Market insights for closed-end fund investors

Key insights:

- Despite consolidation, attractive opportunities exist within select utility and telecommunications companies.
- Credit fundamentals have been solid among high-yield issuers, with some beginning to add leverage. Interest coverage levels are at all-time highs for the majority of issuers.
- Sentiment toward a number of emerging markets has become very negative due to weaker growth data and the overhang of the various trade frictions, but that creates opportunity for investors.

We sat down with Portfolio Managers Tim O’Brien, Niklas Nordenfelt, and Noah Wise along with head of U.S. Mutual Funds Product Management, Aldo Ceccarelli, for a Q&A session about today’s closed-end fund market.

Tim, the Wells Fargo Utilities and High Income Fund and Wells Fargo Global Dividend Opportunity Fund emphasize stocks within the utilities and telecommunications industries. As we’ve seen the universe of stocks in those industries shrink, where are you finding investment opportunities?

There has certainly been a lot of consolidation in the domestic utilities and telecommunications spaces over the years. This isn’t all bad from an investor’s perspective. True, there are fewer names to invest in, but the merged companies have bigger market capitalizations and share turnover and liquidity has improved. There are still quite a few electric and integrated utility names that we could potentially invest in, but there aren’t many natural gas local distribution companies or natural gas pipeline companies left. And of course the irony that AT&T was broken up into eight separate companies in 1984, which subsequently reconsolidated into two, shouldn’t be lost on investors or, for that matter, regulators and political leaders.

There is a substantial number of foreign utility names we can and do invest in. The U.S., for historical legacy reasons, had a very fragmented utility industry in the very early days, which were consolidated into six very large public utility holding companies by 1930. All six of the public utility holding companies went bankrupt in the Great Depression, stayed in reorganization through the end of World War II, and then were broken up and the operating
companies were taken public. So, the industry was very balkanized in the mid-to-late 1940s. Even after all the consolidation, there are a lot of utility companies in the U.S. The foreign utilities, in contrast, are generally national companies that were state-owned at one time before being privatized as socialism lost favor in the 1980s and 1990s and European Union policies generally favored privatization. So, it’s not literally the case but, in general, each European country has an electric company, a gas company, perhaps a grid company and the odd water company or two, plus the telephone company and a few cellular carriers. You’d think by now that there would have been a lot of cross-border consolidation in Europe, but there really hasn’t been that much. So, there are lots of potential investments in Europe and a handful of candidates in Asia, and we use a number of these names in the funds.

**Tim, what is your economic and interest rate outlook, and how do you perceive the outlook for income-oriented companies?**

We’re bound to have a recession sooner or later. The business cycle has not been repealed. That being said, recessions have tended to follow some combination of excessive Federal Reserve (Fed) tightening and/or an energy supply shock. The Fed may well have overdone the tightening, which led to a short but nasty stock market sell-off in December, but the economy continues to chug along; unemployment is at multidecade lows; wages are starting to rise a bit; and, far from facing any sort of energy supply shock, the globe appears to be awash in oil and gas looking for a home. It appears that the Fed tightening is over and the next move in the federal funds rate is likely to be a reduction.

Utility stocks are regarded by investors as bond surrogates, so interest rate sensitive but correlated to bond yields, not money market rates. Bond yields are unlikely to rise much, if at all, unless inflationary expectations accelerate. At the moment, there appears to be little risk of inflation picking up so bond yields should remain stable at the current low level.

**Tim, in the past you’ve discussed the significant investment being made in infrastructure and how that could benefit utility companies. Is that still a factor going forward, or has that already been priced into the market?**

Utilities recover the cost of service and earn a return on assets in service, also known as the rate base. The rate base grew rapidly in the 1950s and 1960s as utility companies raced to build out the suburbs that became so popular after the end of World War II. The buildout was pretty much over by the late 1960s and rate base growth slowed to a crawl, as did utility earnings growth.

