# A Survey of Shareholder Activism and Closed-End Mutual Funds

By Jason Van Steenwyk

## Closed-End Fund Basics – Discounts and Premiums

As most readers are aware, a closed-end fund share does not represent a direct ownership interest in the underlying securities within the portfolio. Rather, the buyer of a closed-end fund (CEF) share owns an interest in a pot of money. The pot, of course, is itself invested in securities of some sort. But there is a definite separation between the investor and the securities in the portfolio.

As a result, the market price of a CEF share can – and usually does – trade at a different price point than the net asset value of the securities in the underlying portfolio.

For example, if you add up the market value of every security in the portfolio at today's close, and then divided that figure by the number of outstanding shares to get the net asset value, or NAV, you might get a value of $10 per share. A conventional open-end mutual fund buys and sells shares directly from the investor at the NAV as of the end of the closing day. Intra-day orders are priced and fulfilled at the price as of the market close for that day. So although there are exceptions for things like redemption fees that may cause a sale or purchase to effectively trade at a different price than the NAV, the NAV and market price of shares are theoretically identical.

But closed-end fund shares don't trade like that. Instead, if you want to sell a share in a closed-end fund, you don't have a right to go to the fund company to redeem it at NAV. Instead, you must sell the share in the open market - for whatever price you can get at the time. The portfolio, of course, still has a net asset value. But the shares are not trading at that price. They trade for whatever someone else can convince you to pay for it.

If the best price you can sell the share for on the open market is $9, then we say the CEF is trading at a 10 percent *discount* to NAV. If the share is selling for $11, we say the fund is selling at a *premium.*

## The Allure of Closed-End Funds

When a CEF is trading at a significant discount, it may attract two kinds of investors. The buy-and-holder, of course, would like to have a reliable share of income from dividends – or growth from the expectation of future dividends. Buying a CEF at a discount is an efficient way of getting a dividend boost, in terms of yield on invested capital. This may be especially true if the CEF in question successfully employs leverage: An investor can invest $9, and theoretically collect dividends based on $10 worth of assets.

But a steep, persistent discount is like chum in the water for a different kind of investor: The activist. This kind of investor may be a long term investor who originally had every intention of holding the fund for the long term. Or he may be an arbitrageur, with little interest in the long-term profitability of the fund. Instead, the arbitrageur believes he can add alpha over and above market returns, if discounts between share market prices and net asset values narrow or are eliminated.

Some arbitrageurs are passive: They just buy shares of a fund at a discount, and rely on the tendency of reversion to the mean to juice their returns.

Others simply write letters to fund management companies, asking that they take steps to narrow the discounts, which is in the best interests of existing shareholders. They may take little action beyond that, though – believing in the strength of the underlying portfolio and the tendency of board members to act in their own best interests in the long run. If the board does not take action, they will vote their proxies to elect board members that will.

And still others take a decidedly active role – aggressively contacting other shareholders and recruiting them to vote their proxies to narrow discounts, potentially fire underperforming fund managers and in some cases, to merge away or liquidate the funds entirely.

Naturally, this can make fund directors and CEF managers nervous. They make their living, after all, from collecting a percentage of the funds' assets every year. It is in their interests, of course, to keep this expense ratio as high as they can and still be retained as the fund manager, advisor or board member, as the case may be.

## The Transformation from Investor to Activist

An activist may be bent on getting the fund management simply to take action to close the gap between the share price and the NAV, via share tenders, repurchase agreements, open-ending, or in some cases, liquidation. In theory, these actions simply unlock the latent value in the underlying portfolios and benefit all shareholders.

In some cases, the activists are simply shooting the wounded. "Some of these closed-end funds have no reason to exist," says John Cole Scott, a principal at Closed-End Fund Advisors, a fee-based registered investment advisory firm that specializes in the closed-end fund world.

At issue – if a closed-end fund is persistently trading at a significant discount to NAV, and it is not engaged in concrete action to narrow those discounts, then the justification for its existence – and for the fees paid to the manager who thus far refuses to liquidate the fund – are very difficult to ascertain.

## What do Activists Want?

Primarily, activist investors want to make money, just like any other investor. However, the activists generally target the discount between the fund's market price and the fund NAV. The goal: To convince or force the fund management to take actions to narrow the discount, or to eliminate the discount altogether.

