



The CEF Alternative

WILL IT BE THE YEAR OF THE CLOSED-END FUND?

Record-breaking closed-end fund (CEF) issuance in the first nine months of 2003 — 40 new issues raising a total of \$21.9 billion — has already outpaced the record \$18.5 billion raised in all of 1993, according to fund-tracker Lipper Inc. Today, 555 CEFs with combined common shareholder assets of \$185.4 billion are available to investors, the Investment Company Institute (ICI) reports. More than 400 CEFs trade on the NYSE. The Exchange's lowering of CEF listing fees in August could result in more CEF listings.

What's driving the growth? Fund issuers and other experts outline several key benefits. First, CEFs offer investors professional management, portfolio diversification and liquidity. Then there is the ease with which investors can trade them. Unlike open-end mutual funds, which issue and redeem shares continuously, most CEFs issue a fixed number of shares in an initial public offering that then trade in the secondary market. "Convenience features exist because they're listed on an exchange," says Don Cassidy, senior analyst at Lipper. These include being able to use the same order types you would with an individual stock, such as limit and stop orders, and being able to buy and sell at market price during the trading day, he explains. "Sometimes — in a volatile market, for example — it's important to be able to complete a transaction right away," he adds.

A CEF's share price, influenced by the same market forces that affect stock and bond prices, often differs from the CEF's per-share net asset value (NAV). If demand for a CEF's shares exceeds the supply, the share price likely will be higher than its per-share NAV, and therefore will trade at a premium. The opportunity to invest at a discount when it's trading below its NAV is another reason for CEFs' popularity, says Brian Smith, executive director of the Closed-End Fund Association (CEFA).

THE YIELD COMPONENT

Another key benefit is their income orientation. Because large amounts of holdings don't have to be kept liquid to meet shareholder redemptions, as mutual funds do, portfolio managers can invest in bonds and other longer-term instruments, says Maureen R. Goldfarb, chairman and CEO of John Hancock Mutual Funds, a division of **John Hancock Financial Services**

Inc. (JHF), which has an expertise in preferred-income CEFs. [John Hancock at press time had agreed to be acquired by **Manulife Financial Corp.** (MFC).] There's also no need to reinvest new cash coming in, "which would have to be invested on an ongoing basis at different rates of return," adds Bill Adams, executive vice president of **Nuveen Investments Inc.** (JNC).

"In a marketplace where CDs yield only 1 to 2 percent, an average 7.5 to 9 percent on a fully taxable CEF make it a terrific alternative, offering diversification for someone looking for income," says Goldfarb.

Another difference between CEFs and mutual funds is CEF's use of leverage to enhance yield. Many CEFs borrow money at short-term rates, invest in longer-term securities paying higher interest, then pass on the difference to shareholders. Of the 85 percent of all CEFs that are

leveraged, most borrow amounts equaling about a third of their assets, says Cassidy. This strategy, Adams reports, is popular among municipal CEFs, of which Nuveen is the dominant issuer, he says. "Since short-term muni rates historically have been low relative to long-term muni rates — more so than in the taxable and Treasury markets — muni bond funds have exploited this inefficiency over time, albeit with some additional risk to principal and a little bit more volatility," he explains.

Such increased net asset volatility is a risk investors need to consider. "Leverage can enhance returns, but if the market goes the opposite way, it can magnify the negative side," cautions Martin Cohen, co-chairman and co-CEO of Cohen & Steers. "But without leverage, a lot of these funds just don't work." He says this strategy "has allowed us to capture a very wide spread and enhance return for investors."

Cohen & Steers, which specializes in equity real estate investment trusts (REITs) CEFs, is among the largest CEF issuers, including **BlackRock Inc.** (BLK), **Citigroup Inc.**'s (C) Salomon Smith Barney, John Hancock, **Merrill Lynch & Co. Inc.** (MER), **Morgan Stanley's** (MWD) Van Kampen Investments, and Nuveen. The first-ever REIT CEF, **Cohen & Steers Advantage Income Realty Fund Inc.** (RLF), issued in 2001, "was the first to use leverage and the first to get a triple-A rating on its leveraged assets. That opened the floodgates," Cohen says.

