A GUIDE TO CLOSED-END FUNDS

SAM

Michael Joseph, CFA
Deputy Chief Investment Officer,
Portfolio Manager

SAM

Buying a Dollar for 50 Cents

Bear markets and speculative stocks don't mix. Throw in some illiquid private placements, and it's no wonder that Source Capital, a closed-end investment company, had fallen out of favor.

It was the early 1970s. The "Go-Go" era of stocks was over. Source Capital was trading close to a 50% discount from the value of the fund's underlying net asset value. And it caught the attention of Warren Buffett and Charlie Munger. They soon owned 20% of the fund.[1]

On their purchase, author Roger Lowenstein quipped that "Buffett and Munger finally came around to Go-Go, but only when everyone else had left the party."[2] It paid off. Their interest in Source Capital was sold in 1977 for nearly $16 million[3], doubling their initial investment.[4]

What Buffett and Munger did was akin to buying a dollar for 50 cents. That's a sound approach in any investment era. But if you're wondering about some of the terms: "closed-end", "private placements", or maybe "net asset value", you're certainly not alone. They're part of the lingo of an obscure corner of the investment universe: closed-end funds (CEFs).

This guide will look to dispel some of the mystery around CEFs. It will provide an introduction to these funds, explain why Stansberry Asset Management (SAM) finds them to be such a compelling opportunity, and give some tips on what you'll want to know before investing.

For those already familiar with the basics, you'll also learn about specific analytical tools you can use to enhance your results. The guide will conclude by revealing how SAM incorporates CEFs into our portfolio strategies.

What is a Closed-End Fund?

Most investors know about mutual funds. These are investment vehicles in which investors pool their money for a shared investment goal. The idea is that with greater collective buying power, investors can own a diversified and professionally managed investment portfolio at an affordable price. Of course, your mileage may vary: diversification, fees, and management ability will vary from fund to fund.

When most people think of fund investing, they're thinking of open-ended funds or mutual funds, which are two ways of describing the same investment.

The mutual part refers to mutually buying investments alongside other investors by pooling your money together. The open-ended part refers to the fund being able to constantly issue and redeem shares to meet the demands of buyers and sellers of the fund.

The price a fund is purchased and redeemed at is based on the net asset value (NAV). The NAV is used to determine the net value of the assets held by the fund. The NAV is always calculated at the end of the trading day. It is commonly used as a per-share value.

NAV=Assets−Liabilities
NAV Per Share=(Assets−Liabilities)/Number of Outstanding Shares

Closed-end funds, on the other hand, cannot continually issue and redeem shares. There are only a few rare instances when a CEF could be redeemed at NAV. It can occur when a CEF converts to become open-ended, when the fund liquidates, or if a tender offer is issued to buy shares at NAV. But apart from these exceptions, you can think of CEFs as having a fixed number of shares.

This generally fixed share count of CEFs affords them two key differences from open-ended funds. First, shares of CEFs can be bought and sold on exchanges throughout the trading day, just like a stock or exchange-traded fund (ETF). And second, the price of shares in a CEF is determined by supply and demand and not the fund's NAV.

As a result, CEF shares can trade at par (at NAV), at a premium (more than NAV), or at a discount (below NAV). In practice, shares very rarely trade at par.

Most CEFs trade at a discount to NAV while some command a premium.

Discount or Premium=
(Share Price−NAV Per Share)/NAV Per Share

A wide disconnect between share price and NAV can create an attractive opportunity. But not always. Understanding why such a disconnect exists is critical in determining whether you've discovered a sound investment or a value trap—that is to say, an investment that looks attractively priced, when in fact it is not.

This guide will identify the causes of NAV discounts, and how you should think about these factors before making an investment. But first, let's take a brief look at the CEF asset class as a whole.

	OPEN-END FUNDS	CLOSED-END FUNDS
ISSUING SHARES	Constantly create and redeem shares	Have an initial public offering (IPO) with a fixed number of shares
LIQUIDATING SHARES	Sellers receive NAV	Sellers receive what the secondary market offers
ASSET BASE	Need to manage for unpredictable flows e.g. may need to liquidate at unattractive prices to meet redemptions	Have a relatively stable asset pool that may be more conducive to successful long-term investing
SHAREHOLDER LIQUIDITY	Orders are processed at the end of the day after the market has closed	Orders can be transacted throughout the trading day

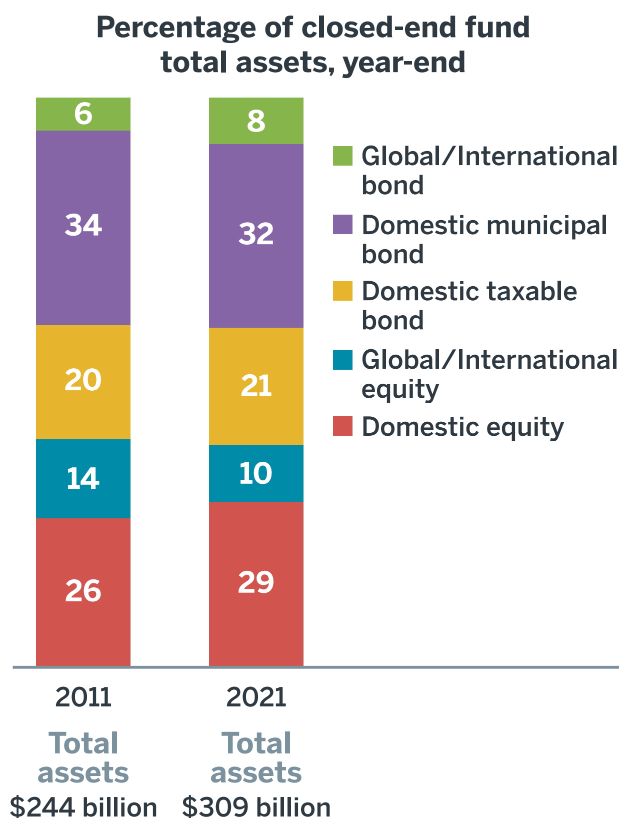
Types of Funds

Despite being a relatively small part of the investment universe, CEFs cover a lot of ground. To categorize the types of CEFs that exist, it's best to start by dividing them between stock funds and bond funds. Roughly 61% of closed-end assets are held by bond funds, with the remainder held in equity funds.[5]

Municipal bonds are the largest single categorical holding of CEFs, making up 32% of total fund assets. These types of bonds are attractive to investors in higher income tax brackets, as they are often exempt from most taxes. Other bond investments can be grouped as domestic taxable bonds and international bonds. But we have really just scratched the surface with this broad categorization. Bond CEFs might specialize in emerging market debt, high yield (junk) bonds, investment grade bonds, convertible bonds, mortgage-backed securities, and limited duration bonds, to name a few.