But saying you want to narrow the discount and actually getting your share prices to move closer to NAV are two different things. Fund activists, therefore, frequently focus on improving corporate governance practices – such as identifying and breaking up so-called "unitary boards." That is, boards of directors

who represent an impossibly large number of funds within the same company. Activists may also seek to break up boards of directors who are too beholden to a given asset management company.

"The closed-end fund world shouldn't be 'clubby,'" asserts Barry Olliff, the founder and current Chief Investment Officer of City of London Asset Management – an investment company that focuses on the closed-end fund world.

City of London was recently instrumental in a shareholder revolt that forced the board of directors to replace Barings Asset Management as the advisor to the Greater China Fund (GCH) in the summer of 2012 – possibly to be replaced by Aberdeen Asset Management.

## Case Study: The Greater China Fund

By any definition, City of London has been a long-term shareholder of The Greater China Fund (GCH). City of London Investment Management (CLIM) first took a position in the fund in 1999, some 13 years prior to the 2012 fund changeover. Olliff's crew started small, picking up shares gradually, topping ownership of 10 percent of the shares outstanding by the end of 2001.

The Greater China Fund's performance was fair enough, but the fund was plagued by a persistent discount from NAV that hung around like a backache. At issue: Oversupply. "There's no shortage of China product out there," explains Olliff, using a shorthand to describe a large number of investment opportunities, all competing for a shot at the finite number of dollars investors want to invest in China.

In 2010, despite the existence of a chronic discount, Baring Asset Management decided to launch a "rights offering." That is, they wanted to sell additional shares in the portfolio – at a discount to what the fund was actually paying for the shares. The effect would be dilutive. "The only motive we could see was to increase their fees," Olliff says. City of London therefore opposed the rights offering, and wrote a letter to the funds' management and board of directors expressing its dissent. The rights offering were simply not in the interests of current owners of the fund, Olliff felt.

Baring decided to proceed anyway, and although City of London Investment Management opposed the offering, they decided to participate – buying additional shares in the fund and upping its ownership to 18 percent of outstanding shares. Despite City of London's differences with Barings and the fund's board of directors, Olliff continued to buy shares at a discount in the open market until his ownership reached 29.9 percent of the fund. After all, with the fund trading at a substantial discount to NAV, there was no particular reason not to continue to buy– the dilutive effect of the offering benefited new shareholders but not current ones. One way to offset the dilutive effect of the new offering was to take advantage of the discount and buy more shares – even as City of London Investment Management worked to convince the Greater China Fund to narrow the discounts on all of them.

The City of London went to the Securities Exchange Commission to see if they could do anything to halt the offering as a violation of the fund's fiduciary duty to shareholders. The SEC declined to intervene, however, saying "market forces" would be the best way to settle the dispute, according to Olliff.

In May of 2010, however, the Greater China Fund extended a small olive branch, announcing an initiative to buy back up to 10 percent of outstanding shares in two separate tender offers of 5 percent each, all at a tender price of 98 percent of NAV. And then in August, the fund announced another offer to double the offer to 20 percent, or about six million shares.

City of London thought that was a good start – but ultimately declined to participate. The reason: City of London believed that as large as it was, the offer was not large enough to undo the significant damage done to shareholders from the earlier 2010 rights offering.

Meanwhile, representatives from J.P. Morgan had approached members of the Greater China Fund's board of directors proposing a merger. Under the terms of the merger, shares of GCH would be redeemed for shares of the China Region fund in an NAV for NAV swap. The J.P. Morgan representatives suggested that the transaction be accompanied by a much larger 50 percent tender offer, at close to NAV.

City of London favored this arrangement: The merger, City of London held, would go a long way to reducing the oversupply of China-focused closed-end funds in the marketplace. With fewer funds competing for the same pool of capital, discounts for both funds should theoretically narrow – and the substantial tender offer, if it came to fruition, would force the issue.

The merger, however, didn't go through – and City of London Investment Management ultimately put forth a proposal to replace the management company.

