



Closed-End Funds | An analysis of the closed-end fund market

July 8, 2016

Return of Capital

Overview

Distributions that are classified as return of capital can be confusing for shareholders of a closed-end fund. Some investors view the return of capital as a negative event, which may or may not be justified. Within this report we are going to define return of capital, discuss differences between estimated and actual return of capital as well as between constructive and destructive return of capital, and how shareholders can anticipate return of capital payments.

Why does a closed-end fund return capital?

A portion of the distribution of a closed-end fund is defined as return of capital when the source of such distribution is not otherwise characterized as interest income, dividend income, or realized capital gains. In other words, return of capital distributions can occur when there is not enough interest income, dividend income or realized gains to support the distribution payment for the particular period. One could argue that return of capital is a distributed realized loss.

Certain types of closed-end funds, such as municipal or taxable fixed-income closed-end funds, rarely return capital. Such closed-end funds primarily distribute interest income derived from bonds. On the other hand, closed-end funds that tend to return capital usually pay shareholders a distribution in excess of what they earn from interest and/or dividend income in order to enhance their distribution rate. Among others, such funds often include equity funds that rely on expected realized

capital gains and losses for their distributions. Such closed-end funds may use a level or managed distribution in order to pay out regular distributions on a quarterly or monthly basis.

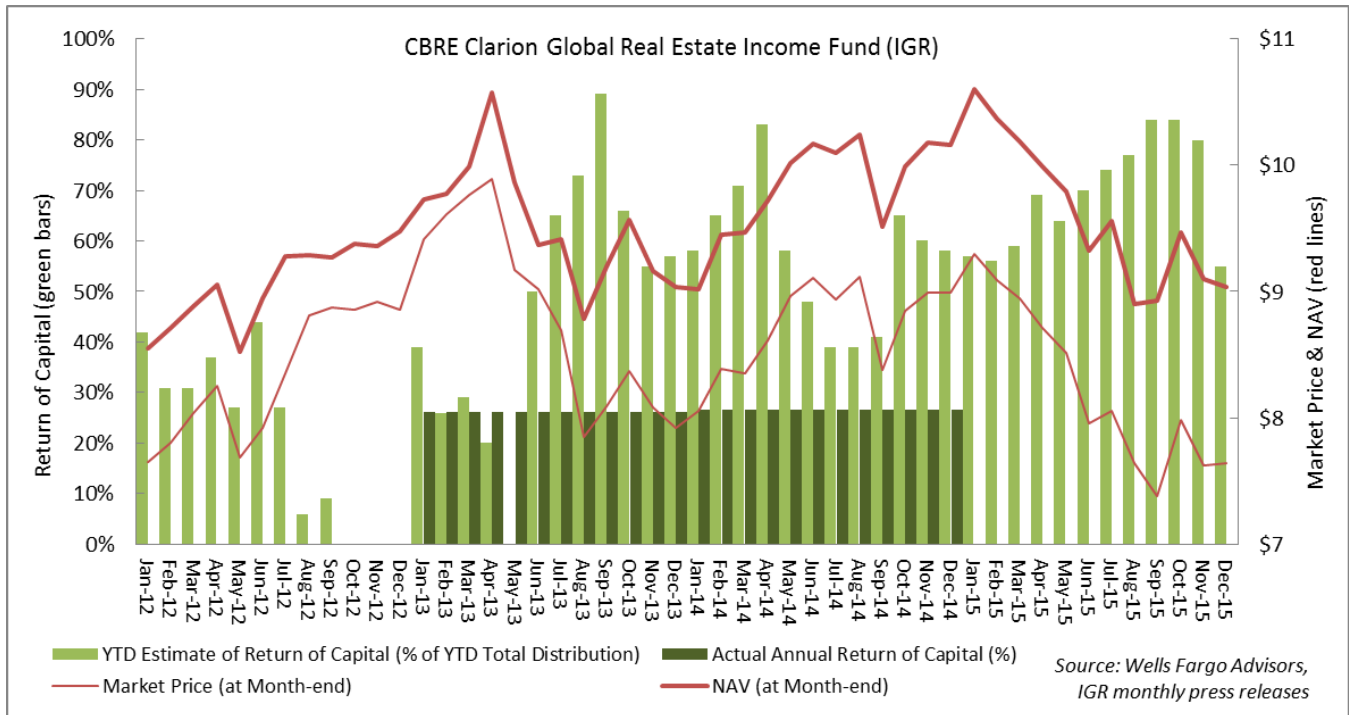
Closed-end fund managers are often under pressure to increase their fund's distribution rates to improve the fund's valuation. Closed-end funds with a higher net asset value (NAV) distribution rate often trade at richer valuations (i.e., a larger premium or narrower discount) than comparable funds with a lower NAV distribution rate. If a closed-end fund trades at a wide discount, activists may pressure its board to recommend a corporate action such as a repurchase of shares, a tender, a conversion to an open-end fund, or in the most extreme case, liquidation, in order to narrow the fund's discount. Accordingly, a fund's board may increase a closed-end fund's distribution in an attempt to avoid a wide discount. The problem arises when the NAV distribution rate is too aggressive relative to the portfolio's exposure leading to the need to support distributions with return of capital.

