Why Closed-End Funds?

A Tale of Two Portfolio Managers

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By **Jason Van Steenwyk**
Senior Editor of Global Investor Spotlight

Shen a traditional, open-end mutual fund manager gets wind of a negative story affecting his stockpicking universe, he frequently breaks out into a cold sweat. If the news catches on, he can expect the orders to redeem shares for cash to come pouring in any second. So he's got to start raising cash... even if he still thinks the stocks in his portfolio are a compelling buy.

If the news hits The Drudge Report, he's going to have to raise a lot of cash... and keep it on hand even though he thinks the fears are overblown. After all, when he totals his capital inflows against outflows at the end of the day, he doesn't have the option of issuing an IOU; the fund company must redeem those shares for cash.

Frantic Trading

So the manager calls the trading desk. "Folks, I need you to sell 400,000 shares of ACME, 500,000 shares of Quality Industries, and 300,000 shares of Amalgamated Industries, Inc., and I need it to happen by close of business today.

So the traders go to work. But if the market is liquid, and everyone else is selling, the mere fact that an institution is adding their stocks to the market's inventory for sale can drive up bid/ask spreads and drive down stock prices substantially - beyond any rational valuation basis. This hurts shareholders who haven't sold - and potentially causes more of them to bolt - adding to the carnage and overwhelming the capacity of marketmakers to cushion the blow. And since the next day, our poor manager doesn't know what kind of redemptions he'll be running into, he'll have to pull his punches - keeping a healthy amount of his portfolio in cash to meet possible redemptions when he knows he should be buying aggressively.

An ugly scenario.

Meanwhile, Back at the CEF ...

Now, consider an alternative scenario: The manager across town runs a closed-end fund. His fund doesn't buy and sell fund shares on the general market. Instead, his fund has a fixed number of shares, which his fund holders can trade amongst themselves on the exchanges. If anyone wants to cash out shares, they can do so at any time, by directing his broker to find a willing buyer. The news may drive down the price of fund shares, yes, and deepen the price to NAV discount for a time. But the cash redemptions are not the closed-end fund manager's problem. Because he doesn't have to redeem shares out of his portfolio, he doesn't have to sell at the wrong time to raise cash. Instead, if he has cash available, he can take advantage of his crosstown colleague's dilemma. Indeed, he may call up his buddy and say "my traders have figured out you guys are dumping shares. Tough break old chap. But no worries ! We're prepared to buy a good portion of your inventory -- if the price gets low enough."

Our closed-end fund manager doesn't have to tear his hair out trying to find the right balance between growth and cash. Instead, he can finish his coffee and go back to what he does best: Analyzing and picking undervalued securities and managing risks. And laugh while his crosstown friend is racking up portfolio expenses- and blood pressure levels-- with all the trading activity.

Closed End Funds Help Manage Liquidity Risk in Narrow Markets

Now, with highly liquid markets, it doesn't need to be a big deal. There are usually enough buyers and marketmakers in treasuries and large cap U.S. stocks to absorb most news-based movements, though there are exceptions. The closed-end fund advantage, though, quickly becomes apparent in narrow, niche markets, such as country-specific funds or industry-specific funds. Indeed, because of their unique architecture, closed-end funds - and their indexed cousins, exchange-traded funds - have enabled retail investors to take advantage of new markets that were previously inaccessible to them, because no large open-end mutual fund could take the risk of exploring tiny, illiquid or niche-y markets without jacking up expense ratios and cash drag to unacceptable levels.

The bottom line: Any substantial portfolio can benefit from the allocation of a modest proportion of its assets to emerging markets and non-western economies with less liquidity. And prudently-managed closed-end funds run by experienced portfolio managers deserve careful consideration. ■