

The Advantages and Risks of Closed-End Funds



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Closed-end Funds (CEFs)

- By closed-end funds (CEFs), I refer to **exchanged-traded closed-end mutual funds**.
 - These mutual funds trade with premiums/discounts, which adds an extra dimension to enhance returns.
 - Leverage is another feature, though not always for the better.
- I will not discuss interval funds, another type of CEF.
- **Fun fact:** ETFs are a special type of CEF where premiums/discounts are kept small by trading of “authorized participants.”

Closed-end Mutual Funds (CEFs)

- Closed-end mutual funds issue a fixed # of shares.
 - Fixed asset base allows CEFs to borrow money to make further investments (**leverage**).
- CEFs trade like a stock (all-day trading), unlike open-end funds.
- Shares trade between investors on an exchange (e.g. NYSE).
- Typically, **the market price** for a closed-end fund **is different** from its **Net Asset Value (NAV) per share**

NAV per share = (total fund assets) / (# of shares)
= value of assets in 1 share
(same as open-end mutual fund)

Premiums/Discounts

- Investors buy a CEF at a **premium** or **discount** based on **market price** versus **NAV**.
- **Example: Fund has an NAV of \$10.00 per share**
 - **If market price = \$9.50** then
 - Market price - NAV = $\$9.50 - \$10.00 = -\$0.50$
 - Percentage-wise $\$-0.50/\$10.00 = -5\%$ (**5% discount to NAV**)
 - **If market price = \$10.50** then
 - Market price - NAV = $\$10.50 - \$10.00 = +\$0.50$
 - Percentage-wise $\$0.50/\$10.00 = 5\%$ (**5% premium to NAV**)

Premiums/Discounts



- A CEF's premium/discount reflects the trading demand for the fund.
- Factors influencing demand include
 - **Historical fund performance**
 - **Management fees** (higher fees = discount)
 - **Investor sentiment for CEF asset class**
 - **General market conditions** (bear market = discounts)
- **Most closed-end funds trade at a discount to their NAV.**
 - Offers investors the ability to buy CEFs “on the cheap”

Analyzing CEFs

- CEF analysis is similar to open-end mutual funds except with added variables of premium/discount and leverage
- Go to cefconnect.com to get general data on a CEF.
- Go to the CEF manager's website for further information on holdings, performance, fees, etc.
 - Google the ticker or fund name and “fact sheet”
 - Data from the company itself is the most accurate.

Example [cefconnect.com](https://www.cefconnect.com) fund page

BlackRock Health Sciences Term Trust:BMEZ

Print View

Manage Alerts

All Overview Fund Basics Distributions Pricing Information Performance Portfolio Characteristics

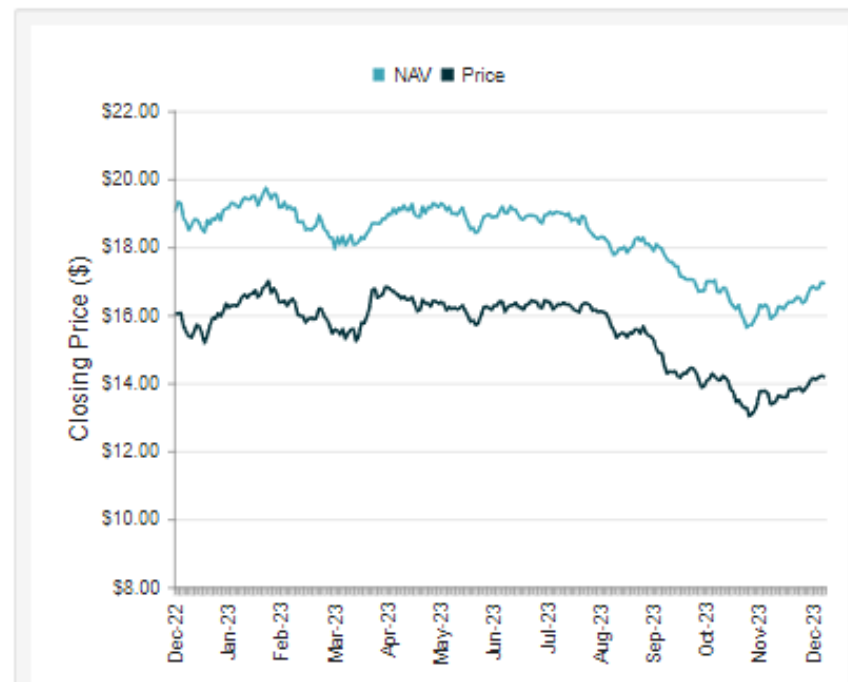
Overview

As of 12/8/2023

	Share Price	NAV	Premium/Discount
Current	\$14.18	\$16.92	-16.19%
52 Wk Avg	\$15.55	\$18.25	-14.82%
52 Wk High	\$17.05	\$19.72	-10.28%
52 Wk Low	\$12.93	\$15.62	-19.06%

Regular Distribution Type†	Managed Distribution
Distribution Rate	7.75%
Distribution Amount	\$0.0916
Distribution Frequency	Monthly

- BMEZ trades at a -16.19% discount.
- BMEZ has pays an 7.75% annual dividend.



