# SHEDDING THE LIGHT ON VALUE IN FORGOTTEN AND IGNORED PLACES

By Donald L. Cassidy

My focus is on two areas of value in the market that are virtually ignored by brokerage firms' research departments and rarely traded by institutional investors: Closed-end funds, which account for roughly one-eighth of common stocks listed on the New York Stock Exchange; and recently issued preferred stocks.

Knowing where to find the hot action areas of the market is always simple: Watch the headlines. The media focus on the day's, quarter's, or year's, biggest winners, whether they are individual stocks, industries, styles, or mutual funds.

Unfortunately, this focus comes after they've already jumped. More conservative, value-oriented, and contrarian investors look away from the glamorous and seek the solid but neglected areas of the market. There, we find intriguing possibilities precisely because the spotlight of media attention is focused far away.

This, of course, is one of the underlying premises on which the AAII's Shadow Stocks screening and selection process is based [see the February 2000 *AAII Journal* articles on stock screening]. In this article, I'll explore some other places where value is being ignored by a large majority of investors.

My focus is on two areas many investors have never explored very thoroughly. The first area is where approximately one-eighth of common stocks listed on the New York Stock Exchange cluster, yet it is virtually uninhabited by institutional investors and ignored by brokerage firms' research departments—closed-end funds. These investment companies present value that can be captured with a little study, analysis, and patience in the following ways:

- Dividend-capture plays are available late each year although primarily for tax-free accounts;
- A December/January cycle exists, in which best and worst performers reverse roles;
- Municipal bond closed-end funds offer unusually strong opportunities, including inefficient market yields;
- World equity funds are generally depressed, trading at just above all-time deep discounts, and many of their underlying markets are presently out of favor;
- The advent of dozens of exchange-traded funds, many duplicating the investment objectives of closed-end funds, implies heightened pressure on the latter to open-end or liquidate.

The second neglected area is recently issued preferred stocks. These issues have virtually no brokerage or institutional support in the aftermarket, providing periodic value opportunities for the patient, contrarian investor.

## CLOSED-END OPPORTUNITIES

A closed-end fund is an investment company registered under the Investment Company Act of 1940; unlike a mutual fund, it does not stand ready to redeem its shares from owners on days the market is open for business. About 90% of closed-end funds are traded on stock exchanges; the remainder are untraded but do offer occasional exit opportunities via tender offers, typically quarterly.

Market-traded closed-end funds are priced according to current supply and

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demand, like any other stock. They therefore can trade either above their reported net asset value, which is referred to as trading at a premium, or they can trade below net asset value, at a discount. Barron's and the Sunday New York Times, as well as the Monday Wall Street Journal, carry weekly tables of premiums and discounts compiled and supplied by Lipper Inc.

### DIVIDEND-CAPTURE PLAYS

Like mutual funds, closed-end funds are required by Internal Revenue Service and Securities and Exchange Commission regulations to distribute their net realized long-term capital gains annually. Just as many savvy investors refuse to buy highly successful mutual funds late each year (so as to avoid "buying the distribution" and its attendant tax consequences), closed-end fund investors display similar behavior. Because of this pattern, an opportunity arises in closed-end funds for those watching the details closely, due to the fact that tax-averse behavior creates changes in premiums and discounts.

As with any other stock, market prices will fall on the ex-dividend date by roughly the amount of the dividend entitlement per share. In closed-end funds, however, tax-averse buyers delay purchasing for the few weeks prior to the "ex" date, and then buy the fund on or right after that day. As a result, the discount predictably widens before the event and suddenly narrows thereafter. It is not uncommon to see a closed-end fund paying a $5/share year-end capital gains distribution trade down only $3 or so on the ex-dividend date.

Capturing this differential offers an immediate profit opportunity if accomplished in a tax-free account such as a Roth IRA, or in a potentially zero-bracket account in a child's name. In such accounts, one buys the stock that others are avoiding just before the ex-dividend date. Thus, one is entitled to the long-term gains distribution. When the stock trades down by considerably less than the dividend amount, two choices arise: selling captures the gain over a very short period, while holding effectively gives the longer-term investor a net cost that has already built in a moderate paper-profit cushion.

