

THE EVOLUTION OF CEFs

Creativity comes to closed-end funds with new features to bump yield and diversification.

BY JEANNE COTRONEO DARROW

WHEN IT COMES TO PRODUCT innovation, one area of growing creativity is closed-end funds (CEFs). As the universe of these exchange-traded, professionally managed investment companies expands with new funds offering creative structures, higher yields and global reach, more investors — particularly the growing wave of yield-thirsty retirees — are turning to CEFs for portfolio diversification and income. Bill Adams, executive vice president and head of the CEF group at **NUVEEN INVESTMENTS INC.** (JNC), explains that the challenge for retirees looking for attractive levels of sustainable distributions is that interest rates (and equity dividend

yields) are historically low, making it hard to get income “the old-fashioned way” by buying CDs, bonds or utility stocks.

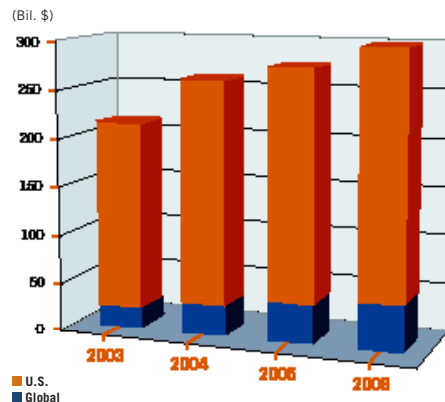
“Ten years from now, as the number of people in retirement explodes, how much recurring cash flow your portfolio can generate will be a key topic people will talk about, and the industry is trying to address that need,” says Adams. “It can’t be done through a conventional approach — that just won’t be enough. CEFs are being creative and finding ways to generate distributions by using equities, asset allocation, leverage and the CEF structure itself.”

CEFs have a fixed number of shares outstanding. Following an IPO, those shares trade throughout the day on an exchange. Share prices are determined by the forces of supply and demand and can be more or less than the fund’s net asset value (NAV). This differs from open-end funds, which continuously offer shares to investors and whose share prices are based on their NAVs, determined at the close of each business day.

Because of their structure, CEFs invest more fully than open-end funds that need cash in their portfolio to meet redemptions, Adams explains. This, he adds, also means CEFs can invest in less-liquid assets, thereby taking advantage of potentially higher returns than more-liquid securities. Plus, CEFs can use leverage: “In the hands of skillful managers, a prudent level of leverage is an additional tool that can

CEF ASSETS

CLOSED-END FUNDS HOLD \$300 BILLION IN SECURITIES.



enhance the fund’s performance,” says Adams. CEFs can also establish distribution policies to pay income and appreciation over time, enabling CEFs to smooth out what otherwise might be lumpy distributions, Adams explains.

LARGEST CEF IPO EVER

As of June 2007, the NYSE trades 497 closed-end funds with a market cap of approximately \$220 billion. In 2006, 19 CEFs — 95 percent of those that qualified — listed on the NYSE and raised about \$9.4 billion. This included the \$2.6 billion IPO of **EATON VANCE TAX-MANAGED DIVERSIFIED EQUITY INCOME FUND** (ETY), the largest capital-raising transaction on the NYSE

BY FEBRUARY, CEF IPOs HAD RAISED \$10.2 BILLION, EXCEEDING THE AMOUNT RAISED IN ALL OF 2006.

for the year and, at the time, the largest CEF IPO in history. That record was broken in early 2007 when **ALPINE TOTAL DYNAMIC DIVIDEND FUND** (AOD) raised \$3.5 billion in January and again when **EATON VANCE TAX-MANAGED GLOBAL DIVERSIFIED EQUITY INCOME FUND** (EXG) raised \$5.5 billion in February. By month’s end, CEFs had raised \$10.2 billion in new equity, exceeding the total \$10.1 billion raised in 2006.

Jonathan Isaac, vice president of CEFs at **EATON VANCE CORP.** (EV), explains that ETY builds on the firm’s strategy behind **EATON VANCE TAX-ADVANTAGED DIVIDEND INCOME FUND** (EVT). Issued in 2003, when tax-law changes lowered the rates on dividends, notes Isaac, EVT was the first CEF created to pay income from a stock portfolio producing only qualified dividend income taxable at 15 percent. The new

ETY maintains that approach but also deploys an options-writing strategy to bump yield. "It's a hybrid of some of the best ideas we've had over the past few years," he says.

