Closed-End Fund Primer

- How Share Repurchase Programs Add Value For Shareholders

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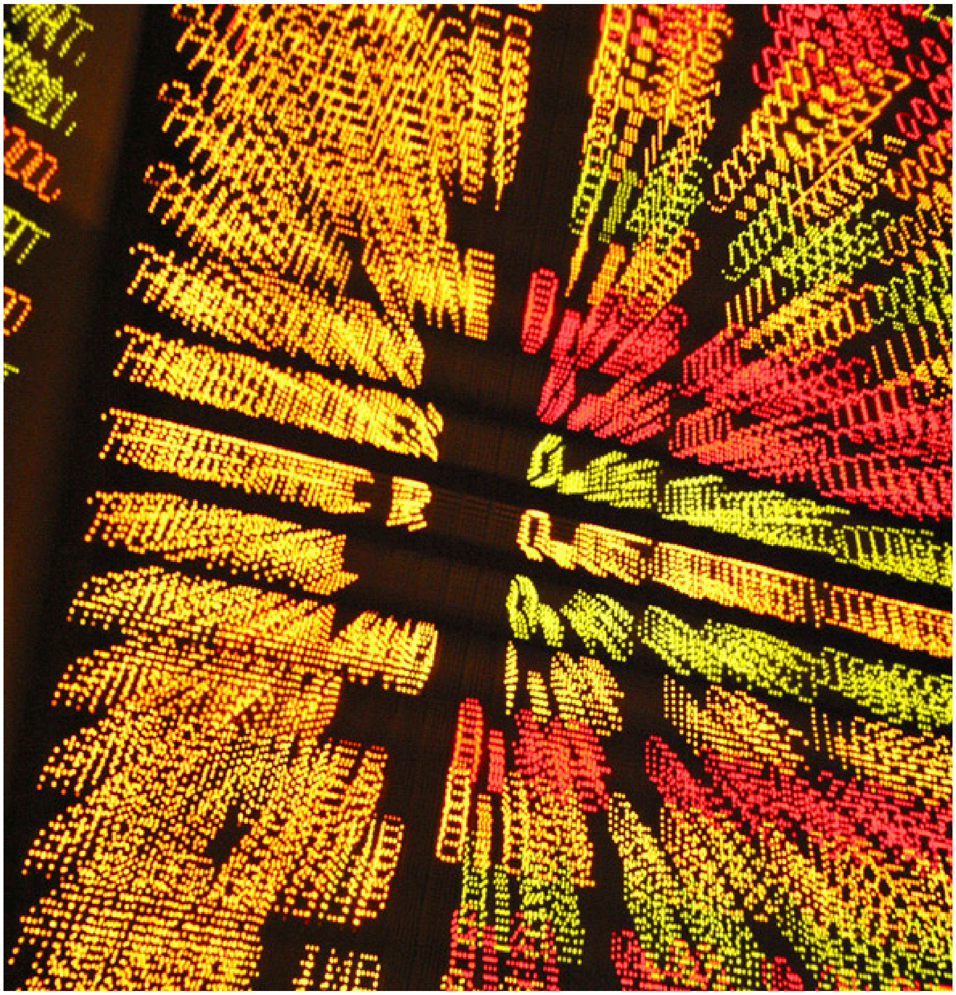

One of the many advantages of closed-end fund investing is the potential for share prices to rise even faster than the share prices of the securities in the fund portfolio. How is this possible? Through the narrowing of discounts (or the expansion of premiums, if the fund is selling at a premium.) This disconnect between closed-end share prices and the value of their underlying portfolios creates another potential source of capital growth. Which means fund managers are constantly on the lookout for ways to narrow discounts. One of the potential tools in their kit is the share repurchase program. Here is how they work:

Discounts and Premiums

Because of the unique structure of closed-end funds, shares in these securities almost always trade at a price that is different from the per-share market value of the securities in the funds' portfolio. This can happen for a variety of reasons: The asset class, sector or region the closed-end fund trades in may simply be out of favor, causing fund shares to trade at a discount, or lower than the net asset value (NAV) of the securities the fund holds. Conversely, if the fund invests in a "hot" segment of the market, or if the management team has an exceptional reputation, investors bid up share prices beyond the NAV, causing the fund to trade at a premium.

