

## The Top Ten Myths About Closed-end Funds

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In 1858, Oliver Wendell Holmes wisely noted, “Put not your trust in money, but put your money in trust.” With only a small change we relate this maxim to closed-end funds, “Put not your trust in money, but put your money in trust, **at a discount.**”

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In 1927, Lazard Frères & Co., along with Lehman Brothers, created one of the first closed-end funds in the United States, General American Investors, which was listed on the New York Stock Exchange. It soon ushered in an era when closed-end funds dominated the investment world—until the Great Depression, that is. Eighty years later, this first U.S. closed-end fund has survived the euphoria of bull markets and the ravages of bear markets, economic booms and busts, and it is still going strong.

A closed-end structure aims for higher returns at lower levels of risk through diversification. This concept was actually born well over a century before Lazard Frères’s General American Investors. It was King William I of the Netherlands who established the first investment trust (a closed-end investment company), a structure that later became very popular in England. One of the first and largest British investment trusts, Foreign & Colonial Investment Trust, was formed to invest in international government bonds and, later, in what was then the largest and fastest growing emerging market, the United States. America’s first transcontinental railways were largely financed by British investment trusts, bringing economic prosperity to the United States and

enormous wealth to the investors in the British investment trusts. Today, the 140-year-old Foreign & Colonial Investment Trust is still generating returns for its investors.<sup>1</sup>

The history of closed-end funds is filled with glamour, speculative excess, frontier spirit, and cutting-edge investment pursuits, as well as littered with spectacular busts, scandals, and disappointments. Closed-end funds also have a history of blossoming and then languishing. During the 1920s and then again during the bull markets of the 1960s, 1980s, and 1990s, closed-end funds experienced phenomenal growth in the United States. Between these times of growth, however, there have been periods when closed-end funds seemed to be an endangered species.

It is not surprising, then, that investors harbor many myths about closed-end funds in general. Are closed-end funds still viable long-term investment vehicles? Is it true that closed-end funds comprise the largest pool of undervalued investments? Will discounts ever narrow? Is it true that closed-end funds’ double layer of fees makes them unattractive?

We answer these and other key questions as we seek to dispel the top-10 myths about closed-end funds.

# 1 Myth:

Closed-end funds' investment universe is limited.

This is not true, as the investment universe for these strategies represents the world's largest pool of undervalued assets, with an estimated \$674 billion in investment companies globally and another \$827 billion in global holding companies. Lazard Asset Management believes that, conservatively, there exists more than \$100 billion of discount that can be unlocked to realize value.<sup>2</sup>

Figure 1 illustrates the discounted assets universe by number of securities and by value of securities, which are quite different.

# 2 Myth:

Closed-end funds' double layer of fees makes the investment unattractive.

This is not accurate because effective managers purchase closed-end funds (and holding companies) at such discounts to their net asset value (NAV) that they outweigh the additional layer of fees. Management fees are netted out of the asset value, and are generally insignificant in comparison to the double-digit discount at which these investments can be purchased.

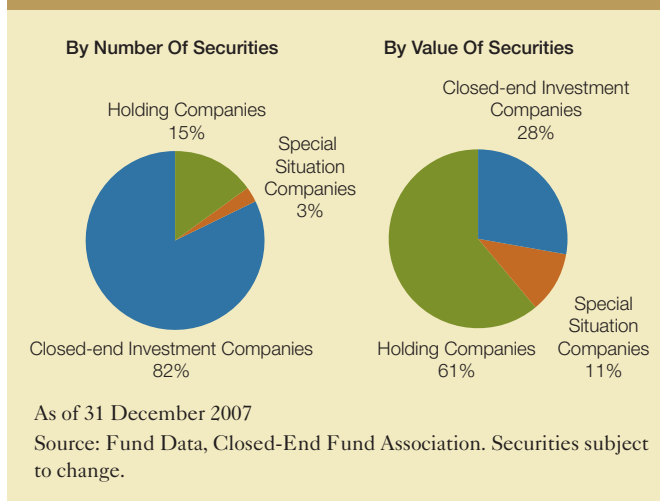
Effective portfolio managers watch the underlying fees closely and often negotiate lower fees. Ultimately, fees should be closely linked with management performance, and a fund's board of directors should reward or penalize the management accordingly.

# 3 Myth:

Closed-end funds' discounts never narrow.

There are several ways for discounts to narrow. One way is to take a controlling stake in a closed-end fund or holding company and advise the board and management team on appropriate discount-narrowing actions. Such corporate actions may include increasing dividend payouts; instituting managed distributions, share buybacks, tender offers, and rewards and penalties for portfolio managers; deciding to acquire or merge with another publicly traded company; selling off noncore businesses; and simplifying the corporate structure. Should these methods not produce the desired results, there are more extreme options available, such as open-ending or liquidation.

