XAI KNOWLEDGE BANK

CLOSED-END FUNDS:

Providing Newfound Access to Institutional Alternatives

Closed-end funds (CEFs) have evolved considerably over the past two decades. Today's CEF designs have the ability to house asset classes that financial advisors and individual investors cannot otherwise access.[1] These newer CEFs are an excellent way to preserve some types of institutional alternatives and avoid the modification or dilution which may plague "liquid alt" mutual funds.[2] Historically, CEFs have contained more traditional asset classes but repurposing them for the sake of offering unique entry to alternatives presents an opportunity for the investor.

In order to fully embrace this new category of CEF, advisors should take a fresh look at how a CEF's specific structural features are being maximized to highlight new investment content. Herein lies the innovation and the CEF's newfound appeal to a wider community of advisor and investor. But defeating the perception that CEFs are old fashioned and a poor fit for the modern-day wealth management practice could prove a challenge. In the recent past, CEFs were sold with a 4.5% upfront sales load. CEFs typically housed traditional asset classes like municipal bonds and high yield bonds. Today, however, CEFs are offered with reduced loads, or no loads at all. They also present a fitting wrapper for alternative investments with the potential for attractive yield, alpha, and more favorable secondary marketing trading relative to traditional strategies.

Moreover, since the CEF structure is highly customizable, it is well-suited for the wide variety of complex alternative strategies typically available to institutions. CEFs have unique attributes which cannot be easily replicated by mutual funds, ETFs or limited partnerships. Alternative CEFs can therefore help advisors enhance and sharpen their own value proposition as they strive to meet investor needs, round out their investment exposure and improve diversification within their client portfolios.

"Closed-end funds are a fitting wrapper for less liquid or illiquid alternatives and mark the next generation of alternative funds made available to the individual investor."

Kim Flynn
XA Investments

"It is simple: fixed capital allows for less liquid investments and no redemption pressures. The CEF world needs great [hedge fund] managers with ideas and investment mandates that are not available or ideal to ETF or open-end funds, to lead the way for this endeavor."

John Cole Scott
CEF Advisors

XA INVESTMENTS

Alternative Access: The Old and the New

The means by which investors access alternatives continues to evolve. Although limited partnerships have existed for decades and liquid alt mutual funds have become a popular access point in recent years, the CEF structure is gaining visibility and traction within the alternatives industry, and arguably represents the next phase in alternative investing.[3, 5, 7]

Over the past five years there has been a marked proliferation of liquid alts, yet these mutual funds not only present numerous structural challenges, but are limited to a narrow universe of alternative options, as noted on the following page. The risks inherent in liquid alternatives stem from the incongruent nature of a liquid structure and potentially illiquid underlying holdings. Under normal market conditions, redemptions are easily met. In a crisis, however, the underlying assets may be difficult to sell at a reasonable price, causing a liquid alt to become highly illiquid. XA Investments LLC (XAI) believes there is no substitute for true alternative investments in fulfilling advisors' and clients' return, volatility, income and diversification objectives. When managers alter their investment process to fit a product structure, an alternative strategy becomes compromised and less likely to produce the same results for an individual mutual fund investor as it does an institution.

Limited partnerships have also been a standard means by which advisors access alternatives, but there are a number of "inconveniences" associated with these structures such as suitability and eligibility requirements, high investment minimums, K-1s, performance fees and a limited number of investors.[4] The combination of few investors and high minimums results in concentration risk, and potential performance fees may spur investor discontent.

In contrast, a CEF's distinctively flexible nature makes the structure well-suited for many institutional alternatives. A CEF improves accessibility for investors but does so with attractive features such as low investment minimums, no performance fees and the ease of 1099 tax forms. In addition, CEFs are designed to offer purity of strategy and provide individuals the same investment opportunity as their institutional counterparts.

Investors should carefully weigh the diversification benefits, expected returns and volatility of liquid alts relative to alternatives offered in a limited partnership or CEF structure. During a liquidity crisis, alternative investments may become less liquid or illiquid and the prices of alternative assets may experience wide fluctuations.

The Versatility of CEFs

CEFs can be designed in myriad ways with the goal of accommodating the strategy as well as investor needs. As a result, the market is experiencing a great deal of innovation in CEF design. The common thread in these CEFs is the ability to invest in less liquid or illiquid assets.

There are two primary ways that CEFs can differ from one another: 1) listed vs. non-listed and, 2) term vs. perpetual. A listed CEF trades on a national stock exchange whereas a "non-listed" CEF does not trade on an exchange but is sold to investors through a continuous offering process. Generally, non-listed funds offer limited liquidity through quarterly tenders at net asset value (NAV).

CEFs also differ when it comes to life span. Those with a permanent life are categorized as "perpetual funds," and those with a specified termination date, at which point the portfolio is liquidated, are categorized as "term funds." In the marketplace, term funds often have a life of 5–15 years.

Although advisors are most familiar with one type of CEF, the listed, perpetual fund, labeled "traditional" in the following table, there are other types to consider.

