Greater Yield through Closed-End Funds?

By Russell Wild *Mon, Jul 8, 2013*

There's no free-gyro lunch in Greek sovereign bonds, and there's no free-lunch in closed-end funds either, warns this guest columnist.

For some, it's a necessity. For others, it's driven by a fond remembrance of yields past. Whichever. A desperate search for yield has gripped older investors. And that in large part explains the recent surge in closed-end funds.

Both the number of new closed-end funds (CEFs) launched and the money going into closed-end funds are at record highs. In one month (March) alone there were four launches. "The CEF industry market size has increased to $288 billion, dispersed among 583 funds that are managed by 103 different asset managers," according to a June report from Cerulli Associates.

Of course, we all know that finding yield, even in today's low-interest environment, is not really very hard. If you want a 12% return right now, you can buy 10-year bonds from the government of Greece. But there's a catch. With high return comes high risk. Do CEFs, some of which offer yields similar to Greek bonds, offer any lesser risk?

Unlikely. Markets tend to be efficient. But that's not to say that closed-end funds are bad. Just move in with eyes wide open. The risk of buying Greek sovereign bonds is readily apparent (huge government deficits, riots in the streets, the potential for default). There's no free gyro lunch.

And there's no free lunch in closed-end funds, either, although the risks are not always so visible. As with any fund, open or closed, you assume whatever risks are inherent in the asset class. So if you buy a high-yield bond CEF, for example, you risk that the underlying high-yield bonds may default en masse or, alternately, plummet in value should interest rates rise. You are also subject to managerial risk, as CEFs tend to be quite actively managed. And your account value is subject to the management fees of CEFs, which tend to be significantly higher than those of open-end funds.

Then there are the subtler dangers:

The discount factor. Because CEFs issue a fixed number of shares, demand may drive the share price higher than the net asset value (NAV) of the underlying holdings. That's called a premium. Conversely, if the fund owners throw an IPO party and no one comes, the share price may dip below street level. That's called a discount.

If you buy shares at a premium, or even at a modest discount, you risk seeing those share values fall, regardless of how the underlying holdings perform. According to my Morningstar Principia software, about 120 CEFs currently sell at a premium, and many others are near par. Beware.

Leverage. Many CEFs (about two-thirds, or 400, per Morningstar) borrow money to create leveraged positions. That's often how certain funds deliver great yields. But, of course, leverage magnifies losses as well as yield and performance. Many of the leveraged high-yield CEF bond funds now selling at a premium, largely for their juicy 10% to 12% yields, took enormous hits in 2008. In some cases, those hits exceeded the 40% or so loss that stocks suffered.

Cannibalism. Consuming capital to raise yield is something that rarely happens in the mutual-fund world, and when it does, it is clearly brought to investors' attention. Vanguard, for example, has three funds with the words "managed payout" in the name. In the world of CEFs, "managed payouts" are not trumpeted. Check carefully to see whether the "distribution rate" includes a return of capital. If it does, your cherished yield may be little more than smoke and mirrors.

Russell Wild, MBA, is the author of Bond Investing for Dummies *and* Exchange-Traded Funds for Dummies*. He recently bought shares of The Central Fund of Canada Limited (ticker CEF), a closed-end fund that invests in precious metals. The management fees are low. He bought it at a discount. The fund is not leveraged. There is no return of capital. And the yield is negligible.*