FIGURE 1: INVESTMENT VEHICLE UNIVERSE BY NUMBER OF SECURITIES



Another way the discount can be narrowed is for the portfolio to outperform or its investment style to be in favor. This usually results in an increase in demand for a closed-end fund's shares, causing the discount to narrow against the net asset value. At times, the discount can even be eliminated, and the fund can then trade at a premium. However, if a closed-end fund portfolio is performing well and its investment style is in favor but its discount persists, this is a clear indication that there are structural issues that must be addressed by the fund's board of directors.

# 4 Myth:

Closed-end funds' discounts are unsustainable.

There has been a structural shift within the closed-end fund industry caused by more stringent corporate governance. As a result, some of the funds with wider discounts have enacted discount-control strategies, and some of the poorer-performing funds have been liquidated. Consequently, the discounts in closed-end funds have narrowed. Despite this, there are still myriad opportunities to invest in funds with meaningful double-digit discounts. We believe that the discounts to net asset value within these investment vehicles represent an estimated \$100 billion of latent opportunities for value realization.<sup>2</sup> As noted previously, holding companies also represent a potential source of investment vehicles that can trade at meaningful discounts to net asset value. Overall, we believe the structural shift within the industry and increased corporate governance make the job of closed-end fund investing easier, when it comes to enacting corporate actions to reduce discounts and realize hidden value.

# 5 Myth:

Closed-end funds are retail, not institutional.

In today's market this is no longer true. When the earliest closed-end funds were created in nineteenth-century England, their purpose was to provide "the investor of moderate means the same advantages as the large capitalists."<sup>1</sup> In the United States, retail investors still dominate ownership of closed-end funds, but many closed-end funds have significant institutional ownership. In contrast, in most other countries and particularly in the United Kingdom, closed-end fund ownership is skewed toward institutions that are looking for exposure to a certain segment of the market through investing with managers who have specialist expertise. Over the past few years, more hedge funds, proprietary trading desks, insurance companies, and activist investors have put money in closed-end funds. As a result, institutional ownership is rapidly increasing.

Institutional ownership is not difficult to understand, since closed-end funds can offer unique investment and structural benefits.

## Investment Advantages

- Value-added discounts, including higher yields
- Capitalizing on pricing inefficiencies
- On-the-ground stock selection in local markets
- Low barriers to entry, making it possible to invest in closed markets

## Structural advantages

- Diversification/risk reduction
- Greater liquidity, making settlement easier
- Cost containment by lowering transaction costs

# 6 Myth:

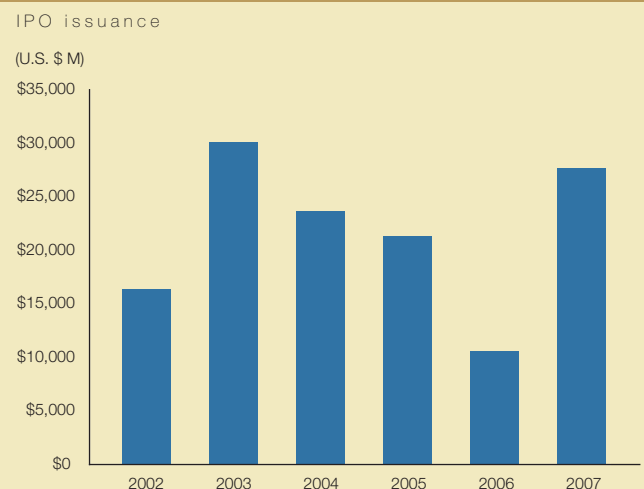
Closed-end funds' issuance is decreasing, narrowing investors' opportunity set.

Issuance is not decreasing but it is changing. Over the past six years, more than \$10 billion of new closed-end fund assets have been raised in the United States each year, and more than \$27 billion was raised in 2007 (Figure 2). Similarly, in the United Kingdom new issuances have been gaining momentum. For instance, investment-trust IPOs in the United Kingdom have been explosive in the alternative investment market.

However, the perception that the closed-end fund universe is shrinking is partially true. We believe that the world has less need for the plain-vanilla country funds, regional funds, or global funds, as investors are becoming more sophisticated and selective. Each year for the past 10 years, corporate action has been gaining momentum, and most plain-vanilla funds are being restructured, closed, or merged with other publicly traded companies, and today's management companies are feeling the pressure from investors to offer unique and differentiated expertise.