### DECEMBER/JANUARY CYCLES

On average, closed-end funds are less than 5% owned by institutional investors (some country and region funds are the few exceptions). Therefore, closed-end funds act like most stocks did decades ago, and as many depressed, low-priced issues still do: They suffer tax selling in December before rebounding in January once that pressure disappears. This is reflected in clearly notable changes in discounts and premiums from about late November through mid-January. Those above-cited weekly tables are helpful since they display 52-week market-basis performance: The big losers are the tax-effect candidates.

Many investors miss an additional, but very profitable, reverse effect in closed-end funds, since conventional thinking focuses on tax-loss selling behavior. Late in the year, funds that have enjoyed the most spectacular gains tend not to be sold by existing holders, who wish to avoid paying taxes soon. Therefore, discounts narrow or premiums widen in such funds during December and immediately reverse in the first few days of January.

This phenomenon also carries potential implications for two different investor groups: Longer-term holders should hold through December but sell immediately in early January to avoid premium shrinkage, while traders will ride the December/January cycle on the long side and may also go short on January 2nd for a few weeks' ride. Again, the logical candidates (biggest one-year gainers) are easily found in the weekly newspaper listings, and also in daily 52-week-highs lists. The sharper an old year's gains and losses, the more significant the profit-capture opportunities tend to be.

Also, in very strong years (like 1998 and 1999), tax-loss selling is unusually intense as investors seek any and all opportunities to offset large gains (and large mutual fund distributions) already realized elsewhere. (The end of 2000 probably will not show such a pattern, since "the market" has been side-

**TABLE 1. BEST AND WORST SECTORS: A YEAR-BY-YEAR GUIDE**

| Year | Best Sector | Worst Sector |
|---|---|---|
| 1990 | Quality-bond funds | Junk-bond funds |
| 1991 | Small-cap funds | (none down; Europe up only 5%) |
| 1992 | Financial services | Western Europe |
| 1993 | Pacific region | Health/biotech |
| 1994 | Technology | Emerging markets |
| 1995 | Health/biotech | Emerging markets |
| 1996 | REIT funds | Japan funds |
| 1997 | Financial services | Pacific ex-Japan |
| 1998 | Technology | Latin America |
| 1999 | Technology | Bond and preferred-stock funds |
| 2000* | Health/biotech, financial services, quality bond funds, small cap, venture cap | Japan, Pacific, gold, Latin America, emerging markets, junk-bond funds |

**Through early October 2000*

ways to down for most stocks; file this aspect for future years' use.)

Which funds are likely to be candidates?

Each year seems to bring its own set of best-and-worst market sectors, as illustrated in Table 1.

Not fully shown in the table is the interesting fact that often the worst and near-worst of one year move to virtually the opposite end of the list in the following year—a contrarian's paradise.

## CLOSED-END MUNI FUNDS

The pre-year-end market in 1999 offered spectacular opportunities for capturing high yield with quality, plus capital appreciation waiting to happen, in municipal bond closed-end funds. Some of that opportunity, albeit less spectacular, remains today. In late 1998 and early 1999, several dozen new municipal bond closed-end funds were offered while bonds were up and older funds traded at mild premiums. As rates rose during 1999, such funds declined. Panic-selling by risk-averse holders (when recent $15 initial public offerings reached $12 or lower) during tax-selling season drove yields on some municipal bond closed-end funds to the 7.5% to 8.0% range, and discounts to value reached 15% to 18% in many cases—some for insured-bond portfolios. By March 2000, those discounts were nearly fully corrected, resulting in good price gains even beyond the predictable January snap-back. Since then, municipal bond closed-end funds have moved to over a 9% median discount and commonly offer tax-free yields of 6.5% or more. When compared with the current rate on taxable U.S. Treasury bonds, such current yields again offer unusual attraction. They exist because very few brokerage firms promote closed-end funds in the aftermarket; because stocks have been more exciting than bonds for several years; because some investors fear the leverage used by most municipal bond closed-end funds [For more on this, see "Fixed-Income Investing: Analyzing Closed-End Municipal Bond Funds" by Albert Fredman, in the May 1997 *AAII Journal*]; and because few investors even look in the closed-end fund corner of the world for opportunities. Opportunities in late 2000 and into 2001 seem most attractive in closed-ends issued in early 1999, since these shareholder families have yet to stabilize, and tax losses are still available. Many such funds' portfolios have locked in call protection for seven or eight years, making dividends quite secure. Yields and discounts are displayed weekly in the closed-end fund tables mentioned previously.

