Payoff Pitch

Update - Time to Extract Value from CEF Investment Recommendation

On July 20, 2015 we wrote a strategic article entitled "Finding Value in the Ninth Inning of the Great Bond Rally" which made the case for an investment in closed end mutual funds (CEF's) backed by municipal bonds. This article reviews the original investment thesis, updates the reader on the performance and attributes of the securities we recommended and concludes with new advice on the position.

In the original article, we analyzed 50 muni-backed CEF's in order to select a manageable sub-set of securities offering the most potential. The analysis supporting the recommendation relied upon many self-imposed factors and risk constraints, many of which we will not rehash in this article and some of which we did not detail in the prior article. There are three factors, however, which are worth reviewing as we evaluate and potentially change our investment recommendation. They are as follows:

1. Discount to Net Asset Value (NAV) - Closed end funds frequently trade at a premium or discount to their net asset value (current market value of the securities held by the fund). One of the driving factors behind our investment decision was the fact that many muni-backed CEF's were trading at historically large discounts to their NAVs. We believed at that time, barring severe credit dislocations in the municipal bond sector that CEF investors would benefit from the normalizing discounts.
2. Interest Rate Forecast - We have written numerous times that we expect the U.S. economy will continue to be plagued with weak economic growth and increasing deflationary pressures. Such an environment typically bodes well for fixed income assets, specifically those that are investment grade. This theory which would result in even lower interest rates was another factor supporting our recommendation.

3. Municipal Yield Spread to Treasuries - Like all bonds, municipals trade at a yield spread, or differential, to U.S. Treasury bonds. Statistically, the relationship between municipal bond yields and Treasury bond yields exhibits a strong correlation. The spread can help astute investors create more dependable risk/reward forecasts. When the original paper was written, we calculated that municipal bonds were trading at a premium versus U.S. Treasury bonds. <u>While the risk existed that the yield spread would normalize, we thought the advantages of the discount to NAV and our overriding interest rate forecast would more than offset the potential yield spread risk.</u>

Performance and Investment Attributes

Since recommending the trade, the selected CEF's have performed very well. The first table below highlights the performance of the CEF's and the second set of tables, on the following page, compares the original attributes table to an updated version.

Total Return 7/20/2015 - 1/11/ 2016			
Ticker	**Name**	**Total Return**	**Annualized Return**
LEO US Equity	DREYFUS STRATEGIC MUNICIPALS	11.75%	22.50%
DSM US Equity	DREYFUS STRATEGIC MUNI BD FD	9.58%	18.35%
MUI US Equity	BLACKROCK MUNI INTERM DURATI	10.31%	19.74%
VKQ US Equity	INVESCO MUNICIPAL TRUST	11.04%	21.14%
NEA US Equity	NUVEEN AMT-FREE MUNI INC FD	11.20%	21.44%
NQU US Equity	NUVEEN QUAL INC MUNI FD	10.39%	19.90%
NQS US Equity	NUVEEN SEL QUAL MUNI FD	8.91%	17.05%
EIM US Equity	EATON VANCE MUNICIPAL BOND F	9.97%	19.09%
Average		10.39%	19.90%

Security Attributes As of July 20, 2015

Ticker	Name	Current Yield %	Current Premium or Discount to NAV	Lowest Discount to NAV 2013	Expense Ratio %	Rating	Effective Duration	Leverage
LEO US Equity	DREYFUS STRATEGIC MUNICIPAL	6.89	-8.33	-7.86	0.90	bbb-	5.310	33.80%
DSM US Equity	DREYFUS STRATEGIC MUNI BD FI	6.85	-8.43	-8.56	0.89	bbb	5.900	30.87%
MUI US Equity	BLACKROCK MUNI INTERM DUR/	5.94	-12.09	-11.50	1.00	bbb	5.190	30.10%
VKQ US Equity	INVESCO MUNICIPAL TRUST	6.77	-11.72	-12.50	1.02	bbb-	7.270	37.00%
NEA US Equity	NUVEEN AMT-FREE MUNI INC FL	6.39	-12.38	-13.67	0.61	bbb	7.590	39.03%
NQU US Equity	NUVEEN QUAL INC MUNI FD	6.16	-12.81	-14.04	**0.81**	**bbb-**	**7.130**	40.06%
NQS US Equity	NUVEEN SEL QUAL MUNI FD	5.98	-12.51	-14.31	0.63	bbb	7.880	40.31%
EIM US Equity	EATON VANCE MUNICIPAL BONL	6.32	-11.26	-11.50	0.43	a	3.010	40.98%
AVERAGE		**6.41**	**-11.19**	**-11.74**	**0.79**		**6.16**	

