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Academic Literature in Support of CEF Activism: We Don't Think Those Studies Mean What You Think They Mean

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Overview

One of the most enduring questions in finance is the puzzle of why closed-end funds (CEFs) trade at a discount to their net asset values (NAV). Despite nearly 60 years of academic research,[1] the issue remains unsettled.[2]

The issue is at the center of a current policy debate. In submissions to the SEC regarding a proposed NYSE rule change,[3] activist hedge funds and their supporters seem to believe it is self-evident that activism benefits all shareholders.[4] The activist supporters argue that activism, by reducing discounts, benefits all CEF shareholders, enhances market efficiency, and aids capital formation.[5] They assert that their claims are backed by four decades of academic literature on CEFs.[6]

Activist supporters' certitude about the literature is surprising, given that academics can't even agree on why CEFs have discounts. In reality, the literature is far more mixed and inconsistent than activist supporters let on. Activist supporters insist (incorrectly) that the literature is clear that discounts reflect CEF agency problems. As we discuss, CEF activism can harm retail investors. Finally, the claim that CEF activism promotes market efficiency and capital formation defies economic logic.

The SEC should work on the presumption that activism definitely benefits activists, but does not always benefit, and in fact may harm, retail investors.

Does Activism Benefit CEF Shareholders?

Activist supporters claim there is broad consensus in the literature that activism benefits all CEF shareholders while takeover defenses harm them. To support this claim, they cite Bradley et al. (2010). [7]

The Bradley paper, however, makes no claim that activist attacks benefit, or that takeover defenses harm, CEF shareholders. The study's authors stick almost assiduously to discussing the paper's positive findings, for instance that activists target CEFs with large discounts, a finding that is neither surprising nor controversial. However, that is a far cry from the normative conclusion activist supporters read into the Bradley paper, namely that activism benefits retail shareholders. Put simply, the Bradley paper makes no such claim.[8]

The Bradley paper in fact undermines the claim that academic studies consistently support activism. Earlier studies sometimes argued that activism benefits fund shareholders by removing highly paid and entrenched managers who tolerate bad fund performance. Activists and their supporters lean heavily into this notion.[9] The Bradley paper, however, states there is little to no evidence that activist attacks are motivated by high fund fees or bad performance.

On reflection, it is by no means self-evident that activism will benefit all shareholders. For example, investors who tender their shares forego the fund's future income distributions. Moreover, the literature finds that a CEF with a large discount is predicted to have above-average risk-adjusted returns in the future,[10] returns investors would forego by tendering their shares. It seems possible that the decision whether or not to tender shares might be a wash in present value terms. As far as we know, no academic study has fully investigated this tradeoff.

Retail shareholders must also consider the tax consequences of a tender offer. When a CEF realizes capital gains—as it may if activism causes the fund to open-end itself and sell assets with embedded gains—it must pass those gains to fund investors, potentially creating a large immediate tax liability for all fund shareholders. Shareholders who tender their shares may know that a tax liability is forthcoming, but shareholders who do not tender their shares could be in for an unpleasant tax surprise. Academics long ago recognized that to compensate investors for potential capital gains tax liabilities, CEF shares may need to trade at a discount to NAV.[11]

Activists' attacks can harm shareholders in other ways. If an attack forces a CEF to open-end itself, the fund must sell assets to accommodate redeeming shareholders. The CEF shrinks, resulting in decreased economies of scale, hence a higher expense ratio and thus lower net returns to remaining shareholders. Asset sales may also significantly change a fund's investment profile, and the new profile may no longer align with the preferences of remaining shareholders.

What Does Academic Literature Say About CEF Takeover Defenses?

Activist supporters claim that CEF takeover defenses, such as classified boards, harm fund shareholders.

To support this claim, they[12] cite Souther (2016).[13] Souther finds CEF takeover defenses are correlated with "higher expense ratios, director compensation levels, and managerial advisor fees" and interprets this to mean that takeover defenses allow CEF insiders to "extract benefits from [CEF] shareholders." Although Souther's article does present clear evidence of such correlations, nothing in his analysis lets him conclude that higher fund fees and directors' compensation were *caused* by takeover defenses. It is elementary in statistics that correlation does not establish causation. To establish causation, Souther would, at a minimum, need to use more sophisticated econometric techniques or make theoretically plausible assumptions that would allow him to pin down causality. Souther does not do that. Consequently, activist supporters are wrong to use Souther's paper to claim that takeover defenses harm CEF shareholders.

