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Investing in Closed-End Funds

Opportunities and Challenges in a Unique Market

By Baird's Private Wealth Management Research

Closed-end funds are among the oldest investment vehicles. It has been almost 120 years since the first closed-end fund was formed in the United States. Yet despite this long history, closed-end funds are often overlooked by investors in favor of mutual funds and exchange-traded funds.

Closed-end funds offer some unique characteristics not available to those who invest in mutual funds or ETFs. This paper provides an overview of the opportunities and challenges associated with closed-end funds, along with some guidance as to how they may be utilized as part of a diversified portfolio.

Closed-End Funds vs. Mutual Funds and ETFs

To gain a better understanding of the way closed-end funds work, it is helpful to consider the characteristics that distinguish them from mutual funds and ETFs.

CLOSED-END FUNDS AT A GLANCE:

Potential Opportunities	Potential Challenges
Discount to net asset value	Premium to net asset value
Investment income	Volatility from leverage
Access to illiquid markets	Return-of-capital
Professional management	Market liquidity

Table 1 illustrates some of the key differences between these product structures. These fundamental differences provide the basis for the opportunities and challenges associated with closed-end funds.

TABLE 1:

	Closed-End Funds	Mutual Funds	ETFs
Approximate Number of Funds	600	7,000	1,200
Total Assets*	$265 billion	$13 trillion	$1.3 trillion
Primary Issuance	Initial public offering	Net asset value	Net asset value
Secondary Trading	Exchange (intraday)	End of day	Exchange (intraday)
Share Price	Premium/Discount	Net asset value	Typically near net asset value
Leverage	Yes	Limited	Varies
Active/Passive	Active	Active and passive	Mostly passive
Transparency	Semi-annual	Semi-annual	Daily

*Data as of 12/31/2012, from 2013 Investment Company Fact Book.

Potential Opportunities With Closed-End Funds

Discounts to Net Asset Value. Perhaps the most well-known characteristic of closed-end funds is that they can trade at a discount or premium to net asset value. For example, a closed-end fund trading at a 15% discount to net asset value provides investors with the opportunity to buy $1 of assets for $0.85.

Discounts or premiums within the broad closed-end market tend to rise and fall over the business cycle. Closed-end fund discounts typically reach their widest margins during turbulent markets accompanied by extreme investor pessimism. Discounts or premiums on individual closed-end funds are driven by a variety of factors and can vary substantially over time.

In addition to the absolute discount, it is important to also consider where a discount lies relative to historical averages. By reviewing average discounts or premiums over time, one can get a feel for the "normal" level of a particular closed-end fund. For example, a fund trading at a 10% discount may be *relatively expensive* if it has typically traded at a 20% discount.

Investment Income. Investors often turn to closed-end funds for additional portfolio income. Closed-end funds that distribute regular payments can potentially provide a source of income for shareholders, which may be especially attractive in low-yield environments. Closed-end funds with "managed distribution policies" commit to making fixed payments (by dollar amount or as a percentage of assets) on a regular basis.

Many equity closed-end funds utilize income-producing strategies that are difficult to replicate using open-end mutual funds. Fixed income closed-end funds often use leverage to amplify the amount of income they are able to receive from a portfolio of bonds. For example, a municipal bond fund with 30% leverage is able to gather income from approximately $130 worth of bonds for each $100 of net assets.

Illustration

Suppose an investor buys a portfolio of bonds yielding 6% with a net asset value of $100 and a market price of $85.

Coupon = $6
Net asset value = $100
Price of closed-end fund = $85
Yield $6/$85 = 7.1%

By purchasing the closed-end fund at a 15% discount, the investor was able to generate a higher percentage yield beyond that available from the underlying securities alone.

Investors can also benefit from implicit leverage, which is obtained by investing in closed-end funds selling at a discount. As illustrated in the sidebar, the impact on yield is the same as if the closed-end fund were applying actual leverage, except that the leverage resulting from a discount to net asset value is achieved free of interest expense.

