Two things typically attract investors to closed-end funds: the potential for attractive income and the ability to access various investment strategies priced at a discount to net asset value (NAV). While these are important factors to consider, the draw of yields and discounts may distract investors from other things that are likely to have a larger impact on returns over the long run. In fact, history shows that by themselves, yields and discounts have done a poor job of hinting at future performance.
Executive Summary

Valuation and income potential are good places to start when evaluating closed-end funds, but investors who rely on them as an indicator of future performance are likely to be disappointed.

Closed-end funds have become a staple of the retail investment community, offering access to a wide range of asset classes and investment strategies, wrapped in packages that typically generate yields well above what their underlying investments provide. Today, closed-end funds continue to enjoy a meaningful income advantage relative to stocks and bonds, with distribution rates for taxable funds averaging 7.4%(1) at a time when attractive income opportunities are scarce. Furthermore, about 90% of taxable closed-end funds trade below NAV amid uncertainty over interest rates, giving investors an additional source of opportunity.

Understanding the yield and the discount or premium of a closed-end fund is an important part of assessing the attractiveness of a potential investment. However, we believe it is critical to look beyond these factors, as our research shows that yields and discounts have been remarkably bad fortune tellers.

We examined long-term data for equity, taxable fixed income and tax-exempt closed-end funds to compare forward 12-month returns at different yields and valuations. The analysis revealed that performance often contradicted what investors might have expected. In fact, some of the best returns followed when yields were relatively modest, or when funds were trading at average premiums. We believe this confirms the view that there is more to understanding opportunities in closed-end funds than searching for a high yield or comparing market price with NAV.

On average, equity closed-end funds have experienced better returns over a 12-month period after trading at:

a) 9.0%–10.5% discounts
b) 4.5%–6.0% discounts
c) 0.0%–1.5% discounts
d) 4.5%–6.0% premiums

For the answer, turn to page 5.

(1) At January 31, 2014. Source: Cohen & Steers and Morningstar. Unless otherwise noted, closed-end funds in this report are represented by the Morningstar U.S. All Taxable Ex-Foreign Equity Closed-End Fund Index. Yield for closed-end funds refers to the distribution rate, which is calculated by dividing the last distribution paid per share (annualized) by the market price. See page 8 for index and distribution rate definitions.
The Yield and Discount Value Propositions

A Potential Income Advantage Over Stocks and Bonds

There are many reasons to invest in closed-end funds, but it’s the potential for attractive cash distributions that seems to entice investors the most. With hundreds of closed-end funds offering distribution rates in excess of 7%, it is not surprising they have become popular, especially considering the substantial income needs of baby boomers, who are retiring at a time when yields on investment-grade bonds are meager at best. Many closed-end funds also offer the potential for capital appreciation, further enhancing their appeal to growth-and-income investors.

Closed-end funds continue to offer a meaningful income advantage over stocks and bonds, due mostly to the use of leverage in their capital structure. Exhibit 1 shows that as of January 31, 2014, the average distribution rate for taxable closed-end funds was 7.4%, compared with yields of 3.2% and 2.6% for U.S. corporate and government bonds, respectively, and 2.0% for U.S. stocks. For a $100,000 investment, this translates into an additional $4,800 in potential annual income compared with a 50/50 mix of stocks and corporate bonds. The tax-exempt market offers a similar advantage, where the average distribution rate for national municipal closed-end funds is 270 basis points higher than that of municipal bonds.

The vast majority of closed-end funds carry distribution rates of more than 7%.
Buying Assets at a Discount

Another quality that investors value in closed-end funds is the opportunity to buy shares at a discount to NAV. Over the past decade, discounts have averaged -4.8% for equity funds and -2.5% for fixed income funds.(1) However, discounts have widened over the past year amid concerns of rising interest rates, stemming from anticipation that the Federal Reserve would begin to taper quantitative easing (QE). As of January 31, 2014, 90% of the taxable closed-end-fund market traded below NAV, with discounts averaging -6.9% and -5.3% for equity and fixed income funds, respectively.

It is not uncommon for market prices of closed-end funds to lag NAV returns in periods of rising rates, as higher borrowing costs can make it harder for funds to sustain their distributions. But in 2013, discounts widened even though borrowing costs remained relatively stable. We believe the cause in this instance was the fear that QE tapering was just the first step in a tightening trend that would lead to higher short-term rates in the near future. However, the Federal Reserve has stated the intention to keep the overnight target rate below 0.25% for the foreseeable future, even if unemployment continues to decline. With this in mind, we believe many segments of the closed-end-fund market could see discounts gradually move toward their historical averages as visibility on short-term rates improves.

Discounts have widened past their long-term average in response to QE tapering. As the path of short-term rates becomes clearer, we would expect these discounts to narrow.

