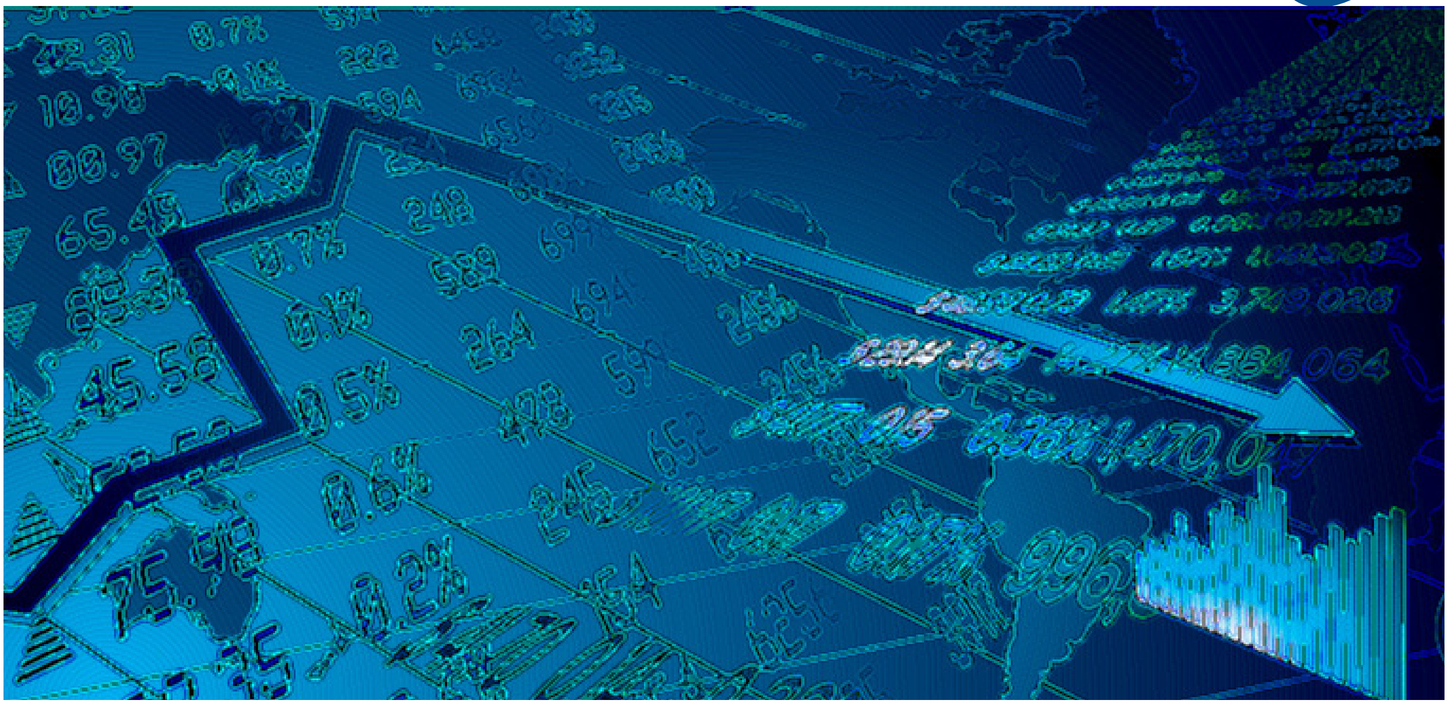

Key Advantages of Closed-End Fund Investments

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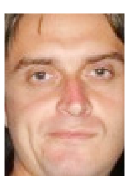

Though, on the surface, their names are quite similar, there are some important differences between closed-end funds and their more conventional open-end mutual fund counterparts that clients should understand before committing to any investment. Closed-end funds issue a fixed number of shares in order to raise a prescribed level of investment capital and tend to focus on specific industries, sectors or geographical markets in specialized portfolios that are actively managed by investment advisors.

