



# Closed-End Funds

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## Closed-End Funds with Finite Lives

*A primer on target-price term trusts and term trusts*

Most investment funds, including closed-end funds (CEFs), are structured so that they have perpetual lives. In other words, there is no maturity date and the investor will need to liquidate his/her holdings if exposure to a particular fund is no longer desired. There are a few CEFs, however, that do have maturities. The purpose of this report is to serve as a primer on two structures of such CEFs, the target-price term trusts and the term trusts, and to discuss what we view as the pros and cons of each.

### Target-Price Term Trusts

Target-price term trusts are the first generation of term trusts. This type of CEF not only has a finite life; it also attempts to return the IPO price at maturity. For example, if a CEF is launched at a price of \$25 it would be the goal of the sponsor to return a price of at least \$25 per share at its maturity. *Note that while the sponsor strives to return the IPO price, the ending distribution is not guaranteed to equal or exceed the IPO price, nor is the sponsor obligated to pay the shareholders an amount equal to any potential shortfall.* At this point, BlackRock is the only CEF sponsor that continues to use the first generation of term trust, of which there are three. Other sponsors have launched second-generation term trusts, which will be discussed shortly.

**How does it work?** Because CEFs, more or less, have a fixed number of shares (excluding the effects of some forms of distribution reinvestment or other corporate actions), the task of returning a specific price is *somewhat* simpler than it would be for an investment product that has share creations/redemptions. Moreover, historically most of these target-price term trusts, and all of the existing ones, have invested in munis because they can retain some of the muni interest to enhance their ability to return the original IPO

price (without any taxation at the fund level). However, creating target-price term trusts is not without complications and the track record for this type of CEF is not perfect as a few have failed to return the full IPO price and others have sacrificed income towards the latter years of their lives in order to return the IPO price. Some of the challenges that such CEFs may face are discussed in the following sections.

One should realize that when a CEF is launched at a price of say, \$25 per share, it does not have a net asset value (NAV) of \$25 per share at commencement. There are fees that are associated with launching a CEF that are taken out of the initial NAV. For example, if launched at \$25 per share, its initial NAV would likely be in the neighborhood of \$23.85 (if a typical offering with typical selling concessions, etc.). Thus, the CEF, which holds \$23.85 of municipal bonds net of leverage, is already in the position of needing to add an extra \$1.15 per share (or \$25.00 minus \$23.85) to achieve its goal of returning \$25 per share. This is often accomplished by investing a small portion of the portfolio in zero-coupon bonds with the same maturity as that of the target-price term trust, which, once they appreciate to par, should cover that initial NAV deficit. So, a *small* portion of the portfolio has to be invested in securities to make the investors "whole," rather than earning an incremental return.

Another possible complication is that the bonds held in the portfolio will likely come due at different times, and few, if any, will have due dates that correspond exactly with the maturity date of the CEF itself. As such, some of these bond-redemption proceeds will need to be reinvested several years before the term trust's maturity. Additionally, if a bond comes due or is called, for example, seven years before the term trust

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matures, chances are that the sponsor is not going to invest the proceeds in longer term bonds given that it is striving to return a specific price seven years later. With a normal yield curve, short-term bonds have lower yields than do long-term bonds and this problem can be exacerbated if the CEF is reinvesting the proceeds from redeemed bonds in a relatively lower interest-rate environment. Because of this, the CEF's income *may* decline as its maturity nears, depending on the interest-rate environment at the time and other factors.

Other factors that may complicate a target-price term trust's ability to pay the IPO price at its maturity is leverage that it may employ or possible defaults on the part of some of the bond issuers to which it is exposed.

#### **Is my principal in a better position in a target-term trust relative to a perpetual CEF?**

The answer to this question depends on, among other things, the holding period of the investor as well as the characteristics of the bonds held by the CEFs. It is imperative to remember that the underlying bonds, even when held in a target-price term trust, will fluctuate in value. As one recent example, the **BlackRock Municipal Target Term Trust (BTT, \$18.18)** was launched on August 29, 2012. This leveraged product has a somewhat long maturity, with a planned maturity date on or around December 31, 2030. Because of the long maturity, the CEF can, and has, invested in bonds with quite long maturities. Its leverage-adjusted duration is about 17.6 years (longer than that of most other fixed-income CEFs), which indicates significant interest-rate sensitivity.<sup>1</sup> As a result, BTT was impacted somewhat harshly in the recent muni-bond CEF selloff, posting an NAV total return of -20.1% from the end of April 2013 through July 26 and a market-price-based total return over the same period of -16.2%, more severe than that of most leveraged muni CEFs, including many of those with perpetual lives. *This period of time was chosen as it roughly encompasses the time period during which the aforementioned selloff occurred. Investors should note that BTT has had a limited life and the recent performance may not be indicative of future results.*

In general, as the CEF approaches maturity and the bonds' lives shorten, its volatility should be reduced, all other factors held constant.

