

June 29, 2003

# How to Learn From Closed-End Funds, Without Buying

By MARK HULBERT

**B**UYING a closed-end fund at its initial offering is rarely a good idea because of the hefty sales commissions that underwriters earn on the deal, according to Owen Lamont, an associate professor of finance at the University of Chicago.

But Professor Lamont says investors can still learn a lot about the stock market by analyzing the types of new closed-end funds that are being sold to the public.

Unlike traditional mutual funds, closed-end funds have a fixed number of outstanding shares. Except in rare circumstances, a closed-end fund cannot issue more shares to meet investor demand or redeem existing shares in response to selling by investors.

Because of this, the prices at which closed-end funds trade often diverge significantly from their net assets per share. If demand for a particular fund is strong, an investor may have to pay a premium above its net assets per share. If demand is weak, a seller may have to accept a discount.

Until about 1990, some contrarian market timers successfully based their trading on the average premiums or discounts of closed-end equity funds in general. Large discounts were considered bullish signals, while small discounts, or premiums of any kind, were seen as bearish. In January 1987, for example, 10 months before the crash, the average discount of closed-end domestic equity funds narrowed to less than 1 percent.

But this market-timing system did not work well in the 1990's. According to Donald Cassidy, senior research analyst at Lipper, the average discount of closed-end domestic equity funds narrowed sharply in 1993, at the early stages of a long bull market. Moreover, the largest average discount since 1990 — more than 17 percent — was at the end of 1999, just before the bear market.

But Professor Lamont, an expert in the study of market inefficiencies, says another aspect of closed-end

funds — the number of new funds that focus on certain market sectors — sheds more light. Because closed-end funds can be hard to bring to market, fund companies tend to start new ones in those market areas where individuals are most eager to invest. That often means that these sectors are overvalued in comparison with the rest of the market.

Because underwriters typically earn a sales commission of 7 percent on a new closed-end fund, he said, "investors are being asked to pay a dollar for significantly less than a dollar's worth of assets." This looks like a good deal only to investors who are wildly enthusiastic about a sector.

Before 1999, for example, no closed-end equity funds focused explicitly on the Internet and high-technology companies. But in that year, two such funds came to market, raising nearly \$600 million. A third arrived in June 2000, raising more than \$100 million. The market peak for Internet and high-tech stocks was in the first half of 2000.

SIMILARLY, many closed-end funds focusing on specific countries' stocks were issued in the late 1980's and early 90's, reflecting investor enthusiasm for foreign stocks. The number of new funds in the category reached a peak — 11 — in 1990, raising more than \$1.3 billion.

That year was also a peak in foreign stocks' relative strength. Over the 10 years through 1990, the Morgan Stanley Capital International Europe, Australasia and Far East index, or EAFE, beat the Wilshire 5000 by an average of 4.4 percentage points a year. By the end of 1995, however, the EAFE had fallen behind the Wilshire, when measured over the trailing 10 years; it has stayed behind ever since.

Recently, real estate has been the focus of many new closed-end equity funds. During the 1990's, only one such fund was issued — in 1993, raising just over \$100 million. But two started in 2001, and six more in 2002, raising a total of more than \$2.1 billion.

Because of that popularity, investors may want to bet that real estate will lag behind the rest of the stock market over the next decade.