

# Understanding managed distribution plans

## Bottom line

- Investors are often attracted to closed-end funds for their historically attractive payouts relative to other investment products (i.e., mutual funds, ETFs) and individual securities.
- Managed distribution plans offer the potential for higher distribution rates throughout a market cycle.
- Managed distributions also expand the menu of investment options for income focused investors and may be more tax efficient, particularly for investors in higher tax brackets.

Investors are often attracted to closed-end funds (CEFs) for their historically attractive distributions relative to other investment products (i.e., mutual funds, ETFs) and individual securities.<sup>1</sup> CEFs are able to pay these attractive distribution rates given certain structural advantages. For example, the “closed” structure allows for greater flexibility in the types of investment strategies that can be used (i.e., leverage) while providing access to less liquid investments (i.e., private securities) that may pay higher yields or may generate higher returns over time.

### Managed distribution plans

Managed distribution plans are typically used by CEFs that potentially generate earnings from multiple sources

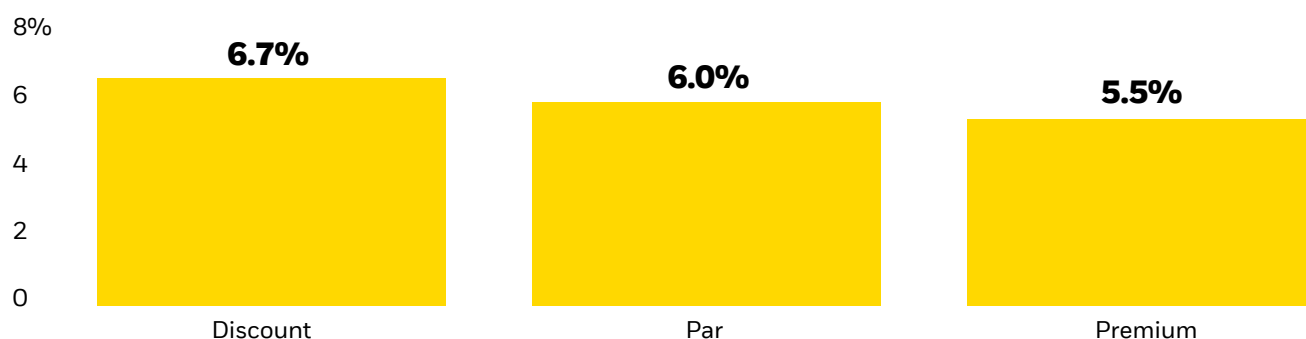
and, therefore, seek to pay a distribution rate that is a meaningful portion of the fund’s total return (income + price appreciation).<sup>3</sup> For example, BlackRock’s taxable fixed income, equity and multi-asset CEFs currently employ managed distribution plans. Managed distributions may be derived from various sources of a fund’s return, including interest, dividends, capital gains and return of capital – the composition will vary for each fund depending on its underlying holdings and portfolio turnover (Exhibit 1). Shareholders can view estimates for each monthly distribution via [Section 19 notices](#) on fund websites. However, the final tax breakdown is provided to each shareholder via a 1099 tax statement at year end.

### Exhibit 1: Potential sources of distribution and tax treatment in a managed distribution plan

Potential sources of distribution in a managed distribution plan	Tax treatment
Net income (including currency)	Ordinary income
Qualified dividend income	Capital gain <sup>2</sup>
Short-term gains	Ordinary income
Long-term gains	Capital gain
Return of capital	Non-taxable to extent of basis

<sup>1</sup> This information is based on Morningstar data (April 2024). <sup>2</sup> Qualified dividend income is taxed at capital gain rates provided the shareholder meets certain holding period requirements. <sup>3</sup> Meaningful portion refers to greater than 50% of a fund’s distribution.

## Exhibit 2: Distribution rate (Market price)



	NAV	Market price	Distribution (Annualized)	Distribution rate (Market price)
Discount	\$10.00	\$9.00	\$0.60	6.7%
Par	\$10.00	\$10.00	\$0.60	6.0%
Premium	\$10.00	\$11.00	\$0.60	5.5%

### Benefits of purchasing discounted funds

CEFs may trade at a premium (market price > NAV) or discount (market price < NAV). Since the distribution is paid from the fund’s NAV, CEFs that trade at a discount naturally pay a higher distribution on market price (the price at which investors transact). For example, a fund with a \$10 NAV that pays a 5 cent per month distribution (60 cents per year) is said to have a distribution rate of 6%. If the market price trades at \$9 per share (10% discount), the fund’s distribution rate is 6.7%. Conversely, if the market price trades at \$11 per share (10% premium), the fund’s distribution rate is just 5.5% (Exhibit 2). Moreover, investors that purchase at a discount will realize a portion of NAV through the distribution – for this reason, BlackRock believes that increasing the distributions rate for certain types of funds via a managed distribution plan can be an effective tool to address discounts and enhance shareholder value.

