What You Need to Know About Investing in Closed-End Funds

Value investors love buying single dollar bills for 85 cents. That's why closed-end funds, a long misunderstood mutual fund relative, attract certain sophisticated investors. A cross between a mutual fund and a stock, these funds have both a net asset value and a share price. Closed-end funds sometimes trade at double-digit discounts to net asset value, creating potential opportunities. Yet because of their quirks, closed-end funds turn off many individuals. This article takes a close look at some subtle points every closed-end fund investor should understand.

The closed-end structure allows managers to work with a stable pool of capital. Unlike a mutual fund, a closed-end fund does not issue redeemable shares nor does it continuously offer shares. Huge inflows or outflows of cash are problematic for mutual fund managers, who may be forced to buy or sell securities at inopportune times. Because closed-end funds avoid this problem, their managers can invest more fully and be more long-term oriented. The closed-end structure is particularly beneficial for single-country funds operating in volatile emerging markets as well as industry-specific portfolios, funds investing in the illiquid micro-cap market and junk bond funds.

Because of their quirks, closed-end funds turn off many individuals, but they also offer many opportunities for disciplined investors who understand what they are buying.

Discounts and Premiums

Like the price-earnings ratio or price-to-book-value ratio on an ordinary stock, the discount or premium on a closed-end fund (the percentage difference between the share price and the portfolio's underlying net asset value) reflects its popularity. Thus, discounts and premiums are a function of demand and supply, which in turn are determined by factors such as investor sentiment and a portfolio's performance.

Abnormal discounts and premiums represent a market inefficiency and may be corrected in time. That's why it's important to compare a fund's current discount with its average past values and those of its peers. Discounts and premiums of individual funds appear at Barrons.com and at WSJ.com. Many funds now provide daily discounts and premiums, which can be viewed on the **Closed-End Fund Association's free website**. You also can call a fund to find out its most recent discount or premium or visit its website, if it has one. Historical discount/premium information is available on the Closed-End Fund Association's site.

Individuals who buy closed-end funds at deep discounts can earn higher returns than they would with an otherwise equivalent mutual fund. Because discounts are “mean reverting,” you can expect abnormally deep discounts to narrow eventually. On rare occasions, investors may even enjoy a windfall profit.

Of course, picking funds solely on the basis of the deepest discounts can lead you to some losers. A closed-end fund also must be analyzed as a mutual fund, considering factors such as its management, performance, volatility and expenses. For starters, compare a fund’s discount with its expense ratio by dividing the former by the latter. A fund at a 15% discount with a 1% expense ratio has a ratio of discount-to-expenses equal to 15 (15%/1%). The higher the number the better, but look for a value of at least 10. This ratio allows you to compare closed-end funds in a given category with different expense ratios and discounts.

Deep Discount Strategies

Discounts leverage up your returns if you buy a fund at a deeper-than-average markdown that subsequently does well. Your return is enhanced from the narrowing of the discount. Here are four strategies that seasoned closed-end fund investors use in their quest for value.

- ***Reaching for value in bear markets and corrections:*** Oversold markets are great bargain-hunting times.
- ***Shopping for year-end bargains:*** During November and December, investors lock in tax losses on funds that have not fared well. This can lead to compelling markdowns.
- ***Milking a cash cow*:** A fund purchased at a sufficient markdown can greatly enhance your long-term return, even if the discount doesn’t narrow. You might pay 80 cents on the dollar, yet you collect income and capital gains distributions from a portfolio worth 100 cents. The deeper the discount and the higher the distribution rate, the better. Closed-end bond funds at deep discounts are particularly attractive because they offer higher yields.
- ***Searching for special situations*:** A unique development such as new management, conversion to an open-end fund or total liquidation could eliminate a deep discount. Special situations may not pan out, so only buy funds you like anyway.

Managed Distributions

To succeed with closed-end funds, you need to understand some of their unique characteristics.

A growing number of funds offer a so-called managed-distribution policy, promising to pay shareholders a fixed periodic minimum. Unlike open-end funds, which can distribute gains only once a year, some closed-end funds are able to distribute capital gains quarterly with prior approval from the U.S. Securities and Exchange Commission (SEC).

Funds that follow a managed-distribution policy are not tax-efficient and are, therefore, most suitable for tax-deferred accounts unless you're income oriented. A fund's desire to differentiate itself from competitors and attempt to narrow its discount are two primary reasons for the increasing popularity of these proactive plans, particularly those with 10% annual payout targets.

