How to Invest in a Closed-End Fund

There are two types of mutual funds — open-end funds and closed-end funds. Imagine they’re twins who share the same DNA but go through life doing things very differently.

Both of these funds sell shares to investors and use the money invested to buy securities that match their investment missions. But that’s where the similarities end.

When people say “mutual funds” they’re usually referring to open-end funds. Open-end funds can sell an unlimited number of shares to investors. The price per share — also known as the net asset value (NAV) — is calculated by dividing the market value of the fund’s assets by the number of shares held by investors.

If a fund has net assets of $100 million and there are 5 million fund shares in the hands of investors, the fund’s share price would be $20. That’s why open-end mutual funds trade only at the end of each day, when trading stops and the final price can be calculated.

Most people own the open-end variety in their retirement and taxable accounts.

Now let’s look at the lesser-known twin, closed-end funds. These funds issue a set number of shares at the fund’s origin that trade on the stock exchange throughout the day. The value of these shares is based on demand. If lots of investors buy shares, the price goes up. If investors dump them, the price goes down.

The same is true for closed-end funds. If you invest in a closed-end fund with a share price that’s lower than its NAV, congratulations, you’re getting a discount. If the gap between that fund’s share price and its NAV narrows after you invest, you’ll receive a bonus when you sell shares. Just as if the price of that bag of coins went up when you sold it.

But don’t get overly concerned with these figures. Most closed-end funds offer a discount. The key is knowing how much of a discount they’re offering and whether you think the fund will perform well over time. If it does, and the discount shrinks after you’ve purchased shares, then you earn a profit.

Like open-end funds, closed-end funds come in dozens of types ranging from U.S. stock and bond funds to funds that invest in a singe country or region. But don’t confuse a closed-end fund with a “closed fund.” A closed fund is an open-end fund that no longer accepts new investors.

Closed-end funds tend to be actively managed — meaning the fund’s manager buys and sells securities in an effort to outperform the fund’s benchmark index, such as the Dow Jones Industrial Average. Watch out: This buying and selling could result in higher fees and increased taxes, if you hold the fund in a taxable account.

**Should You Invest in a Closed-End Fund?**  
In recent years, closed-end funds have fallen out of favor with average investors. That’s due largely to the rise in popularity of open-end funds and exchange-traded funds (ETFs).

To make this simple, think of an ETF as the cousin of the closed-end fund. ETF shares trade on the stock exchange—just like closed-end funds. But ETFs generally track a market index, like the Nasdaq or Dow Jones Industrial Average, making them more efficient (lower fees and natually diversified) than closed-end funds and a lot easier to understand. Most ETFs also charge lower fees and are more tax-efficient because the securities in index-based portfolios aren’t traded often.

Closed-end funds do have a few benefits:

• A closed-end fund’s discount offers you a bonus when the gap between the share price and NAV narrows after investment.  
• A closed-end fund’s manager can invest without worrying that cash may be needed to meet sudden redemptions by large numbers of jittery investors, as is the case with open-end fund managers.  
• Closed-end funds tend to pay investors higher levels of income because they invest more heavily in income-producing assets — more inflows of new money.

Bottom line: Unless you’re willing to roll up your sleeves and research closed-end funds and their discounts, you may be better off in a similar open-end fund or ETF.

**How to Invest in a Closed-End Fund**  
• Scan the horizon. Once you decide what kind of fund to add to your portfolio (U.S. stock, emerging markets, etc.), check out Morningstar’s directory [here](http://news.morningstar.com/CELists/CEReturns.html).  
• Review the discount. The bigger the gap between a fund’s share price and NAV, the more likely it will narrow over time and provide you with a bonus. To evaluate the current gap, ask for the fund’s average one-year discount since its start. Then compare it to the fund’s current discount.

You can generally assume that the fund’s discount eventually will migrate back to its historical average. For example, if a fund’s historical average discount is -7% but it is now trading at a -12% discount, you can expect the fund will return to its historical 7% average — and you’ll wind up pocketing the difference.

•**Size up performance.** The best measure of a closed-end fund’s return is its performance over time, plus the effect on performance of the fund’s distributions. Also, the longer the fund has been in existence with the same manager, the better. We think a fund should have at least five years of performance before you invest in it.

• **Mind the debt.**Beware of closed-end funds with more than 40% of debt to total assets. Such a debt level usually means the fund’s manager is using leverage to boost the income yield paid to investors, which makes the fund riskier.

•**Scope your expenses.**To invest in a closed-end fund, you’ll have to pay a commission on trades as well as fund expenses and high annual management fees that range from 1% to 2% of your investment. To hold costs down, look for closed-end funds with low expenses and fees, and consider trading shares through a discount brokerage.

• **Check the yield.** Closed-end funds tend to generate more income than open-end funds. When considering yield-producing funds, look for an annual yield that’s a couple of percentage points over that offered by U.S. Treasuries. Or look for a fund that has a discount of 10% or more, unless it’s a low-risk bond fund. Just be sure the high discount isn’t the result of capital distributions or a one-time payout.

•**Mind your taxes.**A high percentage of closed-end funds invest in bonds and preferred stocks to provide investors with higher yields than common stocks. Remember, in taxable accounts, this yield will be taxed as income, not the lower dividend tax rate.

• **Skip IPOs.** Buying shares of a closed-end fund just when they’re offered through an initial public offering (IPO) comes with big risks. That’s because the fund’s discount—or gap between share price and NAV—typically widens in the months following an IPO.

• **Size up the manager.**See how long the fund’s manager has been in place. The longer the better if the fund has delivered above-average returns.

• **Compare the fund.** See how the closed-end fund you’re considering stacks up against a similar open-end or exchange-traded fund. Be sure to compare performance, fees and expenses.