What to consider with closed-end funds

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Closed-end funds have been around for over 100 years and make up about 20% of the companies listed on the New York Stock Exchange, yet they are often misunderstood. A closed-end fund is simply a portfolio of professionally managed investments and can be a viable investment option for you. But before you make any investment decisions, we encourage you to learn more about closed-end funds to determine if they are a suitable choice for your portfolio.

What is a closed-end fund?

Closed-end funds are professionally managed funds that usually consist of one specific type of security (e.g., tax-free bonds, convertible bonds, domestic stocks, foreign stocks, etc.). Like mutual funds, closed-end funds have a variety of portfolio choices and strategies, and there are fees and expenses associated with owning them.

A closed-end fund only makes available a fixed number of shares at its inception — unlike mutual funds, which redeem and issue new shares daily. And with a few rare exceptions, the shares initially issued by a closed-end fund are all that will ever be available.

Since closed-end funds are closed to new money, investors buy and sell shares on a stock exchange like they would with traditional stocks. As an investor, you can only buy closed-end fund shares when someone else wants to sell. Shares aren't subject to investor redemptions, and therefore portfolio managers will never be forced to make adjustments based on investors' decisions. It also means that these fund shares can be relatively hard to buy and sell on any given day.

Mutual funds and closed-end funds are priced differently. While mutual fund transactions usually occur once per day, closed-end funds trade throughout the day. Their prices are determined by supply and demand and other daily market factors, so their prices fluctuate daily. They can trade at a discount (below) or a premium (above) to their net asset value (the value of a share on a given day). Typically, they trade at a discount.

Closed-end fund managers often use complex investing strategies rather than a traditional buy-and-hold approach. This can make their operating expenses and fees higher and also increase the funds' volatility and the potential for market loss.

At Edward Jones, we believe investors should buy and hold for the long term, so we screen funds based on a number of criteria and only offer a relatively small number of closed-end funds.

With closed-end funds, be wary of ...

Leverage

Leveraging is the practice of borrowing money at short-term rates to buy additional investments for the fund, but this tactic makes the net asset value and the price of the fund more volatile over time. That's why we don't recommend funds that use leverage in an attempt to enhance their returns. When interest rates are falling, leverage can help a fund, but when rates are rising, leverage can reduce cash flow and decrease the total return of the fund.

High distributions and managed distribution

Closed-end funds can pay investors periodically, but a closed-end fund's cash flow is called a distribution. Distributions can be made up of dividends, capital gains and/or principal. High distributions can be one of the most attractive features of closed-end funds. But if it seems too good to be true, it probably is.

Managed distribution strategy

Shareholders receive a consistent amount, regardless of whether the fund is performing well enough to support it.

You should be aware of the source of these distributions before deciding to buy. Some funds may count on growth to make up a portion of the distribution. This managed distribution strategy means shareholders receive a consistent amount, regardless of whether the fund is performing well enough to support it. If the fund is underperforming, managers may sell some of the investments the fund owns. They employ this strategy because the consistent cash flow stream makes the fund more attractive.

It's important to remember that any portion of the distribution that is paid out but not earned will reduce the fund's value, because the underlying investments are being sold. The fund may have a more difficult time growing in value over time.

Low-quality underlying investments

Some closed-end funds hold low-quality securities as another way to boost their distributions. If they own low-quality stocks and bonds, the funds can be more volatile and carry additional risk. As a result, the funds themselves can be difficult to sell and are subject to increased price fluctuations.

Contradictory fund names and holdings

Sometimes a fund's name can be somewhat misleading. Some funds offer a high yield and significant holdings of high-quality investments, such as U.S. Treasury bonds, and the fund name may imply that's all they own. However, these funds also may hold risky high-yield junk bonds or emerging-market bonds, making them more aggressive than the fund name implies. If at first glance the yield and the makeup of the portfolio seem too good to be true, they probably are.

What to look for instead

Quality

Investment quality in a closed-end fund portfolio should be a major consideration. Stock funds should hold a diversified portfolio of blue chip stocks, and bond funds should own investment-grade quality bonds.

Diversification

Look for diversified stock funds. If investing in sector or country funds, make sure they are used as a complement to a well-diversified portfolio. Ladder your closed-end funds the same way you would ladder any fixed-income portfolio, making sure to avoid over-concentration in long-, medium- or short-term maturity dates.

Price

We only recommend purchasing a closed-end fund when the market price is at a discount to net asset value. In general, most closed-end funds trade at a discount at any given time. While we don't necessarily advocate selling a fund immediately just because it's trading at a premium, we do believe a premium price can give you a nice exit strategy from a fund that is performing poorly or no longer meets your objectives.

Distribution stability

Especially for closed-end bond funds, relative stability of the distribution should be a major consideration. Some bond funds repeatedly return investor capital to maintain a stable distribution. We recommend avoiding such funds. Instead, make sure the fund's distribution strategy is sustainable.

Management

Look for closed-end funds that are several years old for a realistic and fair determination of how managers perform during rising and falling markets. It is also important to compare performance against similar funds.

Expenses

The expense ratios of a fund compare the administrative fees and operating costs against the fund's total assets. When you're looking at a closed-end fund, its expense ratio should be comparable to other, similar funds.

As a rule of thumb, an expense ratio of 1.5% or lower would be acceptable for investment-grade quality domestic bond funds (government, municipal, or corporate) and large-capitalization stock funds. For funds that invest in high-yield bonds, foreign bonds and small- and mid-capitalization domestic stocks, look for a ratio of no more than 1.75%.

In some cases, closed-end funds can make sense as part of a diversified portfolio for long-term investors.

But the intricacies associated with many closed-end funds color our view on them. As a general rule, we don't recommend the use of options, leverage or managed distributions, and many funds employ one or more of these investment tactics, increasing their risk level.

Talk to your Edward Jones financial advisor about whether closed-end funds are the right solution for you — and together, look for funds with quality, well-diversified portfolios, stable distributions, strong management and reasonable expense ratios.