Estimated vs. Actual Return of Capital

A closed-end fund publishes the actual tax composition for its distribution for the year on its Form 1099-DIV tax document. However, if a closed-end fund estimates that a given regular distribution includes any amount of return of capital, the closed-end fund is required by regulation to send out a Section 19(a) notice to shareholders stating how much of such distribution may be considered a

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return of capital. The amount contained in the Section 19(a) notice is only an estimate and should be treated as such. There can be very large differences between the estimated return of capital and the actual classification on Form 1099-DIV for the full-year distribution. An example of these variances can be seen in the case of the CBRE Clarion Global Real Estate Income Fund (IGR) in the chart above. In 2014, the monthly estimated year-to-date portion of return of capital varied from 39% to 83% (light-green bars); however, the actual return of capital as a percentage of 2014’s total distribution was only 27% (dark-green bars). Similarly, in 2015 the 19(a) notices warned about the possible presence of return of capital, but the actual classification at year-end did not include any. Note that the opposite is also possible – no 19(a) notices throughout the year, but a portion of the distribution ends up being categorized as return of capital at year-end. Investors would be best suited by not reading too much into the amounts contained in such Section 19(a) notices. As always, we suggest clients consult a tax professional.

Destructive vs. Constructive Return of Capital

We use the terms constructive vs. destructive return of capital to differentiate between a closed-end fund’s return of capital distribution that arises, in our opinion, as a reasonable attempt to maintain a narrower discount, while destructive return of capital distributions are more likely to erode NAV over time.

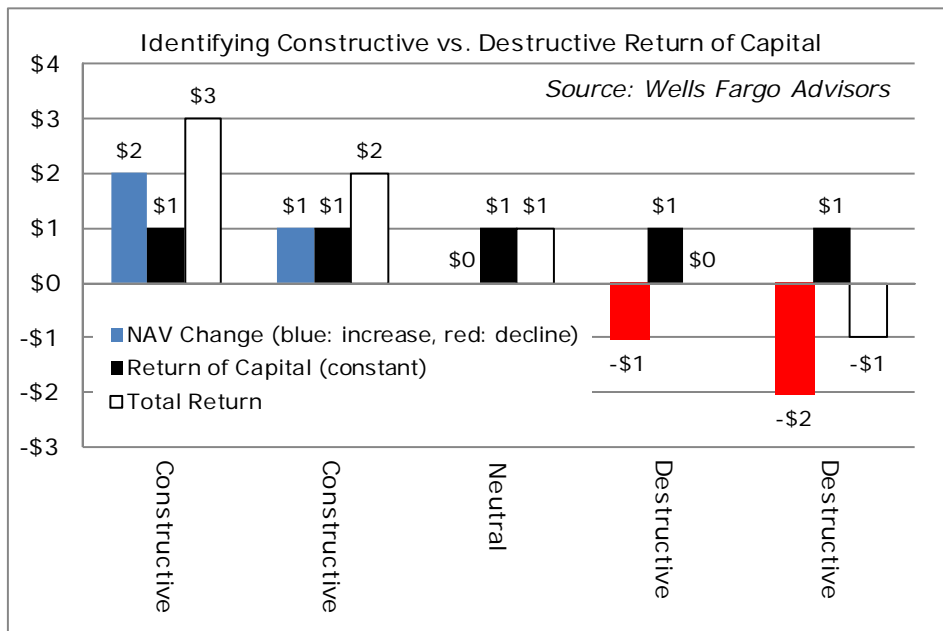
The following hypothetical example should clarify when a closed-end fund returns capital in a destructive manner. If a closed-end fund were to distribute 15% of NAV but it “produces” only 5% in NAV total return on an annualized basis, its NAV will erode over time as the 5% “earnings” rate is too low to replenish assets paid out at the elevated 15% NAV distribution rate. One may compare this scenario to a funnel where the volume of the liquid that is flowing out of it (NAV distribution rate) exceeds the volume that is flowing into the funnel (NAV total return). Eventually, the height of the volume of the liquid inside the funnel (NAV) will decrease.

