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Symposium, Mutual Fund Regulation in the Next Millennium, Commentary on Closed-End Funds

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IV. CLOSED-END FUNDS

PROF. HAAS: I have to take blame for this panel because closed-end funds are something in which I am personally interested. I find them quite fascinating. After you learn more about them you might wonder about me. But I do find them quite fascinating. We are going to look specifically at closed-end funds in the context of a statement made by Michael Porter, veteran analyst at Salomon Smith Barney. As he put it, closed-end funds are "a product whose time has passed." That is the issue. And our moderator is none other than Larry Barnett from Widener University.

MR. BARNETT: Our panelists include Karrie McMillan, counsel at Shearman & Sterling, Ed Bergan, General Counsel of Alliance Fund Distributors, Ron Feiman, partner at Mayer, Brown & Platt, and Professor Haas of New York Law School. Given the short time we have for this panel, let me call on the first speaker, Mr. Ed Bergan.

MR. BERGAN: Okay, thank you. I was asked to talk about an issue, which is sort of the "issue du jour" with regard to closed-end funds: what is a closed-end fund and why are so many people interested in it?

The essential difference between closed-end funds and open-end, or regular, mutual funds is that closed-end funds usually trade on one of the national stock exchanges, normally, in fact, the New York Stock Exchange (NYSE). Like any other NYSE-listed stock, they have their own market price, set by the auction floor. The market price is not necessarily the same as, indeed it is usually different from, the fund's net asset value. So for open-ended funds we can, and do, buy and redeem them every day at their per share net asset value (i.e., book value per share). However, in the case of closed-end funds, you purchase them on the open market at whatever the market price is, which may be at a discount or premium to net asset value, and you sell them in the open market through your broker.

Closed-end funds have an important legal difference, as well. They are not offering redeemable shares. They have a fixed number of shares outstanding, subject of course to subsequent offerings, rights offerings or small issuances through dividend reinvestment plans, for example. Structurally they look much more like operating companies, such as Ford Motor Company. They have a listed class of shares outstanding. They have a large constant number of shares outstanding which are not redeemable. Rather, you sell the shares for cash, which then go through the open market in the same way as shares of Ford Motor Company. It's a very different dynamic from the regular open-end mutual fund. Trading closed-end funds do not involve all of the opportunities and pitfalls that you have when trading shares of IBM, Ford Motor, or Cisco. Therein lies the opportunity and therein lies, some people would say, the problem.

Although there are some exceptions, shares of closed-end equity funds by and large, and, at least for the moment, shares of a lot of the closed-end bond funds, trade at significant discounts from net asset value. Much attention has been focused on what you might call global equity funds. Global equity funds are closed-end funds that invest principally in equity securities issued from outside of the U.S. The classic type of closed-end global equity fund (being the "country fund," like a Spain fund or a Southern Africa fund, to name two of ours) invests largely in the equity securities of foreign issuers.

The principal reason why we have such funds in closed-end form, and this is part of the answer to the broad question of whether these funds are outmoded or not, is that they are investing principally in markets where there is not anywhere near the same day-in, day-out market liquidity that you have here in the United States. Here in the U.S., if you have a portfolio of NYSE-listed stocks, you can take on new positions and you can liquidate positions relatively easily. And if, for instance, you are an open-end fund and you get major redemptions and you need to sell portfolio holdings to raise cash in order to meet those redemptions here in the U.S. markets, that's not really a hard thing to do.

In the case of Austria, to take the other extreme, that is very hard to do. There is not a lot of market liquidity in Austria; for all but a literal handful of the largest stocks, it takes time to build up or eliminate positions in Austrian stocks. There is just not enough market liquidity to be able to deal with the relatively sudden inflows or outflows of cash that you can see coming from the U.S. open-end mutual fund market and in relatively volatile markets, in particular. So, at least with regard to many country funds, the answer to the question may be, "No, the funds are not quite yet obsolete."