Yields and Discounts Are the Beginning, Not the End, of Analysis

Income potential and discounts (or premiums) are just two of many factors to consider when evaluating closed-end funds. In our experience, it is often other factors, such as the relative value of the underlying asset class and the skill of the fund manager, that typically have the largest influence on a fund’s long-term performance. Unfortunately, it is not uncommon for investors to buy a closed-end fund simply because it has a high yield and/or a deep discount, believing this gives them the best expected return.

We examined historical returns to see if the evidence supports our view that discounts and yields have only a tangential effect on performance. What we found is that the relationship often contradicts what an investor might expect.

(1) Equity funds represented by the Morningstar U.S. All Equity & Hybrid Ex-Foreign Equity Closed-End Fund Index; fixed income funds represented by the Morningstar U.S. All Taxable Fixed Income Closed-End Fund Index. See page 8 for index definitions.
Wider Discounts Do Not Necessarily Mean Better Returns

For the following analyses, we observed all available data for closed-end funds going back to 1997 for valuations and 2003 for distribution rates. Exhibit 2 represents the forward 12-month market-price return for taxable fixed income funds (left) and equity funds (right), using a simple average of all days in which the discount or premium was within the specified range.

For fixed income funds, we see that the best returns were associated with modest premiums (+1.5% to +3.0%), although the few occasions when premiums were even higher were generally not good omens. In periods when funds traded below NAV, one might conclude that forward returns were modestly better on average following wider discounts than when discounts were narrower. However, this relationship breaks down in the 7.5% to 9.0% discount range, supporting the view that other factors besides discounts may have a meaningful influence on performance.

Equity funds had their strongest returns during periods in which premiums were at 3.0% or more. An analysis of the underlying data places most of these occasions in the 2003–2004 time frame. This was an exceptionally strong period for equity closed-end funds as U.S. stocks recovered from an economic downturn and benefited from favorable dividend tax reforms. For the remainder of the data, forward returns were not much different whether the closed-end funds were trading at modest premiums or even relatively wide discounts, except in times when discounts exceeded 7.5%.

Since 1997, discounts have had little connection with how closed-end funds performed over the forward 12-month period, except during extreme conditions.

Exhibit 2: Discounts/Premiums and Forward 12-Month Returns

Fixed income funds had the best average returns after trading at modest premiums, although outsized premiums were generally bad omens.

The strong performance of equity funds following instances of high premiums coincided with 2003–2004, a favorable period for closed-end funds.


Performance data quoted represents past performance. Past performance is no guarantee of future results. The information presented above does not reflect the performance of any fund or account managed or serviced by Cohen & Steers, and there is no guarantee that investors will experience the type of performance reflected above. There is no guarantee that any historical trend illustrated above will be repeated in the future, and there is no way to predict precisely when such a trend might begin. An investor cannot invest directly in an index and index performance does not reflect the deduction of any fees, expenses or taxes.

(a) Average total return over the forward 12 months for all days between January 1, 1997 and January 31, 2014, on which the end-of-day valuation was within the specified range; taxable fixed-income funds represented by the Morningstar U.S. All Taxable Fixed Income Closed-End Fund Index, equity funds represented by the Morningstar U.S. All Equity & Hybrid Ex-Foreign Equity Closed-End Fund Index. See page 8 for index definitions.

Answer from page 2: (d)
As shown in Exhibit 2 above, forward 12-month returns for equity closed-end funds have been much higher on average following premiums of 4.5%–6.0% than for discounts even as wide as 10.5%.
Chasing Yield May Also Be the Wrong Approach

Exhibit 3 shows a similar analysis, using current distribution rates rather than valuation. Within fixed income funds, yields above 9% were most often followed by negative returns, whereas an environment of lower yields was generally more favorable. Equity funds also exhibited more favorable returns when yields were at the lower end of the range.

Exhibit 3: Distribution Rate and Forward 12-Month Returns

Historically, fixed income funds often had negative returns when yields were above 9%, while more modest yields generally led to better results.

Equity funds have historically performed the best when yields have been at the lower end of the range.

Municipal Closed-End Funds Have Exhibited More Consistent Relationships

In the taxable closed-end-fund market, we have shown that the relationship between yields, discounts and forward returns has historically been erratic and generally contradictory. By comparison, returns in the municipal closed-end-fund market have been much closer to what one might intuitively expect. As shown in Exhibit 4 on the following page, we see a consistent connection between wider discounts and higher returns. Conversely, municipal funds generally performed poorly after trading at average premiums. We see similar consistency with respect to yields, where better returns have typically followed periods of higher yield levels.
Putting Closed-End Fund Allocations in Perspective

In our view, the data presented here strongly suggests that the performance of closed-end funds does not necessarily line up with what a yield or discount might suggest. Some of the best returns for both equity and taxable fixed income funds have come when funds have traded at premiums, and when yields are at the lower end of the spectrum. We would also note that except at the extremes, closed-end funds have repeatedly exhibited both positive and negative performance following a wide range of discounts and yields.

