Trumbower Financial Advisors, LLC
1st Quarter 2016
Investment Market Commentary

Weeding Out Volatility

Volatility saturated financial markets during Q1. Several equity indices encroached on bear market territory before germinating a bull run. Stocks hit the bottom on February 11th after the S&P 400, Russell 2000, MSCI EAFE and MSCI Emerging Market indices pruned -20% or more from June 2015 highs. The ensuing growth spurt was robust as we saw major indices climb 10% to 18% in just 7 weeks.

Q1 returns for selected index species once again obscured murkier climates. US Large and Mid Caps popped up 1.35% and 3.78%, respectively, while Emerging International equities rose out of the compost over 5.7%. US Small Caps and Developed Foreign indices were plowed under -1.52% and -3.74%.

The Emerging Market recovery was pollinated by stronger commodity prices and currencies. China's Shanghai Composite slumped -15.1% in Q1, but smaller markets in Southeast Asia and Latin America blossomed. Brazil blazed the trail, up 15.5%.

A 12-month drought has taken its toll withering International and Smaller Cap US stalks. The S&P 500, up 1.78%, alone managed to keep its head above ground.

Windblown commodity prices fertilized volatility in other pastures. Crude oil partied with the worms at $26 in February before spurting over 47% to close the quarter at $38.34. Gold budded 20% before settling up

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1st Quarter Equity Market Results

	1st Qtr. % Chg.	12-mth. % Chg.
S&P 500	1.35	1.78
S&P 400	3.78	-3.60
Nasdaq	-2.43	0.55
Russ 2000	-1.52	-9.76
MSCI EAFE	-3.74	-10.67
MSCI Emg	5.71	-12.03

The Essence of CEFs

The two most common pooled investment vehicles are open-end mutual funds "OEF" (the veterans) and exchange traded funds "ETF" (relative newcomers). Closed end funds "CEFs" are used less frequently but this structure predates both of the others. CEFs emerged in Britain in the 1860's as a means of directing capital from multiple investors into a selection of stocks. We wonder if it is time to put the CEF structure out to pasture or if it offers opportunities that are often overlooked.

Distinguishing Features

CEFs arrive on the scene in an initial public offering of a fixed number of shares in a portfolio of securities. They trade on a stock exchange throughout the day – similar to ETFs but different in several important aspects. ETFs allow certain institutional shareholders to redeem their interests in kind. This mechanism discourages, but does not always eliminate, significant divergence from the ETF's price and its net asset value "NAV." Unlike CEFs, ETF shares are created or redeemed throughout the day to meet the demands of buyers and sellers. OEFs are purchased and sold by the fund as investors contribute or withdraw cash at a closing NAV determined by the prices of the underlying positions.

While most CEFs are set up as perpetual trusts, some specify a target dissolution date in their prospectus – like a Unit Investment Trust except the CEF is actively traded.

Pros and Cons

CEF managers don't have to deal with an unexpected influx of cash or satisfy redemptions (except in rare circumstances when demand for their shares disappears). This should make the process more efficient. The fund can remain fully invested and devote resources to research instead of cash management. They are more suitable for less liquid securities hence the prevalence of high yield fixed income, preferred stock as well as "alternatives" within the CEF universe.

On the other side of the coin, the CEF configuration is particularly susceptible to pricing anomalies. When demand and supply do not converge, shares will sell at a premium or discount to NAV. Purchasing the CEF at a premium obviously erodes return regardless of the performance of underlying positions unless it is sustained or widens. Ideally, investors can enhance outcomes when they believe a discounted price will revert to NAV or better yet morph into a premium. Seasoned CEFs may trade at discounts and/or premiums for prolonged periods. Prospective investors can use a Z-score to evaluate the current differential relative to a long-term average. A Z-score of less than -2 suggests that the current price is relatively cheap. A Z-score of +2 or higher may indicate over pricing.

Limited term funds may be viewed as advantageous in that discounts will ultimately dissipate as the dissolution date approaches. The CEF's original term can be extended periodically to avoid unwinding under unfavorable conditions. This feature may deter activist investors from co-opting deeply discounted CEF boards in an effort to restructure them as OEFs and eliminate the gap between market price and NAV.

Initially, CEF share quantities are fixed. Some funds may, however, raise additional capital by selling new shares at the prevailing market price (but never below NAV). At the market or "ATM" offerings allow managers to pursue investment strategies without selling existing holdings and reduce expense ratios by spreading costs over a larger base. They may disadvantage current shareholders by increasing supplies, diluting voting power and diminishing earnings per share pending investment of the proceeds.

Highs and Lows of Leverage

The CEF's stable asset base accommodates leverage better than OEFs. In fact, one of its most appealing and potentially dangerous qualities is the ability to distribute borrowed capital. 76% of CEFs were leveraged at the end of 2014. Typical leverage ratios range from 30% to 50%.

Portfolios may be leveraged with derivatives, margin facilities, lines of credit or by issuing bonds and preferred stock. Different approaches have varying

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The Essence of CEFs

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implications.

Derivatives are generally short-lived tools used to magnify returns on a manager's high conviction positions. Structural leverage is achieved by issuing securities. Term Option Bonds collateralized by the highest quality holdings of the portfolio are popular with municipal bond CEFs. Preferred stock augments the fund's capacity for leverage and avoids inflating ratios with interest expense. Dividends paid to the preferred shareholders obscure the costs of borrowing because they are not included in expense ratios. Annual expense ratios for CEFs range from ~0.5% to ~3%.

Historically CEFs issued Auction Rate Preferred "ARP" but that funding device fizzled during the 2008 financial crisis penalizing issuers with a higher cost of capital. Most ARPs have been replaced by vehicles such as Variable Rate Demand Preferred - similar to ARPs but they have a maturity date, a put feature and are not priced by auction.

