British Asset Manager Calling for Improved Practices at Closed-End Funds

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Corporate governance practices have improved vastly in the last 20 years. But they still have a ways to go.

That's the message from Barry Olliff, the founder and chief investment officer at City of London – who makes a good deal of his money by buying emerging markets closed-end funds at discounts to NAV, and then working with fund companies to take steps to narrow those discounts – boosting returns, and in theory, at least, generating alpha for his investors.

Olliff held a recent conference call in which he discussed at length the central challenge of the closed-end fund universe: The fact that 9 out of 10 funds trade at a discount to the net asset value of the securities in the portfolio.

Olliff took the opportunity to hammer on his central point: Closed-end funds should trade very close to their net asset values. Shareholders have a right to expect NAV. If discounts become too wide for too long, shareholders should expect decisive action from boards and fund managers to narrow them.

What's a Discount Anyway? A Word About CEF Capital Structures

Unlike traditional open-end mutual funds, which sell and redeem an unlimited number shares directly with investors based on the net asset value (NAV) of their portfolios at the end of the trading day, closed-end funds generally only issue a fixed number of shares, which trade just like shares of stock on the exchanges. There is nothing that says the price of the shares on the exchange has to have anything to do with the NAVs in the actual portfolio. Actually, closed-end fund share prices almost never trade exactly at the NAV. In fact, the vast majority of CEFs 518 out of 573 in fact as of February 7th, actually trade at a discount to the NAV price.

That's unacceptable, argues Olliff. Closed-end funds should and do outperform their open-end peers, when it comes to the performance of the underlying portfolio. As Olliff points out, this is because of the intrinsic advantage to the capital structure of closed-end funds. Because CEFs issue a fixed number of shares to people who just buy and sell them from each other on the exchanges, CEF managers don't have to deal with liquidity issues on a day-to-day basis. They don't have to hold cash reserves against redemptions, and typically don't have to unload shares under selling pressure to meet redemptions whenever there's a whiff of panic in the air. Open-end managers have to deal with that all the time.

But the benefits of that capital structure only rarely accrue to the advantage of long-term CEF investors, argues Olliff. In the vast majority

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of those cases, the advantage gets swallowed up in chronic discounts.

An Analogy...

Think of it like driving a new car off the lot. New funds get started up during periods of optimism and euphoria. Fund companies attract capital with elaborate roadshows and sunny press conferences. And then once the fund is available on the NYSE, share values fall off a cliff, and the shiny new fund loses 10 percent of its value for no good reason.

It's ok for liquidity. Value shareholders love to pick up a buck worth of dividends for 90 cents. But all shareholders would benefit from a narrowing of that discount from the average 8-9 percent (and sometimes as high as 16 percent) back to something close to net asset value.

So what, specifically, is Olliff calling for? Here are his central points:

Directors Should Be Truly Independent.

Unfortunately, too often, shareholders allow their boards of directors to lose sight of their responsibilities as watchdogs of shareholder value. The unitary board system, common in the United States, makes it too easy for directors to become too chummy with management companies – and makes them too reluctant to push effectively for reforms or to replace the management team when warranted.

So what should investors expect of their directors, in terms of selection and composition?

- Directors should not be former employees of the fund management company they oversee.
- Directors should be experts on closed-end fund capital structures. This is more important than being an expert on the country or sector the fund invests in. That's the manager's job.
- Directors should not serve longer than three terms on the board.
- Directors should not serve on too many boards simultaneously
- Directors should not become too dependent on compensation they receive as members of the board.

Discount Management Programs Should Have Teeth

Among his points, Olliff argued that every fund should have a robust discount management program written into the prospectus or other governing documents, for everyone to see. For example, the fund should commit to a share buyback program at or very near NAV (allowing for transaction costs). But it's not enough just to have it on paper.

Furthermore, funds should regularly make tender offers at or near NAV. If funds have credibility in doing so, Olliff argues, discounts will narrow, since anyone wanting to liquidate can simply wait until the tender offer comes around. There will be no need for them to discount shares to sell them over the exchanges.

It's not enough just to have a policy on paper, says Olliff. Fund directors should insist that the program be executed vigorously.

What Not to Do.

Furthermore, fund directors should not tolerate the occasional self-serving actions of fund managers that don't add shareholder value, or even undermine it. For example, Olliff described a situation in which one fund of his was trading at a steep discount to NAV. But instead of executing a buyback or taking other steps to narrow the discount, the fund actually moved to issue more shares. The new shares would dilute the ownership interests of existing shareholders. The only effect was to increase the management fees charged by the fund.

In this instance, the decision backfired on the fund company. Olliff bough additional shares at a discount – the only way to counter the dilution caused by the additional float – and brought other shareholders together in a coalition that eventually dismissed the fund management team. ■