The second largest category that CEFs invest in are domestic equities. Like the bond categorizations, there can be a myriad of investment types in an equity fund. There are equity CEFs that specialize in commodities, covered calls, real estate, specific sectors, and master limited partnerships (MLPs). On the international equity side, a fund might invest globally (it invests everywhere), internationally (it invests everywhere but the U.S.), or it could specialize in a specific region or single country.

The composition of the closed-end fund market has remained remarkably consistent over the past decade. The largest shift has been away from international equities and into domestic stocks. This is reflected in net share issuance (proceeds from public offerings less repurchases and fund liquidations) over the years. Domestic issuance surpassed international in seven of the past 10 years.[6]



Source: *ICI Research Perspective*, "The Closed-End Fund Market 2021"

When it's time to roll up your sleeves and analyze CEFs, you'll want to examine the holdings carefully. There can be wide differences among funds in the same category. Knowing what you're actually investing in is a great starting point in your analysis. But there's more to analyzing a fund than picking a category and looking at the holdings. We'll discuss analyzing a CEF later in this guide.

Why Aren't Closed-End Funds More Popular?

It's a fair question. After all, who wouldn't want to buy a proverbial dollar for 50 cents like Buffett and Munger did with their Source Capital investment? If CEFs are so great, why don't more people know about them? There are a few factors at play that keep CEFs under the radar of most investors.

It's a small universe.

At the end of 2021, there were 461 closed-end funds in operation. The number of closed-end funds has been consistently shrinking, down 27% over the past decade.[7] Investors had approximately $309 billion invested in CEFs. By contrast, U.S.-registered mutual funds controlled $27 trillion. Add another $7.2 trillion in ETFs, and it's clear that CEFs are the little fish in the big investment company pond.[8]

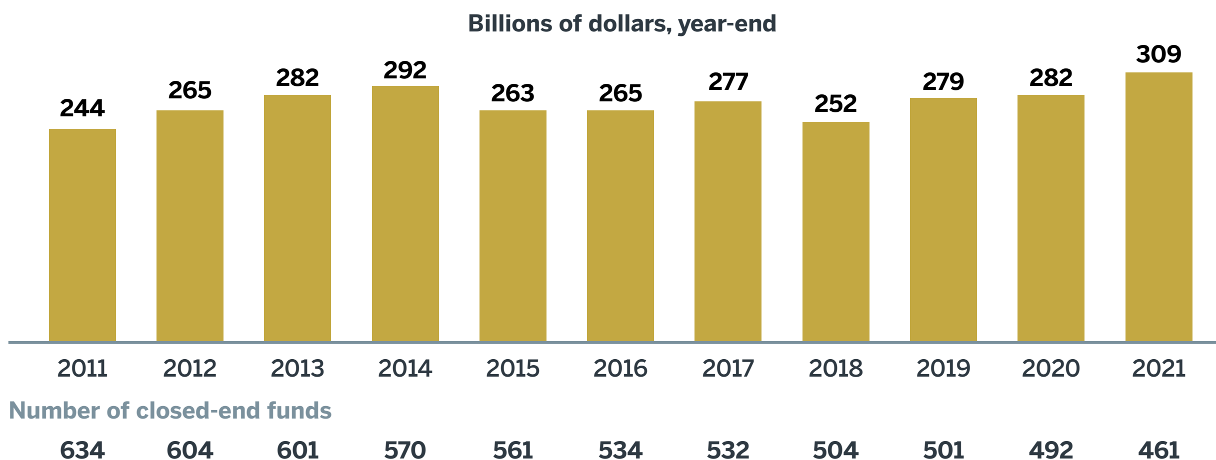
It wasn't always this way. 100 years ago—during the Roaring Twenties—CEFs were in their heyday. The economy was growing. Incomes were rising. Optimism ran high. The number of investors swelled. Wall Street bankers were happy to take their cut from the rapidly growing number of closed-end fund IPOs.

Then the market crashed. The highly levered CEFs of the day led to huge losses. At the time of the 1929 crash, CEFs dominated the investment company industry. Many were wiped out in short order. By the end of the year, 174 survived, with assets of $2.6 billion.[9]

But they had caused investors to suffer terribly. The investing public lost their confidence in CEFs, and they would never regain their prominence. By 1940, the total closed-end market had dwindled to $65 million.[10]

Open-end mutual funds didn't have the baggage that CEFs came with. Their lack of leverage and ability to redeem shares at NAV offered a feeling of stability that investors wanted. Open-end funds had taken the lead in number of shareholders and assets by 1944.[11] They exploded in popularity after World War II, and never looked back. Meanwhile, CEFs never regained their previous stature in the investment world.

Total Assets of Closed-End Funds Were $309 Billion at Year-End 2021



Note: *Total assets* is the fair value of assets held in closed-end fund portfolios funded by common and preferred shares less any liabilities (not including liabilities attributed to preferred shares)
Source: Investment Company Institute

They don't advertise.

This one's pretty simple. Open-end mutual fund companies are constantly trying to attract more investor assets to their funds. Part of their effort involves advertising. And because they advertise, the general investing public is more likely to be aware of these funds.

On the other hand, closed-end funds—by definition—are not in the business of issuing more shares. Unless you're buying during an IPO, you'll be acquiring your shares in the secondary market from another investor, not the CEF itself. And since the CEF doesn't have shares to sell you, there's little reason to bother with advertising the fund.

Wall Street doesn't make money off them.

Not much anyway. Sure, there's some underwriting fees to be made off an IPO. But the number of funds is dwindling. It's not every day that a new CEF gets launched. And the dollar amounts tend to be small potatoes compared to what's at stake when a high-profile "unicorn" gets taken public.

It's not just bankers. Brokers aren't compensated for selling CEFs like they are with open-ended funds with loads. Load is a euphemism for sales commission. Mutual funds pay a "load" to brokers to compensate them for selling you their fund.

The U.S. Security and Exchange Commission (SEC) caps this payout at a generous 8.5%.[12] With such an arrangement, if you invested $100,000 in a fund, only $91,5000 would actually get invested. $8,500 would go directly into the pocket of the broker that sold you the fund.

This dynamic is nothing new. Benjamin Graham, the father of value investing, wrote about it in his classic book *The Intelligent Investor*.

