

# What Are Closed-End Funds and How Do They Work?

## What is a Closed-End Fund?

The closed-ended fund structure originated in Holland in 1822, in London in 1850, and in the United States in 1893. A closed-end fund (CEF) is a type of professionally managed investment company that uses an initial public offering to generate capital, then invests that capital in financial assets such as public and private stocks, bonds, or other securities.

A CEF is one of three basic types of investment companies along with open-ended mutual funds, including exchange-traded funds and unit investment trusts. In the United States, publicly traded CEFs must be registered under both the Securities Act of 1933 and the Investment Company Act of 1940.

Closed-end funds can potentially provide investors with steady and predictable streams of income, while exposing them to a range of income-producing assets that are often difficult to access using other vehicles.

From an accounting perspective, CEFs are like any publicly traded company, with regular reporting requirements, balance sheets, and annual meetings of shareholders. CEFs are often managed by focused teams with expertise in the kind of assets they invest in.

Like exchange-traded funds, which are structured as open-end funds, CEFs allow investors to buy shares of an actively managed fund and are continuously traded over an exchange. However, the two fund types have key differences:

Closed-End Funds	Exchange-Traded Funds
Offers a fixed number of shares at inception and a stable share count over time.	Continually redeems and issues new shares.
Actively managed and can offer various types of leverage, potentially enhancing investor returns and regular distributions. May have private or Level 3 assets over 15% of the fund's holdings.	Traditionally passively managed by tracking an index or other benchmark. However, Active ETFs are a growing fund structure. Neither use traditional leverage. Required to have private or Level 3 assets under 15% of assets.

Closed-End Funds	Exchange-Traded Funds
Can trade at a discount or a premium to their net asset value (NAV) based on investor demand or sentiment. Disconnected from NAV over time.	Priced at or near the NAV of the underlying benchmark or the underlying securities held within the fund through creation and redemptions of the ETFs units.
Regular dividends are paid monthly or quarterly for most (95%) CEFs at an average 8%+ annualized rate.	Dividends are not a focus of the investment structure and are paid directly to investors or reinvested only as announced by the fund.
Reasonable expense ratios when the impact of leverage and leverage cost is removed. Average expense over assets excluding leverage: Equity funds 1.24%, taxable bond funds 1.19%, and municipal bond funds 0.71%.	Active funds have noticeably higher fees and average expense ratios (equity 0.71% and fixed income 0.41%), while passive funds tend to have much lower fees and average expense ratios (equity 0.44% and fixed income 0.22%).**

## How do CEFs Work?

### Buying and Selling

CEF shares are not redeemable at NAV, and investors typically buy and sell their shares in the secondary market on national exchanges. Because they aren't tied to NAV like ETFs or traditional open-end funds, the market price of a CEF will trade above or below its NAV based on demand. Premiums occur when a market has more buyers than sellers and shares sell at a price higher than

NAV. Discounts, by contrast, result from an excess of sellers in the market when shares sell below the NAV.

The NAV of any fund is based on the sum of the market value of a fund's holdings and minus any liabilities. When the market price of a fund is beating the NAV, the fund's discount is said to be "narrowing," whereas the opposite scenario creates a "widening" discount.

When you already own a CEF, you want discounts to narrow, but if you haven't bought the fund yet, you might want the discounts to widen before investing. While pervasive discounts can frustrate some investors, they are a feature enjoyed by many long-term investors in the universe of funds.

CEFs tend to be more volatile than open-end funds because of their market price and the fluctuation of discounts and premiums around NAV. However, this allows patient and experienced investors to potentially buy or sell the fund's shares at better prices. Orders can be placed throughout the day, including via limit orders.

The mechanism for changing the number of shares in a CEF includes dividend reinvestment — a tender to reduce the shares, or a rights or secondary or at-the-market (ATM) offering to increase the number of shares.

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## Leverage

After a CEF closes to new capital, fund managers sometimes employ leverage to finance new investments or enhance a fund's yield. Some tax-free CEFs employ leverage by issuing preferred shares, commonly at 30% or 40% of the fund's total capital. Few CEFs actually borrow money. Leveraged funds have historically outperformed unleveraged funds in a bull market, though they may underperform in a bear market.

## Performance

***“When assessing the performance of a fund manager, the fund’s total return based on its NAV is more useful — because the manager’s decisions impact NAV directly while influencing the premium or discount only indirectly.”***

*John Cole Scott, AICA Founder and Chairman*

CEFs deliver their earnings to shareholders as income dividends or increases in the price of the fund. 95% of funds pay shareholders monthly or quarterly and the average fund pays about 8.2% annualized, according to [CEFData.com](http://CEFData.com).

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Total return to an investor can be calculated by combining the change in the fund's market price over time with the impact of its distributions, be they reinvested or paid out in cash.

## The Universe of CEFs

CEFs often invest in specialized, less liquid assets such as private equity and real estate, and there are different “wrappers” for different types of closed-end investment strategies:

(See graphic on next page) ->

## Average CEF Universe Data:

	US/Global Equity CEFs	Sector Equity CEFs	Taxable Bond CEFs	Municipal (Tax-Free) CEFs
# Funds	82	92	132	108
Disc/Prm	-10.87%	-4.46%	-0.53%	-6.81%
10-Yr Avg Disc/Prm	-9.93%	-4.72%	-4.62%	-5.35%
Market Yield	8.23%	8.05%	9.90%	5.50%
3-Yr Div Growth	14.38%	27.42%	7.36%	2.42%
3-Yr ROC %	29.93%	28.79%	20.07%	10.25%
Leverage	9.03%	16.18%	25.37%	30.76%

Data as of 09/09/2024 from [CEFData.com](https://www.cefdata.com)

\*\*ETF data provided by ETF Global.

Disclosure: The opinions of the speakers / presenters are their own opinions and may not be the opinions of AICA. Listed closed-end funds and business development companies trade on exchanges at prices that may be above or below their NAVs. There is no guarantee that an investor can sell shares at a price greater than or equal to the purchase price, or that a CEF's or BDCs discount will narrow or be eliminated. Non-listed closed-end funds and business development companies do not offer investors daily liquidity but rather on a quarterly or semi-annual basis, often on a small percentage of share. CEFs often use leverage, which can increase a fund's risk or volatility. The actual amount of distributions may vary with fund performance and other conditions. Past performance is no guarantee for future results.