WHAT YOU NEED TO KNOW ABOUT CLOSED-END TAXABLE BOND FUNDS

By Albert J. Fredman

Closed-end bond funds have a stock dimension in addition to their income attributes—their stock prices fluctuate with changes in sentiment. Astute investors can profit from this while collecting income, but those who buy at the wrong time will lose.

Bond funds comprise the majority of closed-end industry assets even though the first one didn't go public until 1970. A wide array of taxable categories is available, ranging from diverse multi-sector funds to one that targets floating-rate debt of issuers in developing countries. Most importantly, closed-end bond funds have a stock dimension in addition to their income attributes. Their stock prices fluctuate with changes in sentiment, amplifying (or sometimes cushioning) any changes in the underlying portfolio. Astute investors can profit from the stock dimension of discounted bond funds while collecting generous income. But those who buy at the wrong time will lose.

THE CURRENT MARKET

Closed-end bond fund investors have suffered since the early months of 1999 because of increasing interest rates and inflationary concerns. A perhaps even greater bond-market depressant has been the simple fact that investors have grown tired of enduring such dismal returns relative to stocks—particularly those in the technology arena. When bonds are out of favor, closed-end bond funds fall to deeper discounts, adversely impacting owners but eventually making the funds better buys.

Table 1 contains historical average and median year-end discounts (or premiums) for all taxable closed-end bond funds. The December 1999 average and median discounts of 13.8% and 15.7% were significantly deeper than the markdowns in any other year. In fact, only in the late 1970s and early 1980s did discounts dip as steeply as those prevailing in 1999. As of this writing (late March), many of these funds traded at or near their all-time deepest discounts. You can even see markdowns of 20%, which is highly unusual for closed-end bond funds.

TABLE 1. PAST DISCOUNTS (-)/PREMIUMS (+) OF CLOSED-END TAXABLE BOND FUNDS

Year-End	Average (%)	Median (%)	No. of Funds in Avg
1988	–0.2	–0.4	71
1989	–2.2	–4.0	84
1990	–6.0	–6.1	89
1991	+0.1	+0.1	88
1992	+1.0	+0.9	108
1993	–1.7	–2.7	138
1994	–7.3	–9.4	148
1995	–8.0	–9.6	140
1996	–7.1	–8.9	136
1997	–2.6	–4.5	135
1998	–3.2	–4.8	140
1999	–13.8	–15.7	135

Source: Lipper Inc.

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Several advantages differentiate closed-end bond funds from their open-end counterparts:

- Buying deeply discounted shares results in a higher yield. In addition, there is an opportunity for a stock market profit if the discount narrows or disappears.
- Investors have a trading advantage. A closed-end fund's share price often fluctuates more than its net asset value. Using limit orders, you can nail down more favorable prices by buying when markets are temporarily weak and by selling on strength.
- Costs of operation are lower because managers work with a stable pool of capital. Ongoing expenses associated with distributing new shares and meeting cash redemptions are avoided.
- A fund can be more fully invested because a cash buffer for redemptions (common in mutual funds) is unnecessary.
- A fund's stable pool of capital also allows managers to leverage up their yields. About 57% of closed-end taxable bond funds are leveraged through borrowing or a preferred stock issue. Leverage can enhance returns but adds risk.

Closed-end bond funds, however, are more complicated than their open-end peers. Information is not as readily available and greater sophistication is needed to be able to tell whether you are getting value or gimmicks. In addition, more patience and discipline are essential because fluctuating discounts and premiums—often coupled with leverage—may lead to greater price volatility. Finally, there's no guarantee that a 20% discount won't expand to 25%.

DETERMINANTS OF YIELD

Most individuals shop for yield because the measure indicates how much monthly income can be expected. The same factors that affect yields on open-end bond funds influence yields on their closed-end relatives. In addition, the size of the discount or premium and the form and degree of leverage (if used) play a role. Thus, key variables affecting yield include the following:

- *Portfolio expenses*: Funds make distributions after subtracting expenses, including management fees and interest cost (if leveraged). Higher expense ratios lead to lower yields, other things equal.
- *Average portfolio duration*: Duration measures a fund's sensitivity to interest-rate changes. Assuming an upward sloping yield curve (longer-term bonds yield more than short-term bonds), funds with lengthier durations or maturities generally yield more but carry greater "interest-rate risk." When rates increase, the prices of bonds with longer durations tend to decline more than their shorter duration counterparts.
- *Quality of holdings*: Less creditworthy bonds normally produce higher yields, but also expose investors to more risk. Increasing credit concerns depress such bonds.
- *Size of coupons*: Higher coupon bonds typically yield more. Yet they often face greater "call risk" than lower coupon issues so a high yield may not be sustainable. Early calls become more common during times of declining interest rates.
- *The discount or premium*: The deeper a fund's discount, the more its yield on *market price* exceeds its yield on *net asset value*.
- *Leveraging*: Under normal conditions, the return from the bonds held exceeds the cost of leverage, thereby amplifying yield. Leverage poses added risk if problems arise due to rising interest rates or increasing credit risk.

