MARKETS

Pricing Oddity Has One Manager Advising Clients Not to Buy His Fund

Bets by investors who pay large premiums to net asset value can turn ugly fast

Pacific Investment Management Co.'s offices in Newport Beach, Calif., last year. The Pimco Global StocksPLUS & Income Fund trades at a 70.2% premium to its net asset value. *PHOTO: MIKE BLAKE/REUTERS*

By Daisy Maxey and Ben Eisen
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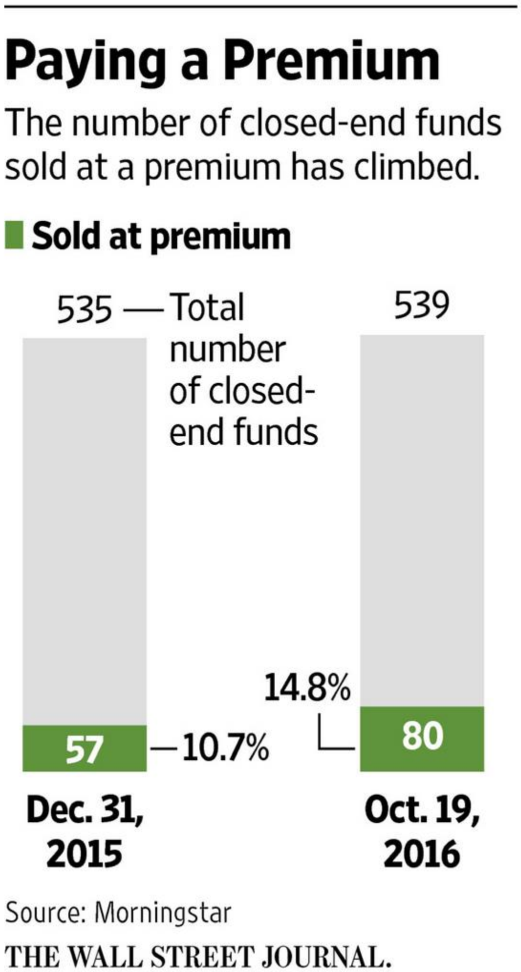
A growing number of closed-end funds are trading at prices above the value of their assets, a market distortion that could subject holders to sharp declines should interest rates pick up.

Eighty of the 539 closed-end funds listed in the U.S. traded at a premium to net asset value as of Oct. 19, according to research firm Morningstar Inc. At the start of the year, 57 traded at a premium.

Closed-end funds typically throw off sizable distributions, which look increasingly attractive in a low-rate world but less so as rates rise. While discrepancies between market prices and asset values on closed-end funds aren't uncommon, large premiums rarely last, investors say.

"I think you'll see these premiums disappear in a hurry," said Rajeev Das, a principal at Bulldog Investors, an activist money manager that targets closed-end funds and other investments. "I don't think it will be slow or gradual, especially if dividends are cut. It will be a crash and burn."



Closed-end funds have become increasingly popular in recent years, with nearly $243 billion in assets at the end of September, up from about $219 billion at the end of last year and $128 billion at the end of 2008, according to Morningstar.

Closed-end funds are tradable on stock exchanges but, unlike traditional "open-ended" mutual funds, closed-end funds have a set number of shares. That means a surge in demand can overwhelm stagnant supply, pushing market values above the sum of their underlying assets for little fundamental reason.

The funds are among a swath of income-generating investments, from options strategies to high-dividend stocks, whose popularity has been boosted by low interest rates that have pushed investors to pile into alternatives.

At the same time, these so-called yield plays have become more vulnerable to a reversal, particularly as expectations build for the Federal Reserve to increase interest rates. Investors in the market for federal-funds futures put a 70% probability on an interest-rate rise before the end of the year, according to CME Group data.

Because the funds often borrow money to increase their holdings, employing a tactic known as leverage, rising borrowing costs can hit share prices by hampering the funds' capacity to make distributions to investors.

The Gabelli Utility Trust commands a premium of about 21.9%, and a new fund, Gabelli Go Anywhere Trust Combo, trades at a premium of more than 45%.

“Big premiums make no sense, and big discounts make no sense,” said Mario Gabelli, chairman and chief executive of Gamco Investors Inc., which runs the two funds. “That Go Anywhere fund should not sell at that premium. We are advising people not to buy it.”

Investors who pay these large premiums are essentially betting that other investors will be willing to pay an even higher price, experts say, a mind-set common in markets that have experienced large gains over a period of years. It is a bet that can turn ugly fast.

The $178.4 million Pimco Global StocksPLUS & Income Fund, for example, pays a distribution yield of 10.5% and currently trades at a 70.2% premium to its net asset value, according to Morningstar.

That is a lofty premium even after a sharp decline this month. After the market’s close on Oct. 3, Pacific Investment Management Co. announced a 20% cut to the fund’s monthly distribution yield, lowering it to 15 cents a share. The following day, the fund’s share price fell, which narrowed the fund’s premium to 71% of net asset value from 106%.

Pimco declined to comment beyond its press release on the fund’s distribution cut, which said that the change reflects in part “current and expected earnings, the overall market environment and Pimco’s current economic and market outlook.”

Other closed-end funds haven’t reached such high premiums but still command prices that are lofty relative to the value of their holdings. Pimco High Income Fund trades at a 44.2% premium to its net asset value and yields 12.9%, according to CEF Connect, a data service run by Nuveen Investments. After the fund cut its payout for the first time last year, its premium evaporated and it briefly traded at a discount.

The Pimco Strategic Income Fund trades at a 27.2% premium and yields about 9.6%, and the John Hancock Tax-Advantaged Global Shareholder Yield Fund trades at a nearly 18% premium, according to CEF Connect.

“If investors are looking for yield—and that seems to be the name of the game—do a little bit of homework,” said Erik Herzfeld, president of Thomas J. Herzfeld Advisors Inc., a Miami investment-advisory firm. Higher-yielding funds trading at discounts “are the ones I would focus on.”

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