WHAT YOU NEED TO KNOW ABOUT INVESTING IN CLOSED-END FUNDS

By Albert J. Fredman

Because of their quirks, closed-end funds turn off many individuals, but they also offer many opportunities for disciplined investors who understand what they are buying.

Value investors love buying single dollar bills for 85 cents. That's why closed-end funds, a long misunderstood mutual fund relative, attract certain sophisticated investors. A cross between a mutual fund and a stock, these funds have both a net asset value and a share price. Closed-end funds sometimes trade at double-digit discounts to net asset value, creating potential opportunities. Yet because of their quirks, closed-end funds turn off many individuals. This column takes a close look at some subtle points every closed-end fund investor should understand.

The closed-end structure allows managers to work with a stable pool of capital. Unlike a mutual fund, a closed-end fund does not issue redeemable shares nor does it continuously offer shares. Huge inflows or outflows of cash are problematic for mutual fund managers, who may be forced to buy or sell securities at inopportune times. Because closed-end funds avoid this problem, their managers can invest more fully and be more long-term oriented. The closed-end structure is particularly beneficial for single-country funds operating in volatile emerging markets as well as industry-specific portfolios, funds investing in the illiquid micro-cap market, and junk bond funds.

DISCOUNTS AND PREMIUMS

Like the price-earnings ratio or price-book value ratio on an ordinary stock, the discount or premium on a closed-end fund (the percentage difference between the share price and the portfolio's underlying net asset value) reflects its popularity. Thus, discounts and premiums are a function of demand and supply, which in turn are determined by factors such as investor sentiment and a portfolio's performance.

Abnormal discounts and premiums represent a market inefficiency and may be corrected in time. That's why it's important to compare a fund's current discount with its average past values and those of its peers. Discounts and premiums of individual funds appear weekly in Barron's and The Wall Street Journal (on Mondays). Many funds now provide daily discounts and premiums, which can be viewed on the Closed-End Fund Association's free Web site (www.cefa.com). You also can call a fund to find out its most recent discount or premium or visit its Web site, if it has one. Historic discount/premium information is available on the Closed-End Fund Association's site and on Morningstar's site (www.morningstar.com).

Individuals who buy closed-end funds at deep discounts can earn higher returns than they would with an otherwise equivalent mutual fund. Because discounts are "mean reverting" you can expect abnormally deep discounts to narrow eventually. On rare occasions, investors may even enjoy a windfall profit. For example, Baker, Fentress & Co., a domestic equity fund, closed at a 26.45% discount on May 6, 1999. On that day the company announced a liquidation plan after the market had closed. The following day, Baker,

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Fentress surged 21% on heavy volume closing at a 12.4% discount, less than half of its level a day earlier. There was no prior indication of plans to liquidate.

Of course, picking funds solely on the basis of the deepest discounts can lead you to some losers. A closed-end fund also must be analyzed as a mutual fund, considering factors such as its management, performance, volatility, and expenses. For starters, compare a fund's discount with its expense ratio by dividing the former by the latter. A fund at a 15% discount with a 1% expense ratio has a ratio of discount-to-expenses equal to 15 (15%/1%). The higher the number the better, but look for a value of at least 10. This ratio allows you to compare closed-end funds in a given category with different expense ratios and discounts.

DEEP DISCOUNT STRATEGIES

Discounts leverage up your returns if you buy a fund at a deeper than average markdown that subsequently does well. Your return is enhanced from the narrowing of the discount. Here are four strategies that seasoned closed-end fund investors use in their quest for value.

- *Reaching for value in bear markets and corrections:* Oversold markets are great bargain-hunting times.
- *Shopping for year-end bargains:* During November and December, investors lock in tax losses on funds that have not fared well. This can lead to compelling markdowns.
- *Milking a cash cow*: A fund purchased at a sufficient markdown can greatly enhance your long-term return, even if the discount doesn't narrow. You might pay 80 cents on the dollar yet you collect income and capital gains distributions from a portfolio worth 100 cents. The deeper the discount and the higher the distribution rate, the better. Closed-end bond funds at deep discounts are particularly attractive because they offer higher yields.
- *Searching for special situations*: A unique development such as new management, conversion to an open-end fund, or total liquidation could eliminate a deep discount. Special situations may not pan out, so only buy funds you like anyway.

