Screening for Income Producing Closed-end Funds (CEFs)

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At SmartTrust®, we look to provide for diversified income and total return opportunities through innovative investment strategies. The majority of SmartTrust® Unit Investment Trusts (UITs) offer diversified income opportunities (*as well as the potential for total return*) and have incorporated such underlying investment strategies as individual taxable and tax-free bonds, individual stocks, preferred stocks, business development companies (BDCs), closed-end funds (CEFs) and exchange traded funds (ETFs). This particular report will focus on how we select CEFs for our income based strategies.

CEFs are a packaged product structure that is often misunderstood by advisors, investors and the media alike. While most are attracted to the higher distribution potential of CEFs, they are often deterred by the inherent price volatility and underlying leverage employed by many of the portfolio strategies. Investor interest in the product structure appears to have waned in recent years as a result based on the number of CEFs available in the marketplace. According to Closed-end Fund Advisors (CEFA), as of August 15, 2014, there are 584 CEFs outstanding with over $270 billion in assets, broken down by CEFA's major groupings as follows:

- Taxable Bond – 158 CEFs with $74 billion in assets
- Special Equity – 126 CEFs with $89 billion in assets
- National Municipal Bond – 104 CEFs with $47 billion in assets
- State Municipal Bond – 93 CEFs with $19 billion in assets
- Non-U.S. Equity – 63 CEFs with $18 billion in assets
- U.S. Equity – 40 CEFs with $23 billion in assets

These figures have been trending down as CEF strategies have been closed and the pace of new CEF IPOs has slowed over the past 10 years. The chart below from Closed-end Fund Advisors helps to illustrate the slowdown.

Traditional Closed-end Fund IPOs (2004 – June 2014)

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014 YTD
Number of IPOs	50	47	21	40	2	13	17	19	23	25	4
Average Assets (in $ millions)	462	452	506	690	131	200	451	316	517	580	320
Total New CEF IPO Assets (in $ billions)	23.1	21.2	10.6	27.6	0.3	2.6	7.7	6	11.9	14.5	1.3

Interestingly, while the number of CEF IPOs had been increasing since the dramatic market downturn in 2008, it is significantly behind pace through the first six months of 2014. The 10 year average for CEF IPOs is 26 new funds per year with an average of $431 million per fund and $12.6 billion in total new fund assets per year. If I annualize the data reported for the first two quarters of 2014, would bring the 2014 CEF IPO numbers to just 8 new funds for the year with an average of $320 million per fund and $2.6 billion in total new fund assets. All the more reason to be very thoughtful and diligent when selecting CEFs for investment portfolio strategies.

There are also a wide range of CEF strategies currently available for portfolio managers and advisors to select from. According to CEF Connect, there are 54 category/strategy combinations of CEFs as follows:

Category	Strategy
Tax-Free Income (20)	High Yield
	National
	Arizona
	California
	Colorado
	Connecticut
	Florida
	Georgia
	Massachusetts
	Maryland
	Michigan
	Minnesota
	Missouri
	North Carolina
	New Jersey
	New York
	Ohio
	Pennsylvania
	Texas
	Virginia
Taxable Income (10)	Convertible
	Government
	High Yield
	Investment Grade
	Limited Duration
	Mortgage Bond
	Multi-Sector
	Municipal
	Preferreds
	Senior Loan
US Equity (13)	Covered Call
	Dividend Equity
	Equity Tax-Advantaged
	General Equity
	Growth & Income
	Real Estate – US

	Real Estate - Global
	Sector - Commodities
	Sector – Energy/Resources
	Sector - Utilities
	Sector - Finance
	Sector – MLP
	Sector – Health/Biotech
Non-US/Other (11)	International – Asia Equity
	International – Latin American Equity
	International – Emerging Market Equity
	International – Emerging Market Income
	International & US – Global Equity Dividend
	International & US – Global Equity Dividend
	International & US – Global Growth & Income
	International & US – Global Income
	International & US – Global Equity
	Other Non-US Equity
	Undefined

Recognizing the importance of income production and the sustainability of that income production over the life of each of our incoming-oriented unit investment trusts, the question then becomes how to find the CEFs that pay a high relative dividend while possessing the ability to likely sustain that dividend in the future and are currently trading at a reasonable price. Put another way, we are trying to filter out those CEFs that are likely to cut their distributions based upon available fund data. Accordingly, when selecting CEFs for applicable SmartTrust® UITs, the factors that typically serve as our primary screening criteria generally include, but are not limited to, the following:

- **Category/Strategy Combination** – one of 54 category/strategy combinations assigned by CEF Connect. Some of our UIT strategies are asset class or sector specific so filtering on these combinations is critical.