Access to Illiquid Markets.
The closed-end structure provides managers with a relatively stable pool of capital, allowing them to invest in more illiquid markets without having to worry about potential shareholder redemptions. This feature gives closed-end fund managers greater control over their portfolios and allows them to invest in some market segments that may be less accessible for open-end mutual funds. The closed-end structure also allows portfolio managers to maintain a long-term mindset and minimizes the amount of cash required to meet shareholder redemptions.

Professional Management.
Closed-end fund investors can access some of the most well-known portfolio managers and investment management firms. Many firms choose the closed-end structure for strategies they would prefer to isolate from the effects of shareholder-driven cash flows.

As with actively managed mutual funds, the quality of the management team is of paramount importance when evaluating closed-end funds. Net asset value returns provide an indication of how successful a manager has been over historical time periods.

Potential Challenges Related to Closed-End Funds

Premiums to Net Asset Value.
Just as closed-end funds often trade at discounts to net asset value, they can also trade at premiums when investor demand pushes prices above net asset value. When buying a closed-end fund trading at a 15% premium, one is forced to pay $1.15 for $1 of net assets.

Investors have been known to favor closed-end funds with high distribution rates, sometimes pushing their prices substantially above net asset value. Additionally, a fund typically trades at a premium near its initial public offering date. One must exercise caution when considering funds priced at substantial premiums, since prices may decline without any corresponding loss in net asset value should investor sentiment turn against them.

In some cases, it may be preferable to own a well-managed closed-end fund trading at a slight premium rather than a poorly managed fund trading at a discount. As a general rule, investors are better off avoiding closed-end funds priced at substantial premiums above net asset value.

Volatility From Leverage.
While leverage is the source of some beneficial characteristics for closed-end funds, it is important to recognize that it typically comes with

additional volatility. For example, a bond fund with 30% leverage is exposed to the capital gain or loss from $130 worth of bonds for every $100 invested. As a result, the magnitude of gains and losses may be greater for bond funds that utilize leverage. Some leveraged closed-end bond funds are exposed to even greater risk during periods of rising interest rates, which often increase the cost of leverage, although they may use interest rate derivatives to hedge some of that risk.

Closed-end funds can create leverage by raising money in order to purchase additional assets in accordance with the fund's investment strategy. Most fixed income closed-end funds utilize leverage as a means for enhancing yields. Some equity closed-end funds use leverage to attempt to enhance the yield of the fund, or to increase their asset base without a secondary offering.

Return-of-Capital.
It is important to consider not just the size of distribution payments, but also the source of those distributions and whether the current distribution rate is sustainable given performance and market expectations.

Distribution payments are always composed of some or all of the following three components: income, realized capital gains, and return-of-capital. The final component, return-of-capital, represents the portion of a distribution payment that comes from principal or unrealized capital gains.

There are some cases where a certain amount of return-of-capital may be acceptable, such as when a fund is priced at a substantial discount to net asset value. Consider, for instance, an investor who recently purchased a closed-end fund at a 20% discount to net asset value. In this case, receiving a $1 return-of-capital for every $0.80 invested may be beneficial for shareholders. On the other hand, investors should be particularly mindful of return-of-capital when considering funds that are priced at a premium above net asset value.

Note that return-of-capital is not taxable upon its receipt. Instead, the cost basis of a closed-end fund is reduced by the amount of return-of-capital so that potential capital gains may be deferred until the shares are sold.

Illustration

Return-of-capital has a destructive effect on a closed-end fund's net asset value when the total distribution rate (as % of net asset value) exceeds long-term income and capital appreciation.

Consider a closed-end fund that has had a trailing **12-month net asset value return of 10%** and makes regular payments, including return-of-capital:

> **Distribution Rate of 11%** = Destructive. Distributions have exceeded income and capital appreciation.
>
> **Distribution Rate of 9%** = Non-destructive. Income and capital appreciation have adequately covered the distribution payments.

Over extended periods of time, the reliance upon destructive return-of-capital can result in decreased growth potential or the erosion of net asset value.

