

Financial Foresight

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Closed-End Funds

While many investors are familiar with open-end funds (OEFs), few are aware of another investing option, closed-end funds (CEFs). As of September 30, 2009 there were 632 CEFs with \$223.5 billion in assets. This may sound like a lot until you realize that all those funds combined are worth less than the combined value of just three of the largest OEFs. Though they appear to not be that popular, there may be a reason to give CEFs a second look. In addition we will discuss some critical differences and look at some of the risks.

Like the more popular OEFs, CEFs are managed by investment companies where managers build stock & bond portfolios. Unlike OEFs, CEFs issue a fixed number of common shares that are listed on the exchanges and trade like stocks throughout the day. (OEFs issue new shares and redeem shares when investors are looking to buy and sell. OEFs also only trade one time per day.) When purchasing or selling CEFs, you are actually doing so from other investors, just like stocks. This makes it easier to manage, as the company does not need to deal with investors sending in or taking out money due to the fixed number of shares.

The primary reason to purchase a CEF is the potential ability to acquire it at a discount to its net asset value (NAV). Because new shares are not issued by the management company but are bought and sold between investors, the prices can fluctuate wildly to a premium or discount to the NAV. On 6/21/10 I ran a screen on www.cefconnect.com and found the biggest discount to NAV was at 52.83%, while the biggest premium to NAV at 66.19%. However, for most funds, the discounts and premiums are in a much tighter range. Investors should look for a well managed fund with a decent expense ratio that is trading at a discount of 10% or more. Look at the three-year

chart of Templeton Global Income Fund (GIM)¹. You can see in late 2007 and early 2008 that the price and NAV moved pretty much in tandem. However, in the 4th quarter of 2008 when the bond market was experiencing extreme volatility, GIM was trading around a 15-20% discount to its NAV. Once the markets calmed down later in 2009 you can see the price actually moved above the NAV by about 5%. This closing of the NAV gap provided an extra 20% of return in addition to the interest income and market appreciation. Many of the CEFs selling at a discount are in out-of-favor sectors like real estate and banking, while many bond funds are at a premium.

CEFs, while diversified, can still provide a way to invest in a specific sector, country or style. For example, you could focus on clean energy, China, or dividend stocks, etc. Like stocks, bonds and ETFs, CEFs trade throughout the day. Some investors value this flexibility.

There are several concerns to point out regarding CEFs. Remember, even if the market goes up, your CEF could lose share price due to a widening discount. About 70% of CEFs use leverage, meaning they borrow money to invest.² This volatility can work for you, but also against you. I

generally stay away from leveraged funds.

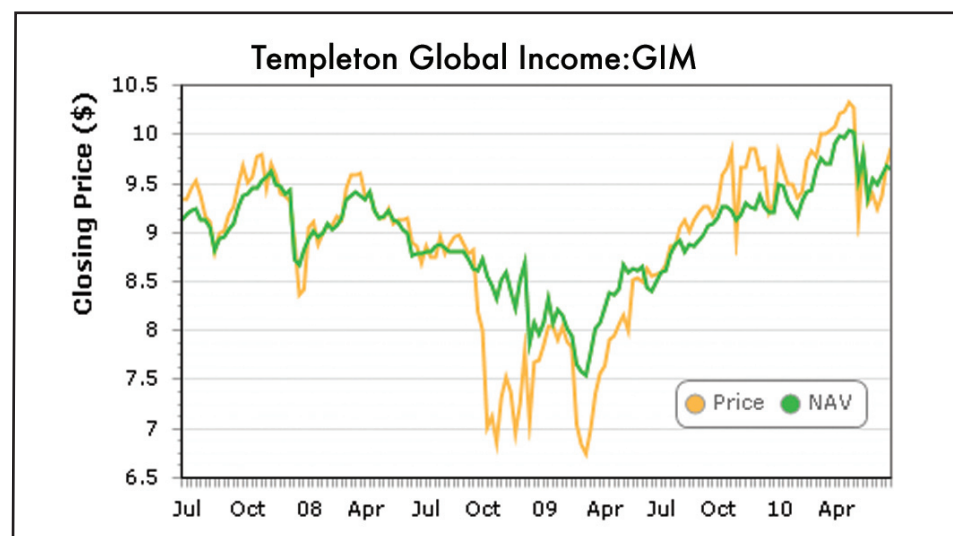
Some funds selling at a big discount do so for a reason: their performance is not great or their costs are high. In regard to cost, avoid buying a CEF on its first day of trading. You can quickly lose 5-6% due to the commission cost alone. Be careful of the quoted "yield". Often times CEFs set a distribution policy which actually may include a return of your principal, thus not a true "yield".