By this time, City of London had nearly 40 percent of outstanding shares in GCH – and so only needed a small number of other investors to come on board with the proposal. They got the votes, and in the summer of 2012, the fund announced that Baring's contract as fund advisor was being terminated, and the hunt for a new advisor was on.

In September, the Board of Directors voted unanimously to approve a recommendation that Aberdeen would take over as the fund advisor. As of this writing, however, a formal shareholder vote ratifying the Board's recommendation has not taken place. Other possibilities include a merger with the China Region fund or some other fund, or the outright liquidation of the Greater China Fund – which would effectively result in the fund's stockholders receiving the full NAV.

## What Do Activists Expect?

At their best, closed-end fund shareholder activists want fund managers to act in the best interests of their *current* investors. This means adhering to sound corporate governance practices, keeping fees under control, being proactive with shareholder communications, and using shareholders' money prudently.

While the closed-end fund industry, by and large, has been successful enough to attract substantial assets from the investment community, closed-end fund managers and board members are human, and they sometimes fail to live up to the standards expected of them.

At a minimum, CEF activists expect fund boards of directors to act as vigilant watchdogs over the capital investors entrust to them. This means boards should be strong, independent, accountable to shareholders, and free of conflicts that would interfere with their duties.

This doesn't always happen, though. Too often, seats on boards are taken up by individuals who may not have their fiduciary duties to fellow shareholders uppermost in their minds:

- Officers and former officers of the fund management company.
- Relatives of officers or relatives of other individuals beholden to the fund advisor.
- Individuals with a recent or current business relationship with the fund management company outside of the fund.
- Individuals on the boards of too many funds at one company.
- Anyone serving in a 'cross-directorship' capacity that could result in 'quid pro quos' that are not in the best interests of shareholders.

## Why Don't Unhappy Investors Just Sell?

In an infinitely liquid market, a closed-end fund investor would be able to simply cash out. Sell his or her shares to another investor, and move on with life. This is not a problem for most individual investors, who own just a few hundred shares of any given fund. But selling doesn't make sense for two kinds of investors:

**The arbitrageur**. In some cases, an investor or institution may adopt activism as a deliberate investment strategy. They actively seek out CEFs that trade at persistent discounts, and intend to gain significant alpha specifically from narrowing or eliminating the discount.

In these cases, poor management practices are a *feature,* not a bug. They are part of the investment thesis of the company, in the same way a private equity company may seek out a "turnaround situation," in which it can buy a troubled company for pennies on the dollar, and lead it back to health so it can be sold again at full value.

Selling out before they can affect a turnaround would amount to surrendering their investment strategy.

**The income-oriented investor.** The income oriented investor will take a narrowing discount if he can get it. But in the meantime, the fund is generating sufficient dividend or interest income that they are content to stay put. When an income-generating closed-end fund is trading at a discount, the income an investor receives on a percentage ROI basis is actually greater than it would have been had the fund been an open-end fund trading at NAV. A narrowing discount or even a premium would not affect this equation.

**The large investor.** When a large investor has a big position in a closed-end fund, and isn't happy with the fund's management or board, it's like holding a tiger by the ears: The investor knows he doesn't want to hold on forever. But he can't simply let go, either.

> Some closed-end funds have very little trading volume. An institutional investor may actually wind up accumulating a large position in a closed-end fund over years – and find its own portfolio stuffed with months' worth of the entire trading volume for a fund in its portfolio.
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> It would therefore take months or years for the investor to unwind his position without flooding the markets, further impacting fund share prices, and widening the discount substantially.
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> Part of the reason these funds trade so far off of their NAV is the theoretical 'liquidity discount,' the price the investment community shaves off of an investment if they can't sell it easily.

Phil Goldstein, a principal at Bulldog Investors, has a broader argument for staying in the fight and reforming from within.

"People ask, 'Why not just get out?,'' says Phil Goldstein, a principal at Bulldog Investors, a wealth management firm that frequently engages in shareholder activism as a core part of its business model. "I don't like that solution. How does that discipline corporate management in any way? If everyone did that, all corporations would be mediocre."

## How Funds Become Targets

Whether because of insider corruption, lack of vigilance or laziness, fund managers and boards have done more than enough to make targets of themselves.

