CEF Monthly

July Was a Mixed Bag for CEFs

The crises in Ukraine and the Middle East dragged on European stock CEFs, but Asian-focused funds shone last month.

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At the start of July, the markets were relatively calm despite escalating crises in Russia and the Middle East, though as the month wore on news from abroad began to weigh on the market. Despite largely positive economic news out of the United States near month-end, Argentina's pending default cast a shadow on the market. The S&P 500 Index plunged 2.4% in the last five trading days of July, closing the month down 1.4%.

Meanwhile, the bond market saw a rush of money flow out of high-yield bond funds even as the economic picture in the U.S. continued to improve. During July, the high-yield bond Morningstar Category saw about $3.5 million in net outflows. This was only the second month of net outflows for the category in the past year. Investors may have been reacting to Federal Reserve Chairman Janet Yellen's comments about the high valuations of high-yield bonds, as well as the unsettling economic news from abroad. In addition, credit spreads remained tight and yields were at historic lows for junk bonds. Overall, the Bank of America Merrill Lynch US High Yield Master II Index dropped 1.3% in July.

Best- and Worst-Performing CEF Categories

With good news out of China and Japan, Asian-focused funds fared well in July. China announced that its economy grew more than 7% in the second quarter of 2014, matching previous forecasts. Bank lending in China also grew to CNY 1 trillion in June from CNY 870 billion in May, after the government encouraged increased lending to small businesses. Concerns over easy monetary policy implemented to maintain the country's 7.5% growth rate remain a hot topic, but CEF investors are not too worried yet. The average fund investing solely in China jumped 4% in price during July, while the average fund's net asset value grew 3.6%.

The worst-performing categories for the month of July included many foreign-stock funds. During the month, the crisis in Russia and the Ukraine showed no signs of slowing, and the Israeli-Palestinian conflict continued to escalate. Add in Argentina's default, and it's no wonder some investors were spooked. The CEF with the largest allocation to Argentina--more than 8% as of June 30--was Stone Harbor Emerging Markets Income EDF. Including distributions made in July, this CEF posted a 4.6% share price loss (including distributions) during July, most of which occurred in the last week of the month shortly after Argentina's potential default hit the headlines. The fund's NAV total return dropped just 0.15% for the month, but this is likely a function of delayed pricing updates by the fund. Minus distributions, the fund's price dropped 5.5% and NAV dropped 1.0%.

July was also a rough month for high-yield bonds, one of the largest Morningstar CEF Categories. As a whole, the funds performed poorly: The average high-yield bond CEF lost 3% in share price and 1.2% in NAV in July. The single worst-performing high-yield bond fund, Dreyfus High Yield Strategies DHF, lost 8.5% in price and 1.9% in NAV. Most of the drop occurred in the last week of July, and the fund began selling at a discount by month-end. Dreyfus High Yield Strategies had been selling at a fairly persistent premium since early 2010, reaching a high of nearly 25% in November 2011. The fund closed the month at a slight 1% discount.

Below are the best- and worst-performing Morningstar Categories over the month of July based on share price returns, including distributions.

