**Buying Mutual Funds at a Discount**

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**Robert L. Losey, Ph.D.**

**Introduction**

Mutual funds are classified as either “open-end” or “closed-end” funds. Open-end funds are purchased and redeemed directly through the parent company (Dreyfus, Fidelity, Pimco…), or in some cases, through an agent of the parent company of the fund, while closed-end funds are issued as an initial public offering, then bought and sold on exchanges just like stocks. Open-end funds typically are sold at net asset value (plus a commission in some cases), while closed-end funds sometimes trade for a premium (mark-up) above NAV, and sometimes trade for a discount from NAV. Buying a mutual fund at a discount from NAV is (other things equal) a good thing, because you are buying the underlying stocks and/or bonds at a fraction of their market value. This paper discusses some of the ins and outs of buying closed-end funds at favorable prices.

**More On Closed-End Funds Selling at a Discount**

Historically the majority of closed end mutual funds (CEFs) sell for a discount from net asset value (NAV). The discount or premium for particular funds and the average discount for CEFs are both reported in the section on CEFs in Barron’s on a weekly basis. Daily figures are available for most individual CEFs from CEFconnect.com. Other sites provide similar information.

**Why you should care** whether your CEF sells for a discount or a premium to NAV is simple: If your fund sells for a discount this means that you can buy $1.00 worth of fund assets for less than a dollar when you invest in the fund. Alternatively, if your fund sells for a premium, you have to pay more than a dollar for each dollar in fund assets.[[1]](#footnote-1) Other things equal (and they sometimes aren’t) investors are better off buying assets at a discount from NAV.

**Why CEFs typically sell for a discount** is a matter of conjecture. Academics have offered a number of theories. Perhaps it is because CEFs are promoted less actively than their closest substitutes[[2]](#footnote-2), the much more popular open-end funds. After a CEF is sold, it no longer accepts investments from new investors, hence the need to keep the a CEF’s name in the public eye may be viewed by fund sponsors as less important than for an open-end fund that seeks to grow by attracting new investors. There are often other identifiable reasons that help explain why a particular CEF sells at a significant discount. CEFs that invest in illiquid assets, small CEFs without economies of scale, CEFs with high expense ratios, CEFs with embedded capital gains that may impose tax burdens[[3]](#footnote-3), and (possibly) CEFs that invest in other mutual funds are more likely to trade for discounts than CEFs that do not have these characteristics.

1. A CEF **holding illiquid assets** faces at least two challenges – it often finds that it is difficult to report a fair market price on its assets, and it also finds that it is difficult to sell assets quickly for a fair price if it decides that it wants to trade out of a position.[[4]](#footnote-4) Mutual funds that invest in start-up companies or hedge funds are examples of this combination. The values of their assets are difficult to ascertain because there is no active market for trading investments in start-ups. An example of a CEF that specializes in start-ups is RENN Global Entrepreneurs Fund (RCG). As of mid-August 2012 RCG had the second largest discount from NAV (at approximately 28%) for the CEFs reported on Cefconnect.com.[[5]](#footnote-5)

2. **Small CEFs** face several obstacles. They may have a more difficult time attracting research talent and, because some expenses are fixed regardless of the size of the fund, the expenses per dollar of assets under management will often be higher for small funds.

3. **Fund expenses** differ from fund to fund, often for no discernible reason. Studies primarily focusing on open-end funds reveal a significant inverse correlation between expenses and fund returns to investors. It is logical to expect that the same phenomenon applies to CEFs, and if so, the natural result is that investors react to higher expenses (which lower net revenues) by paying lower prices for such funds .

4. Many investors have heard of the “**fund of funds**” concept in which a mutual fund searches for the “best” funds and forms a portfolio of “best” funds. The idea sounds promising, but it has the drawback that the investor in a fund of funds pays is in effect saddled with two sets of fees, one on the fund of funds and a second imposed by the “best” funds that the fund of funds buys. The question arises, why not just buy the best funds and cut out the fund of funds intermediary?

Some examples: BIF and BTF (two CEFs from the same fund family) tend to rather consistently report high discounts from NAV. Their management fees are relatively high (over 1.4%, not including advertising fees), and they have have had large positions invested in Berkshire Hathaway shares. Though this writer has purchased both of these funds when their discounts from NAV have exceeded 20%, I have normally viewed these investments as short-term. I am a fan of Warren Buffet and Berkshire Hathaway, but why should I pay a 1.4% annual management fee to BIF to put my money to work in an investment that I can very easily buy directly without incurring an extra 1.4% annual cost?