Utility assets are very long-lived and are typically depreciated for accounting purposes over 40 years. This means that there are a lot of utility assets that are at the end of their economic and depreciable lives. A utility earns nothing on a fully depreciated asset because it has already recovered all of its capital investment. So, what we’ve enjoyed for the past decade or so has been a big upsurge in capital spending as the worn-out utility assets placed into service in the 1950s and 1960s are replaced. The upsurge in rate base growth translates directly into the acceleration of utility earnings growth that we currently enjoy. Thirty years ago, the utility business was a 1%–2% growth business at best. Today, because of the acceleration of utility investment, also known as rate base growth, utility earnings are generally growing at 5% to 8% per year. At some point, the bulk of the replacement capital spending will have been done and utility earnings growth will slow, but for the foreseeable future, the industry seems to have a sufficiently robust pipeline of projects to invest in to sustain rate base growth, and therefore earnings growth, which potentially may occur in the middle to high single digits.

Utility stocks once traded at a substantial discount to the broad equity market and for several years now have traded at a modest but noticeable premium. Some investors think that this means that utility stocks must be overvalued, but we don’t really see it that way. Utility stocks are growing earnings per share at 5% to 8% and pay dividends of about 3%. This means that the expected total return for utility stocks is about 8% to 11%, which is competitive with the broad equity market.
But, utility stocks are only about 70% as volatile as the broad equity market. So, if investors expect returns similar to the expected return for the broad equity market, with only 70% of market volatility, then utility stocks should trade at a premium to the broad equity market.

So, we think that utility stocks should continue to perform well versus the broad equity market unless it looks like bond yields are going to go up due to inflationary concerns or the industry capital spend looks like it is going to decelerate. We see no signs of either.

**Niklas, can you give us an update on high-yield markets these funds invest in?**

High yield has been very strong in 2019, benefiting from solid economic conditions but mostly from market expectations for rate cuts by the Fed. Such expectations have led to a rally in risk assets across markets in addition to rate-sensitive fixed-income securities. Meanwhile, the low default environment has persisted and technicals have been supportive with more issuers migrating to investment grade (rising stars) relative to issuers downgrading into high yield (fallen angels) along with solid inflows into the high-yield market.

**Niklas, can you comment on the credit fundamentals for lower-rated issuers, and are you seeing leverage increasing?**

Credit fundamentals have been solid. However, high-yield issuers have begun to add some leverage due to less robust growth combined with some modestly more aggressive issuance. Recent issuance has been largely earmarked for dividend payments and general corporate purposes as opposed to refinancings and deleveraging. However, interest expenses are at all-time lows, resulting in interest coverage (a measure of an issuer’s ability to pay interest expense) levels at all-time highs for the majority of issuers.

**Given the size of the BBB market within investment-grade credit, how might the composition of the high-yield universe change if we suddenly start seeing a number of issuers fall into high yield?**

Eventually, we expect the economy to turn and the large number of BBB-rated bonds that have been issued in recent years will be at risk of a downgrade to high yield. History suggests that a wave of downgrades may pressure the high-yield market, but high yield has typically rebounded quickly from such technical pressure. Indeed, high yield has often outperformed investment grade during such periods since the high-yield market is able to capture the rebound from potential forced selling pressure of issuers migrating from investment-grade indices to high-yield indices. We deem this risk and opportunity to be more relevant in the future as opposed to the near term.

**Noah, the Wells Fargo Multi-Sector Income Fund is a multi-sector fund that invests in a wide range of debt, from high-yield corporate bonds and loans, to adjustable- and fixed-rate mortgages, to debt from international and emerging market entities. Can you comment on the relative valuations of bonds across some of these sectors?**

Within the high-yield space, we prefer bonds over loans for several reasons. First, high-yield bond fundamentals remain reasonably strong, while loan protections have eroded significantly over the past several years. Second, high-yield bonds are benefiting from a better technical backdrop than loans, as investors are no longer concerned about the Fed increasing interest rates later this year. In an environment of lower interest rates, high-yield bonds have tended to perform better than loans because the floating-rate nature of loans limits the capital appreciation potential in those instruments.

Outside of high yield, we continue to favor financials over industrials in the investment-grade market, where fundamentals are sound and valuations are fair. We are also finding value in certain local currency emerging market government bonds, where real yields are high relative to the U.S., inflation is stable or expected to decline, and currency valuations are attractive. Sentiment
toward a number of emerging markets has become very negative due to weaker growth data and the overhang of the various trade frictions. However, that negative sentiment is also creating opportunities where we believe fundamentals may hold up better than consensus currently anticipates.