**Insular or Incestuous Boards.** A board of directors that is too closely beholden to the management company cannot police that company, even in theory – and shouldn't be expected to, according to Barry Olliff.

Research supports the claim: In a study called "The Impact of Corporate Governance on Closed-End Funds (2006), researchers Gordon Gemmill and Dylan Thomas, the researchers found that where boards had low levels of outsider representation, they were more likely to approve higher fees benefiting the management company – at the expense of investors.

**High Fees.** Unreasonable fees are closely related to the lack of independent representation on a fund's board of directors, but the topic bears repeating. Another of Gem mill's findings was that the relationship between fund fees and investor returns was not linear. Fund managers and investors are not engaged in a zero-sum game, but in a negative-sum game: For every 1 percent increase in fees, investor performance actually *declined* by 1.5 percent.

As exchange-traded funds – the indexed cousins of closed-end funds – become more and more widely accepted, they are soaking up more and more capital that closed-end funds normally compete for. Higher fees for CEFs accentuate the price advantage of ETFs, and work to accelerate the process. As more capital leaves CEFs for ETFs and other alternatives, discounts inevitably widen, and the asset price – the CEF share – must fall relative to NAV to become competitive.

**Low Manager Ownership.** Performance is worse, and fees are higher, where the fund management company is not eating its own cooking.

**Too Many Members on the Board.** Board members have to be paid. But too many board members take up additional money – which must be paid out of fund fees. But additional members on the board don't necessarily provide any value for investors. Gimmell, et. al. also found that the larger the board of directors, the worse the fund performed.

**"Unitary" Boards**. It is common, in the United States, for boards of directors to be substantially identical across all of the funds in a company. Industry trade groups, including the Investment Company Institute, the principal trade group representing mutual funds, argue that this approach is successful in passing economies of scale to mutual fund shareholders.[1]

Critics of the arrangement argue that there is no way a director can perform adequate oversight of any one fund if he is simultaneously on the board of directors of a hundred others with the same mutual fund company.

"My lawyer told me, that if I ever have any litigation against one of these boards of directors, to put one of these guys on the stand in front of a jury and ask him to list the companies he's on the board of," laughs Phil Goldstein. "He'd never be able to name them!" Goldstein added, "If you're on the board of say, BlackRock, and you're on a whole bunch of boards, you can make $100,000, $200,000 a year from sitting on the board. You're not going to be inclined to vote against BlackRock, who put you on the board in the first place."

This arrangement may work well across a portfolio of many funds at one company. But when any single fund is underperforming, and the argument is strong that the fund should be taken over by someone else, or liquidated, the tendency for a unified board to do nothing in order to preserve their relationship with a company that has them on 50 other funds is a powerful thing.

## Other Considerations

A fund can be very poorly run, and not be a very juicy, high-value target for an arbitrageur-type shareholder activist. No matter how bad the board is, a typical activist investor is going to look for other criteria as well:

**Institutions.** It's too expensive to mount a direct mail campaign to 50,000 individual, small shareholders to form a posse. The activist is looking for a healthy representation of institutions – so they can get their message out to a large percentage of the voting power with just a few letters and phone calls.

**Like-Minded Shareholders.** Not just any institutional ownership will do. Some brokerage houses, for example, don't like to rock the boat. They tend to be happy to vote for present management. Activists

[1] Dragon Yongjun Tang, Sophie Kong, Unitary Boards and Mutual Fund Governance, University of Hong Kong, 2007.

like to run with other activists, so they can combine their votes to force action. This is an important reason why Laurel Hill strongly recommends that fund managers and board members who want to keep their posts know their ownership. When companies with a track record of activism are loading up on shares, the Visigoths may be massing outside the gate.

**Liquidity.** Are shares traded frequently enough in enough volume? A large hedge fund interested in activism may not be able to form a meaningful position if the fund is too small, or if the fund doesn't have much liquidity.

## Attacking Discounts

Shareholder activists are clear: Allowing a significant discount to NAV to persist without taking aggressive action to address it is inexcusable. As Barry Olliff wrote in the Investment Policy Statement, available on City of London Investment Management's Web site: "We view the failure by a Board to address a persistent discount is a breach of the implicit Board/Shareholder contract."

