Global Manager Research

Topical Report

Closed-End Funds: *Tender Offers*

Executive Summary

» *Sometimes a closed-end fund (CEF) offers to tender its shares for a defined period of time. This report reviews the basics of such a corporate action, its consequences, and how shareholders may decide to respond to it.*

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When the market price of a CEF's shares trades at a persistently wide discount to its net asset value (NAV), its board of directors may decide to announce a tender offer, which would usually allow shareholders to tender a portion of their shares to be purchased by the CEF at some point in the future at a narrower discount than the prevailing discount. The objective of conducting a tender offer is usually to attempt to narrow the discount to NAV.

How it works

To illustrate how a tender offer may be structured, we offer a hypothetical example. Assume a CEF is trading at a market price of $9.00 per share and its NAV is $10.00, so it is trading at a discount to NAV of 10%. At this time, the CEF initiates a tender offer to purchase up to 10% of its outstanding shares at 98% of the NAV (i.e. 2% discount) with an expiration date that is 30 days from now (the specific date will be included in the offering materials provided by the CEF). In our hypothetical example, the tender period would commence in five days, meaning that shareholders can submit their shares between the commencement date and the expiration of the tender period (a 25-day window in this case). Please note, until the tender offer expires, shareholders will not know the exact NAV used to calculate the tender price (98% of NAV). In addition, it is common for more than the allotted amount of the outstanding common shares to be tendered (10% in this example). Should that be the case, the shares tendered will be purchased on a pro rata basis and shareholders cannot be assured that the CEF will purchase all of the tendered shares. For example, if all shareholders were to tender all of their shares, the CEF would purchase only 10% of each shareholder's shares. Historically, tender offers are typically oversubscribed because activists or opportunistic investors usually purchase shares after the announcement in order to participate in the tender offer in an attempt to benefit from a potentially narrowing discount. Such an individual may sell short a comparable exchange-traded fund to hedge its long position in the CEF.

Consequences

The tender offer, in the previous example, may provide shareholders with the opportunity to liquidate at least a portion of their shares at a 2% discount to the NAV as of the expiration date. However, one of the considerations that must be taken into account is that the value of the NAV at expiration is unknown at the commencement of the tender period. For example, if the NAV were to fall 10% during the tender period, the price received would be 98% of $9.00, or $8.82 — or lower than the $9.00 market price when the tender was announced. Of course, the NAV could instead increase by 10%, in which case the price received would be 98% of $11.00, or $10.78. As mentioned above, shareholders should not necessarily expect all shares tendered to be purchased by the CEF. Tender offers will usually cause discounts to narrow to a degree. However, given that tenders are typically for a small percentage of the outstanding shares, the degree to which the discount may narrow is difficult to predict. In most cases any narrowing that occurs because of a tender offer tends to be moderate and temporary.

Triggers

Historically, fund management has not initiated a tender offer because it will not voluntarily reduce its assets under management, i.e. willingly reduce its fees that can be collected. In our view, a tender offer is not necessarily in the best interest of long-term shareholders because fixed operating expenses become a more substantial percentage of the diminished asset base. Additionally, the reduced number of shares shrinks liquidity on the secondary market. Rather, it is usually a CEF-savvy and opportunistic investor, who is willing to purchase a significantly large position of a CEF to influence its board, that is the trigger for a tender offer. In order to attempt to prevent wide discounts that may induce activists into action, a few CEFs have policies that trigger a tender offer automatically in the event that the average discount is wider than a specific level (e.g., 10% discount) for a defined measurement period (e.g., a 12-week period ending each December).

How to respond

Generally speaking, Global Manager Research (GMR) does not favor tender offers. Although they do provide shareholders the ability to liquidate positions at a potentially narrower discount and may cause a short-term moderate tightening of the discount, tender offers reduce the asset size of a CEF. As a result, certain fixed operating expenses become a larger percentage of the assets, and smaller CEFs typically exhibit lower trading volume in the secondary market.

Nonetheless, once a tender has been announced, we think it is usually advantageous to tender shares in order to attempt to capture a potential higher price relative to NAV, but is in no way guaranteed. Proceeds from the tender may be used to buy more shares in the open market after the tender, if the discount widens again. Shareholders should consider any tax consequences from such actions.

Closed-End Funds (CEFs) are actively managed and can employ a number of investment strategies in pursuit of the fund's objectives. Some strategies may increase the overall risk of the fund and there is no assurance that any investment strategy will be successful or that the fund will achieve its intended objective. A CEF has both a market price and net asset value (NAV), and these two values and their respective performances may differ. Changes in investor demand for a particular fund may cause the fund to trade at a price that is greater (lower) than it's NAV, creating a share price premium (discount) to its NAV. CEFs are subject to different risks, volatility, fees and expenses. Many CEFs can leverage their assets to enhance yields. Leverage is a speculative technique that exposes a portfolio to increased risk of loss, may cause fluctuations in the market value of the fund's portfolio which could have a disproportionately large effect on the fund's NAV or cause the NAV of the fund generally to decline faster than it would otherwise. The use of leverage and other risk factors are more fully described in each closed-end fund's prospectus under the heading "Risks."

Risk Factors

Exchange-Traded Funds (ETFs) are subject to risks similar to those of stocks. Investment returns may fluctuate and are subject to market volatility, so that an investor's shares, when redeemed, or sold, may be worth more or less than their original cost. ETFs may yield investment results that, before expenses, generally correspond to the price and yield of a particular index. There is no assurance that the price and yield performance of the index can be fully matched.

Short selling involves sophisticated investment techniques that can add additional risk, and involves the risk of potentially unlimited increase in the market value of the security sold short, which could result in potentially unlimited loss for the fund. In addition, taking short positions in securities is a form of leverage which may cause the fund to be more volatile.

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