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Parametric Enhanced Income Core

Many investors are drawn to the closed-end fund universe as a source of income. In this paper we highlight how closed-end funds may lend themselves to this aim, as well as some of the potential drawbacks. We also describe an investment process designed to efficiently capture a stable income stream from the closed-end fund universe. This process will necessarily evolve over time to meet investment targets.

Product overview

- Separately managed account
- Objective: High level of current income
- Strategies:
 - Enhanced Income Core
 - Enhanced Income Tax-Advantaged Core
- Invests in domestically traded closed-end funds
- Turnover target: 20%–40%
- Number of securities: 40–70

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Closed-end funds for income-oriented investors

Closed-end funds are one of the oldest types of collective investment vehicles in the US. Unlike open-end funds, closed-end funds raise capital during an initial public offering and don't create or redeem shares in response to investor flows. This distinguishes closed-end funds from other collective investment vehicles in two key respects. First, shares can trade in the secondary market at a discount or premium to net asset value (NAV),¹ depending on investor sentiment. Second, a steady capital base enables many managers to employ leverage by issuing debt or preferred shares and holding certain less-liquid investments.

These two unique features may help raise the income stream from closed-end funds beyond what might be available from other investment vehicles. However, they can also increase return volatility.

The distribution rate from any given basket of closed-end funds will be higher if the shares were purchased at less than NAV. However, changes in that discount amplify movements in the value of the underlying holdings, which could be a boon or a bane in total return terms. For example, if a fund's discount narrows while the value of the underlying holdings appreciates, the price return will be greater than the NAV return, benefiting the investor. The opposite is true if a fund's discount were to widen while the value of the holdings declines. Generally a closed-end fund's price volatility is greater than its NAV volatility.

Using leverage enables closed-end funds to increase the pool of assets available to invest. If the return on those investments is greater than the cost of leverage, this increases the capital available for distribution. Leverage is typically employed in less volatile asset classes, such as municipal or investment-grade bond funds, and is subject to regulatory constraints. A sharp reduction in the value of holdings, funding availability, or an increase in funding costs could force the fund to sell assets in order to reduce liabilities, possibly putting downward pressure on distributions.

Closed-end funds generally distribute the majority of any dividends, interest, or capital gains received from the underlying holdings every year. They may also make distributions in excess of income or realized capital gains, termed *return of capital*. Although not unique to closed-end funds, the return-of-capital component of the distribution is commonly an area of concern to investors but may actually be less worrisome than many realize. Investors are commonly advised to be wary of return-of-capital distributions that reduce NAV, since this partially liquidates the fund. However, what's critical is whether the fund is trading at a discount or a premium when the distribution is made. A liquidating distribution is actually beneficial if made when the fund trades at a discount and only value destroying if made when the fund trades at a premium.

In summary, the opportunity to purchase closed-end funds at a discount, as well as the funds' focus on income, may serve the income-oriented investor well, but investors should understand how these distribution levels are achieved and the potential ramifications of the funds' unique features.

¹ Any fund's NAV equals its assets, which includes its investments less its liabilities. Open-end fund shares are created and redeemed for entering and exiting investors at this value, typically determined at the end of each trading day. Closed-end fund shares are traded in a secondary market, and the price tends to deviate from the NAV.

The Parametric approach to closed-end funds

The Parametric Enhanced Income Core strategy seeks to exploit some of the unique features of closed-end funds to provide a high level of current income—with capital appreciation as a secondary objective—in an actively managed portfolio of 40–70 funds. The strategy is executed following a quantitative, rules-based process that allocates capital to funds with characteristics expected to help produce a more stable income stream. This disciplined, unemotional approach is designed to help investors maintain diversified exposure to income opportunities within the closed-end fund universe while striving to minimize trading costs.

Investment process

The strategy ranks all US-traded closed-end funds as part of each model rebalance and targets allocations to the highest-ranking funds within each asset class of the investable universe.