Best and Worst Categories by Share Price Morningstar Category	1-Mo Price Total Return (%)	1-Mo NAV Total Return (%)	YTD Price Total Return (%)	YTD NAV Total Return (%)	1-Yr Price Total Return (%)	1-Yr NAV Total Return (%)	3-Yr Price Total Return (%)	3-Yr NAV Total Return (%)
Top Performing								
China Region	4.03	3.57	4.29	4.82	16.45	13.55	1.97	1.22
Pacific/Asia ex-Japan Stk	3.45	3.19	10.20	10.15	13.43	13.21	-0.28	0.63
Japan Stock	1.88	1.35	4.31	8.49	12.14	16.08	6.71	7.61
Diversified Pacific/Asia	1.74	1.45	2.99	0.77	7.82	6.52	3.26	2.13
Muni California Intermediate	1.14	0.18	8.24	9.83	11.08	10.98	6.70	6.09
Technology	1.01	-0.44	18.19	9.68	26.34	22.63	14.16	13.18
Diversified Emerging Mkts	0.70	0.48	6.60	7.42	8.72	11.03	0.78	0.36
Latin America Stock	0.40	0.54	6.55	5.75	7.73	6.74	-1.79	-2.52
Multicurrency	0.18	-0.32	15.93	5.94	11.33	2.08	0.00	-1.79
India Equity	-0.24	1.04	29.38	27.38	41.87	40.37	1.97	3.30
Bottom Performing								
Europe Stock	-4.55	-4.67	-2.65	-0.94	13.95	13.03	5.80	5.53
Foreign Large Blend	-3.64	-3.42	1.72	-4.23	12.83	6.68	4.33	3.37
Small Blend	-3.60	-5.52	0.15	-3.04	16.67	10.86	14.95	11.17
Convertibles	-3.48	-2.24	6.86	3.42	14.03	10.96	10.16	9.86
Foreign Large Value	-3.35	-1.63	6.19	6.49	8.16	15.99	3.96	7.05
Utilities	-3.33	-3.85	13.78	11.36	17.52	17.68	12.05	14.66
Equity Precious Metals	-3.24	-0.98	13.26	16.27	1.23	4.80	-15.15	-13.99
Energy Limited Partnership	-3.12	-4.05	11.63	13.92	12.16	20.56	16.14	18.18
High Yield Bond	-3.04	-1.22	5.39	4.76	9.79	10.33	9.30	10.68
Corporate Bond	-2.86	-0.39	6.88	5.57	9.94	7.36	7.24	5.92

Most Expensive and Inexpensive CEFs

Despite the drop-off in some foreign-stock funds and taxable-bond funds, many of those CEFs remain fairly valued on a three-year basis using the z-statistic. Certain municipal bond funds, however, look inexpensive as of the end of July. Although some retail investors have shed municipal CEFs, likely due to negative headlines out of Puerto Rico, the supply and demand picture remains attractive, as do the tax advantages. Limited supply of new issues continues to push prices of municipal bonds up, and the tax breaks on distributions pushed the average aftertax distribution rate at share price to nearly 8% from under 6% as of the end of July.

Below are the most expensive and most inexpensive CEFs as of Aug. 1, 2014.

Most Expensive & Inexpensive CEFs									
Expensive Funds	Ticker	Morningstar Category	Discount	Total Dist. Rate at Price (%)	3-Yr z statistic	1-Yr NAV Total Return (%)	1-Yr Price Total Return (%)	3-Yr NAV Total Return (%)	3-Yr Price Total Return (%)
Royce Micro Cap Trust Common	RMT	Small Blend	-8.79	7.97	2.57	13.91	20.10	13.22	17.55
Nuveen Tax-Adv Total Return Common	JTA	Aggressive Allocation	-1.57	7.17	2.49	14.72	21.20	15.85	21.06
Advent Claymore Conv & Income Common	AVK	Convertibles	-3.74	5.99	2.41	8.07	11.71	7.42	9.09
MFS Special Value Trust Common	MFV	Conservative Allocation	11.55	9.25	2.38	8.00	17.69	8.86	13.32
Nuveen Core Equity Alpha Common	JCE	Large Growth	-1.64	6.74	2.30	16.80	24.04	16.56	20.10
Lazard World Dividend & Income Common	LOR	World Stock	-3.08	6.57	2.28	19.06	24.10	11.56	14.32
First Trust Specialty Finance Common	FGB	Financial	4.97	8.05	2.25	4.34	6.76	12.20	16.17
Royce Value Trust Common	RVT	Small Blend	-9.69	8.11	2.16	7.80	13.24	9.11	12.35
Boulder Growth & Income Common	BIF	Large Value	-17.72	0.22	2.13	10.50	17.01	15.15	15.94
EV Tax-Managed Glb B-W Opps Common	ETW	World Stock	-3.93	9.36	2.06	13.95	22.40	9.17	13.96
Inexpensive Funds									
Cornerstone Progressive Return Common	CFP	Tactical Allocation	7.51	20.25	-6.81	19.36	14.02	13.81	8.24
Tortoise Energy Infrastructure Common	TYG	Energy Limited Partners	-7.30	5.06	-2.44	22.93	4.67	21.95	13.21
AllianceBernstein Glb High Inc Common	AWF	Multisector Bond	-9.39	7.09	-2.31	9.79	4.04	9.64	8.14
PIMCO CA Municipal Income II Common	PCK	Muni California Long	11.18	6.76	-2.21	21.16	9.41	13.91	10.46
BlackRock Municipal Income II Common	BLE	Muni National Long	-6.47	6.95	-2.17	16.34	12.67	10.32	8.82
ClearBridge Energy MLP Opps Ord	EMO	Energy Limited Partners	-10.07	5.91	-2.12	18.22	3.02	18.74	12.98
Nuveen Municipal Value Common	NUV	Muni National Long	-6.99	4.63	-2.03	8.93	7.59	6.64	5.39
Nuveen Real Estate Income Common	JRS	Real Estate	-3.82	8.32	-2.02	14.63	-0.40	12.65	9.02
PIMCO Municipal Income III Common	PMX	Muni National Long	2.46	6.92	-2.01	18.73	12.29	12.21	8.98
Invesco Trust NY Inv Gra Mn Common	VTN	Muni New York Long	-6.29	6.41	-1.99	12.32	8.78	8.27	6.73