"Open-end (mutual funds)... are being sold by many thousands of energetic and persuasive salesmen, (while) the closed-end shares have no one especially interested in distributing them."[13]
—Benjamin Graham

CEFs or Mutual Funds?

In some respects, investors would be attracted to a CEF for the same reasons they'd be interested in an open-ended mutual fund. For one thing, they want professional management. Few investors possess the skill, temperament and time to successfully manage their own assets.

Diversification is another attractive feature in fund investing. It's been called "the only free lunch" on Wall Street. CEFs hold a portfolio of securities, which helps to spread market risk. It's worth noting that investment companies like CEFs may be considered "diversified investment companies" or "non-diversified investment companies". Diversified funds are more likely to invest across several sectors, while non-diversified investments usually take a more focused approach. The latter may still have numerous holdings. But as an example, owning 30 different natural gas pipeline companies in an energy infrastructure fund doesn't provide all that much diversification benefit.

Just like with CEF categories, when it comes to diversification—don't just trust, verify! And know that when you're looking at a holdings list, you're looking at a snapshot in time. It will change. Astute investors will monitor their fund's holdings and be aware of style drift or other changes in approach.

As an investor, you can't take these features for granted. Just because a fund is managed by a professional does not mean they will do a particularly good job managing your money. Even if they are highly competent, that doesn't mean their style is a match for what you're looking for.

And diversification, while undoubtedly offering some benefit to investors, can easily be overdone. Especially with funds. There are many funds out there that own hundreds of stocks. If you own 10 funds, you could potentially own thousands of stocks!

This can result in overlapping holdings and unexpected concentrations. It's inefficient from a trading and tax perspective. And of course, those fund managers don't know you or what you own.

Because of these issues and others, SAM is not an advocate of a portfolio consisting entirely of funds. Frankly, we are not fans of mutual funds.

However, closed end funds possess an attractive trait over open-end funds. It is, in SAM's view, the biggest reason why you should consider CEFs.

Closed-End Funds Can Trade at a Substantial Discount to NAV

Imagine going to a department store to purchase a jacket you already planned to buy—and you see it on a sale rack at 30% off! There's a good chance you're in luck. But wait a minute. Why is it on sale? Maybe a reason you don't care about—the store ordered too much inventory, for example. But don't assume. Maybe a button is missing. Or the liner is coming undone. Was there a manufacturing error that makes the jacket fit poorly? A tear or stain that isn't noticeable at first glance? A closer look is warranted.

It's the same with CEFs. The discount *could* be a great bargain. It provides a unique sort of leverage. (I don't mean capital structure leverage—we'll get to that.) Imagine buying $50,000 of shares in a CEF trading at a 50% discount. You paid $50,000, but you effectively own $100,000 of securities! And if those securities yield 3%—guess what? Since you bought them at a 50% discount, your yield is 6%! This is in part how CEFs manage to offer such attractive yields.

Remember that mention about mutual funds with a load—the commission that the broker gets for selling you the fund? If done right, buying a CEF at a discount resembles the opposite of that. When you invest in an open-ended fund with a 5% load, you'll only receive $950 of securities for every $1,000 you invest. On the other hand, investing in a CEF at a 15% discount would get you $1,000 worth of securities for only $850.

But let's not get too excited—there can be very good reasons for a CEF to be "cheap". On the other hand, the reason may not deter you at all. In any case, it's worth exploring why these NAV discounts exist in the first place.

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Why Would a Fund Trade at a Discount?

There's no one-size-fits-all answer here, and that's why you'll want to get a better understanding of the CEF you're interested in instead of simply looking for ones with the biggest discount.

A CEF may trade above or below its NAV for a variety of reasons. Some are specific to the fund. Some are market driven. Some lean towards extraneous, like year-end tax selling. Here are the primary drivers of NAV discounts you'll want to consider:

Poor performance. Just as "star managers" will attract a lot of capital, the opposite is also true—capital gets pulled from poor performers.

Fees. CEFs will charge management and fund expense fees before any income is distributed to shareholders. It makes sense that a fund with higher management and administrative expenses should trade at a larger discount than a comparable fund with a lower expense ratio. (We'll cover this in more depth in the Analyzing Closed-End Funds section).

Illiquid holdings. Some CEFs hold illiquid holdings such as private placements. These can be difficult to value, and could require a price concession if they had to be liquidated. The opaque nature of these holdings and difficulty of selling them for a fair price could contribute to a CEF selling at a NAV discount.

Unattractive or infrequent distributions. Income generation is a primary objective for many CEF investors. A fund that pays shareholders a generous monthly distribution will likely have a narrower discount than an otherwise comparable fund with a stingy payout to be received quarterly or annually.

Market sentiment. Discounts to NAV tend to be larger for CEFs across the board in bear market periods than in bull markets. Sector or country funds are particularly vulnerable to swings in market sentiment when problems or uncertainties develop, or their area of specialization simply falls out of favor.

Inability to redeem at NAV. While trading in the secondary market is what creates the possibility of a discount, not every investor wants that. Some view CEFs as more risky than open-ended funds because they cannot be redeemed at NAV on demand.

Trading volume. From year-end tax selling to big orders from institutional players, a rush of trading volume can quickly dislocate a CEF from its NAV—particularly for a smaller CEF with limited liquidity.

Some of these reasons are universally appreciated. Nobody likes paying high fees, for example. Others may be more or less important depending on your situation. The key is to understand why the discount likely exists, and what that means for you.

If this is not an income investment for you, do you really care how frequently distributions are made, as long as you believe in the management of the fund?

If you're a contrarian investor, do you care about market sentiment? Perhaps you're inclined to patiently hold out of favor CEFs and get paid to wait for that NAV discount to narrow once more.

But let's address the elephant in the room…

Do CEFs Trade at a Discount Because They Are Bad Investments?

Certainly some investors think so…and they are part of why that discount exists! If there was more investor demand for CEFs, that gap between share price and NAV would naturally close.

Just like any other type of investment, CEFs have wiped out some investors. I mentioned earlier their freefall during the Great Crash of 1929. In the late 1980s, CEFs had a popularity surge with the launch of several single-country funds. With names like "Korea Fund" and "Spain Fund", these CEF's weren't stretching the boundaries of creative marketing. They didn't have to. Single-country funds were all the rage.

Until they weren't. Single-country CEFs commonly traded at premiums above 100% in 1989. By 1990, investors were taking it on the chin. The Korea Fund and Spain Fund saw their share prices drop 39.0% and 42.4% in less than 5 months.[14] Many other single-country funds followed suit. A switch in market sentiment combined with an ever-increasing number of international investment options discouraged investors from paying such extraordinary premiums.

