

CEF Weekly Article

A Rundown of Return of Capital

Return of capital is a nuanced topic.

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Return of capital in closed-end funds is a hot-button issue for investors. On one side of this often-polarizing argument are investors who believe all return of capital is bad and who avoid any fund that has ever distributed return of capital. On the other side are investors who believe return of capital isn't that bad in light of a fund's discount. The truth lies somewhere in the middle.

Distributions and Discounts

It's important to understand why a fund might return capital as part of a distribution payment. Generally, funds with higher distribution rates tend to sell at a narrower discount or a wider premium than similarly invested peers. In that vein, cutting a distribution payment typically results in the fund's share price taking a hit while raising the distribution payment can cause the share price to rise. Investors tend to dislike volatility of share prices, in general, and the volatility caused by noodling with the distribution payments, in particular. The market provides enough share-price volatility on its own.

CEFs can make distribution payments from three main sources: income from interest and dividends earned by underlying holdings, realized capital gains (both long- and short-term), and return of capital. Many fund families believe that investors prefer smooth, predictable distribution payments, meaning the same percentage of net asset value or the same dollar amount each payment period. Because fund firms generally set distribution policies before knowing how much a fund will actually earn in a given period, they make estimates based on a number of criteria, including market forecasts and the fund's underlying strategy. These estimates are not always correct, which can lead to a shortfall in cash to distribute. A fund could decide to lower the distribution payment if it hasn't earned enough income or realized enough capital gains to make the payment. But, because of the link between distributions and discount, funds are loath to make changes to the policy because of a periodic shortfall.

If a fund's strategy is out of favor or market conditions forecast lower returns for the medium term, funds should lower distribution payments. For example, many bank-loan and high-yield funds have lowered distribution rates over the years since the 2008 market crash as the Fed's low-interest-rate policy has pushed coupons to record lows and high investor demand narrowed spreads and depressed yields, creating a difficult environment for managers to find investments to meet high payouts.

But, if a fund's strategy is simply experiencing a short-term challenge or a one-time event that has caused the fund to fail to meet its promised payout, lowering the distribution rate may be the wrong choice. For example, during 2008, equity funds hummed along in the

first half of the year, making regular payments to investors from income and (realized and unrealized) capital gains. But, as the market spiraled downward in the fourth quarter, equity funds were faced with a big problem--many of the gains expected to be realized by year-end were wiped out, but the fund had already paid most of the distributions for the year. Not knowing whether the market was going south for a long time or if this was a short-term blip, many funds resorted to return of capital to make up the shortfall.

And this is where return of capital gets sticky.

More Art Than Science

Deciding whether return of capital is "good" or "bad" is not black-and-white. For starters, it helps to understand why the fund returned capital, but most investors don't have access to managers or board members who could (though often don't) answer that question.

A quick rule of thumb for all CEFs (excluding master limited partnerships, a topic addressed next week) is to look at the fund's net asset value over the period of distribution. If a fund's net asset value rose by more than the amount of the return of capital, the fund is likely relying on unrealized gains to make those payments. In general, this is not bad. Forcing a manager to sell holdings simply to meet distribution payments--even if they believe the asset prices had more room to rise--could hurt long-term shareholders. To be sure, there is no guarantee that those unrealized gains will ever be realized. On the other side of that coin, if a fund's net asset value fell by more than the amount of the distribution, the fund has no potential gains to back this up. The table below illustrates this example.

Good vs. Bad ROC Example			
Fund A "Good" ROC		Fund B "Bad" ROC	
NAV as of 12/31/2012	\$10.00	NAV as of 12/31/2012	\$10.00
2013 distribution		2013 distribution	
Income	\$0.50	Income	\$0.50
Realized Gains	\$0.30	Realized Gains	\$0.30
Return of Capital	\$0.20	Return of Capital	\$0.20
Total Distribution	\$1.00	Total Distribution	\$1.00
NAV as of 12/31/2013		NAV as of 12/31/2013	
Change in NAV over the year		Change in NAV over the year	
Return of Capital	\$0.20	Return of Capital	\$0.20
NAV change minus ROC	\$0.05	NAV change minus ROC	(\$0.10)

Source: Morningstar.