A persistent failure to take decisive action to address a discount is the fastest way for a board to invite the Visigoths to the gate. But what actions are available to a fund looking to narrow its discount?

**Actions Available**

Depending on the fund's situation, potential for portfolio income and access to capital, there are a variety of actions that a fund management company can take to narrow discounts. Indeed, fund managers that want to retain their jobs should be proactive in taking action.

> **Boost marketing and PR.** Simply making fund managers more available to press can boost interest and the profile of the fund. This is especially true for smaller funds, where a few appearances on CNBC and Fox Business News, or the Wall Street Journal, can make a dent in shareholder demand. The shareholders attracted may be small, but every little bit helps. As the old saw goes, 'there's nothing so good it doesn't have to be sold.' Increased demand for shares probably won't eliminate the discount, but it wouldn't hurt. Further, a forward-leaning media posture can help fund management allay the concerns of existing shareholders, boosting their comfort level and marginally lowering their vulnerability to a proxy campaign to remove them.
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> The IR/PR Firm Pristine Advisers reiterates, "We are strong advocates for utilizing an aggressive IR/PR Program for our clients. We always recommend being proactive all year long, not just when there is a problem. We incorporate media relations and public relations as a means of highlighting our clients positively in news articles, radio shows, television shows and conference events. We understand the industry exceptionally well, especially the closed-end fund industry. We follow the trends and stories and are always seeking ways to help highlight our clients. It is an exceptional way to help promote the Funds to investors and the investment community. It is also a way of giving the Funds a voice, allowing them the spotlight to talk about their investment strategies, their outlook and commentary. The outreach for the media and conference venues ranges far and wide, especially nowadays with social media. It is a great

means for Funds to remain transparent, provide updates and keep the investment community apprised of their sentiment, changes in direction, ideas for their portfolios and outlook," states Patricia Baronowski-Schneider, President of Pristine Advisers.

**Announce a Managed Dividend Policy.** A fund can announce that it will henceforth pay a fixed dividend. In the mutual fund world, this is a bit like the equivalent of Babe Ruth pointing at the wall announcing to the world that he's going to hit a home run on the next pitch. The markets tend to interpret the announcement of a managed dividend payout policy as a vote of confidence. Research indicates that fund companies that do so are substantially more likely to reduce discounts than funds that don't. This is true even though such a policy does not reduce the supply of shares on the market.

**Reduce the Share Supply.** If discounts are a symptom of an oversupply of shares compared to demand, reducing the supply will theoretically close the gap between fund shares and their NAV. The fund's management company can conduct a tender offer, meaning buy back investor shares at a price somewhere between the going market rate and the NAV – several recent buybacks were done at 98 percent of NAV.

The fund company can accomplish much the same result by buying shares of the fund in the open market for its own account, as well. A public announcement and commitment to buy back a significant number of shares at once increases demand for shares – at least temporarily, allows existing investors to exit some or all of their position at an attractive price point, and shows the wider investment community that the management company has confidence in the portfolio and manager and is willing to put its money where its mouth is.

**Change the Investment Strategy**. Occasionally it becomes clear that a given investment strategy is not a wise use of capital. A fund may find that there's not enough liquidity in a given market to accomplish its objective, for example – or it may find that it needs to consider a different asset class for its portfolio – for example, to create a portfolio that delivers more potential for income.

If a fund trading at a significant discount switches to a more income-oriented strategy, that has benefits of its own: It is using the discount to advantage, because income-oriented investors naturally seek to buy closed-end funds at a discount, which is a way of leveraging their investment to generate extra income. Income funds tend to trade at lower discounts than non-income-generating funds. If a fund can gracefully make the transition – and if market conditions warrant it – then income investors should, theoretically, bid up the price of shares, relative to NAV.

**Change Managers.** This may occur if a shift in strategy occurs – directors of a fund switching from a growth to an income strategy may want to simultaneously switch to an advisory firm with a proven income-focused team, for example. Or the board may simply want a better manager to manage the existing strategy.

“It’s not like we’re putting people out of work,” says Goldstein. “The only people who lose their jobs are overpriced managers and fund folks, and they’ll be alright.”