In our view, the most important considerations should be an investor's outlook for the underlying asset class and the quality of the fund manager. We believe these decisions should be made in conjunction with a financial advisor to determine whether an allocation to closed-end funds is appropriate. The following page shows the variety of ways investors can access opportunities in this market.
No matter how one participates in closed-end funds, yields and discounts are just two of many factors to consider.

As the closed-end-fund market has grown, more vehicles have been introduced to help investors take advantage of these opportunities. Below are some of the ways investors can participate.

- **Individual closed-end funds**, purchased either through an initial public offering or in the secondary market
- **Unit investment trusts that invest in closed-end funds**, comprising a fixed portfolio with a finite life that is not actively managed
- **Exchange-traded funds of closed-end funds**, typically based on a passive index
- **Actively managed mutual funds (open-end and closed-end) that invest in closed-end funds**, offering the potential to benefit from inherent inefficiencies in the closed-end market, with the benefit of professional management

Whichever approach investors choose, we believe closed-end funds can be a valuable part of a diversified portfolio, offering the potential for attractive income and capital appreciation through a wide range of strategies and asset classes.

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**Index Definitions**

Investors cannot invest directly in an index, and index performance does not reflect the deduction of any fees, expenses or taxes.

The BofA Merrill Lynch Corporate Master Index (Credit quality: A-) tracks the performance of U.S. dollar-denominated investment-grade corporate debt publicly issued in the U.S. domestic market.

The BofA Merrill Lynch Municipal Master Index (Credit quality: AA-) tracks the performance of U.S. dollar-denominated investment-grade tax-exempt debt publicly issued by U.S. states and territories, and their political subdivisions, in the U.S. domestic market.

The Morningstar U.S. All Equity & Hybrid ex-Foreign Equity Closed-End Fund Index measures the market-cap-weighted total return of 162 equity and hybrid-equity closed-end funds; it excludes taxable fixed income, municipal, international, regional and country closed-end funds.

The Morningstar U.S. All Taxable Ex-Foreign Equity Closed-End Fund Index measures the market-cap-weighted total return of 341 taxable equity and fixed income closed-end funds; it excludes international, regional and country closed-end funds.

The Morningstar U.S. All Taxable Fixed Income Closed-End Fund Index measures the market-cap-weighted total return of 172 taxable fixed income closed-end funds; it excludes national and single-state municipal closed-end funds.

The Morningstar U.S. National Municipal Closed-End Fund Index measures the market-cap-weighted total return of 98 municipal closed-end funds; it excludes single-state municipal closed-end funds.

The S&P 500 Index is an unmanaged index of 500 large-capitalization, publicly traded U.S. stocks representing a variety of industries.

**Important Disclosures**

*Performance data quoted represents past performance. Past performance is no guarantee of future results.* The views and opinions in the preceding commentary are as of the date of publication and are subject to change without notice. There is no guarantee that any historical trend illustrated in this commentary will be repeated in the future, and there is no way to predict precisely when such a trend will begin. There is no guarantee that a market forecast made in this commentary will be realized. This material represents an assessment of the market environment at a specific point in time, should not be relied upon as investment advice, is not intended to predict or depict performance of any investment and does not constitute a recommendation or an offer for a particular security. We consider the information in this presentation to be accurate, but we do not represent that it is complete or should be relied upon as the sole source of suitability for investment.

Returns in this report are based on market price and assume the reinvestment of all distributions. All returns include the deduction of management fees, operating expenses and all other fund expenses, and do not reflect the deduction of brokerage commissions or taxes that investors may pay on distributions or the sale of shares.

**Risks of Investing in Closed-End Funds**

Shares of many closed-end funds frequently trade at a discount from their net asset value. The funds are subject to stock market risk, which is the risk that stock prices overall will decline over short or long periods, adversely affecting the value of an investment in a fund.

**Distribution Rate**

The distribution rate is calculated dividing the last distribution paid per share (annualized) by the market price. Note that the number of income distributions is based on the fund’s distribution payment frequency (i.e. monthly or quarterly). A fund may pay distributions in excess of its net investment company taxable income and, to the extent this occurs, the distribution yield quoted will include a return of capital. Under federal tax regulations, some or all of the return of capital distributed by a fund may be taxed as ordinary income. In addition, distributions for funds investing in real estate investment trusts (REITs) may later be characterized as capital gains and/or a return of capital, depending on the character of the dividends reported to each fund after year-end by REITs held by a fund.