As of January 8, 2016

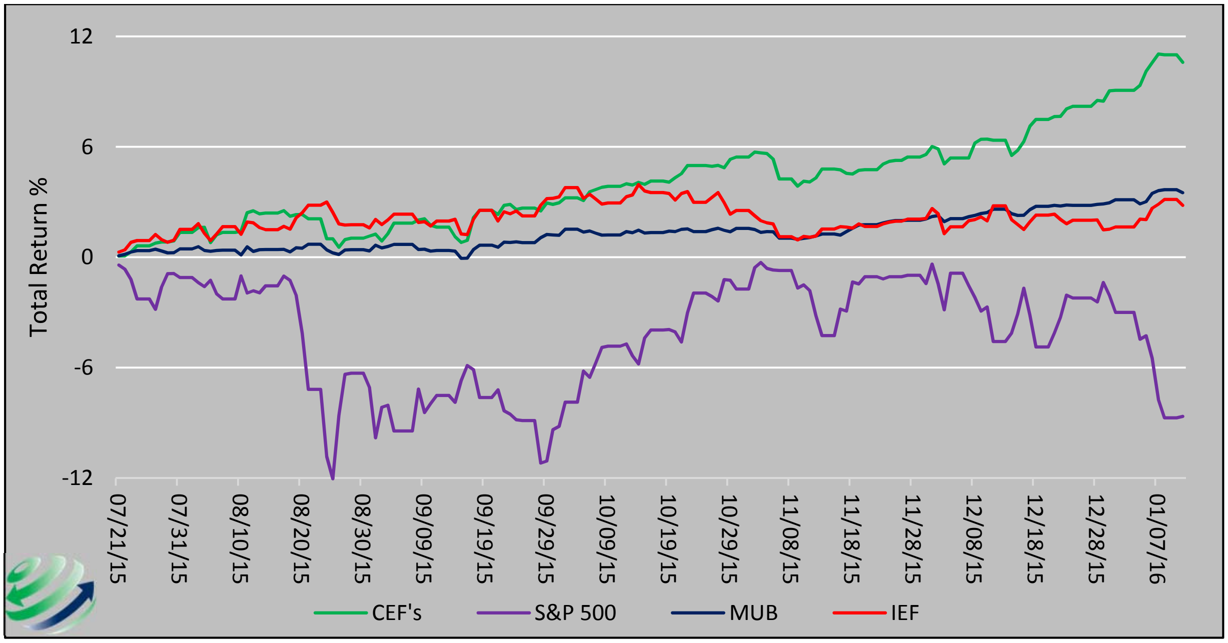
Ticker	Name	Current Yield %	Current Premium or Discount to NAV	Lowest Discount to NAV 2013	Expense Ratio %	Rating	Effective Duration	Leverage
LEO US Equity	DREYFUS STRATEGIC MUNICIPAL	5.94	-2.78	-7.86	0.90	bbb-	5.31	33.80%
DSM US Equity	DREYFUS STRATEGIC MUNI BD FI	6.06	-5.61	-8.56	0.89	bbb	5.90	30.87%
MUI US Equity	BLACKROCK MUNI INTERM DUR/	6.74	-9.16	-11.50	0.96	bbb	5.19	30.10%
VKQ US Equity	INVESCO MUNICIPAL TRUST	6.26	-8.16	-12.50	1.02	bbb-	7.27	37.00%
NEA US Equity	NUVEEN AMT-FREE MUNI INC FL	5.69	-8.88	-13.67	0.61	bbb	7.59	39.03%
NQU US Equity	NUVEEN QUAL INC MUNI FD	5.74	-10.42	-14.04	0.81	**bbb-**	7.13	40.06%
NQS US Equity	NUVEEN SEL QUAL MUNI FD	5.58	-11.07	-14.31	0.63	bbb	7.88	40.31%
EIM US Equity	EATON VANCE MUNICIPAL BONL	5.86	-8.18	-11.50	1.05	a	3.01	40.98%
AVERAGE		**5.98**	**-8.03**	**-11.74**	**0.86**		**6.16**	
Holding Period Change		**-0.43**	**3.16**	**0.00**	**0.07**		**0.00**	

Data Courtesy: Bloomberg -- A negative number in the premium/discount to NAV column represents a discount

Within the tables are a few points worth detailing.

First, the CEF's, on average, have a total return of +10.39% or nearly +20% annualized. The graph below compares the cumulative total return of the CEF's to that of the S&P 500 (-8.64%), IEF a 7-10 year U.S. Treasury ETF (+2.82%), and MUB a municipal bond ETF (+3.51%). The returns include both price appreciation and dividends.

Cumulative Total Return CEF's vs Popular Investment Alternatives



Data Courtesy: Bloomberg

Second, the discount to NAV, for all of the securities, improved. The CEF's, on average, witnessed a 3% decrease in the discount. Think of this as appreciation in the value of the fund above and beyond changes to the value of the fund's holdings. While all of the securities still trade at attractive discounts, they are currently trading back in line with their 3 year average.