For investors seeking bargains in municipal bonds, closed-end funds of this variety offer five advantages over the purchase of individual municipal bonds:

- The fund format provides diversification and much better market liquidity than purchasing individual bonds.
- They trade at discounts to the value of the (mildly discounted) underlying bonds held.
- They offer aftertax yields already above those on federal bonds, but also enhanced by the price discount.
- When the bond market rallies, these funds will run further because of their use of leverage (but this is a double-edged sword since it will also magnify losses when the bond market drops).
- They present a tax-simplification "plus." If you buy individual bonds at a discount, you must amortize, and pay current tax on, the non-cash income that is represented by the gradual closing of the discount to par at maturity. That IRS rule applies only to bonds, not to bond funds, which are equities. If you are cautious about equity valuations and do not expect a return of inflation, muni-bond closed-end funds present a very significant opportunity not well publicized. Only a sharp cut in marginal federal tax rates would harm municipals' attractiveness. Political realities imply that targeted deductions/exemptions and larger zero-tax brackets are much more likely than big rate cuts following the 2000 election results.

## WORLD EQUITY FUNDS

Nearly 70 country, region, and world-equity closed-end funds are available, almost all actively traded on the New York Stock Exchange. As this article was written, they stood at a median discount of 24%, within 2% of their all-time deepest markdowns relative to net asset value. Many academic studies have indicated that discounts and premiums tend to eventually revert to their long-term averages. Even if only some of the discount is erased over time, funds representing underpriced assets (emerging markets, Asia, Japan, and Latin America) can provide meaningful profits for the patient investor as both the net asset value and discount improve.

In addition, it is well-documented that the open-ending/liquidating pressure brought on closed-end funds by insurgent investors focuses nearly entirely on deeply discounted funds and especially on foreign-investing funds (where institutional-holder allies can most readily be found).

In the 1990s, about 2% to 3% of all closed-end funds liquidated or open-ended annually on average, but the percentages were much higher in country funds. And the profits are more attractive than at first glance: A fund that is at a 25% discount gains 33% (for instance, from $75 to $100 net asset value) when these events occur, holding aside the trend of underlying net asset value, of course.

That trend may be even further magnified by the emergence of a new fund competitor—the exchange-traded fund. Dozens of exchange-traded funds have sprung into being in recent months, with assets now over $50 billion and surging. The oldest, called World Equity Benchmark Shares (WEBS) at their March 1996 debut, but now renamed "iShares MSCI," focuses on individual countries' markets, offering nearly complete index-fund qualities but adding the choices that intraday trading on an exchange (American Stock Exchange) bring. [For more on exchange-traded funds, see "Exchange-Traded Funds: A New Twist on Index Investing" by Albert Fredman, in the July 2000 *AAII Journal*.]

