Groundhog Day for CEF Discounts?

Punxsutawney Phil will look for his shadow this upcoming Sunday, predicting six more weeks of winter weather or an early spring. From a statistical viewpoint, our portfolio is feeling eerily similar to where it was at the beginning of last year – is Bill Murray secretly hiding out in our offices? Our portfolio’s average discount to start last year was 16.1% with an annualized cash distribution yield of 4.6% (as of 12/31/2018). We start this year with an average discount of 16.9% and an annualized cash distribution yield of 5.7% (as of 12/31/2019). Keep in mind, all of this coming off a year where the Matisse Discounted CEF Strategy composite returned +25.8% (for calendar year 2019).

From a discount perspective, our portfolio is actually in a slightly more favorable position today than where it was one-year ago. But how can our portfolio today (after a solid year of performance) be more discounted on average and have a higher annualized cash distribution yield? The answer lies in our approach: sticking to a disciplined, contrarian strategy that rotates into and out of CEF positions as discounts become more or less attractive relative to their historical average discount. When we break down our strategy’s return in 2019, NAV movement of the underlying CEFs contributed +11.9%, discount narrowing contributed +7.2%, and income distribution contributed +6.7% (for a total return of +25.8%).

Twelve months ago, many investors were uncertain about what calendar year 2019 would bring them from a total return perspective. The fourth quarter of 2018 was extremely volatile (S&P 500 was down -13.5%; Matisse Discounted CEF Strategy was down -7.4%), so much that we put out a special market update to discuss the historic discount levels we were seeing at the time (see December 21st, 2018 State of the Closed-End Fund Market).

Now flash forward to today – many investors have long forgotten the uncertainty they may have felt twelve months ago, but our team remembers the investment opportunities that arose and the discount environment created from Q4 2018.

In today’s income starved world, we can’t find many other suitable places where you can generate the same level of income we are seeing in CEFs. And there certainly aren’t any other places today where you can generate this level of income, while also benefitting from potential discount narrowing.
Case Study: Bill Ackman’s Closed-End Fund

It’s our belief that buying deeply discounted closed-end funds works, even if discounts don’t quickly move back to their historical average (sometimes you need to wait). A great real-world example of this is with Bill Ackman and his closed-end fund, Pershing Square Holdings Ord (PSH).

Bill Ackman notably went through a tough 3-year stretch of underperformance in his hedge fund (for any manager, but especially tough relative to his hedge fund’s historical performance). He was often in the news for his investment decisions that weren’t panning out (Herbalife), and the negative press hurt not only his hedge fund, but also the closed-end fund that he launched in 2014. However, as professional investors we know that Bill Ackman didn’t just “get stupid” overnight – so we’ve viewed this as an opportunity to capitalize on the big discount that his closed-end fund has been trading at.

Sure enough, Pershing Square turned it around in a big way in 2019 (with a +58.0% at-NAV return). Even though PSH’s discount to NAV widened to 29.0% (as of 12/31/2019; compared to its average discount of 17.0% since inception), our investors earned +51.0% on the position in 2019.

PSH remains an incredible bargain in our opinion: a huge discount to NAV, buying back shares (highly accretive to NAV), and paying a quarterly cash distribution as well. It remains one of the largest positions in our strategy.

Historical CEF Discounts

(as of 12/31/2019)

Source: Matisse Capital

-24%
-22%
-20%
-18%
-16%
-14%
-12%
-10%
-8%
-6%
-4%
-2%
0%
2%
4%

Discount to NAV

Average Discount for Entire CEF Universe (since 2005)
Average Discount for Bond CEFs (since 2005)
Average Discount for Equity/Other CEFs (since 2005)
Average Discount for Our Portfolio (since 2005)
Current Discount

Our Portfolio

Source: Matisse Capital

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What’s Happening at Matisse:

MATISSE HIRED BY LARGE INSTITUTION TO MANAGE FIXED INCOME ONLY CEF ACCOUNT

Following a lengthy period of due diligence, our firm was hired in November to manage a sleeve of a $3.8 billion fixed income mutual fund. More information about the opportunities in fixed income only CEF portfolios will be coming in the future. We are still contemplating which vehicle would be most appropriate for a fixed income only CEF strategy, and we plan to keep our readers appraised.

CONTENT FROM THE AICA CEF / BDC / INTERVAL FUND BOOTCAMP AND ROUNDTABLE

Eric Boughton, CFA was featured in various media content while attending the Active Investment Company Alliance Boot Camp and Roundtable in New York. Click here for a video replay of the panel he was featured on. Click here to see his solo interview with the AICA. Click here to listen to his comments on the Money Life with Chuck Gaffe podcast.

MDCEX ASSIGNED 5-STAR RATING FROM MORNINGSTAR® (as of 12/31/2019)

Our publicly traded mutual fund that employs our Discounted CEF Strategy has been assigned a 5-Star rating from Morningstar® for 3-Years, 5-Years, and Overall in the category of Tactical Allocation (as of 12/31/2019).

Portfolio Composition:

TYPICAL ACCOUNT LOOKTHROUGH ALLOCATION 12.31.19

<table>
<thead>
<tr>
<th>Asset Allocation</th>
<th>Equity Cap Allocation</th>
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<tbody>
<tr>
<td>Fixed Income</td>
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<tr>
<td>Cash</td>
<td>Small</td>
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<tr>
<td>Other</td>
<td>Medium</td>
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<tr>
<td>Not Classified</td>
<td>Giant</td>
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<tr>
<td>Non-U.S. Americas Equity</td>
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TOP 10 HOLDINGS 12.31.19

<table>
<thead>
<tr>
<th>RMR Real Estate Income Fund</th>
<th>NexPoint Strategic Opportunities Fund</th>
<th>Pershing Sq Hldgs</th>
<th>Dividend and Income Fund</th>
<th>GDL Fund</th>
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<tbody>
<tr>
<td>ASA Gold and Precious Metals</td>
<td>Third Point Offshore USD Ord</td>
<td>Gabelli Global Small &amp; Mid Cap Value Tru</td>
<td>MS India Investment</td>
<td>Salient Midstream &amp; MLP</td>
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</tbody>
</table>
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1. Matisse Capital (Deschutes Portfolio Strategy, LLC) is the advisory firm to the Matisse Discounted Closed-End Fund Strategy and mutual fund. Performance cited currently represents a composite of all Matisse Capital-advised accounts employing our discounted closed-end fund strategy, including our publicly traded mutual fund, net of all commissions, and separate accounts with a presumed 1% management fee. For details of the performance calculation method, please see our separate audited report. All performance figures for the strategy (except cash distribution yield) are total returns net of actual commissions incurred, and net of a presumed 1% annual management fee. Benchmark returns, by contrast, do not reflect a deduction for fees. You cannot invest directly in an index. **Performance comparisons are for illustrative purposes only and are not a forecast of future returns.** Alpha, beta and R2 are annualized since inception. Please contact us if you would like to receive a copy of the performance audit from ACA Compliance Group (formerly Ashland Partners). Although the above data is derived from sources deemed to be accurate, Matisse Capital does not guarantee its accuracy.

2. Matisse Capital is not affiliated or endorsed by Morningstar, Inc. Morningstar® has placed our publicly traded mutual fund into its Tactical Allocation category.

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