Interest Rates to Zero? Discounted Bond CEFs Might be your Hero

For the modern American, it seems almost absurd to consider bonds with no return. Why would anyone invest in them? The U.S. 10-year Treasury yields about 2.0% today and has averaged over 6% for the last 50 years. What fool would predict rates going to zero?

But imagining this scenario probably seemed absurd in Japan in 1997 and Germany in 2011, too. However, by 2016 in both countries, 10-year rates were zero and 10-year bonds were being issued with zero coupons. In fact, today over $10 trillion of developed country debt trades at a negative yield to maturity. U.S. rates (at 2.0%) suddenly seem high. Could the U.S. be next?

Let’s assume interest rates in the U.S. go to zero. Is there an intelligent way to invest? Evidence from Japan suggests that stock market returns could be anemic or even negative while rates are falling. Money market returns would average less than 1% per year if rates go to zero from here.

What about longer-term bonds? It was only a few years ago that most investors were afraid to own long-term bonds, as the Fed began to raise short-term rates. The thinking here was that if long-term rates rose as well, then long-term bond prices (which move inversely to interest rates) could fall sharply. The fear was, in part, justified: an investment in 10-year Treasuries in summer 2016 would have lost about 9% a few years later. The 7-year trailing return on a constantly rebalanced investment in 10-year Treasuries is just over 2% per year.

However, when rates fall, bond prices go up (where there’s risk, there is also reward).
If interest rates on the 10-year Treasury fall to zero over the next five years, we believe investing in Discounted Bond CEFs could be very beneficial for investors. When properly done, investors can buy bond funds at a deep discount to NAV, take advantage of structural leverage that many CEFs have, reap yields above 6%, and realize potential annual returns of 7-9%.

What if interest rates rise instead?
Briefly, without getting into the gory details, it turns out that even if rates rise (say to 5% over the five-year period in question), an investor is likely to lose money due to duration – but the beneficial characteristics of discounted CEFs are likely to limit losses to less than 2% per year. And losing a little will not only be not too much worse than other investors, but it also might be acceptable as a bit of an “insurance payment” for protecting your portfolio against the very real possibility of zero.

Warren Buffett, at his annual investor conference in May, said that if interest rates stay at today’s levels, stocks are ridiculously cheap. He went on to say he believes interest rates, over the long-term, will go up (and not down). We will wait and see.
What’s Happening at Matisse:

OREGON BUSINESS MAGAZINE BRAND STORY

Our firm’s story and involvement with Discounted Closed-End Funds was featured in the May 2019 publication of Oregon Business Magazine. Click here to read the article.

PUBLISHED IN THE PORTLAND BUSINESS JOURNAL

Eric Boughton, CFA was recently published in the Portland Business Journal’s 2019 Financial Services Guide. Click here to read the article.

MDCEX ASSIGNED 5-STAR RATING FROM MORNINGSTAR® (as of 6/30/2019)

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 6/30/2019).

AUDITED RETURNS ON FIXED-INCOME AND EQUITY COMPONENTS

Based on demand, we have broken out our historical return streams for Fixed-Income Only CEFs and Equity Only CEFs. These returns have been audited by ACA Compliance Group (available on request).

Portfolio Composition:

TYPICAL ACCOUNT LOOKTHROUGH ALLOCATION 6.30.19

<table>
<thead>
<tr>
<th>Asset Allocation</th>
<th>Equity Cap Allocation</th>
</tr>
</thead>
<tbody>
<tr>
<td>US Stocks 56%</td>
<td>Giant 18%</td>
</tr>
<tr>
<td>Greater Europe Stocks 17%</td>
<td>Medium 32%</td>
</tr>
<tr>
<td>Greater Asia Stocks 1%</td>
<td>Small 14%</td>
</tr>
<tr>
<td>Cash &amp; Other 10%</td>
<td>Micro 5%</td>
</tr>
<tr>
<td>Bonds 10%</td>
<td></td>
</tr>
<tr>
<td>Non US Americas Stocks 6%</td>
<td></td>
</tr>
</tbody>
</table>

TOP 10 HOLDINGS 6.30.19

- NexPoint Strategic Opportunities Fund
- RMR Real Estate Income Fund
- GDL Fund
- Pershing Sq Hldgs
- Dividend and Income Fund
- Eagle Growth & Income Opportunities Fund
- Adams Natural Resources Fund
- Salient Midstream & MLP
- Gabelli Global Small & Mid Cap Value Tru
- Boulder Growth & Income

Source: Morningstar®

FOR PROFESSIONAL USE ONLY – NOT FOR PUBLIC DISTRIBUTION
Disclaimers:

1Matisse 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.

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

The newsletter contains information about Closed-End Funds and related financial markets. The information is not advice, and should not be treated as such.

For More Information:

**CONTACT**

Bryn Torkelson – President, CIO
Bryn@matissecap.com – (503) 210-3001

Eric Boughton, CFA – Portfolio Manager & Chief Analyst
Eric@matissecap.com – (503) 210-3005

Matisse Capital
4949 Meadows Rd. Ste. 200 Lake Oswego, OR 97035
https://www.matissecap.com – (503) 210-3000