



HIDDEN COSTS OF INVESTING: CLOSED-END FUNDS

Investors often ask me to look at their existing portfolios and offer my thoughts on them. Over the years, I've wondered why so many of these portfolios contain closed-end funds. They are fickle investments, often trading in the market at a discount to their underlying portfolio value, usually in investment categories with perfectly good alternatives available.

I'm not the only person ever to wonder about closed-end funds. The persistent discount to underlying value at which closed-end funds often trade has been fodder for academic discussion for years. In my view, we now know the solution to this puzzle. To me, the mystery is why anyone buys them at all.

CLOSED-END FUNDS

Like their more familiar cousins, open-end mutual funds, closed-end funds are a type of investment company. An investment company is a corporation set up specifically to establish a portfolio of securities (with a manager to run it) and distribute shares representing interests in the portfolio to the public. Both open- and closed-end funds come under the regulatory ambit of the Investment Company Act of 1940.

If you invest in an open-end fund (the familiar mutual fund), your cash increases the size of the fund, and the fund issues you new shares. To calculate how many shares to give you, the fund trustee divides your dollar investment by the fund's net asset value per share, so you receive shares representing a fair proportion of the fund's portfolio. (If you invest in a load fund, you receive a number of shares representing what's left of your investment after the sales load. The bulk of the load goes to your broker.) When you sell your shares, you receive net asset value for your shares, less any redemption fees or back-end sales charges. Your withdrawal reduces the size of the fund. After it redeems your shares, the fund simply cancels them.

While an open-end fund expands and contracts to accommodate investor demand, a closed-end fund issues a fixed number of shares. The only time you can buy new shares is during the fund's initial selling period. Once the selling period is over, buying and selling of fund shares only occurs in the secondary market. To buy (or sell) shares of the fund, you have to find a seller (or buyer), and trade at a market-clearing price. This market price will not necessarily equal, or

even be especially close to, net asset value. Many seasoned closed-end funds, in fact, trade at persistent discounts to net asset value.

THE CLOSED-END FUND DISCOUNT “MYSTERY”

Academics have puzzled for years over the persistent discount to NAV at which many closed-end funds seem to trade. A closed-end fund holds a pool of securities, whose value the fund manager reports every day. Why should an investor be able to buy that pool of securities at a price (the fund’s market price) below its value (the fund’s net asset value, or NAV)? More puzzling still, many closed-end funds trade at a premium to NAV for a while after launch, only to fall to a discount later. What’s happening here?

Study of the closed-end fund discount goes back at least to Burton Malkiel, who wrote about the phenomenon in 1977.¹ Professor Malkiel looked at investment management fees as a possible explanation, but concluded that they were too small to explain the discount. Countless investigators since then have simply quoted Prof. Malkiel, and ignored management fees. Another tentative explanation has come from proponents of behavioral finance. They have argued that the closed-end fund discount arises from some sort of collective derangement among investors, driving fund premia and discounts according to investor sentiment.

In my view, neither Prof. Malkiel nor the behaviorists are correct. To me, the most persuasive (and best-documented) explanation of the closed-end fund discount is from my dissertation advisor, Stephen A. Ross, now at MIT.² Prof. Ross argues that the explanation does lie largely with investment management fees. The closed-end fund discount, he contends, represents the fraction of the present value of the fund’s cash flows that go to fees, rather than to investors. When you own an open-end fund, you are in a pool of assets whose value you can realize on any given day. So while the open-end fund manager’s fee reduces performance, it does not impose a discount to the fund’s value relative to NAV. With a closed-end fund, you buy the assets, but you also enter into an obligation to pay an investment manager to manage the portfolio. If there’s a discount, it represents the value — the *negative* value — of the investment management contract that encumbers the fund.

¹ Malkiel, Burton, 1977, The valuation of closed-end investment company shares, *Journal of Finance* 32, 847–859.