Of course, a handful of rough periods shouldn't undermine an entire asset class. There is ample evidence that CEFs can be a profitable investment choice.

A classic study by Professor Seth Copeland Anderson that spanned two decades certainly suggested so. While at the University of Alabama, he studied eight different strategies involving buying CEFs at predetermined NAV discount gaps and selling once the gap narrowed to certain levels. The buy and sell signals varied across the eight strategies.

The results: ***Every one of them outperformed the S&P 500***. The most successful strategy was to buy funds selling at a 20% discount, and to sell them once the discount narrowed to 15%. Not rocket science. But this simple strategy resulted in a nearly 3,000% return over the 20-year test period.[15]

Active trading isn't a requirement: simply buying and holding CEFs was a winning strategy compared to the S&P 500. It also outperformed a few of the active CEF strategies.

The Anderson study corroborates an earlier study by Professor Rex Thompson, who studied CEF performance over a 35-year period. He found that "discounted fund shares, adjusted for risk, tended to outperform the market."[16] He also noted that "funds selling at a premium appear to have been bad investments over the same time period."[17]

So are CEFs a great investment? It depends on the fund. And the timing. In that regard, they are not much different than any other investment. Mr. Buffett and Mr. Munger doubled their money with a CEF in just a few years. That doesn't mean you will. But maybe you can! Those sort of gains are much more likely if a discounted fund can substantially close the gap between its share price and NAV.

Closing the Gap

Earlier we examined the reasons why a CEF is likely to trade at a discount. Logically, when those reasons are remedied (market sentiment improves or performance gets better, as examples), the discount to NAV should narrow.

But there are three specific actions that can be implemented to directly address the issue of a large gap between share price and NAV.

Buy back shares. Fund management can opt to do a tender offer in which they will buy back some of the CEF's discounted shares at or close to NAV. This is often achieved by selling securities from the portfolio at their full market value and using the proceeds to repurchase shares. A tender offer such as this allows shareholders to exit some or all of their shares at a better price than they're likely to get on the secondary market.

Open-end the fund. By restructuring the CEF to an open-ended mutual fund, existing shareholders can redeem at NAV, immediately eliminating the NAV gap.

Liquidate. Rather than restructure, a CEF can close up shop—liquidating the fund's investment portfolio at full market value and returning capital to shareholders.

You might already be sensing the conflict in these decisions. Fund management has a duty to promote what is in the best interests of shareholders. For a fund trading at a stubbornly high discount to NAV, it would seem likely that taking steps to allow shareholders to recognize the full value of their investment would be appropriate.

At the same time, the fund managers typically earn a management fee based on the size of the fund's assets. Liquidating the fund means they're out of a job. Open-ending the fund would likely result in a massive wave of redemptions, shrinking the asset base.

Sometimes management does take these steps on their own. If they don't, and a NAV discount persists, it can attract activist shareholders. Some may be enticed by the potential to unlock attractive short-term returns if they can open-end or liquidate the fund. Longer-minded investors may have an interest to take board seats, reorganize the fund, or even manage it themselves.

"Raiders" have short-term gains in mind. They purchase a significant number of shares on the open market and then attempt to force the fund to open-end or liquidate. As dominant shareholders, they attempt to influence management and other shareholders. The most common way to force a fund to open-end is through proxy solicitation.

Raiding a fund is nothing new. Before expanding his activist playing field to all of corporate America, Carl Icahn specialized in pressuring CEF managers to liquidate their portfolios.[18] And while the Buffett/Munger investment doesn't fall into the raid category, Munger joined the fund's board and was reportedly not shy about taking a sledgehammer to anything he didn't like about the fund's portfolio.[19]

More recently, Saba Capital CEO Boaz Weinstein has launched a campaign for board seats at three Franklin Templeton closed-end funds.[20] The funds have traded at notable discounts to NAV and consistently lagged the performance of their benchmark index. Saba has launched dozens of campaigns to prompt CEFs to take action to reduce or eliminate their discounts.[21]

Funds that are most likely to be activist targets could have a wide discount to NAV, poor performance and management, and own liquid securities. Outside investors are required to file a Schedule 13D with the SEC when their holdings amount to 5% or more of the company's outstanding shares. Following these filings can alert you to which CEFs may have caught the attention of an activist investor.

But it may be folly to try to predict which CEF will be a target, or even to piggyback off a raider. CEF veteran Thomas Herzfeld reckons that in only about two or three of every 10 takeover attempts do shareholders get out at NAV.[22] Meanwhile, the cost to defend the fund runs up the expense ratio—penalizing existing shareholders.

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Should I Only Buy CEFs at a Discount?

When a CEF first comes to market it has an IPO, similar to a stock. Funds are typically issued at a premium to NAV. And even after it's been traded in the secondary market for some time, you can still find CEFs trading at a premium to NAV.

Why would people buy a CEF at a premium? Is there ever an instance when it is advisable?

A CEF can trade at a premium for several reasons. Perhaps it's a specialized fund investing in a hot area. Maybe investors have extreme confidence in the fund's management to outperform. If the fund invests in a restricted or difficult to access investment area, like certain foreign countries, that can also drive investors to bid CEF share prices to a premium.

Just because other investors are willing to pay a premium doesn't mean you should. As it pertains to IPOs, multiple studies suggest it is a bad idea. One such study by Professor Kathleen Weiss examined the IPOs of 64 CEFs between 1985 and 1987, when CEFs were experiencing a resurgence. She found that aftermarket performance of CEF IPOs was notably worse than ordinary stock IPOs. She also noted a "substantial average decline in the value of the funds" during the first 120 trading days after the offering.[23]

A more recent study, provocatively titled ***Closed-end Fund IPOs: Sold, Not Bought***, had similar conclusions. Professors Diana Shao and Jay Ritter found that six months after their offering, CEFs had a negative return of -4.75%, underperforming seasoned funds by 8.52%.[24]

IPO or not, the discount is one of the more attractive aspects of investing in CEFs. Even if the discount remains, you could enjoy (in the case of a 20% discount, for example) the income and appreciation on a full dollar's worth of assets for an 80-cent investment.

This has the effect of amplifying returns. The table below compares a fund purchased at par to one purchased at a 20% discount to NAV. A 10% return on the par portfolio results in just that—a 10% return. But when the underlying assets of the discounted fund appreciate 10%, it actually generates a higher return for the shareholder.