*Also, note that there are other target-term CEFs with shorter durations than that of BTT (however, there are factors in addition to duration that should be considered in an investment decision).*

#### **Term Trusts**

A more recent development is the term trust. Like the target-price term trusts, this type of CEF also has a finite life; however, the CEF's sponsor does not necessarily strive to return a specific price at maturity. We realize that on the surface the term trusts may sound less appealing than the target-price term trusts. However, most of these products are structured so that the maturities of the underlying bonds are in close proximity to the maturity of the CEF itself (it is doubtful that many sponsors of these types of trusts would place themselves in a situation of having to terminate a trust at maturity while still holding bonds that have several years to maturity left in an uncertain interest-rate environment). Also, because they don't have to focus so much on ending at a certain price, the income stream may be less jeopardized over the life of the trust.

Another advantage of a term trust (and also a target-price term trust) relative to a perpetual trust is that much of the time many CEFs trade at discounts to NAV. At times an investor may have thought: "It is nice to be able to buy a fund at a discount to NAV, but it would also be nice if the discount subsequently narrows." Given that shareholders will receive NAV at termination, the discount (or premium) should narrow and disappear as the termination date approaches. In other words, the market price will converge towards NAV as the CEF approaches maturity.

As with the target-term trusts there is a wide range of durations/maturities from which to choose. As such, some may be considerably more volatile than others.

A list of both target-price term trusts and term trusts that are in our coverage universe follows. Note that this list is provided for informational purposes only and does not necessarily constitute a "recommended list."

<sup>1</sup> Duration attempts to measure interest-rate sensitivity. Generally, the greater the number (usually expressed as "years"), the greater the interest-rate sensitivity.

Data as of July 26, 2013										Listed in Order of Expected Termination Dates		
Fund Name	Ticker	Maturity*	Type	Advisory Services Group Classification	(Discount) /Premium on Last NAV Date	Total Lev Ratio (%)	Net Assets Mils USD	Average Daily Volume Mils USD	Last Closing Price			
BlackRock Defined Opps Credit	BHL	12/31/2017	Term	Corporate Loans - Majority	-4.35	27.0	130.9	0.494	13.86			
BlackRock Muni 2018 Term Trust	BPK	12/31/2018	Target-Price	National Muni	1.28	22.2	248.8	0.664	15.83			
Nuveen Mortgage Opp Term Trust	JLS	11/30/2019	Term	Structured Finance	-5.62	26.3	415.6	1.859	24.68			
Nuveen Mort Opp Term Fund 2	JMT	2/28/2020	Term	Structured Finance	-6.14	26.5	128.5	0.526	24.75			
BlackRock Municipal 2020	BKK	12/31/2020	Target-Price	National Muni	0.29	35.5	323.9	0.692	16.05			
Western Asset Muni Defined Opp	MTT	4/30/2021	Term	National Muni	-5.96	0.0	261.9	0.836	20.53			
Western Asset Mortgage Def Opp	DMO	3/1/2022	Term	Structured Finance	-6.55	10.8	247.2	1.274	22.27			
Nuveen Intermediate Dur Muni	NID	3/31/2023	Term	National Muni - Non IG	-8.53	36.3	599.7	2.236	11.69			
Nuveen Inter Dur Quality Muni	NIQ	6/30/2023	Term	National Muni	-7.33	25.5	160.4	0.573	11.89			
Nuveen Preferred & Income Term	JPI	8/31/2024	Term	Preferreds Leveraged	-6.37	28.3	571.6	2.065	23.52			
Western Asset Glb Corp Def Opp	GDO	12/2/2024	Term	Multi-Sector Debt - Leveraged	-10.18	13.9	311.6	1.141	18.08			
Mainstay DeTerm Muni Opps	MMD	12/31/2024	Term	National Muni	-3.97	34.6	423.7	1.919	16.44			
Western Asset High Yld Def Opp	HYI	9/30/2025	Term	High Yield Non-Leveraged	-5.88	0.0	427.4	1.89	18.08			
Blackstone/GSO Strategic Cred	BGB	9/15/2027	Term	Corporate Loans - Majority	-4.53	33.3**	802.6	2.939	18.35			
EV Municipal Income Term Trust	ETX	6/30/2028	Term	National Muni - Non IG	-8.53	39.9***	158.5	0.788	14.37			
BlackRock Muni Target Term Tr	BTT	12/31/2030	Target-Price	National Muni	0.64	42.2	1163.0	5.857	18.87			

\* In many cases, investors should view the maturity dates as *approximate* dates at which the CEFs will terminate.