Closing Price (\$) vertical range: Narrow Wide

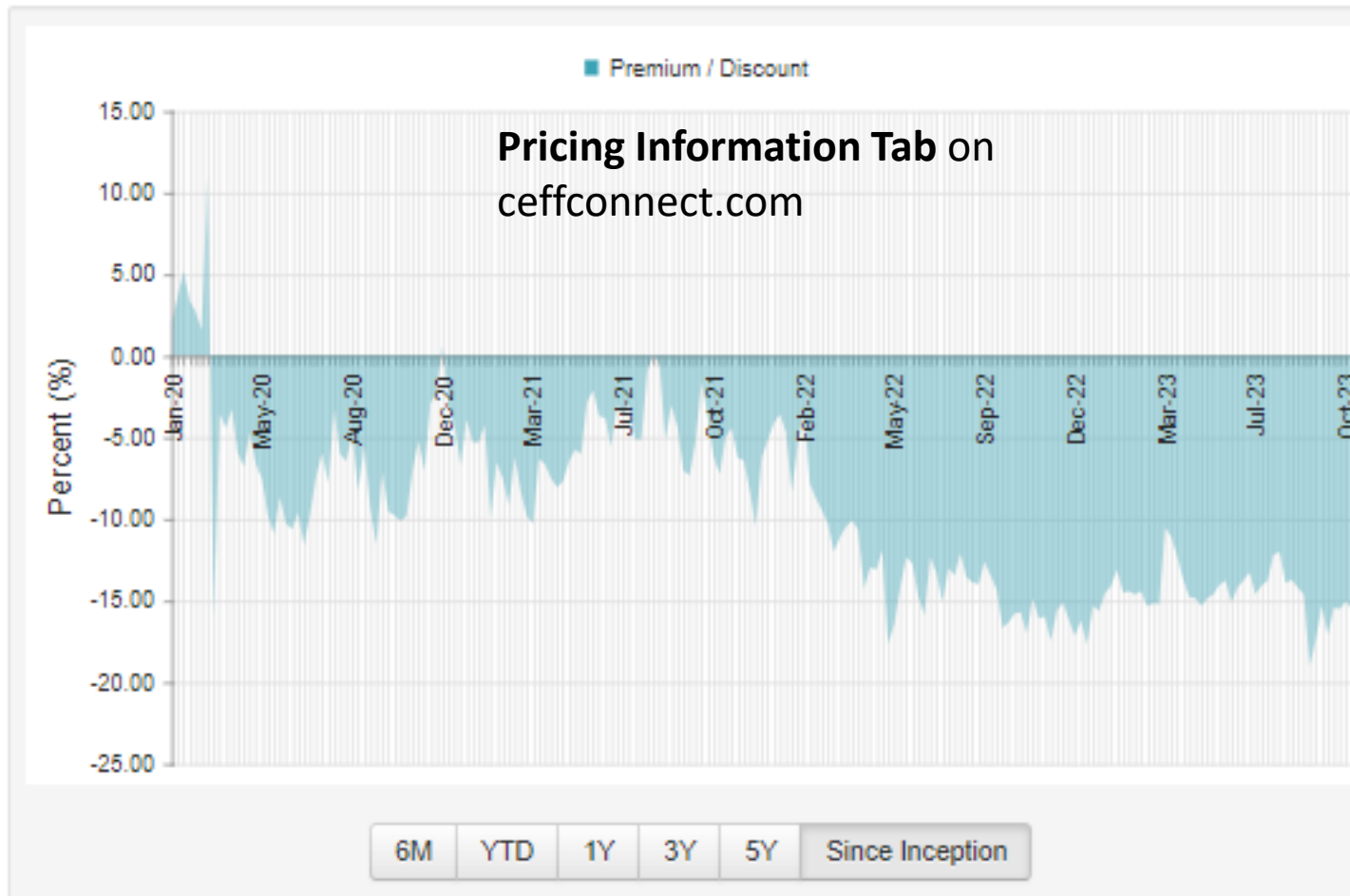
5D 1M YTD 1Y 3Y 5Y Since Inception

Discount Changes with Time Based on Supply/Demand for Fund

Pricing Information

BMEZ Historical Discount

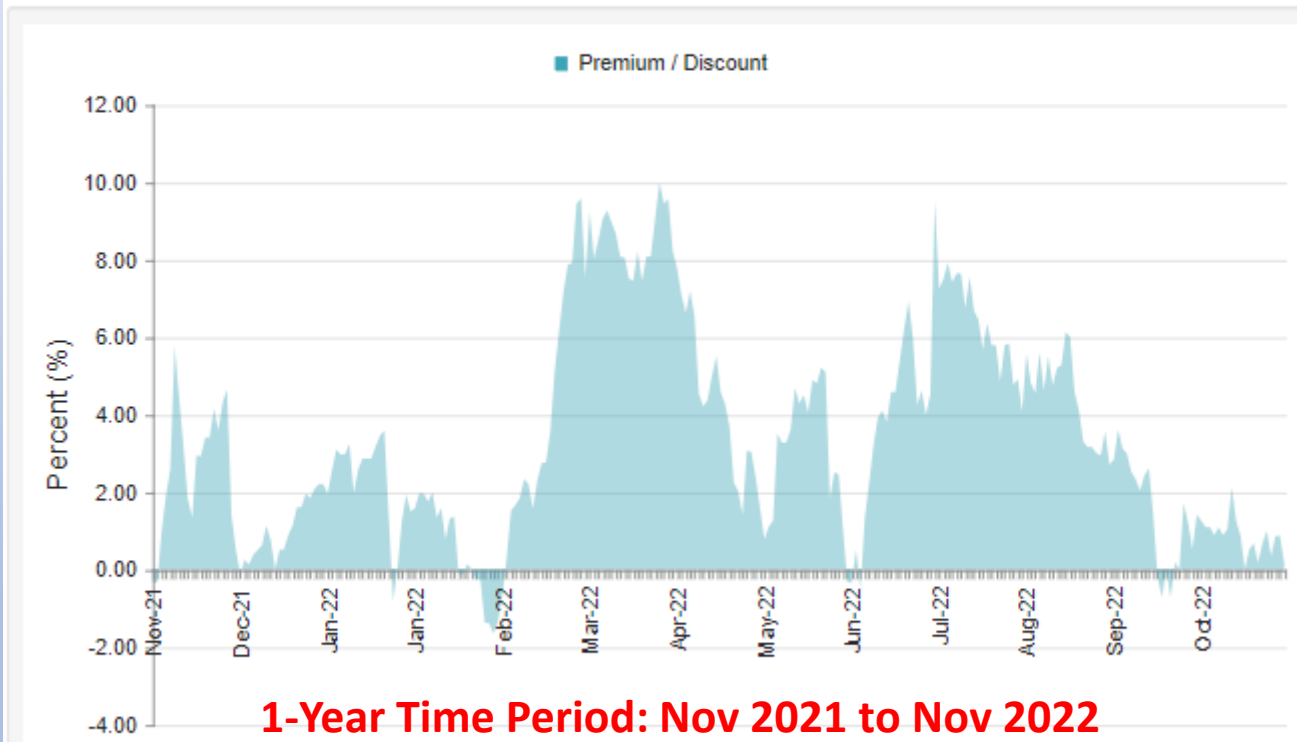
Premium/Discount Information



I Look at Historical Prem/Disc Levels to Look for Trading Ranges