Comparing leveraged CEFs to OEFs and ETFs is challenging. Leverage inevitably ramps up volatility including the impact of market interest rate movements on fixed income portfolios. The prospects for a wilder ride can be alluring to adventurous investors. For example, over the past 22 years there have been a number of periods that proved to be excellent entry points into junk bonds. The High Yield Index averaged 9.8% annualized over 15 months following such episodes whereas High Yield CEFs averaged 19.58% annualized over the same periods and substantially outpaced the Index in all but one.

Never forget that leverage can lead to the permanent annihilation of capital under extreme circumstances. During the 2008 crisis some funds were forced to sell downtrodden securities when their asset coverage ratios fell short of required limits. That capital was MIA during the recovery.

Yield Deception

CEFs tempt investors in search of cash flow with relatively high payout rates. But it is misleading to describe CEFs as reliable sources of higher yield. As is the case for all Registered Investment Companies, interest, dividends and recognized capital gains net of expenses must be paid out to shareholders annually. Some CEFs are in the habit of returning capital "ROC" in addition to gains. ROC may be benign but can be destructive when used to maintain an otherwise unsustainable distribution pattern. Novices are warned to avoid purchasing shares of a CEF at a premium on the basis of historically generous payout rates. Investors should pay attention to the prospectus and report disclosures concerning the composition of dividend distributions.

Also be on the lookout for funds with high levels of Undistributed Net Investment Income "UNII". Managers may choose to stock pile income earned in one quarter for distribution in a leaner future period. The person who buys UNII gets nothing more than a higher tax bill. In this instance new shareholders would be better served by non-taxable ROC.

Should you "Like" CEFs?

Do their special qualities improve the chances that CEFs will deliver superior returns? *Morningstar's* category averages for the last 15 years over rolling 5 year periods indicate that equity CEFs did not generally keep up with OEFs. US equity CEFs topped OEF averages in 2 to 9 (depending on the market cap) of 41 trials.

Bond fund comparisons tell a different story. Intermediate, Corporate, Multi-sector, High Yield, High Yield Muni and Intermediate Muni closed end bond funds achieved higher returns than their US OEF counterparts in at least 75% of the periods tested.

However, CEF returns in all the aforementioned categories were 1.5 to 3 times more volatile than unleveraged OEFs. Volatility reduced risk-adjusted return metrics such as Sharpe and Sortino Ratios. This is not a positive development for an asset class with lower risk objectives.

We conclude that leveraged CEFs might be just the ticket for a short-term ride in a beleaguered asset class or sector if risk tolerance and conviction in recovery are both high. They demand a very thorough check under the hood because some of their unique charms can turn into poison apples.

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16.5% - the metal's largest quarterly gain in 30 years. Lean hogs, up 35%, proved to be the hardiest commodity. Apparently consumers are buying bacon with savings from lower prices at the pump.

Central banks cultivated volatile Q1 conditions as well. Following the Federal Reserve's December rate hike, China disrupted global capital flows with aggressive tactics to devalue the yuan. Following in European furrows the Bank of Japan planted their interest rate under water. Eroding yields pushed prices for foreign government bonds ahead 7%.

Their appeal has thawed since the Q1 rally. 65% of worldwide government bonds yield less than 1%. 40% of Developed sovereign bond yields have evaporated entirely. For example, 5-year German Bunds yield -0.3%. Attempts to revive a persistently acidic economy have bestowed negative yields on 75% of Japan's bonds.

Credit rating firms downgraded sovereign debt of 10 countries staking bets that the bloom will wear off Q1 roses. S&P issued negative outlooks or downgrade warnings on more than 30% of Emerging Market issuers – the highest level in 6 years. Higher risk perceptions and absent yields on other instruments should bode well for US equity gardens as capital seeks more fertile fields.

The US dollar, as measured by the WSJ Dollar Index, finally drooped -4.1% during Q1. Yet the US Treasury yield curve flattened when long-term rates wilted into the steepest decline in more than 3 years. The 10-year note dropped nearly 50 basis points since year-end thinning its spread over 2-year notes to the lowest level in 8 years.

Theoretically, rising rates at the short end of the stick are syphoned up the curve, but longer term yields remain stubbornly unresponsive. Forecasters could view this as a sign of dawdling future growth rates.

Reminiscent of inverted curves that plagued Alan Greenspan a decade ago, it is unrelenting demand for long US paper that has stifled yields. Back in those days China's appetite for dollars was a principal culprit. More recently, however, China has been shedding Treasuries so other investors weary of paying governments for the privilege of owning their debt must be picking up the slack. Our economy may be healthier than the Treasury yield curve suggests.

Meanwhile the spread between investment grade corporates and 10-year Treasury notes is the highest it has ever been at the beginning of a tightening cycle. High quality corporate bond investors are earning a pretty premium for assuming an historically minor marginal degree of risk.

Unemployment has remained relatively flat at around 5% and there has been a modest increase in average hourly wages. Aside from heightened demand for bacon, however, consumers seem reluctant to spend their gas price bonus. Inflation is still below the Fed's 2% target. The core rate on personal consumption expenditures "PCE" is 1.7%. Fed Chair Yellen expects improving labor market conditions to aerate inflation.

1st quarter 2016 earnings of S&P 500 companies were projected to drop -8.7% from last year. The reporting season is now in full swing and the results have been mixed, but so far the average for the S&P 500 is down just -.5% from Q1 2015. 25 of the 35 issues who had reported as of last week beat their forecasts. Rising labor costs, while positive for the workforce, will clip corporate profits until people regain enough confidence to recycle earnings by spending.

Congratulations to Heath Brewer who recently passed the CFP© Exam requirement – the first step toward achieving CFP© certification.

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