Capturing Alpha with Closed - End Dividend Funds

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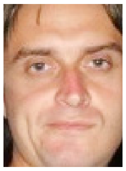

Closed-end dividend funds are one of the better-kept secrets in the investment markets and because of this some of the benefits of these funds are not as widely known as they should be. These funds offer significant advantages over traditional mutual funds that specialize in dividend payouts, so investors with longer-term time horizons will do well to consider buying into some of the more reputable names in order to capture these benefits.

Closed-end funds generally focus on a specific segment of the stock market in developing a clearly defined investment objective to bring value to their clients. These funds offer a variety of ways for investors to generate alpha (excess returns) relative to a specific benchmark. Because of this, closed-end funds present some interesting alternatives when compared to open-end mutual funds, as their fixed share offerings and potential discounts (relative to their Net Asset Value, or NAV) can lead to investment opportunities that cannot be found in other areas of the market. Here, we will look at some of the ways investors can use closed-end funds to gain exposure to stocks with high dividend payouts.

Comparing Relative Dividend Yields

Dividend yields in stocks typically range between 1 and 3 percent, with some sectors (such as real estate, utilities, and certain financials) surpassing these averages and ranging between 4 to 6 percent. But closed-end funds can improve even on these levels as the use of leverage can boost returns and create the potential for higher yield payouts for shareholders. As a starting point, it is important for investors to identify relative yield advantages, as this is the best indication of the amount of dividend income you will be receiving for your initial capital outlay.

Simply choosing a fund with a high dividend might be insufficient, however, as another important factor to consider is the fund's dividend history. This is the surest way of knowing whether or not the current yield level matches the longer-term averages. If the fund's attractive dividend is not a one-time event, there is a much better chance that yields will remain elevated during the life of the investment.

Potential investors will often read a fund's most recent quarterly report in order to determine whether or not a higher dividend payout included a return of principal. Funds that use a return of principal to increase dividend payouts are less preferable because the income attraction of these payouts is limited – you are simply having your own principal returned to you. In addition to this, the share price of the fund will drop to reflect the decreases in capital.

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Using Closed-End Funds to Generate Alpha

Essentially, there are two ways for investors can use closed-end funds to generate alpha and secure long term income from their investments. These can be seen in the potential discount capture that can be derived from these instruments and in the dividend yield enhancements that are offered in some of the more attractive cases. It is useful for investors to have a better sense of all of the common approaches used by investors to generate excess gains and here, we will discuss both options to get a sense of how each strategy works in practice.

Discount Captures

When buying into a closed-end fund at a discount (at a value cheaper than the fund's NAV), a discount capture can be seen if the value of the fund rises and the total discount narrows. This can also be seen if the fund is trading at a premium (above its NAV), which later widens. This latter situation, of course, is riskier as the premium could later disappear and create losses.

Let's assume that an investor buys into a closed-end fund at a 15%

discount. If the NAV were $100, the entry price for the investment would be $85. Hypothetically, if the market improves by 20%, the value of the company matches this change in price, and the discount narrows from 15% to 10%, the discount capture could be easily calculated. Since the NAV is now equal to $120, and the market value is equal to a 10% discount (0.90 x 120 = $108), the return can be seen at 27% (108/85 = 1.27). In this case, the alpha that is generated by the discount capture would be equal to 7%.

Dividend Yield Enhancements

The second common means for capturing alpha can be seen in dividend yield enhancements, which tend to be preferable for longer term investment horizons. The reason for this is that a successful outcome does not depend on changes in the relative discount to the NAV.

Using another hypothetical example, let's assume you bought into a closed-end fund that annually distributes 10% of the company's NAV as a dividend and trades at a 15% discount. If the NAV is equal to $100 and the fund has a market value of $85, the annual dividend of $10 will be equal to 11.8% of the current market value. With this, you would be earning another 1.8% that comes from the yield enhancement alpha relative to the fund's discount.