The stock prices associated with closed-end funds move in response to the common market forces of supply and demand but are also influenced by the changing values of the underlying securities that make up the total holdings in the fund. In order to capitalize on these movements, these funds are designed to offer several key advantages to investors so that long term gains can be realized, bringing returns that outpace those of more traditional investments. Here, we will look at some of these benefits and outline the reasons closed-end funds present an attractive choice when compared to the alternatives.

Comparing Closed-End Funds with Open-End Funds

When looking the critical aspects of portfolio management, several

characteristics of closed-end funds can be identified which enable clients meet their investment goals. These relate not only to the affordable fees that are generally associated with these funds but also in the ways each portfolio is structured and actively managed. Cash flows in and out of open-end funds create a greater sense of unpredictability making it difficult for fund managers to focus on longer-term strategies and seize on opportunities that might involve less liquid securities. But this is not true for closed-end funds, as unexpected cash flows are limited and managers are able to approach investments in a more predictable fashion.

With the number of shares in a closed-end fund remaining constant, fund managers are not forced to keep excess cash available or sell shares to account for shareholder redemptions when markets are in decline or experiencing drastic changes in trading volume. At the same time, closed-end fund managers are not showered with new cash that must be invested at rising prices during bull markets. Instead, closed-end fund managers are able to remain heavily invested (without much excess cash) and focus on securities that can perform well over longer time frames. This helps create advantages in the closed-end fund structure when dealing with investments in specialized areas (which might involve low liquidity securities, venture capital prospects, or real estate investments).

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When dealing with open-end funds, market values trade equal to the NAV (net asset value) of that fund. This means that if $100 is invested in an open-end fund, the investor is buying shares that are worth $100 in underlying assets (without considering transaction charges and the investment costs associated with the fund). When dealing with a close-end fund, an investor might buy in at a premium (for example, buying $90 worth of assets for $100) or at a discount (buying $100 worth of assets for $90). These differences can bring some critical flexibility when dealing with current trading values and the performance outlook that is associated with the fund's assets.

Two examples of funds that show specialized investments can be seen with the LMP Real Estate Income Fund (RIT) and ASA Gold (ASA), with their central focus in real estate and precious metals. ASA is a Morningstar Bronze medalist, the Fund buys stocks of companies engaged in the exploration, mining or processing of gold, silver, and other precious minerals. With the long term rallies in precious metals reasserting themselves in recent months and the Fund's current discount of 8.7% (above its six month average of 6.9%), ASA is poised for further strength in the fourth quarter. RIT has seen even stronger rallies this year (higher by 23.5% year-to-date) but with current market values at less than half of the values seen at their all-time highs, there is clear scope for long term gains.

Limiting Transaction Costs

Many of the beneficial differences that can be found in closed-end funds are financial in nature. With closed-end funds, investors are able to avoid the costs that would otherwise accrue when shares are created or redeemed. Additionally, the potential for investor returns is enhanced by the fact that very little excess cash is kept in these portfolios. For these reasons, market fluctuations are generally viewed as being less consequential in terms of how it affects the fund's performance record. When stocks drop in an extreme (and potentially irrational) fashion, closed-end funds are often in a position to step in at bargain prices where open-end funds are typically forced to sell too early and at unfavorable market values.

One common concern when clients are considering an investment in a closed-end fund is the question of additional requirements or limitations that might be associated with each transaction but, since the process is essentially identical to the purchase or sale of any stock on a traditional exchange, this is not the case. All of the common investments strategies (such as market orders, limit orders, stop orders, short selling, and margin buying) are accessible in the buying and selling of closed-end funds.

