BUSINESSWEEK INVESTOR

Capitalizing On the Yearend Dash

As tax-savvy investors race to dump dogs, here's how to cash in

Wall Street is in the throes of the tax-loss season, when investors dump shares to create losses that will help them shave their tax bills next spring. With the market in negative territory and thousands of issues in the red, there are plenty of stocks to deep-six--depressing prices further.

This selling can, however, create some great opportunities, especially in the little-known market for closed-end funds. For a number of reasons, these funds often tend to trade at a price that's a discount to the value of their holdings. At this point in the year, such discounts are usually at their widest, and renewed buying in the new year traditionally narrows that gap. The whole cycle, says Thomas Herzfeld, whose Miami investment company specializes in closed-end funds, "is as predictable as Christmas." Savvy investors like Herzfeld look to pick off some plums ripe for rebound.

Good bets abound in many sorts of closed-end equity funds, from bread-and-butter large-cap equity portfolios to those that zoom in on foreign markets like Korea or Eastern Europe, or industry sectors such as health care or high technology (table). There are discounts to be had in closed-end bond funds, too, but they're not as compelling. That's because the fixed-income markets have done well over the past year, except for the credit-sensitive high-yield bond and emerging-markets bond funds.

First, a few basics. Like mutual funds, closed-ends hold securities whose prices fluctuate with the market. So does their net asset values (NAV). Closed-ends differ from mutual funds in that they have a fixed number of shares, and those shares trade on the stock exchanges (a few on Nasdaq). These markets are not that efficient, and the price of a share on the Big Board is usually different from the NAV of the fund. If the market price is above the NAV, the fund is said to trade at a premium. If it's below, the fund is at a discount.

Buy a fund that sells at a 20% discount to NAV, and you get $1 worth of stocks for 80 cents. You also get two ways to make money: One, the value of the underlying investment goes up, and two, the discount narrows or even closes. Best yet is to choose funds that have a chance of doing both. Want to make a bet on the beat-up Internet sector? The LCM Internet Growth Fund, for example, which has a $7 market price, trades at a 22% discount to NAV. The stocks in a regular Internet mutual fund are just as beaten up, but you pay 100 cents on the dollar.

Plain-vanilla equity funds offer some good investment plays today. Kevin McNally, a Salomon Smith Barney analyst, notes that 43 of 46 closed-end domestic equity funds have outperformed the Standard & Poor's 500-stock index (through Nov. 10), when measured by market price or NAV gains. Still, the funds now sell at an average 9% discount, though some are as wide as 35%.

Among such funds are Adams Express (ADX), a U.S. equity fund, with a 7.4% discount, recommended by George Cole Scott, president of Closed-End Fund Advisors in Richmond, Va. Adams Express, which has been around since 1929, owns a passel of large-cap stocks like Corning (GLW), General Electric (GE), and Cisco Systems (CSCO). The other attraction is the rock-bottom expense ratio of 0.34%. Royce Value Trust (RVT), another general equity fund, sports a discount of 13%, even though its NAV return so far this year has been an impressive 10.4%. Manager Charles Royce's specialty is small-cap value stocks.

In the red-hot health-care sector, take a look at H&Q Healthcare Investors (HQH), selling at 30, a discount of nearly 25%. That's an especially large break considering the fund's stellar record. The portfolio gained 66% so far this year, and the share price, 61%. Another star is INVESCO Global Health Sciences Fund (XGHSX), up 48% this year, trading at an 11.4% discount.

The discounts also afford you a chance to invest with the same portfolio or in the same investment program as a well-regarded mutual fund at a considerable savings. John Schroer, who runs INVESCO Global Health, also manages a similar mutual fund, INVESCO Health Sciences (FHLSX), which is up just 23% and charges investors 0.64% more in expenses. John Hancock Bank & Thrift Opportunity Fund, at an 18% discount, is similar to John Hancock Regional Bank, an open-end fund. In addition, the cost of buying a closed-end is a brokerage commission. The Hancock mutual fund carries sales charges as high as 5%.

The closed-end format can work well with bonds. When a bond fund trades at a discount, the yield is amplified. Take Franklin Multi-Income Trust (FMI), which sports an annual dividend of 67 cents. That's a 6.75% yield on the fund's $9.92 NAV. But the fund trades at a 17.5% discount, so the yield is 8.18%.

Other windfall gains could accrue to the closed-end investor. When the discount persists, some fund-management companies buy back shares. That reduces the share count, which usually narrows the discount. For example, Mentor Income Fund (MRF), which invests in mortgage-backed securities and corporate bonds, adopted a provision in October for a tender offer of 20% of its shares. The discount, as high as 22% earlier this year, is now less than 9%. The discount on Dresdner RCM Global Strategic Income Fund (DRGTX), near 20% earlier this year, narrowed to 4% in October after Phillip Goldstein, president of Kimball and Winthrop, a Pleasantville (N.Y.) investment firm, petitioned management to convert it to a conventional mutual fund. When a closed-end becomes a mutual fund, the discount disappears because investors can redeem the shares directly from the fund company; they don't have to sell them on the open market.

A large discount can make a closed-end fund alluring, but buying just for the discount is foolhardy. Funds that have had a large discount for a long period of time could be problematic. That's why fund investor Scott avoids such deeply discounted funds as Equus II (EQS), in which the average discount for this year is 37%. And sometimes discounts persist just because the closed-end market is not that efficient. Gregg Wolper, senior analyst at Morningstar, points to the Irish Investment Fund (IRL). It's one of the few foreign closed-ends with positive NAV returns this year, yet the discount has not been less than 22%. "It's hard to know why," says Wolper. One theory: Closed-end funds now have competition from new sorts of exchange-traded funds such as iShares. Because of a different legal structure, these newer funds trade at or near their NAVs. So some analysts think investors are opting for iShares since they'll always be able to sell out at or near NAV. Still, in a skittish market, buying $1 worth of assets for 80 cents is not a bad deal.

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