It normally makes sense to buy closed-end funds at a deeper-than-normal discount because they can offer greater value. Nevertheless, it's essential to consider other factors that may explain a fund's deep discount. Actually, most investors buy closed-end bond funds for their yields, not the size of their discounts. Thus, funds that offer higher yields on a net asset value basis tend to sell at smaller discounts or at premiums because their prices have been bid up relative to lower-yielding funds. A higher yielding fund may have lower expenses so that more income flows to the bottom line, but it also could hold riskier bonds or be highly leveraged.

It's important to know whether a fund pays fixed or variable dividends. Most bond funds pay fixed monthly dividends. Variable dividends are based on each month's earnings, which are partially dependent on the number of days in the month. Variable payout funds tend to accrue higher income in longer months and the lowest income in February. This confuses investors because most quote services annualize yields based upon the prior month's dividend. March's annualized yields may understate the true yield because they are based on February's 28 days (29 days in leap year). Buying opportunities can occur in variable payment funds during March due to selling pressure because investors have erroneously perceived a permanent dividend cut.

TAXABLE BOND CATEGORIES

It helps to think of closed-end bond funds in terms of categories, even though variations are extreme within most categories. The bond-fund groups listed in the weekly closed-end fund tables in Barron's and The Wall Street Journal (on Mondays) provide a broad guide to fund types. The list on page 4 goes a bit further by separating several of the more diverse taxable bond groups in the weekly table into additional categories. The Closed-End Fund Association's Web site (www.cefa.com) and Morningstar's site (www.morningstar.com) identify a fund's category in their profiles.

Taxable Closed-End Bond Fund Categories

- ***U.S. Government Funds***: U.S. Treasury and agency securities are the primary focus. Some non-U.S. government issues may be mixed in.
- ***U.S. Mortgage Funds***: The primary focus is on mortgage-backed bonds such as Ginnie Maes, which are issued or backed by the U.S. government or certain federal agencies.
- ***U.S. Mortgage Term Trusts*:** These bond-like portfolios have a target maturity date at which they hope to return a predetermined amount of principal to investors.
- ***Investment-Grade Funds***: Corporate debt rated triple-B or higher is the primary holding. Some U.S. governments may be held.
- ***Loan-Participation Funds***: Senior secured floating-rate loans are the staple of these unique funds. Both continuously offered and exchange-traded funds are available.
- ***High-Yield Funds***: Relatively high income from investments in below-investment grade securities or junk bonds is the primary objective.
- ***Multisector Funds***: A mixture of U.S. government, high-yield corporate, and foreign-government bonds is typical.
- ***Flexible-Income Funds***: Managers move among different fixed-income sectors in their quest for income and appreciation. Some stocks may be held.
- ***Global Funds***: These broad-based portfolios hold U.S. and foreign bonds.
- ***Emerging Market Debt Funds***: These more volatile portfolios focus on developing market bonds.

The different sources aren't always consistent in assigning funds to categories because some funds may straddle two or more categories.

HIGHER-QUALITY INCOME

The U.S. government, mortgage-backed bond, and investment-grade bond funds primarily target higher quality bonds. But a fund can be volatile even if its bonds are of top quality. For instance, U.S. government funds must invest at least 65% of their assets in U.S. government securities but could invest up to 35% in other, riskier debt such as foreign bonds. Further, such a fund could try to juice up its returns by betting on interest-rate moves through the use of leverage and derivatives. Thus, individual funds must be carefully analyzed. Funds in the U.S. government category include ACM Government Securities, Kemper Intermediate Government, and MSDW Government Income.

Investment-grade bond funds focus primarily on corporate debt rated triple-B or higher. Some U.S. government securities are typically mixed in, along with perhaps modest amounts of investment quality foreign debt. By and large, these plain-vanilla funds have low expenses and do not leverage. Current Income Shares, 1838 Bond-Debenture Trading Fund, John Hancock Income Securities Trust, Pacific American Income Shares, and Transamerica Income Shares are illustrative of this group.