² Professor Ross has spoken extensively on this subject; one example was Stephen A. Ross, “Behavioral Finance — The Closed End Fund Puzzle,” IMA Public Lecture, University of Minnesota, March 30, 2004. The slides are available at <http://www.ima.umn.edu/public-lecture/2003-04/ross/index.html>

THE INITIAL PREMIUM

Management costs may explain a persistent discount, but early in their lives closed-end funds often trade at a *premium* to net asset value. Professor Ross slides past the issue, but he makes a couple of observations that point to the answer. He observes, “IPOs [initial public offerings, the process through which securities, including closed-end fund shares, originally come to market] are designed to prevent buyers from inferring information from prices.”³ Put bluntly, the premium often persists during the fund’s initial selling period. The sales process rewards brokers for selling closed-end fund shares to their customers for more than they’re worth, and the product’s design and sales methods aim to make brokers — not customers — more successful.

Let’s look at a specific example, the First Trust/Aberdeen Global Opportunity Income Fund (ticker FAM). This is a global high-yield (that is, junk) bond fund, sporting a high yield and an expense ratio of 1.8%. Currently (6/19/06), its NAV per share is \$18.27, and its market price is \$16.74, a discount of 8.4%. The fund didn’t always trade at a discount. Here’s a graph of the fund’s NAV *versus* its market price since inception November 23, 2004⁴:



The fund started its life at a significant premium; in fact the fund’s fact sheet says that its initial market price was \$20.00 per share, and its initial NAV was \$19.10. Where does that premium come from? Well, let’s look at an excerpt from the fund’s prospectus:

³ See Ross, *op. cit.*, slide 23.

⁴ Source: Fund information sheet at

<http://www.ftadvisors.com/retail/Pages/products/cefproductpage.aspx?Ticker=FAM>. As of 6/20/06.



The following table shows the public offering price, estimated offering expenses, sales load and proceeds to the Fund.

	Per Share

Public offering price.....	\$20.00
Sales load.....	\$.90
Estimated offering expenses.....	\$.04
Proceeds, after expenses, to the Fund..	\$19.06 ⁵

As the prospectus discloses, the initial premium is part of the product’s design. You pay \$20.00 per share, your broker receives a sales load of 90 cents, the fund pays 4 cents of other expenses, and \$19.06 goes into the portfolio. The broker’s job is to persuade you to pay \$20.00 for a security that will be worth \$19.06 on day one. The broker keeps most of the difference. The initial premium is just a sales commission.

Let me summarize. The ongoing discount at which closed-end funds often trade represents compensation to the fund’s *managers*, and the initial premium represents compensation to the people that *sell* the fund. If you buy the fund during the initial selling period and then hold it until it falls to a discount, you end up paying both. Once you’ve paid these costs, they’re sunk. You may have been much better off just waiting for the discount to appear.

What about the transition from premium to discount? In our example, the premium persists for several months, and then the market price suddenly collapses to a discount. Why? The underwriters that bring the fund to market generally can’t sell it all at once, so the selling period lasts for some weeks. If the fund’s market price fell to a discount before the underwriters sold all their shares, interested investors would just buy at a discount in the secondary market. The underwriters would find themselves stuck with shares they’d need to unload, and brokers would lose their opportunity to collect their sales charges. The solution (well, it’s a solution from the point of view of the people selling the fund) is simple — price stabilization, as permitted by regulation and disclosed in the prospectus:

Until the distribution of the Common Shares is complete, Securities and Exchange Commission rules may limit Underwriters and selling group members from bidding for and purchasing the Common Shares. However, the representatives ***may engage in transactions that stabilize the price of the***

⁵ Preliminary prospectus for the First Trust/Aberdeen Global Opportunity Income Fund, included in registration statement for the fund’s shares. I have edited the table for clarity and alignment. Original at <http://www.sec.gov/Archives/edgar/data/1302624/000087562604002167/n2a.txt> at page 38.

Common Shares, such as bids or purchases to peg, fix or maintain that price. ...

Purchases of the Common Shares to stabilize the price or to reduce a short position may cause the price of the Common Shares to be higher than it might be in the absence of such purchases.⁶

This isn't the most transparent language, but it says, in essence, that the underwriters can step into the market to support the market price to prevent it from falling to a discount until the initial distribution of the shares is complete. Further, the underwriters agree not to take advantage of the fact that the price supports will create a market price that is artificially high.

