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'Failed' auctions spell opportunity, experts say

Closed-end mutual funds, now volatile, could offer investors underpriced assets

By **David Hoffman**
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Closed-end mutual funds caught in "failed" preferred-securities auctions are making investors nervous, but industry experts and advisers say there are opportunities for those who look beyond the current turbulence.

Troubling investors are the several closed-end funds — specifically, those comprising municipal bonds — that have been party to an un-precedented number of failed auctions for their preferred securities recently.

Auction-rate preferred shares are issued by closed-end funds, which use the proceeds to boost their performance by leveraging their purchases of portfolio securities. The preferred shares, which have become popular among institutional buyers, are intended to provide re-turns comparable to those on short-term instruments, such as the 30-day yield on money market funds. The preferred shares' yields are determined by periodic auctions of the shares.

After one auction failed Jan. 22, several auctions began failing in mid-February as broker-dealers stepped out of the process, said Mariana Bush, a Washington-based analyst of closed-end and exchange traded funds with Wachovia Securities LLC of Richmond, Va.

Until the recent spate of failures, Ms. Bush said, she could not recall a single failed auction in the 20-year history of auction-rate preferred securities.

State regulators in Massachusetts and Ohio have said they are scrutinizing sales of such securities by closed-end funds.

Support for the auctions among brokerage firms has dried up largely as a result of the subprime-mortgage mess, which continues to roil the credit markets, industry experts said.

The failed auctions have resulted in increased volatility, meaning greater variations between the closed-end fund's net asset value and its market price. Closed-end funds, which are listed on an exchange and comprise fixed portfolios of securities, typically trade at a discount or a premium to the net asset value of their underlying stocks or bonds. Academics and market experts still debate the reason for these seemingly irrational price discrepancies.

The recent failed auctions are creating larger discounts, making many closed-end funds a bargain when compared with the value of their holdings.

"People are panicking and dumping closed-end funds because they think they have to, but they don't," Ms. Bush said.

Virtually all the underlying assets in the closed-end funds involved in failed auctions are sound and unaffected by the turmoil, said Anne Kritzmire, managing director of closed-end funds for Chicago-based Nuveen Investments. As a result, she said, long-term individual investors — as opposed to traders and market participants who profit from short-term trading opportunities — may welcome a chance to buy securities at hefty discounts.

Despite forgoing the boost provided by the sale of preferred shares, the affected closed-end funds "don't need to cut dividends and don't need to de-leverage," Ms. Kritzmire said.

Year-to-date through Feb. 20, prominent municipal closed-end funds trading at discounts included the $1.96 billion Nuveen Municipal Value Fund, trading at a 2.62% discount; the $1.52 billion BlackRock MuniYield Insured Fund Inc., from BlackRock Advisors LLC of Wilmington, Del., a unit of BlackRock Inc. of New York, at a 9.1% discount; and the Van Kampen Trust for Investment Grade Municipals, from Van Kampen Investments Inc. of Oakbrook Terrace, Ill., at a 6.71% discount, according to Morningstar Inc. of Chicago.

At a time when investors are seeking income — and finding it hard to come by in a world of low interest rates — the fact that some closed-end funds are paying high dividends and trading at substantial discounts as a result of the turmoil make them attractive, closed-end-fund experts said.

For example, as of Feb. 20, the Nuveen Municipal Value Fund had a trailing 12-month yield of 4.67%, the BlackRock MuniYield Insured Fund Inc. had a yield of 4.75%, and the Van Kampen Trust for Investment Grade Municipals had a yield of 5.14%, according to Morningstar.

By comparison, the yield of the 10-year Treasury as of Feb. 20 was 3.93%, and the 20-year Treasury was 4.63%.

Municipal bond closed-end funds, however, may become even more attractive in about a week, said Thomas Herzfeld, president at closed-end-fund specialist Thomas J. Herzfeld Advisors Inc., a Miami firm with $100 million under management.

"We're looking to buy them back, but not yet," he said. "I think they're going to get cheaper."

It's a good strategy, said George Cole Scott, president of Closed-End Fund Advisors Inc., a Richmond, Va.-based firm with $82 million in assets.

There still could be more fallout from the subprime-mortgage mess which has yet to work its way through the system, he said.

Such fallout could taint all closed-end funds, even those not involved in the failed auctions, Mr. Scott said.

"It's possible one group could affect another in this crazy world," he said.

There is definitely investor "skittishness" concerning all closed-end funds right now that can be traced back both to the failed auctions and the fact that many closed-end funds use leverage to achieve higher yields, Ms. Kritzmire said.

For those investors brave enough, however, the current climate of uncertainty surrounding closed-end funds has resulted in what appear to be some pretty good deals beyond those funds directly affected by failed auctions.

Closed-end funds that look particularly attractive include income-oriented funds that invest in preferred stocks. Their market returns, NAV returns and trailing-12-month yields have been impressive — and many are trading at discounts.

Such equity-oriented income funds "jumped to the head of the closed-end class" in January and haven't given up their lead since, said Tom Roseen, a Denver-based senior analyst with Lipper Inc. of New York.

For example, the $851 million John Hancock Preferred Income III Fund, advised by John Hancock Advisers LLC of Boston, a unit of John Hancock Financial Services Inc., had a market return of 7.67%, an NAV return of 9.62%, a trailing 12-month yield of 7.41%, and was trading at a discount of 6.65%, year-to-date as of Feb. 20, according to Morningstar.

Similarly, the $378.5 million BlackRock Income Trust Inc. had a market return of 7.88%, an NAV return of 6.85%, a trailing 12-month yield of 5.9% and was trading at a discount of 13.39%.

The solid performance of preferred-stock funds surprised Mr. Roseen, who said that about 70% of preferred shares are issued by financial institutions, many of which were directly affected by the subprime-mortgage mess and have seen their common shares slide.

The recent run-up may have been a reaction to the drop in the preferred stocks of financial companies at the end of last year, Ms. Kritzmire said.

To some extent, she said, there was no where for them to go but up.

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Thomas Herzfeld: *Will buy closed-end municipal bond funds if their prices drop more.*