	INVESTMENT	10% NAV APPRECIATION	RETURN ON INVESTMENT
FUND AT PAR	$1,000	$1,100	10%
FUND WITH DISCOUNT	$800	$900	13%

Of course, if the NAV of the discounted fund narrows over time (from 20% to 10% in the table below), the returns can become even more attractive.

	INVESTMENT	10% NAV CLOSURE	10% NAV APPRECIATION	RETURN ON INVESTMENT
FUND AT PAR	$1,000		$1,100	10%
FUND WITH DISCOUNT	$800	$900	$1,000	25%

An investor buying CEFs at a premium to NAV is playing the opposite game. They take on the risk of that premium narrowing or turning into a discount. Consider a fund purchased at the beginning of the year for $15 per share with a NAV of $12. The fund is trading at a 25% premium. A poor market reduces the NAV of the fund to $10 per share by year-end: a 17% NAV decline.

That's bad enough to stomach. But we're not done. CEF discounts tend to widen during uncertain economic times, and shrink, or move to a premium, during bull markets.

What if the fund's lofty 25% premium to NAV shifted to a more-typical 10% discount? The share price will have crashed 40%—more than double the loss of the underlying assets.

	BEGINNING OF YEAR	END OF YEAR	RETURN
NAV	$12	$10	-17%
SHARE PRICE	$15	$9	-40%
PREMIUM/ DISCOUNT	25%	-10%	

With the huge variety of CEFs trading at meaningful discounts, it is hard to justify buying one at a premium.

Analyzing Closed-End Funds

When it comes down to buying CEFs, you need to know what you are looking for—and whether the fund you're looking at is a match. There are many different kinds of funds. Are you looking for a broad equity fund? Exposure to a certain sector or region? After you narrow that down, it's time to dive in!

Composition Analysis

Once you decide what kind of fund you are looking for, it's time to analyze the holdings. Don't assume based on a fund name that you know what the fund is investing in. What you find might surprise you. Roll up your sleeves and know what you'll own before owning it. The time to be surprised about holdings is before you decide to buy.

What you're looking for will depend on the type of fund. For bonds, you'll want to understand the portfolios' average duration, maturity, and credit quality. For a specialized equity fund, you might focus on how closely the holdings follow what you'd expect from the fund. If it is an international fund, what does the geographic exposure look like? If the fund focuses on a particular sector or industry, do the actual holdings match up with the fund's objective? Specialized funds will often own holdings in a related industry. An Energy fund might own Utilities, for example. That doesn't make it bad. The point is to know what you are buying, and make sure it is in line with your goals.

Many CEFs use options, futures, and other derivatives. Do such positions exist in the fund you're looking at? Are you comfortable with that?

Finally, many CEFs hold private placements and other illiquid holdings. This was noted earlier as a reason that funds may trade for a discount. Know if they're in the fund you're looking at. Understand the risk involved. Make sure it's a risk you're willing to take before buying. If it's not—keep looking!

Expense Analysis

Here's the dirty secret about CEFs. Most of them SHOULD trade at a discount. The reason is fees. Just like an open-ended mutual fund or ETF, there are fees associated with closed-end funds, including management fees.

Mutual funds and ETFs typically attract larger amounts of capital than CEFs. Since they are earning their management fee on a larger asset base, there is an economies of scale advantage that enables these funds to operate efficiently at a lower cost than most CEFs. This allows them to charge management fees that are often lower than that of a typical CEF.

If you're holding the same securities you could buy in the open market, only you're paying a 2% annual fee, it makes sense to want a discount. Especially today, when low-cost ETFs and open-ended mutual funds abound.

Some funds will charge more than 2%. Some less. After narrowing down the type of fund you're interested in, and taking a look under the hood at the actual holdings, understanding what you'll be paying to own it is a good next step. We do that by calculating the expense ratio.

Expense Ratio=
Annual Operating Expenses/Average Net Assets

Any CEF will have information about their expenses available to investors. You can find a detailed breakdown of operating expenses in the fund's Statement of Operations. Annual operating expenses will include the fund management fee and various administrative expenses. Management fees are typically the largest portion of expenses.

Net asset value applicable to common stockholders should be readily available in the annual report under Statement of Assets & Liabilities. Many CEFs also have their NAV as of the last market close prominently displayed on their website.

It makes sense to compare the CEF you're looking at to comparable funds—that is, CEFs that are investing in a similar way. Does your fund stick out? Is it in the middle of the pack compared to other funds? Cheapest is not always best, but all other things being equal, the lower the expense ratio the better.

Fees will change from year to year. It's a good idea to calculate the expense ratio for several prior years—the more, the better. Have costs been consistent over time? Are there anomalies? If so, why? Even something as mundane as analyzing historical expense ratios can unearth valuable clues about the fund you are looking at—and potentially shed light on risks you hadn't considered.

Wondering where to find statements and other fund documents? Most CEFs have their prospectus, shareholder reports and other documents on their website. You can also find various fund filings on the U.S. Securities and Exchange Commission's (SEC) website at www.sec.gov.

Leverage Analysis

Many CEFs have high distribution yields. Many CEFs use leverage. The two are not mutually exclusive. Most CEFs use leverage to enhance the fund's return and distributions to shareholders.

You'll want to determine if the CEF you're considering is a levered fund. That is, does the fund borrow money or issue senior securities (preferred stock or debentures) to increase its investment exposure? Most of them do. Sometimes, like in the example below, the CEF will separate operating and leverage expenses. Other times, they are lumped together under "Expenses".

Operating and Leverage Expenses for Tortoise Energy Infrastructure Corp.

OPERATING EXPENSES	
ADVISORY FEES	4,746,537
ADMINISTRATOR FEES	213,774
PROFESSIONAL FEES	382,569
DIRECTORS FEES	80,679
STOCKHOLDER COMMUNICATION EXPENSES	165,109
CUSTODIAN FEES AND EXPENSES	20,026
FUND ACCOUNTING FEES	58,642
REGISTRATION FEES	55,066
STOCK TRANSFER AGENT FEES	56,404
OTHER OPERATING EXPENSES	157,653
TOTAL OPERATING EXPENSES	**5,936,459**
LEVERAGE EXPENSES	
INTEREST EXPENSE	3,644,078
DISTRIBUTIONS TO MANDATORY REDEEMABLE PREFERRED STOCKHOLDERS	1,352,798
AMORTIZATION OF DEBT ISSUANCE COSTS	84,455
OTHER LEVERAGE EXPENSES	229,776
TOTAL LEVERAGE EXPENSES	**5,311,107**
TOTAL EXPENSES	**11,247,566**

Source: Tortoise 2021 Annual Report

Yields and borrowing rates change over time. In a rising rate environment, a CEF's yield could suddenly look less attractive compared to other income-generating investments. It also increases borrowing costs for the fund.