THE WOE OF THE CLOSED-END FUND INVESTOR

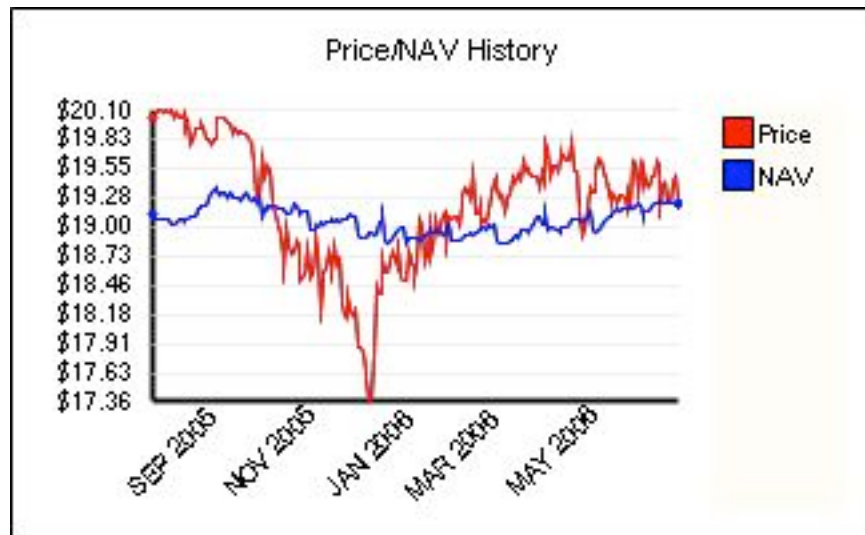
Investing in closed-end funds is not an automatic prescription for losing money. But investing in them at their inception, with the sales load in force, can be costly. If your broker tries to sell you a newly-created closed end fund, here's what may happen. You may well buy at a premium, which represents the sales load that compensates your broker. During the initial sales period, underwriters and members of the selling group may support the price in the market, protecting the sales load by preventing the shares from falling to a discount. Once the selling period is over and the selling group members remove any price supports, the market price of the fund is free to revert to its "natural" level. Often, this level is a discount to NAV. The drop from premium to discount can be sudden. At this point the fund's pricing truly reflects its fundamental value — the value of the pool of assets, adjusted for the encumbrance of the portfolio management agreement.

The table at the end of this note shows results for the current family of First Trust closed-end funds. It gives each fund's inception date, offering price and starting NAV, current (6/21/06) premium or discount, and total return, both in terms of NAV and market value. "Market value total return" reflects what investors might have earned based on the fund's market value; the comparison to NAV market value shows the cost of the closed-end structure.

Note that two funds still trade at a premium. These are the FT Strategic High Income Fund (FHI) and Fund II (FHY), the original and the sequel. This pair makes an interesting case. Let's look at how the premium of the older fund reacted when the newer one came out. FHI's inception date was 7/26/05, and FHY's was 3/28/06. FHI came to market at a premium to NAV, then fell to a discount. By late 2005, the discount had widened to around -8%. Early in 2006, though, the discount reversed to a premium. By the time FHY came to market in March 2006, FHI's premium was broadly comparable to that of the new fund. The connection is

⁶ Prospectus, *ibid.*, page 38. Emphasis added.

suggestive; certainly if FHI had continued to trade at a discount, underwriters would have had much more difficulty selling FHY. One possibility is that the re-emergence of a premium on the original fund provided the impetus to launch the sequel. Alternatively, the re-emergence of the premium on FHI may relate to price supporting operations on FHY, either through arbitrage or more direct intervention. The chart shows the evolution of the NAV and market value of FHI.



Data for First Trust Strategic High Yield Fund (FHI). Source www.ftadvisors.com as of 6/22/06.

SOLVING THE MYSTERY

Although academics have puzzled over the evolution of a typical closed-end fund's premium and discount, more recent analysis suggests that the principal explanation is cost. The premium typical of new funds corresponds to a sales load, supported for a time by market intervention on the part of the underwriters and selling group members. Once that support vanishes, funds often fall to a discount to NAV, which, as Prof. Stephen Ross has argued, reflects the portion of the fund's future cash flows that the investment manager stands to capture. Put another way, the discount reflects the (negative) value to the investor of the investment management contract encumbering the assets in the fund.