### Demystifying return of capital

As noted above, a CEF’s distribution may include return of capital (“ROC”) from a tax perspective. While this term infers that a fund is simply returning cash to shareholders, that is not necessarily the case, and it is important to understand why this occurs. For example, a growth-focused equity fund that has generated a total return equal to or in excess of its distribution rate may still pay ROC if earnings (i.e., net realized gains plus income) are less than the distribution

rate for that period. In this example, the fund’s return is likely driven by unrealized gains; until those gains are realized, the fund’s distributions will be in excess of its earnings and the difference treated as ROC from a tax perspective.

Importantly, ROC distributions are not immediately taxed and simply reduce the investor’s cost basis in the fund.<sup>4</sup> Therefore, ROC distributions may be more tax efficient relative to funds that pay out ordinary income as shareholders receive the monthly income while deferring taxes until the position is sold and, if held for at least one year, will be taxed at the current capital gains rate (max 20%) versus the shareholder’s ordinary income tax rate, which may be higher. Finally, if a CEF is trading at a discount and paying ROC, the shareholder is realizing NAV on a portion of their investment while deferring the tax obligation.

Now, the discussion above assumes the fund has “earned” its distribution, but investors should also be aware that CEFs may pay return of principal – this occurs when a fund pays more than it earns. In this case, shareholders still benefit from monthly payments and liquidity at net asset value<sup>5</sup>, however, the size and liquidity of the fund may decline and potentially increase fund expenses over time.

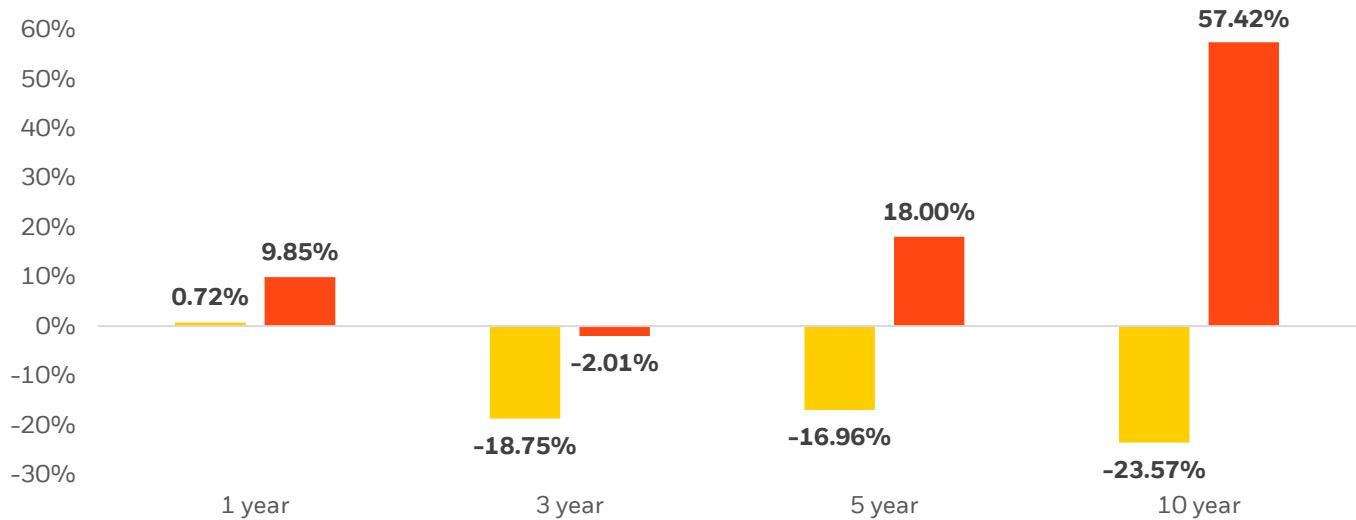
<sup>4</sup> Once cost basis is reduced to zero, any additional ROC is taxable as capital gains. <sup>5</sup> If the fund’s market price is below its net asset value.

### The client statement problem

One of the advantages of the CEF structure is the potential for a high income stream. These higher distributions can represent a large portion of the CEF's total return and can sometimes be overlooked by investors when analyzing the performance of their CEF investment. Rather than simply looking at a CEF's share price appreciation or depreciation since an investor's initial investment, a calculation of a CEF's total return takes into

account both the change in share price, as well as any distributions paid by the fund (Exhibit 3). In some cases, financial statements from brokerage firms may only show share price performance without showing distributions paid by the fund, (i.e., price return), which understates the CEF's performance from a total return perspective. Accordingly, when calculating the CEF total return, the amount of the distributions paid by the CEF should be added back to the share price of the fund.

### Exhibit 3: Simple price vs. total return



- Price return (cumulative, not including distributions)
- Total return (cumulative, including distributions)

Source: Morningstar as of 4/30/2024 please note that this chart is showing cumulative returns. CEFs are represented by the average of all funds in the Morningstar closed-end fund universe. In general, CEF distributions may be sourced from net investment income, realized gains and return of capital. For specific information about a fund's distribution sources, visit the fund sponsor's website. **Past performance is not a guarantee of future results. Morningstar category returns are shown for illustration purposes only and are not meant to represent the past or future performance of any fund. You cannot invest directly in an unmanaged index.**

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