Discounts trouble people. Relatively few of these funds are very new, so relatively few of these funds have, as any sizable portion of their shareholder base, purchasers in their initial public offerings. So much of what has been said about the plight of the investor in the initial public offering (IPO) may be somewhat beside the point these days because most of the shareholders, a rather large majority of the shareholders, tend to be purchasers who bought their shares at whatever the current market price was one or two years ago, whenever they bought them. And if they bought them in recent years, then they bought those shares at much the same discounts that they happen to be trading at now.

That said, the question is "Why do you have these discounts?" Again, looking at the issue from the standpoint of the global equity fund, which I think presents the starkest cases and which have seen much of the more interesting legal developments in the last two or three years, much of the work done by the analysts suggests that there is (and this ought not to be too surprising), a rather close correlation between the direction of open-end mutual fund flows and closed-end fund discounts. In other words, if open-end global equity funds happen to be selling well here in the U.S., then normally you will see, and this is historically demonstrable, a trend towards narrowing closed-end equity fund discounts, closed-end global equity fund discounts, or even their going premiums. For instance, these funds generally did trade at premiums in the late 1980's, early 1990's. However, when open-end global equity funds are not selling well, closed-end global equity funds tend to trade at larger discounts.

Are those unrelated developments? Well, obviously not. Both open-end equity funds and closed-end equity funds are deriving their buy side appetites from the same universe of U.S. retail investors. When the U.S. retail investor, for all the obvious reasons, is as logically fixated on the U.S. market as U.S. retail investors have been for the last six years, we have a very hard time selling our global open-end equity funds, even though some of them do perform very, very well. And all of our closed-end global equity funds are trading at the same sizable discounts as all the other funds are. It is more of a macro-phenomenon than sometimes you read. I think it has also been demonstrated that there really is no correlation between relative fund performance and relative fund discount. It is, again, rather more macro.

PROF. HAAS: Obviously your company sells a fair number of closed-end funds. When a prospective shareholder buys shares in an IPO of a closed-end fund, which is much like an IPO for a dot.com company these days, there are underwriting commissions and discounts, and other expenses. Is it safe to say that those equal about nine to ten percent?

MR. BERGAN: Less.

PROF. HAAS: A little less than that?

MR. BERGAN: Yes.

PROF. HAAS: Let's say, what do you want to give me, eight percent?

MR. BERGAN: Five to seven.

PROF. HAAS: Five percent? Okay, five percent.

MR. BERGAN: Five to seven, yes.

PROF. HAAS: Five percent off the top. So, when I buy a dollar's worth of closed-end funds in an IPO I only get ninety-five cents in terms of assets?

MR. BERGAN: Yes. Using a five percent spread like that, you would be investing ninety-five cents, indeed.

PROF. HAAS: Why would I want to do that? Why would I want to give you a dollar and get ninety-five cents in return?

MR. BERGAN: In most of the deals done over about the last seven years, you would not have to do that. Bear in mind that it's just the same for a dot.com; nonetheless, it may be more visible with an investment company because of the certainty of the underlying book value. What we, for instance, and the underwriters, and most of the other large closed-end sponsors, began to do about '93 or '94 was to provide that the underwriting spread would not be paid by the shareholder in the IPO. Rather, it would be advanced by the fund's sponsor so that shareholders would not pay that five percent and all 100 cents on the dollar would be going to work right away. The sponsor, over a period of eight or so years, would be gradually reimbursed through the fund's management and other fees.

MR. FEIMAN: Could I step back to answer that question as to the reason why closed-end funds theoretically exist, what it is about them, and what they can accomplish, that makes them more attractive to investors. It's that justification, together with the existence of the discount, that induces shareholders to invest in a closed-end fund. Because they can buy illiquid securities and they don't have to redeem, closed end funds have less invested in cash instruments for defensive purposes. That means, theoretically, that they can achieve a higher return than that of a fund that has fifteen percent of its assets earning money market rates. They can also engage in other strategies that are not permitted to open end funds. They can engage in more leverage: they can offer securities to some investors at rates that are low or floating or are fixed at a certain level. Or they can engage in short selling or other strategies that you might think more common in hedge fund.

There are other examples of closed-end funds that have the same approach. There are a series of funds that invest in bank loans. Bank loans are not as easily traded as other types of debt instruments, so they've adopted a closed-end fund format with, usually, periodic repurchases to reflect the fact that they are illiquid securities and only have to liquidate when they are ready to repurchase.