MANAGED DISTRIBUTIONS

To succeed with closed-end funds you need to understand some of their unique characteristics.

A growing number of funds offer a so-called managed-distribution policy, promising to pay shareholders a fixed periodic minimum. Most pay out 2.5% of net asset value quarterly (10% annually), although several have different rates and frequencies, as illustrated in Table 1. Unlike open-end funds, which can distribute gains only once a year, some closed-end funds are able to distribute capital gains quarterly with prior approval from the Securities and Exchange Commission.

Funds that follow a managed-

TABLE 1. SELECTED FUNDS WITH MANAGED-DISTRIBUTION POLICIES

	First Managed Payment	Annual Payout Rate (%)	Payout Frequency
Domestic Equity (Exchange: Ticker)			
Alliance All-Market Advantage (N: AMO)	12/23/94	10	Quarterly
Bergstrom Capital Corporation (A: BEM)	6/9/97	6	Annually
Blue Chip Value (N: BLU)	2/1/89	10	Quarterly
Gabelli Equity Tr (N: GAB)	8/1/88	10	Quarterly
Liberty All-Star Equity (N: USA)	7/1/88	10	Quarterly
Liberty All-Star Growth (N: ASG)	5/7/97	10	Quarterly
Royce Value Trust (N: RVT)	9/23/97	9	Quarterly
Source Capital (N: SOR)	6/1/76	10	Quarterly
TCW Convertible Securities Fund (N: CVT)	7/1/88	10	Quarterly
Zweig Fund (N: ZF)	6/1/87	10	Quarterly
Foreign Equity			
Austria Fund (N: OST)	4/9/98	10	Quarterly
Europe Fund (N: EF)	1/14/91	7	Annually
First Australia Fund (N: IAF)	1/1/98	9	Quarterly
France Growth Fund (N: FRF)	Q3 '98	12	Quarterly
INVESCO Global Health Sciences (N: GHS)	3/1/98	10	Quarterly
Spain Fund (N: SNF)	4/1/98	10	Quarterly
Templeton Dragon Fund (N: TDF)	9/15/98	10	Quarterly
Domestic Bond			
Zweig Total Return (N: ZTR)	9/1/88	10	Monthly

Exchange Key: N = New York Stock Exchange; A = American Stock Exchange
Source: Lipper Inc.

distribution policy are not tax-efficient and are, therefore, most suitable for tax-deferred accounts unless you're income oriented. A fund's desire to differentiate itself from competitors and attempt to narrow its discount are two primary reasons for the increasing popularity of these proactive plans, particularly those with 10% annual payout targets.

The plan isn't always successful because the manager may have problems during difficult markets. The policy can constrain a fund's flexibility; for example, managers may be forced to sell investments they otherwise wouldn't. Funds with managed-distribution policies may hold more cash and bonds than those that do not have the policy. Source Capital, which pioneered the managed-distribution policy in 1976, normally keeps 20% or more of its assets in cash and bonds. A managed payment may not work as well for country funds as their domestic equity counterparts because the former can be extremely volatile. In addition, country fund investors tend to be growth-oriented and might not be that interested in regular payments.

Some funds have been criticized for managing their portfolios for yield. These funds might be returning some capital to investors, particularly if they're trying to maintain a 10% annual distribution. A return of capital distribution occurs if the payout exceeds the fund's net investment income and realized net capital gains. This is not necessarily bad when a fund trades at a sufficiently deep discount because the distributed assets are worth 100 cents on the dollar. However, demand for funds with more aggressive distribution policies leads to smaller discounts or even premiums.

SHARE REPURCHASES

A number of discounted funds have instituted share repurchase programs. Repurchasing shares is an anti-dilutive procedure that results in an immediate increase in net asset value per share for the remaining shares. In addition, share repurchases help enhance the liquidity of a fund's stock and may reduce the discount. A significant share repurchase program is a good signal that management is looking out for its shareholders' best interests. Some funds are reluctant to buy back shares because it may lead to an increase in the expense ratio as assets decline. Most of the funds that have buyback programs will repurchase shares when the discount reaches or exceeds some predetermined point, such as 10%.