It can also be hard to find research opinions on CEFs. A few good sites to research CEFs are www.closed-endfunds.com and www.etfconnect.com. Both sites will let you screen by manager, performance, discount/premium, costs and leverage. You can find CEFs through many of the same companies that offer OEFs, such as PIMCO, Franklin Templeton & Pioneer.

I feel CEFs should be held sparingly. As with any portfolio, diversity is important. If you do your homework and purchase them carefully, they can be a valuable part of your overall portfolio.

¹<http://www.cefconnect.com/Details/Summary.aspx?ticker=GIM>

²*Frequently Asked Questions About Closed-End Funds and Their Use of Leverage*, http://www.ici.org/faqs/ci.faqs_closed_end.print (17 June 2010).



A 'Black Swan' Dive

By Gregory Thomas

Predictably random...

The stock markets are unique among games of chance; there are an infinite number of possible outcomes. Yet, investors consistently think its price movements are predictable and then seem so surprised when stock prices "misbehave."

Usually, the market's unpredictable movements fall within acceptable norms. While unpleasant, a 10% market decline seems reasonably manageable because investors know that, historically, the necessary 11% (or more) correction to get back to even has happened over 50% of the time.

Occasionally, however, the markets move in unacceptable patterns; share prices experience extreme and seemingly "unfair" downdrafts for which most investors are unprepared. "How could I have seen that coming?" is the common response.

That random event probably won't happen again. But, some other random event surely will; and most investors will be just as unprepared for the next random shock as for the last.

Marketplace meltdown...

A case in point happened on May 6, 2010 when the Dow fell 998 points during the day. This was the largest point drop in history and seemed to have no immediate explanation.

At first, it was thought that the market feared a repeat of the last damaging random event, the bankruptcy of Lehman; only this time it would be the bankruptcy of Greece that would bring global markets to their knees.

While that fear may have contributed to

investors' reactions and other explanations may emerge, the current thinking is that the initial trigger might have been a sale of a futures contract by a hedge fund advised by Nassim Taleb, author of the book, *Black Swan: The Impact of the Highly Improbable*, put in motion an improbable sequence.

According to most reports, this sale of a futures contract on an options exchange inspired others to sell stocks on the New York Stock Exchange which, in turn, caused the broad market indexes to fall which, in turn, triggered selling by the exchange-related funds which...well, you get the drift. Eventually, the markets seized and liquidity was gone; one large company's share price fell to \$.01/share from about \$42.00/share then recovered to about \$41.00/share!

The irony...

The irony is that it was Nassim Taleb who introduced the notion that the stock market movements are far more influenced by unpredictable and random events than most realize. He called these random events 'Black Swans,' a reference to how an American could spend his whole life observing only white swans and, therefore, assume and even wager that the next swan to would be white too. Imagine his shock (and lost wager) when a black swan from Australia flew into the pond.

The significance of 'Black Swan' events is broad, but not fully appreciated because they are unpredictable. The only way for an investor to protect against a 'Black Swan' is to assume that one will happen and prepare accordingly; advice that is germane to market risk protection, in general.

'Black Swan' defense...

Almost every financial plan created by a financial services person makes two assumptions: 1) that stocks will go up, over time; and 2) that investors will be able to spend those gains in retirement.

Almost every financial plan that fails does so because of those same two assumptions. It fails when stock prices do not go up for extended periods of time. It fails when the lack of spendable capital gains forces the distribution and consumption of principal.

A good financial plan, therefore, is positioned to enjoy rising markets; but does not require them. A good financial plan does not require capital gains because it generates significant levels of recurring portfolio income from dividends, interest, and rents. The income can be spent or reinvested when 'Black Swans' wreak havoc with share prices; and when capital gains are still a planning assumption but not a portfolio reality.

Income growth...

It would be a mistake to think a portfolio income stream inhibits growth. Over the last 40 years, the share price appreciation, on average, of all stocks that paid dividends exceeded the price appreciation, on average, of all stocks that did not pay dividends.

Dividends can grow, too, even if share prices do not. There are currently over 250 domestic stocks that have increased their dividends each year for ten years. Some have increased them every year for over 25 and even 50 consecutive years.

In other words, the 'Black Swan' insurance offered by owning dividend-growing common stocks has historically come without additional cost. Who says there's no such thing as a free lunch?

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If you would like to learn more about ThomasPartners or get a portfolio review, please contact Don at ddempsey@dempseyinvestments.com.