

# Rodney Dangerfield Investing: Closed-End Opportunities

By John Deysher

Compared to closed-end funds, exchange-traded funds (ETFs) are relative newcomers to the investment scene, yet we're reading lots about ETFs, which are mushrooming in popularity, but very little about closed-end funds.

Like the late, great Rodney Dangerfield, closed-end funds still don't get the respect they deserve.

But in the world of value investing, "no respect" can translate into opportunities.

## **The Big Three: Basic Differences**

Most investors are familiar with the basic structure of an open-end mutual fund. These funds register with the SEC under the Investment Company Act of 1940 and issue and redeem shares at net asset value (NAV) on any day the markets are open. The share price reflects the net asset value with no premium or discount and, unless a fund closes, any number of shares may be issued. Shareholders pay a percentage of assets (the expense ratio) for management of the fund, with active managers (most, but not all, mutual funds are actively managed) charging higher expense ratios than passive managers. A distribution of net capital gains and net investment income must be made at least annually.

Closed-end funds are slightly different. A finite pool of capital is raised, there's no continual offering of shares, and trades occur on a stock exchange at a price determined by



the number of buyers and sellers. Excess demand will sometimes cause closed-end funds to trade at a premium to underlying net asset value, while excess supply may cause them to trade at a discount. Most

closed-end funds are also actively managed, charge an expense ratio and make distributions at least annually. Closed-end fund share prices and premiums or discounts are posted weekly in Barron's and in Monday's Wall Street Journal.

Exchange-traded funds represent a hybrid of the open-end and closed-end structure. Like both closed-end and open-end funds, an ETF is a pool of securities with a dedicated purpose—to mimic a particular index or invest in a particular industry or country. ETFs are generally passively managed and tend to have lower fees than mutual funds or closed-end funds. Since ETFs trade on an exchange, shares can be bought and sold throughout the day at net asset value.

[For a complete description of ETFs, see the "Guide to ETFs" in the October 2006 *AAII Journal*, also available at [AAII.com](http://AAII.com) in the AAIL Guides area.]

## **Why No Respect?**

Despite the similarities, mutual funds and ETFs have proven immensely popular, while closed-end funds have never really caught on. In our opinion, there are several reasons why closed-end funds don't get any respect, including:

1) **Lack of sponsorship.** Very few are followed by Wall

**Table 1. Asset Growth of ETFs vs. Closed-End Funds**

	Exchange-Traded Funds			Closed-End Funds		
	Number of Funds	Assets		Number of Funds	Assets	
Total (\$ Bil)		Per Fund Avg (\$ Mil)	Total (\$ Bil)		Per Fund Avg (\$ Mil)	
2006	357	423	1,185	640	300	470
2005	204	296	1,473	634	276	435
2004	151	226	1,497	619	254	410
2003	119	151	1,269	586	214	365
2002	113	102	903	545	159	291
2001	102	83	814	493	141	286
2000	80	66	825	482	143	296
1999	30	34	1,133	512	147	287
1998	29	16	552	493	156	316
1997	19	7	368	488	152	311

Source: The Investment Company Institute.

The underlying portfolio value is declining because of fundamental issues *and* the share price is declining as sellers outnumber buyers on the exchange. The result is often a share price trading at a huge discount to underlying net asset value.

When the Asian crisis hit several years ago, many country funds collapsed. The Japan Equity Fund (JEQ) fell from \$13 a share to \$4, and traded at a discount to net asset value of 20%. The Indonesia Fund (IF) fell from \$13 a share to \$2 and traded at a small discount. The Chile Fund (CH) fell from \$27 a share to \$8 and traded at a discount of 30%. We bought shares of all three in late 2001 and early 2002. All were sold for an average 100% gain in two to three years as fears subsided, investor capital returned and the discounts narrowed. Notice that we bought a basket of these issues to minimize the risk of being exposed to one country.

Not many closed-end funds trade at substantial discounts these days. However, a recent review of Barron's yielded a handful of U.S.-based closed-end funds trading at 13% to 15% discounts (see Table 2). Despite the discounts, these funds are up an average 17% for the last 12 months as of mid-March.

We prefer a 20/20 multi-year low situation—the shares have declined by 20% or more over the last 12 months, the discount to net asset value is 20%

Street research firms or owned by institutions. After a flurry of investment banking activity surrounding an initial or secondary offering, research coverage normally wanes and the shares languish.

2) **Mediocre performance.** Most closed-end funds, despite active management, do little more than match the benchmark index they measure themselves against. Very few outperform their index over many years.