A management must abide by the extensive SEC regulations governing corporate buybacks. On any trading day, a company cannot repurchase a quantity of shares amounting to more than 25% of that stock's average daily trading volume over the past four weeks. Qualified block purchases are an exception. These often are privately negotiated trades with a large shareholder that do not take place on the stock exchange. A repurchase program also must conform to a fund's insider trading policy. After a fund has determined the percentage (or dollar amount) of outstanding stock to be repurchased and the duration of the buyback, a press release containing the details is issued. Normally, there is a public relations effort associated with a repurchase program.

Adams Express, Central Securities, Clemente Strategic Value Fund, General American Investors, Petroleum & Resources, Salomon Brothers Fund, Swiss Helvetia and Tri Continental are examples of funds that have repurchased their shares. In order to be effective, a repurchase program should be ongoing and the fund must buy back a meaningful percentage of its outstanding shares. Between the time it began its repurchase program in March 1995 and October 1999, General American Investors bought back almost 28% of its outstanding shares for about $157 million, at an average discount of about 14%.

DIVIDEND REINVESTMENT

When a closed-end fund trades at a discount, the reinvestment price will be the market price rather than the net asset value, as with a mutual fund. You benefit by reinvesting at the discounted price because you receive more shares than if you had reinvested at net asset value. However, dividend reinvestment probably is not as widely used with closed-end funds as it is with mutual funds because many individuals use closed-end funds more as trading vehicles—buying and selling based on fluctuating discounts and premiums. In addition, about 75% of closed-end assets are in bond funds, which commonly are held for income.

The following three general types of dividend reinvestment plans are used, although nuances are evident among individual plans:

- *Open-market purchased shares.* An agent buys shares in the open market to fill reinvestment orders. Dilution is avoided since additional shares are not issued. The purchase of shares can serve as short-term support for the stock.
- *Newly issued shares or reissued treasury stock.* This approach can be dilutive when a fund trades at a discount because shares outstanding will increase. However, investors who take shares benefit from getting them at a discount, which offsets the dilution.
- *Hybrid plan.* Many plans use both repurchased and new shares.

Should you reinvest or take cash? This depends on factors such as your need for cash and your time horizon. Reinvestment can be beneficial if you plan on holding a fund for many years. But those with shorter horizons may find it simpler to take the cash.

LEVERAGED FUNDS

Closed-end managers can leverage their common stockholders' returns

with preferred stock or loans. As evident in Table 2, preferred stock is more widely used as a form of leverage than debt. The proceeds from a preferred offering or from a loan would be invested in additional bonds or stock, depending on the fund type.

Table 2 also indicates that closed-end bond funds, particularly municipal bond funds, are more inclined to leverage than their equity counterparts. About 79% of the 233 municipal bond funds are leveraged with Dutch-auction preferred stock. The yield on their munis normally exceeds the cost of the preferred, so leverage generally boosts income. For example, if the fund issues preferred with a 3.25% cost and earns 6% on its bonds, common shareholders benefit from the 275-basis-point spread. But the preferred adds risk, which becomes evident when rates rise. The muni preferred rate typically is reset every seven or 28 days by Dutch auction. If rates are rising, the preferred's cost will quickly increase. (For more on how leverage works with closed-end municipal bond funds, see "Fixed-Income Investing: Analyzing Closed-End Municipal Bond Funds" in the May 1997 *AAII Journal*; also available on our Web site at www.aaii.com).

In the equity category, Source Capital has had a preferred issue for many years. Since 1996, the following equity funds also chose to issue preferred: Gabelli Convertible Securities, Gabelli Equity Trust, Gabelli Global Multimedia Trust, General American Investors, Royce Focus Trust, Royce Micro-Cap Trust, and Royce Value Trust. Most equity-fund preferred issues pay fixed quarterly dividends, are cumulative, and become callable five years after issuance. The more recent issues pay between 7.2% and 8%, so the leverage will be favorable if managers can achieve higher average long-run returns. The extent to which a fund is leveraged is reflected in its preferred stock coverage ratio. This value is determined by dividing a fund's total net assets by the face amount of the preferred stock. The higher this ratio, the lower the degree of leverage. Coverage ratios of equity funds normally exceed 300%.

