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Fire Sale for Closed-End Muni Funds Means Only Brave Should Buy.

- **Average discounts on muni closed-end funds are 9 percent**
- **Leverage fees are up and longer duration means more volatility**

Shares of municipal-bond funds are trading at their deepest discounts since 2013 as the rising cost of leverage, dividend cuts and the market's worst first quarter since 1996 have pushed share prices down.

The discount, or the difference between a closed-end fund's share price and the underlying value of its assets, is 9.1 percent, according to Ryan Paylor, a portfolio manager at Thomas J. Herzfeld Advisors, Inc. in Miami who invests in the sector. Those gaps reached a more than four-year high of 9.67 percent in March, dangling a potential arbitrage opportunity.

"If you've got the stomach for it, this is a fairly decent level to be adding because discounts are wide and should provide some cushion if there's a further sell-off in rates," Paylor said.

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 are traded on stock exchanges and can trade at premiums or discounts to their net value of the securities they own.

Many closed-end funds borrow short-term and buy higher-yielding, long-dated debt. Short-term borrowing costs in the muni market have almost doubled to 1.51 percent in a year.

Those rising leverage costs narrow the profit that can be made by investing in long-dated debt, whose yields haven't increased as much, eating into distributions to investors, Paylor said. More than 80 percent of municipal closed-end funds have cut dividends in the past year, according to data compiled by Bloomberg. Bond traders are pricing in a more than 50 percent probability that the Federal Reserve will hike rates three more times this year.

The overall muni market has lost about 1 percent this year, posting the biggest first-quarter loss in more than two decades, largely because of the January sell-off triggered by concern the Fed would raise interest rates more aggressively than previously expected.

Muni closed-end funds have fared worse, losing an average of 4.5 percent, according to Paylor. If inflation and economic growth pick up more steam, causing interest rates to rise, closed-end funds will incur even bigger losses.

This potential for higher rates and the risk that the lower corporate tax rate will spur selling by banks and insurers has led BlackRock Inc. to shorten duration, reduce leverage and buy bonds with higher credit ratings, Peter Hayes, the head of the company's municipal bond group, said in a conference call with the firm's muni closed-end investors last week.

"The market hasn't really been tested thus far," Hayes said.

But there are opportunities in closed-end funds for more conservative investors, Paylor said. Some muni-closed-end funds that don’t use leverage are also trading at discounts and have higher dividend yields than municipal exchange traded funds, which trade at their net asset value. Investors are better off buying the closed-end fund, which gives you the opportunity for price appreciation when discounts narrow, Paylor said.

“In my experience, that discount goes away,” he said.

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