Premiums Matter

To complicate matters, any discussion of return of capital must include discounts and premiums. If a fund's share price is equal to its net asset value, the above calculation can be a useful tool. But most funds trade at a discount or premium. For funds trading at a discount, any return of capital can be accretive to total shareholder value. For funds trading at a premium, any return of capital has a negative impact on total shareholder value. Here's why.

When a fund makes a distribution payment, the net asset value drops by the amount of the distribution. The share price would also drop by the amount of the distribution if the share price was equal to the net asset value. In the case of a discount, the share price falls by less than the amount of the distribution. What's more, for investors who reinvest distributions, purchasing new shares at a discount is accretive to long-term value. In the case of a premium, the share price falls by more than the amount of the distribution.

The table below illustrates an overly simplified version of the role that discounts and premiums play. The biggest assumption made is that the fund's discount or premium remains the same. The example assumes a \$2 return-of-capital distribution is made.

Discounts, Premiums, and ROC			
	Price = NAV	Discount	Premium
NAV/share (\$)	10.00	10.00	10.00
Discount (%)	0	10	10
Share Price (\$)	10.00	9.00	11.00
ROC Distribution (\$)	2.00	2.00	2.00
Share Price (\$)	8.00	7.20	8.80
Share Price + Distribution (\$)	10.00	9.20	10.80
Gain/Loss (\$)	0	+0.20	-0.20

Source: Morningstar.

In the discount scenario, after one year, the investor's per-share total value increased from the \$9 purchase price to \$9.20 even after the fund returned capital. In the premium scenario, the shareholder's total value dropped to \$10.80 from the \$11 purchase price after the fund returned capital. Investors can extrapolate this to mean that the lower the discount, the bigger the advantage and the higher the premium, the bigger the disadvantage.

Of course, funds selling at wide discounts may be poorly managed, underperforming funds. Identifying funds selling at deep discounts returning lots of capital is not a recommended investment strategy. This is simply a tool for investors to use when evaluating whether a fund's use of return of capital is acceptable and appropriate for an individual's investment goals and income needs.

Master Limited Partnerships

Master Limited Partnerships, or MLPs, are partnerships, not corporations. Buying a share of a corporation (that is, a stock) means the investor owns a portion of that firm's equity. Buying a share of a partnership means the investor owns a unit of the partnership's business interests. Unlike a firm, partnership units are not taxed at the business level but at the investor (or partner) level. Thus, taxable income from a stock's dividends and MLP cash distributions are not the same. Under accounting rules, an MLP's pipelines (most MLPs own and operate energy pipelines) are depreciated as an expense. Because of the accounting treatment of depreciation expense, taxable income for MLPs is typically less than their actual cash flow generation. Conversely, the amount of cash available for distribution is usually higher than taxable income recorded.

That presents partnership unitholders with two distinct issues. First, partners have to report their proportion of the partnership's net income on their individual tax return, even if the partnership distributes none of that income and the partner does not sell any units. Second, any distributions received from the partnership are declared for tax purposes but are tax-advantaged relative to a dividend from a company. These distributions are often considered a "return of capital," and taxes on these distributions are deferred. We'll revisit that taxation issue below.

Covered Calls

Covered-call funds are not special cases in the same way that MLP funds are, but they're worth mentioning separately.

Covered-call funds hold underlying equities and write call options on indexes or individual equities in an effort to generate additional income for distributions. Investors may notice that a covered-call fund tends to distribute more return of capital than an equity fund using a similar strategy without the call overlay.

When a fund writes a call option, it earns a premium. This premium is not "earned" by the fund until the option contract has expired or is closed. Once this happens, the fund will either book a gain or loss on the option contract (although it is also possible that a fund would break even) based on the price of the underlying security relative to the strike price and the premium received. Any option premiums distributed to investors are categorized as a combination of short-term and long-term capital gains for tax purposes. Because of netting of capital gains and losses, these funds may end up returning capital.

Let's look at two oversimplified scenarios. They assume a fund is writing call options on an index and holding securities that mimic the index. At the start of the year, the fund's net asset value is \$10 per share. Assume that no trades are made throughout the year and that the fund does not earn income from dividends of underlying holdings.

