Municipal Closed-end Funds

Rise in Rates in October and Moderate Year-end Tax Loss Selling Widened Discounts

At this point, we think municipal closed-end funds are attractive only for those investors who are fully aware and willing to take the interest rate risk of this type of fund. We think the widening of the discounts of municipal closed-end funds over the last couple of months began with a two-week rise in rates in October. Even though rates have fallen since October, we believe discounts have remained stubbornly wide due to moderate year-end tax loss selling. We expect the prices of municipal closed-end funds to recover in January as the year-end tax loss selling subsides.

The Rise in Municipal Rates in October

Municipal interest rates rose in October for a couple of weeks as shown on Graph 1 above. This rise in rates caused the net asset values of municipal closed-end funds to decline. The funds’ use of leverage accentuated the decline in their net asset values. In other words, when rates rise the net asset value of a leveraged fund declines more than that of a nonleveraged fund, and vice versa. (In late February, rates also rose for three weeks and municipal closed-end funds experienced the same behavior as in October.)

In addition, discounts of municipal closed-end funds tend to widen when interest rates rise, and October was no exception as shown on Graph 2. In other words,
Expect Newer Municipal Closed-end Funds To Generally Be More Interest Rate Sensitive than Most of the Older Funds

There has been a deluge of new municipal closed-end fund offerings over the last three and a half years. The interest rate sensitivity of newer municipal closed-end funds is generally higher than that of older funds. Several factors contribute to the interest rate sensitivity of a fund.

- All the funds that have been offered since 1995 are leveraged. Leverage increases the interest rate sensitivity of a fund. Newer funds have been more likely to have leverage ratio of 35% and 38%, while the leverage ratio of older funds was generally a lower 33%.
- The recent municipal closed-end funds have been offered in a low interest rate environment. This has meant that the bond coupons in the portfolios are fairly low, which increases the interest rate sensitivity of a fund.
- The new funds have better call protection than most of the older funds. In other words, the new funds have invested in bonds with longer maturity dates. Longer maturity bonds that have good call protection for several years are more interest rate sensitive than seasoned bonds that are likely to be called in the near future.
- A few funds hold inverse floaters, derivatives that enhance the yield of a fund but also increase its interest rate sensitivity.