

A GUIDE TO

Closed-End Funds

A **closed-end fund** is a type of investment company whose shares are listed on a stock exchange or are traded in the over-the-counter market.



Contents

This guide includes an overview of the types of closed-end funds and how they operate. However, each closed-end fund is different, and investors should learn more about a particular fund before investing. Closed-end funds—like all investments—involve risk, including the possible loss of principal.

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What Is a Closed-End Fund?

Closed-end funds are professionally managed investment companies. They generally issue a fixed number of common shares that typically are listed on a stock exchange. Once issued, a closed-end fund's common shares are not typically purchased or redeemed directly by the fund, but instead are bought and sold in the open market. The market price of closed-end fund shares fluctuates like that of other publicly traded securities. Closed-end funds invest in a wide variety of domestic and international securities, including common stocks, preferred stocks, high-yield bonds, municipal bonds, and corporate bonds.

FEATURES OF CLOSED-END FUNDS

A closed-end fund raises cash for investment by selling a fixed number of shares during an initial public offering (IPO), and the manager invests the cash in accordance with the fund's investment objectives and policies. The fund does not issue redeemable securities and typically does not offer its securities for sale on an ongoing basis.

Because a closed-end fund does not need to maintain cash reserves or sell securities to meet redemptions, the fund has the flexibility to invest in less liquid portfolio securities. For example, a closed-end fund may invest in securities of very small companies, municipal bonds that are not widely traded, or securities traded in countries that do not have fully developed securities markets. Closed-end funds also have flexibility to borrow against their assets, allowing them to use **leverage** as part of their investment strategy.

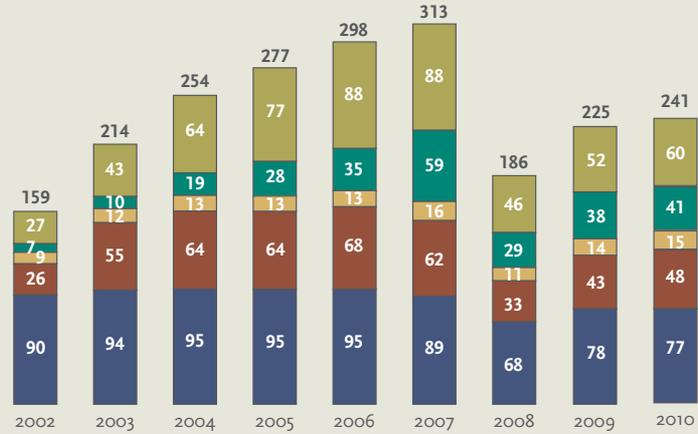
TYPES OF CLOSED-END FUNDS

There are two main types of closed-end funds—equity and bond. Of the total \$241 billion invested in closed-end funds at the end of 2010, \$101 billion was invested in equity funds and \$140 billion in bond funds. Bond closed-end funds accounted for more than half of all closed-end fund assets at year-end 2010. Bond funds were the most common type of closed-end fund, accounting for 67 percent of the total number of funds.

ASSETS OF CLOSED-END FUNDS

Billions of dollars, year-end

- Domestic equity
- Global/International equity
- Global/International bond
- Domestic taxable bond
- Domestic municipal bond



Note: Components may not add to the total because of rounding.
Source: Investment Company Institute

NUMBER OF CLOSED-END FUNDS

Year-end

- Domestic equity
- Global/International equity
- Global/International bond
- Domestic taxable bond
- Domestic municipal bond



Source: Investment Company Institute

Closed-End Equity Funds

All closed-end equity funds are subject to the risk that the portfolio securities held by the fund will decline in value, thus causing a decline in the fund's net asset value (NAV) and market price. The value of a particular stock in a fund's portfolio may increase or decrease for a variety of reasons, including the business activities and financial condition of the issuer of the stock, market and economic conditions affecting the issuer's business, or the stock market generally.

Closed-End Bond Funds

All closed-end bond funds are subject to some degree of market risk and credit risk. Market risk is the risk that interest rates will rise, lowering the value of bonds held in the fund's portfolio. Generally speaking, the longer the remaining maturity of a fund's portfolio securities, the greater the volatility of its NAV due to market risk. Credit risk is the risk that issuers of bonds held by the fund will default on their promise to pay principal and interest. A closed-end bond fund's investment policies typically define the credit quality and maturity of the investments the fund may make.