But bond CEFs clearly outnumber equity CEFs: 433 versus 122, according to ICI data. "In the last 10 to 15 years, there's been very little

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equity CEF issuance outside those that focus on income, such as real estate securities, preferred stock and convertibles,” Cassidy says.

New equity-income CEFs issued in 2003 include **Eaton Vance Tax Advantaged Dividend Income Fund (EVT)**, **F&C/Claymore Preferred Securities Income Fund (FFC)**, **BlackRock Preferred Opportunity Trust (BPP)**, **Preferred Income Strategies Fund Inc. (PSY)** and **John Hancock Preferred Income Fund III (HPS)**. Another, **Cohen & Steers REIT & Preferred Income Fund Inc. (RNP)**, blends real estate securities and corporate preferreds. Like a Nuveen issued in March, **Nuveen Preferred and Convertible Income Fund 2 (JQC)** invests in preferreds and convertibles.

Municipal bond funds are the largest CEF category, reports CEFA, followed by taxable U.S. bond funds. Also available are global funds containing U.S. and foreign securities, international funds containing only non-U.S. investments, as well as some 80 single-country funds, such as **The Mexico Fund Inc. (MXF)** and **The Korea Fund Inc. (KF)**.

HISTORIC BEGINNINGS

CEFs in the U.S. date back to 1893, more than 30 years before the first mutual fund was formed in the country, according to CEFA, which says the oldest U.S. CEF still in operation is **General American Investors Co. Inc. (GAM)**, organized in 1927. A handful of other pre-Depression-era funds — including **Salomon Brothers Fund Inc. (SBF)**, **Adams Express Co. (ADX)**, **Petroleum & Resources Corp. (PEO)** and **Tri-Continental Corp. (TY)** — still exist today, only now they are regulated under the Securities Act of 1933, the Investment Company Act of 1940, and, unlike mutual funds, the Securities Exchange Act of 1934.

“Closed-end funds are actual companies,” says the CEFA’s Smith. “In fact, all the post-Enron corporate accountability changes were really not as big an issue for the industry because managers were already familiar with significant oversight, accounting responsibilities and due diligence.”

Many CEF issuers have been proactive about transparency. For example, in 2001 Nuveen launched industry Website www.etfconnect.com, which includes details of exchange-traded CEFs and index exchange-traded funds (ETFs), to provide “awareness and understanding of each fund’s risk and return profile,” says Adams. (See the Nov./Dec. 2002 *nyse magazine* for more on indexing and ETFs, or visit www.nyse.com/ETF.)

WHAT’S AHEAD

Adams believes that investors will continue to look to exchange-traded vehicles to fulfill their portfolio strategies: “We believe investors are realizing the convenience and transparency of owning shares in this form, making us a growing category over time.” With CEFs penetrating only an estimated 3.1 percent of U.S. households, ICI reports, the potential is vast.

Supporting this notion is the fact that “the demographics in this country portend very strongly toward income-oriented investments as the first wave of baby boomers retire in the next five to 10 years,” says Greg Phelps, senior vice president and portfolio manager at John Hancock Mutual Funds. “And if interest rates remain low and equity markets volatile, pockets of demand could arise again.”

Tailoring new funds to react to shifts in the market is contributing to the industry’s success, issuers say. “The true innovation in this industry has been the ability to recognize and react to those changes, and having the expertise to get a product to the Street quickly,” says Goldfarb.

What types of CEFs can investors expect next? Cohen points to the growing popularity of dividend-paying securities following the dividend tax cut earlier this year. “More CEFs will invest in the growing number of dividend-paying common and preferred stocks,” says Cohen, “and I expect they’ll become very popular.” □

For more information on closed-end funds, visit www.nyse.com/CEF.