Liberty All-Star Equity:USA

Premium/Discount Information

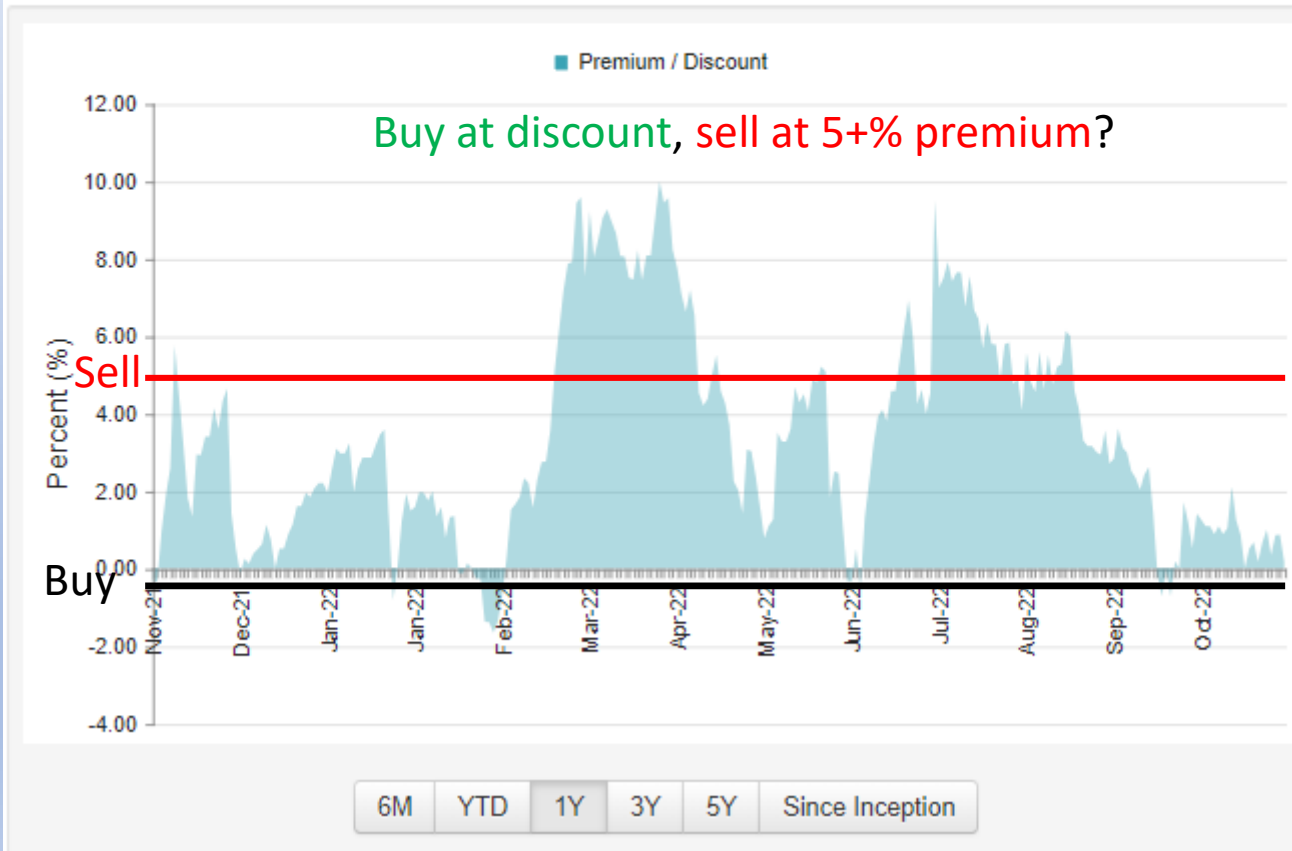


6M YTD 1Y 3Y 5Y Since Inception

I Buy at Low End of the Range and Sell at Middle to Upper End of the Range

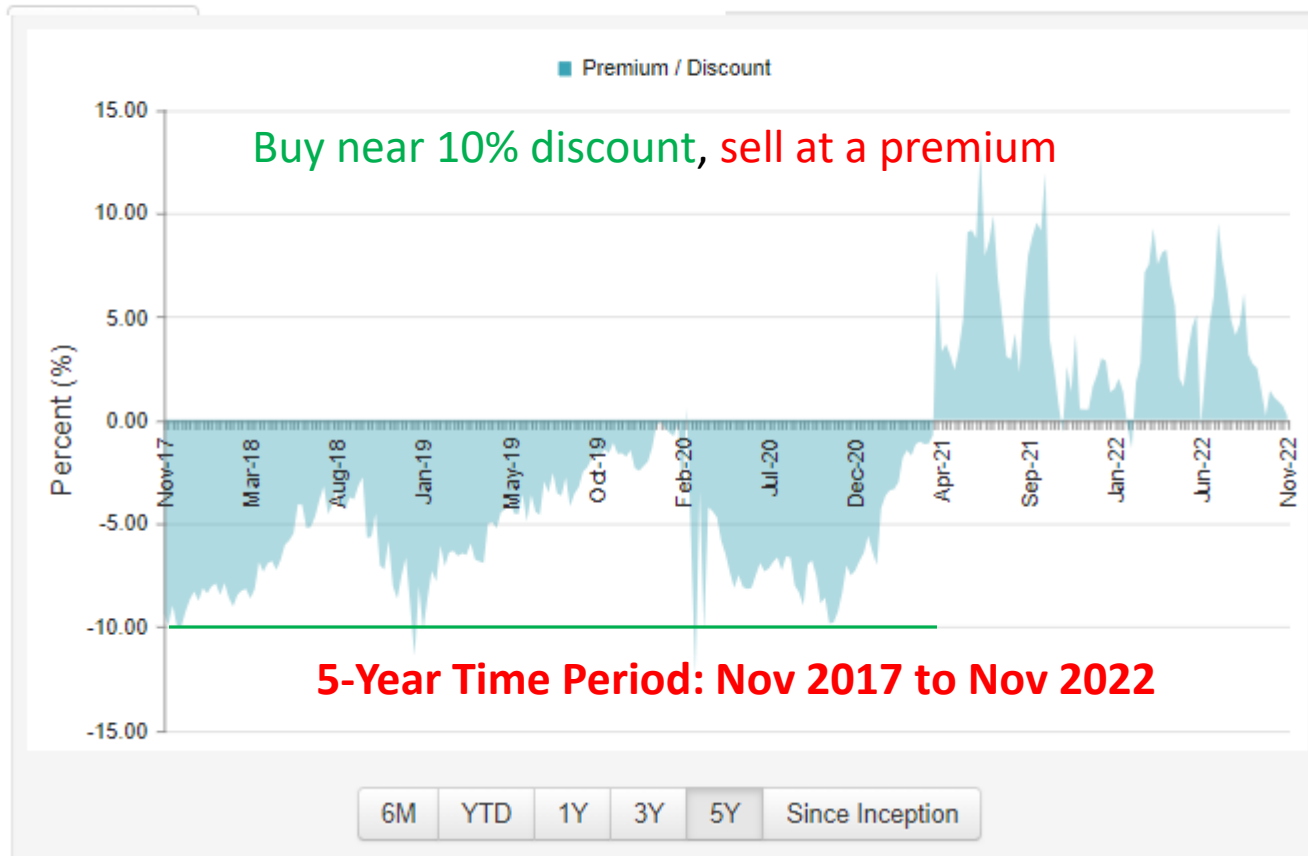
Liberty All-Star Equity:USA

Premium/Discount Information



Be Careful to Consider a Long Time Period, Though!

