# Investor Insights

## Exploring Potential Benefits of Closed-End Fund Discounts

**Key Takeaways**

- Closed-end funds are unique in that they often trade at discounts to their net asset value.
- These discounts may be advantageous if the price of the fund appreciates after purchase and/or the fund distributes income to the investor.
- Closed-end fund discounts may present an attractive investment opportunity.

One of a handful of differentiators of the closed-end fund ("CEF") vehicle is the likelihood that the market price will be materially different than the value of the fund's underlying assets, also known as the net asset value or "NAV." As of 6/30/2024, 85% of US listed CEFs traded at a discount to NAV, the remaining 15% traded at a premium, and only 6% of all CEFs traded within +/- 1% of their NAV[1]. While this unique dynamic may cause many investors to pass over CEFs in their search for sound investments, we believe a few simple examples can illustrate how these price dislocations may present attractive opportunities for investors to buy assets with strong return potential.

### Understanding Premiums and Discounts

Premiums and discounts exist with CEFs due to the unique structure and market dynamics of these investment vehicles. Unlike shares of open-end mutual funds, which are bought and sold at their NAV, shares of CEFs trade on stock exchanges like individual stocks. Investors who want to purchase a closed-end fund will generally buy from the secondary market, with the market price of the fund determined by current supply and demand. Since closed-end funds typically consist of a basket of underlying stocks, bonds, and other investments that have a known price of their own, the net asset value serves as a gauge of the per share value of the underlying assets, less any liabilities. This leads to two different measures of value: Net Asset Value and Market Price.

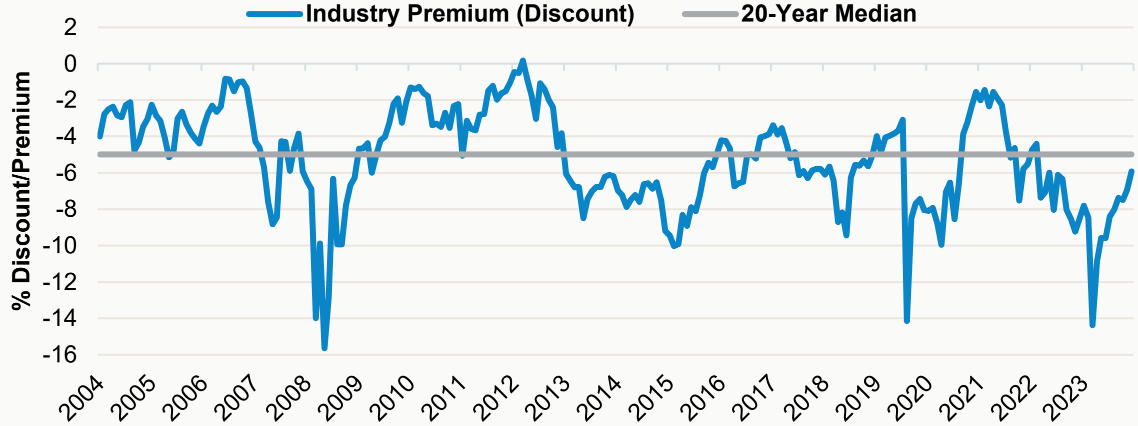
If NAV is the per share value of the underlying assets, net of liabilities, then why would the market price be any different? This question has been debated since listed CEFs first came on the market. While there's no simple formula to answer this question, fund managers and investors alike generally agree that numerous factors lead to CEF market prices drifting from their NAV including, but not limited to, economic conditions, interest rates, fund performance, market performance, asset class sentiment, distribution rate, leverage, firm reputation, secondary market support, and manager track record, just to name a few.

**Potential Factors Causing CEF Discounts & Premiums**

- Economic Conditions
- Interest Rates
- Fund Performance
- Market Performance
- Asset Class Sentiment
- Distribution Rate
- Leverage
- Firm Reputation
- Secondary Market Support
- Manager Track Record

*1. As of 6/30/24; Source: Morningstar Direct*

History has shown that closed-end funds on average have oscillated between trading at deep discounts (market price < NAV) and very small discounts or even premiums (market price > NAV), as illustrated in the chart below.




*As of 6/30/24; Source: Morningstar Direct. Data is based on Morningstar US CEF All Peer Group Index, unweighted daily discount. One cannot invest directly in an index.*

Because CEF discounts move up and down rather than remain static, this presents an opportunity to buy a fund at a deep discount and potentially benefit from the price rising toward net asset value.