**Announce a “Lifeboat” Provision.** In closed-end funds, a lifeboat provision is a guarantee to shareholders – usually inserted into the prospectus – that the fund will repurchase shares from investors if the discount reaches a certain level. The repurchase can occur via a Dutch auction process, or via purchases in the open market. In some cases, the fund company will commit to converting to an open-end structure or liquidation if the discount reaches a critical level for a long enough period of time.

**Become an Interval Fund.** In a nutshell, an interval fund makes a regular, periodic offer to buy back shares from investors at or near NAV. This provides a significant upward boost to share prices versus NAV, since investors know that they can unload at least part of their position at or near NAV on a regular basis.

**Merge.** It may not make sense for two funds with nearly identical investment strategies, objective and approaches to pay two managers, two teams of analysts, two marketing departments, two investor relations departments and two boards of directors. Two funds may be able to merge resources and slash costs.

**Open-end.** When a fund goes “open-end,” the fund company commits to buying and selling shares directly from the investor. This is a contrast to the closed-end structure, in which a fund company issues a fixed number of shares and investors buy and sell shares from each other over the exchanges. With open-end funds, the number of outstanding shares is elastic, not fixed. Investors generally buy and sell fund shares in existing funds at NAV

This should cause discounts to vanish immediately – and usually makes existing shareholders very happy. In the long run, though, the open-end structure has some downsides, which become apparent in very thinly traded or small markets. Specifically, the fund company has to keep some cash on hand to meet redemptions. This causes ‘cash drag’ in bull markets, and limits the limits the funds’ options in bear markets. Swings in cash flows can become very pronounced – especially if panic seizes a particular market. Where such an event is a non-issue for a closed-end fund, which is not engaged in either buying or selling its own shares, it can become a significant issue for an open-end fund.

**Liquidate.** This is the death sentence for a closed-end fund. But occasionally it has to be done. If a fund trades at a significant discount, does not generate enough income to warrant its own expense ratio, or is so thinly traded that it traps its investor’s money rather than facilitates their investment objective, then it’s time to give the fund the proverbial shot in the paw.

In some cases, the fund portfolio may be too illiquid to convert to cash in a short amount of time. Some funds will convert to a term trust, while the positions are gradually unwound and proceeds forwarded to shareholders.

## Self-Defense for Fund Companies

In closed-end funds, the 'bolt from the blue' is rare. The CEF community is still fairly small, and the handful of firms with a history of activism are generally well-known, to the ones that are paying attention. But not every fund manager does.

"Critical to a successful defense is identifying your shareholder base, understanding their voting policies and engaging in dialogue,'" says Sylvia Hermina, a senior vice president of operations with Laurel Hill, a proxy services and advisory firm that frequently works with closed-end funds. Among its services, Laurel Hill helps fund managers understand their shareholder base, and monitor who has been taking an interest in the fund. If an investor with a history of activism is 'backing up the truck' and buying shares, it's time to engage in a communications effort.

"The institution's specific activism history is very advantageous to know," advises the Laurel Hill management team. They suggest fund companies take a gimlet eye to their list of shareholders at any given point:

- Have they prepared letters to shareholders stating their concerns?
- Have they sent letters to management stating their concerns?
- Have they issued shareholder proposals?
- Have they taken steps as aggressive as launching proxy fights in the past?

"This type of information will allow the closed-end fund to effectively communicate with these shareholders and prepares management to take EARLY appropriate actions if necessary," writes Hermina in a draft document listing some lessons learned from Greater China's experiences.

Pristine Advisers echo's this statement. "We monitor 13F filings constantly, and rely on the proxy firms and shareholder identification firms to fill in the gaps of investor movements that are not yet available on 13F's. We are in constant contact with the Funds investors and reach out every quarter to offer one-on-one conference calls with management. We have an open door policy with each investor, letting them know that they can contact us at any time if they have any questions, comments or concerns or if they are seeking to connect with management. We monitor chat rooms and social media and relay investor sentiment to management every day. We arrange webcasts to update the investment community and tie our IR programs together with PR and media/social media relations. We also utilize the Funds websites to ensure all information is updated, easy to find and easy to navigate through. Having an efficient proxy/sid firm that works together with the IR firm is one of the most effective means of avoiding a problem before it starts or at the very least, dealing with a problem before it becomes a major issue," states Pam O'Brien, Senior Vice President at Pristine Advisers.

