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 manage / 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 %

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

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.

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

Source: CEFA's CEF Universe Report 1/13/12 (cefuniverse.com)

Return of Principal Examples

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

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

Source: CEFA's CEF Universe Report 1/13/12 (cefuniverse.com)

Return of Capital Destructive Guidelines

- Above normal CEF Yield for peer-group average
- Bellow 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 you 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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