Liberty All-Star Equity:USA



2023 More Reflective of Longer Time Period

Liberty All-Star Equity:USA

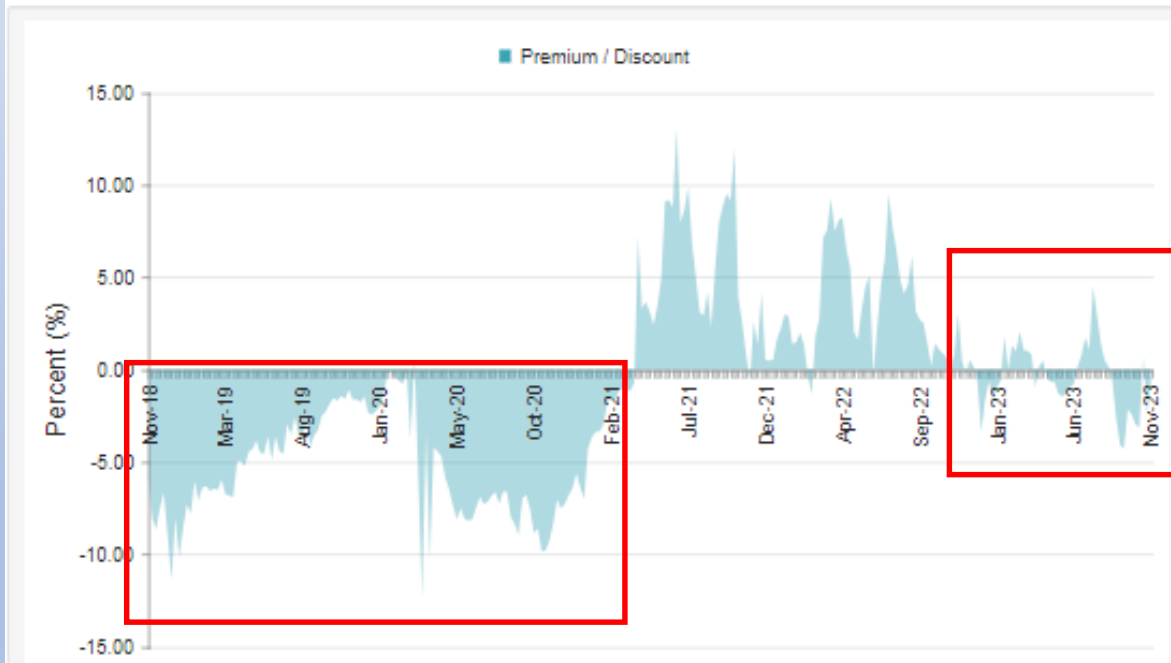
Print View

All Overview Fund Basics Distributions Pricing Information Performance Portfolio

Pricing Information

Time Period: Nov 2018 to Nov 2023

Premium/Discount Information

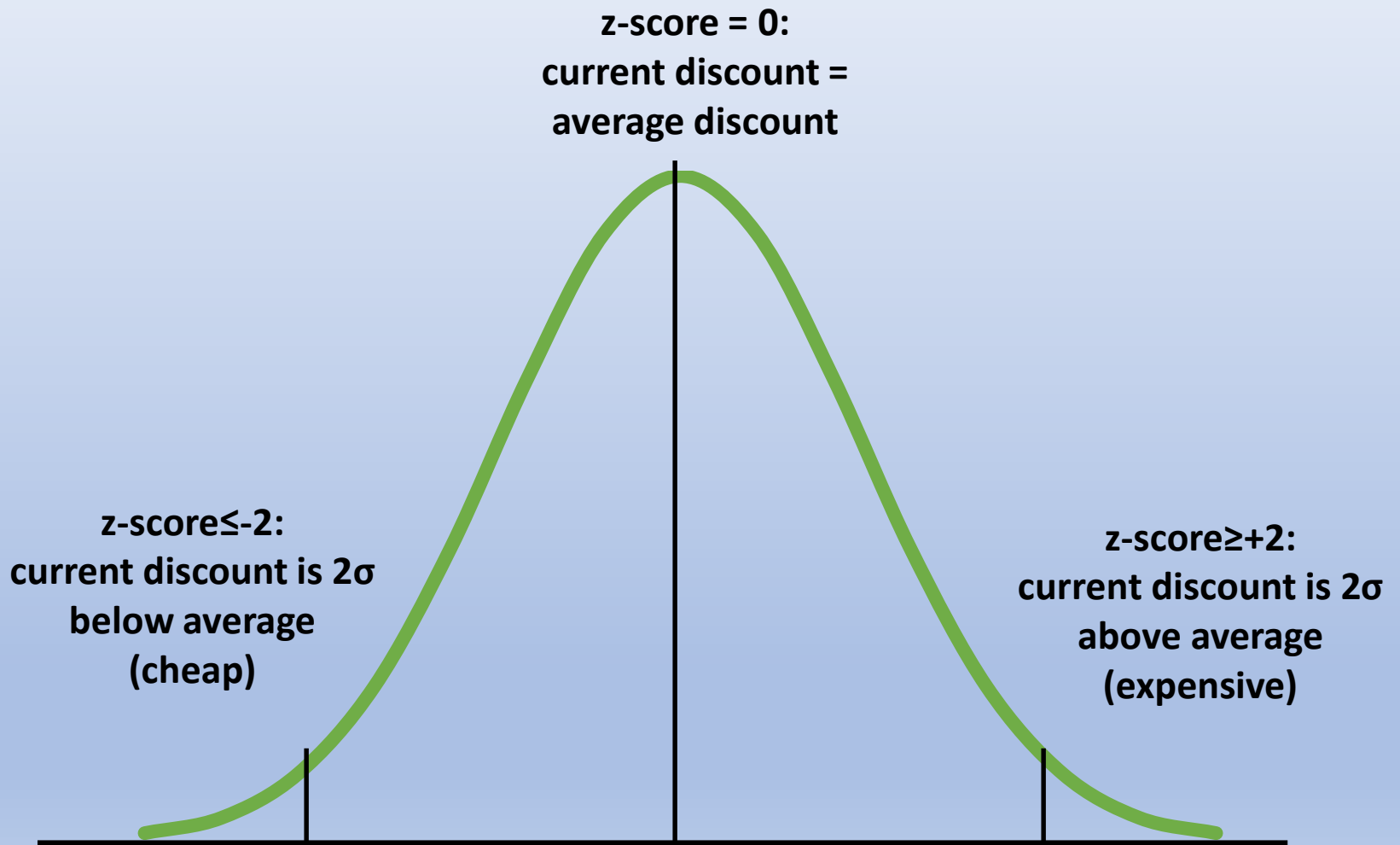


Recent discounts reflective of the longer timer period

Finding Attractive CEFs

- **Discount-related factors to look for in choosing a CEF**
 - **Large discount** – the larger discount the better the deal. However, some funds trade at large discounts because they stink.
 - **Negative z-score** – A negative z-score indicates a fund is trading cheaper than normal.
 - **Limited Term** – some funds pay you back NAV after a fixed term. That means the discount should go to 0 over time.
 - **Shareholder activism** – if an activist investor owns the fund, the activist may get the company to reduce the discount.

z-score roughly measures how many standard deviations the fund discount is from average



Destra Multi-Alternative:DMA

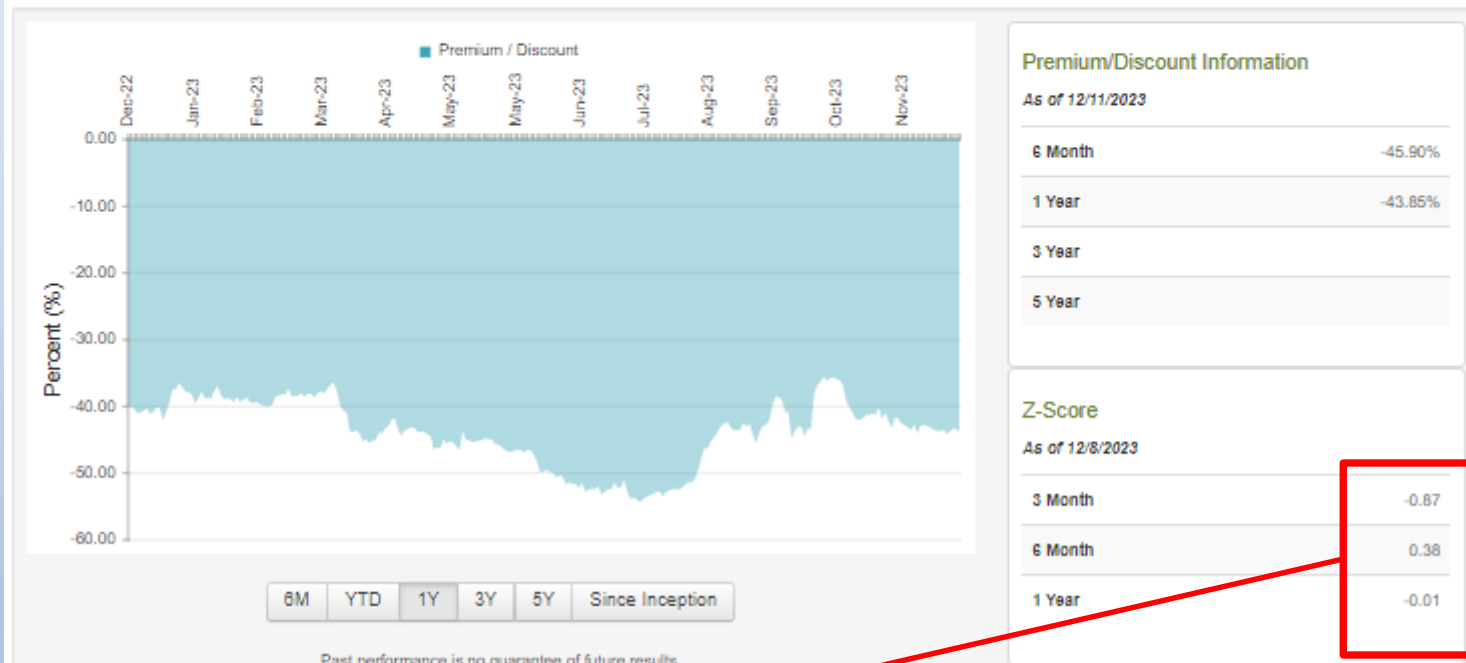
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All Overview Fund Basics Distributions Pricing Information Performance Portfolio Characteristics

