

Closed-end funds can generate income – and they're cheap. Here's how they might fit in your portfolio

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Income-seeking investors can get a hold of double-digit yields on the cheap, provided they know where to look.

Enter the closed-end fund, essentially a cousin to the traditional mutual fund. Closed-end funds offer a fixed number of shares, but they also trade publicly on exchanges.

Since they offer a limited number of shares – which makes closed-end funds different from mutual funds and exchange traded funds – their share price may trade at a discount or a premium to their net asset value. These funds also use leverage, which can allow them to deliver enhanced returns over time, provided you can stomach the resulting volatility.

Right now, a confluence of events is resulting in some sharp discounts for closed-end funds, especially for those that hold bonds. First, a runup in yields this fall, which led to the rate on the [10-year Treasury](#) to breach 5%, dented the prices of the underlying bonds in these funds, according to Dave Lamb, head of closed-end funds at Nuveen. Bond yields and their prices move inversely to one another.

Second, October and November are prime time for investors who want to dump assets that have fallen in value and use those losses to offset taxable gains elsewhere within their portfolios. Investors in closed-end funds have shed some of

those holdings and that's resulting in sharper discounts to net asset value.

"There's a lot of sell pressure, which has contributed to the discount levels," said Lamb. "But that provides opportunity."

Indeed, billionaire investor Jeffrey Gundlach recently highlighted this play as the funds encounter a period of seasonal weakness due to tax-loss selling. "You can get yields without a lot of risk of 12, 13% in the closed-end fund universe," he recently said in an appearance on CNBC's ["Closing Bell."](#)

Closed-end fund plays



VIDEO 28:07

Watch CNBC's full interview with Ritholtz's Josh Brown and DoubleLine CEO Jeffrey Gundlach

Financial advisors have called out closed-end funds holding municipal bonds as a way to add duration on the cheap. Duration is a measure of a bond's price sensitivity to fluctuations in interest rates, and issues with longer maturities tend to have greater duration.

The kicker for muni bonds is that they spin out income that's free from federal taxes.

For instance, the [Western Asset Intermediate Muni Fund \(SBI\)](#) is trading at a nearly 15% discount to its net asset value, and it offers a distribution rate of 3.86%, according to CEF Connect, a database of closed-end funds. The portfolio also has an effective duration of about six years.

State-specific muni funds are also available for investors in high-tax locales: Consider that the top income tax rate is 10.9% in New York. Residents can collect income free of state taxes if they reside where the bond was issued. The Nuveen New York Select Tax Free Income fund (NXN) is trading at an 8.66% discount to NAV, and it offers a distribution rate of 4.44%, per CEF Connect.

CLOSED-END FUNDS AT A DISCOUNT

| TICKER | NAME | DISCOUNT TO NAV | DISTRIBUTION RATE | EXPENSE RATIO |
|--------|--|-----------------|-------------------|---------------|
| NXN | Nuveen New York Select Tax Free Income Fund | -8.66% | 4.44% | 0.42% |
| NFJ | Virtus Dividend Interest and Premium Strategy Fund | -15.87 | 8.88% | 1.07% |
| BOE | BlackRock Enhanced Global Dividend Trust | -15.33% | 8.05% | 1.06% |
| SBI | Western Asset Intermediate Muni Fund | -14.82% | 3.86% | 1.70% |

Source: CEF Connect, fund websites

"If you're of the belief that rates are going to go down over the next 18 to 36 months, it's a way to get some exposure to longer-duration assets," said Robert Finley, a certified financial planner and portfolio manager at Virtue Asset Management.

Closed-end funds offer other ways to pick up income: Paul Winter, CFP and portfolio manager at Five Seasons Financial Planning, likes funds that use buy-write strategies. That is, these funds sell call options on their underlying equity positions to generate additional income.

"I think it's a somewhat interesting strategy in this environment, but if you can buy it at a 14, 15% discount to NAV, it becomes really interesting," Winter said.

Funds that have caught his attention include the Virtus Dividend Interest and Premium Strategy Fund (NFJ) and the [BlackRock Enhanced Global Dividend Trust \(BOE\)](#). Both BOE and NFJ are trading at a discount that's greater than 15% of NAV, and offer distribution rates of about 8%, per CEF Connect.

It's not just the discounts

As tempting as distribution rates and discounts may be, investors should take a few other factors into consideration before they hop into the closed-end fund space.

Keep an eye on the fund's expense ratio, as higher costs take a bite out of your returns. These costs can exceed 1%.

Investors should also be aware of a fund's use of leverage, which can introduce volatility into the fund and can magnify

downside. “Investors should think about their risk tolerance as they do with any investment,” said Nuveen’s Lamb.