Closed-End Fund Basics:
An Ongoing Series Understanding Discounts and Premiums

June 27, 2011
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Most investors understand garden-variety open-end mutual funds just fine: While portfolio theory can get complex, the basics of open-end mutual fund investing are very simple: Investors sell and buy shares directly to and from the fund company, and they price they pay or receive is the net asset value of the shares as of the end of the trading day. That's it.

With open-end mutual funds, you never pay the fund company a discount or premium. You buy your fund shares for the exact cost the market assigns to the securities in the fund portfolio for that day, plus commissions, if any.

Closed-end funds add a whole other layer of fun. Why? Because with closed-end funds, you don't directly pay the aggregate market price of the funds in the portfolio; Instead you pay a price equal to what the market thinks the portfolio and the managers who created it are worth.

Because you don't buy closed-end funds from the fund company, but from other investors through the exchanges, there's no single correct price on any closed end fund share. A closed-end fund and an open end fund could have the exact same portfolio, with the exact same management - and still fetch very different prices in the market.

For no good reason.

And that's the beauty of it.

Discounts and Premiums

When the securities in a closed-end fund portfolio have a net asset value at the end of a trading day of $10, but fund shares trade at $8 per share, we say the fund trades at a discount of 20 percent. If the same closed-end fund were moving shares at $11 per share, we say it is trading at a premium.

We love buying fund shares at a discount. Any time we can buy $10 worth of assets for $8, it's like getting free money. Except that with closed-end funds, that free money doesn't always materialize. For example, that fund can trade at an 8 percent discount indefinitely. Or the discount can become even greater, if the fund's manager falls out of grace with

the market. On the other hand, if the fund's NAV rebounds, the positive market move could attract enough money to push fund shares to a premium: magnifying returns.

Price Dynamics and Arbitrage

If a closed-end fund's price discount gets big enough, sometimes the best move the fund can make is to purchase its own shares on the market. Funds trading at deep discounts have even been known to announce their own liquidation - causing money to pour in at the last minute, driving share prices up and narrowing the discount between the portfolio NAV and fund share prices. Those who bought in when discounts were at their deepest, but shortly before the liquidation realized a windfall in this circumstance.

How to get paid to wait

There are never any guarantees in mutual fund investing. Buy a fund at a 20 percent discount and

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it could go nowhere. Share prices will go up and down, and the discount could widen. But if you buy at a discount, and hold the fund long enough, you do have an advantage: As the shareholder, with an 80 cent investment, you reap the benefits of the dividends and capital gains of a portfolio worth a dollar. The advantages of buying a closed-end fund at a discount are particularly valuable with dividend-paying funds. Here's how: If a fund portfolio is generating a yield of 5 percent, and you can buy at a 10 percent discount, you are actually getting a 5.5 percent dividend. That advantage doesn't go away over time. Whether dividends and interest rates rise or fall, and whether discounts narrow or widen, you will be reaping the benefits of that purchase until the end of time.

Role in a Portfolio

Investors should be prepared to accept an additional layer of volatility in closed-end funds. When a fund falls out of favor, a widening discount as investors dump shares exacerbates the fall in NAVs that precipitated the decline. And this can even plague funds that invest in conservative securities. On the other hand, changes in discounts and premiums can magnify returns on the upside, as success begets success. The result is a higher potential for volatility in closed-end funds than in a comparable open-end fund under similar market conditions. But that volatility comes with potential, and that means closed-end funds can be very attractive for risk-seeking investors. ■