News You Can Use

On the last day of July, Tekla Healthcare Opportunities Fund THQ raised $770 million in an IPO. This was only the fourth CEF launched this year and the only non-MLP fund to take the plunge. THQ will invest in health-care stocks and is managed by the same firm that runs H&Q Healthcare Investors HQH and H&Q Life Sciences Investors HQL, two health-care-focused CEFs that have been strong performers over the years.

On July 10, Waddell & Reed terminated William Nelson, the lead portfolio manager of several of its high-yield bond funds, reportedly for causes unrelated to his portfolio-management responsibilities. Chad Gunther, an 11-year Waddell & Reed veteran, will replace Nelson as lead manager on several funds, including Ivy High Income Opportunities IVH and its open-end counterpart, Ivy High Income IVHIX. This is the second manager change in two years for the funds; the previous lead manager, Bryan Krug, left the firm in November 2013 to join Artisan Partners. In response to the firing, IVH's discount widened slightly from 10% (the day prior to the announcement) to more than 11% by the end of the month. To be sure, some of the sell-off was likely tied to a broader sell-off in high-yield mutual funds.

Continuing with a broader CEF merger trend, Brookfield High Income HHY received shareholder approval for a merger with Helios Advantage Income HAV, Helios High Income HIH, Helios Multi-Sector High Income HMH, and Helios Strategic Income HSA. The merger should complete during the third quarter of 2014.

BlackRock also announced a number of fund mergers, with expected completion dates in late 2014. BlackRock Dividend Income BQY will merge with BlackRock Enhanced Equity Dividend BDJ, and BlackRock EcoSolutions BQR and BlackRock Real Asset Equity BCF will merge with BlackRock Resources & Commodities BCX.