Because they can buy illiquid securities, closed-end funds have less invested and they don't have to redeem. They have less invested in cash instruments. That means, theoretically, that they can achieve a higher return than that on a fund that has fifteen percent of its assets earning money market rates. They can also engage in other strategies that are not permitted to open-end funds. They can engage in leverage. They can offer securities to some investors at rates that are low or flow or are fixed at a certain level. Or they can engage in short selling and other strategies that you might think are more common in a hedge fund.

Now, by doing so, closed-end funds are telling investors that with a riskier strategy (i.e., through leverage, through investing in illiquid instruments) that they ought to be able to achieve a higher return. The additional risk should result in additional rewards.

And that's why people in theory would be buying at a discount, an initial discount. They would be getting ninety-five cents worth of assets that will grow at a higher rate than the assets that they would invest at 100 cents on the dollar.

PROF. HAAS: So that five cents really is, I guess, the ticket of admission to an investment portfolio that they really couldn't get elsewhere, they couldn't get on the open market.

MR. BARNETT: That's right. That's what's being offered.

MR. BERGAN: That's been the theory.

PROF. HAAS: That's been the theory.

MR. BERGAN: I think, practically speaking, you will not see too many deals done anymore with front-end spreads like that.

MS. McMILLAN: It's also important to remember that many open-end funds also charge loads or they charge a 12b-1 fee, which is a percentage of assets every year. It is more of a hidden charge, but it is still a charge that investors are paying for the distribution costs. In the case of open-end funds, many of them charge a front end load. So, the shareholders' money is not all going to work in the beginning. Or the shareholders pay a 12b-1 fee, which is a fee that's paid out of fund assets each year, say one percent or seventy-five basis points. It's very similar to the traditional spread in a closed-end fund, but you don't find a lot of people saying, "Oh, we should do away with open-end front end loads." It's just the entrance price, for a fund distributed by a brokerage firm.

MR. FEIMAN: In part, that's the answer to why an initial discount might exist. Ed has answered, to some extent, why a subsequent discount exists: namely, that there's a lack of market interest in the particular flavor of that type of security. If you don't want to buy Austrian securities at all, then a fund that holds a lot of them is not going to have the interest that a fund in dot.com companies would have when such stocks are hot. Therefore, you'd expect a lack of market interest to be reflected in the discount.

MR. BERGAN: We are one of the largest closed-end sponsors, although actually about ninety-five percent of our assets are on the open-end side, but we have nine different closed-end bond funds with assets ranging between $100 million and about $1.5 billion. All nine funds, which had been trading by and large pretty near par in the last two months of 1999, suddenly went to sizable discounts virtually in lock step with almost every other closed-end bond fund out there. The reason was that investors were obviously in need of tax losses. 1999 was a rather good year. People were trying to find tax losses. There were not too many places to find them other than closed-end bond funds. It hadn't been a good year in the U.S. bond market, as you know. So you had very substantial discounts, moves of fifteen to twenty percent of underlying book value, rapidly appearing in the last months of the year. They are now in the process of rapidly disappearing. And, again, discounts are coming back to normal levels. I offer that simply as a demonstration that as large as these funds look, they are relatively thin markets.

MR. FEIMAN: Before we get to figure out how to fix the discount, I wanted to throw in a couple of other theories about why they might exist at this point.

One theory is that the stock market has been rising and flows into open-end funds have been steadily increasing. Obviously, at a time where money is flowing into funds, they don't need to maintain the same degree of liquidity that they would during a downturn. Which means that the difference between a closed-end fund and an open-end fund, in terms of preserving a cushion for liquidity, is reduced. Therefore, at the moment, open-end funds can perform more competitively, if not better, than closed-end funds and have done so. When you can invest in an open-end fund or a closed-end fund with the same degree of risk or lack of risk and you can get your money out whole, with the assurance of net asset value from an open-end fund, there is again a market disincentive to invest in the closed-end fund. But should conditions reverse, the impetus for a closed-end fund will again be demonstrated and the discount should be reduced competitively.

