MarketViews™

6 KEY reasons to Consider Closed-End Funds

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One hundred years ago, closed-end funds were just about the only game in town for individual investors in search of diversified pools of assets. Now, as then, these publicly-traded investment companies raise a fixed amount of capital through an initial public offering (or IPO), and are then listed and traded like a stock on a stock exchange—something like a cross between an open-end fund and an individual stock.

Closed-end funds differ from the better-known open-end funds, in several fundamental ways. There is no prospect of additional shares being issued by the managers of a closed-end fund, regardless of the demand from investors. There is also no prospect of a forced redemption. The value of the fund simply rises and falls based on investor demand for their shares.

Depending on their charters, closed-end funds invest in bonds, stocks or very focused investments such as a specific municipality's tax-exempt bonds. Also, depending on their charters, they can invest in illiquid or unlisted securities. Many closed-end funds employ leverage, which enables managers to borrow money to boosts their bets, and other sophisticated investment strategies, which is part of their appeal for some investors, as well as a potential source of risk. Shares in closed-end funds can swing widely, trading at a significant discount or premium to the net asset value, or NAV, of the fund's underlying investments.

The popularity of closed-end funds has waned in recent years, as they have been largely eclipsed by conventional mutual funds and, more recently, by the more transparent and less expensive exchange-traded funds, or ETFs. However, closed-end funds can shine in periods of market volatility, and investors who are willing to take on more risk for the prospect of higher returns are taking another look at these investment vehicles. Here are six reasons to consider investing in closed-end funds.

1 DISCOUNTS TO NET ASSET VALUE

Although closed-end funds trade in fixed amounts, their underlying assets fluctuate, often quite markedly. In volatile markets, these shifts can create a significant difference between a closed-end share price and the NAV of its constituent investments. In other words, the fund is often worth more than its price. For example, a closed-end fund trading at a 15% discount to its NAV (which is not uncommon) would enable an investor to gain access to $100 worth of assets for $85. Most closed-end funds trade at a discount. Of course, this can also work the other way around, with shares of a closed-end fund trading at a premium to its net asset value.

In addition to the absolute discount, investors looking for a deal should also consider the relative discount to the fund's historical average, across full business cycles. It's important to note that closed-end fund prices generally revert to their long-term average premium or discount, rather than to their NAV. In some cases, it may be better to invest in a well-managed fund trading at a premium to NAV than in one that has traded for years at a substantial discount.

2 ACCESS TO ILLIQUID MARKETS

Closed-end funds are able to invest in more illiquid securities than their open-end fund counterparts. (Illiquid securities are defined by the Security and Exchange Commission as ones that can't be sold within seven days at close to their net asset value). Illiquidity is generally associated with increased risk, as investors may be unable to sell the assets as and when they wish. However, when liquid stock and bond valuations are high, as they are now, this ability can be very attractive to investors looking for alternatives to traditional assets.

3 FLEXIBLE MANAGEMENT

Closed-end fund managers are spared forced redemptions, as the assets within their portfolios are not redeemable. As a result, managers of closed-end funds often have more flexibility than those of open-end mutual funds.

Depending on their mandates, managers may be able to invest directly in higher-yielding foreign markets, employ leverage or other relatively sophisticated investment strategies, and tactically manage distributions. This allows them to take advantage in depressed or volatile markets by switching sectors, increasing leverage or simply riding out the crisis in a manner that is the envy of their mutual fund manager peers.

4 STEADY INCOME

Many closed-end funds distribute regular payments that can be very attractive to investors in a low-yield environment. These funds, which have managed distribution policies, make payments in either absolute amounts or in fixed percentage terms. The value of these distributions needs to be weighed against the associated fees and taxes, as closed-end funds are often more expensive than conventional mutual funds, but the prospect of steady returns is very appealing to many investors in this market.

5 ENHANCED PERFORMANCE

Closed-end funds can outperform their market indices as a result of their often focused or unconventional investment strategies, including the use of leverage. For example, a municipal bond fund with 25% leverage is able to generate income from approximately $125 worth of bonds for each $100 of net assets. More debt equals more risk, however, and funds with really significant levels, say 50%, may be too risky for some individual investors.

6 STABLE INVESTMENTS FOR THE LONG-TERM

Investors generally buy and hold closed-end funds for long periods—even passing them on through generations. Talented portfolio managers are often drawn to the closed-end fund structure, as it enables them to invest a relatively stable pool of capital over the long-term and gives them more flexibility in their investing, both in terms of technique and potential asset segments.