- **Market Cap** – total net assets, in U.S. dollars, of the CEF. We generally look for CEFs with total net assets of $100mm or greater, while also giving consideration for average trading volume.

- **Distribution Rate** – this is the current distribution rate, or yield, of the CEF and is a measure of the current annualized distribution amount by the current price - *not the NAV*.

- **Managed Distribution Policy** – we prefer to not use CEFs with managed distribution policies as these CEFs will be enticed to employ techniques, such as returns of principal, to maintain their managed distribution amounts.

- **Distribution Amount** – most current cash distribution amount per share. We are only interested in looking at regular income distributions and disregard returns of principal, special (i.e. non-regular) distributions, short term capital gains and long term capital gains.

- **Earnings per Share (EPS)** – most current amount that the CEF earned per share. We exclude those CEFs with negative earnings per share.

- **Earnings/Distribution Coverage Ratio** – this ratio compares current earnings to current monthly distribution amounts where ratios over 100% indicate that the CEF is "over-covered" from an earnings/distribution standpoint and ratios under 100% indicate that the CEF is "under-covered" from an earnings/distribution standpoint. We prefer CEFs that have a high Earnings/Distribution Coverage Ratio and an overall weighted portfolio Earnings/Distribution Coverage Ratio of 100% or greater.

- **Undistributed Net Investment Income (UNII)** – the life-to-date balance of a fund's net investment income less distributions of net investment income. UNII appears in shareholder reports as a line item on a fund's statement of changes in net assets. We consider UNII as a cash buffer or a cash reserve to a CEF portfolio. We typically do not consider CEFs with negative UNII balances, unless such balances are typical to that category/strategy combination (*Ex. Covered Call Funds*).

- **UNII/Distribution Coverage Ratio** - this ratio compares current UNII balances to current monthly distribution amounts to determine how many months of distribution coverage are covered by the CEF's UNII balance.

- **Premium / (Discount)** –the amount which a closed-end fund market price exceeds (premium) or is less than (discount) the CEF's net asset value (NAV). We contend that a CEF trading at a premium does not necessarily mean it is overvalued and a CEF trading at a discount is not undervalued. There is nothing written in stone that states that a closed-end fund (CEF) ever has to trade at its net asset value. This is different from open-end mutual funds that trade at their NAV, exchange traded funds (ETFs) that trade at or near their NAV and unit investment trusts (UITs) that trade at their NAV once in the secondary market. This is also different from bonds that can be purchased at a discount to their par value (*i.e. $100*). In the case of bonds, bond holders can view this discounted price as a true discount seeing that they expect to receive a higher value (*i.e. the par value*) at maturity. CEFs, on the other hand, rarely, if ever, trade at their NAVs. In fact, historically, CEFs have traded at an average discount to NAV of 4% over the last 10 years.

- **52 Week Average Premium / (Discount)** – to help gauge the relative value of the current premium / (discount) of a given CEF, we compare the current to premium / (discount to the 52 week average premium / (discount). Such comparisons are done not only for the CEF itself but also in relation to their category/strategy. CEFs trading below their 52 week averages represent greater relative value to us than those CEFs trading above their 52 week averages.

- **Effective Leverage *(and type of leverage employed)*-** total economic leverage exposure of the CEF and includes structural leverage, which is calculated using leverage created by a fund's preferred shares or debt borrowings by the fund, as well as leverage exposure created by the fund's investment in certain derivative investments (including, but not limited to, reverse repurchase agreements). Leverage is typically represented as a percentage of a fund's total assets. Given the current record low interest rate environment, many CEF managers are currently employing some form of leverage to enhance their portfolio yields and take advantage of low relative borrowing costs. For example, approximately 90% of all national tax-free income CEFs currently employ some form of leverage. Recognizing that portfolio leverage may increase a CEF's volatility and can provide less value when short-term rates approach or exceed long-term rates, we pay careful attention to the type and amount of leverage that each CEF strategy employs, especially as start to head into a rising interest rate environment.

