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Closed-End Funds

Once used to finance U.S. railroad construction, today's closed-end funds offer advantages to investors willing to tolerate market swings

Prepared for *Cigar Aficionado*, *by Mario J. Gabelli*

Mutual funds come in all shapes, colors and sizes. By far the most popular today are open-end funds (both load and no-load), which offer and redeem shares at the net asset value (NAV) of the portfolio at the end of each trading day. However, the first mutual funds were closed-end funds, which issue a fixed number of shares in public offerings and trade on the exchanges just like the stocks of individual companies. While the net asset value of a closed-end fund portfolio certainly has an impact on its price, closed-end funds can trade at discounts or premiums to NAV. Put another way, dispassionate computers calculate the price at which you can buy or sell open-end funds, while the temperamental Mr. Market (supply and demand) determines the prices of closed-end funds.

Approximately 80 percent of all closed-end funds trade on the New York Stock Exchange, with market prices published daily in the stock tables. The NAVs of closed-end funds are a bit harder to track. They are published just once a week in Barron's, in Monday's Wall Street Journal, in Sunday's New York Times, and on several Web sites, including The Closed-End Fund Association (www.closed-endfunds.com).

A Long, Colorful and Controversial History

Before detailing the renaissance of closed-end funds and the advantages of the closed-end fund structure, let's review their long, colorful and controversial history. The first closed-end funds were British investment trusts that were formed in the 1860s. Many were created to invest in the New World, particularly to provide capital for the construction of U.S. railroads. The shares were usually leveraged with money borrowed from banks or raised through the sale of debentures. Their primary investment objective was income rather than capital gains.

During the “Roaring Twenties,” closed-end funds began to proliferate in the United States. Prior to the Great Crash of 1929, closed-end fund assets totaled $4.5 billion, a significant percentage of the total capitalization of the market. While most closed-end funds were managed by responsible investment advisory firms, they were also among the favorite tools of the market shysters of the era. With the stock market roaring and common folks (best exemplified by Joe Kennedy's famous shoeshine boy) chasing instant riches, it was relatively easy for some of the shady characters of the day to sell “blind pool” closed-end funds to the gullible investing public. These funds were easily manipulated, with insiders pumping up share prices and then dumping at a tidy profit.

Due to the extensive use of leverage by legitimate managers, pyramiding (funds buying other funds), and, to a lesser degree, the aforementioned shenanigans, closed-end funds were among the biggest casualties of the Great Crash. Although the Securities Act of 1933, the Securities Exchange Act of 1934 and the Investment Company Act of 1940 reformed the closed-end fund industry with regulations designed to avoid excessive leverage and help protect shareholders from fraud, closed-end funds remained tainted and languished for decades, eventually being supplanted by open-end mutual funds.

Rising From the Ashes

The closed-end fund structure continued to be largely ignored until the mid-1980s, when a number of well-known portfolio managers, including Charles Allmon, Martin Zweig, Chuck Royce and yours truly, successfully brought new closed-end funds to market. Demand for what the financial press dubbed “celebrity funds” was strong, and other prominent investor advisers followed suit.

Due to the spectacular performance of emerging market equities in the early 1980s, closed-end “country funds” also became quite popular. Developing countries need investment capital that is patient and investment bankers correctly decided that the fixed capitalization structure of closed-end funds was much better suited to help build the backbone of emerging market economies than the open-end fund format.

The growing popularity of sector funds (portfolios of stocks in specific industry groups) in the late 1980s and 1990s also gave a boost to the closed-end fund industry. Sector fund aficionados tend to be traders rather than buy-and-hold investors, and the trading flexibility of closed-end funds suited their purposes.

New fixed-income-oriented closed-end funds should come to market as investors look for better returns in a low interest rate environment

Old Dogs and New Tricks

But innovation also deserves credit for closed-end funds' renewed popularity. At the risk of breaking my arm patting myself on the back, Gabelli Funds was one of the leading innovators in the closed-end fund arena.

Our closed-end Gabelli Equity Trust (NYSE–GAB) came to market in August 1986. It was to be a concentrated portfolio of value stocks, and because concentrated portfolios tend to be more volatile than widely diversified portfolios, we believed the closed-end structure was more appropriate. We envisioned the Equity Trust as a capital appreciation vehicle for aggressive investors, and on the “road shows” promoting the Equity Trust for its underwriters, I jokingly described the fund as “ideal for widows and orphans, provided they drink wine, smoke cigars and ride motorcycles.” A little more than a year later, October 1987, the stock market collapsed. Although the Equity Trust portfolio had held up relatively well in the mini-crash and performed quite well as the market recovered in the year ahead, the fund traded at what to us was an unacceptable discount to its net asset value. We thought our shareholders deserved better. So, in an effort to narrow the discount, we created a dividend distribution policy that provided a yearly distribution equaling 10 percent of the fund's NAV. Of course, if the portfolio's return didn't exceed 10 percent, part of this dividend would be a return on shareholder capital-not ideal, but since return on capital is not taxed, not the worst thing for shareholders, either. Our dividend distribution policy was well received and the Equity Trust began trading at a narrower discount to its NAV.