Offering original, distinctive products characterizes the mission of closed-end funds today and since their inception nearly two centuries ago. In the 1980s, offerings in international and emerging markets were explosive. Today, offerings in U.S. equity funds paying dividends, sector funds, and emerging market specialties such as Asian or Eastern European proper-

FIGURE 2: U.S.-LISTED CLOSED-END FUNDS



As of 31 December 2007

Source: Citigroup, Closed-End Fund Association

ties are in great demand. Investors are reaping the benefits from the shrinking of those closed-end funds that are unable to justify their existence, as well as from the industry's constant push for better products.

Figure 3 shows the inflow into listed funds in the United Kingdom, Europe, and the United States.

## 7 Myth: Closed-end funds are illiquid.

The very purpose of a closed-end fund is to create liquidity out of illiquid markets (i.e., they offer access to markets and sectors that are otherwise inaccessible to investors). For example, it is very difficult for investors, be they retail or institutional, to access the Chinese, Vietnamese, or Kazakh domestic markets, but one easily can buy a NYSE-listed closed-end fund investing in Chinese, Vietnamese, or Kazakh domestic shares.

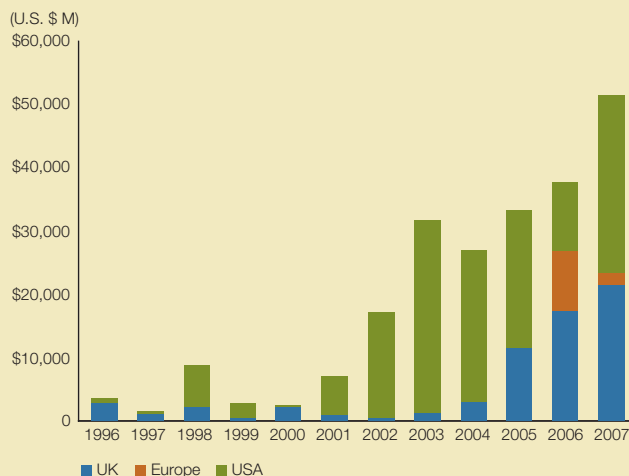
All closed-end funds are listed on recognized stock exchanges and trade on a daily basis. Liquidity can vary among funds, depending on the size of the fund and whether the strategy is in or out of style. And, as with stocks, some closed-end funds trade infrequently. However, when investing in a diversified portfolio of 30 to 60 closed-end funds, these liquidity issues are largely mitigated at the portfolio level.

Investing in closed-end funds can also have liquidity advantages, since many of them are able to bypass restrictions that still stymie foreign investors and access markets otherwise closed to foreign investors. Buying closed-end funds listed on international exchanges also mitigates the burdensome issues of local custody, capital restrictions, limited access to stocks, and other difficulties that investors face in some of the less-developed global markets.

## 8 Myth: Closed-end funds are not transparent.

Closed-end funds are no less transparent than a typical listed company and are much more transparent in terms of value on a daily basis. All closed-end funds are legally obligated to release their entire portfolios on a semiannual and annual basis. Most provide disclosures quarterly, and many more are disclosing significant positions on a monthly basis. An overwhelming majority of U.S. and U.K. closed-end funds publish their net

FIGURE 3: INFLOW INTO LISTED FUNDS



As of 31 December 2007

Source: Closed-End Fund Association, NYSE Euronext, AIM Global

asset values on a daily basis, and it is mandatory that almost all publish their net asset values on a weekly basis. At any point in time, an investor can be reasonably certain about the value of the assets in the fund. It is also important to remember that closed-end funds typically have lower levels of asset turnover, since the manager has a fixed pool of assets and need not be concerned with cash flows.

Transparency in closed-end funds should not be compared with that of hedge funds or private equity funds, for which there may be limited clarity on underlying positions, or to ordinary companies that are required to make disclosures only on a trailing quarterly basis.

## 9 Myth: Open-end funds are more attractive, as they cannot go to a discount.

Open-end mutual funds will always trade at par to net asset value unless, in an extreme circumstance, the manager restricts liquidity. However, we believe that closed-end funds have the capacity to consistently establish, on average, better returns than open-end funds. This is largely because a closed-end fund portfolio manager is never under pressure to sell shares to raise cash for redemptions. A closed-end fund does not redeem its shares. Rather, they are freely traded on the world's stock exchanges exactly like stocks. In a weak market, an open-end manager often has to sell shares at low prices in

order to raise cash for redemptions, while closed-end funds can take advantage of a weak market by buying shares at depressed prices.