Other secondary screening factors that are typically reviewed but do not necessarily serve as our primary screening criteria generally include, but are not limited to, the following:

- **Historical Nature of Distributions –** it is important to distinguish between the various types of distributions that may include ordinary income, special income, returns of principal, short-term capital gains and long term capital gains. We are primarily interested in those CEFs with a history of paying consistent ordinary income distributions. We also pay attention to when CEFs have historically cut their distributions relative to other CEFs within their category/strategy combination.

- **Distribution Frequency –** we always review the frequency of distributions for each respective CEF. The majority of CEFs make distributions on a monthly basis though some pay quarterly, semi-annually or even annually. This is an important factor to consider as many advisors are interested in trying to provide for consistent monthly streams of income within their client's portfolios.

- **Expense Ratio –** when selecting CEFs for our UIT strategies, we are cognizant of the effect that the underlying CEF expense ratios have on the overall portfolio performance of the strategy. As result, we consider the total expense ratio reported for each CEF's most recent fiscal year. As an aside, in order to perform a more meaningful comparison of the expense ratios between open-end funds and closed-end funds, one should review the adjusted total expense ratio. According to Morningstar, by regulation, CEFs utilizing debt for leverage must report their interest expense as part of their total expense ratio. On the other hand, funds utilizing preferred shares or non-1940 act leverage are not required to report the cost of leverage as part of their expense ratio. The adjusted total expense ratio does not include the debt leverage cost thus allowing for a more arguably useful comparison data point across all closed-end and open-end funds. Regardless, we choose to consider the full cost of each CEF as part of our screening process.

- **Average Volume –** the liquidity, which we gauge through historical reviews of average trading volumes, of each CEF is important to understand not only for purchases and sales during the primary offering period of each UIT series but also at each series termination.

- **1 Year Price and NAV Return –** as stated earlier, CEFs often trade below their net asset value NAV) so we like to review price and NAV performance in isolation and relative to their peer group over different time periods, such as 1 year.

- **3 Year Price and NAV Return -** as stated earlier, CEFs often trade below their net asset value NAV) so we like to review price and NAV performance in isolation and relative to their peer group over different time periods, such as 3 years.

- **5 Year Price and NAV Return -** as stated earlier, CEFs often trade below their net asset value NAV) so we like to review price and NAV performance in isolation and relative to their peer group over different time periods, such as 5 years.

- **Credit Quality (Fixed Income)** – a review of credit quality relates to our fixed income strategies, primarily our portfolios of municipal closed-end funds. Most CEF sponsors report the credit quality breakdown of the underlying bond holdings within their portfolios at different reporting periods. We then weight this reported information in accordance with the allocation to the CEFs within our UIT strategies to arrive at a weighted credit quality for the overall portfolio. We endeavor to arrive at a weighted credit quality of investment grade for our municipal closed-end fund portfolios which typically have a weighted credit rating of A or better.

- **Maturity (Fixed Income) -** a review of maturity dates relates to our fixed income strategies, primarily our portfolios of municipal closed-end funds. Most CEF sponsors report the maturities of the underlying bond holdings within their portfolios at different reporting periods. We then weight this reported information in accordance with the allocation to the CEFs within our UIT strategies to arrive at a weighted effective maturity for the overall portfolio. This information may be an essential driver of the selection criteria used if maturity or duration is part of the Trust's investment strategy.