PROF. HAAS: A question for the panel. One of the ways companies going public choose a lead underwriter is they have a beauty contest. Underwriters come in and explain what services they are going to provide and why they are particularly good at marketing securities for this particular type of company. One of the ways you distinguish between underwriters is what I call after-market support. That is, what will the underwriter do for your company after it goes public? Will it be out there with research reports? Will it engage in stabilization activities with respect to the stock price? Is there after-market support for closed-end funds? And is that part of the problem? Is that one of the reasons why people are not interested in closed-end funds?

MR. BERGAN: It's a question with a somewhat intricate answer. I mean, there are underwriters who have a historical specialty or strength in doing closed-end funds. Indeed, it's usually the same four suspects. They do provide after-market support in the sense of good analyst coverage, good coverage within their own sales forces which, after all, tends to be where most of the stock stays. And that's good. We get research from underwriting companies all over the Street. The market research they do, though, is it as helpful as analyst coverage and what I'll call the sales system support? No.

I have made a number of presentations over the years on the general proposition that one contributing factor to closed-end discounts, particularly among U.S. equity funds and to some extent the bond funds, has been the practical inability of closed-end funds to pay the sort of ongoing trail commissions that are paid on behalf of open-end funds routinely. That is now starting to change. The law has more or less come around and for once the operation systems trail the law, rather than the other way around. And the operation systems are now starting to come around. So you will see them beginning that change. I am on record as having said that it might make some difference in some cases.

PROF. HAAS: Well, that is certainly going to help going forward, that is, having brokers compensated for, in essence, pushing shares of closed-end funds to their clients.

MR. BERGAN: Yes. And it is basically leveling the playing field between closed and comparable open-end funds. This will take time. It will not come in overnight.

PROF. HAAS: There's no doubt that in the mutual fund world closed-end funds are the Rodney Dangerfields. That is, they don't get any respect. And it is not going to change unless things like this change. Now, the discount. The portfolio of a closed-end fund indicates it is worth $20 per share. However, it is trading at, say, $18.50 on the stock market. Can we do anything to change that to get that market price up to net asset value?

MR. BERGAN: You know, gravity works perspective. How many operating companies, how many listed companies on the

NYSE trade below book? A big, big number. Maybe even more than half. It's not an exceptional circumstance. And when you have assets of an unusually certain value and people wanting to be compensated for taking risk, I think you have got to realize people wanting to get paid for risk don't want to own a fund if they cannot get it for a few points below book.

PROF. HAAS: In the case of funds, closed-end funds that hold illiquid securities, ones that aren't easily disposed of, the discount seems to make some sense in that people are suspicious that the board of that fund is overvaluing those illiquid assets.

MR. BERGAN: That's right.

PROF. HAAS: But how does that explain discounts for your bond funds, which have assets that are liquid?

MR. BERGAN: People are making market calls. If one of our big U.S. bond funds is trading, say at a three percent discount, that's a market call on rates. The bond funds particularly trade to a deal or, more accurately, trade to a projected deal.

MS. McMILLAN: I think you also find that some of it self-perpetuates. For all that you learn about efficient capital markets and rational markets, that's not necessarily the case. And right now you are finding that a lot of arbitrageurs and others are going out to the press and to the public and saying, "Gosh, discounts are a horrible thing. This is the worst thing that's ever happened to closed-end funds. You've got to eliminate the discount." So you have a lot of investors looking around and going, "Closed-end funds, bad thing. Don't want to buy them." You find that the market persona of closed-ends also becomes negative and it just feeds on itself. It is hard to quantify and it is hard to be able to say exactly how much that is contributing to the problem, but I think it is a contributing factor right now.

PROF. HAAS: I certainly agree with that. Let us say I was running an operating company and the share price was trading below book value. I am screaming to the press that you are not valuing my company properly, that is, the intrinsic value is really worth a lot more than my share price. But the market is coming up with an objective price based on a fair amount of information. In situations like this, we have these wonderful things called hostile takeovers where, if a company is not living up to the value of its assets, that is, its intrinsic value, someone can swoop in, buy the shares, oust management, and either run the company better so that share price increases, or break up the company and sell it in bits and pieces and realize value that way. Why don't we have an effective system with respect to closed-end funds where we can basically close discounts right away by taking over the poor performing funds?

