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Rout Drives Discounts on Muni-Bond Funds to Most in Five Years.

- Average closed-end fund trades at 11 percent less than assets
- · Bond price drop, rising cost of leverage take a toll

The swift rise in interest-rates and growing leverage costs have pushed discounts on municipal-bond funds to their widest in almost five years.

The discount, or the difference between a closed-end fund's share price and the underlying value of its assets, is 11.1 percent, according to Ryan Paylor, a portfolio manager at Thomas J. Herzfeld Advisors Inc. in Miami. Such funds have lost 7.3 percent this year, more than five times the loss in the broader municipal market, and investors will likely sell shares if prices bounce to offset capital gains tax liability, he said. That could delay any recovery.

"It has been ugly," said Paylor.

Many closed-end funds use leverage, which boosts returns when prices rise and sharpens losses when they fall. Yields on 30-year municipals have climbed 0.23 percentage point since the beginning of the month, reducing the value of debt held by the funds. Meanwhile, leverage costs have continued to rise as the Federal Reserve increases short-term rates, shrinking the income generated by the funds.

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 sell at premiums or discounts to their net value of the securities they own.

Tax-loss selling before the end of the year could cause discounts on muni-closed end funds to widen further. More than 90 percent of municipal closed-end funds have posted a loss this year. About 15 percent of 168 funds have lost more than 10 percent.

"Even if munis bounce, muni CEFs won't until 2019," Paylor said.

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By Martin Z Braun

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