

## The Stock Market Crash That Almost No One Heard

By Randall W. Forsyth Dec. 21, 2018 1:32 p.m. ET



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There was another crash you probably didn't hear amid the cacophony in the financial markets, one that at its worst was equivalent to a 3,000-point plunge in the Dow Jones Industrial Average. On Thursday, some closed-end funds traded down as much as 15% before pulling out of a free fall that some seasoned pros likened to their collapse during the great financial crisis, following the bankruptcy of Lehman Brothers in the fall of 2008.

Back then, that turned out to be a marvelous buying opportunity, at least for those who heeded Kipling's admonition to keep your head while all about you are losing theirs. In the small market for closed-end funds, some pros feared that history was repeating itself on Thursday, after selling began, with few bids to absorb it.

To be sure, the stock market also was in full retreat. The speculative parts of the credit market were close behind, especially after the Federal Reserve's interest-rate increase on Wednesday and, more important, disclosure of its plan to raise rates further in the coming year, while continuing to shrink its bond portfolio.

But the retreat turned to rout for CEFs, owing to both the slide in the value of their underlying assets and their own peculiarities. Closed-end funds consist of a fixed number of shares that trade in the secondary market at prices that may be a premium or discount to their net asset values.

CEFs also have other oddities. Individual investors own the lion's share of them, which can make the market less efficient than your finance prof would have had you believe. In addition, they are almost all small-capitalization

stocks and many qualify as micro-caps, so relatively small buys and sales can push their prices around (making limit orders—which specify a price—advisable). Then there's the calendar: It was the last chance for tax-loss selling in 2018, after which many pros and other opportunistic investors shut up shop for the holidays.

All those quirks conspired with the developing bear in equities and speculative credit to produce Thursday's thunderous crash. What was extraordinary was that many CEFs had been selling off for weeks, with their discounts steadily deepening. According to Maury Fertig, chief investment officer at Relative Value Partners, CEFs were already extraordinarily depressed, with valuations at the 96.7th percentile of his records. Thursday's plunge put them in the 99th percentile, meaning they were within 1% of their all-time cheapest.

Part of the selling seems to have come from individuals, some of whom apparently have odd ideas about when to get in and out. Steve O'Neill, a portfolio manager with RiverNorth Capital Management, which specializes in CEFs, relates that a big closed-end fund (from one of the largest managers, whose name he wouldn't mention, but that everybody knows) went into a free fall on Thursday when it crossed its initial public offering price. Why? The moms and pops who got in on the IPO (back in 2013) now had a loss and wanted out. No matter that the closed-end was run by some of the most highly regarded managers around, who had managed to generate a positive return on its assets.

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To be sure, there are also rational, fundamental reasons for the slide, especially those related to the credit market, in which the predominant variety of CEFs invests. High-yield bonds and bank loans have been selling off sharply as investors demand fatter yields to compensate for the perceived increase in credit risks from higher corporate debt and a less-exuberant economy. For instance, the iShares iBoxx \$ High Yield Corporate Bond exchange-traded fund (ticker: HYG) and the Invesco Senior Loan ETF (BKLN), popular ETFs that respectively track the junk-bond and leveraged-loan markets, also saw their slides accelerate on Thursday.

Still, CEFs suffered massively bigger losses than corresponding ETFs, owing to less liquidity and the use of leverage in most cases, which magnifies risks as well as returns. Yet for those able to follow Warren Buffett's credo to be greedy when others are fearful, there are significant opportunities. Some CEFs are trading as low as 82 cents on the dollar, according to pros who have lived through massive market dislocations similar to the one that's taking place.

Indeed, conditions for CEFs are more favorable now than in the dark days of late 2008, maintains Boaz Weinstein, the founder of Saba Capital Management, which uses CEFs as part of strategies that also include hedging institutional portfolios against the "tail risk" of market crashes. One big improvement is the way that CEFs now lever their portfolios, he says. Back then, many used auction-rate preferred stocks. That meant the funds effectively had to raise capital as often as every week—problematic in 2008.

Now CEFs typically use bank lines of credit, far more reliable sources of funding.

Investors averse to leverage, RiverNorth's O'Neill says, can opt for unlevered ones. But he's most enthusiastic about target term trusts, which aim to liquidate and return net asset value in a particular year, like a bond, and thus limit risk. Some of these relatively short-term CEFs have seen their discounts widen to 10%, which could be recouped by the time they are redeemed in about three years. That would augment their current yields over 6%, which also ought to rise along with short-term rates, for an attractive total return. (O'Neill described these on the condition of not naming names.)

Fertig was less reticent. He likes a closed-end fund with a termination date, the [Eaton Vance Floating-Rate 2022 Target Term Trust \(EFL\)](#), which closed on Thursday at a 10.04% discount to NAV after taking a wicked 2.72% hit, while yielding 6.41%, based on its current distribution.

To be sure, that attractive valuation is the flip side of a dreadful 2018 price return of negative 6.21% through Thursday, according to Morningstar, owing mainly to the widening of the discount. The fund's NAV return, which reflects the managers' performance, was a modest minus 1.41%. Leveraged loan prices have been under pressure of late, in part because of liquidations by investors in various funds. A big advantage of CEFs is that they don't have to sell assets to meet redemptions, which invariably come at the worst time in shaky markets.

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Fertig also calls out the Nuveen Credit Strategies Income fund (JQC), which doesn't have a termination date, but last week announced an unusual plan to narrow its wide 15.58% discount. Nuveen said it would return 20% of the assets to shareholders over the next three years. But Fertig says the market ignored this investor-friendly action.

Sangeeta Marfatia, senior closed-end strategist Americas for UBS Global Wealth Management, observes that CEFs that invest in preferred stocks were hit with losses of 5% to 6% on Thursday, while their underlying NAVs were down 1% or less. Her choices include the Cohen & Steers Limited Duration Preferred & Income fund (LDP), at a 14.8% discount and a distribution yield of 9.41%; the fund also hedges the risk of rising rates, she adds. The Nuveen Preferred & Income Securities fund (JPS) saw its discount widen to 16.55% while having a 9.01% distribution yield. Similarly, the discount on the Calamos Strategic Total Return fund (CSQ) widened to 9.63% while paying a distribution yield of 10.14%. (All data as of Thursday's close from the respective funds' websites.)

Indiscriminate selling, the likes of which was seen in the crisis of 2008 and on Thursday, has historically created bargains. As Saba's Weinstein suggests: "I think we will look back six months from now and see this was a great opportunity."

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