4 Types of U.S. Registered '40 Act CEFs

	Perpetual	Term
Non-listed	Interval CEF	Tender Offer CEF
Listed	Traditional CEF	Term CEF

Non-Listed CEFs: Interval Funds and Tender Offer Funds

The closed-end fund structures known as interval funds and tender offer funds provide intermittent liquidity while offering a more appropriate wrapper for a large swath of alternative strategies. Both types of non-listed CEFs may invest in private and public assets.[6] Both typically provide shareholders quarterly tender offers at NAV, in contrast to listed CEFs where liquidity comes from the ability to sell shares on the exchange at market price. With quarterly tenders, liquidity is typically capped at 5%. If a tender is oversubscribed, the fund generally will repurchase a pro rata portion of shares tendered by each shareholder, resulting in shareholders receiving less than the amount they tendered.

Once considered a niche product, non-listed CEFs are gaining popularity. According to DST Systems, AUM in interval CEFs was less than $8 billion five years ago, while today it stands at close to $30 billion.[8] Moreover, the number of alternative interval and tender offer fund launches has increased the past few years as advisors search for strategies that offer low correlation and differentiated risk/return benefits.

Listed CEFs: Traditional and Term

Listed CEFs, either traditional or term, are traded on a national stock exchange and offer intra-day liquidity. These CEFs trade based on market price (not NAV) and subject CEF shareholders to market volatility risk including the potential for a fund to trade at a discount to NAV. Investors in the primary market purchase on the IPO (initial public offering) before the fund closes and lists on the exchange. Any new investors can buy or sell shares in the secondary market, shares which may trade at a premium or discount to the NAV.

Sources: XA Investments (XAI); Investment Company Institute (ICI); Closed-End Fund Association

The Key Differences Between Mutual Funds and Closed-End Funds

	Mutual Fund	Closed-End Fund
Asset classes	All traditional and a limited range of alternatives	All traditional and a broad range of alternatives
Dollars invested	Not fully invested due to daily flows and a required minimum cash reserve to meet redemptions	Listed CEFs are fully invested thereby eliminating any cash drag[6]
Ability to invest in less liquid or illiquid investments	Limited to 15% or less	Up to 100% illiquid investments permitted
Leverage	Limited to derivative forms of leverage	Leverage limited to 33% borrowings or a maximum 50% preferred
Impact of fund inflows	Potential for performance dilution[9]	Listed CEFs do not have daily inflows. No performance dilution[6]
Impact of fund outflows	Under normal circumstances, outflows may result in performance dilution. During times of crisis, rapid outflows transform portfolio managers into forced sellers. Potential for negative tax consequences, total return drag due to increased trading costs and investment opportunity cost[10]	Listed CEFs do not have daily flows. Listed CEFs are "closed" and can protect the portfolio in the event of a crisis because portfolio managers are not forced sellers. A crisis may present buying opportunities for the CEF manager[6]

Sources: XAI, SEC, ICI

Structure Matters: Alternatives and CEFs Are a Good Match

CEFs, for both regulatory and structural reasons, are the right type of registered fund to house illiquid alternative investments while still offering liquidity to investors at the fund level.

The freedom from liquidity constraints in a CEF has had an important impact on the alternatives industry as managers seek ways to preserve their strategy and invest capital similarly to their existing limited partnerships while offering greater accessibility to the individual investor market.[8] Since most institutional alternatives are highly illiquid, such as private equity and debt, timberland, farmland, structured products or hedge funds strategies, CEFs offer unlimited, unfiltered access relative to mutual funds where the strategy risks alteration or dilution. Interestingly, these less liquid institutional alternatives may present higher expected returns as a result of the liquidity premium (also referred to as the "illiquidity premium").

Another key advantage is less regulatory but rather more structural. In times of market stress, listed CEFs may trade at a discount. Managers, however, are not forced sellers due to the fund's "closed" nature. They do not have to meet redemptions and may be uniquely positioned to capitalize on market volatility by reinvesting or redeploying assets and optimizing the portfolio for investors.

This is a key structural feature for alternative investment managers because these asset classes require long-term capital. Managers must be able to invest without worrying about unexpected redemptions and need freedom to execute their strategy during market dislocations. Using a CEF to invest in illiquid alternatives is therefore an opportunity to properly match structure with strategy.

Investors considering an allocation to alternatives should evaluate the risks associated with alternatives including greater complexity and higher fees relative to traditional investments. An investment in alternatives involves risk, including loss of the entire principal amount invested.

> **"...the structure allows the fund manager to focus on what matters most: the fund's investments. Because closed-end funds are not subjected to investor flows, the fund manager is able to optimize the fund's holdings, creating exactly the portfolio desired with minimal cash reserves."**
>
> *John Tobey, CFA*
> *Investment Directions.*

The CEFs of Tomorrow

The CEFs of tomorrow are not the CEFs of yesterday. The variety of formats and structural features presents new choices for advisors. Even if some CEFs are deemed "traditional" in structure, the investment strategy may be considered non-traditional in the marketplace; the CEFs of tomorrow provide access to alternative managers and strategies that have been difficult to access in the past. The customizable nature of CEFs and their ability to make institutional alternatives accessible to a broader investor base truly represent the innovation occurring within the industry. This innovation bodes well for the future of CEFs.