Mortgage-backed bond funds primarily target various types of mortgage-backed securities and mortgage derivatives. The objective is high current income. Mortgage securities possess very high credit quality and attractive yields relative to U.S. Treasuries. But they are highly complex compared with the plain-vanilla Treasury. Monthly cash flows consist of interest and amortization of principal. Prepayments of mortgages by homeowners accelerate the maturity date in an unpredictable way and complicate the usual calculations of duration and yield. Mortgage funds are somewhat similar to U.S. government funds because most mortgage-backed securities have the direct or implied backing of the government.

TERM TRUSTS

A number of the mortgage funds are structured as finite-life term trusts and require separate consideration. BlackRock Target Term Trust, the first of its kind, was introduced in November 1988 and seeks to return $10 per share to investors on or about December 31, 2000. It initially invested about 30% of its assets in zero-coupon bonds and the balance in mortgage-backed securities. BlackRock now manages six taxable and six municipal term trusts, which are profiled on its Web site (www.blackrock.com). Several other companies also offer such funds.

Term trusts pay monthly income but the payment stream will not remain constant, as will a bond's. Dividend adjustments are expected due to continual reinvestment of cash flows into shorter maturity securities as a trust's maturity approaches. Term trusts try (but do not guarantee) to pay a bit more than a bond of like maturity and quality through the use of complex strategies.

A trust's terminal price usually is the same as its original offering price. But unlike a bond, the target price is not guaranteed. A trust could return less than 100% of its target, as several did in the 1990s. These trusts lost money as they stumbled by trying to earn extra yield with mortgage derivatives. Further, a trust may not hold sufficient zero coupon bonds to ensure that it can meet its target. BlackRock 1998 Term Trust was the first to meet its target—it paid shareholders $10.02 in December 1998. Like a bond, a term trust becomes more conservative as it approaches termination. A trust that matures in 2001 will not have the same potential for appreciation as one with a 2010 target. In addition, a term trust's discount typically narrows as maturity nears. Trusts with more distant maturities sometimes trade at double-digit discounts.

HIGH-YIELD FUNDS

Below investment-grade bonds are the focus of high-yield (or junk bond) funds. Some issues may even be near, or in, default. The closed-end format has a special advantage for a high-yield portfolio, as managers are not forced to sell illiquid holdings to raise money to redeem shares. High-yield bond returns tend to have relatively low correlation with returns of other bond groups. When the economy is strong, junk-bond issuers generally fare well. If the Federal Reserve raises interest rates to cool an expansion, interest-sensitive Treasuries and other long-term bonds can be hit hard, but the lower duration junk bonds are less sensitive to rate fluctuations. In a recession, long-term Treasuries do well when interest rates decline and their prices rise. But high-yield issuers can be facing difficulties.

Junk bonds tend to yield two to five percentage points more than high-quality debt securities. The spread widens when lower-rated bonds are out of favor. It reached an extreme of 10 percentage points in late 1990. Contrarians become more interested when the spread is wide. This presumably would be when discounts on high-yield funds are deeper, as they were during the fourth quarter of 1999. Although they may offer higher returns, junk funds have a higher level of credit risk. In addition, some use leverage, which increases volatility.

Some high-yield funds mix floating-rate bank loans with junk bonds, which reduces their volatility. These include Debt Strategies Fund, Debt Strategies Fund II, Debt Strategies Fund III, and Senior High Income Portfolio. On average, these funds have about 40% of their portfolios invested in floating-rate loans, adding a significant element of stability. Despite their floating-rate loan holdings, these funds were recently trading at discounts in the mid to high teens.

Allocate no more than 10% to 25% of your fixed-income holdings to high-yield funds, if they appeal to you. Be prepared to reduce exposure if a recession looms on the horizon. Lean toward funds with assets greater than $100 million and an average daily volume of at least 100,000 shares to ensure adequate liquidity. Good management is essential.

MULTISECTOR FUNDS

Multisector funds make good core holdings because of their built-in diversity. Such funds seek income with moderate volatility; capital appreciation is secondary. They invest primarily in three key sectors: U.S. government bonds, high-yield corporate issues, and foreign-government bonds. Macro factors such as the rate of economic activity, interest rate movements, and the changes in the dollar's value affect the different sectors to varying degrees. For example, U.S. governments are most sensitive to interest rates, while high-yield corporates respond to changes in economic activity. Consequently, these sectors move somewhat independently. Foreign fixed-income investing provides an opportunity to take advantage of global interest rate and currency trends. Multisector funds offer active asset allocation as well as security selection. However, you don't want a market timer that moves around too much.