Leverage can enhance returns, but it also increases volatility and amplifies market risk. You'll want to determine your personal comfort level with investing in levered funds. And if you're willing to invest in them, you also have an extra step to do in your expense ratio analysis.

The Investment Company Act of 1940 requires debt-leveraged CEFs to include the interest expense on debt in their expense ratio. As investors, we want clarity on how much a CEF is using leverage and what the cost is. But comparing the expense ratio of a levered and non-levered CEF is a bit apples to oranges.

The "leverage-adjusted" expense ratio strips out the cost of debt financing from the reported expense ratio.

Leverage-Adjusted Expense Ratio=
Expense Ratio−(Interest Expense/Net Assets)

As an example, a levered fund reports a total expense ratio of 3%. The CEF has net assets of $400 million and total assets (including leverage) of $500 million. This means that leverage as a percent of total assets is 20%. (When comparing levered funds, analyzing the degree of leverage used among similar CEFs is another useful exercise).

Our imaginary CEF paid a 2% interest rate on $100 million of leverage, or $2 million dollars. By subtracting the portion of the expense ratio related to leverage from the total expense ratio, we see the fund has a leverage-adjusted expense ratio of 2.5%

Here's how it looks:

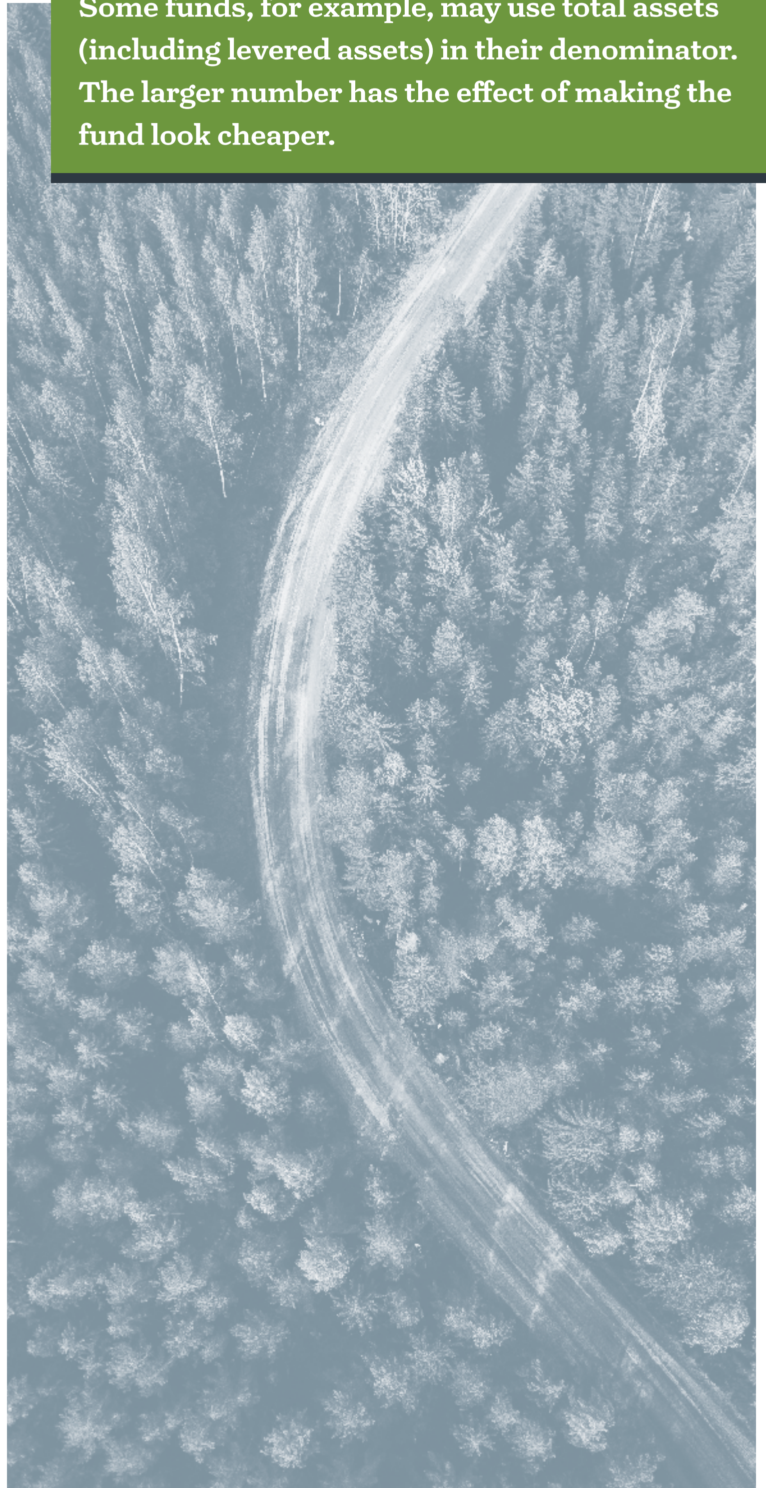
3% expense ratio–($2 million interest expense/$400 million net assets)=2.5%.

This is a quick way to achieve a better comparison among levered and unlevered funds. Or levered funds with varying degrees of leverage. But it's far from perfect.

For example, instead of using debt, CEFs can obtain leverage by issuing preferred shares. Even though preferred shareholders may receive payments just like bond creditors, those payments are categorized as dividends (paid out of operating earnings) rather than operating expenses.

Unfortunately, there are no shortcuts. Just like understanding a CEF's composition requires looking at the actual holdings, understanding a CEF's leverage requires looking at their financial statements.

Watch Out! While the SEC requires CEFs to report operating expenses/net assets as an expense ratio, it does not prohibit them from reporting other versions of the expense ratio. Some funds, for example, may use total assets (including levered assets) in their denominator. The larger number has the effect of making the fund look cheaper.



Distribution Analysis

Many investors looking at CEFs are in search of high and relatively dependable distributions. Two basic types of shareholder distributions will be familiar to many investors:

Income distributions—includes both bond interest payments and dividends from stocks.

Capital gains distributions—realized capital gains are generated from selling holdings that appreciated in value.

Some insight can be gained by looking at the history of these distributions. Have they been steady over time? While past performance can't guarantee the future, stability is a positive sign. Was there a highly erratic year? That warrants further investigation into what happened.