Common CEF Objections and Misconceptions

A common objection to listed CEFs in the secondary market is pricing. Many advisors believe that regardless of the underlying investment or strategy, listed CEFs are prone to trading at a discount to the fund's NAV. In reality, a CEF's trading history is driven by various factors, including portfolio performance and distribution rates. A CEF premium occurs when the price is greater than the fund's NAV per share and may occur when demand outweighs supply of shares in the marketplace due to strong performance or an attractive current distribution rate.

The discount to NAV experienced by many listed CEFs is driven by multiple factors, including yield and the upfront load. Ultimately, both discounts and premiums are determined by supply and demand.

The new generation of CEFs fills a gap in the marketplace where demand for institutional alternatives is high and supply extremely low. With so few access points and demand strong, alternative CEFs may be more likely to trade at a premium than a traditional CEF. By contrast, CEFs containing traditional stock and bond investments may compete with mutual funds or ETFs offering similar strategies. In a crowded marketplace, where competition is heavy and investors are easily distracted, it can be challenging for traditional managers to attract new buyers; therefore, the necessary supply/demand dynamic is not always strong enough to drive a premium in a CEF with a traditional strategy.

The new generation of CEFs has features that appeal to a greater number of advisors and their investors.

	CEF Misconception	CEF Reality
Asset classes	Access limited to traditional investments only	Ability to access a variety of traditional and alternative investments
Listed or Non-listed	CEFs are exchange-listed	CEFs may be structured as listed or non-listed funds. Recent CEFs have been structured in a non-listed, continuously offered format
Fund life	CEFs have a perpetual life	CEFs may be structured with a limited term or perpetual life. In recent years CEFs have had set terms and a defined time horizon for liquidation at NAV
Discounts	CEFs trade at discounts in the secondary market	CEF discounts may be driven by excess supply and low demand. Alternative CEFs may behave differently and increased demand may generate better secondary market trading
Fees	CEFs are sold with upfront loads of 4.5%	In keeping with current industry trends, CEFs are being sold with lower upfront loads of 1–2%. No load funds may also be available
Leverage	CEFs are mutual funds with leverage	CEFs are permitted to use leverage, and have a number of unique attributes relative to mutual funds

Sources: XAI; ICI; Closed-End Fund Association

Risks

The information in this publication is provided as a summary of complicated topics and does not constitute legal, tax, investment or other professional advice on any subject matter. Further, the information is not all-inclusive and should not be relied upon as such. CEFs frequently trade at a discount to the fund's net asset value (NAV). An investment in CEFs involves risks, including loss of principal. Past performance is not necessarily indicative of future results. Diversification does not eliminate the risk of experiencing investment losses. You should not use this publication as a substitute for your own judgment, and you should consult professional advisors before making any investment decisions. This information does not constitute a solicitation of an offer to sell and buy any specific security offering. Such an offering is made by the applicable prospectus only. A prospectus should be read carefully by an investor before investing. Investors are advised to consider investment objectives, risks, charges and expenses carefully before investing. Financial advisors should determine if the risks associated with an investment are consistent with their client's investment objectives.

Footnotes

1 For purposes of this publication, "Closed-End Funds" or "CEFs" refers to investment vehicles that are registered with the U.S. Securities and Exchange Commission ("SEC") under the Investment Company Act of 1940, as amended ("'40 Act"), and are not open to investment on a daily basis. Shares of CEFs typically are listed and trade on a stock exchange. CEFs frequently trade at a discount to the fund's NAV.

2 The term "mutual fund" refers to an open-ended fund that is registered under the '40 Act. Shares of a mutual fund are continuously offered and bought directly from the fund and may be redeemed daily from the fund at their NAV, which is based on the value of the fund's portfolio of securities, calculated at the day's close.

3 The term "liquid alts" refers to a mutual fund that purports to offer alternative investment strategies, which based on the SEC requirements of a mutual fund must be highly liquid (generally, 85% of a mutual fund's portfolio must be liquid, meaning its securities can be sold within 7 days without significantly impacting their value).

4 Shares of limited partnerships that offer alternative investment strategies typically may be sold only to "qualified purchasers" who are defined under the '40 Act as individuals with at least $5 million in investments and certain institutional investors. CEFs and mutual funds may be purchased by individuals without a net worth or investment portfolio minimum requirement, although advisors must consider whether an investment is suitable for a client based on the client's financial situation, investment objectives and experience, investment time horizon, liquidity needs, risk tolerance and other factors.

5 Not all institutional alternative strategies will fit in a CEF structure. While CEFs are allowed to hold less liquid assets, the '40 Act imposes certain limitations on a CEF's portfolio, including trading restrictions and leverage limitations.

6 Non-listed CEFs may have periodic inflows and may provide liquidity on a monthly or quarterly basis and therefore may have a cash drag, may experience performance dilution and may not be able to protect their portfolios.

Sources

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