate increases and Detroit's bankruptcy filing.

"Municipal closed-end bond funds are on sale," says Cecilia Gondor, executive vice president at Thomas J. Herzfeld Advisors Inc., a Miami investment-advisory firm, which oversees about $167 million.

Closed-end funds can deviate significantly from the value of their underlying assets. The five Michigan-specific municipal closed-end bond funds currently trade at discounts of 12.45% to 13.5%, while the average discount on all municipal closed-end bond funds is 7.31%, according to Ms. Gondor's firm.

While discounts on the Michigan funds are much wider than those of muni closed-end funds generally, "they all seem to be out of favor," she says.

Investors in closed-end municipal funds have had a very positive experience over the past several years as interest rates fell, the values of the funds' underlying bond holdings rose and the funds, which use leverage, paid out attractive distributions.

But many investors sold in May when interest rates began rising. And Detroit's July 18 filing kept the bad news coming.

"It was a double-edged sword; it started with the interest-rate shock and then continued with the credit shock. People were saying, 'Maybe this isn't risk-free return,'" says Maury Fertig, chief investment officer of Relative Value Partners LLC in Northbrook, Ill.

Though many experts believe the selling has been overdone, the discounts linger. "Investors are still afraid of them," says Ms. Gondor, "and their distributions are even more attractive on the lower share price."

Mariana Bush, closed-end fund analyst at Wells Fargo Advisors, says those closed-end fund investors that understand leverage have become concerned about rising rates over the past few months. "They recognize that just as the (net-asset value) can go up more because of leverage, it can go down more because of leverage."

A few months ago, Wells Fargo Advisors didn't include any muni closed-end bond funds on its "select" list for financial advisers, she says. But it has since added Eaton Vance Municipal Bond Fund (EIM), Nuveen Dividend Advantage Municipal Fund 2 (NXZ) and MFS Municipal Income Trust (MFM), among others, on its list of most favorable closed-end funds.

Over the past few weeks, Dennis Houlihan, a financial planner with Houlihan Asset Management Inc., purchased BlackRock MuniYield Michigan Quality Fund (MIY) and Nuveen Michigan Quality Income Municipal Fund (NUM) for clients who live in Michigan.

“They were oversold at such deep discounts to net-asset value that they were at almost historic lows,” says Mr. Houlihan, whose Fort Wayne, Ind., firm manages about $50 million.

The BlackRock and Nuveen funds currently trade at discounts of 12.45% and 13.5%, respectively, but have three-year average discounts of 3.78% and 6.24%, according to Morningstar Inc. Each have distribution rates of more than 7%.

“I’m not necessarily expecting them to bounce back immediately,” says Mr. Houlihan, “but I think you’re going to see a stabilization, and as they revert to fair market value, you’re getting paid a nice monthly income.”

The funds offer a bargain for those willing to take on some risk “unless you believe this is a seminal moment of a triple-A general obligation bond no longer having the full faith and taxing power of whatever the underlying municipality,” he says. “If that’s no longer any good, well, the whole muni market is going to fall apart.”

A. Raymond Benton, a financial planner with Lincoln Financial Advisors in Denver, has been buying muni closed-end bond funds over the past few weeks. “A number of the funds that had been selling at premiums are at fairly significant discounts,” he says.

Mr. Benton is assuming that the muni-bond market’s reaction to concerns about Detroit’s treatment of general obligation bondholders has been overblown, and that interest rates are unlikely to rise as fast as many believe.

Among the funds he has purchased is Nuveen Select Tax-Free Income Portfolio (NXP) and Invesco Municipal Income Opportunities Trust (OIA), which trade at nearly 8% and 10.1% discounts, respectively, and offer distribution rates of about 5% and 6.8%, according to Morningstar.

But Mr. Benton says one has to be “something of a contrarian” for the funds to be appealing. Closed-end funds will be more volatile because they are leveraged, and if market sentiment changes, the discounts can widen immediately, he says.

Mr. Fertig of Relative Value Partners, whose firm oversees $750 million for wealthy families and small institutions, says he hasn’t been buying muni closed-end bond funds. Their generally long durations make them very interest-rate sensitive, he notes, adding that some muni closed-end bond funds also have been cutting their dividends.

Instead, he has been purchasing discounted taxable closed-end funds, he says.

Still, Mr. Fertig doesn’t rule out buying some muni closed-end bond funds later in the year when, he says, they may present a good opportunity: “We don’t want to move too early on them.”