The next example — a simplistic portfolio starting with equal weights in stocks A and B — will seek to clarify when a closed-end fund returns capital in a constructive way. For simplicity and illustrative purposes, let’s assume the price of stock A rises, and stock B falls in price. The portfolio manager may decide to hold stock A because she thinks that it will continue to rise, and decides to sell stock B expecting its price to continue to decline. Furthermore, this hypothetical closed-end fund pays a distribution, but neither of the two stocks paid any dividends (and there is no interest income from bonds). The manager did not realize any capital gain — short or long — during our hypothetical holding period. Only a capital loss was realized. In this example, the distribution would be considered a return of capital and, if the price of stock A rises by a greater magnitude than stock B’s price decline — and the total return exceeds the distribution — the NAV would appreciate. Thus, we have a closed-end fund with a rising NAV and with a non-taxable distribution. Note that return of capital is not taxable, but the holder would need to adjust the position’s cost basis by the amount of capital returned during the holding period. In other words, we have a desirable situation — a case of a constructive return of capital.

It is also possible that a CEF takes advantage of previous tax-loss carry forwards to offset current realized capital gains, creating a more tax-advantageous distribution — a return of capital. With the aftermath of 2008, for example, a number of CEFs sheltered subsequent years’ distributions with capital loss carry forwards.

How does one know if capital returned was constructive or destructive?

Unfortunately, fund companies do not designate if capital returned was constructive or destructive. Still, one can get a sense of its merit by observing how the NAV changed relative to the amount of capital returned during that period. Ideally, the NAV should remain stable or increase while capital is returned for a given period. It is more sensible to use a longer period for this assessment — a period of only a few months or quarters is too short, in our opinion. In other words, the amount of the distribution should not exceed the NAV total return (distribution plus change in NAV.) The chart below illustrates various hypothetical scenarios where the return of capital remains constant at \$1 per share (black bars), but the total return (white bars) varies. For example, the second set of bars illustrates a



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simplified scenario where the return of capital was \$1 per share and during the holding period the NAV increased by \$1. In other words, the total return (\$2) exceeded the amount of returned capital (\$1). We would consider this return of capital to be of the constructive kind. On the contrary, the last set of bars in the same chart illustrates a scenario where the total return (-\$1) is less than the amount of returned capital (\$1), which resulted in an erosion in NAV (-\$2). We would consider this to be destructive return of capital.

Anticipating return of capital distributions

The previous suggestions to identify the kind of returned capital are useful for a holding period in the past, but in no way do they necessarily identify if a CEF is likely to return capital in a destructive manner in the future. We think the best way to help

avoid an eroding NAV is to evaluate the level of the CEF's NAV distribution rate given the expected return for its underlying assets. Returning to the idea of the funnel, where the rate of outflow is low or below the historical rate of inflow, the funnel is more likely to remain filled. In the closed-end fund world, we favor a closed-end fund with an NAV distribution rate that does not exceed the expected total return of its NAV.

Conclusion

Return of capital is not always detrimental. The process of identifying future destructive return of capital is an art, not a science. We favor NAV distribution rates that are reasonable given the expected return of the closed-end fund's underlying assets or strategy.

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Closed-End Funds (CEFs) are actively managed and can employ a number of investment strategies in pursuit of the fund's objectives. Some strategies may increase the overall risk of the fund and there is no assurance that any investment strategy will be successful or that the fund will achieve its intended objective. A CEF has both a market price and net asset value (NAV), and these two values and their respective performances may differ. Changes in investor demand for a particular fund may cause the fund to trade at a price that is greater (lower) than its NAV, creating a share price premium (discount) to its NAV. CEFs are subject to different risks, volatility, fees and expenses. Many CEFs can leverage their assets to enhance yields. The use of leverage and other risk factors are more fully described in each closed-end fund's prospectus under the heading "Risks."

Closed-End Funds are traded on the secondary market through a stock exchange. The Fund's investment return and principal value will fluctuate so that an investor's shares may be worth more or less than their original costs.

Real estate investments have special risks, including possible illiquidity of the underlying properties, credit risk, interest rate fluctuations, and the impact of varied economic conditions.

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Concentration in the real estate industry may cause the portfolio to be more volatile than a portfolio that is broadly diversified over numerous sectors of the economy. This will increase the Fund's vulnerability to any single economic, political or regulatory development affecting the sector and may result in greater price volatility.

The sources of closed-end fund distributions can include portfolio income, capital gains/losses, and/or return of capital. The final determination of tax characteristics of each CEF's distributions will occur after the end of the year, at which time it is reported to the shareholders. Distributions are not guaranteed.

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