Pricing Information

Premium/Discount Information



DMA Z-Scores: DMA is

- Slightly cheap versus its 3-month average (-0.87)
- Slightly expensive versus its 6-month average (+0.38), and
- In-line with its 1-year average (-0.01)

Leverage and Bond CEFs

- Unlike open-end mutual funds, CEFs can use leverage (borrowed money) to invest.
- This can make bond CEFs attractive
 - Leveraged bond CEFs **usually** offer higher yields to their investors
 - Funds borrow at low rates and invest at higher rates.
 - Funds borrow at cheaper rates than you can borrow at your broker.
- With Fed Funds rate high, leveraged bond CEFs are less attractive.
 - Leverage is risky.
 - High Fed Funds rate means high borrowing expenses and lower dividends.
 - Fed rate cuts would change the outlook.
 - Will discuss more in my next talk

BrandywineGLOBAL – Global Inc Opp Fund:BWG

Print View

Manage Alerts

All Overview Fund Basics Distributions Pricing Information Performance Portfolio Characteristics

Basic Information

Investment Objective

The Fund's primary investment objective is to provide current income. As a secondary investment objective, the Fund will seek capital appreciation. The Fund seeks to achieve its investment objectives by investing, under normal market conditions, at least 80% of its assets in global fixed income securities. The fund normally invests at least 80% of net assets in global fixed-income securities.

Capital Structure

As of 12/8/2023

Total Investment Exposure:	\$264.638M
Total Common Assets:	\$153.981M
Common Shares Outstanding:	16,791,836

Leverage

As of 12/8/2023

Preferred Share Assets:	\$49.657M
Total Debt (USD):	\$61.000M
Regulatory Leverage (USD):	\$110.657M
Effective Leverage (USD):	\$110.657M
Effective Leverage (%):	41.81%

Fund Management

Fund Sponsor

Franklin Templeton Investments

Portfolio Managers

Anujeeet S. Sareen, Jack P. McIntyre, David F. Hoffman, Tracy Chen, Brian L. Kloss

Basics

Category: Fixed

Ticker:

NAV Ticker:

Average Daily Volume (shares):

Average Daily Volume (USD):

Inception Date:

Inception Share Price:

Inception NAV:

Tender Offer:

Term:

Fiscal Year End:

October 31

Third Party Links & Reports

Leverage:
Investment exposure > assets.
This means the fund uses leverage (borrowed money).

The fund BWG has about \$1.72 invested for every \$1.00 of assets (\$264.638/\$153.981), so it is 1.72x as risky as a regular bond fund.

Leverage is most commonly used in bond closed-end funds.

Finding Attractive CEFs Part II

- **Other factors to look for in choosing a CEF**

- **Low expense ratio** – hard to find, since closed-end funds have high fees.
 - I don't include borrowing costs in the expense ratio because the fund earns interest on borrowed money.
- **Good long-term performance versus benchmark** – strong long-term performance is a plus, especially if you plan to hold the fund for a long time
- **Strong earnings and undistributed investment income** – bond funds publish their earnings and dividends. Funds with earnings **above/below** their dividend may **raise/cut** the dividend.
- **High yield** – Investors love funds with high dividends. However, the fund may be taking excessive risk or paying a “return of capital,” which is simply paying you your money back.