Moreover, an alternative, more benign hypothesis can explain Souther's correlation. A CEF might have higher expense ratios, director compensation, and managerial fees because it has a less liquid portfolio, follows more complex investment strategies, has higher leverage, and requires more sophisticated or intensive management or oversight. These factors might necessitate takeover defenses to allow these complex investment strategies to unfold over the long term. Souther's article itself recognizes (but does not test for) this possibility: "Perhaps higher compensation levels go to higher-quality managerial teams, who are then performing more complex, long-term tasks that require additional protection."[14]

Moreover, some academic evidence suggests that takeover defenses *benefit* CEF shareholders. For instance, a 2016 paper investigates the impact of takeover defenses (such as poison pills) on CEF investor returns.[15] This paper, though not mentioned by activist supporters in their submissions to the SEC, is noteworthy because it deals with the correlation versus causation issue carefully and convincingly. The authors find "… that giving CEFs the ability to defend against activist attacks increased the value of the funds' shares."[16]

Do Activists Enhance Market Efficiency?

Activist supporters further argue that hedge funds must have free rein to attack CEFs in order to promote efficient capital markets. Their logic is: (i) CEF discounts are inconsistent with frictionless markets; (ii) discounts cannot be arbitraged away because shareholders cannot redeem at NAV; and thus (iii) activists must be allowed to force CEFs to open-end or liquidate to ensure that CEFs trade in an efficient market. However, this logic faces difficulties.

First, it is important to recognize that the concept of an efficient market is a theoretical "best standard" against which to measure market quality. But in the real world, many markets are inefficient to varying degrees. For example, economists typically think of the corporate and municipal bond markets as inefficient. Even the Treasury bond market, the world's deepest and most liquid bond sector, has at

times become inefficient (e.g., during March 2020, when spreads on on-the-run versus off-the-run Treasuries widened anomalously).

Second, CEFs often hold illiquid assets and hence can have high liquidity costs. A recent article suggests that, to the extent these high liquidity costs are passed on to investors via the bid-ask spread on a CEF's shares, that could help explain the fund's discount.[17] Moreover, high liquidity cost is a market friction. Even if an activist forces a CEF with a wide discount to open-end or liquidate itself, the fund's assets, once sold off, will remain illiquid. Thus, activism does not, and cannot, remove the frictions that characterize the CEF's underlying holdings.

Third, historical evidence shows that activism reduces CEF discounts only temporarily. When an activist targets a fund, the fund's discount tends to close. After the tender offer, however, the discount returns within a year or so to about the level seen before the activist attacked the fund.[18] In other words, activism, even if successful, does not leave the CEF market any more "efficient" than it was before the attack.

Does Activism Boost Capital Formation?

Activist supporters also try to argue that CEF activism fosters capital formation. However, they cite no academic studies to support this claim. Moreover, their economic logic is unsound. Suppose an attack on a CEF is successful, the CEF is liquidated, and the fund's capital is paid out to investors. That does not create capital; it simply redirects it from the CEF to somewhere else.

Moreover, activist supporters do not consider the alternative that capital formation may suffer if CEFs have inadequate takeover defenses. Conversations with fund providers suggest that activists' attacks, left unfettered, will cause the demise of CEFs. We see this happening already. The number of CEFs declined 23% between 2018 and 2024. This means retail shareholders are at risk of losing one of the only investment vehicles giving them exposure to private equity and credit markets. At the same time, without CEFs, private markets may lose access to the large and stable supply of capital that retail investors might otherwise provide. This development cannot be good for capital formation.

Conclusion

Hedge fund activists and their supporters like to claim that decades of academic research support the idea that activism is good for shareholders, improves market efficiency, and fosters capital formation. The literature is, in fact, much less consistent and compelling than they say. Some of the literature they cite either does not support or contradicts their claims. Also contradicting their claims are some very recent studies they do not cite. Perhaps most striking is that the most basic question about CEFs—why they often trade at a discount to NAV—remains unsolved. If academics, despite 60 years of work, cannot answer that fundamental question, how can activist supporters credibly claim that the academic literature overwhelmingly backs their claims that takeover defenses harm all CEF shareholders, create inefficient markets, and stifle capital formation? To paraphrase Inigo Montoya in *The Princess Bride*—we don't think the literature means what you think it means.