The plan isn't always successful because the manager may have problems during difficult markets. The policy can constrain a fund's flexibility; for example, managers may be forced to sell investments they otherwise wouldn't. Funds with managed-distribution policies may hold more cash and bonds than those that do not have the policy. A managed payment may not work as well for country funds as their domestic equity counterparts because the former can be extremely volatile. In addition, country fund investors tend to be growth-oriented and might not be that interested in regular payments.

Share Repurchases

A number of discounted funds have instituted share repurchase programs. Repurchasing shares is an anti-dilutive procedure that results in an immediate increase in net asset value per share for the remaining shares. In addition, share repurchases help enhance the liquidity of a fund's stock and may reduce the discount. A significant share repurchase program is a good signal that management is looking out for its shareholders' best interests. Some funds are reluctant to buy back shares because it may lead to an increase in the expense ratio as assets decline. Most of the funds that have buyback programs will repurchase shares when the discount reaches or exceeds some predetermined point, such as 10%.

A management must abide by the extensive SEC regulations governing corporate buybacks. On any trading day, a company cannot repurchase a quantity of shares amounting to more than 25% of that stock's average daily trading volume over the past four weeks. Qualified block purchases are an exception. These often are privately negotiated trades with a large shareholder that do not take place on the stock exchange. A repurchase program also must conform to a fund's insider trading policy. After a fund has determined the percentage (or dollar amount) of outstanding stock to be repurchased and the duration of the buyback, a press release containing the details is issued. Normally, there is a public relations effort associated with a repurchase program.

Dividend Reinvestment

When a closed-end fund trades at a discount, the reinvestment price will be the market price rather than the net asset value, as with a mutual fund. You benefit by reinvesting at the discounted price because you receive more shares than if you had reinvested at net asset value. However, dividend reinvestment probably is not as widely used with closed-end funds as it is with mutual funds because many individuals use closed-end funds more as trading vehicles—buying and selling based on fluctuating discounts and premiums. Of the total closed-end fund assets, closed-end funds account for roughly 60% of total assets, although this percentage has been declining for many years.

The following three general types of dividend reinvestment plans are used, although nuances are evident among individual plans:

- ***Open-market purchased shares.*** An agent buys shares in the open market to fill reinvestment orders. Dilution is avoided since additional shares are not issued. The purchase of shares can serve as short-term support for the stock.
- ***Newly issued shares or reissued treasury stock.*** This approach can be dilutive when a fund trades at a discount because shares outstanding will increase. However, investors who take shares benefit from getting them at a discount, which offsets the dilution.
- ***Hybrid plan.*** Many plans use both repurchased and new shares.

Should you reinvest or take cash? This depends on factors such as your need for cash and your time horizon. Reinvestment can be beneficial if you plan on holding a fund for many years. But those with shorter horizons may find it simpler to take the cash.

Leveraged Funds

Closed-end funds have the ability to use leverage as part of their investment strategy. The use of leverage by a closed-end fund can allow it to achieve higher long-term returns, but also increases risk and the likelihood of share price volatility.

Closed-end fund leverage can be classified as either structural leverage or portfolio leverage. The majority of closed-end funds use structural leverage. Structural leverage affects the closed-end fund’s capital structure by increasing the fund’s portfolio assets. Types of closed-end fund structural leverage include borrowings and issuing debt and preferred shares, with little more than half of structural leverage being preferred stock. However, only about 10% of all closed-end fund total assets are funded by proceeds from preferred shares, with bond funds accounting for roughly 90% of outstanding preferred share assets, according to the Investment Company Institute (ICI). The proceeds from a preferred offering or from a loan would be invested in additional bonds or stock, depending on the fund type.

Portfolio leverage results from particular types of portfolio investments, including certain types of derivatives, reverse repurchase agreements, tender option bonds and other investments or types of transactions.

Closed-end funds are subject to asset coverage requirements if they issue debt or preferred shares. Currently, for each $1.00 of debt issued, the fund must have $3.00 of assets immediately after issuance and at the time of dividend declarations (commonly referred to as 33% leverage). Similarly, for each $1.00 of preferred stock issued, the fund must have $2.00 of assets immediately after issuance and at the time of dividend declaration dates (commonly referred to as 50% leverage).

Although leverage can be highly effective in a prolonged bull market, losses are magnified in a bear market. In addition, the preferred dividend obligation would be burdensome during an extended period of low equity returns. Equity fund managers must be prepared to reduce stock market exposure when troubled times are anticipated.

Rights Offerings

With an open-end fund, good performance attracts new investors who increase the fund's asset base and the total management fees that are earned. Not so with a closed-end fund. Instead, management occasionally may have a rights offering.