Target asset allocation

The target asset allocation is a NAV-based representation of the US closed-end fund universe, adjusted so that at least half the portfolio is invested in fixed-income funds and the bulk of the remainder in equity funds. The balance is held in real-asset funds. The allocation is designed to move the universe toward a more equally weighted representation to improve the diversification characteristics while being sensitive to liquidity constraints. Cash is allowed to fluctuate between 1% and 3% to minimize trading due to the mismatching of distribution payments and withdrawals. A full list of asset-class categories can be found in the appendix.

Investable universe construction

Every fund is assigned an asset class based on fund holdings and the stated objective. Those falling into the single-state municipal bond or concentrated categories are excluded from further consideration, since they don't add significantly to diversification. Within the remaining categories, funds that are too small, illiquid, unseasoned, or excessively leveraged are also filtered out to define the investable universe for our portfolio construction process.

Model portfolio construction

Prior to construction, each fund is ranked using a z-score methodology based on its discount, total distribution rate, and risk characteristics within its asset class. Because many ranking metrics are relatively stable, changes in ranking are driven primarily by price movements—those funds that go from a discount to a premium, for example. The highest-ranked funds within each asset class constitute the model portfolio, subject to liquidity considerations. ETFs may be temporarily employed to maintain asset-class exposure if the target allocation can't be fulfilled solely via discounted funds.

Other considerations

No fund will constitute more than 10% of the portfolio at the time of purchase. Trades triggered by the model are evaluated first for trading cost and market impact before being implemented. Since closed-end funds typically trade with volume similar to small-cap stocks, they benefit from a thoughtful approach to building and exiting positions that focuses on minimizing execution impact. The strategy strives to maintain a 20%–40% turnover rate.

For taxable accounts, several techniques are used to help improve the tax efficiency of the implementation. Existing holdings in closed-end funds can be transferred to the account to provide initial funding and will be transitioned to the model portfolio in a tax-sensitive manner by tracking individual tax lots and prioritizing the sale of higher-cost-basis lots. Additionally, the core bond allocation will be populated exclusively by municipal bond CEFs. Finally, the core equity allocation will emphasize tax-managed and tax-efficient equity funds, which may create distributions with favorable tax treatment.

Appendix

Understanding fund discounts

Movements in a fund's discount or premium to NAV are somewhat independent of returns on the underlying assets and can be a major contributor to fund performance. Consider a fund with a NAV per share of \$10.00 and a discount of -5%, resulting in a price per share of \$9.50 at the time of purchase. In scenarios A and B in figure 1, movement in the discount amplifies the NAV return, resulting in a much higher or lower price return than NAV return. In scenarios C and D, the discount movement dampens the NAV return.

In addition, the distribution rate relative to the price is presented in the rightmost column of the table to demonstrate the impact of the discount on the distribution rate.

Figure 1: Discount dynamics example

Scenario	NAV return	NAV per share	Discount (premium)	Price per share	Price return	Distribution rate*
Purchase		\$10.00	-5%	\$9.50		10.5%
Sale—varying assumptions						
A	10%	\$11.00	0%	\$11.00	16%	9.1%
B	-10%	\$9.00	-10%	\$8.10	-15%	12.3%
C	10%	\$11.00	-10%	\$9.90	4%	10.1%
D	-10%	\$9.00	0%	\$9.00	-5%	11.1%

*Assumes a distribution of \$1.00 per share

Source: Parametric. Hypothetical example for illustrative purposes only.

Understanding fund leverage

The simplified example in figure 2 demonstrates the impact of leverage on closed-end fund returns. Assume leverage is achieved by issuing preferred stock with a coupon rate of 2.5% and that portfolio returns are derived solely from income. In the top panel, the fund's total assets are invested in a portfolio with a 5% income rate of return, which is higher than the coupon rate paid on the preferred stock. As the gray boxes indicate, the rate to the common shareholders is enhanced in proportion to the degree of leverage. The opposite is true if the portfolio income rate drops to 2%, which is lower than that of the preferred stock coupon rate. Leverage could also negatively impact closed-end fund returns if the cost of leverage were to rise, returns from non-income sources—such as capital gains—were reduced, or both.