Benjamin Graham's positive statements in *The Intelligent Investor* (1949) may be the best argument for closed-end funds, "If you want to put money in investment funds, buy a group of closed-end funds at a discount of, say, 10% to 15% from asset value instead of paying a premium of about 9% above asset value for shares of an open-end company. Assuming that the future dividends and changes in asset values continue to be about the same for the two groups, you will thus obtain about one-fifth more for your money from the closed-end shares." The advantage of a closed-end fund versus an open-end fund is clear: Investors may buy a dollar's worth of assets for less than a dollar. There are multiple closed-end funds with attractive double-digit discounts. Furthermore, closed-end funds often have lower expense ratios, in part because they do not pay 12b-1 fees to cover marketing and distribution expenses. Finally, closed-end fund managers may issue senior securities (for example, preferred stock) or borrow money to leverage their investment positions, providing the portfolio manager with an opportunity to enhance yield and returns for the fund.

# 10 Myth:

A portfolio of closed-end funds does not easily fit into an investor's overall asset allocation.

Most portfolios, be they institutional or retail, can benefit from diversification. Consider this: A portfolio of discounted securities provides exposure to a broad range of closed-end funds that are being managed in local markets by some of the world's top investment managers in their particular fields. Being able to invest in these funds, at a discount to the value of the assets being purchased, provides an additional bonus. A portfolio of 30 to 60 closed-end funds and holding companies, each of which may hold numerous underlying companies, can provide an investor with more stocks and greater diversification than a standard stock or bond portfolio could possibly provide. In addition to closed-end funds' specialist expertise and broad diversification benefits, their discounts result in a portfolio with higher yields and lower beta, and, should discounts narrow, much higher returns at lower levels of risk.

## NOTES:

1 Foreign & Colonial Investment Trust, [www.foreignandcolonial.com](http://www.foreignandcolonial.com).

2 As of 31 December 2007, the total closed-end fund universe was US\$674 billion (Source: CEFA, Fundamental Data). Within this universe, the average discount of the U.K. and U.S. universes was approximately 20% and 10%, respectively (Source: CEFA, Fundamental Data). Although the U.K. universe is slightly larger than the U.S. universe, we used a conservative estimate of 15% as our average discount. This gives us an estimated discount of approximately \$101 billion (US\$674 billion · 15%).

Published on 22 April 2008

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## Lazard Asset Management's Discounted Assets Strategies

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Closed-end funds have admirably supported investors' needs for higher returns with reduced risk over the past 200 years, through their broad diversification, local specialist expertise, and fixed-capital structure. Also, closed-end funds have always been at the forefront of investment innovation, due to their structural benefits, including diversification and risk reduction, greater liquidity (which makes settlement easier), and cost containment via the lowering of transactions costs.

At Lazard Asset Management (LAM), our funds-of-closed-end-funds strategies are named "Discounted Assets strategies": Emerging Markets Discounted Assets, International Discounted Assets and Global Discounted Assets.

Unlike most other similar strategies, LAM's Discounted Assets strategies' investment approach is to buy publicly traded companies that trade at a discount to net asset value. These publicly traded companies can be investment companies (closed-end funds, investment trusts, or country funds trading at an explicit discount), holding companies (when the parent company trades at a discount to the value of its listed parts), and special situations (when the discount can be clearly and unambiguously calculated). These investments do not include exchange-traded funds or open-end mutual funds and, since the first of LAM's three Discounted Assets strategies was launched in 1984, a major part of the investments have been closed-end funds, because the portfolio team has found in these assets attractive discounts and possibilities for unlocking value.

Compared to other funds of closed-end funds, we believe the opportunity set for Lazard Asset Management's Discounted Assets strategies is larger (encompassing the global, international, and emerging

markets), our history is longer, and, accordingly, our portfolio team's experience is broader.

Narrowing the discount is an important aspect of the investment process for LAM's Discounted Assets strategies. The portfolio team will only invest in discounted securities when the portfolio managers can identify catalysts that they believe will result in the securities' discounts narrowing or disappearing altogether. Lazard Asset Management is a leading corporate activist in the closed-end fund and holding company environment, and we have significant experience in enacting corporate actions that have resulted in the narrowing or elimination of funds' discounts.

LAM's Discounted Assets portfolio team believes that significant retail ownership can provide opportunities. Retail investors have been known to follow a herd mentality, invest more emotionally, and latch on to trends, causing the market to be less efficient. The portfolio managers look to take advantage of the swings in investor sentiment in order to buy at a discount and sell at a premium.

On the other hand, increasing ownership from institutions supports the portfolio team's mission of unlocking and enhancing value by eliminating discounts.

In summary, at Lazard Asset Management our goal is to generate alpha in the Discounted Assets strategies from two different sources. The first source of alpha is derived from the underlying equity exposure of the closed-end funds. The second source of alpha is derived from discount narrowing. We believe this unique approach to alpha generation may enable our Discounted Assets strategies to provide strong returns over the long term, in all market conditions, and at lower levels of risk.