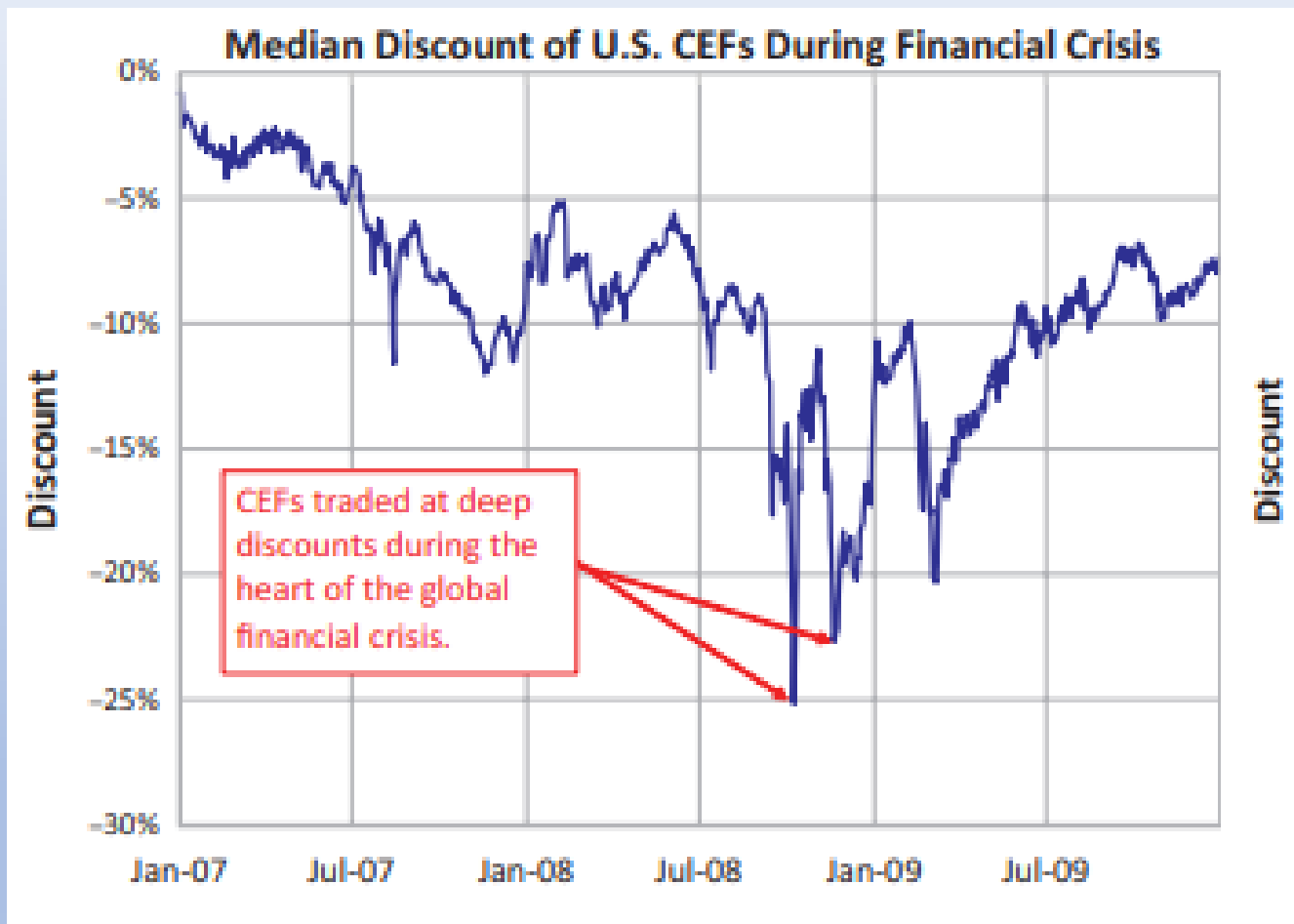
CEFs: Trading vs. Holding

- There are several negatives that make CEFs more suited for trading than long-term buy and hold:
 - **CEFs often trade at larger discounts in down markets, so you lose extra money in down markets.**
 - **Many CEFs have higher fees than open-end funds.**
 - **Some CEFs use leverage, and investing with borrowed money is risky, especially in down markets.**

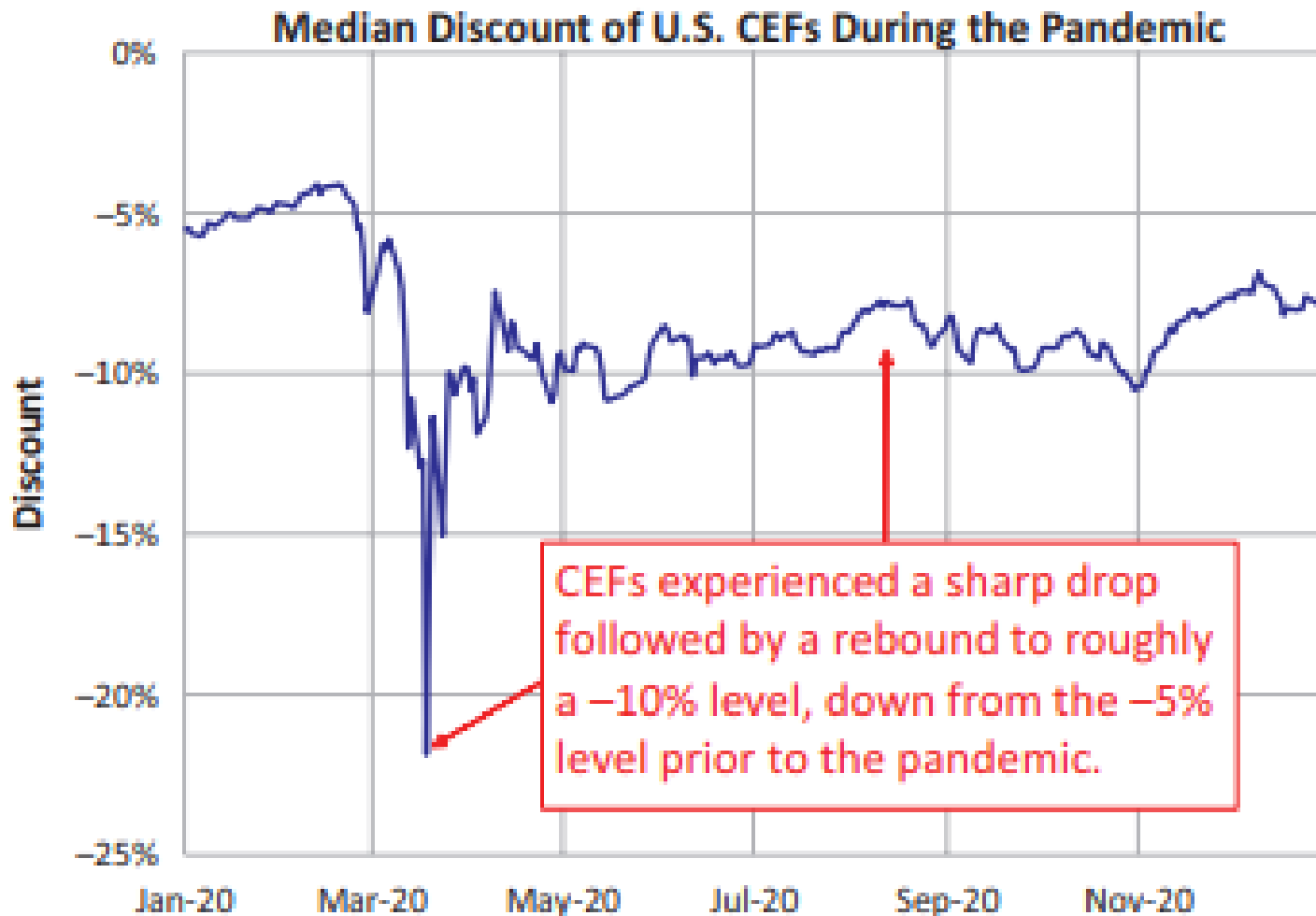
Closed-end Fund (CEF) Trading

- A good strategy with CEFs is to buy when they are out of favor (large discounts) and sell when they are in favor (small discounts).
 - **Large discounts often occur in times of market panic.** If the market is crashing, you can often find great deals.
 - **CEFs also tend to have bigger discounts around year-end (tax loss selling).**
- The website <http://www.cefconnect.com/> has a **fund screener** that you can use to find funds based off of discount, sector, management fees, dividend, etc.
- You can also look up basic on information on a specific fund at [cefconnect.com](http://www.cefconnect.com), which also provides a link to the fund's website.