3) **Perpetual discounts.** Closed-end funds normally trade on an exchange at a 10% to 20% discount to the net asset value of the underlying portfolio. During times of distress, a falling share price may cause the discount to widen to 30% to 40%. Alternatively, open-end funds and ETFs typically trade close to the net asset value of the underlying portfolio.

4) **High fees on a captive asset base.** As can be seen from Table 1, the average size of a closed-end fund is only \$470 million, about half the size of the average ETF. Many closed-end funds have less than \$100 million in net assets. That's a small asset base over which to spread their expenses, many of which are fixed, resulting in typically higher expense ratios than open-end funds or ETFs.

5) **Return of capital.** In the interest of attracting investors, many closed-end funds have adopted the posture of paying more in distributions than they earn from realized capital gains and net investment income. When this occurs, the excess distribution is known as a return of capital. The shareholder is taking home the fund's principal, not its profits, which over time will erode the fund's net asset value. For this reason, the "managed distribution" programs that pay a fixed amount each month or quarter have come under greater scrutiny by the SEC, which has stopped approving new managed distribution requests.

So why would a mutual fund portfolio manager such as me be interested in a financial backwater like closed-end funds?

### **No Respect = Opportunities**

Value investors love situations like these because of the opportunities they present. We have found several ways to make money in closed-end funds.

### **Market or Sector Downturns**

When a particular industry or country represented by a closed-end fund comes under pressure, investors often sell the shares in a panic, creating a double-whammy on the downside.

## **Scrutinizing Closed-End Funds**

When examining closed-end funds, look for:

- 1) Low turnover
- 2) A 10-year record or better
- 3) The premium/discount history
- 4) Constant or declining shares outstanding
- 5) No returns of capital or leverage
- 6) High insider ownership
- 7) Activist/dissident presence
- 8) Low expense ratio

or greater, and the shares are making multi-year lows. At that point, further downside is probably limited and we get interested.

### Activist/Dissident Shareholders

As a result of dismal performance over many years, closed-end funds sometimes are vulnerable to changes championed by activist shareholders who have accumulated large positions. Typically, the activists want to eliminate the discount and capture a quick profit, either through conversion to an open-end fund or liquidation.

As might be expected, incumbent managers and boards generally oppose either measure. Conversion to open-end exposes the closed-end fund to redemptions if dismal performance continues, and liquidation returns funds to shareholders immediately. In both cases, assets under management and fees decline.

Over the years many closed-end funds have been liquidated, converted or merged into other funds at net asset value, yielding nice profits to dissidents and their followers. Even the \$1.5 billion Salomon Brothers Fund converted to open end recently under pressure from dissidents.

No one has yet accomplished a hostile takeover, but sometimes activist pressure is enough to push closed-end fund boards in the right direction.

### Leveraged Portfolios

Some closed-end bond and equity

## Finding Value in Closed-End Funds: No Respect = Buying Opportunities

- 1) During market or sector downturns, discounts may widen in funds concentrating on that sector of the market
- 2) Leveraged portfolios can see discounts widen when interest rates turn against them
- 3) Tax-loss selling can cause discounts to widen
- 4) High current income bond funds can see discounts widen when interest rates rise or the economy slows, presenting buying opportunities
- 5) Also: Activist/dissident shareholders may pressure funds to eliminate the discount through open-end conversions or liquidations

funds employ leverage to enhance returns. Typically, they'll borrow 20% to 40% of their asset base at low rates by issuing short-term securities (commercial paper and auction rate preferred stocks are favorites), or tapping a bank credit line. Proceeds are invested in longer-term, higher-yielding stocks or bonds, and the difference (spread) enhances overall returns.

This can be an effective strategy when the spread is positive, but can be problematic if spreads narrow or become negative. This might occur if short-term rates rise or long-term rates fall and the yield curve flattens, as recently occurred. When this happens, net interest income gets squeezed, reducing the amount available for shareholder distributions, and possibly triggering a dividend cut or elimination. If this occurs, shareholders often sell the shares, creating opportunities to buy at significant discounts to net asset value.

drives the price to a significant discount to net asset value, allowing astute investors to acquire shares at favorable prices. Once the selling pressure subsides in the new year, the shares rebound.

Toward year end, I always review the performance of all closed-end funds and zero in on those with the biggest negative performance that might be candidates for tax-loss selling. Issues that make the cut will be subjected to further due diligence scrutiny outlined below.

### High Current Income

Investing in bond closed-end funds can offer some attractive opportunities. When high-yield bond closed-end funds were bottoming in mid-2002 after a multi-year decline, shares could be bought for a yield of 10% to 12%, better than actual high-yield bonds were offering. In most cases, the shares rebounded nicely over the next 12 to 18 months, providing excellent total returns. High-yield bonds now trade near historical highs due to a strong economy and few defaults. But if interest rates rise or the economy slows, some high-yield bonds will come under pressure, spelling opportunity.