## How Might a Discount Benefit Investors?

An investor's preference for a CEF to trade at a discount or premium has much to do with the investor's perspective as either a current fund owner or a prospective fund owner. Similar to owning an asset like a house or a car, current owners of CEFs generally prefer to see the market price of the fund rise, lowering the discount or even surpassing the NAV to a premium. Alternatively, prospective buyers often wait for lower prices, or discounts to widen, in order to buy at attractive valuations and potentially have a higher upside from price appreciation. Let's look at a hypothetical example.

| | | Fund A | Fund B |
|---|---|---|---|
| *Beginning* | NAV | $ 100 | $ 100 |
| | Market Price | $ 90 | $ 100 |
| | Discount/Premium | -10% | 0% |
| *Ending* | NAV | $ 105 | $ 105 |
| | Market Price | $ 100 | $ 105 |
| | Discount/Premium | -5% | 0% |
| | NAV Return | 5% | 5% |
| | Market Price Return | 11% | 5% |

As you can see to the right, both Fund A and Fund B begin with a $100 NAV, but Fund A trades at a 10% discount ($90) while Fund B trades at NAV ($100). An investor can choose to purchase either fund, paying $90 for Fund A or $100 for Fund B. Time passes, and both Funds' NAV rises to $105, representing a 5% NAV return. Simultaneously, Fund A's market price rises to $100 representing an 11% price return, while Fund B's price continues to track NAV and rises to $105, representing only a 5% price return. In this example, both funds experienced the same NAV performance but had the investor purchased Fund A instead of Fund B, they'd have experienced an additional 6% return, keeping in mind that the market price return is the return an investor experiences when investing on the secondary market.

Of course, there is no guarantee that purchasing at a lower price will lead to greater price appreciation than purchasing at a higher price. The purpose of this example is to simply illustrate the potential that a discount presents.

Another interesting facet of closed-end fund discounts that may attract investors is the underlying income return dynamic specific to CEFs trading at a discount. First off, there are two primary components of return for investment funds: price return (also known as capital appreciation or capital gains) and income return (also known as yield). Price return is simply the change in price of the asset from when purchased to when sold. Income return is the sum of all income paid out by the fund in the form of distributions. Since income return is calculated on the basis of purchase price (not NAV), buying a fund at a discount makes it easier to earn a higher yield than you otherwise would when purchasing at NAV, or closer to NAV. Let's look at another example.

| | Fund A | Fund B |
|---|---|---|
| **NAV** | $ 100 | $ 100 |
| **Market Price** | $ 100 | $ 80 |
| **Discount/Premium** | 0% | -20% |
| **Shares Outstanding** | 10 | 10 |
| **Total Net Assets (shares x NAV)** | $ 1,000 | $ 1,000 |
| **12-month Distribution/Share** | $ 8 | $ 8 |
| **Yield (Distribution / Market Price)** | 8% | 10% |

Imagine an investor that's looking for a CEF that will pay a 10% yield, and they're looking at two options: Fund A and Fund B. As you can see in the graphic to the right, Fund A and Fund B are virtually identical, except that Fund B is trading at a 20% discount. By purchasing Fund B at a 20% discount, the same distribution amount ($8) equates to a 10% yield for the investor, which is 2% more than the yield of Fund A. Put differently, the portfolio manager of Fund B only has to achieve an 8% return on total net assets in order to yield the investor 10%, whereas Fund A would have to achieve a 10% return on total net assets for the investor to have the same outcome.

While market price movements are unpredictable and distributions are not guaranteed, it's important for investors to understand the potential benefits of CEF discounts. We encourage you to visit CloughCEFs.com to learn more and contact us at investorrelations@cloughcapital.com to discuss these dynamics further.

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*Investing in closed-end funds involves risk; principal loss is possible. Closed-end funds shares may frequently trade at a discount or premium to their net asset value (NAV). When sold, shares may be worth more or less than the purchase price or the NAV. Liquidity is limited to secondary market supply and demand.*

*Open-end mutual funds, exchange-traded funds, and CEFs are different types of investment vehicles with different expense structures and different inflows/outflows and distribution requirements. All investments carry a certain degree of risk and there is no assurance that an investment will provide positive performance over any period of time.*

**Definitions**

**Premium:** A closed-end fund is trading at a premium when the fund's market price is greater than its net asset value.
**Discount:** A closed-end fund is trading at a discount when the fund's market price is less than its net asset value.
**Morningstar US CEF All Peer Group Index:** Morningstar offers US Closed-End Funds Peer Group Indexes with an unweighted (equal-weighted) methodology. The index is free of survivorship bias and the constituents are all U.S.-listed CEFs that have been in existence over the period from 31 December 1996. One cannot invest directly in an index.