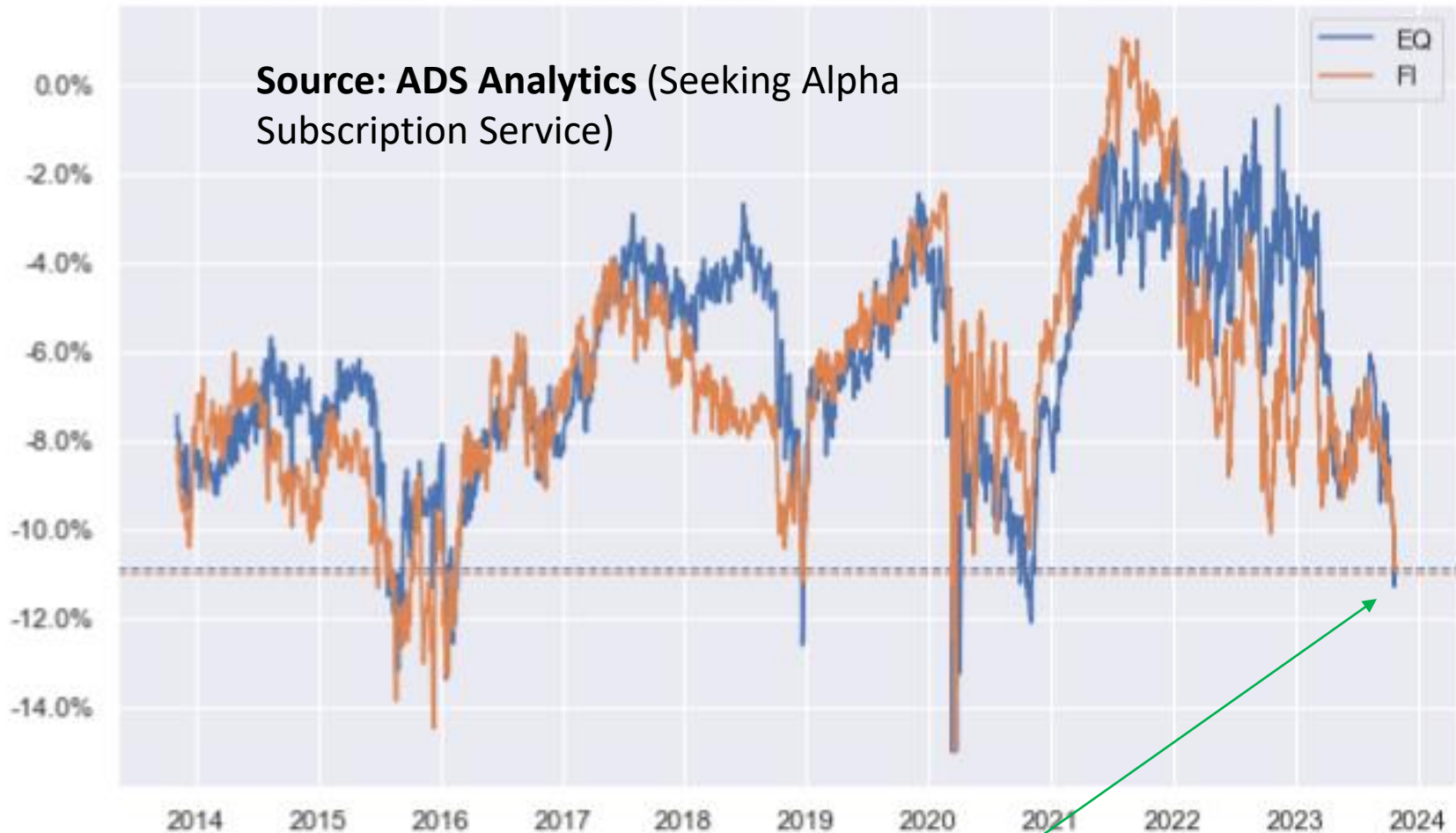
Good CEF discounts in Bear Markets



Good CEF discounts in Bear Markets II



MEDIAN SECTOR DISCOUNTS



**There were large discounts in October 2023.
Discounts have shrunk, but still some potential buys.**

Tax-loss Selling Strategy

- When investors have large losses, they often sell an investment to take a tax deduction. This lowers their tax bill.
 - For most investors, Dec 31 is the date by which they must sell investments to get a tax write-off for the year.
 - For mutual funds, Oct 31 is the date by which they must sell investments.
- When investors sell to take tax losses, investments get cheap for a non-investing reason.
- **This can be a great buying opportunity.**

Side Note on Tax-loss Selling

- The investments most impacted by tax-loss selling have low liquidity and trading volume.
- For illiquid investments, any selling can drop prices significantly. These investments include
 - Closed-end mutual funds
 - Preferred and exchange-traded notes/bonds
 - Small-cap stocks.

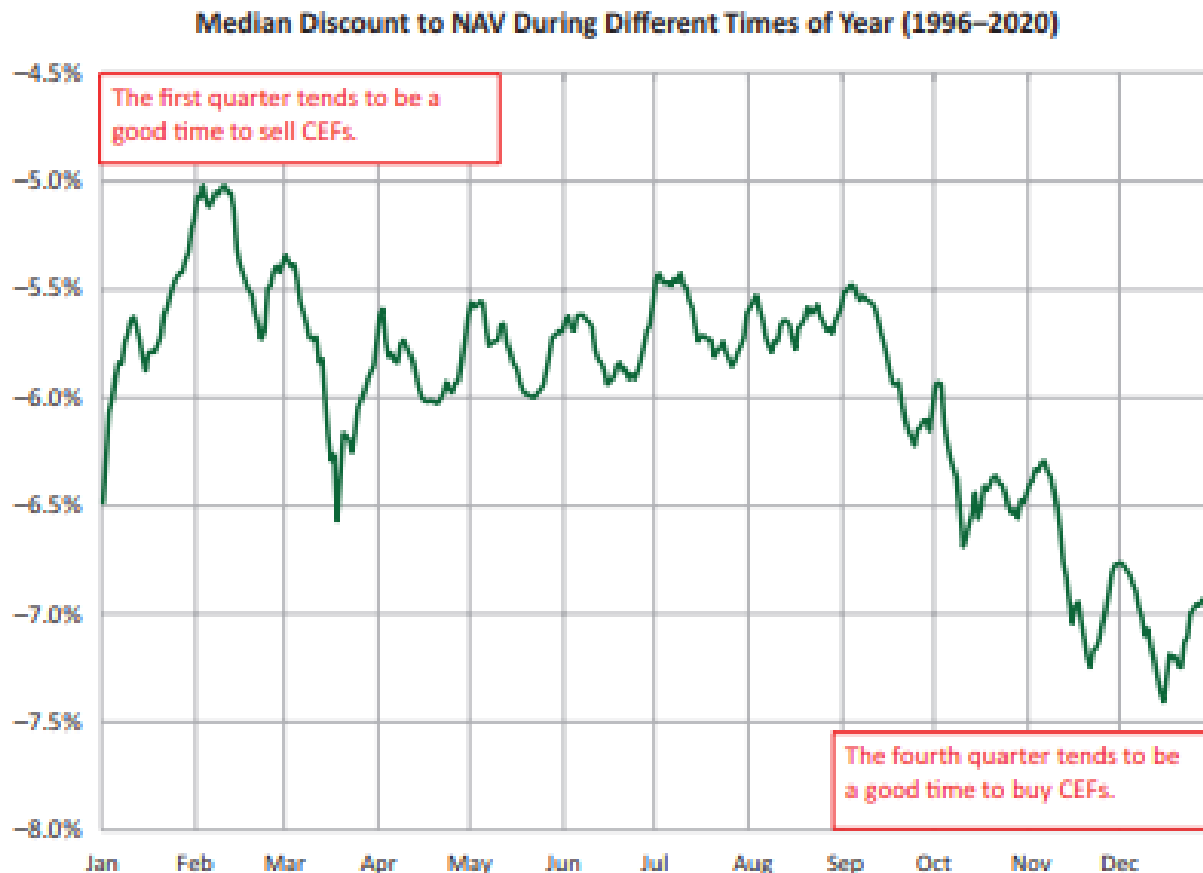
Tax-loss Selling Strategy for CEFs

- The tax-loss selling strategy is to look for CEFs with big discounts to find year-end buys.
- This can be done using the CEFconnect **Fund Screener**.
- If the discounts are wider-than-normal, buy CEFs with the expectation for a rebound in Q1 of the next calendar year (e.g. smaller discounts next year)
- This is short-term trading strategy.

