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Buying Quality at a Discount: Closed-End Funds

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Most people do not realize that closed-end funds can be attractive investment vehicles for advisors who wish to diversify their clients' holdings. There are over 677 closed-end funds and exchange traded funds (ETFs) trading on US national exchanges. CEFs are best known for leveraged bond funds and single-country/regional and emerging market funds, but may also be found in such sectors as health care, energy, utilities, corporate bond funds, multi-sector funds and convertible bond funds. CEFs work very well within fee-based accounts because they are highly liquid, unlike mutual funds.

At its IPO, CEFs can create quite a "splash" in the marketplace, but once capitalized, few brokers pay much attention to them, as the only way to increase portfolio size (and management fees) is for the fund to generate positive returns. Since capitalization of a CEF is fixed, the number of outstanding shares is also fixed. This varies greatly from open-end funds which are almost always looking for new money/investors and is always spending millions of dollars a year to advertise in its solicitation of new business. Readers should understand that a closed-end fund is **not** a mutual fund that is closed to new investors. Rather, closed-end funds are the forefathers of open-end or mutual funds. Some CEFs date back to the 1920s, having survived the 1929 Crash and Great Depression. Before we can fully understand CEFs and how they can help accomplish one's investment goals, it is necessary to understand their characteristics.

CLOSED-END FUNDS CAN INCREASE RETURN AND REDUCE INVESTMENT RISK, ESPECIALLY WHEN INVESTING OUTSIDE THE UNITED STATES

Advantages of CEFs

Limited Number of Shares. CEFs have a limited number of outstanding shares because of their fixed capitalization. Open-end funds are constantly redeeming and issuing new shares. (Think of a CEF as a stock. The only way for Coke to increase the number of shares outstanding is through splits, warrants, rights offerings or secondary offerings. The only way to reduce the number of shares is to buy back shares.)

Trading. Since the number of shares within a CEF is fixed, this type of fund trades in the secondary market on an exchange, whereas open-end funds issue or redeem their own shares. A CEF therefore will trade above or below its net asset value (NAV), i.e., said to be at a premium when above NAV or at a discount when below NAV. Because of this, investors can buy and sell at known prices. Investors may also utilize limit and buy-stop and sell-stop orders with CEFs. Institutions can buy and sell ETFs intraday, if they wish. This gives professionals more control to manage client's portfolios and is considered a major advantage of these funds.

Lower Expenses. CEFs usually have lower expense ratios, in part because they do not have 12b-1 or other hidden fees, which open-end funds may levy in order to pay for marketing the fund. This keeps the costs down for better returns.

Inefficient Market. Information about CEFs is not always available, which often creates a pricing inefficiency among closed-end funds. This can allow professional managers to take advantage of the inefficiencies for clients. (Many professionals agree that the serious money on Wall Street is made when inefficiency is found.)

No Inopportune Cash Flows. CEF portfolio managers do not need to worry about ill-timed redemptions. Investors still tend to add money to those funds whose NAV is rising and withdraw when it is performing poorly. This may force an open-end fund manager to buy when the value of a security is rising or sell when the value of a security is falling – something Investing 101 teaches us NOT to do. This is one of the primary reasons we believe CEFs outperform the open-end counterparts in the long term.

Closed-end funds provide investors with greater flexibility. A closed-end fund portfolio manager is never under pressure to sell shares in order to raise cash for redemptions. A closed-end fund does not redeem its shares; they are tradely freely on the stock exchanges, exactly like stocks. In a weak market, an open-end/mutual fund manager may be often forced to sell

shares at low prices in order to raise cash for redemptions. A closed-end fund manager can also buy into relatively illiquid foreign markets because the fund is free of the redemption pressures that could force it to liquidate shares in an unfavorable environment.

Higher Volatility. CEFs tend to be more volatile than mutual funds. While the NAV volatility should be the same for both fund types, the price volatility of a CEF tends to be higher because of its market price and the narrowing/widening of the discount. This can help to create great buying or selling opportunities.

Leverage. A CEF will sometimes borrow assets at a lower rate and then invest those assets, but very few funds use this form of leverage. Most of the income generated in CEFs are leveraged through debt or through the issuance of preferred shares in order to enhance the fund's yield. Additional yield can come at the expense of higher volatility. A leveraged fund should outperform the un-leveraged fund in a bull market, though it may underperform in a bear market.

Liquidity. Some CEFs are small in size, and their shares do not trade often or in great sizes. This can affect the CEF's market price. Utilizing not-held orders and patient buying/selling can help professionals invest wisely in funds that many may overlook.