### Scrutinizing Closed-End Funds

Generally, we look for the following in closed-end funds:

#### Low Turnover

High turnover generates commissions and taxes. We prefer turnover of

### Tax-Loss Selling

Many holders of closed-end funds that have done poorly in a given year will sell their shares toward year end for tax-loss purposes. This sometimes

**Table 2. A Sampling of Closed-End Funds Trading at a Substantial Discount**

Fund (Ticker)	Recent Discount* (%)	Gain Over Last 12 Mos.* (%)
Foxby Corp (FXX)	14	8
DWS RREEF Real Estate Fund (SRO)	15	30
Western Asset Emerging Debt Fund (ESD)	14	6
Cohen & Steers Select Utility (UTF)	14	29
DWS Global Commodities (GCS)	13	14
Adams Express (ADX)	13	14

\*Source: Barron's.  
Data as of March 12, 2007.

## Closed-End Funds Web Sites

### Closed-End Fund Association

[www.cefa.com](http://www.cefa.com)

Useful information on various categories of closed-end funds, distributions, IPOs (initial public offerings), leverage, rights offerings, and performance.

### Closed-End Fund Forum

[www.closedendfundforum.com](http://www.closedendfundforum.com)

Now 10 years old, this site offers a wealth of fund statistics, industry reports and information on events, interviews & conferences.

### QuantumOnline

[www.quantumonline.com](http://www.quantumonline.com)

Although this site requires registration, it won't bother you with unwanted spam. As an income investing site, it includes multiple lists of closed-end funds, REITs (real estate investment trusts), master-limited partnerships, ETFs, royalty trusts, business development companies and other ideas.

25% to 30% or less per year, which implies a holding period of at least three to four years.

### 10-Year Record or Better

This is long enough to see how a fund does throughout the cycle. We see how the NAV performance compares to the benchmark, and we prefer funds that at least match their benchmark. Market price performance is of less interest, since portfolio managers can't control the premium or discounts, but they can influence the net asset value through astute securities analysis and portfolio management.

### Premium/Discount History

We'll look at how big the premiums or discounts became over a 10-year period. A significant discount alone is no reason to buy a closed-end fund. But if we like everything else, we'd rather buy when the discount is at its widest. Conversely, when selling, we'd rather sell when the premium is at its widest. Knowing the historical fluctuations in discounts and premiums will help you do this.

Never buy an initial public offering (IPO) or secondary offering, which typically come near the top of the market.

### Constant or Declining Shares Outstanding

We generally aren't excited by closed-end fund capital raises via rights offerings or secondaries. We prefer smaller asset bases to larger asset bases, which can sometimes lead to style drift or market-cap creep.

A few funds have actually repurchased shares in recent years which, if done properly at less than net asset value, can be accretive to shareholders, increasing the net asset value per share.

### No Returns of Capital or Leverage

We do not want a fund returning principal to us, or a fund speculating through the use of leverage. If we want the benefit of leverage, we'll buy the shares in a margin account. We'll borrow the money, not the fund.

### High Insider Ownership

All closed-end funds file proxies in conjunction with their annual meetings

showing insider ownership. The higher the ownership, the better.

### Activist/Dissident Presence

Proxies may also show the presence of activist shareholders. Under the 5% owner section, look for those who've filed a Form 13D with the SEC. This indicates the filer is dissatisfied with how the fund is being managed and may be willing to take hostile actions to remedy the situation.

A Form 13G filing is also worth noting, since it also indicates at least a 5% ownership position.

### Low Expense Ratio

We prefer a low expense ratio, ideally under 1.5% for equity funds and under 1% for bond or hybrid funds.

### Building a Position

Once we find an attractive situation, we'll normally start buying, slowly at first as we decipher how the shares trade. We'll use limit orders when necessary and attempt to build our position over time without moving the market.

### Conclusion

Astute investors can find pay dirt in the sleepy corner of the investment world called closed-end funds. There are riches in these niches, but you need to do your homework.

Patience is required, and you should be familiar with past performance and expense ratios, portfolio manager tenure, history of discount/premium fluctuations, presence of activists and other factors. Building a diversified portfolio is critical to limiting risk, and adept timing is important to maximizing reward.

At least a few closed-end funds will come under pressure in future market or segment downturns, and knowing what to look for can generate some attractive returns for the intelligent investor.

Happy hunting. ▲

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