CLOSED-END FUNDS

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Mariana F. Bush, CFA
(202) 237-1279
mbush@wachoviasec.com

What is a Closed-end Fund?

A Primer on a Type of Fund Little Understood by Many Investors

We believe the easiest way to describe a closed-end fund is to explain the similarities and differences between it and the ubiquitous open-end fund, more commonly known as mutual fund. Neither type of fund is superior to the other, but we believe the investment characteristics of one type of fund are more appropriate than those of the other given the risk profile of a specific individual.

Similarities

- Both are portfolios of securities.
- They may invest in domestic or foreign securities, income or equity securities, taxable or non-taxable securities.
- They are managed. (Index open-end funds are passively managed.)
- They are perpetual. (Very few closed-end funds have a termination date, at which point they will return the underlying assets to investors.)
- Both have a net asset value, which is the value of the portfolio's underlying securities (minus any liabilities) divided by the number of shares.
- Both types of funds must distribute most of the income earned or realized capital gains in a given year in order to maintain their tax status as investment companies.

Differences

- *Limited Number of Shares*. Closed-end funds have a limited number of shares[1]. On the contrary, the number of shares of open-end funds changes constantly as shares are bought and redeemed.
- *Trading*. Because the number of shares of a closed-end fund is limited, this type of fund trades on an exchange[2]. Open-end funds do not. Consequently, the price of a closed-end fund may trade above the fund's net asset value (or it is trading at a premium), at its net asset value or below its net asset value (or it is trading at a discount).

  If the Net Asset Value is $10, and
  if the Price is $11.50, then the fund is trading at a 15% premium;
  if the Price is $9.00, then the fund is trading at a 10% discount.

- *Lower Expenses*. Closed-end funds usually have lower expense ratios in part because they do not have 12b-1 fees, fees that open-end funds may levy in order to pay for marketing the fund.
- *Inefficient Market*. Information on closed-end funds is not always easily available (yet.) This may sometimes create pricing inefficiencies among closed-end funds.
- *No Inopportune Cash Flows*. Portfolio managers do not need to worry about ill-timed cash flows[3]. Investors still tend to add money to those funds whose net asset value is rising and withdraw money from those funds that are performing poorly. That may force managers to buy when the value of a security is rising or sell when the value of a

[1] *The number of shares of a closed-end fund can change in a number of cases: if the fund offers rights to purchase additional shares, retires shares through a buy-back share program or issues shares in a dividend reinvestment program.*
[2] *Mainly the New York Stock Exchange, but also the American Stock Exchange.*
[3] *Yet a closed-end fund may have an ill-timed rights offering, which would add assets to the portfolio near the peak of its underlying market.*

security is falling. This is what Investing 101 teaches us *not* to do. Therefore, we think closed-end funds should outperform equivalent open-end funds in the long-term. (Unfortunately, we have found no truly comparable closed-end and open-end funds — same manager, same objective, same characteristics[i] — to prove this theory in a statistically significant manner.)

- *Higher Volatility*. Closed-end funds tend to be more volatile. While the net asset value volatility should be the same for both types of funds (assuming equivalent funds), the price volatility of a closed-end fund tends to be higher as its discount or premium narrows or widens.
- *Leverage*. A closed-end fund can borrow assets at a lower rate at which it can invest those assets. The majority of income closed-end funds are leveraged. The purpose of leveraging a closed-end fund's assets is to enhance its yield. This additional yield will come at the expense of higher volatility. In other words, a leveraged fund should outperform a nonleveraged fund in a bull market. In contrast, it will underperform an identical nonleveraged fund in a bear market.
- *Liquidity*. Some closed-end funds are small in size and their shares do not trade significantly. Therefore, a larger-than-usual trade may move the closed-end fund's price.
- *Prospectus*. Closed-end funds issue a prospectus only at their initial public offering. After that, they publish an annual and a semi-annual report, which are required by law. More shareholder-friendly managers publish quarterly reports and monthly updates online.

Conclusion

Closed-end funds are more complicated than open-end funds. We think this sometimes results in a less efficiently priced fund since fewer investors understand closed-end funds. But, therein lies the opportunity. Closed-end funds are not better or worse than other similar products. We think they are more (or less) appropriate for a specific investor.

Additional information is available upon request.

[i] *We found several funds — an open-end and a closed-end — with the same portfolio manager and similar investment objectives, but the funds still had some crucial differences that accounted for the divergence in their performance. For example, a banking open-end fund had a much larger median market capitalization than its closed-end fund twin due to its larger asset size and the need to invest in more liquid stocks in case of redemptions. A health care closed-end fund owned restricted securities, not found in its twin open-end fund. An emerging markets equity open-end fund held a larger cash position compared to its fully-invested twin closed-end fund.*