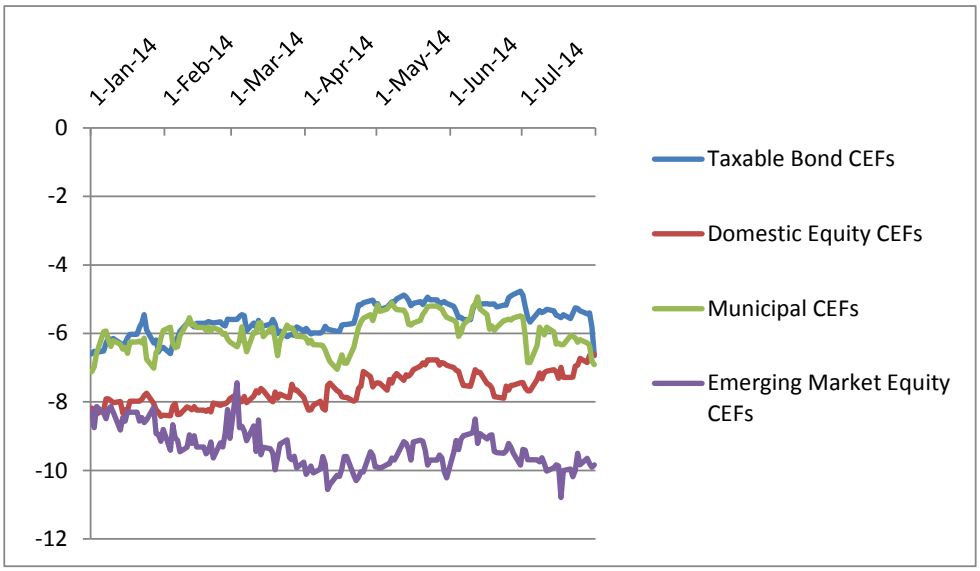
Distribution Changes and Discounts

For the year to date through July, CEF distribution cuts outweighed increases. As of the end of July, there were 149 reductions from 113 funds and only 84 increases from 63 funds. Only 23 funds ended the first seven months of the year with a higher distribution rate (up 9% on average), while 58 funds ended the period with lower distribution rates (a 10% cut on average).

The average discount for taxable-bond CEFs started and ended the seven months at 6.6%. After months of narrowing, the average fund's discount reached 4.8% at the end of June, but it gapped out in July to close the month at 6.6%. Discounts for municipal CEFs bounced around this year, but the average discount ended almost where it started. The average muni fund closed July with an average discount of 6.9%, only slightly narrower than the average of 7.1% at the start of the year.

In the equity space, better economic news out of the U.S. and a rising stock market helped domestic-equity funds' discounts narrow to an average of 6.7% from 8.2% at the start of the year. Shaky news from abroad caused emerging-markets equity CEF discounts to widen since the start of the year. The volatility in the average fund's discount was also quite high, especially in July, when the average emerging-markets equity fund's discount reached a seven-month low of nearly 11%.

The chart below shows the average CEF discounts for broad category groups for the year to date through July 31.



In all, July was a mixed bag for CEFs. Domestic equities tended to fare better than their foreign counterparts, but Asian-focused funds were a clear bright spot. On the fixed-income side, attractive values remain in municipal funds for investors seeking tax-free income. The risks of chasing "yield" with leveraged junk-bond CEFs were apparent as losses hit the high-yield market. Investors should be prepared for more volatility to come. As such, those funds should be used sparingly with full knowledge of the risks.

This month, CEF investors experienced what can happen to share prices when the markets get spooked--though this was a relatively mild shock. Investors have enjoyed a low-volatility environment for some time now but should keep a close eye on the amount of risk in their portfolios.

All performance data in the accompanying tables is as of the market close Thursday, July 31, 2014. All other data as of August 1, 2014. In some limited cases, funds do not disclose their daily NAV values, and in such cases their estimated NAV (based on the performance of their most recently published holdings) is used.

** The funds listed in the Most Expensive & Inexpensive table are ranked using three-year z-scores. This statistic measures how many standard deviations a fund's discount/premium is from its three-year average discount/premium. For instance, in these tables, a fund with a z-score of -2 would be two standard deviations below its three-year average discount/premium. Over a long period of time, a fund would be expected, statistically speaking, to have a z-score of -2 or lower only 2.14% of the time. Funds with the lowest z-scores are considered to be relatively cheap, while those with the highest z-scores are considered to be relatively expensive. We consider funds with a z-score of -2 or lower to be "statistically undervalued" and those with a z-score of +2 or higher to be "statistically overvalued."*