your wealth

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OPEN TO THE CLOSED

It is always nice to have a head start with any endeavour you undertake and this includes investing. So when there is an opportunity to pick up an investment at a significant discount, it deserves attention. Where can an investor find this free lunch? Closed-end funds may offer this opportunity from time to time. This article will educate readers on this area of equity investing and direct the reader to items worth paying attention to.

Closed-end funds have many of the same advantages of open-end mutual funds and a few disadvantages. These disadvantages can play into the hands of the patient investor. The similarities are they both offer the investor a way to invest in a diversified basket of securities that may include common stocks, income trusts, and a varietiy of bonds and cash securities. They both can offer either active or passive management. Active management is when the portfolio manager of the pool attempts to add value by changing security selections to improve returns (we hope). Passive management is when the portfolio manager replicates the performance of an index, index sector or maintains a fixed weighting to a pool of securities as set out in the prospectus. Costs to run the fund in both cases are deducted from the returns of the security pool.

Returns of both types of funds will be driven by the performance of the underlying securities. They both can go up and/ or down in value. They both can have very aggressive or conservative investment objectives as laid out in the prospectus. However, it is important to note that neither type of investment is guaranteed.

Here are some of the important differences between open and closed-end mutual funds. The fund company of a mutual fund (open-end) will always have the fund available for sale or redemption on a continuous basis (liquidity). The assets of the fund will either grow or decline through time based on investor interest in the fund. The fund manager will clear purchases and sales at the net asset value (NAV) of the fund at the end of every business day. This continuous sales cycle is important as the costs to support the sales effort in terms of marketing and fees paid to advisors make up a significant part of the costs to run the mutual fund. In some cases almost half of the Management Expense Ratio (MER). This process also means there are no "sales" or discounts on the units in mutual funds.

In a closed-end fund, the fund manager offers the fund for sale once, as a new issue. The marketing costs are embedded into the fund right up front. The result is the ongoing costs (MERs) usually are much less. It also means that at new issue the assets are priced at a premium to pay for these costs. We will discuss the importance of this later. After the new issue the closed-end fund is listed on an exchange where shareholders may offer for sale and investors can make bids on the shares. Quite often the prices vary significantly from the underlying value of the pool of securities. There are often significant discounts on these assets. Closed-end fund managers will usually make available on their websites the NAV of the fund and investors can compare the underlying value to the price on the exchange.

Why would this be the case? It is one of the drawbacks of closed-end funds for the impatient investor. They lack the liquidity that their open-end counterparts have. A closed-end fund may have a small asset base, they have limited research coverage relative to other mutual funds and a very small investor following. There is only one reason to buy a security (you want it to go up) and thousands of reasons to sell (buy a house, pay taxes, university, health emergency and so on) and if someone needs the money badly enough and it is a narrow market they will offer a deal to move it and this results in a discount. ☛

A discount is only useful if there is a reasonable belief that the investor can have the investment realize its true value. Closed-end funds do have mechanisms in place to help with this. Investors and advisors must carefully read the prospectus so they understand their rights because not all closed end funds have the same covenants. Common clauses may include annual or monthly redemption privileges directly to the fund manager at NAV or at some defined discount to NAV. There may also be a windup date at some point in the future where the manager will sell the securities and send the proceeds to the shareholders to realize the underlying value of the securities. Usually there will be a shareholder vote at that time to determine if they wish to wind-up or continue on.

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Should investors buy closed-end funds at new issue? The answer is, it depends. There are a significant number available for purchase in the after market (on the exchange) and most are offered at some discount. Most of the new offerings are variations on an existing theme. There are a few that offer unique twists that are worth looking at but most often it is best to buy them afterwards on the exchange. The reason is, as mentioned before, the distribution costs are front ended on most closed end funds at new issue. The result is that the investor ends up purchasing assets at some premium to pay for the distribution costs versus the opportunity to buy them at a discount later on the exchange.

If your advisor recommends you a closed-end fund you may want to ask if there is a similar fund available on the exchange already. It may amount to an immediate improvement of return. Other important questions to ask include;

- What are the redemption privileges and when does the fund intend to windup?
- What is the mechanism for this process?
- Have they read the prospectus and what do they think are the key elements?
- What are the pages you should refer to in the prospectus?

By asking these questions you will quickly find out if your advisor has done their home work. The Sedar website (www.sedar.com) will almost always have a copy of the prospectus for review.

I have seen instances in portfolio audits where an investor has two closed-end funds from the same manager but where offered at new issue a year apart from each other. The funds were variations on a theme, one was an equal weight on the index and the other was the top 100 securities equally weighted. The performance of these two funds would be very similar going forward. The difference was that the investor had the opportunity to buy the older fund on the exchange at a significant discount rather than the new issue at a premium. It was a 10% head start. It would have been very difficult indeed for the new issue to make-up the performance differential over time even when including the trading costs to buy the older fund on the exchange.

Here is an example of where I like to employ closed end funds in portfolio construction. I use them predominantly in adding income trust allocations in modest portfolios. It provides the portfolio with solid diversification and it is very cost effective. One in particular, is an equal weighted basket of income trusts and it is rebalanced every year. It is a passive approach and avoids one of the major flaws of indexing. Indexing will allocate assets according to the weighting each security and sector have in the index. It can lead to very heavy over-weights over time. For example the energy sector today or the telecoms sector in 2000.

The other wonderful part about benefit of certain closed-end funds is that they can save the investor almost 1.5% in MERs versus many actively managed income trust mutual funds. It will be very hard for a manager to make up that gap over time. They also have a free decision making process down the road as there are no deferred sales charges (DSC fees). My view is that investors should avoid DSC fees. They hinder good investment decisions and do not balance investor and advisor outcomes. The reader can refer to my previous articles on this subject.

Closed-end funds often offer better value than Exchange Traded Funds (ETFs) because ETFs tend not to trade at discounts and often the discount embedded in closed-end funds more than make up for the variations in the MERs.

So while closed-end funds are not a free lunch per se they can offer great value if you follow some of the tips above. Copies of previous articles are available on www.jpeterhodgson.com .

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