SOURCES OF

Closed-End Fund Information

Information on closed-end funds, including NAVs, market prices, and discounts or premiums, can be found in stock market tables on most major financial websites and in the financial pages of most major newspapers.

Some stock market tables offer other information, including a closed-end fund's high and low market prices for the past 52 weeks; dividend payments made during the past 12 months; and the high, low, and closing market prices for the previous day.

COLUMN 1	COLUMN 2	COLUMN 3	COLUMN 4	COLUMN 5
Fund name (Symbol)	NAV	Market price	Premium/ Discount	52-week market return (or 12-month yield or distribution rate)
ABC Fund	8.26	7.49	-9.3	10.2
XYZ Fund	17.18	17.62	+2.6	7.1

COLUMN 1:

The name of the closed-end fund and its ticker symbol.

COLUMN 2:

NAV per share—the total market value of the closed-end fund's portfolio securities less expenses and liabilities divided by the number of shares outstanding.

COLUMN 3:

The market price of the closed-end fund.

COLUMN 4:

The plus or minus figure indicates the percentage premium (+) or discount (–) above or below the fund's NAV per share at which the shares last sold.

COLUMN 5:

For equity funds, the final column shows the 52-week percent change in stock market price plus dividends. For bond funds, the final column shows dividends paid from income, capital gains, and principal during the last 12 months, as of the prior month's end, as a percentage of market price. This is the fund's distribution rate, sometimes mistakenly referred to as yield.

Other sources of information about closed-end funds include the financial press and the fund itself. Many closed-end funds have personnel available to answer questions about the fund and to provide written information. In addition, periodic reports, proxy statements, and, in some cases, fund registration statements can be found on the U.S. Securities and Exchange Commission's (SEC) website at www.sec.gov.

PRICING

Many closed-end funds calculate the value of their portfolios every business day, while others calculate their portfolio values weekly or on some other basis. The NAV of a closed-end fund is calculated by subtracting the fund's liabilities (e.g., fund expenses) from the current market value of its assets and dividing by the total number of shares outstanding. The NAV changes as the total value of the underlying portfolio securities rises or falls.

Because a closed-end fund's shares trade in the stock market based on investor demand, the fund may trade at a price higher or lower than its NAV. For example, a closed-end fund in great demand may trade at a share price higher than its NAV. In this case, the fund's shares are said to be selling at a "premium" to the NAV.

The opposite may also be true. Based on a variety of reasons which may include a less favorable perception of its underlying portfolio or of the market in which it trades, or a lack of investor knowledge or market recognition, a fund may trade at a share price lower than its NAV. Such a fund's shares are said to be selling at a "discount" to the NAV. For example, if a fund has an NAV per share of \$100, based on the current value of its portfolio, but is priced at \$90, it is selling at a 10 percent discount. Viewed from another perspective, when a share is trading at a 10 percent discount to NAV, an investor can purchase a \$100 share of the fund's assets for \$90.

Fund management may take measures in an attempt to reduce discounts, including increasing market visibility of the fund through public reports and communications. A closed-end fund may also attempt to increase the demand for its shares by offering a dividend reinvestment plan, engaging in tender offers (where the fund offers to purchase its shares directly from shareholders at NAV), or instituting a stock purchase program (where the fund purchases its shares on the open market). Further, some closed-end funds may periodically consider conversion to open-end status, which would permit shareholders to redeem their shares at NAV.

Of course, any such measures must be approved by the fund's board of directors as consistent with the best interests of the fund.

INVESTMENT RETURN

There are three components to a closed-end fund's investment return:

- » **SHARE PRICE APPRECIATION OR DEPRECIATION.** A closed-end fund's share price may increase or decrease based on the market demand for the fund's shares. Market demand for fund shares may be influenced by many factors, including market perceptions about the fund or its investment manager, perceptions about the types of securities or geographic region in which the fund invests, and the investment performance of the fund.
- » **DIVIDEND INCOME.** A closed-end fund may earn interest and dividend income from securities held in its portfolio. This income, minus fund operating costs, is typically distributed to shareholders as dividends. Bond funds tend to be chosen for their dividend-earning potential, although equity funds may earn income too. Investors can also choose funds that earn income exempt from federal income tax. If a fund's dividend payments exceed the dividends and interest the fund earns on its portfolio during the fiscal year, shareholders will receive distributions of capital gains or the capital (or principal) they invested in the fund.
- » **CAPITAL GAIN DISTRIBUTIONS.** If a fund profits from selling securities during a calendar year, the fund may distribute the gains to investors. Distributions of capital gains typically occur annually near the end of the calendar year. Some funds distribute capital gains more frequently pursuant to managed distribution plans.