Isaac attributes ETY's success partly to last year's positive price performance of many CEFs trading in the secondary market, which even outperformed the broader U.S. stock market. For example, domestic equity CEFs gained an average of 28.4 percent on a market basis in 2006, according to Lipper, beating the S&P 500's 15.8 percent return for 2006. Also, the average discounts on CEFs narrowed significantly through the year (to 2.7 percent in January 2007 from 4.9 percent in January 2006), to the point that many funds were trading at a premium to their NAVs, notes Isaac. The fact that the market absorbed such a large issue with "no real impact on the secondary market is a sign that new players are being attracted to the CEF market and that it may be getting larger," he says.

CEFs' use of derivatives is gaining momentum. For example, **BLACKROCK PREFERRED AND EQUITY ADVANTAGE TRUST (BTZ)**, which came to market in December, invests at least 80 percent of its managed assets in preferred and equity securities and derivatives with economic characteristics similar to those equities.

A FUND OF FUNDS

A new twist on CEFs arrived last year in the form of **COHEN & STEERS CLOSED-END OPPORTUNITY FUND (FOF)**, the first-ever closed-end fund of funds. FOF invests in the common stock of a wide array of CEFs from investment managers such as Eaton Vance, Pimco, Nuveen and **BLACKROCK INC. (BLK)**. (Cohen & Steers CEFs are excluded.) Fund manager Doug Bond notes that FOF seeks total return consisting of high current income and potential capital appreciation. Executive Vice President John McCombe points to the fund's innovations, including a lower spread than typical CEFs and a provision to allow shareholders to consider converting FOF to an open-end fund if it trades at a specified discount after five years.



MORE CEFs OFFER GLOBAL DIVERSIFICATION, WITH \$48.5 BILLION INVESTED IN NON-U.S. ASSETS.

Until recently, the market was "neither large enough nor diverse enough to give us the investment flexibility we need to perform for our shareholders," says Bond. "But today, about 40 percent more CEFs exist than five years ago. This gives us many more funds and strategies from which to choose. In fact, we're excited about the opportunities; in just the past four months, the investment universe for FOF has grown by about 10 percent due to a strong new-issue market."

A FUND FOR CHINA

Another 2006 innovation was **MORGAN STANLEY CHINA A SHARE FUND INC. (CAF)**. This U.S.-registered fund, the first to invest at least 80 percent of its assets in A shares of Chinese companies listed on the Shanghai and Shenzhen

stock exchanges, gives U.S. investors access to a market that is available only to local Chinese residents and qualified foreign institutional investors, the company explains. It adds that CAF, which sold out in less than an hour, follows other international CEFs from **MORGAN STANLEY (MS)**, including **THE THAI FUND INC. (TTF)**, **THE MALAYSIA FUND INC. (MF)** and **THE TURKISH INVESTMENT FUND INC. (TKF)**.

Issued last July, **NUVEEN GLOBAL VALUE OPPORTUNITIES FUND (JGV)**, managed by Nuveen's Tradewinds affiliate, also has a global strategy that invests across a range of asset classes and markets worldwide. "We're able to seek returns away from the domestic market," says Adams. In fact, the Investment Company Institute reports that the amount of global assets held by CEFs grew to \$48.5 billion in 2006 from \$41.2 billion in 2005 (see chart).

Like all 116 Nuveen CEFs, Adams says JGV is available to investors for the long haul. Nuveen's first CEF, **NUVEEN MUNICIPAL VALUE FUND INC. (NUV)**, will mark its 20th anniversary in June. He reports that it has paid tax-free distributions every month since its inception. "That's our philosophy," says Adams. "If we do a good job, our funds stand the test of time."

OUTLOOK FOR 2007

For this year, Cohen & Steers expects a better interest-rate environment, which it believes may lead to increased demand and stronger levels of new issuance. "The Fed is more likely to keep rates on hold, even reduce them, as long as inflation stays contained," says Bond. This, he explains, will benefit CEF prices; a benign interest-rate policy helps them maintain above-average yields.

Bond and McCombe point out that the CEF market is still "quite inefficient," which might not be a bad thing. "Research analysts do not broadly cover CEFs, and the growth in newly listed funds over the past five years has only widened the coverage gap," McCombe explains. "A lack of coverage within a relatively illiquid market can create compelling values." □