How do rights offerings work? Basically, subscription rights are issued to shareholders of record, giving them the option to buy up to a given number of new shares at a specified price, usually at a discount to the lower of the fund's net asset value or its market price. For example, the discount might be 5% applied to the lower of the fund's net asset value at the expiration of the offering or the average market price during the last few days before the rights expire.

You receive one right for each share you own. Several rights are needed to acquire each new share. For instance, you may need three rights for each share you purchase. Thus, a holder of 300 shares could subscribe to 100 new ones. Shareholders have a few weeks to exercise their options. Offerings are either ***transferable*** or ***non-transferable***. Transferable rights can be sold separately during the "ex-rights" period if you choose not to exercise them; the more common non-transferable rights cannot.

Rights offerings typically dilute net asset value because new shares often are issued at a price below net asset value. The dilution depends mainly on the size of the discount of the subscription price to net asset value and the number of new shares to be added. However, participating shareholders maintain their proportional ownership interest.

To avoid diluting your position if you don't want to add to your investment, make sure you do one of the following:

- If the rights are ***transferable***, sell them on the open market as soon as possible, because the stock typically declines during the offering period. By doing this, you will lock in the value of your rights.
- If the rights are ***non-transferable***, exercise them and simultaneously sell the number of shares you purchased at the higher market price, locking in an arbitrage profit.

Finally, you may want to sell all of your shares before the ex-rights date if you are not enthusiastic about the investment outlook anyway. You can always buy back later if the price is right.

Rights offerings can create buying opportunities for prospective shareholders. If the offering exerts sufficient downward price pressure it can result in an attractive discount for the vigilant bargain hunter. But buy only if you like the fund and feel it has good long-term potential since the shares could remain depressed for some time.

Shareholder Activism

There are times when closed-end funds go through open-endings and liquidations. Such events can lead to windfall gains for those who bought shares at deep discounts because they are able to realize net asset value—or close to it—for their investment.

Deeply discounted funds may entice institutional investors searching for bargains. Prominent activists try to acquire a big stake in a fund and encourage other shareholders to help pressure management to narrow the discount. If successful, the activists pocket their gains and move on to the next target.

You can never be sure that a fund will open-end, or if it does, when it might occur. Activists have fought lengthy battles. The shareholders often are an obstacle, particularly if there are many small investors who tend to be relatively apathetic toward corporate actions. Two good indicators of whether or not a fund will open-end are the size of its discount and its shareholder composition. In the typical case, the discount is at least 15% and activist institutions hold large blocks of the fund's stock, normally 20% or more of the outstanding shares.

An open-ending can hurt loyal, long-term investors because assets tumble as investors rush to cash out at net asset value. The manager is forced to sell stocks and distribute capital gains. It's not uncommon for a fund to lose a third or more of its assets. Expense ratios increase with a smaller asset base. And a fund may be forced to change its style. Management companies generally are opposed to open-ending because their fees decline if assets go out the door. To preserve their closed-end structure, more funds have instituted managed-distribution policies, share repurchase programs and other strategies aimed at narrowing a deep discount.

Getting Information

Morningstar.com is a good place to start online when researching closed-end funds. Additional websites devoted to closed-end funds include **CEF Connect** and the **Closed-End Fund Association (CEFA)**. Additionally, most funds have their own website.

A Shopping Guide

Closed-end funds may offer opportunities for disciplined investors who understand what they are buying. By taking advantage of attractive discounts, you may be able to earn a higher return on your investment than the fund itself generates on a net asset value basis. Here are eight key points to keep in mind when shopping for discounts.

- Know when to bargain hunt. Bear markets, corrections and the tax-selling season during November and December provide excellent opportunities.
- Closed-end funds can be used as core holdings to profitably augment a mutual fund portfolio, substituting them for the latter when compelling discounts exist.
- Deeply discounted funds aren't always a steal. They may be saddled with excessive expenses, bad management or other problems.
- Avoid funds selling at premiums. Like outrageously high price-earnings ratios, excessive premiums can quickly deflate.
- Know whether or not a fund is leveraged and recognize the added risk if it is. Good management is essential with a leveraged fund.
- Closed-end funds are not necessarily long-term investments. It often pays to realize a profit when a fund's discount narrows appreciably or turns to a premium.
- Limit orders may enable you to lock in a favorable price. Saving a fraction of a point on each trade can add up, especially with larger orders.

This article was adapted from one written by Albert J. Fredman for the January 2000 issue of the AAII Journal. *At the time, Fredman was a professor at California State University, Fullerton. He is also co-author (with Russ Wiles) of the book "How Mutual Funds Work."*