**Fund Actions**

Fund companies should take a proactive stance, writing letters explaining their strategy, and detailing steps that they plan to take to increase wealth for their shareholders. Between letters to shareholders, phone calls to key institutions and large shareholders and appearances in the financial media to reach individual shareholders, fund managers should be getting out ahead of any activist proposals – simply out of self-interest.

Managers should be willing to pick up the phone, and not hide behind their green eyeshades. The exact type of communications effort – a mix of personal calls to major shareholders, direct mail and email, and even phone bank operations to contact individual shareholders – depends on the shareholder makeup of the fund.

A call to a sophisticated institutional investor and a call to an individual investor who owns a hundred shares is a very different conversation," says Hermina. Obviously, fund managers don't want to spend all day dialing 20,000 individual shareholders. And in the individual market, they may not be able to if they wanted to: Brokerage companies such as Charles Schwab and others frequently own large numbers of shares on an OBO basis. OBO stands for "objecting beneficial owners." These are owners who do not want to be bothered with direct contact from the fund. In this case, fund managers must focus on "NOBOs," or *non-objecting* beneficial owners.

**Open Lines of Communication**

Another technique, which Hermina says is very effective, is opening an email address and even a 1-800 number that any shareholder can call to express his or her opinion. Sometimes the volume gets so high that the fund manager can't get through them all. But this measure can be an invaluable tool in sensing any mounting discontent among shareholders that would make the funds' advisors or board of directors at risk of getting relieved of their duties. The board and management team can then take proactive steps to address shareholder concerns.

Another measure funds can take is monitoring what is said about them in the media and on relevant Internet discussion forums and bulletin boards. Again, monitoring allows the management and investor relations team to address misconceptions, quash rumors, and be proactive in taking steps to address shareholder concerns.

**Board Actions**

Fund boards should be adhering to sound best practices in corporate governance. This shouldn't be news to board members, who should be representing the interests of shareholders and be providing rigorous oversight of management and accountability to shareholders for the stewardship of their money. This also means rigorously asserting their independence – publicly, so they may be held to account. This also sends a powerful preventive signal to fund companies.

**The Proposal Stage**

A shareholder may write a letter to the fund managers and the board of directors – either public or private, expressing concerns.

**Develop a Strategy**

Fund companies looking to preserve their positions should develop a threat matrix, to borrow a term from the military – and list countermeasures to neutralize threats. Specifically, Hermina advises fund companies to specifically develop an engagement strategy with Glass-Lewis and Institutional Shareholder Services (ISS). These firms are key advisors for a large number of institutional shareholders in the closed-end fund arena. "If the fund has a large institutional presence, ISS and Glass Lewis will wield a very large influence on the outcome of any proposal put to vote," writes Hermina. You may want to approach these firms directly – armed with a formal presentation to short-circuit any arguments mounted against you by critics and activists.

# Proxy Fight Costs

> **"Now we could do it with conventional weapons, but that could take years, and cost millions of lives. No, I think we have to go all out. I think that this situation absolutely requires a really futile and stupid gesture be done on somebody's part!"**
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> **-"Otter," Animal House (1978)**

When competing shareholder interest clash in a proxy battle, the fight is being waged on two fronts: The activist or dissident shareholder has costs in terms of man-hours in researching and preparing the proxy battle. The activist must also locate the owners of enough shares to reach a critical mass – either enough shares to force a change, or at least to get the fund or company management's attention.

They must then mount a communications effort to reach the other shareholders. Although there are other cheaper methods available in the age of the Web, expensive and polished print materials still play a role.

Further, the fight often involves the copious expenditure of expensive attorney man-hours.

The incumbent management team has costs, too: If management contests the proxy effort – and they frequently do, if only out of the interests of self-preservation – they must mount a communications counteroffensive. They do this through public relations, direct mail, and road shows to visit key investor constituencies. They also rack up substantial attorneys' fees in the effort as well.

The difference: The activist investor is using his own money to wage the proxy campaign. The fund manager is using *shareholders'* money – a dynamic not lost on Phil Goldstein. "They only spend a lot of money on that when they're using other peoples' money," he quips. "Nobody spends their own money."

