



Miller/Howard High Income Equity Fund

6 December 2015

By **Thomas Hughes**

Senior Editor of Global Investor Spotlight



Not all CEF's are built the same. The Miller/Howard High Income Equity Fund has two unique features; responsible income and a term limit that guarantees investors receive full NAV at exit.

A Closed End Fund With High Income And Full NAV At Exit

CEF's, closed end funds, are a tough nut to crack. Basically, they are mutual funds with a set number of shares which trade on the open

market just like stock. The draw, they are a managed portfolio that often offer higher returns than the stocks they are based on. The caveat, for some reason CEF's typically trade at discounts to their NAVs, offering unique opportunities but also the risk of value trap. The trap, if the fund trades at a discount indefinitely investors may never realize the full value of their shares. This is one reason why the Miller/Howard High Income Equity Fund is so unique. It is structured with a 10 year term limit that alleviates concerns of value traps, a key point manager Steve Chun hit on several times during my talk with him.

At the end of term the fund will

liquidate and pay each shareholder the full net asset value. This, plus 10 years of dividend payments equals total return for initial investors, a gain of nearly 40% at today's prices. While the term limit is a very important feature of this fund it is the dividend, the income, that matters most. After all, it is a high income fund so it should deliver on that promise.

At current share prices yield is close to 12% annually, with regular monthly distributions every month since inception. I know, 12 months is not a lot of time with which to judge a funds performance and dividend health but there are two things to consider. The first is that Miller/Howard has over 25 years experience with dividend and income investing strategies. The second is that the fund is based on "responsible income", another key point hit on by Mr. Chun. Responsible income means that distributions are paid from income produced by the portfolio, with the goal of 100% coverage before the end of term.

According to him it is HIE's term limit and the goal of sustainable income that allowed the fund to incorporate in the first place. Without those there was little reason for yet another CEF to hit the street. At this time the fund is still using a small amount of leverage, about 13% of portfolio, and option strategies to generate distributions but over time the plan is to reach 100% coverage. Once this is met managers will eventually raise HIE's distribution. Mr. Chun thinks that this could happen by the 4th or 5th year but warned it is still premature for shareholders to expect any dividend increases.

HIE's discount to NAV has been running near -12% for the last couple of months which offers a significant gain for new investors just for buying the shares. The 12 month average discount is closer to -6%

◀ which suggests the fund could be undervalued relative to its discount. The 1-year Z statistic is -1.28, another sign that the fund is undervalued relative to its discount to NAV. New investors can expect to see both NAV and share price move higher over the course of the remaining 9 years as the portfolio grows and the secular bull market wears on.

Portfolio, Strategy And Results

The portfolio is built on a wide variety of high yield equities including but not limited to stocks, MLP's and REITs. The strategy is to seek out undervalued companies with good cash flow and healthy dividend coverage with the highest probabilities of increasing distributions in the future, a methodology consistent with the double goal of high income and capital appreciation. The top five sectors are REITs, MLP's, energy, financials and industrials comprising 68% of the portfolio. The remaining 32% is split largely between information technology, telecommunications and utilities with a some exposure to consumer discretionary, consumer staples and health care.

Over the past quarter results within the portfolio have been mixed. A little more than 45% of holdings missed earnings expectations with most of those in the energy and MLP sectors. Despite the poor showing on earnings all companies paid their dividends, 26% of them raising their distributions and only one cutting. Most of the increases were in the MLP and REIT sectors but otherwise spread evenly throughout the remaining sectors.

There was one shining star and one dud within the portfolio. The



dud, Textrainer Group, a holding company in the shipping container business. The company had one of its worst quarters on record and cut its dividend by nearly 50%. The move is mitigated by an announced \$100 million dollar stock buy back plan but does little to alleviate the drop in shares prices following the announcement.

The star was North Star Realty, no pun intended. The diversified REIT upped its distribution by 87.5% in preparation for the spin-off of North Star Europe. This is likely a one time deal however as executives have already indicated payments would likely fall to near \$0.15 after the spin is completed and the company performs its 1:2 reverse stock split. Holders of NFR received one share of NRE (pre-split) for each share they own so I expect to see this name pop up in HIE's portfolio holdings at next

reporting. North Star Europe also pays a substantial dividend, \$0.60 annually or just over 5.5% at today's share prices.

The Outlook Is Good

There is no doubt that in today's market environment Mr. Chun and HIE's management team has a tough job of work cut out for them. The upshot is that outlook is good for the broader market and for the HIE. Not only is the economy expected to grow at a faster pace in 2016 than it did in 2015, corporate revenue and earnings are expected to grow, as are dividend distributions. This will provide an environment in which fund managers can continue to deploy Miller/Howard's proprietary strategies and deliver value to shareholders. The best part, long term holders of this fund can expect to receive healthy payments as well as full NAV at term expiration.