Market Liquidity. By looking at the typical trading volume and bid-ask spreads for a closed-end fund, investors can get a feel for how difficult it would be to enter or exit a position without causing a detrimental price movement. Trading volumes can vary significantly between closed-end funds, but tend to be rather low compared to most stocks and ETFs. Recent trading volumes for closed-end funds have varied widely between 1,800 – 2.7 million shares per day. In contrast, the SPDR S&P 500 ETF has an average daily trading volume of approximately 171 million shares.

Limit orders can be used by closed-end fund investors to specify the price above which they will not buy and below which they are not willing to sell. Limit orders provide a safeguard against adverse price movements that may be caused by sudden increases in trading volume.

Closed-End Fund Types and Strategies

The benefits of closed-end funds can be applied to any segment of a portfolio. Table 2 provides some ideas suggesting how the benefits of closed-end funds apply across different asset classes.

TABLE 2:

Closed-End Fund Investment Opportunities

Taxable Fixed Income	Relatively high yields can be obtained through the use of leverage. The closed-end structure can be beneficial for bond funds that invest in illiquid assets.
Tax-Exempt Fixed Income	Higher yields can be obtained through the use of leverage. There are more than 150 closed-end funds that invest in tax-exempt bonds from individual states.
U.S. Equity	Active closed-end fund managers do not face the challenges caused by shareholder purchases and redemptions. Higher yields may be available through leverage.
International Equity	Regional and single-country closed-end funds can provide access to relatively illiquid foreign markets with the benefits of diversification and active management.
Specialty	Closed-end funds provide access to some specialized strategies such as master limited partnerships. Closed-end funds allow investors to buy a diversified pool of master limited partnerships without the tax and administrative burdens of direct ownership.

Questions to Ask

- What is the underlying strategy?
- Does the fund utilize leverage?
- How liquid is the market for the closed-end fund?
- Does the fund manager provide adequate transparency?
- Is the closed-end fund priced at a reasonable discount to net asset value?
- Does the fund have a managed distribution policy?
- How volatile has the fund been historically?
- Does the fund have a shareholder-friendly board of directors?

Important Considerations When Buying Closed-End Funds

The sidebar at left highlights some important questions and items of consideration that should be addressed before investing in any particular closed-end fund. By answering these questions, investors can gain a better understanding for a closed-end fund and its distinguishing characteristics.

Conclusion

Despite having some unique advantages, closed-end funds are often overlooked in favor of mutual funds and exchange-traded products. Careful consideration of the benefits and risks associated with closed-end funds may reveal interesting opportunities and potentially valuable additions to a well-diversified portfolio.

For more information, please contact your Financial Advisor.

Disclaimers

An investment should not be made in a closed-end fund solely for the potential for a steady stream of income as the fund itself may decline in value, reducing the amount of an investor's principal investment.

Diversification does not ensure a profit or protect against loss.

All investments are subject to risk. Prior to considering closed-end funds, an investor should be aware of the risks of the underlying securities, including the potential for high volatility in master limited partnerships and foreign securities.

The use of leverage may lead to increased volatility of a fund's NAV and market price relative to its common shares. Leverage is likely to magnify any losses in the fund's portfolio, which may lead to increased market price declines. There is no assurance that a leveraging strategy will be successful.

The term "derivative" indicates that the investment has no independent value – its value is entirely derived from the value of the underlying asset. Derivatives allow investors the potential to earn large returns from small movements in the underlying asset's price. However, investors could lose large amounts if the price of the underlying asset moves against them significantly. There is no assurance that any derivative strategy used by closed-end funds will succeed.

ETFs are subject to the same risks as their underlying securities and trade on an exchange throughout the day. Redemptions may be limited, and, if purchased outside of a fee-based advisory portfolio, brokerage commissions are charged on each trade.

Investors should consider the investment objectives, risks, charges and expenses of a fund carefully before investing. This and other information is found in the prospectus or summary prospectus. For a prospectus or summary prospectus, contact your Baird Financial Advisor. Please read the prospectus or summary prospectus carefully before investing.

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