TABLE 2. LEVERAGED CLOSED-END FUNDS BY CATEGORY

	Total Funds in Category	Number Leveraging w/Debt	Number Leveraging w/Preferred	Total Number Leveraged	Percent Leveraged (%)
Bond					
Municipal	233	0	184	184	78.97
Taxable—Domestic	99	52	7	59	59.60
Taxable—Global	30	12	2	14	46.67
Taxable—Emerging Mkt	7	4	0	4	57.14
All Bond	**369**	**68**	**193**	**261**	**70.73**
Equity					
Domestic	51	5	13	18	35.29
Sector	12	2	2	4	33.33
Global	7	0	3	3	42.86
Non U.S.	69	2	1	3	4.76
All Stock	**133**	**10**	**18**	**28**	**21.05**
All Funds	**502**	**78**	**211**	**289**	**57.57**

Source: Wiesenberger, a Thomson Financial Company. Data as of 10/22/99.

Although leverage can be highly effective in a prolonged bull market, losses are magnified in a bear market. In addition, the preferred dividend obligation would be burdensome during an extended period of low equity returns. Equity fund managers must be prepared to reduce stock market exposure when troubled times are anticipated.

RIGHTS OFFERINGS

With an open-end fund, good performance attracts new investors who increase the fund's asset base and the total management fees that are earned. Not so with a closed-end fund. Instead, management occasionally may have a rights offering. The largest closed-end rights offering ever was made by First Australia Prime in 1998, netting the fund $365 million.

How do rights offerings work? Basically, subscription rights are issued to shareholders of record, giving them the option to buy up to a given number of new shares at a specified price, usually at a discount to the lower of the fund's net asset value or its market price. For example, the discount might be 5% applied to the lower of the fund's net asset value at the expiration of the offering or the average market price during the last few days before the rights expire.

You receive one right for each share you own. Several rights are needed to acquire each new share. For instance, you may need three rights for each share you purchase, as in the First Australia Prime offering. Thus, a holder of 300 shares could subscribe to 100 new ones. Shareholders have a few weeks to exercise their options. Offerings are either *transferable* or *non-transferable*. Transferable rights can be sold separately during the "ex-rights" period if you choose not to exercise them; the more common non-transferable rights cannot.

Rights offerings typically dilute net asset value because new shares often are issued at a price below net asset value. The dilution depends mainly on the size of the discount of

TABLE 3. SELECTED RESOURCES FOR CLOSED-END FUND INVESTORS

Closed-End Fund Association (www.cefa.com)
This free Web site provides daily discounts and premiums on most closed-end funds, based on Wiesenberger data. In addition, it contains useful fund profiles, links to fund company Web sites, articles and other information.

The Closed-End Fund Reader (Phone/Fax: 201-891-3814)
Published weekly by Alfred T. Blomquist Jr. in Franklin Lakes, N.J.
Covers about 42 equity, 25 tax-exempt bond, and 25 bond portfolios and includes timely observations by Al Blomquist.

The Internet Closed-End Fund Investor (www.icefi.com)
This Web site tracks about 500 closed-end funds using Wiesenberger data. The site also contains a useful free public closed-end fund forum where seasoned investors exchange thoughts.

Morningstar's Principia for Closed-End Funds (Phone: 800-735-0700)
A comprehensive Windows-based software program allowing you to analyze about 500 closed-end funds in various ways.

Morningstar's Web site (www.morningstar.com)
Includes year-by-year performance and discount information, a Morningstar star rating, style box, and a profile on all closed-end funds for free. Additional data are available as a part of Morningstar's premium service.

the subscription price to net asset value and the number of new shares to be added. However, participating shareholders maintain their proportional ownership interest.

To avoid diluting your position if you don't want to add to your investment, make sure you do one of the following:

- If the rights are *transferable*, sell them on the open market as soon as possible, because the stock typically declines during the offering period. By doing this, you will lock in the value of your rights.
- If the rights are *non-transferable*, exercise them and simultaneously sell the number of shares you purchased at the higher market price, locking in an arbitrage profit.