**Pros and Cons Relative to Buying Discount CEFs** The major advantage of buying a CEF selling at a discount relative to buying an open-end fund is self-evident. Other things equal (and they often are, as CEF expenses and increases in prices are typically comparable to open-end funds), paying a lower price per dollar of assets held by the fund has an obvious advantage. Consider a CEF and a comparable open-end fund that own the same assets and have the same expenses, but the open-end fund is purchased for 100% of NAV (this is the norm) and the CEF is purchased for a 20% discount from NAV. Assume that both the open-end fund and the CEF pay an annual distribution of 4% of assets. Ignoring changes in prices of the funds, the return from fund payout to the investor in the open-end fund will be 4% of his/her investment, while the return to the investor from payout in the CEF will be 5%.[[6]](#footnote-6) The difference of 1% may appear to be small, but over a long period of time the investment returns from the CEF that consistently earns a 1% extra return can have a very substantial effect on the value of the investor’s position. For example, $100 invested (with earnings reinvested) in an open-end fund earning 8% per year or a CEF earning 9% per year will have accumulated to $1479 in 35 years if invested in the open-end fund but will have reached $2041 if invested in the CEF.[[7]](#footnote-7)

During the stock market crash associated with the financial markets meltdown in the fall of 2008 the average discount to NAV of CEFs reached levels never seen before. Data reported for LMP Capital and Income Fund from cefconnect.com as of 10/10/08 illustrates this.

**LMP Capital and Income Fund, Inc (SCD)**

ce_etf_icon **Closed-End ETFs**

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| **Fund Quick Facts** | *As of 10/10/2008* | |  | | --- | |  |  |  |  |  |  |  | | --- | --- | --- | --- | --- | | Closing NAV: | $**10.89** |  | Current Distribution Rate: | 24.35% | | Closing Share Price: | $6.90 |  | Premium/(Discount): | -36.64% |  |  |  | | --- | --- | | 52 Week High-Low NAV: $23.24-$13.82 | *As of 09/30/2008* | | 52 Week High-Low Share Price: $20.3500-$11.0300 |  | |

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According to an investor’s perspective, this extreme discount may have represented a calamity or (at least in retrospect) a golden opportunity. It was a calamity for investors in SCD and similar CEFs who needed to sell the CEFs to generate cash, as the NAVs of their funds had typically halved in value like the market as a whole, but had declined even more as the discount from NAV for CEFs went from single digits prior to the market collapse to greater than 20% discounts for many CEFs, and to discounts that exceeded 30% for more than a few solid, well-managed CEFs.[[8]](#footnote-8) As it turns out, the widening of the discount to NAV of CEFs represented a great buying opportunity, as investors who bought CEFs benefitted from the subsequent turnaround in the market, but received an extra boost from the narrowing of the discount to NAV that subsequently occurred.

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**An Aside: Did your financial advisor represent your best interests in the fall of 2008?**

In the fall of 2008 I sent an e-mail to friends, relatives, and some former students that CEFs were trading for historically wide discounts from NAV, and that it might be a good time to think about selling open-end funds and buying CEFs. I provided an article discussing CEFs and the discount phenomenon and suggested that it might be worth educating oneself on this phenomenon. (Please note, though I have taught investments at the university level many times, I am not a registered financial advisor, and my e-mail advised education on the matter, and did not specifically recommend a strategy.) One of my former students who had become an investment advisor and I corresponded at length on this topic. Though he liked the idea, his employer had an agreement with a particular fund group that prevented him from being able to overtly recommend buying discounted CEFs. If your financial advisor is similarly constrained, can (s)he best represent your financial interests?

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The increase in the discount from NAV by most CEFs during the financial crisis is a phenomenon that may partially explain why they typically sell for a discount, to wit, they exhibit greater price volatility than open-end funds. Thus, as previously discussed, the fact that the typical CEF offers an advantage in return because it sells for a discount from NAV comes at a price, CEFs are likely to exhibit greater price volatility.

**Are CEFs Priced as Efficiently as Open-End Mutual Funds?**

The efficient market hypothesis is the focus of a significant chapter in almost every investment text book used in U.S. colleges and universities. This hypothesis argues that securities (including mutual funds) tend to be fairly priced. However many observers of financial markets (this writer included) will argue that closely followed securities (GE, IBM, Exxon) tend to be priced fairly more consistently because they are followed by a multitude of high-powered analysts looking for opportunities to buy low and sell high. In contrast, many CEFs (as well as preferred stocks and convertible securities for that matter) trade infrequently and may not be followed by high-powered analysts. Aren’t they more likely to be temporarily either high or low relative to “fair value” because they do not face the continuing scrutiny of sophisticated stock analysts? This, in combination with the discount from NAV often observed for CEFs, may suggest that CEFs are a useful investment vehicle for small and medium investors that (at least sometimes) offer an opportunity to make above-average returns relative to their risk exposure.

**Selected Bibliography with selected comments by RLosey**

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# [2] Chandar, Nandini, and Bricker, Robert, “Incentives, Discretion, and Asset Valuation in Closed–End Mutual Funds,” *Journal of Accounting Research*, pp. 1037–1070.