First, take a declining market scenario in which the fund's underlying holdings fall 10% during the year (at a steady pace throughout the year, which means none of the fund's options are exercised). The NAV at year-end is \$9 per share. During the year, the fund sold call options and recorded a \$1 per-share capital gain from those premiums. The fund pays an annual distribution of \$1 per share. Thanks to

the option premiums, this distribution is categorized as a combination of short-term and long-term capital gains. But the fund's total return (which includes distributions) is zero: The \$1 per-share distribution perfectly offsets the \$1 per-share decline in NAV. The table below illustrates this scenario.

Table 1: ROC in Covered Call	
10% decline in holdings	
Beginning NAV	10.00
Option Premiums earned	1.00
Unrealized losses	-1.00
Ending NAV before distribution	10.00
Distributions	
Short-term & Long-term capital gains	1.00
Ending NAV after distribution	9.00
Total Shareholder Value (End NAV + Dist)	10.00

Source: Morningstar.

In the reverse scenario during which the market steadily increases by 10% to \$11 per share, the fund still sells call options. Because the market is rising, the options are exercised, so the fund does not book any gains from the option premiums. Instead, assume a break-even scenario in which the premium earned by selling the call option exactly offsets the cost to the fund incurred by the counterparty exercising the option. At the end of the year, the fund pays the \$1 per-share distribution.

Table 2: ROC in Covered Call	
10% increase in holdings	
Beginning NAV	10.00
Option Premiums earned	0.00
Unrealized Gains	1.00
Ending NAV before distribution	11.00
Distributions	
Return of Capital	1.00
Ending NAV after distribution	10.00
Total Shareholder Value (End NAV + Dist)	10.00

Source: Morningstar.

But the fund has not made any trades and, therefore, has not realized any capital gains and has no option premiums to distribute. In order to make the distribution, the fund could sell some of the underlying holdings that have appreciated and then distribute the realized gains. But, if managers believe the market will go higher, they may not choose to sell shares simply to meet the distribution. In this case, the fund's total return is zero--the \$1 increase in NAV is offset by a \$1 distribution from return of capital, which lowers the NAV. Table 2 above illustrates this scenario.

It is important to note here that the tools described at the start of this discussion are still applicable for covered-call funds. Looking at the change in NAV relative to the amount of return of capital helps to quickly assess whether the use of return of capital is "good" or "bad." And the fund's discount or premium matters. In fact, these covered-call equity funds have historically sold at discounts, so these funds may be more attractive for certain investors, despite heavy use of return of capital.

Taxes

A key tax advantage of owning a fund that returns capital is the ability to defer long-term capital gains until the shares are sold. For a non-MLP CEF that distributes return of capital, investors pay no tax on that portion of the distribution. Instead, this lowers the cost basis of the investment. When the shares are sold, the investor pays taxes on the difference between the cost basis (including any reductions due to return of capital distributions) and the price at which the shares were sold, assuming that number is positive.

Circling back to MLPs, owning individual MLPs can be an administrative nightmare at tax time. Investors must keep track of cost-basis adjustments for all MLPs owned. In addition, if an MLP has pipelines in 20 states, the investor may need to prepare 20 out-of-state tax filings. Putting a CEF wrapper around a portfolio of MLPs makes a lot of sense. Investors in the fund get nearly all of the benefits of direct MLP investing without the tax-administration headaches, though CEF investors must pay management fees.

Return-of-capital distributions are also the reason that most MLP CEFs trade at large premiums to reported NAV. When the CEF receives a return-of-capital distribution from an MLP in its underlying portfolio, it, too, must write down its cost basis for that MLP. Deferred taxes come into play, and often MLP CEFs have very large deferred tax liabilities. Such liabilities, by definition, lower the reported NAV, even though some of those deferred liabilities may never actually be recognized. Astute investors realize all of this and are willing to pay more than reported NAV for the fund. Investors interested in these tax benefits should consult a tax professional to fully understand the impact these complex tax scenarios may have on an investment portfolio.

Return of capital is a complex topic that takes time to fully understand. There are many moving parts that make it difficult to determine whether it is constructive or destructive to long-term shareholder value. But informed investors have many tools at their disposal to make decisions regarding the appropriateness of a fund's use of return of capital for their own investment needs. And it's important to remember that it's not what you make, it's what you keep. Total return trumps "yield" every day.