HOW TO IDENTIFY DESTRUCTIVE RETURN OF CAPITAL VS. CONSTRUCTIVE RETURN OF CAPITAL FOR CLOSED-END FUND DIVIDENDS

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What is Return of Capital?

Distribution for closed-end funds can be classified in four ways

1. Ordinary Income
2. Short-term capital gains
3. Long-term capital gains
4. Return of capital (a catch-all category)

Primary sources of Return of Capital Dividends

• Pass-through income from MLP funds, option income, REITs and other accounting driven reasons
• Constructive – from unrealized capital gains
• Destructive – erosion from the fund’s NAV to shareholders.
  • Return of Principal
Causes of Return of Capital (ROC)

1. Closed-end funds know that it is preferential for a CEF to trade near of above it’s net asset value (NAV).
2. A CEFs Total forward looking distribution rate is a primary factor in its current and historical discount levels.
3. CEF Shareholders prefer stable dividends payments over the course of a year

**Managed Distribution Policies (MDP)**

Requires an exemption to rule 19(b) of the 1940 Act which states, “It shall be unlawful...for any registered investment company to distribute long-term capital gains ... more often than once every twelve months.”
Operating a MDP

1. Typically the fund’s board in conjunction with the portfolio manager/investment advisor will forecast the expected income and capital gains for the upcoming year. Then they set the monthly or quarterly dividend based on that estimate’s average.

2. The estimates can be wrong, so the fund may have to distribute shareholder capital to meet the expected dividend.

Section 19 Notices

- During the year the fund estimates the breakdown of their distributions with their 19 notices to shareholders.
- However, the 1099-DIV sent in January is the final record of the taxability and classification for the funds dividend components.
### 2011 Closed-End Year-End ROC %

<table>
<thead>
<tr>
<th>CEF Group</th>
<th>Average ROC</th>
<th>Number of Funds</th>
</tr>
</thead>
<tbody>
<tr>
<td>US Equity Funds</td>
<td>24.8%</td>
<td>21/52 CEFs (40.4%)</td>
</tr>
<tr>
<td>Specialty Equity Funds</td>
<td>34%</td>
<td>51/107 CEFs (47.7%)</td>
</tr>
<tr>
<td>International / Non US Equity Funds</td>
<td>5.5%</td>
<td>9/65 CEFs (13.9%)</td>
</tr>
<tr>
<td><strong>Average Equity Closed-End Fund</strong></td>
<td><strong>23.4%</strong></td>
<td><strong>71/224 (36.2%)</strong></td>
</tr>
<tr>
<td>Taxable Bond Funds</td>
<td>5.6%</td>
<td>27/153 (17.6%)</td>
</tr>
<tr>
<td>National Municipal Bond Funds</td>
<td>0.0%</td>
<td>0/105 (0%)</td>
</tr>
<tr>
<td>State Specific Municipal Bond Funds</td>
<td>0.0%</td>
<td>1/150 (0.7%)</td>
</tr>
<tr>
<td><strong>Average Bond Closed-End Fund</strong></td>
<td><strong>2.1%</strong></td>
<td><strong>28/408 (6.9%)</strong></td>
</tr>
<tr>
<td><strong>Average Closed-End Fund</strong></td>
<td><strong>9.5%</strong></td>
<td><strong>109/632 (17.3%)</strong></td>
</tr>
</tbody>
</table>

*Source: CEFA’s CEF Universe Report 12/30/11 (cefuniverse.com)*
Return of Principal Examples

This is not a complete list of the return of capital CEFs, but use for educational purposes.

<table>
<thead>
<tr>
<th>Ticker</th>
<th>Sector</th>
<th>% ROC</th>
<th>Total Yield</th>
<th>Discount</th>
<th>Leverage</th>
<th>12 Month NAV TR Performance</th>
</tr>
</thead>
<tbody>
<tr>
<td>GGE</td>
<td>Equity / Tax Advantaged</td>
<td>50%</td>
<td>7.7%</td>
<td>-14.09%</td>
<td>20%</td>
<td>14.1</td>
</tr>
<tr>
<td>JTA</td>
<td>Equity / Tax Advantaged</td>
<td>59.7%</td>
<td>8.6%</td>
<td>-10.48%</td>
<td>30</td>
<td>-2.3%</td>
</tr>
<tr>
<td>DVM</td>
<td>Equity Dividend</td>
<td>73.5%</td>
<td>7.2%</td>
<td>-7.43%</td>
<td>0</td>
<td>5.9%</td>
</tr>
<tr>
<td>CFP</td>
<td>General Equity</td>
<td>33.5%</td>
<td>17.8%</td>
<td>+22.42%</td>
<td>0%</td>
<td>4.2%</td>
</tr>
<tr>
<td>CLM</td>
<td>General Equity</td>
<td>97.6%</td>
<td>19.6%</td>
<td>+10.57%</td>
<td>0%</td>
<td>1.6%</td>
</tr>
<tr>
<td>GAB</td>
<td>General Equity</td>
<td>100%</td>
<td>12.5%</td>
<td>-3.93%</td>
<td>24%</td>
<td>-0.8%</td>
</tr>
<tr>
<td>IDE</td>
<td>Global Equity</td>
<td>33.6%</td>
<td>11.0%</td>
<td>-10.89%</td>
<td>0%</td>
<td>-8.0%</td>
</tr>
<tr>
<td>IAF</td>
<td>Misc. Non US Funds</td>
<td>62.8%</td>
<td>11.9%</td>
<td>+3.49%</td>
<td>0%</td>
<td>-9.6%</td>
</tr>
</tbody>
</table>

