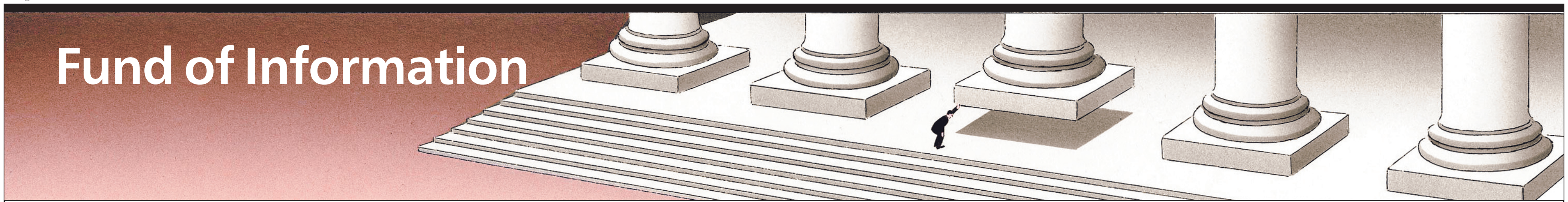

When Buying Closed-End Funds Makes Sense

by Eric Uhlfelder

TO MOST INVESTORS, CLOSED-END FUNDS ARE TARGETED PLAYS on various markets whose use of leverage can generate robust yields. A dollar, for instance, can buy $1.30 worth of exposure and the extra income that comes with it.

Patrick Galley and Stephen O'Neill, co-managers of RiverNorth Capital Management, which runs more than $2.3 billion, instead see the anomalies of this less-explored asset class as a source of uncorrelated positive returns.

"What drives opportunity," explains Galley, "is that 95% of the investors in this $300 billion market are retail, and they tend to overreact to events, creating short-term mispricing."

Unlike open-end funds, whose prices are tallied every day to match the sum of their securities' value, the price of closed-end funds is also affected by day-to-day demand. (In fact, one in five securities traded on the New York Stock Exchange is a closed-end fund.) As such, their market prices always deviate from the value of their underlying assets. When the market price is below a fund's net asset value, it's selling at a discount; above, at a premium.

This price distinction creates a unique dynamic. If momentum favors, say, U.S. large-company stocks, a closed-end fund comprising these stocks should receive a double boost—from the enhanced value of its portfolio and from additional demand for the fund itself.

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But looking at data from January 1997 through June 2014, Morningstar reports that closed-end funds trade at average discounts ranging between 0% and 10%. (Currently, the average is 6.5%.) That deviation between market price and NAV is what creates trading opportunities for RiverNorth.

Since starting up **RiverNorth Core Opportunity** fund (ticker: RNCOX) in December 2006, Galley and O'Neill have generated annualized gains of 9% through August 2014. That's 2.5 percentage points a year better than a blended stock/bond benchmark (60% Standard & Poor's 500 and 40% Barclay Aggregate Bond Index), and tops the S&P 500 by 2.2 percentage points. The returns have helped boost assets to $755 million.

The financial crisis fueled much of this outperformance when discounts jumped to 25% and created major buying opportunities. The fund outpaced the market by nearly 10 percentage points in 2008, and by more than 20 points in 2009.

The managers' investment strategy is straightforward; depending on their assessment of the markets, they'll keep anywhere from 40% to 80% in stocks, 20% to 60% in fixed income, and the residual in hybrids (preferreds and convertibles) and cash—which can at times be substantial. (The two represented 40% of the fund in June 2013.)

Within their core holdings, the managers look for discounts forming in specific closed-end fund sectors, often triggered by investor fear or a misreading of events. They aim to buy expanding discounts, and sell when they're shrinking, usually as investors recognize the risks weren't as great as anticipated. These shifts take time to play out, explaining the fund's modest 46% turnover.

But change doesn't always come slowly—from June 2013 through June 2014, the fund moved from 19% in fixed income to 44%. The managers saw an opportunity as 10-year rates spiked from 1.66% in May 2013 to 2.5% in early July, and a small closed-end fixed-income fund premium became a 7.5% discount. "We thought the selloff in both the bonds and funds was excessive, so we began building up our exposure," says Galley.

Retail investors often overreact to events, and that provides the opportunities in these funds.

By the end of 2013, the discount reached 9%. It has since backed down by a third. Ten-year rates hit 3% in December, but they too have fallen, to 2.54%. Galley expects to see further reduction in both numbers as rate-increase fears ease over the near term.

When they don't see closed-end fund opportunities, such as several years ago when investors poured into bond funds, the managers will instead buy exchange-traded funds to maintain exposure without being subject to the higher carrying costs.

Now, nearly a quarter of the fund is in ETFs, whose average cost is about 0.18%—and yet investors are paying RiverNorth 1.35%. That's a high expense ratio to manage some of the cheapest investments around. And when the fund is more fully invested in closed-end funds, the total fees the investor pays (inclusive of those passed on from the underlying funds) can climb. Today, the total expense ratio is 2.22%. The highest ratio was five years ago at 2.45%. That's hefty. And it hasn't helped the fund's recent performance.

Over the past three years through August, Core Opportunity has trailed its blended benchmark annually by nearly 1.3 percentage points and the red-hot S&P 500 by almost 8.5 percentage points.

But the fund's high expense is the price of gaining exposure to this less-crowded trade—a quality that's key in generating steady uncorrelated returns.

Notwithstanding 2009, when the fund rocketed nearly 50%, RiverNorth's strategy doesn't target large gains. Rather, Galley and O'Neill designed the fund to produce consistent absolute returns in the high-single and low-double digits, which outperform when markets turn volatile. And after 5½ years of a euphoric bull run, that may be the kind of strategy investors should include in their portfolios. ■

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