FIGURE 2

Seasonality of Closed-End Fund Discounts

Closed-end fund discounts tend to widen during the fourth quarter and tighten during the first quarter. The widening of discounts tends to be the most dramatic in those CEFs that have dropped during the year and are incurring the highest level of apparent tax-loss selling.



Using the CEF Fund Screener

The screenshot displays the CEF Connect Fund Screener interface. The top navigation bar includes 'Home', 'Daily Pricing', 'Fund Screener', 'Portfolios', 'Alerts', and 'Education Center'. Below this, a secondary navigation bar features 'Dashboard', 'Strategies', 'Criteria', 'Sponsors', 'Presets', and 'Settings'. The 'Criteria' section is active, showing a sidebar with categories: Fund Basics (2), Distributions (2), Pricing (2), Performance (0), and Portfolio Info (0). The main content area contains four filter cards: 'Effective Leverage %' (options: UNDER 20%, 20% - 30%, 30% - 35%, OVER 35%), 'Market Capitalization' (options: UNDER \$300 MM, \$300 MM - \$600 MM, OVER \$600 MM), 'Distribution Rate' (options: UNDER 5%, 5% - 7%, 7% - 9%, OVER 9%), and 'Distribution Amount' (options: UNDER \$0.05, \$0.05 - \$0.10, \$0.10 - \$0.20, OVER \$0.20). Each card has an 'ADVANCED VIEW' button. At the top right, there is a 'Quick Search' box and buttons for 'MOST COMMON DATA POINTS' and 'CLEAR CATEGORIES'.

- **Create a free account** to use the screener
- Click **Strategies** to choose a fund strategy
- Click **Criteria** to select criteria. I focus on **Pricing - Discount /Premium** and **Pricing Z-Scores** but also look stuff like at **Performance – Annualized Return on NAV**, and **Distributions – Distribution Rate**
- Click **View Funds** at bottom to see the funds. Click a column to sort in ascending/descending order.

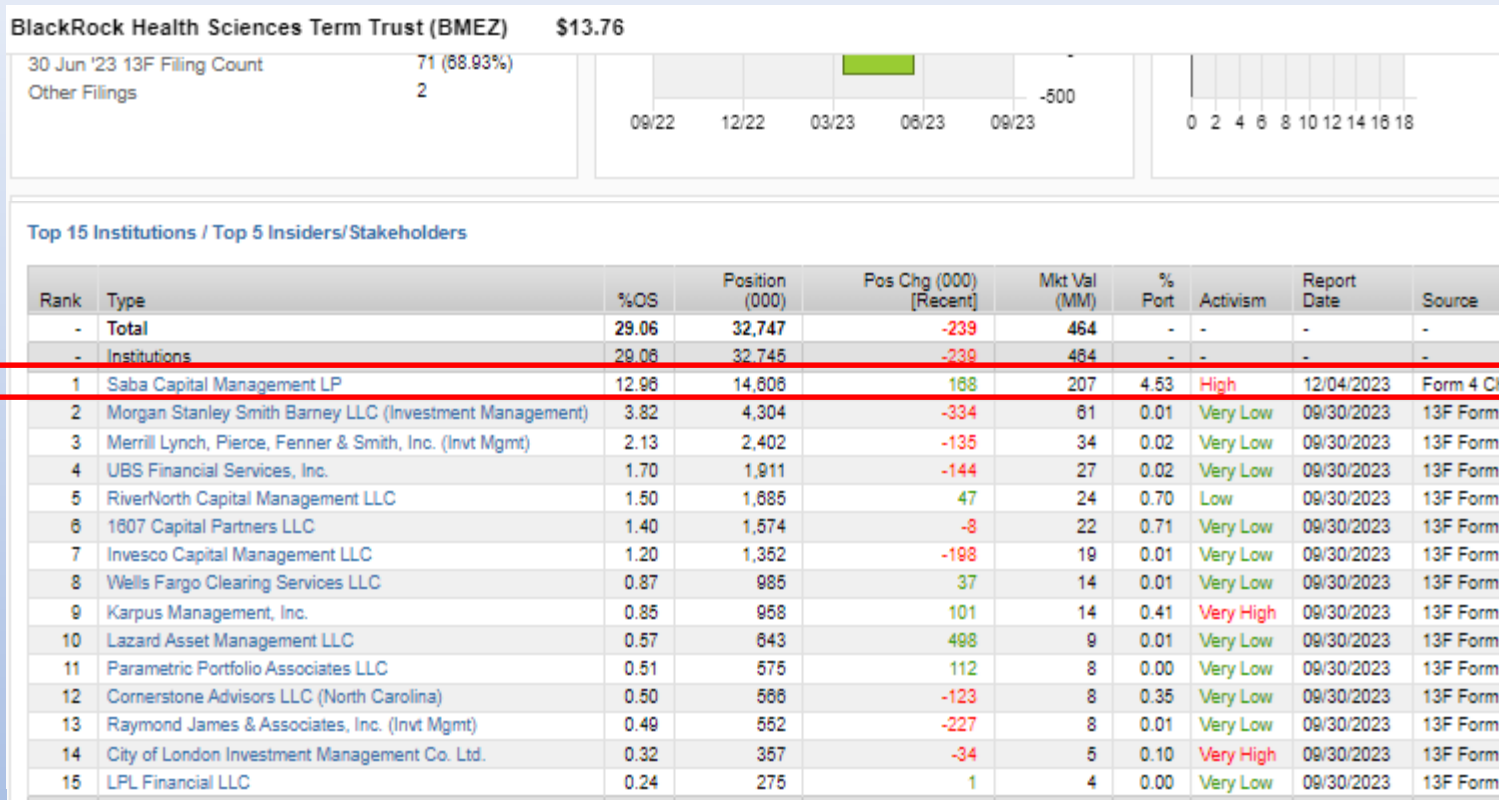
CEFCConnect Screener Disclaimer

- The CEFCconnect.com screener is a first step.
- Don't buy CEFs from the screener without researching them further.
- **You must still do your own due diligence!**
- **Check the CEF holdings, expenses, trading volume, performance, news, etc.**
- Avoid cheap CEFs with upcoming rights offerings, as shareholders get diluted by new shares.

Other Plus to Owning a CEF –Activists

- **Activist investors try to force CEFs to do a merger, tender offer, or liquidation that reduces the discount.**
- Activists usually file 13-D SEC filings.
- Current activists include **Saba Capital**, **Bulldog Partners**, **Karpus**, and sometimes **City of London**.
- You can check for activists in [Institutional Holders on Nasdaq.com](#) or in SEC filings (13Ds and 13D/As)
- Sometimes, you will see shareholder proposals made by activists in SEC filings: **PRE14A's** or **13D's** or **13D/A's**.

BMEZ has an activist who owns ~13% of shares.



- If activist succeeds, fund could merge into an open-end fund (discount 0%).
- Or, it could buy back shares at a small discount (e.g. buy 15% of shares at 2% discount in a tender offer)

Summary

- CEFs offer opportunities unavailable in open-end mutual funds due to discounts and leverage.
- CEFs are more for trading than holding.
- Large discounts and negative Z scores are two items I look for in trading. An activist shareholder is also a plus.
- Opportunities are typically best during market sell-offs and seasonally in Q4.
- Next time, I will discuss the CEFconnect screener, CEF dividends, and bond CEFs.
 - This will include background on interest rate analysis
 - I'll also discuss using earnings reports to predict future dividends.