The Distribution Dilemma: Examining the Complexities of Closed-End Fund Payout Policies

PRESENTED BY CECILIA L. GONDOR
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Investor Demand for Income

Investors increasingly view closed-end funds as “income” investments; even extending this view to funds that have growth objectives.

This perception is the result of:

- The ability of closed-end funds to use leverage to boost income to common shareholders
- The use of various investment strategies, such as covered call writing and dividend capture, to add to or increase the income component of equity funds
- Underwriters favoring funds that can provide attractive distribution rates when selecting IPO candidates
- The marketing of new closed-end funds as income vehicles over the past several decades
- Investor demand for yield in the ongoing low interest rate environment
Distribution Rates and Discounts

- Closed-end fund Boards are increasingly attentive to discount valuations, frequently evaluating actions that may be taken to reduce or eliminate the level of discount to net asset value at which a fund trades.

- Funds that persistently trade at wide discounts may be the subject of dissident activity. Typically, a dissident group will request that the Board take action designed to narrow the discount.

- Research has shown that, all other factors being equal, funds that have higher distribution rates tend to trade at narrower discounts to net asset value, or even at premiums above net asset value.¹

- As a result of these factors, many closed-end funds are under pressure to make attractive payouts and this has had a profound influence on distribution policies.

Yield vs. Distribution Rate

Investors will often want to know a closed-end fund’s “yield,” however, the term “yield” is confusing when applied to closed-end funds because funds make distributions that may include:

- Net investment income  -- OR --
- Tax-exempt net investment income
- Net realized short-term capital gains
- Net realized long-term capital gains
- and, in some cases, Return of Capital
Types of Distribution Policies

- **Earned Payout Policy** – seeks to pass through only amounts needed to satisfy IRS requirements, generally paying out net investment income throughout the year and net capital gains at calendar year-end.

- **Level Payout Policy** – pays equal distributions of expected annual net investment income monthly or quarterly, with distributions from net capital gains, if any, generally included with the last payment.

- **Managed Payout Policy** – board sets a fixed cents/share payout or formula distribution based on an annual percentage of NAV or share price, i.e., the fund may set a distribution rate of 8% of NAV annually, paid in four equal quarterly payments.

**NOTE:** A very important distinction of Managed Payout Policies is that they typically include distributions from net long-term capital gains more than once a year and this requires special exemptive relief from the SEC.
Regulatory Oversight

In early 2013, the Financial Industry Regulatory Authority (FINRA) put closed-end fund payouts on its “Priority List.”

- FINRA’s concerns center around funds that distribute a high percentage of Return of Capital (ROC) which investors may mistake for income
- FINRA’s focus is on sales practices and disclosure requirements

The Securities and Exchange Commission (SEC) exerts some indirect influence over how funds make distributions

- Closed-end funds that wish to make distributions that include long-term capital gains more than once a year (or more often than allowed by various exemptions) must request exemptive relief from the SEC
- The SEC looks for specific representations within such exemptive relief requests that deal with board oversight of distributions of ROC. These particular types of representations focus on proper disclosure as well as establishing limitations that seek to prevent paying out amounts that consistently exceed the fund’s long-term performance.
ROC is Confusing and Controversial

Factors that contribute to misunderstandings surrounding ROC:

- Allocation of distribution sources are based on estimates made during the course of the year based on year-to-date information or projections. As a result, source allocations are often reclassified after calendar year-end.

- Differences between financial accounting and tax accounting can result in unanticipated allocations to ROC.

- Loss carryforwards realized in past years can be used to offset current year realized gains, reducing the amount required to be paid out from such gains in the current period.

- Trading activity and the use of complex trading strategies can influence source allocations of distributions.

- Cursory media coverage of the subject has often been negative and oversimplified leaving the impression that funds that include ROC distributions should be avoided.
Evaluating Return of Capital

- Investors increasingly accept that many types of closed-end funds will pay some ROC, for technical reasons or as part of their distribution policy.
- Most analysts place emphasis on whether the payout is “good” or “constructive” versus “bad” or “destructive.”

**Rule of Thumb:** If the fund’s annual payout is less than average long-term total return, it is generally considered to be “good” or “constructive” ROC; if the annual payout exceeds long-term total return, it is considered to be “bad” or “destructive” ROC.

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**Diagram:** Distribution Scenarios and Expected Federal Tax Treatment

- **Net Investment Income:** Cash from stock dividends.
- **Realized Short-Term Capital Gains:** Cash, Ordinary Income.
- **Realized Long-Term Capital Gains:** Cash, 15%.
- **Unrealized Stock Gains:** Portfolio appreciation not yet realized.

**Total Return:**

1. Distributions less than or equal “real cash.”
2. Distributions exceed “real cash,” but less than total return on NAV = some “good” return of capital (ROC), which is not currently taxed.
3. Distributions exceed total return on NAV = some “good” return of capital (ROC) lead some “bad” ROC.

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Source: 2009 Nuveen Investments, Inc. Used with permission.

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This diagram is for illustrative purposes only depicting a hypothetical equity fund. To show that Return of Capital (ROC) as a source for fund distributions may in some cases represent a beneficial tax choice, a depiction of shareholders’ capital-in principal or both, depending on the fund’s individual circumstances. The diagram does not address the real possibility that a fund’s total return may be negative, or that the components of a fund’s total return (i.e., the example: net investment income, realized ST capital gains, realized LT capital gains, and unrealized stock gains) may be zero or individually negative.
Magnitude of ROC Components

Approximately 1/3 of all taxable closed-end funds pay some ROC and this figure has remained relatively constant over the past several years.

The component of ROC in an individual closed-end fund’s payout can vary greatly:

- Municipal funds rarely include ROC and tend to pay out amounts in line with the annual level of net tax exempt interest earned on portfolio holdings
- 30.41% of all taxable funds had a ROC component in a 2013 Survey, consistent with results for previous years
- Funds that invest in MLPs pay out the most ROC, but ironically are less affected by the ROC’s negative stigma

Prevalence of ROC Distributions

% of Taxable Funds with ROC - 2013 Survey

- Loan Participation: 0%
- Taxable Bond Funds: 15%
- Foreign Bond Funds: 15%
- Foreign Equity Funds: 25%
- Convertible Funds: 25%
- Equity Funds: 46%
- Specialized Equity (excluding MLP): 51%
- MLP Funds: 95%

Board Considerations

When setting a closed-end fund’s distribution policy, Board members may consider asking the following questions:

- What is the fund’s current distribution policy? From what sources are distributions paid?
- What type of distribution policy do other funds in the same peer group employ?
- Can/should the distribution policy or payout schedule be used to complement current discount management initiatives?
- Would a managed or level payout policy be consistent with the fund’s investment objectives and in the best interest of shareholders?
- If the fund currently pays some ROC and would changes to the distribution policy increase or decrease amounts of ROC paid?
- Does the fund currently operate under SEC exemptive relief that influences the type of distribution policy that can be used?
Final Thoughts

- Distribution policies are increasingly being viewed as one piece of a closed-end fund’s discount management puzzle and not just as a way to make IRS required distributions.

- It is important to understand how investors as well as regulators will view the fund’s distribution policy.

- The impact of modifying a fund’s distribution rate or policy can vary widely:
  - Changes that result in a reduction in the distribution rate tend to have an immediate, typically sharp negative impact with share price usually rebounding somewhat after the initial decline.
  - The impact of changes that result in an increase in the distribution rate may take much longer to manifest, but tend to have a more sustained effect.

- More is not always better: paying out distributions in excess of long-term total return can erode the fund’s capital base and future earning potential.
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