Aldo, each of the funds has the opportunity to repurchase shares when there is an opportunity to benefit shareholders. How does the share repurchase program work, and have the funds been active in this regard?

Share repurchase plans are common among closed-end funds as a way to address elevated discounts. Under the current term, the Wells Fargo Funds Board of Trustees has authorized the repurchase of up to 10% of each fund’s outstanding shares during the 2019 calendar year. The funds’ investment advisor, Wells Fargo Funds Management, LLC, has discretion to determine the amount and timing of the repurchase of shares of each fund in accordance with the best interests of the fund. The buybacks are executed in open-market transactions in accordance with the best interests of the fund and are subject to applicable legal limitations. Year to date through June 30, 2019, the Wells Fargo Income Opportunities Fund has repurchased 4,227,974 shares, or 6.4% of outstanding shares; the Wells Fargo Multi-Sector Income Fund has repurchased 735,448 shares, or 2.3% of outstanding shares; and the Wells Fargo Global Dividend Opportunity Fund has repurchased 843,586 shares, or 1.9% of outstanding shares. The Wells Fargo Utilities and High Income Fund has not repurchased any shares in the current program year.

There is no assurance that the funds will purchase shares at any specific discount levels or in any specific amounts; that the market price of the funds’ shares, either on an absolute or relative basis to net asset value, will increase as a result of any share repurchases; or that the share repurchase plans will enhance shareholder value over the long term. Each fund’s repurchase activities will be disclosed in its shareholder report for the relevant period.
risk of default and tend to be more volatile than higher-rated debt securities. This fund is exposed to mortgage- and asset-backed securities risk.

The Multi-Sector Income Fund is leveraged through a revolving credit facility and also may incur leverage by issuing preferred shares in the future. The use of leverage results in certain risks, including, among others, the likelihood of greater volatility of net asset value and the market value of common shares. Foreign investments are especially volatile and can rise or fall dramatically due to differences in the political and economic conditions of the host country. These risks are generally intensified in emerging markets. Derivatives involve additional risks, including interest rate risk, credit risk, the risk of improper valuation, and the risk of noncorrelation to the relevant instruments that they are designed to hedge or closely track. Bond values fluctuate in response to the financial condition of individual issuers, general market and economic conditions, and changes in interest rates. Changes in market conditions and government policies may lead to periods of heightened volatility in the bond market and reduced liquidity for certain bonds held by the fund. In general, when interest rates rise, bond values fall and investors may lose principal value. Interest rate changes and their impact on the fund and its share price can be sudden and unpredictable. High-yield securities have a greater risk of default and tend to be more volatile than higher-rated debt securities. This fund is exposed to mortgage- and asset-backed securities risk.

For the Global Dividend Opportunity Fund, the fund is leveraged through a revolving credit facility and also may incur leverage by issuing preferred shares in the future. The use of leverage results in certain risks, including, among others, the likelihood of greater volatility of net asset value and the market value of common shares. Derivatives involve risks, including interest rate risk, credit risk, the risk of improper valuation, and the risk of noncorrelation to the relevant instruments they are designed to hedge or closely track. There are numerous risks associated with transactions in options on securities and/or indices. As a writer of an index call option, the fund forgoes the opportunity to profit from increases in the values of securities held by the fund. However, the fund has retained the risk of loss (net of premiums received) should the price of the fund's portfolio securities decline. Similar risks are involved with writing call options or secured put options on individual securities and/or indices held in the fund's portfolio. This combination of potentially limited appreciation and potentially unlimited depreciation over time may lead to a decline in the net asset value of the fund. Foreign investments may contain more risk due to the inherent risks associated with changing political climates, foreign market instability, and foreign currency fluctuations. Risks of foreign investing are magnified in emerging or developing markets. Small- and mid-cap securities may be subject to special risks associated with narrower product lines and limited financial resources compared with their large-cap counterparts, and, as a result, small- and mid-cap securities may decline significantly in market downturns and may be more volatile than those of larger companies due to their higher risk of failure. High-yield lower-rated bonds may contain more risk due to the increased possibility of default. Illiquid securities may be subject to wide fluctuations in market value. The fund may be subject to significant delays in disposing of illiquid securities. Accordingly, the fund may be forced to sell these securities at less than fair market value or may not be able to sell them when the advisor or subadvisor believes that it is desirable to do so. This closed-end fund is no longer available as an initial public offering and is only offered through broker-dealers on the secondary market. A closed-end fund is not required to buy its shares back from investors upon request. The final determination of the source of all dividend distributions in the current year will be made after year-end. The actual amounts and sources of the amounts for tax-reporting purposes will depend upon a fund’s investment experience during the remainder of the fiscal year and may be subject to change based on tax regulations. Each fund will send shareholders a Form 1099-DIV for the calendar year that will tell shareholders how to report these distributions for federal income tax purposes.