Perhaps the greatest mystery is why investors consent to paying the up-front sales loads for new funds. Whatever the reason in any individual case, the persistence of the sales loads testifies to the incentives and success of the salespeople that bring new funds to their customers. The data suggest that if you buy a new closed-end fund at the time of its issue, you are likely to experience a substantial sacrifice of value as the initial premium falls to a discount. While this does not always happen, it happens with enough regularity to suggest careful scrutiny to any



offer of a new fund. If you already own a fund that trades at a discount, the story is a bit different. While the discount may persist, if it has reached a reasonably stable level, that suggests that the cost penalty in the early life of the fund is past, and holding the fund may not be a bad idea. And in some instances, buying a fund that trades at a discount may be reasonable, though the discount may persist, or even widen, through time.

As an investor, you're entitled to full and fair disclosure of the costs of your investments. Granted, the sales charges and the possibility of price deterioration are part of the standard disclosures in any closed-end fund's prospectus. But finding these disclosures takes a sharp eye. One imagines that the brokers that sell these funds like it that way.

-Jonathan Tiemann
Menlo Park
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Tiemann Investment Advisors, LLC is an SEC-registered investment advisor based in Menlo Park, California. For more information, please send your request to information@tiemann.net or visit www.tiemann.net.

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**Selected Data for First Trust
Closed-End Funds**

Source: First Trust, at www.ftadvisors.com. As of 6/22/06.

Fund Name	Inception	Price/NAV at incep	Disc/ Prem 6/21/06	NAV total rtn Incep to date	Market total rtn Incep to date	NAV total rtn YTD 5/31/06	Market total rtn YTD 5/31/06
FT Aberdeen Global Oppty Inc (FAM)	11/23/04	\$20.00/ \$19.10	-6.91%	+9.10%	-4.05%	+0.75%	+6.25%
FT Strateg High Income Fd (FHI)	7/26/05	\$20.00/ \$19.10	+1.25%	+8.71%	+5.93%	+5.39%	+10.38%
FT Strateg High Inc Fund II (FHY)	3/28/06	\$20.00/ \$19.10	+2.80%			+1.10%	-1.25%
FT Value Line 100 Fund (FVL)	6/12/03	\$15.00/ \$14.33	-5.83%	+51.11%	+32.20%	+3.09%	+3.71%
FT Value Line Dividend Fd (FVD)	8/27/03	\$15.00/ \$14.33	-11.64%	+47.27%	+21.22%	+4.71%	+3.34%
FT Value Line Ibbotson Eq Alloc (FVI)	4/27/04	\$20.00/ \$19.10	-8.54%	+52.03%	+29.87%	+6.14%	+6.27%
FT IDAC Mortgage Income Fund (FMY)	5/25/05	\$20.00/ \$19.10	-12.47%	+2.52%	-13.84%	+2.16%	+5.98%
FT Fiduciary AM Cov'd Call (FFA)	8/26/04	\$20.00/ \$19.10	-6.08%	+11.48%	-2.44%	+0.41%	+2.07%
FT Four Corners Sr Float Rate Inc (FCM)	9/25/03	\$20.00/ \$19.10	-5.86%	+17.62%	+4.06%	+3.19%	+7.53%
FT Four Corners Sr Float Rt Inc II (FCT)	5/24/04	\$20.00/ \$19.10	-5.77%	+12.43%	-0.49%	+3.32%	+7.94%
Lehman Bros FT Inc Oppty Fd (LBC)	7/28/03	\$15.00/ \$14.30	-5.80%	+35.43%	+23.30%	+3.52%	-8.30%
Macquarie FT Global Infra/Util Divd Inc (MFD)	3/25/04	\$20.00/ \$19.10	-14.21%	+47.72% (3/31/06)	+32.09% (3/31/06)	+3.85% (3/31/06)	+3.31% (3/31/06)
Energy Income and Growth Fd (FEN)	6/24/04	\$20.00/ \$19.10	-11.87%	+38.55%	+15.04%	+9.98%	-2.28%