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Closed-End Fund Investors Migrate Toward Stocks

By DAISY MAXEY

NEW YORK—Investor enthusiasm for closed-end bond funds appears to be waning somewhat as paltry yields force investors to cozy up to stock funds.

"There are still some closed-end bond funds out there that I think are rather attractively priced, but on average, the whole fixed-income side of the closed-end fund market is overpriced," said J. Scott Miller, chief investment officer at Blue Bell Private Wealth LLC, an advisory firm in Blue Bell, Pa., that manages more than $200 million. "That's rectifying very slowly."

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Unlike open-end funds, closed-end funds issue a fixed number of shares in an initial public offering, which trade like a stock. Depending on demand, the shares may trade at a discount or a premium to the value of their underlying holdings.

Although closed-end bond fund valuations remain historically strong overall, average premium valuations for bond-fund sectors have been declining and, in some cases, inverting to discounts, according to Thomas J. Herzfeld Advisors, a Miami investment firm that tracks closed-end fund data and manages about $156 million.

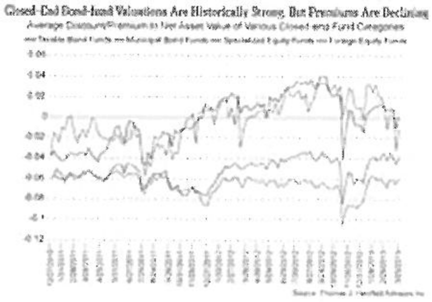
Meanwhile, average discounts on closed-end equity funds have been narrowing, said Cecilia Gondor, the firm's chief investment officer.

"Equity closed-end funds were in the doghouse for years," she said, but with stock indexes reaching new highs, some closed-end equity funds with double-digit discounts have caught retail investors' attention. "Those discounts have slowly been narrowing, although there are still some at attractive discounts," she said.

At the end of September, the average discount of the 15 U.S. equity funds in the Herzfeld Closed-End Average was 8.59%--narrowed from 10.71% at the end of 2012. By the end of last week, it had narrowed further to 7.52%, Ms. Gondor said.

At the same time, the average premium on closed-end taxable bond funds has narrowed to 0.19% at the end of last week from 4.02% at the end of September, she said.

Because municipal-fund investors tend to overreact to any negative factor, which widens discounts, they may act as the canary in the bond-scare coal mine. A slight



increase in long-term interest rates for muni bonds in March led to another round of selling pressure in closed-end municipal funds--something that has been happening with increasing regularity, Ms. Gondor said.

Portfolio managers of some closed-end bond funds have been working to reset investors' expectations.

"Corporations issuing debt in this environment do not think interest rates are going any lower; otherwise they would wait for lower rates to issue their bonds," wrote Mario Gabelli, manager of the Gabelli Dividend & Income Trust (GDV), to shareholders at the end of 2012. "We cannot help but believe the bond market rally that came to life in 1981 has finally reached the ninth inning."

Mr. Miller at Blue Bell Private Wealth said the average closed-end bond fund is cheaper than it was over the last year, while the average closed-end equity fund is "probably a little more dear." A few months ago, closed-end high-yield bond funds were very sought-after, he said. Some remain overpriced, though many are now much cheaper than they had been, he said.

Senior-loan funds are still generally much more expensive than they normally are, he said. Investors are more apt to pay up for such short-term bond funds than for longer-term funds, he said.

Maury Fertig, chief investment officer at Relative Value Partners, which oversees about $750 million for wealthy families and small institutions in Northbrook, Ill., said he sold most of his closed-end taxable bond funds. Mr. Fertig also maintains sizable positions in the equity income funds Eaton Vance Risk-Managed Diversified Equity Income Fund (ETJ) and Eaton Vance Tax-Managed Diversified Equity Income Fund (ETY).

"In many cases, we saw an extreme move in the tightness of the discounts," he said. One example: Eaton Vance Limited Duration Income Fund (EVV), which he bought at a discount of about 10% to 12% in 2011 and sold in 2012. The fund now trades at a premium of about 2%.

"We felt we had squeezed a lot of performance out of it," Mr. Fertig said.

As for equity funds, their discounts "have crept in slightly," but they still offer much more value than bond funds, he said. Retail investors haven't moved into them in a big way, but "that will ultimately happen," Mr. Fertig said.

Thomas J. Herzfeld Advisors, a value investor, has been buying equity funds at deeply discounted prices with the expectation they will improve as retail interest increases. "We certainly are seeing the start of this trend," said Ms. Gondor.

(CORRECTION: An earlier version of this article misstated in the 14th paragraph that Maury Fertig sold all of his closed-end taxable bond funds.)