Notes

[1]Cherkes, M (2012), "Closed End Funds: A Survey", *Annual Review of Financial Economics*, 4, 431-445, states that the first academic study documenting the presence of CEF discounts was Pratt (1966), "Myths associated with closed-end investment company discounts," *Financial Analysts Journal*, 22, 79–82.

[2] The existence of a price discrepancy or "discount puzzle" in CEFs has long perplexed academics. To explain it, they have proposed various theories, including investor sentiment, tax effects, liquidity services, leverage, market segmentation, NAV calculation, and liquidity transformation. As Cherkes (2012) notes, "a list of possible reasons for discounts … is still being discussed 35 years later, and no consensus has been reached regarding the source of discounts. New developments worth mentioning are the renewed interest in management fees as a source of discounts, the realization that CEFs invest mainly in illiquid assets while their shares are more liquid than their holdings, and the emergence of models that juxtapose managerial fees versus managerial skill or versus liquidity transformation as a basis for a rational explanation for the discount puzzles."

[3] Paul Cellupica and Kevin Ercoline, "Governance Protections of the 1940 Act and Abuses Allowed by Annual Meetings," November 4, 2024.

[4] See Working Group on Market Efficiency and Investor Protection in Closed-End Funds (2024), A comment letter to the SEC in response to the NYSE's proposed rule change to exempt closed-end funds from an annual meeting requirement ("Working Group Letter"), page 4, arguing that "What is puzzling … is the claim that elimination of the CEF discount — allowing investors to sell their shares at prices near NAV — causes investors significant harm."

[5] Working Group Letter.

[6] Jackson, R.J (2024), A comment letter to the SEC in response to the NYSE's proposals to exempt closed-end funds registered under the investment company act from the requirement to hold annual shareholder meetings ("Jackson Letter") states at page 10 that "…the benefits of CEF activism have been documented for decades in the peer-reviewed economics literature."

[7] Bradley, M; Brav, A; Goldstein, I & Jiang, W (2010), "Activist arbitrage: A study of open-ending attempts of closed-end funds," *Journal of Financial Economics*, 95(1).

[8] For more detail, see Paul Cellupica and Shelly Antoniewicz, Investment Company Institute letter to Securities and Exchange Commission, commenting on the NYSE rule proposal, January 24, 2025.

[9] See Jackson Letter at page 10, arguing that "the benefits of CEF activism have been documented for decades in the peer-reviewed economics literature … because CEF investors lack the power to exit at NAV and, thus, escape the effects of underperforming management." See also Working Group

Letter at page 4 stating that “The management and board of poorly performing CEFs will naturally oppose [activism as it can] result in the loss of … fees, or even their jobs.”

[10] Burton Malkiel and Yexiao Xu (2005), “The Persistence and Predictability of Closed-End Fund Discounts,” working paper, *SSRN* (“It is well-known that the level of closed-end fund discounts appears to predict the corresponding fund’s future returns”). Rex Thompson (1978), “The Information Content of Discounts and Premiums on Closed-End Fund Shares,” *Journal of Financial Economics*, 6 ,151-186 (“discounted closed-end fund shares tend to outperform the market, adjusted for risk”).

[11] Malkiel, Burton (1977), “The Valuation of Closed-End Investment Company Shares,” *Journal of Finance*, Vol. XXXII, No. 3, June, 847-859.

[12] See Jackson letter at 10. See also Bebchuk, L.A. & Jackson, R.J (2024), A comment letter to the SEC in response to the NYSE’s proposals to exempt closed-end funds registered under the investment company act from the requirement to hold annual shareholder meetings (“Bebchuk Letter”) at page 10 arguing that “The [Souther] study documents that… takeover defenses are associated with higher private benefits for CEF insiders.”

[13] Souther, M.E (2016), “The effects of takeover defenses: Evidence from closed-end funds”, *Journal of Financial Economics* 119(2), 420-440.

[14] Souther (2016) at page 438.

[15] Cremers, M; Jackson, R & Morley, J (2016), “The Value of Takeover Defenses: Evidence from Exogenous Shocks to Closed-End Mutual Funds.”

[16] Cremers et al. (2016) at pages 5-6.

[17] See David A. Lesmond and George P. Nishiotis (2019), “Closed-End Funds,” working paper, Freeman School of Business, Tulane University.

[18] ICI Comment Letter on the SEC Instituting Proceedings to Determine Rule Changes on Closed-End Funds, October 4, 2024, at page 12.

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