Prospectus. CEFs issue a prospectus on the IPO. Afterwards, they publish an annual and semi-annual report. Some CEFs provide quarterly and monthly updates to shareholders, and most have websites.

The Risks of CEFs

Premium Risk. When a CEF trades at a premium or narrow discount, there is always the risk that the premium could become a discount or that the discount could widen. This can occur with no correlation to the performance of the manager and his portfolio.

Transactional Cost Risk. As mentioned in the section above, CEFs are bought and sold through a broker on an exchange, just as you would buy any stock and a commission is paid. This means that it can easily become cost-ineffective to trade closed-end funds for small amounts of money. This would make funding an IRA or a 529 Plan on a monthly basis totally cost-ineffective. In this case, mutual funds are an important option for investors. CEFs and mutual funds are not interchangeable but rather, they complement each other.

Spread Risk. Because CEFs are bought and sold independent of the fund manager or fund management company, they are bought by those who want the fund and sold by those who no longer wish to hold the fund. In true capitalist fashion, the buyers and sellers meet in the free market at the current market price. If there is little stock available, then the difference between the bidding and asking price can occasionally be as high as 5%-15% of the value of the fund.

IPO Risk. Because many closed-end funds tend to trade as discounts of 3%-12%, it usually does not make sense to buy a fund on an IPO. You may be able to purchase the same fund at a discount if you wait for the market to settle after the IPO.

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How Does the Discount/Premium Work?

Closed-end funds generally trade at a discount to their net asset value (NAV). For example, if the total market value of all securities in a closed-end fund was $100 million and there were 10 million shares outstanding, the NAV would be $10 per share. Historically, most closed-end funds have traded at a discount to NAV. Therefore; it is often possible to purchase shares of the fund for less than $10. Careful and prudent investors are continually trying to purchase one dollar of assets for less than one dollar.

On the other hand, open-end funds trade at their NAV since investors can redeem their shares at NAV on demand. When an investor purchases an open-end fund, he receives exactly a dollar's worth of market value for his one-dollar investment.

Where the Money Is Made in CEFs

Investors can profit in two ways in a closed-end fund. First, by identifying a fund that has the potential to increase in value or narrow its discount, providing an additional profit on the share price. For example, a closed-end fund with NAV of $10 is purchased at a 10% discount, or $9 per share. As the NAV moves up to $11 (a 10% gain), it is likely that the discount will decrease from 10%, let's say, to 6%. With an NAV of $11 and a discount of 6%, the price will be 10 3/8. Hence, the NAV has gained 10%, and the price has appreciated 15%. While this does not always happen, investors must realize that performance can be good without a narrowing discount.

Secondly, funds that trade at a discount can use one of two techniques to benefit the shareholders by eliminating the discount. The fund can either make a tender offer at NAV or the fund's shareholders can vote to open-end the fund. Either event will cause share prices to equal the NAV.

The best way I have found of explaining the variance of the market price/performance of a fund and NAV (what it is actually worth) involves the understanding that in our markets the price of a stock or CEF is usually based on valuation. When a stock/CEF is deemed to be worth more than its current market price (usually tied to the performance of the NAV), then there are more buyers and the price rises. The reverse happens when a fund is deemed to be worth les then the current market price. Market price in simple terms is the fund's popularity.

Case for Investing in Foreign Markets

If your portfolio contains only US stocks, you are missing out on about 60% of the world's investment opportunities. A sense of missed opportunity is created when one studies world stock market performance over virtually any period in the last decade. Since 1976, the US percentage of world market capitalization dropped steadily. In 1980, the investor, who participated only in the US market, had access to about half the world's stock market value. The case for global diversification is compelling when you consider that the domestic market represents about 40% of the world market and is decreasing.

Today, a balanced portfolio must be invested in global stock and bond markets in order to enhance long-term market performance. Closed-end funds, purchased at discounts to their NAV, can offer the most accessible mechanism for achieving cross-border diversification for investment portfolios. In order to highlight the international segment of the CEF world and to help advisors realize why the structure of a CEF is a powerful investment tool, we recommend your reading "Interview with Mark Mobius of Franklin Templeton Investment," *The Scott Letter: Closed-End Fund Report,* Febaruary 2003 (http://www.closedendfunds.org/sl0302.html).