Funds in the multisector category include Liberty-Colonial InterMarket Income, MFS Multimarket Income Trust, Putnam Master Income Trust, Putnam Master Intermediate Income Trust, and Putnam Premier Income Trust. Most of these funds are unleveraged. The absence of leverage combined with sector diversification helps lower volatility. The multi-sector funds use junk bonds to increase their yield but are not exposed to this sector to the extent that a pure junk fund is. A fund that is reaching for higher yields might have 50% of its assets in the junk sector. A manager could trim back riskier holdings when circumstances warrant.

OTHER OFFERINGS

A wide assortment of other bond funds exists. The flexible Zweig Total Return Fund normally invests 25% to 35% in stocks in addition to its stakes in high-quality bonds and cash. When increasing risk is perceived the fund will retreat to cash. The characteristically volatile Franklin Universal Trust is a quasi-high-yield fund. It generally has 60% of its assets in high-yield bonds and 25% in utility stocks. The remainder is invested in other stocks and convertibles.

In the international arena, Global High Income Dollar spreads its assets among the world's emerging markets, investing in bonds with little sensitivity to interest rates. Templeton Emerging Markets Income tempers the risks of emerging-market investing by focusing on bonds of stable governments and blue-chip corporations. BlackRock

North American Government invests only in U.S. and Canadian government debt. First Australia Prime Income invests primarily in high-quality fixed-income securities issued in Australia. A May 1998 prospectus revision allows the fund to invest up to 35% of its assets in Asian bonds. With $1.56 billion in total net assets, the Amex-traded First Australia Prime is one of the largest taxable bond funds.

Loan-participation funds diversify their portfolios among slices of bank loans to below-investment-grade borrowers. As they have no interest-rate risk, they provide excellent diversification when mixed with stock and bond investments. Their yields range from one to three percentage points above the one-year CD rate. Five of the loan funds are exchange traded offering an opportunity to hunt for discounts. [For further information on this fast-growing category, see the October 1999 issue of the *AAII Journal* for the mutual funds article "Loan-Participation Funds: Broadening Your Bond Portfolio."]

TABLE 2. VALUATION AND PERFORMANCE DATA ON SELECTED BOND FUNDS*

Fund (Ticker)	Discount (–) or Premium (+): 1-Year Range (%)	Discount (–) or Premium (+): 5-Year Average (%)	Average 5-Year Return: Net Asset Value (%)	Average 5-Year Return: Market Price (%)
Higher-Quality Domestic Bond				
ACM Government Securities (GSF)	–16.7 to +3.9	–3.3	9.24	5.58
BlackRock Income Trust (BKT)	–19.9 to –10.7	–13.2	9.82	7.86
Fort Dearborn Income Securities (FTD)	–17.6 to –1.5	–8.4	9.18	7.48
Pacific American Income Shares (PAI)	–18.9 to +3.0	–4.9	9.78	7.32
High-Yield Bond				
New America High Income (HYB)	–19.0 to +10.8	+3.6	11.67	7.73
Pacholder High Yield (PHF)	–14.2 to +4.5	+0.6	8.83	4.30
Prospect Street High Income (PHY)	–12.0 to +19.6	+6.0	4.54	3.73
Senior High Income Portfolio (ARK)	–16.1 to –1.8	–0.2	8.00	4.63
Multisector Bond				
Liberty-Colonial InterMarket Income (CMK)	–20.4 to –5.0	–6.4	9.29	5.48
MFS Multimarket Income (MMT)	–21.9 to –10.0	–10.8	9.27	6.61
Putnam Master Intermediate Income (PIM)	–21.5 to +0.3	–9.4	8.15	6.27
Other Domestic Taxable Bond				
Franklin Universal Trust (FT)	–18.5 to +0.2	–5.2	10.24	7.66
John Hancock Income Securities (JHS)	–17.5 to –4.6	–6.3	8.47	6.35
Zweig Total Return (ZTR)	–17.6 to +6.8	+3.1	10.13	6.31
Non-U.S. Bond				
First Australia Prime Income (FAX)	–19.3 to +3.2	–5.9	5.78	1.58
Global High Income Dollar (GHI)	–21.8 to –12.4	–14.0	15.78	13.72
Templeton Global Income (GIM)	–20.9 to –12.1	–13.3	8.01	6.64

**As of 12/31/99*
Source: Wiesenberger, A Thomson Financial Company

DUE DILIGENCE PAYS OFF

Table 2 provides discount/premium and performance data on some older funds selected for illustrative purposes. For best value, the present discount should be at least five percentage points deeper than the average past discount (or premium). Using the five-year average, all funds in Table 2 easily met this test when they traded at the low ends of their recent year's ranges. Even funds that have typically sold at premiums sometimes languish at steep discounts. Discounts can change markedly from week-to-week (and even day-to-day) so that a fund that's a good buy now can become less desirable in a matter of days. And a discount that appears historically deep could get deeper as the end-of-year tax-selling season rolls around. This is particularly true in years such as 1999 when bonds fared badly.

