Closed-End Fund Basics:

What Makes Discounts Narrow?

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Closed-end investors are a strange breed. They are constantly looking to buy funds at a steep discount to their net asset values. They buy into these funds precisely because of their NAV discounts. And then they do nothing but complain about the substantial discount to NAV - the reason they bought the fund in the first place!

Naturally, existing shareholders do benefit from a tightening of discounts relative to NAV - all things being equal. When NAV is flat, tightening discounts can help you eke out a modest gain. When NAV is rising, attracting buyers, and NAV is tightening, it's like strapping a rocket booster to your returns.

So what causes discounts to narrow? The simple view is that discounts narrow for the same basic reason they open up in the first place: The law of supply and demand goes to work on closed-end fund shares, the way it does with any other commodity.

With open-end funds - the traditional, garden variety mutual funds you are probably most familiar with, where you buy and sell shares directly from the fund company - the number of shares is theoretically unlimited. The fund can take in new money continually and put it to work. In fact, in traditional mutual funds, a flood of new money is a problem - there is only so much they can invest at once without beginning to distort the market against themselves. Eventually they start bidding up asset prices, to the detriment of shareholders, or they have to settle for lower-yielding opportunities. But in theory they can issue as many shares as they like, and collect their

fat expense ratio fees on ever more assets, without providing more value to existing shareholders.

With closed-end funds, however, the number of shares is finite. This means that every buyer has to convince every seller to sell, with a decent, competitive offer. When there is more interest in a particular closed-end fund - because of a nice media spot on Squawk Box, for example, or because the market the fund concentrates on has been heating up, or because of a manager's appearance on the cover of a magazine - then buyers have to bid against each other to buy a share.

Sellers, meanwhile, sell to the highest bidders, regardless. The losers either up their bids to get shares - forcing discounts to narrow - or they exit the market, yielding to higher bidders.

When buyers want to buy more shares than sellers want to sell, discounts narrow, and the fund may even sell at a premium. When sellers want to dump more shares than buyers want to buy, then premiums fall, and discounts widen. All this action happens quite independently from the actions of the fund managers, buying and selling securities for the underlying portfolio. It's no different than real estate. House prices can rise and fall, based on the number of houses people are looking to sell versus buy - even though market rents may remain constant.

But that's the theoretical finance school answer. In the real world, both shareholders and managers often jockey to manipulate discount spreads - usually to narrow them.

How does this occur? A variety of ways:

Public Relations. Fund companies launch aggressive PR campaigns to bring attention to either a

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fund's success. Public relations professionals, of course are looking for ways to shape their funds' successes and potential successes to the financial media - which will then pick some of them to cover. The more coverage a fund gets, the more likely it is to generate investor interest, which leads to buy orders. If buy orders outpace sell orders, this generally cause discount spreads to narrow.

A secondary effort - jointly run by marketing and public relations professionals, targets the advisor community. These are the financial advisors, planners, brokers and in some cases, institutional managers who make recommendations to clients about what securities to buy and sell. This is a quieter effort, but an important one in the effort to attract assets.

Buybacks. When the fund discount gets intolerably wide, the fund's management team may initiate a buyback program. The fund itself may offer to buy back shares until discounts narrow. It does make sense to do this if the discounts get wide enough. After all, the fund is, in effect, replicating its own portfolio, but at a discount. If the portfolio was any good - and obviously, the management team must think it is, or they would get a different portfolio - then it theoretically makes sense to buy as many of the fund's own shares back from the public as possible.

This has the effect of making other

shares more valuable - each share represents a fractionally greater claim on the same portfolio as it did before. The portfolio stays the same - the number of shares and securities in the fund portfolio remains the same. Only the number of shares in the fund, floating around in the market, changes. And after the buyback, there are fewer shareholders, fewer shares, and more scarcity from the point of view of future buyers.

It's also a great excuse for the fund's PR and marketing team to issue a press release and reach out via newsletters, emails and other communications to advisors, at once trumpeting the buyback program itself and the value in the portfolio's securities.

Do buybacks work? Do they actually translate into improvements in fund share prices? Studies indicate that they do.

The dark side of buybacks, of course, is that the cash to execute a buyback has to come from somewhere. And that somewhere is either through debt - saddling the remaining shareholders with an interest payment, or via selling off a good portfolio prematurely to raise the cash on the sly.

Managed Dividend Programs. A managed dividend program occurs when a fund's management team publicly commits to issuing a consistent dividend going forward. This is tricky, because the fund does not want to get cornered into selling off valuable assets too cheaply in order to make the dividend payments. Therefore, it's an offer that can be made only when the fund management team is extremely confident of the soundness of its portfolio. And that's the reason it's so effective - it's like a poker player pushing all his chips into the center of the table. Except that if he's not

bluffing, you win - a steady stream of income.

It's a riskier strategy than a share buyback program. A share buyback is really a form of arbitrage. But studies indicate that managed dividend programs are even more effective than share buybacks at narrowing discounts.

Shareholder Activism. Occasionally, some shareholders themselves will pressure the fund company to take action to narrow discounts - possibly through one of the methods above. But shareholders ultimately have a nuclear option at their disposal: If discounts are stubbornly wide, or if they have no confidence in the management team to narrow them, they can use their proxy votes to elect a board of directors that will vote to change the fund managers.

In some cases, a hedge fund may target a particular closed-end fund with a steep and persistent discount and undertake a proxy campaign to force fund managers and directors to undertake actions to reduce discounts, or lose their jobs. The hedge fund is looking to make a quick gain on the narrowing discount, and is not concerned with the fund's other shareholders or the long-term outlook for the fund.

Alternatively, the fund directors could switch the fund to an open-end fund, though this could cause problems later - the fund would have to give up all the advantages of the closed-end fund structure, a major consideration in less liquid markets. The 50 megaton bomb option is liquidation: The incoming board members force the fund to distribute all its assets to shareholders at net asset value. This could cause tax issues for some shareholders, but you can insulate yourself from a taxable distribution by holding the fund within an IRA or other tax-deferred account.

The Dark Side of Shareholder Activism

Not all shareholder activism is created equal. Proxy campaigns aren't always necessarily all about unlocking value for shareholders. Institutionally installed boards of directors could have outside loyalties of their own that aren't necessarily tied to the fund shareholders at large. It could be a matter of putting someone's nephew or golf buddy on the board of directors.

Shareholder activism can make fund managers very nervous, of course. No one wants to bust their tail researching securities and building a great portfolio. Some managers have been targeted proxy battles despite outstanding investment performance on an NAV basis, only to get fired because the markets haven't caught on to their performance. But that's life in the wild and wooly world of mutual fund management. ■