MR. FEIMAN: The difference between the operating company and the closed-end fund is that the performance of the operating company is something that shareholders may wish to change. It is the performance of management in managing the underlying assets in the business that they have. Whereas a closed-end fund cannot improve the price of the Austrian security in which it has invested; it is what it is, just as the bond that is trading at par is what it is. Therefore, the discount is not a judgment on management and its capabilities, except to the extent that management is able to reduce the discount. Rather, it's a judgment on the asset class that's being owned by the closed-end fund.

When health care stocks were hot, health care funds would sell at a premium. Now health care stocks are not doing so well and you'd expect a discount. The discount or premium reflects the desirability to investors of owning that type of asset. The discount reflects the volatility of the class. To the extent that the whole purpose of the closed-end fund is to be more volatile than an open-end fund, you'd expect large discounts and sizable premiums as the underlying assets become more or less desirable. I don't think, just theoretically, that the existence of a discount is a negative judgment on management. Clearly, a takeover and an attempt to open-end or to dispose of the assets will allow the arbitrageur to capture the discount. But then he eliminates the opportunity that shareholders have bought for that asset class to turn around. If you believe that such a thing is possible, then you should not be fighting so hard to judge the quality of the fund on the basis of its discount.

MR. BERGAN: Two comments on that. One is that you do see some cases where in fact there have been hostile takeovers and after a certain amount of trial and error, both practically and legally, the hostile takeovers have, I think, found a fairly effective tactic if they are willing to invest. If you are an arbitrageur, this is a definite gulp call. But, nonetheless, you do see those willing to invest two years or about a year and a half, long enough to gain a sizable position take over two classes of a three class staggered board. If you do that, then you can do whatever you want. The reduction in the closed-end equity fund population during the last two years has everything to do with that. So I would say yes, to some extent there is that sort of mechanism working. Why does it work? Well, practically speaking, I think it's a case of relative shareholder value within particular types of fund classes. Or, to put that in less grandiose terms, it's where the arbitrageurs think they can make the most money. So, to that extent, there is self-correction.

The second thing is that, like operating companies, there are some of us who have buybacks running in four different bond funds right now. You use buybacks in less than drastic situations for the purpose of introducing limited corrections to what you see as market inefficiencies, and also for the express purpose of drawing attention to your own fund performance or whatever else. So you will, in fact, use things that way.

MR. FEIMAN: I am speaking on a theoretical basis. Because if you look at closed-end fund performance on the average level it has not achieved the spectacular returns that were projected. In many instances, closed-end funds haven't performed as well as their open-end counterparts. Clearly, you would say that lousy investment selection ought to result in a greater discount. To that extent, as a judgment on the stock or bond picking abilities of the manager, some level of the discount presumably exists to reflect that. I don't believe that the arbitrageurs really intend to turn around the company and operate it as a more successful business doing better stock picking.

PROF. HAAS: Can I add to that point? I've got a quote from some individuals who studied closed-end funds. Lee, Shliefer and Thaler in their 1991 study stated: "Like casinos and snake oil, closed-end funds are a device by which smart entrepreneurs take advantage of a less sophisticated public."[1] I think the evidence has certainly indicated that, in periods of investor euphoria, closed-end funds tend to be put together and sold. However, when investor

1. Charles M. Lee, Andrei Shleifer & Richard H. Thaler, *Investor Sentiment and the Closed-End Fund Puzzle*, J. OF FINANCE 75, 84 (Mar. 1991).

sentiment is not very favorable you don't see many closed-end funds coming out.

MR. FEIMAN: I think it is a sad but true thing about the markets, that investors tend to want to go into things when they have been successful. But is it more of an evil for investors to jump into a closed-end fund that may suffer a discount when there is a decline in the type of investments that it holds, than for them to invest in an open-end fund that will have to sell its investments in a declining market as investors redeem? Open-end funds are also created during periods of market euphoria.