Closed-End Funds 101

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Closed-End Fund Definition

A closed-end fund (CEF) is a publicly traded investment company that can invest in stocks, bonds and other types of securities, based on its investment strategy, and raises capital primarily through an initial public offering (IPO) by issuing a fixed number of shares. After the IPO, the issuance of new shares is closed to investors and the fund is typically listed and traded similar to a stock on a stock exchange. "Closed" indicates that, unlike open-end mutual funds, CEF shares are typically not continuously offered.

Also, unlike open-end mutual fund shares which trade with the fund sponsor, closed-end fund shares are typically traded with other investors just like a stock. However, unlike a stock, a CEF share represents ownership in a portfolio of securities that is actively managed by an investment manager, as opposed to an individual holding.

Closed-End Fund Investors

Typical investors of CEFs are seeking a product that not only provides regular income to meet current obligations, but also provides the potential for long-term total return. CEFs may be well-suited for investors seeking greater diversification for the income-generating portion of their portfolio.

Closed-End Fund Potential Benefits

» Income-oriented CEFs provide regular cash flow, typically monthly or quarterly, to help shareholders pay current obligations.

» Subject to certain regulatory limits, CEFs have the ability to apply leverage, depending on the market environment, by either borrowing capital or issuing preferred shares in order to enhance distribution levels and performance. The use of leverage can allow the CEF to potentially achieve higher long-term returns if the investment performance on the capital borrowed exceeds its cost, but may also magnify losses if the investment on the capital borrowed underperforms.

» CEFs may have the ability to be fully-invested and invest in less liquid markets due to the fact that investment managers do not need to account for daily subscriptions, redemptions and cash requests.

Closed-End Fund Terminology

Discount/Premium. Unlike open-end mutual funds that are purchased and sold at the fund's net asset value (NAV), a CEF is bought and sold at its market price, which often differs from the fund's net asset value:

» If the market price is greater than the NAV, the closed-end fund is said to trade at a **premium**.

» If the market price is below the NAV, it trades at a **discount**.

Factors that affect the discount or premium include, but are not limited to, the fund's performance, the fund's distribution rate, desire for the fund's investment strategy, and the current market environment.

Distribution Rate. This ratio measures how much a closed-end fund pays out in income each year relative to its market price, or otherwise stated as how cash flow is generated for each dollar invested. The distribution rate will play a major role in determining whether a CEF trades at a premium or discount. For instance, a CEF that has a higher sustainable distribution rate than its peers will likely trade at a relatively reduced discount or higher premium, all other factors being equal.

Distribution Policy. CEFs distribute income earned from interest or stock dividends to shareholders typically on a monthly or quarterly basis. Realized capital gains are also distributed to shareholders. Short-term capital gains are typically included in the monthly distributions while long-term capital gains are paid once or twice a year, unless the fund has exemptive relief from the SEC allowing for greater frequency. At times, CEFs may use return of capital to maintain a steady distribution in an effort to potentially optimize its market price.

CEFs utilize either a Level Distribution Policy or a Managed Distribution Policy. In a Level Distribution Policy, the closed-end fund intends to make monthly distributions at a level rate established by the Board of Trustees. A Managed Distribution Policy is similar but instead of paying long-term capital gains only once or twice a year, it pays them as part of the monthly distribution.

Leverage

A CEF can apply leverage, subject to regulatory limits, by borrowing at short-term rates and investing the additional capital in the strategy of the fund with the goal of achieving higher long-term returns. The difference between the higher longer-term returns and the short-term rates, net of borrowing costs, supports the total return and distribution of the fund. As a result, leverage increases a shareholder's exposure to fund performance beyond their investment.

Interest Rate Swaps

CEFs can employ techniques like interest rate swaps to help manage their borrowing costs associated with leverage. As financial derivative instruments where two parties agree to exchange interest rate cash flows, interest rate swaps may help CEFs limit their exposure to rising interest rates by allowing a fund to "lock down" an attractive fixed rate on borrowed capital.

Types of Strategies

There are approximately 600 closed-end funds available to U.S. investors. Many of them offer strategies with exposure to a single asset class while others invest in multiple asset classes in an attempt to balance risk and reward.

Types of closed-end funds include:

- Convertible Securities Funds
- General Equity Funds
- Specialized Equity Funds
- Preferred Stock Funds
- World Equity Funds
- U.S. Mortgage Bond Funds
- Investment Grade Bond Funds
- Loan Participation Funds
- High Yield Bond Funds
- World Income Funds
- National Muni Bond Funds
- Single-State Muni Bond Funds
- Energy/MLP Funds
- Equity Covered Call Funds

CLOSED-END FUND SOURCES

- www.calamos.com/cef
- cefconnect.com
- cefa.com
- capitallink.com
- ici.org

Select Closed-End Fund Considerations

The principal risks of investing in the Funds include: convertible securities risk, synthetic convertible instruments risk, foreign securities risk, emerging markets risk, equity securities risk, growth stock risk, interest rate risk, credit risk, high yield risk, portfolio selection risk, and liquidity risk.

Leverage creates risks which may adversely affect return, including the likelihood of greater volatility of net asset value and market price of common shares; and fluctuations in the variable rates of the leverage financing. The ratio is the percent of borrowings to total assets.

Parties entering an interest rate swap take on exposure to a given interest rate; the exposure can be long or short depending on whether a counterparty is paying or receiving the fixed rate. At the same time, each party takes on the risk - known as counterparty credit risk - that the other party will default at some time during the life of the contract.

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