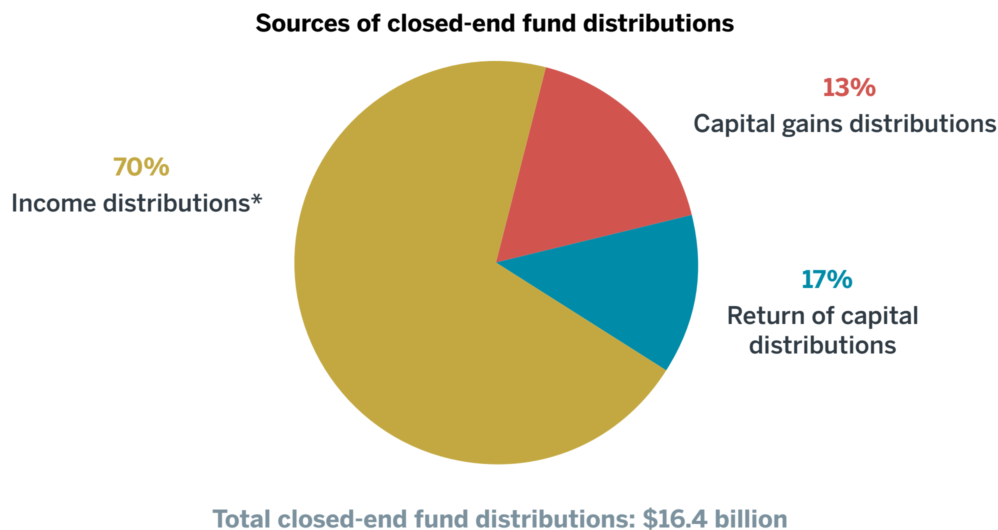
Many investors will simply look for the highest distribution rate. That's where their analysis ends, and that's the CEF they put their money into. Don't be that investor.

Distribution rates you'll find quoted on a fact sheet, closed-end fund screener, or your broker's website can be very misleading. Abnormally high yields are often driven by large capital gains distributions that are highly unpredictable from one year to the next.

Analyze the ratio of income distributions to total distributions. The higher the ratio, the more income-oriented the CEF. While dividends can be cut and bonds can default, income should be a more stable source of distributions. Relying on capital gains for a high distribution rate is not sustainable and likely to result in disappointment for investors seeking income.

CEFs are required to distribute most investment income and realized gains to shareholders every year. But fund management has the option to tap into another source for distributions called return of capital.

Closed-End Fund Distributions



*Income distributions are paid from interest and dividends that the fund earns on its investments in securities.
Source: *ICI Research Perspective*, "The Closed-End Fund Market 2021"

Return of capital distributions—a return consisting of a shareholder's original principal investment.

Return of capital is something of a hot button topic for CEF investors. Is it good? Bad? The truthful yet admittedly frustrating answer: it depends.

There are three scenarios where a return of capital by CEF management is reasonable:

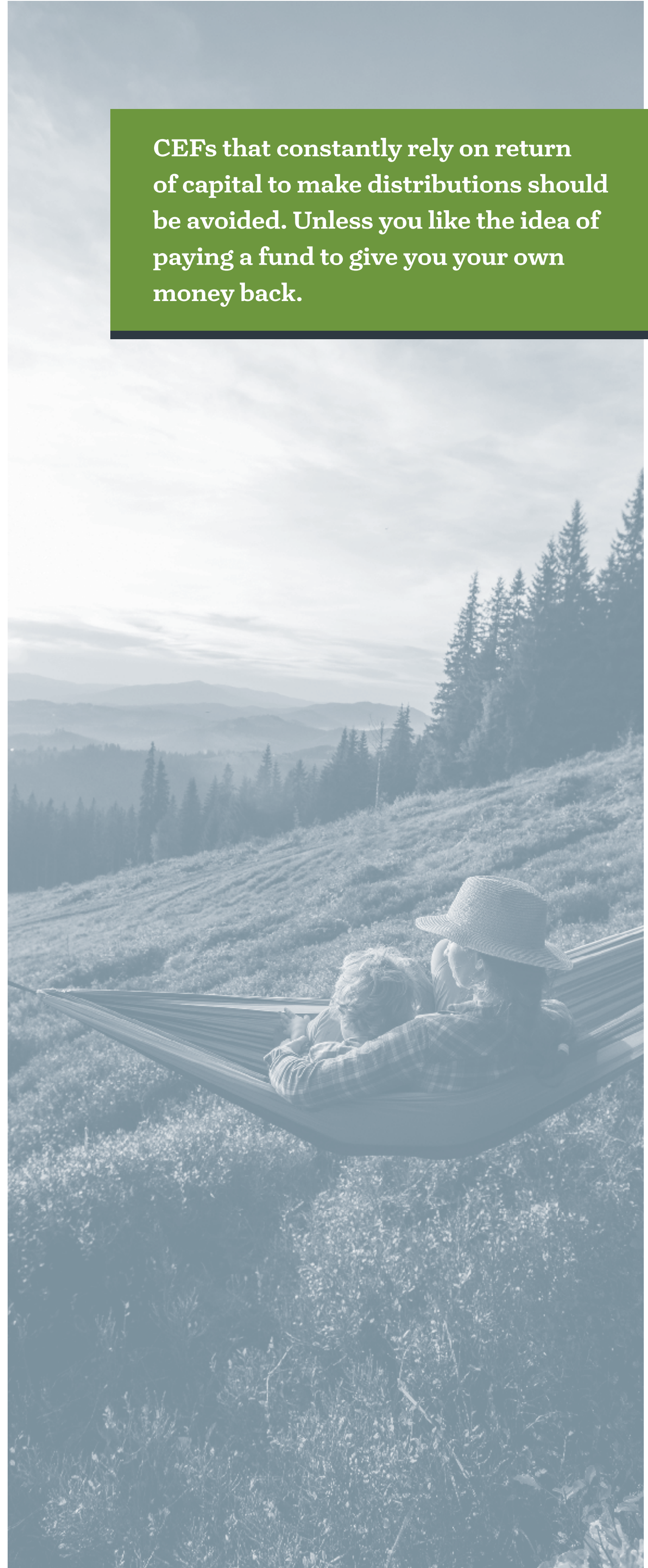
Most investors appreciate consistent distributions. If a CEF faces short-term issues or a one-time event that causes it to fall below its distribution target, perhaps a return of capital is preferable to lowering the distribution rate. After all, cutting the distribution rate could result in the CEF's share price taking a hit, harming existing shareholders in the process.

What if the CEF has substantial unrealized capital gains—that is, portfolio positions with gains that haven't been sold? There may be tax advantages to returning capital rather than selling positions just to meet distribution targets.