Figure 2: Leverage dynamics explained

Portfolio return vs. preferred expense	Leverage	None			9%			33%		
		Assets	Income	Rate	Assets	Income	Rate	Assets	Income	Rate
Greater (5.0% vs. 2.5%)	Common shares	\$1,000.00	\$50.00	5.00%	\$1,000.00	\$52.50	5.25%	\$1,000.00	\$62.50	6.25%
	Preferred shares	\$ -	\$ -	2.50%	\$100.00	\$2.50	2.50%	\$500.00	\$12.50	2.50%
	Total assets	\$1,000.00	\$50.00	5.00%	\$1,100.00	\$55.00	5.00%	\$1,500.00	\$75.00	5.00%
Less (2.0% vs. 2.5%)	Common shares	\$1,000.00	\$20.00	2.00%	\$1,000.00	\$19.50	1.95%	\$1,000.00	\$17.50	1.75%
	Preferred shares	\$ -	\$ -	2.50%	\$100.00	\$2.50	2.50%	\$500.00	\$12.50	2.50%
	Total assets	\$1,000.00	\$20.00	2.00%	\$1,100.00	\$22.00	2.00%	\$1,500.00	\$30.00	2.00%

Source: Parametric. Hypothetical example for illustrative purposes only.

Understanding return of capital

Figure 3 shows how return of capital can occur under varying circumstances and may have low indicative value if considered in isolation. Consider a closed-end fund that starts with three holdings and pays a distribution of \$5 in each period. For simplicity, assume the fund has no expenses or liabilities and its only assets are the holdings described.

- Period 1:** The fund sells holdings 1 and 2 without reinvesting the cash and retains holding 3. The realized gain on holding 1 is offset by the realized loss on holding 2, and holding 3 results in an unrealized gain. The fund has no income in the period, so all the distribution is considered return of capital. However, even after the distribution, the fund's NAV has still increased from \$300.00 to \$315.00. This is commonly referred to as "constructive" return of capital.
- Period 2:** Holding 3 experiences no gain or loss but generates \$5.00 of income, which is left in cash. This fully covers the distribution, so there's no return-of-capital component. NAV is unchanged.
- Period 3:** Holding 3 declines in value, producing an unrealized loss of \$20.00. The fund maintains its \$5.00 distribution, all of which is considered return of capital. However, unlike in period 1, the fund's NAV declined to \$290.00 from \$315.00 after the distribution. This is commonly referred to as "destructive" return of capital, since it's a partial liquidation of the fund.

Figure 3: Return-of-capital dynamics example

NAV	Period 1			Period 2		Period 3	
	Start	End		Start	End	Start	End
Holding 1	\$100.00	\$110.00	Sold	-	-	-	-
Holding 2	\$100.00	\$90.00	Sold	-	-	-	-
Holding 3	\$100.00	\$120.00		\$120.00	\$120.00	\$120.00	\$100.00
Cash	\$0.00	\$200.00*		\$195.00	\$200.00	\$195.00	\$195.00
Total	\$300.00	\$320.00		\$315.00	\$320.00	\$315.00	\$295.00
Realized net gains		\$0.00			\$0.00		\$0.00
Unrealized net gains		\$20.00			\$0.00		-\$20.00
Income		\$0.00			\$5.00		\$0.00
Distribution		\$5.00			\$5.00		\$5.00
Return of capital		\$5.00			\$0.00		\$5.00
NAV after distribution		\$315.00			\$315.00		\$290.00

*Proceeds from holdings 1 and 2.

Source: Parametric. Hypothetical example for illustrative purposes only.

Return of capital isn't taxed at the time of distribution but instead lowers the investor's cost basis. Therefore, fund managers might actually strive to maximize this tax-advantaged portion by realizing losses to offset income and gains.

However, rather than destroying capital, liquidation simply transfers it back to the shareholder and is only "destructive" if done when the fund trades at a premium. This occurs because each unit transferred back to the shareholder at par represents a lost opportunity to sell that capital in the market at a premium to par value. On the other hand, receiving capital at par that's otherwise trading at a discount in the open market unlocks value, even if it represents a partial liquidation of the fund.