## [3] Chay, J. B., and Trzcinka, Charles A., “Managerial Performance and the Cross-Sectional Pricing of Closed-End Funds,” [*Journal of Financial Economics*](http://www.sciencedirect.com/science/journal/0304405X), 1999, pp. 379–408. *(The authors argue that discounts and premiums of closed-end funds reflect the market's assessment of anticipated managerial performance.)*

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[6]Lee, Charles M. C., Schlifer, Andrei, and Thaler, Richard H., “Anomalies: Closed-End Mutual Funds”, *Journal of Economic Perspectives*, Fall 1990, pp. 153-164.

### [[7] Malkiel, Burton G., “The Valuation of Closed‐End Investment-Company Shares](http://onlinelibrary.wiley.com/doi/10.1111/j.1540-6261.1977.tb01993.x/abstract),” The Journal of Finance, June 1977, pp. 847-859. (*RL - Malkiel is one of the great minds in finance. However, this study is dated. Developments that have changed the landscape of investing since 1977 include a dramatic decline in commission rates and an increase in the availability of information.)*

### [8] Pontiff, Jeffrey, “[Costly Arbitrage: Evidence from Closed-end Funds](http://qje.oxfordjournals.org/content/111/4/1135.short),” *The Quarterly Journal of Economics*, 1996, pp. 1135-1151.

### [9] Reichert, Carolyn & Timmons, J. Douglas, "[Closed-End Investment Companies: Historic Returns and Investment Strategies](http://ideas.repec.org/a/eee/finser/v7y1998i2p83-93.html)," [Financial Services Review](http://ideas.repec.org/s/eee/finser.html), 1998, vol. 7(2), pages 83-93

### [10] [Weiss](http://scholar.google.com/citations?user=c4t2L3MAAAAJ&hl=en&oi=sra), Kathleen, “[The Post-Offering Price Performance of Closed-End Funds](http://www.jstor.org/stable/10.2307/3665649),” *Financial Management,* Autumn 1989, pp. 57-67.

# [11] Zweig Martin E., An Investor Expectations Stock Price Predictive Model Using Closed-End Fund Premiums,” *The Journal of Finance,* March 1973*,* pages 67–78.

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1. If you go to CEFconnect.com and click on “Fund Sorter” so that funds are sorted by “premium,” in recent years you would almost always have found that either PHK or PGP were at the top of the list. On Aug. 13, 2012 these funds were trading at premiums in excess of 70%. On August 19, 2014, PGP was trading for an 80% premium, while PHK was second on the list, trading for a 52% premium. Thus, on August 19, 2014, to buy $1.00 worth of the portfolios held by PGP, you would have to pony up approximately $1.80. The logical explanation (if there is one) for the premiums is probably related to the fact that both are managed by the highly successful Pimco group of funds. PGP bottomed out at a NAV of about $6 in early 2009, and doubled in value by early 2012. During that period it has paid a monthly dividend of $.18 a share. The combination of capital gains and dividends would have yielded an investor buying at the $6.00 price an annualized rate of return of over 50% if dividends had been reinvested in PGP. In the two years from August 2012, PGP hasn’t done as well, but has earned approximately 15% per year based on NAV growth, a hearty rate of return. In spite of this record, short sellers (including yours truly) are skeptical about the large premium over NAV: I have tried to short this fund multiple times but always have found that the stock was unavailable for short selling (Lucky for me given the continued appreciation in PGP). [↑](#footnote-ref-1)
2. In [7] Malkiel argues that brokers have little incentive to sell CEFs given that many open-end funds pay brokers a load (commission) to market open-end funds. [↑](#footnote-ref-2)
3. [↑](#footnote-ref-3)
4. Many providers of capital to start-ups are set up as limited partnerships. Perhaps this suggests that the CEF structure has drawbacks as a provider of start-up financing. [↑](#footnote-ref-4)
5. In early 2011 this writer owned FOFI (First Opportunity Fund). In the spring of 2011 I sold my position in this fund when it announced that it would be transitioning to a CEF specializing in investments in hedge funds. Subsequently the NAV of FOFI widened. On Aug. 19, 2014 the discount from NAV was 19.97%, the third widest discount reported by CEFconnect.com for all closed-end funds. [↑](#footnote-ref-5)
6. If $100 is invested in the open-end fund, then the CEF selling for a 20% discount from NAV will be selling for $80. If both pay out a distribution of $4 one year after purchase, the percentage return to the two investors will be 4% and 5% respectively. Other things equal, investors should strongly prefer the investment in the CEF. [↑](#footnote-ref-6)
7. These figures assume all distributions are reinvested. [↑](#footnote-ref-7)
8. The only time this writer actually demonstrated to students in real time every step involved in how to consummate a stock market trade occurred during an afternoon financial markets students class in the fall of 2008 when I went on-line to illustrate the widening discount from NAV of CEFs and found that SLA, a CEF that I was following, was sporting a discount of approximately 35%. I couldn’t resist the lure of buying the SLA portfolio at a mark-down of 35% from its market value so I demonstrated the steps involved in making a trade and actually hit the “buy” button and bought SLA. [↑](#footnote-ref-8)