Originally, many analysts thought exchange-traded funds might help close discounts on closed-end funds, since some investors would seek arbitrage plays when the latter traded widely below net asset value. Instead, it appears exchange-traded fund have become substitutes: Their relative volumes have risen, and in most cases trading in an exchange-traded fund now exceeds that for the same country's closed-end fund. Since investors and traders prefer liquid markets, such advantages tend toward self-perpetuation. No one can prove any single cause, but a suspiciously above-average percentage of closed-end funds that have matching iShares have dissolved or open-ended since 1996, eliminating discounts in the process. Among the examples are closed-end funds that invested in the UK, Germany, Spain, and Mexico. And since 1996, when WEBS first appeared, the number of new closed-end funds investing in countries for which exchange-traded funds exist is exactly zero. More countries were added to iShares' coverage last summer, and some regional and industry exchange-traded funds are now available, with even more coming. These have significant advertising support and proactive public relations campaigns by the Amex, Barclays Global, Merrill Lynch, and Morgan Stanley; Vanguard as well as Nuveen are expected to enter the arena in the near future.

Institutional and individual investors alike prefer the way exchange-traded funds trade, without risk of wide discounts developing. By contrast, closed-end funds almost totally lack aftermarket support. One could make a reasonable case that exchange-traded funds might crowd out closed-end funds where investors have alternate means of investing in the same securities. Nearly 20 country funds, a dozen or more regionals, and worldwide emerging-market closed-end funds, plus over a dozen that focus on industries and sectors (e.g., real estate, health/biotech, technology, energy, utilities, and small caps) could become open-end or liquidation candidates if they trade at persistently uncomfortable discounts.

Discounts that holders regret and resent are discounts that potential raiders love. Herein lies a chance for astute investors, who are patient and willing to buy what is out-of-favor at considerable discounts, to perhaps reap considerable profit in a neglected corner of the market.

## PREFERRED STOCKS

Generally, it is difficult to justify long-term ownership of non-convertible preferred stocks for individual investors. Here, the safety of the fixed payment is obviously subordinate to that of the corporate bonds, yet the cash yields offered by preferred shares tend to be lower because of tax benefits that only corporate investors can use. Thus, preferred stocks are priced to reflect corporate buyers' desired returns.

Occasionally, however, interesting opportunities arise in preferred stocks. December 1999 was one such time, and a smaller echo may occur this winter. Many companies—including real estate investment trusts (REITs) utilities, and a few closed-end funds, among others—issued $25-par preferred stocks in late 1998 and early 1999 when interest rates (and thus capital costs) were low. These preferred stocks quickly became lost cousins when interest rates rose and most investors opted for more speculative issues with higher expected returns. Thus, recently issued preferred stocks that carried 8% and 9% original dividend rates found themselves trading at yields of 12% to 13% during last year's tax-selling season. Examples included Host Marriott, which owns much of the realty in which the hotel chain operates, and Apartment Investment Management, a REIT whose focus is obvious.

Purchased during distress selling at tax-loss time, these preferreds provided good quality with junk-type yields, plus the prospect of considerable price recovery. Many have since closely approached their original issue prices.

A smaller crop will be available at year-end 2000, since fewer have come to market lately as rates rose. How can you find them? Check the New York Stock Exchange new-lows lists in coming weeks, and look at the convenient separate table of preferred stocks in Investor's Business Daily. Look for unusually high cash yields where corporate quality risk is not proportionally high.

Preferred stocks are definitely among the most inefficient market opportunities available to individuals. Screenable databases exclude preferred issues, focusing on common stocks. On-line, Web sites carry no news headlines under preferred symbols (when they even do provide charts). Virtually no brokerage firms have analysts who follow and promote preferreds, while many follow junk bonds and all follow common equities. So, you need to do your own homework. You can get the prospectus from the SEC's EDGAR Web site, or phone the company and ask for one by mail. Also read the traditional print manuals by Moody's or S&P in your local library. Be sure your are buying a true long-life preferred and not an animal-namesake temporary preferred that eventually becomes common stock at a probable price sacrifice and a certain income loss.

## FINDING HIDDEN VALUE

Value investors, by nature, avoid

those areas of the market that are spotlighted by the media and Wall Street. Searching in the dimly lit corners of Wall Street, and in inefficient market niches, can provide those willing to do their homework—and invest patiently—with unusual financial opportunities. I've tried to provide you with some illumination in certain areas that currently are being ignored. Happy hunting. ❖