In Table 2, you can see that the average five-year returns based on net asset value (NAV) exceed the returns based on the actual market price for each fund. The reason is that discounts deepened over the analysis period, adversely impacting investors who bought their funds at lesser discounts or at premiums. Net asset value returns are the more meaningful measure of how well a fund is managed because fluctuating discounts and premiums do not affect the performance measurement. The total return based on the actual market price is a more meaningful

measure of an investor's actual return experience and incorporates both the fund manager's performance and the investor's timing decision in buying and selling the fund shares.

The stock's liquidity is also important, particularly if you're taking a relatively large position. It's easier to get in and out of a fund that has a fairly high daily trading volume, say, more than 100,000 shares on an average day.

Be sure you know whether a fund is leveraged or not before investing. Focus on unleveraged funds with shorter durations if interest-rate increases are a concern.

Closed-end bond funds sometimes have rights offerings to raise additional capital, although it has not been nearly as common as with their equity counterparts. First Australia Prime and Prospect Street High Income have a history of rights offerings. The former raised $365 million in 1998 in the largest closed-end fund rights offering ever.

Shareholder activists have not targeted deeply discounted closed-end bond funds for possible restructuring to the same extent they have with equity funds, although this could change if deep discounts persist. If a bond fund trades at a steep discount, its manager may announce a share repurchase program to increase the fund's net asset value with the prospects of reducing the discount. Share buyback programs may provide additional secondary market support for a fund's stock and liquidity for investors desiring to cash out.

In addition to studying its stock characteristics, analyze a closed-end bond fund as you would its open-end counterpart considering management quality and tenure, expenses, portfolio turnover, credit quality, duration, yield, and total return. Fund names and category labels are not always descriptive. A fund that sounds high-quality may have up to 35% of its assets in risky debt and be heavily leveraged. Examine the yearly total returns to see how much volatility you might expect. How did the portfolio fare in difficult years such as 1994 and 1999?

CLOSED-END RESOURCES

The Internet offers several good sites to help with your research. The Closed-End Fund Association's site (www.cefa.com) is an excellent place to begin. In addition to daily net asset values, you will find recent and long-term average discounts (or premiums), net asset value and market price returns, and information about the fund's objectives and portfolio composition. There is also a link to the fund's Web site, if it has one. Morningstar (www.morningstar.com) is another good source for data on many closed-end bond funds. You'll also find a message board. The new Yahoo closed-end fund discussion group provides a unique opportunity to be attune to what other investors are thinking (clubs.yahoo.com/clubs/closedendfunds).

Many closed-end funds have obtained secondary Nasdaq ticker symbols for their net asset values, which you can use along with the share price to calculate daily discounts or premiums. Typically, an "X" precedes and follows the fund's regular stock symbol. Thus, the net asset value for Putnam Premier Income Trust (regular ticker PPT) is "XPPTX." Not all symbols follow this general rule. For example, the stock ticker of Franklin Universal Trust is FT and XFUTX is its net asset value symbol. The funds you are interested in can tell you if they have a special net asset value symbol. You also could try a ticker symbol lookup on a site such as Yahoo! Finance (finance.yahoo.com). The day's net asset values should be available by 7 p.m. Eastern time.

CONCLUSIONS

Because of their stock dimension, closed-end bond funds have greater potential rewards (and higher risk) than their open-end peers. With proper selection and timing, they can offer above-average yields with a potential stock-market-type kicker. The magnitude of the discount is of paramount importance. Negative bond-market psychology due in large part to investor fixation on the unprecedented Nasdaq returns has created excessively deep discounts recently. When bonds rebound, closed-end bond funds could do even better as their discounts narrow.

A major risk of investing in any closed-end fund is that the discount could deepen. Buy only when the discount is significantly wider than its average past levels to minimize the risk of painful stock-market losses.

If the discount narrows appreciably or turns to a premium, consider selling. Your holding period may be shorter than it would be with an otherwise comparable open-end fund. ◆