TAXES

In order to avoid the imposition of federal tax at the fund level, a closed-end fund must meet IRS requirements for sources of income and diversification of portfolio holdings, and must distribute substantially all of its income and capital gains to shareholders annually.

Generally, shareholders of closed-end funds must pay income taxes on the dividends and capital gains distributed to them. Each closed-end fund will provide an IRS Form 1099 to its shareholders annually that summarizes the fund's dividends and distributions. When a shareholder sells shares of a closed-end fund, the shareholder will realize either a taxable gain or a loss.

REGULATION AND DISCLOSURE

Closed-end funds are regulated under federal laws designed to protect investors. The Investment Company Act of 1940 requires all funds to register with the SEC to meet certain operating standards and to deliver information to investors; the Securities Act of 1933 requires registration of the fund's shares and the delivery of a prospectus to investors who purchase shares in the IPO; and the Securities Exchange Act of 1934 regulates the secondary market trading of the fund's shares and establishes antifraud standards governing such trading. Finally, the Investment Advisers Act of 1940 regulates the conduct of fund investment managers and requires them to register with the SEC.

All U.S.-registered closed-end funds are subject to stringent laws and oversight by the SEC and the exchanges on which their shares are listed. All funds must provide a written prospectus containing complete disclosure about the fund when its shares are initially offered to the public. Following the IPO, other disclosure documents, including the annual and semiannual reports and the proxy statement, provide information to investors.

The SEC conducts inspections of fund operations to determine compliance with applicable laws and SEC regulations. Stock exchanges on which a fund's shares are listed also impose certain requirements. Stock exchanges require the prompt public disclosure of material information and require certain corporate governance and management procedures, including annual shareholder meetings.

FEES AND EXPENSES

A closed-end fund incurs operating expenses, including those associated with fund portfolio management, fund business operations, custody of the fund's assets, and shareholder services. These operating expenses are paid by the fund from its assets before any distributions are made to the investor. A fund's expenses are summarized in a fee table included in the fund's prospectus. Updated expense information is provided in a fund's semiannual and annual reports to shareholders.

BUYING AND SELLING SHARES

Closed-end fund shares are bought and sold in much the same way one would buy corporate stocks—through registered broker-dealers.

During the IPO, a fixed number of closed-end fund shares are offered to investors. After the IPO, an investor may purchase shares of existing closed-end funds in the secondary market.

In an IPO, a closed-end fund's shares are typically sold subject to a sales charge that is paid to the underwriter and the broker-dealer who sells the shares. A closed-end fund investor buying or selling shares in the secondary market likely will pay a sales commission to a broker at the time of the transaction. The purchase or sale price for shares reflects the current market price, adjusted for the brokerage commission.

To raise additional capital, a closed-end fund may make additional public offerings of its shares. A fund also may institute a rights offering, in which shareholders of the fund are issued rights to purchase additional fund shares at a price established by the fund, usually at a discount to NAV.

SHAREHOLDER INFORMATION

The annual and semiannual reports that closed-end funds provide to shareholders contain financial statements and information on the fund's portfolio, performance, and investment goals and policies. A fund's annual report contains financial statements that have been audited by the fund's independent public accountants and management's discussion of fund operations, investment results, and strategies. In addition, a fund or an investor's broker may provide statements that update and summarize individual account holdings and values.

FOR MORE INFORMATION

- » “The Closed-End Fund Market, 2010,” *ICI Research Perspective*. Available at www.ici.org/pdf/per17-01.pdf.
- » Frequently Asked Questions About Closed-End Funds and Their Use of Leverage. Available at www.ici.org/faqs/faq/faqs_closed_end.
- » Find quarterly updates to closed-end fund asset data at www.ici.org/research#statistics.



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