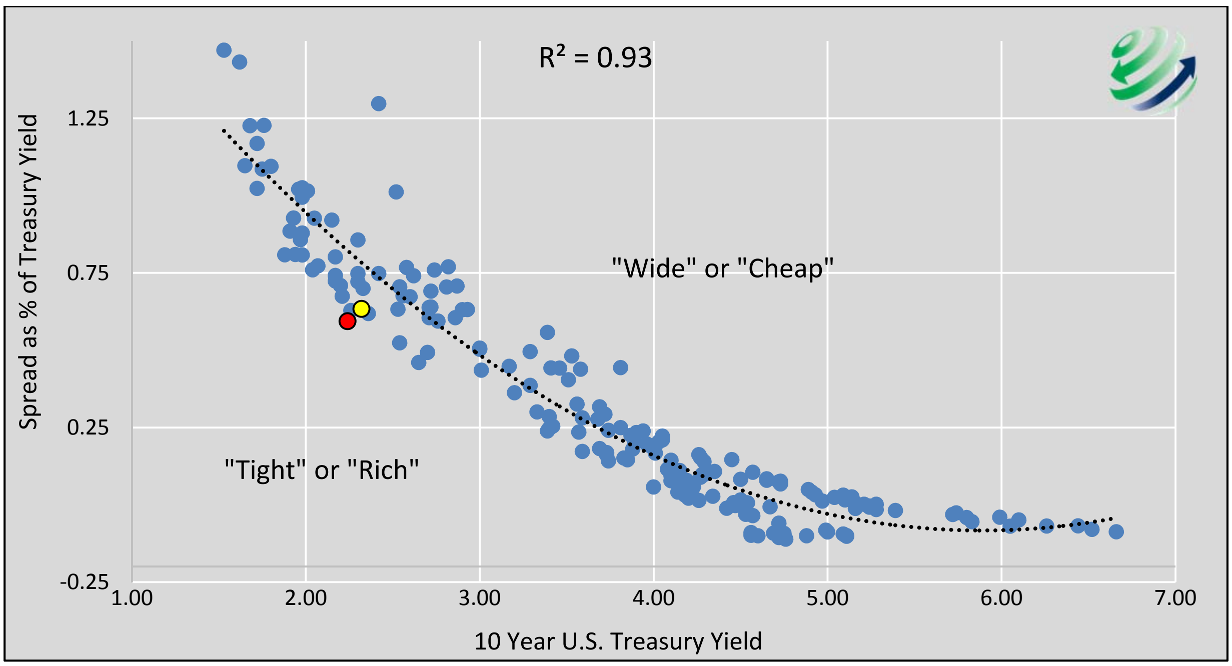
Third, the CEF's also benefited from a drop in yields during this holding period. The lower CEF yields were a function of the aforementioned decrease in the discount to NAV, as well as a general move lower in municipal and Treasury yields. During the period, the average yield on the selected CEF's fell by .43% while comparable Treasury yields fell by .22% and the Bond Buyer GO 20 Municipal Bond Index fell by .32%. The bonds underlying the funds, likely saw yields on average decrease more than Treasury bonds during this period. In bond market parlance one would say the municipal -Treasury yield spread tightened or became richer, to the benefit of municipal bond holders.

Investment Review

As previously mentioned at the time we wrote the article we were comfortable with the risk that municipal bond yields might underperform Treasury bond yields. Our thought being that any widening of municipal/Treasury spreads would likely be more than offset by our expectation for lower yields in general and the normalization of discounts to NAVs. Given the improvement in the discounts to NAV and lower yields, we need to re-address the risk that municipal yields underperform Treasury yields. Said differently, it is worthwhile here to assess the risk that the municipal-Treasury yield spread could widen or cheapen.

The scatter plot below compares municipal-Treasury spreads as a percentage of Treasury yields through different interest rate environments since 2000. While there are many ways to evaluate the spread, the method shown is attractive as it accounts for spreads with consideration for the absolute level of rates. The effectiveness of this model is supported by an R-squared of .93, which denotes a very tight relationship between the factors. Data points that lie below the regression trend line are instances where the spread is considered tight or rich, with the difference between municipal yields and Treasury yields being lower than average. The opposite holds true for data points above the line.

Municipal/Treasury Spreads as a % of Treasury Yields – January 2000 - Current



Data Courtesy: St. Louis Federal Reserve (FRED) – Ten Year Treasury CMT vs Bond Buyer G.O. 20 Index

The current spread is represented by the red dot, and the spread from July 2015 is yellow. By comparing the two highlighted data points, one notices the spread tightened further over the last 6 months. Statistically this can be quantified by measuring the distance between each dot and the trend line. During this period the spread moved from 1.40 standard deviations to 2.25 standard deviations below the trend line. The current spread, is now the tightest (furthest from the trend) that it has been since at least the year 2000.

Current recommendation

Given that the factors driving our original recommendation (discount to NAV and lower yields) are not as compelling today as they were in July, coupled with a probable widening of the municipal-Treasury spread, we are not as comfortable with the risk-reward scenarios as we were. To further appreciate the tight spread, consider that if the spread were to instantly revert back to trend, the prices on the bonds underlying the CEF's, on average, would decline by about 3%. Given that the CEF's employ leverage the likely price drop of the CEF's would be greater than the drop in the bond prices underlying the CEF's.

Due to our concern over the potential for spread widening and weakened prospects for further discount normalization we are recommending that investors sell LEO (Dreyfus Strategic Municipal Fund) as the discount to NAV is nearing zero. We also recommend investors sell half of their shares in the other holdings. Take well-earned profits and remain vigilant on the remaining holdings, perhaps consider employing a stop loss order to sell shares. The remaining CEF's still offer a sound value proposition.

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