We then looked for ways to enhance portfolio performance. We introduced the conservative use of leverage via sales of preferred shares with fixed dividends. Preferred shareholders received a reasonably attractive yield and common shareholders benefited if the portfolio generated returns in excess of our obligations to preferred shareholders. We recognized that this use of leverage could work against common shareholders in declining markets. However, we believed over the longer term, it would work to our advantage.

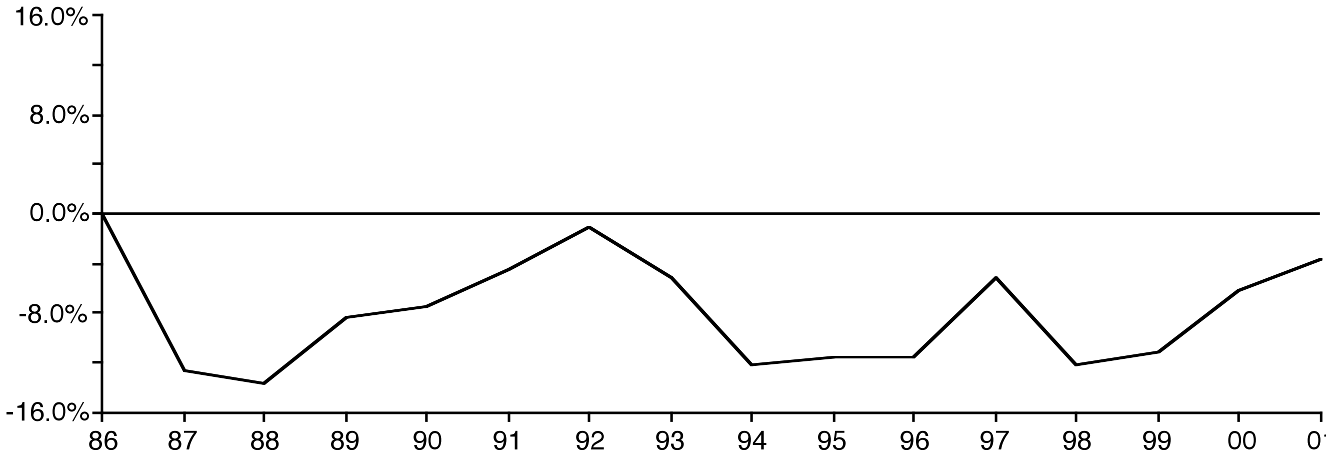
We didn't invent dividend distribution policies or the use of leverage through the issuance of preferred shares. However, we were among the first to reintroduce these strategies and in recent years, other closed-end managers have followed our lead.

The State of the Closed-End Union

During 2000, only six new closed-end funds were brought to market, according to Lipper Inc. However, in 2001, initial public offerings for 39 new closed-end funds raised a total of $7.3 billion, largely in closed-end municipal bond funds. More fixed-income-oriented closed-ends should come to market as investors continue seeking ways to boost investment returns in a low interest rate environment.

Presently the closed-end fund industry has about 588 funds with $150 billion in assets (including preferred issues). According to the Closed-End Fund Association, about two-thirds of these assets are devoted to bond funds. Municipal bond funds are the largest category. The issuance of sector funds devoted to industries such as health care, biotech, banking, energy, multimedia and venture capital is still growing.

However, perhaps a better reflection of the investing public's renewed appreciation of closed-end funds is the very favorable trend in market pricing relative to net asset value. Historically, shares of closed-end funds have traded at discounts, with their market prices often substantially lower then the NAV. But for the first time in decades, many closed-end funds are trading at narrow discounts or even premiums to NAV. This is demonstrated by the following chart of the Herzfeld Closed-End Average, which was established in 1987 and is published weekly in Barron's. This index, which measures average discount/premium to NAV for the domestic closed-end equities fund universe, had never risen to a premium until May 2001. It moved back to a discount in June, rose to a premium again in August, and moved back to a discount in November. At the close of the year, the discount remained modest relative to the historical average.



Source: Herzfeld Closed-End Fund Average. All data from last week in December

The Structural Advantages of Closed-End Funds

The closed-end fund structure offers advantages to fixed-income and equities investors. Closed-end bond funds generally use leverage (borrowing at money market rates and investing in longer-maturity, higher-yielding debt), which can produce higher yields than their normally unleveraged open-end brethren. Consequently, market pricing of closed-end bond funds has been particularly strong.

The narrowing of the discount for closed-end equity funds may reflect investor recognition of the benefits of a fixed capitalization in volatile markets. Speaking for portfolio managers everywhere, I can assure you that money pours in at or near market tops and drains out at or near market bottoms. This penalizes open-end fund managers, who unless they maintain sizable cash positions in their portfolios at all times (always a political dilemma and a performance restraint in rising markets), are often forced to sell when they'd like to be buying and obliged to buy when they'd prefer to be selling. All other things being equal-most notably the ability to attract assets and earn fees-if asked whether it would be preferable to manage a closed-end or open-end fund, every portfolio manager I know would opt for the former.

The more democratic nature and the daily “marked to market” NAV pricing of open-end funds will very likely continue to appeal to the majority of investors. However, those willing to tolerate the vagaries of market-driven pricing for closed-end funds should enjoy the long-term benefits of the funds’ structure, giving fixed-income managers the ability to enhance yield and equity managers more flexibility to buy cheap and sell dear.

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