For the Income Opportunities Fund, the fund is leveraged through a revolving credit facility and also may incur leverage by issuing preferred shares in the future. The use of leverage results in certain risks, including, among others, the likelihood of greater volatility of net asset value and the market value of common shares. Derivatives involve additional risks, including interest rate risk, credit risk, the risk of improper valuation, and the risk of noncorrelation to the relevant instruments that they are designed to hedge or closely track. Bond values fluctuate in response to the financial condition of individual issuers, general market and economic conditions, and changes in interest rates. Changes in market conditions and government policies may lead to periods of heightened volatility in the bond market and reduced liquidity for certain bonds held by the fund. In general, when interest rates rise, bond values fall and investors may lose principal value. Interest rate changes and their impact on the fund and its share price can be sudden and unpredictable. High-yield securities have a greater risk of default and tend to be more volatile than higher-rated debt securities.
For the Utilities and High Income Fund, the use of leverage results in certain risks, including, among others, the likelihood of greater volatility of net asset value and the market price of common shares. High-yield, lower-rated bonds may contain more risk due to the increased possibility of default. Foreign investments may contain more risk due to the inherent risks associated with changing political climates, foreign market instability, and foreign currency fluctuations. Risks of international investing are magnified in emerging or developing markets. Funds that concentrate their investments in a single industry or sector may face increased risk of price fluctuation due to adverse developments within that industry or sector. Small- and mid-cap securities may be subject to special risks associated with narrower product lines and limited financial resources compared with their large-cap counterparts. Derivatives involve additional risks, including interest rate risk, credit risk, the risk of improper valuation, and the risk of noncorrelation to the relevant instruments they are designed to hedge or closely track. There are numerous risks associated with transactions in options on securities. Illiquid securities may be subject to wide fluctuations in market value and may be difficult to sell.

As of May 31, 2019, the Utilities and High Income Fund held 2.81% of AT&T. As of May 31, 2019, the Multi-Sector Income Fund, Global Dividend Opportunity Fund, and Income Opportunities Fund did not hold any shares of AT&T. Portfolio holdings are subject to change and may have changed since the date specified. The holdings listed should not be considered recommendations to purchase or sell a particular security.

Current month-end performance is available by calling 1-800-222-8222.

The closed-end funds (CEFs) are no longer offered as initial public offerings. Investors who wish to buy or sell fund shares of a CEF need to place orders through an intermediary, or broker, who will buy or sell fund shares on the stock exchange in a process identical to the purchase or sale of any other listed stock. A CEF is not required to buy its shares back from investors upon request.

The ratings indicated are from Standard & Poor's, Moody's Investors Service, and/or Fitch Ratings Ltd. Credit-quality ratings: Credit-quality ratings apply to underlying holdings of the fund and not the fund itself. Standard & Poor's rates the creditworthiness of bonds from AAA (highest) to D (lowest). Ratings from A to CCC may be modified by the addition of a plus (+) or minus (-) sign to show relative standing within the rating categories. Moody’s rates the creditworthiness of bonds from Aaa (highest) to C (lowest). Ratings Aa to B may be modified by the addition of a number 1 (highest) to 3 (lowest) to show relative standing within the rating categories. Fitch rates the creditworthiness of bonds from AAA (highest) to D (lowest).

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