For example, imagine a fund with a NAV of \$10.00 per share currently trading at a -10% discount with a market price of \$9.00 per share. If the fund were to immediately liquidate in its entirety, the shareholder would receive \$10.00 per share. This would eliminate any future income flows, but the investor would realize a onetime 11% return on the investment at the time of liquidation. Of course, this typically occurs on a much smaller scale, since funds are fully liquidated infrequently.

For a more detailed treatment of the return-of-capital concept, please refer to Eaton Vance’s *Return of Capital Distributions Demystified* (funds.eatonvance.com/includes/loadDocument.php?fn=6348.pdf).

Figure 4: Asset class categories

<p>Limited duration</p> <ul style="list-style-type: none"> Floating-rate loans Short-duration bonds <p>Core bonds</p> <ul style="list-style-type: none"> Taxable bonds (Enhanced Income Core) National municipal bonds (Enhanced Income Tax-Advantaged Core) <p>Spread bonds</p> <ul style="list-style-type: none"> High-yield bonds Emerging-market bonds <p>Excluded asset class categories</p> <ul style="list-style-type: none"> Single-state municipal bonds Concentrated (such as single-country commodity funds) 	<p>Hybrid capital</p> <ul style="list-style-type: none"> Convertible bonds Preferred securities <p>Core equity</p> <ul style="list-style-type: none"> Domestic equity (Enhanced Income Core) Global equity (Enhanced Income Core) Domestic Tax-Managed Equity Income (both strategies) Global Tax-Managed Equity Income (both strategies) <p>Real assets</p> <ul style="list-style-type: none"> REITs Infrastructure
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Z-score methodology

To consider several different metrics simultaneously, we rank the funds using a multi-metric z-score methodology, which projects each CEF-specific metric onto the same peer-relative scale. Figure 4 contains definitions for three such metrics.

The z-score for asset i on metric m is equal to the observed CEF-specific metric for asset i less the mean of the metric with the peer asset class, μ_m , scaled by the standard deviation of the metric within the peer asset class. Such z-scores are calculated for all metrics of interest across all asset classes. To prevent highly unusual positive data points from having an overstated influence on our model, z-scores for any given metric are capped at two. Because highly negative z-scores can indicate a significant increase in risk in the fund, they're left unadjusted.

Since the z-scores are standardized to have the same units, they can be added together to create a rank. Using multiple metrics diversifies our information set and provides a more stable alpha signal. This ranking system will evolve over time to reflect new developments in closed-end fund markets.

Figure 5: Metric definitions

$$Z_{i,m} = \frac{a_{i,m} - \mu_m}{\sigma_m}$$

Example metrics	Description
Discount	The premium (or for negative values, the "discount") to NAV of a fund is calculated as Price/NAV - 1.
Total distribution rate	(Annualized last declared distribution)/(Current share price). Distribution includes income, capital gains, and return of capital. Nonrecurring distributions are excluded.
Volatility	The standard deviation of monthly returns based on fund NAV or price. Standard deviation measures the dispersion of a set of data from its mean. The more spread apart the data, the higher the deviation, or volatility.

About

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“closed-end fund,” legally known as a “closed-end company,” is one of three basic types of investment companies that also include mutual funds and unit investment trusts. Closed-end funds are subject to SEC registration and regulation, which subjects them to numerous requirements imposed for the protection of investors. Closed-end funds are regulated primarily under the Investment Company Act of 1940 and the rules adopted under that act. Closed-end funds generally do not continuously offer their shares for sale. Rather, they sell a fixed number of shares at one time (in an initial public offering), after which the shares typically trade on a secondary market, such as the New York Stock Exchange or the Nasdaq Stock Market. The price of closed-end fund shares that trade on a secondary market after their initial public offering is determined by the market and may be greater or less than the shares’ NAV. Closed-end fund shares generally are not redeemable. That is, a closed-end fund is not required to buy its shares back from investors upon request.

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