General Fund Advantages

There are some characteristics of closed-end funds in general that can provide investment benefits for clients. The first is that commission charges are clearly defined before any transactions are completed. Clients pay one commission charge to buy shares in a closed-end fund and then another commission charge to sell those shares back later (closing the investment). Typically these are the sole transaction-related costs that will be seen during the life of the investment as closed-end funds typically won't impose "trail commissions" (12b-1 fees), which are annual charges that are required by many mutual funds. Another factor to consider is that closed-end funds differ from most mutual funds in that there are no minimum values for share purchases or sales.

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Buying-In at Discount Prices

Perhaps the most often discussed advantage of buying into a closed-end fund can be seen when a fund is bought at a discount relative to its NAV. Essentially, this means that investors can buy $10 worth of assets for less than $10. This possibility offers up some clear advantages for two reasons.

In income generating funds, yields will be higher when measured against Dollars that were initially invested at a discount to NAV. For example, assume a fund has a NAV of $40 per share and a market price of $36 per share (while generating income equal to $2 per year). Investors buying into a mutual fund trading at its NAV would receive a yield of 5%. But when investing in a closed-end fund, the yield relative to the actual Dollar value invested would be 5.6% ($2 divided by $36).

Alternatively, returns can be realized if the discount narrows during the holding period of the investment. The reduction in the discount creates additional opportunities to achieve gains once the fund's shares are sold. Assuming the same scenario in the previous paragraph (buying in at a $4 discount to NAV), gains would be achieved if the discount narrowed, say to $2. In a case like this, the total gains would be calculated by adding the change in the fund's NAV and the $2 reduction in the fund's discount.

Controlling the Timing and Pricing of Each Transaction

Unlike mutual fund orders (which are placed at the end of daily trade, and bought or sold at the closing price), closed-end fund orders can be placed at any time during the trading day. Transaction prices in mutual funds are determined by the closing NAV (minus commissions) but this limited flexibility is generally viewed as unfavorable for more active investors. Additionally, closed-end funds that are purchased using brokerage accounts can be integrated with the various offerings that are provided by the servicing broker. Common examples of this include consolidated statements, "sweeps" of excess cash, margin and broker guidance.

The Use of Leverage

While many of the investment strategies that are used in closed-end funds closely resemble those seen in their open-end counterparts, another key difference can be seen in the use of leverage to maximize returns. To achieve this, fund managers essentially borrow capital or issue preferred shares in order to leverage the portfolio and increase position sizes.

When equity markets trend upward and borrowing costs are lower than the net long-term rates earned by the fund's underlying assets, common shareholders in the fund receive enhanced returns that can far surpass what is typically seen in more traditional investments. It should be remembered that when leverage costs are too high (or if the underlying assets decline in value) volatility can build and losses can accrue more quickly than if position sizes had not been maximized. But given the long-term historical performance of many of the best closed-end funds, risk to reward ratios typically favor the enhanced (leveraged) position sizes as gains tend to far outweigh potential losses.

Automatic Dividend Reinvestment Plans

Another key advantage of closed-end funds can be seen in the fact that they do not carry the ongoing costs that are commonly associated with share distributions. Because of this, the expense ratios tied to closed-end funds will, in many cases, be lower than other investment alternatives. Lower expense ratios tend to boost returns over time, so investors with long-term time horizons will find this to be particularly beneficial. These factors, when combined with automatic dividend reinvestment plans, can provide an additional layer of risk protection, helping to prevent negative returns during the life of the investment.

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In funds with an automatic dividend reinvestment plan, shareholders have added options when receiving dividend distributions. Specifically, shareholders have the option to receive their dividends distributions in cash, or to use those dividend payments to purchase additional shares in the fund. Since these dividend reinvestment plans will automatically reinvest dividend payments in additional fund shares, there will generally be opportunities for clients to make share purchases at less expensive levels and improve on the average entry price of the investment. This added layer of protection can help to limit the possibility of declining returns over time.

