Definitively Speaking

Archives

Grace Murphy

appreciation (*ă?prē?shĭ?ā?shŭn)*, *n.* **1.** A favorable critical estimate. **2.** Awareness or perception of excellence. **3.** A rise in exchangeable value. **4!** A significant investment advantage with closed-end bond funds.

What Investing in Closed-End Bond Funds Can Really Mean

Most of us understand how mutual funds work. We buy shares from a company that pools investors' money to buy securities. For this investment, we get the experience and knowledge of professional management of our money, the risk reduction of diversification in our investments, and the economy of the fund's ability to buy and sell in large quantities. These familiar investment opportunities- commonly called mutual funds- are actually more accurately known as open-end mutual funds.

Many of us, however, have been less aware of closed-end funds. These funds have the advantages of open-end mutual funds-professional management, diversification, and economy of scale-plus some unique characteristics that make them particularly appealing. Closed-end funds, unlike open-end mutual funds, have a fixed number of shares issued. These shares are traded like stocks and, as a result, they offer a variety of ways to increase the return on our investment that are not possible with open-end mutual funds. One of the most powerful advantages of closed-end fund investment is the ability to benefit from market-price appreciation.

It works like this. You decide to buy a closed-end bond fund whose NAV (net asset value) is calculated at $10. But the trading price of the fund is not the same as the NAV. Your bond fund may, in fact, be trading at $8-a $2 *discount* from the NAV. Then, if the market shows a gain of 20% over a period of time and the NAV of the fund reflects the market performance, the NAV will move from $10 to $12-also a 20% gain. But, meanwhile, the trading price of the fund may move at a different rate, say from the original $8 (a $2 discount from the NAV of $10) to $14 (a $2 premium on the NAV of $12). So, rather than a 20% gain, your closed-end bond investment has gained 75%.

But let's consider what happens if the market doesn't advance. Even if the NAV doesn't change at all and the trading discount doesn't actually turn into a trading premium, you still can benefit from a higher yield on your investment if you bought your closed-end bond funds at a discount. Since dividends are calculated on the NAV and not on the trading price, a yield of 10% on an NAV of $10 ($1/$10) is actually an effective yield of 12.5% ($1/$8) on your original $8 investment.

The structure of closed-end funds also provides other advantages to the fund investor. Open-end mutual fund managers may be pressured to buy high and sell low by a flood of new investors as the market tops or decreased investment as it declines. By contrast, closed-end fund managers are dealing with a steady pool of money. They have the ability to make decisions based on a long-term strategy that is less subject to market fluctuations and can provide a high-level portfolio performance.

Clearly closed-end funds offer some attractive investment opportunities. So what's the catch? Well, as with all investments, it's important to do your homework. Some closed-end funds invest in volatile markets that can move as much as 50%-up or down-in a week. But many have long-term, stable management and performance histories. Closed-end bond funds are also subject to the market risk that interest rates will rise and lower the value of the bonds in the portfolio, or to the credit risk that bond issuers will default. And, since closed-end funds are traded, they involve broker commissions. Many open-end mutual fund investors buy directly from the investment company and are not used to the broker costs incurred in trading.

Although they are less well known, closed-end funds have a long history-beginning in 1893-and often shares have been passed from one generation to another. They provide a unique, but often under appreciated opportunity for the long-term investor.