Finally, an exception should be made for CEFs investing in MLPs. They will regularly have substantial returns of capital. This has to do with accounting rules. Simply put, cash distributions from an MLP are not treated the same as dividends from a stock. The CEF is simply passing through the return of capital they received from the MLPs in their portfolio onto CEF shareholders. It is not in and of itself a red flag.

So, there are some reasons that a return of capital makes sense. But what if management is consistently falling short of expectations and constantly relying on return of capital? Or worse, if management is using return of capital to drive up the distribution rate, knowing that unwitting investors may simply invest in CEFs with the highest "yield"?

These are CEFs to avoid. Unless you like the idea of paying a fund to give you your own money back.



CEFs that constantly rely on return of capital to make distributions should be avoided. Unless you like the idea of paying a fund to give you your own money back.

Management Analysis

When you invest in a CEF, you're counting on the management behind the fund to do a good job. It's important to do your due diligence on the manager or management team. This is more art than science: there isn't a simple formula that will tell you if your money is in good hands. But there are particular areas that you'll want to pay attention to.

Experience. How long have they been managing the CEF? What does their previous performance look like? Every manager will have up and down periods. Skilled portfolio managers can have a tough year. Bad portfolio managers can get lucky. It's the long-term track record that you'll want to consider—on its own, and relative to the market and to comparable CEFs. It is a common investor folly to go with the manager that has done the best in the past 12 months. Such a short time tells you very little about that manager's capabilities in different market cycles.

Philosophy. Does the manager's approach to investing and managing risk agree with your own? You don't have to agree with everything they say, and every decision they make. But it's a good idea to find a manager that's on the same page as you when it comes to how the CEF should be invested. If there's too much of a divergence between your investment philosophy and that of the CEF manager, the chances are great that you're looking at a fund that is not compatible for you. Annual reports can be a great place to get familiar with a manager's thinking. Depending on the CEF, you might also obtain insights on management from webinars, podcasts and published commentaries.

Ownership. Does the manager have skin in the game? Officers and directors must file a Form 4 with the SEC when they buy or sell shares of their CEF. This filing alerts the public to insider transactions. You can also find ownership information in the proxy materials that are sent to shareholders prior to the annual meeting. It is preferable for management to have meaningful ownership in the fund. It shows their commitment and confidence in the CEF, and puts their interests more in line with other shareholders.

Keeping Up on Your Fund

CEFs may trade like an individual stock, but don't expect the media to spoon-feed you news and updates like you'd get about a stock like Apple or Tesla. This is an obscure part of the market, and to keep abreast of what's happening with your fund, you'll need to do some reading.

Fortunately, CEFs are legally required to provide shareholders with accurate and up-to-date reports. CEFs will typically issue annual and semiannual (and sometimes quarterly) reports with commentary from fund management regarding fund performance and their outlook, portfolio composition, operating financials for the fund, and additional important information. You'll also have the opportunity to attend shareholder meetings.

Stay alert! News will come across that can directly impact you as a CEF shareholder. For example, the fund may have a tender offer to buy back shares—you'll want to be aware of the terms to determine if you should participate. Many CEFs offer monthly updates detailing portfolio characteristics and holdings. Monitoring these updates can alert you to significant changes in the underlying assets of the fund. When offered, it's advisable to sign up for email alerts so you can keep abreast of fund news.

The SAM Approach

A critical concept for most investors is to buy an asset when it is trading at a discount to its intrinsic value. That is, buy things on sale. Easy to understand. Harder to execute.

Intrinsic value is difficult to quantify. There are a lot of variables that can quickly change the value of an asset.

CEFs are a rare exception. It is easy to determine when they are trading at a discount. As Stansberry Research Editor Dr. David Eifrig noted:

"You don't have to project future earnings, sales, or price-to-earnings ratios on an individual stock. When you spot a CEF selling for cheaper than its value, you get to buy it at that price...at a discount to its true value."[25]

The idea of purchasing at a discount relates to a concept called margin of safety. It has been written about extensively by billionaire investor and hedge fund manager Seth Klarman. As Klarman wrote:

"A margin of safety is achieved when securities are purchased at prices sufficiently below underlying value to allow for human error, bad luck, or extreme volatility in a complex, unpredictable, and rapidly changing world."[26]

At SAM, we take this concept one step further with CEFs. We look for CEFs that own assets that we believe are *already* trading at a discount to their intrinsic value in the open market. If the underlying assets are trading at a discount, and the CEF itself is trading at a discount on top of that, we're effectively investing with a double margin of safety.

In other words, SAM doesn't rush out to buy every CEF at a discount. We take a much more selective approach. First and foremost—we're only interested if the CEF is investing in areas we already love. If we don't want to own the underlying assets, we don't want to own the fund. We then conduct analysis similar to what we've shared in this guide, including a deep review of expenses, leverage and management.

It takes some work. But selectively including CEFs trading at substantial discounts to their NAV has been part of a winning investment formula in SAM strategies.

SAM

Interested in Learning More?

A SAM colleague would be more than happy to walk you through how we help clients achieve their long term financial goals every day.

SAM
420 Lexington Avenue, Suite 2216
New York, NY 10170
646.854.2995
info@stansberryam.com
STANSBERRYAM.COM

SCHEDULE A CALL:
https://stansberryam.com/contact/

Michael Joseph, CFA
Deputy Chief Investment Officer, Portfolio Manager

About the Author

Michael is a Portfolio Manager and Deputy Chief Investment Officer at SAM. His duties include sourcing investment opportunities and conducting ongoing due diligence across SAM's portfolios. Michael co-manages our Income and Tactical Select strategies.

Prior to joining SAM, Michael worked with high-net-worth private clients for the largest independent wealth management firm in the United States. He was also a senior analyst for one of the largest investment-grade bond managers in America. Michael joined SAM in 2017.

Michael's investment thinking has been featured in publications including Fortune, Advisor Perspectives, and the Stansberry Digest. He has also been a featured speaker at the annual Stansberry Conference, the Legacy Investment Summit, and the Titan Investors Conference.

Michael holds an MBA from the University of California, Davis and a BA from San Francisco State University where he majored in History. He earned the Chartered Financial Analyst (CFA) charter in 2017.

Michael currently resides in Arizona with his wife and two children. He serves as a Board Member for Copper State Credit Union, an Advisory Board Member for the Arizona Council on Economic Education, and is a member of the Practice Analysis Working Body of the CFA Institute.

SAM

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Endnotes

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646.854.2995 · info@stansberryam.com · STANSBERRYAM.COM