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Adjusted Expense Ratios

Another factor to consider is the adjusted expense ratio. This is determined by looking at the expense ratio and subtracting the alpha generated by the dividend yield enhancement. In some instances, a negative adjusted expense ratio will be present, and cases like this will provides a layer of protection what will help to prevent losses. So that we can visualize how a negative adjusted expense ratio would come about, assume that the expense ratio in the fund described above is 1% each year.

Since the alpha generated by the dividend yield enhancement is 1.8% (the discount x the distribution percentage), the adjusted expense ratio will be a negative number (–0.8 = 1.0 – 1.8). This essentially means that investors will gain $8 for every $1,000 that is invested in the fund.

Understanding The Effects of Leverage

In order to enhance returns for investors, many closed-end funds (roughly 70%) will use leverage in order to increase position sizes. Leverage is often described as a double-edged sword in that both gains and losses can be magnified significantly, depending on the performance of the investment. For example, assume that a closed-end fund manages assets valued at $100 million and this money is used (with leverage) to buy income-producing assets (such as stocks or bonds) valued at $150 million. The fund will earn yield on the total figure ($150 million) but, at the same time, the yield will apply only to the base value of the fund.

In today's market environment, attractive yields can be difficult to find and many funds will look to apply leverage as a means for generating greater income levels for shareholders. It should be remembered that the use of leverage, in and of itself, is not necessarily a negative that should deter investors from a fund. Dividend yields above 8% are uncommon without the use of leverage but at the same time, these increased position sizes can increase the element of risk profile associated with the investment. Higher leverage tends to create additional volatility in the price of the fund as increased exposure makes investors more vulnerable to declines.

Closed-end dividend funds have attracted a great deal of attention this year, due largely to their impressive yield offerings relative to their counterparts. But since many of these funds have very different approaches to leverage, conservative investors will need a firm understanding of the fund's approach to leverage so that riskier investments can be avoided. Ultimately, conservative investors will accept much lower yields as long as risk is reduced and no leverage is implemented. For investors that are more aggressive and income-oriented, leveraged funds will be viewed a more appropriate option.

Isolating Secure Investment Opportunities

Since most closed-end dividend funds utilize at least some amount of leverage, it is important to separate the high-risk opportunities from those with the potential for stable and sustainable gains. Ideally, the fund will rise in value but if this is not the case, the income produced by the fund will, in many cases, offset any capital losses. The strategic use of leverage offers key advantages when compared to traditional mutual fund or ETF investments, as income-producing funds are able to borrow money at short-term rates and then use that money to make effective secure investments on longer-term rates.

The positive result is an enhanced level of income that can be funneled to shareholders. Downsides, however, can be seen when NAV volatility indirectly creates volatility in the fund's share price. But the use of leverage tends to have positive results as long as the short- and long-term rate spreads don't narrow enough to put pressure on profit margins. Spreads will generally narrow in increasing interest rate environments.

But looking from a longer-term perspective, investors that are focused mainly on generating income can use leveraged funds to isolate enhanced opportunities and gain exposure to a wide variety of assets. As long as investors understand the effects of leverage and the potential risks involved, stable income opportunities can be isolated and greater income gains can be captured.

Cost Advantages of Closed-End Dividend Funds

Since most investors tend to buy into traditional mutual funds well after a bull run has started, mutual fund managers are often forced to buy into stocks trading at expensive levels. In the reverse scenario, most of these investors will sell their mutual fund holding after markets have experienced excessive declines, forcing fund managers to sell stocks at their lows in order to raise the capital that is needed to redeem fund shares. Because of these flawed (and very common) behaviors, mutual funds, in many cases, are forced to buy when prices are elevated and sell when prices are low.

But this is not something closed-end fund managers typically encounter. Aside from portfolio gains and losses, closed-end fund managers have a fixed amount of capital to put toward investments. This means that investment decisions can be made without the need to raise cash for share redemptions. This added stability is clear advantage for funds that specialize in dividend payouts for shareholders. ■