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Closed-End Funds: Tax-Exempt Bonds

The funds buying municipal bonds have done well. All but two of the 133 that have been around for at least a decade delivered portfolio returns better than the 5.3% earned by the Vanguard Long-Term Tax-Exempt Fund (Admiral class shares).

Did the closed-ends accomplish this feat with brilliant bond selection? Perhaps a few did. But the explanation for the category's success lies elsewhere. Almost all of these funds use leverage.

Typical leverage in a closed-end muni fund is 35%. The fund buys \$1,000 of long-term bonds, using \$350 of borrowed money alongside \$650 of money from the common shares whose performance is reported here. Funds borrow by issuing floating-rate preferred stock or its equivalent in some more complicated derivative. The preferred pays interest in the form of a tax-exempt dividend.

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