[Bond Case Briefs]

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[These Muni-Bond Funds May Offer Year-End Bargains.]

Bargain hunters can find plenty of discounted stocks these days. But year-end tax-loss selling may be creating good bargains in closed-end funds, particularly those that hold municipal bonds, according to a note from BlackRock.

CEFs have two prices: the fund's share price and its underlying net asset value, or NAV. When the share price falls below the NAV, the fund is said to trade at a "discount." A 10% discount enables investors to buy a fund's underlying securities, such as stocks or bonds, at 90 cents on the dollar, for example. Investors can profit when the discount to the NAV narrows even if the underlying securities don't budge much.

Historically, CEF discounts widen in the fourth quarter as tax-loss selling kicks in, according to Stephen Minar, head of closed-end funds at BlackRock. Investors sell the funds to realize capital losses in the tax year. That may be especially prevalent this year as stock and bonds have slumped, putting some categories of CEFs in negative territory.

Yet the funds tend to bounce back in the new year-a well-known "January effect." CEF discounts have narrowed in January in 16 of the last 20 years, Minar points out. "Based on historical trends," he wrote, "BlackRock believes that tax-loss selling may present an opportunity to reap the rewards of a temporary mispricing in the CEF market."

Some of the best deals may be on municipal bond CEFs. Interest income from muni bonds isn't taxed at the federal level and may be tax-free at the state level (if the bonds are issued in the investor's state).

Investors should calculate their tax-equivalent yield to see if munis make sense for them. For example, a 5% muni yield would be equivalent to a 6.9% taxable yield for investors with income of $100,000 in the 28% federal tax bracket, according to Bankrate.com. The higher a person's tax rate, the more of a break they would receive from investing in munis.

National muni CEFs, which invest in state and local debt from across the country, are down by an average of 8.7% this year, through Oct. 31, including dividends, and they trade at an 11.3% discount to NAV. That's steeper than their historical discount of 7.3%, according to BlackRock. Indeed, muni CEFs have traded at a narrower discount on 99% of trading days over the last 20 years, averaging 3.5%, Minar writes.

"At BlackRock, we believe these conditions are cyclical and discounts this wide are not likely to persist longer term," he says.

Granted, bonds have been under pressure as the Federal Reserve has raised interest rates and investors have grown increasingly concerned about inflation. Those trends aren't likely to disappear in the new year, keeping up the pressure on bond prices and making it tough to generate positive returns.

To help lower risks, consider funds with a relatively low average “duration,” or sensitivity to interest rates. Another consideration is a fund’s use of borrowed money, or leverage. Many CEFs use leverage to juice their distributions, and the more leveraged a fund, the steeper its yield is likely to be. But leverage can amplify losses when a fund’s underlying securities lose value.

The BlackRock MuniAssets fund (ticker: MUA) has a moderate duration of six years, well below that of long-term bond funds that would lose more in a rising-rate climate. Its distribution rate is 5.2% and it trades at an 8.2% discount to NAV, a wider gap than its 52-week average of 3.7%, according to Cefconnect.com, a closed-end fund research site. More than half of the fund’s $500 million in assets are in investment-graded munis, rated BBB or higher. The fund’s leverage is relatively low at 12.5%.

The Eaton Vance Municipal Bond fund (EIM) trades at a 14.2% discount to NAV, below its 52-week average of 10.6%. Its distribution rate is 4.6%. The fund’s duration is 7.3 years, giving it more rate-sensitivity than the BlackRock fund, but the underlying debt is of higher quality. The portfolio of nearly $1 billion consists of investment-grade bonds, with 70% rated AA or AAA.

If you’re willing to take more interest-rate risk in exchange for a higher yield, consider Nuveen AMT-Free Municipal Credit Income fund (NVG), one of the largest muni bond funds with $3.2 billion in assets. Trading at a 13% discount, the fund yields 5.9%. More than 60% of its bond holdings are rated investment-grade, and the fund emphasizes munis that don’t subject investors to the alternative minimum tax.

Nonetheless, the fund uses a considerable amount of leverage, at 39% of assets. With an effective duration of 13 years, the fund’s shares will get hit hard if rates continue to increase. That could sting long after the January effect wears off.

Barron’s

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