Buying at a Discount

Buying at a discount is no guarantee that share prices will go up. In fact, discounts can persist for years. But buying at a discount does give shareholders an edge in a couple of important ways. First, shareholders realize a greater return on equity from any dividends or interest payments the fund kicks off. Second, if market sentiment changes, the shareholder enjoys the compound upside of increasing asset prices and a narrowing discount acting together. With that in mind, closed-end fund managers are always looking for ways to add shareholder value and cause any discounts to narrow.

Share Repurchase Programs

One of the ways a closed-end fund manager can add value for existing shareholders is through a share repurchase program. When fund shares are trading at a substantial discount from the NAV, a closed-end fund may offer to repurchase shares from existing shareholders. This is a win-win, both for those who elect to take advantage of the program and sell their shares, as well as those who remain.

When a fund trading at a discount announces a share repurchase program, they will offer a price greater than the current market price of the shares. This is a better price than those who sell could get elsewhere. Meanwhile, the fund is still acquiring equity for shareholders who remain - at a price lower than what they would pay for if they simply bought shares. Existing shareholders benefit from the lower dilution after a share buyback, simply because with fewer shares in circulation, future dividends and earnings from the portfolio need be split fewer ways

Case Study: Greater China Fund

Let's take a real-world case in point. As of this writing, shares of the Greater China Fund (NYSE - GCH), a prominent closed-end fund specializing in Chinese equities, recently completed a share repurchase program. Specifically, the fund's trustees authorized a repurchase for cash of up to 20 percent of the outstanding shares. The offering price is a 2 percent discount from the fund's net asset value. With the fund currently trading at an 8.34 percent discount from its NAV. Existing fund shareholders benefitted from a substantial premium over the market price over the shares. If they were waiting to sell, the share repurchase program was the ideal time to do so. Meanwhile, existing fund shareholders - those remaining in the fund - stood to have the intrinsic value of their own shares increased by 20 percent, just because of the anti-dilutive effects of the share repurchase program. In this particular case, it is too soon to tell whether shareholders will be rewarded with future outperformance.

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Do Share Repurchases Add Value?

Do share repurchase programs affect returns? Research suggests that the short-term effect of share buyback programs is modest and temporary. However, over the longer haul, a share repurchase program is a very good indicator of future outperformance. A recent study, published in the Financial Review, found that closed-end funds that had executed repurchase agreements exhibited significant outperformance, compared with closed-end funds that had not done repurchase agreements (Akhigbe, et. al., 2007). This was true even after accounting for different regions and asset classes. The effect was most pronounced among equity funds like the Greater China Fund, as well as funds that began the repurchase program trading at significant discounts.

Managed Dividend Programs

Another way closed-end fund managers can potentially add value over and above their NAV returns is through announcing a managed dividend program. This is simply an announcement that the fund plans to issue a minimum dividend each year, regardless of market returns. One common arrangement is a 2.5 percent dividend, distributed quarterly, for a total of 10 percent in dividend payments each year.

To commit to such an arrangement, fund managers must be very confident that the investment environment warrants it. Historically, this practice sends a very powerful market signal that the fund management is bullish about the future prospects for securities in their market, and funds with managed dividend programs tend to outperform funds without them - at least on a pretax basis.

There are, however, a couple of pitfalls for investors. First, these funds are not very tax-efficient. They work best when held in nontaxable accounts, such as IRAs.

Second, when dividends from the portfolio are not sufficient to cover the dividend promised to shareholders, the fund is forced to make up the difference by returning a portion of investors' own capital to them. Do not confuse the managed dividend program yield with an actual dividend yield. The two are not the same things. ■