\*\* The targeted amount as indicated by the sponsor

\*\*\* Our estimate based on recently reported leveraged and non-leveraged durations

Sources: Morningstar Traded-Funds Center and Wells Fargo Advisors

CEF	Ticker	Annualized Returns (%)							Assets		
		1 year		5 Years		Since Inception			Expense Ratio	Under Mgmt (mils)	Market Price
		Price	NAV	Price	NAV	Price	NAV	Inception			
BlackRock Defined Opportunity Credit Trust	BHL	9.5	9.5	7.0	6.6	6.1	6.2	1/28/2008	1.61%	\$131	\$13.85
BlackRock Municipal 2018 Term Trust	BPK	0.3	3.0	7.4	8.5	6.5	6.7	10/26/2001	0.85%	\$249	\$16.04
Nuveen Mortgage Opportunity Term Fund	JLS	12.5	21.0	N.A.	N.A.	8.8	11.2	11/24/2009	1.45%	\$416	\$24.37
Nuveen Mortgage Opportunity Term Fund 2	JMT	13.7	21.8	N.A.	N.A.	9.0	11.5	2/24/2010	1.61%	\$129	\$24.50
BlackRock Municipal 2020 Term Trust	BKK	5.3	3.4	9.0	8.6	6.4	6.9	9/25/2003	0.93%	\$324	\$15.99
Western Asset Municipal Defined Opportunity Trust Inc	MTT	-5.1	1.9	N.A.	N.A.	6.9	8.5	3/26/2009	0.68%	\$264	\$20.54
Western Asset Mortgage Defined Opportunity Fund Inc	DMO	22.7	32.0	N.A.	N.A.	15.9	17.2	2/23/2010	1.89%	\$248	\$22.22
Western Asset Global Corporate Defined Opportunity Fund Inc	GDO	1.9	9.5	N.A.	N.A.	5.3	9.1	11/24/2009	1.34%	\$308	\$17.84
Western Asset High Yield Defined Opportunity Fund Inc	HYI	3.0	16.0	N.A.	N.A.	4.4	9.2	10/27/2010	0.89%	\$436	\$17.60

All data as of July 26, 2013, except for return data, which are as of June 30, 2013.

Funds that had not been in existence for at least one year as of June 30, 2013 were excluded from the table above.

Source: Bloomberg, Wells Fargo Advisors, and the funds' websites.

In addition to the funds' expense ratios listed above, the funds are subject to brokerage fees.

*Past performance does not guarantee future results. Investment returns, price, and NAV fluctuate with changes in market conditions.*

Additional information can be obtained at the respective CEFs' websites:

For BHL, BPK, BKK, and BTT: <https://www2.blackrock.com/us/financial-professionals/products-performance/closed-end-funds>

For BGB: <http://www.blackstone-gso.com/bgb-index.php>

For JLS, JMT, NID, NIQ, JPI: <http://www.nuveen.com/cef/?gclid=CJe9ai71bgCFdBCMgoddXwAtg>

For MTT, DMO, GDO, and HYI: <http://www.westernasset.com/us/en/>

For MMD: <http://www.nylinvestments.com/portal/site/MainStayClosedEndFund>

For ETX: <http://funds.eatonvance.com/Municipal-Income-Term-Trust-ETX.php>

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All prices are as of August 1, 2013, unless indicated otherwise.

A closed-end fund has both a net asset value (NAV) and a price, and these two values may differ. A closed-end fund's NAV is the total value of the securities in the portfolio minus any liabilities, divided by the CEF's number of common shares outstanding. The CEFs' price is the market value at which the CEF trades on an exchange. Changes in investor demand for a particular closed-end fund may cause the CEF to trade at a price that is greater (lower) than the NAV; in that case the CEF is trading at a premium (discount) to its NAV. Since a CEFs' premium or discount to its NAV may narrow or widen, a closed-end funds' price return may differ from its NAV return.

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