Finally, you may want to sell all of your shares before the ex-rights date if you are not enthusiastic about the investment outlook anyway. You can always buy back later, if the price is right.

Rights offerings can create buying opportunities for prospective shareholders. If the offering exerts sufficient downward price pressure it can result in an attractive discount for the vigilant bargain hunter. But buy only if you like the fund and feel it has good long-term potential since the shares could remain depressed for some time.

SHAREHOLDER ACTIVISM

Open-endings and liquidations have been on the rise since 1997. Such events can lead to windfall gains for those who bought shares at deep discounts because they are able to realize net asset value—or close to it—for their investment. Shareholders who are frustrated by steep discounts and lagging performance have become increasingly powerful in getting management to do something. The SEC recently has shown greater investor support by reaffirming shareholder democracy.

Deeply discounted funds have enticed institutional investors searching for bargains. Prominent activists or so-called "fundbusters" try to acquire a big stake in a fund and encourage other shareholders to help pressure management to narrow the discount. If successful, the fundbusters pocket their gains and move on to the next target.

You can never be sure that a fund will open-end, or, if it does, when it might occur. Activists have fought lengthy battles. The shareholders often are an obstacle, particularly if there are many small investors who tend to be relatively apathetic toward corporate actions. Two good indicators of whether or not a fund will open-end are the size of its discount and its shareholder composition. In the typical case, the discount is at least 15% and activist institutions hold large blocks of the fund's stock, normally 20% or more of the outstanding shares. Activists have targeted a large number of deeply discounted world-equity funds in recent years.

An open-ending can hurt loyal, long-term investors because assets tumble as investors rush to cash out at net asset value. The manager is forced to sell stocks and distribute capital gains. It's not uncommon for a fund to lose a third or more of its assets. Expense ratios increase with a smaller asset base. And a fund may be forced to change its style. Management companies generally are opposed to open-ending because their fees decline if assets go out the door. To preserve their closed-end structure, more funds have instituted managed-distribution policies, share repurchase programs, and other strategies aimed at narrowing a deep discount.

GETTING INFORMATION

Standard & Poor's Stock Reports

contain profiles of virtually all closed-end funds in customary S&P format. You also can phone the fund to obtain copies of its most recent shareholder reports. An increasing number of funds now have Web sites. Unlike mutual funds, closed-end funds do not generally provide a prospectus unless they are having a rights offering. Closed-end funds are included in the quarterly mutual fund surveys contained in both Barron's and The Wall Street Journal. Brokerages that research closed-end funds include A.G. Edwards, First Union Securities, Merrill Lynch, Morgan Stanley Dean Witter, PaineWebber, Prudential Securities, and Salomon Smith Barney.

Table 3 lists a variety of additional resources.

A SHOPPING GUIDE

Closed-end funds may offer opportunities for disciplined investors who understand what they are buying. By taking advantage of attractive discounts, you may be able to earn a higher return on your investment than the fund itself generates on a net asset value basis. Here are eight key points to keep in mind when shopping for discounts.

- Know when to bargain hunt. Bear markets, corrections and the tax-selling season during November and December provide excellent opportunities.
- Closed-end funds can be used as core holdings to profitably augment a mutual fund portfolio, substituting them for the latter when compelling discounts exist.
- Deeply discounted funds aren't always a steal. They may be saddled with excessive expenses, bad managements or other problems.
- Avoid funds selling at premiums. Like outrageously high price-earnings ratios, excessive premiums can quickly deflate.
- Know whether or not a fund is leveraged and recognize the added risk if it is. Good management is essential with a leveraged fund.
- Closed-end funds are not necessarily long-term investments. It often pays to realize a profit when a fund's discount narrows appreciably or turns to a premium.
- Closed-end funds can be bought and sold through an on-line broker at substantial commission savings. When trading on-line, it also is very easy to monitor a fund's bid, asked, and size (which represents the number of shares bid for and offered).
- Limit orders may enable you to lock in a favorable price. Saving a fraction of a point on each trade can add up, especially with larger orders. ◆