The irony, of course, is that the management team is using a portion of the activist shareholders' money against them.

The amounts involved can be significant: Expenditures related to proxy battles can range from tens of thousands of dollars at the low end to millions, where there are sizeable assets at stake and where litigation is involved.

**Cost to inactive shareholders**

While a number of studies have found that a well-constructed closed-end fund activist campaign can have a beneficial effect for shareholders, these campaigns don't come free, or cheap. Depending on state law, activist shareholders can, and frequently do, demand reimbursement for their expenses incurred in a proxy campaign.

Departing briefly from the mutual fund world: In the case of one well-known corporation, Six Flags, dissident shareholders spent spent some $10.4 million in the effort to seat a minority on the Board of Directors – and then demanded that the company – that is, the other shareholders – reimburse them. The Board did so, approving a $10.4 million reimbursement to the dissidents as "reasonable," though one wonders if the other Six Flags investors weren't taken for a ride.

While $10.4 million would certainly be high in a closed-end fund proxy fight, fund companies do occasionally put up a spirited defense of their own interest – using other peoples' money.

The irony: A fund management company will frequently settle to avoid a full-on proxy fight. And as terms of the settlement, the fund will agree to reimburse the activist for whatever they spent mounting the proxy campaign.

However, it's been relatively rare, in recent years, for a fund activist to take a campaign all the way to a pitched proxy battle, with a full mobilization on both sides. Few activists are interested in spending the kind of money it would take to do multiple proxy solicitations and invest in the kind of lawyering that it may take.

"To win without fighting is the acme of skill" wrote Sun Tzu in the Chinese classic of military science over 2,000 years ago. Goldstein, whose Bulldog Investments has been involved in some 35 proxy fights over the years, observes that as his firm grew in credibility, it has been more and more common for closed-end funds to reach a settlement with his firm and other investors who may be joining with Bulldog's lead. "Understanding the possible consequences of a proxy fight makes a proxy fight less likely," observes Goldstein.

What's involved in a settlement? Generally, a commitment to pursue one or more of the discount narrowing strategies listed above, and perhaps some measure of reimbursement to the firm for expenses incurred.

However, both Goldstein and Olliff deny undertaking great, expensive measures to target funds. "We never solicit other shareholders," says Olliff. Both managers say their approach is usually to write a very public letter. Other investors see them out front and sometimes follow their lead.

**Greater China**

When the end came for the Barings team at the Greater China fund, it came quickly. While the dispute with City of London over the rights offering was over two years old. CLIM already held some 40 percent of the fund float. Bulldog held another 7 percent or so, so it didn't take much more than that to storm the Bastille. A large scale outreach effort to individual shareholders wasn't necessary for the offense – nor would it have been much use for the defense – though it would have been tremendously expensive.

## Conclusion

The thesis that there is money to be made in buying at a discount and selling when discounts "revert to the mean" seems to have been borne out. And strategies where investors specifically target funds that are trading at a discount, with the express purpose of agitating to close the discount, one way or another, have been by and large profitable.

This is in part because companies like Bulldog and City of London are not expending a great deal of money in the effort. While hostile takeovers of publicly traded companies can frequently include multiple proxy mailings, the generation of expensive marketing materials, and the general execution of a meaningful political campaign.

Activists do not want to get involved in a situation where a change in investment policy, management or structure would be so expensive to effect. They therefore seek to limit their efforts to the most vulnerable funds.

There is a point at which a proxy battle can become disruptive to the fund, or harmful to the interests of other shareholders. But this appears comparatively rare in the closed-end fund industry. Activists here will tend to gravitate toward funds that have a high percentage of institutional ownership. The activists can reach a large number of proxy votes easily with just a few letters and phone calls – as can the fund management. This moderates the cost, and a Six Flags-like scenario with both sides burning millions and generating no value for shareholders is unlikely.

If a proxy campaign is likely to involve an aggressive outreach to tens of thousands of passive individual shareholders, such a fund is a less likely target for arbitrageurs. Frustrated investors could possibly mount a grass roots campaign – but given the levels of expenditure involved, it may well be more trouble than it's worth.