

The Double-Edged Sword:

LEVERAGE AMPLIFIES EVERYTHING — INCLUDING YOUR MISTAKES.



Thomas J. Herzfeld built his reputation on a simple but powerful insight: price and value are not the same thing, and the gap between them is where opportunity lives. But identifying a discount and understanding the catalysts that might close it are only part of the picture. Inside many closed-end funds, a third force is at work, one that can accelerate gains in favorable markets and devastate portfolios when conditions shift.

That force is leverage.

Leverage is not inherently good or bad. It is a tool that magnifies whatever is already present in a fund. When the underlying assets perform well, leverage amplifies the upside. When conditions deteriorate, it amplifies the losses. Understanding how leverage works, and what it costs, is essential to disciplined closed-end fund investing.

Original Investment Principle



At its core, leverage allows a fund to invest more capital than it otherwise could on its own. By utilizing borrowed capital, typically through credit facilities, preferred shares, or reverse repurchase agreements, a fund increases its exposure to underlying assets and potentially generates higher returns for common shareholders.

"In rising markets, funds with highly leveraged capital structures have much more appeal than those without. Conversely, in declining markets, the buying of funds with leveraged capital structures should be avoided".¹

— Thomas J. Herzfeld

¹ Thomas J. Herzfeld, *The Investor's Guide to Closed-End Funds* (New York: McGraw-Hill, 1980), 13.

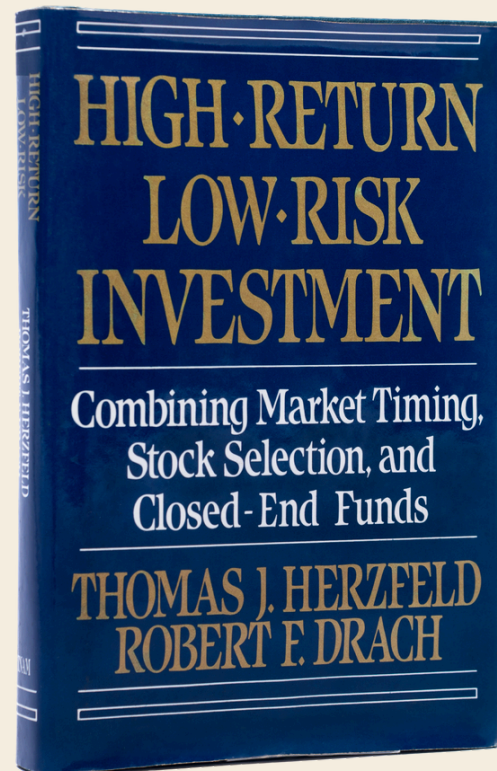
Tom Herzfeld recognized early that leverage does not determine whether a fund is attractive or dangerous. Rather, leverage must be viewed in the context of a fund's overall portfolio, structure, and ability to adapt to changing market conditions. Evaluating leverage through this broader lens is essential to determining whether it is creating opportunity or introducing unnecessary risk.

Spotlight Principle: Where Opportunity and Risk Become Inseparable

Leverage is where conviction meets consequence. A fund can own attractive assets, trade at a compelling discount, and offer an appealing yield but leverage changes how all of those characteristics behave in both favorable and unfavorable markets. At Herzfeld Advisors, we don't view leverage as strictly positive or negative — rather, we see it as a structural feature that must be fully understood before any position is established.

In practice, this means evaluating three key components of a fund's leverage profile:

- **Leverage Ratio:** How much borrowed capital is being employed, and how that compares to historical norms and peer funds. A highly leveraged fund in a rising rate environment faces meaningfully different risks than one operating at modest levels.
- **Underlying Assets:** The quality and volatility of the assets being leveraged. Leverage applied to high-grade municipal bonds behaves very differently than leverage applied to high-yield credit or emerging market equities. The asset matters as much as the amount.
- **Financial Flexibility:** The fund's ability to manage borrowing costs and navigate periods of market stress, activist filings, or policy reviews.



A fund with diverse financing sources and a conservative leverage profile is better positioned to weather volatility without being forced into asset sales at inopportune times.

Together, these three factors form the foundation of how Herzfeld Advisors evaluates leverage -not as a binary risk, but as a variable that requires ongoing monitoring and contextual judgment.

Market Insights: Leverage in 2026

The benefits and risks of leverage are closely tied to interest-rate conditions. While markets entered 2026 anticipating a further rate cut from the Federal Reserve, inflation pressures and geopolitical developments have created uncertainty around future rate decisions. A resilient labor market, coupled with higher energy prices, has reinforced concerns that inflationary pressures may prove more persistent than previously expected.

The impact of rising rates was on full display in 2022, when the Federal Reserve embarked on one of the fastest tightening cycles in decades, raising the federal funds rate from a target range of 0.00%-0.25% in March to 4.25%-4.50% by year-end. Municipal bond closed-end funds were among the sectors most affected as rising rates pressured bond prices and increased borrowing costs across leveraged portfolios. Average municipal CEF discounts widened from approximately -0.92% at the beginning of 2022 to -10.05% by year-end, while average sector yields increased from 4.27% to 4.84% as market prices adjusted to the changing interest-rate environment. The combination of higher financing costs and wider discounts created a challenging backdrop for leveraged income-oriented strategies throughout the year.

Today's backdrop differs from 2022 in an important way. Rather than beginning from a near-zero interest-rate environment, leveraged funds are operating with short-term rates already near 3.75%. Although any future rate increases would likely be far less dramatic than the 425-basis-point tightening cycle experienced in 2022, financing costs remain elevated compared to much of the previous decade. Municipal bond closed-end funds have remained relatively resilient throughout 2026, with average sector discounts ending May at -2.67% and yields holding near 6.42%. While the current environment differs meaningfully from the conditions experienced in 2022, the lessons from that period remain applicable to today. As financing costs remain elevated compared to much of the previous decade, factors such as leverage levels, asset selection, and financial flexibility continue to play an important role in how leveraged closed-end funds navigate changing market conditions.

Did You Know?

Under the Investment Company Act of 1940, leveraged closed-end funds must maintain a specific asset coverage ratio: for every \$1.00 of debt issued, the fund must hold \$3.00 in assets limiting structural leverage to 33%. According to the Investment Company Institute, the average leveraged CEF today operates right at that ceiling.

Looking Ahead

Leverage shapes the return profile of a closed-end fund, but it does not work in isolation. The quality of the underlying portfolio - the securities a fund actually owns - determines how leverage behaves and whether the opportunity is real.

In our next issue, we'll explore the principle: "The Portfolio Is the Foundation—Everything Else Is Context."

We'll examine how Herzfeld Advisors evaluates the underlying holdings of a closed-end fund - credit quality, sector concentration, geographic exposure, and manager track record - and why understanding what a fund actually owns is an essential step in disciplined CEF investing.

For more information, please contact us.

+1.305.777.1660

info@herzfeld.com