Table 1 represents two examples of international CEFs. EMF is a broad based emerging markets fund that invests around the globe, and TRF invest primarily in Russia and eastern

Table 1.
Fund Facts for Templeton Emerging Markets Fund (EMF) and Templeton Russia and East European Fund (TRF)
Data as of May 31, 2003

	EMF	TRF
NAV Total Returns		
YTD	+11.20%	+31.51%
1 Year	-0.99%	+23.37%
3 Year	-2.60%	+20.84%
5 Year	-0.24%	+10.75%
Since Inception (EMF: 1987 /TRF: 1995)	+11.71%	+14.64%
Return Rank Within Category		
EMF - Emerging Market Equity TRF - Non-US Equity	1/3 = 32%	1/75 = 2%

	3-Year	5-Year	3-Year	5-Year
MPT Statistics (NAV)				
Standard Deviation	21.13	27.46	25.50	52.68
Beta	0.90	0.97	0.90	1.62
Sharpe Ratio	-0.25%	-0.13%	0.68%	0.13

	EMF	TRF
Return Statistics		
Number of Years Up	10	5
Number of Years Down	5	2
Best 1 Year	+199.80%	+96.11%
Worst 1 Year	-83.67%	-41.26%

Source: Thompson Financial

Europe. With TRF you take on more risk, but have the opportunity for greater reward.

Analysis of Country Fund Risk. There are many challenges when you invest in foreign markets. You have the same market risk as any investor in the domestic markets, but you also face many other challenges. These include currency risk, political risk, and the likelihood of greater uncertainly and skittish investors.

Currency Risk. When you invest with the US dollar into foreign markets, part of your gain/loss is due to the changes in the valuation of the countries currency in comparison to the performance of the US dollar.

Political Risk. With civil wars, global terrorism and ever-changing political landscapes, it is difficult to know what changes in legislation and political doctrines will have on not only the underlying portfolio (NAV) but the perception/popularity of a fund (market price) Discounts can widen or close very quickly in the foreign funds.

Get Your Clients Diversified

The key to protecting your clients portfolios for market downturns is to have them diversified across many different asset classes as well as understanding that the vehicle (fund, stock, etc.) that you use is the best option for their objective. CEFs offer the best way to invest abroad with professional management. They also allow great opportunities for REIT and domestic stock investing. As with any investment, it is important to have the infrastructure and accountability in place to make sure that managers are serving the needs of your clients. The volatility of many of these funds over 1, 3, and 5 years adds a layer of deep diversity into an overall portfolio, however because of the built-in cyclical nature of these funds, investors and financial professionals should understand that the "buy and hold forever" mindset is not always the most prudent in the international markets.

Last year we started tracking the performance of our International Opportunity separately managed accounts of CEFs. We diversified a portfolio typically with 5-15 funds (depending on size of the account). Investing around the globe reduced volatility and maintain diversification (see Table 2).

The foreign markets offer the possibility to hedge portfolios against domestic market declines, and we are currently recommending an asset allocation mix of 15%-30% into the foreign markets for many of our clients. Similar to the diversity found in a portfolio of stocks and bonds, adding international exposure allows investors to have an overall portfolio with less volatility. Bonds are still at historical lows, and current investments into domestic debt securities should only be done for asset allocation and diversification reasons. When rate rises, the same investors who watched their NASDAQ 100 portfolio erode month after month will wonder how they can lose money in bonds. Meanwhile, there are income opportunities in the foreign markets where there is still room for rates to fall. In layman's terms, since March of 2000, investment professionals have been in much greater need, but have had to work harder and smarter to achieve their clients' goals and objectives. So, why invest in only one market when you can use CEFs and invest in 40 markets? ■

About the Author

John Cole Scott is a Certified Fund Specialist with Closed-End Fund Advisors. A member of The Richmond Association of Business Economist and Business Networking International, John has been quoted in the "Money" section of *USA Today*. Closed-End Fund Advisors is a Richmond-based firm that manages individual accounts on a fully discretionary basis through advisors of choice. Their goal is to structure portfolios that consistently outperform the S&P 500 index, the Lipper indices, while maintaining emphasis on capital preservation.

For those interested in learning more about CEFs, visit their web site at www.closedendfunds.org or the Closed-End Fund Association's web site at www.cefa.com. Closed-End Fund Advisors presently offers a Sub-Advisor and Referral Program (http://www.closedendfunds.org/broker.html) as well as free monthly newsletter on CEFs. Feel free to call (1-800-356-3508) or email John (jcscott@closedendfunds.org) with questions.

Table 2.
Performance of CEFA International Portfolio
(Net Commissions and Fees)

Period	Performance
1 Year (6/30/02 - 6/30/03)	+13.21%
First Quarter 2003	- 1.32%
Second Quarter 2003	+20.76%
YTD 2003	+21.78%

NOTE: Past performance is not indicative of future results.

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