- **Option Adjusted Duration (Fixed Income) -** a review of option adjusted duration (OAD) relates to our fixed income strategies, primarily our portfolios of municipal closed-end funds. While all CEF sponsors do not necessarily report the OAD of the underlying bond holdings within their portfolios at different reporting periods, financial software providers, such as Bloomberg, do calculate and provide this information. We then weight this calculated information in accordance with the allocation to the CEFs within our UIT strategies to arrive at a weighted OAD for the overall portfolio. This information may be an essential driver of the selection criteria used if maturity or duration is part of the Trust's investment strategy. We view duration as a more important factor than maturity as duration is seen as a better indicator of the sensitivity of a bond's price to a change in interest rates. In general, bonds with higher durations are more sensitive to changes in interest rates and vice-versa. In a rising interest rate environment, this can be a very important factor to take into consideration when constructing a "static" investment portfolio. Option adjusted duration is an even better measure of the interest rate sensitivity of bonds with embedded options - such as bonds with call features. For these types of bonds, the duration measure should be adjusted to account for the fact that the bond's embedded options may change the expected cash flows of the bond. For example, if a given bond is called, interest payments on that bond stop and the principal is returned to the investor earlier than the bond's stated maturity. Hence, we use OAD as our measure of duration for our fixed income strategies.

- **% of Bonds Callable over life of the Trust series (Fixed Income) -** a review of the percentage of bonds callable over the life of the Trust series relates to our fixed income strategies, primarily our portfolios of municipal closed-end funds. Most CEF sponsors report the timeline associated with the bonds callable of the underlying bond holdings within their portfolios at different reporting periods. We then weight this reported information in accordance with the allocation to the CEFs within our UIT strategies to arrive at a weighted bonds callable over the life of the Trust series for the overall portfolio. This information is invaluable as portfolios with a high percentage of bonds callable over the life of a given series of a UIT may have more difficulty sustaining their distribution rates over this timeframe.

- **AMT Percentage (Fixed Income - Municipal) -** a review of AMT percentages relates to our fixed income strategies, primarily our portfolios of municipal closed-end funds. Most CEF sponsors report the AMT percentages of the underlying bond holdings within their portfolios at different reporting periods. We then weight this reported information in accordance with the allocation to the CEFs within our UIT strategies to arrive at a weighted AMT percentage for the overall portfolio. This information is often useful for advisors with high net worth clients and we therefore look to minimize the overall AMT Percentages in our UITs.

- **% of Portfolio Pre-refunded (Fixed Income)** - a review of the percentage of portfolio pre-refunded relates to our fixed income strategies, primarily our portfolios of municipal closed-end funds. Most CEF sponsors report the percentage of their portfolios that are pre-refunded related to the underlying bond holdings within their portfolios at different reporting periods. We then weight this reported information in accordance with the allocation to the CEFs within our UIT strategies to arrive at a weighted percentage of portfolio pre-refunded for the overall portfolio. We generally look favorably on pre-refunded bonds and higher weighted percentages of portfolio pre-refunded for the overall portfolio are preferred. To appreciate our perspective, it is necessary to understand how pre-refunded bonds work. Pre-refunded bonds are issued to fund another callable municipal bond, where the issuer of the municipal bond actually decides to exercise its right to buy its bonds back before the bond's scheduled maturity date. The proceeds from the issue of the lower yield and/or longer maturing pre-refunding bond will usually be invested in U.S. Treasury bills until the scheduled call date of the original bond issue occurs, thereby reducing the credit risk of the original bond issuance significantly.

Here are some representative examples of current SmartTrust® UIT strategies, developed through our own research, which invest entirely in CEFs and use the screening criteria described in this whitepaper.

- **Tax Free Income Trust**
- **New York Municipal Portfolio of Closed-End Funds Trust**
- **New Jersey Municipal Portfolio of Closed-End Funds Trust**
- **Diversified Income & Growth Trust**

In addition, here are some representative examples of current SmartTrust® UIT "hybrid" strategies, developed through our own research, which invest a portion of their portfolios in CEFs and use the screening criteria described in this whitepaper for the CEF allocations.

- **Tax-Advantaged Growth & Income Trust**
- **Enhanced Value Trust**
- **Dynamic Sector Income Trust**
- **Strategic Growth & Income Trust**
- **Rising Interest Rates Hedge Trust**

While no screening criteria can guarantee the sustainability of dividend payments over time, we believe that the multi-factor approach employed at SmartTrust® can be helpful in providing portfolio strategies that strive to pay high, sustainable levels of income, and total return potential, over the duration of each respective UIT series.

If you are interested in learning how we screen for high levels of sustainable distribution opportunities for other security types (*Ex. Stocks*), please do not hesitate to contact our Internal Support Desk at 888-505-2872.

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