DOW THEORY FORECASTS

Income on sale

Most closed-end funds offer high income on the cheap — but with a few notable twists.

Depending on a fund's underlying holdings, distributions may include interest income, dividends, long and short-term capital gains, and even return of capital. Some managed-income funds pay a fixed amount, even if they don't generate enough income to cover the obligation.

Closed-end funds trade throughout the day, with supply and demand setting their market price. Among 560 closed-end funds tracked by Morningstar, 496 trade at discounts, meaning they are cheaper than their net asset value (NAV) — the underlying value of the stocks and bonds in their portfolios. In other words, you can buy a dollar's worth of assets for less than a dollar.

Factors such as a fund's distribution rate, relative performance, trading liquidity, and potential tax liabilities from unrealized gains can impact the discount or premium. On average, funds holding stocks trade at a discount of 10.1%, versus 6.2% for bond funds, according to Lipper. To put a fund's discount in perspective, compare it to its historical norm.

Fund performance is reported relative to market price. However, closed-end funds also report returns based on their NAV. Importantly, when a fund's discount narrows, the market-price return will exceed that fund's NAV return.

For example, suppose you pay $8 for a fund with an NAV of $10, putting the discount at 20%, or a $2 spread. Assuming a year later the NAV climbs 10% to $11 and the spread narrows to $1, the market price would be $10, implying a return of 25%.

Many funds use leverage, or borrowed money, to enhance returns and boost income distributions. Notably, leverage can also increase a fund's share-price volatility and expenses, and thus its risk.