Generally, closed-end funds will pay higher levels of income to investors because of their heavier exposure to income-producing assets. This creates consistent inflows of new cash but when clients are considering an investment in a yield-producing fund, it is important to find annual yields that are at least two percentage points above what is seen in US Treasury bonds. Without this, investors should look for funds trading at a discount of at least 10% (assuming it isn't a low-risk bond fund). Warning signals, however, should be acknowledged if the high discount comes from capital distributions or an uncommon one-time payout that won't likely be seen again.

Investors looking for a top performing closed-end fund in this category (international treasuries) should consider the Aberdeen Asia-Pacific Income Fund (FAX), which was given a Gold rating by Morningstar and is one of the only closed-end fund options that provides investors with exposure to the elusive debt markets of emerging Asian nations (in addition to Australia). FAX has seen stable gains so far this year (6.41%) and with continued deterioration in economic conditions, bond markets are likely to remain well-supported into the end of the year. As allocators continue to reassess the status of traditional safe-havens in the treasury markets, regions with robust growth prospects and room for flexibility in monetary policy will likely see continued strength in bonds FAX is positioned to capitalize on these prospects, making it an attractive option in this category.

Focused Diversification and Clear Objectives

When investing in closed-end funds, clients buy into portfolios that are designed to spread potential market risks throughout a variety of sectors. If any one area of the portfolio performs inefficiently, the negative impact will be mitigated by

the securities showing a more stable performance. This balancing effect helps to protect against unexpected market volatility and unpredictable downswings in share values. Portfolio managers monitor these activities on a full-time basis and can adjust positions accordingly in order to meet the demands of a changing market.

A majority of the most well-known closed-end funds tend to specialize in either stock selection or fixed-income securities that meet a clear and consistent objectives (such as capital appreciation or consistent income). Some of these funds will specialize even further (choosing to focus on a certain region or country, for example) and this highly specialized approach allows investors to choose funds with objectives and management styles that are best suited to meet your financial goals.

Two examples of region-specific funds that have received strong ratings can be found with Thai

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Capital Fund (TF) and the European Equity Fund (EEA). TF has received a four-star rating from Morningstar and both funds are rated in the top 10% in their category for the last three months. Economic conditions in Thailand have been relatively sluggish, given the recent weakness in the country's export sector. But with analysts expecting a cut in interest rates in October, we could start to see some positive moves in the Thai banking sector and some support to stock prices in general. With the Thai Capital Fund trading at a discount to NAV (of nearly 8%)

and share values off of their 52-week highs, TF looks set for another run higher into the end of the year.

Alternatively, the European Equity Fund is another top rated performer, investing primarily in equity and equity-linked securities of companies in the Eurozone. EEA has seen a massive rally so far this year (improving by nearly 15% year-to-date) as markets start to price-in increased confidence levels with respect to the ways central bank actions are distributing aid to debt-troubled nations. The Fund invests in a wide variety of sectors (including financials, energy, industrials) and with central bank policy likely to remain accommodative for the remainder of this year, European markets should remain supported. With EEA trading well below its long term averages, there is still an excellent opportunity for investors (even with the substantial rallies seen earlier this year).

Cashing-In on the Benefits

Once you have made the decision on which type of fund to add to your portfolio (emerging markets, commodities, fixed income), clients will benefit from reviewing the discount offered in each potential closed-end fund investment. Broadly speaking, a larger gap between the share price of the fund and its NAV will lead to an increased likelihood that this discount will narrow over time and add to your returns.

A proper evaluation of a fund's discount requires an understanding of the fund's average yearly discount since its IPO. This value should then be compared to the current discount offered by the market with the assumption that stock prices tend to revert back to historical averages over time. For example, if the historical average discount in the fund you are considering can be found at -8%, and market values now show the fund trading at a discount of -13% discount, there is a reasonable expectation that the fund will return to its historical 8% average during the life of your investment (with you pocketing this change in value). Since this is a factor that is not typically seen in more traditional types of fund investments, closed-end funds should be viewed as a strong opportunity to cash in on added benefits. ■