Source: CEFA’s CEF Universe Report 1/13/12 (cefuniverse.com)
Return of Principal Examples

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<th>12 Month NAV TR Performance</th>
</tr>
</thead>
<tbody>
<tr>
<td>NAI</td>
<td>Covered Call Equity</td>
<td>100%</td>
<td>15.8%</td>
<td>-5.61%</td>
<td>0%</td>
<td>-14.5%</td>
</tr>
<tr>
<td>FFA</td>
<td>Covered Call Equity</td>
<td>27.5%</td>
<td>8.0%</td>
<td>-12.76%</td>
<td>0%</td>
<td>+3.2%</td>
</tr>
<tr>
<td>SRV</td>
<td>MLP Funds</td>
<td>100%</td>
<td>9.6%</td>
<td>+17.59%</td>
<td>41%</td>
<td>+2.8%</td>
</tr>
<tr>
<td>KMF</td>
<td>MLP Funds</td>
<td>100%</td>
<td>6.6%</td>
<td>-7.81%</td>
<td>27%</td>
<td>+19.0%</td>
</tr>
<tr>
<td>RQI</td>
<td>REIT Funds</td>
<td>68.9%</td>
<td>8.2%</td>
<td>-7.54%</td>
<td>30%</td>
<td>+7.8%</td>
</tr>
<tr>
<td>CHY</td>
<td>Convertible Bonds</td>
<td>30.8%</td>
<td>8.3%</td>
<td>-2.15%</td>
<td>26%</td>
<td>+2.8%</td>
</tr>
<tr>
<td>GCF</td>
<td>Global Bond Non Lev.</td>
<td>100%</td>
<td>7.0%</td>
<td>-12.59%</td>
<td>0%</td>
<td>-1.5%</td>
</tr>
<tr>
<td>PHK</td>
<td>High Yield Bond – Lev.</td>
<td>14.6%</td>
<td>11.7%</td>
<td>+70.30%</td>
<td>40%</td>
<td>-5.1%</td>
</tr>
</tbody>
</table>

Source: CEFA’s CEF Universe Report 1/13/12 (cefuniverse.com)
Return of Capital Destructive Guidelines

- Above normal CEF Yield for peer-group average
- Below average leverage
- Trading at small discount to a premium.
- Net Asset Value lagging peer-average or index performance
- History of 1099-Div containing high ROC
- NOT a MLP, REIT or Option Writing Fund
Return of Capital Constructive Guidelines

- MLP, REIT or Option Writing Fund
- Positive NAV Growth over time
- History of Updating Section 19s with the 1099-DIV
- Normal range of dividend yield per-peer group.
- All dividend yields over 8.5% are suspect and should be researched in detail.
Calculating If ROC is Destructive vs. Constructive

Stating NAV: $10
Dividends over the year: $1

Ending NAV: Below $9.01 then (100% destructive)
Ending NAV between $9.01 and $10 (partial destructive)
Ending NAV over $10.01 (100% constructive)
Tax Implications for ROC

• Investors often do not understand the tax implications of return of capital and mistakenly file incorrect tax returns.
• Return of capital is treated differently under the U.S. tax code. Although a fund’s monthly and quarterly distributions will include estimates of their sources in their accompanying press releases, fund families send out the actual sources once a year in 1099-DIV forms.
• These forms are what you use to file your taxes. You do not use the estimates.
• ROC reduces your fund’s cost basis, making a later sale in a taxable account have a higher tax liability.
Summary of ROC

• Return of capital is not always bad.
• Pass-through and constructive return of capital is not economically harmful.
• Short-term/minor destructive return of capital can also be forgiven.
• A CEF's consistent use of destructive return of capital to artificially inflate a distribution rate should reduce your interest in the fund.
• Some investment strategies return capital in other forms.
• It's important to understand the tax consequences of return of capital.
QUESTIONS?

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