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Characteristics and Risks of Closed-End Funds

The Closed-end funds (CEFs) sector is a small but diverse subset of investment products that has recently seen an increase in popularity. Many of the newer funds have also seen a significant increase in complexity. Clearly, not all closed-end funds are suitable for all investors. One of our missions at Benjamin F. Edwards and Company is to provide an appropriate mix of suitable products for each of our clients. As a part of that process, we want to make an extra effort to answer any questions or concerns you might have about any recent or pending purchases of CEFs. We urge you to contact your BFEC financial advisor if you would like any further explanation of the features, characteristics and risks of any particular security.

CLOSED-END VS TRADITIONAL MUTUAL

Closed-end funds are similar to mutual funds in many ways. Both are structured as investment companies and are intended to provide access to a professionally managed, widely-diversified portfolio that adheres to a prescribed investment strategy. Both forms rely on an investment adviser to actively manage the security selection and investment decisions for any fund.

Traditional mutual funds, which are sold by prospectus, are "open-ended," meaning that new shares can be created at any time to accommodate new investment. Likewise, the number of shares outstanding can decline when shares are redeemed. All purchases and sales use the fund's current net asset value (NAV) as the base price. Any such trades typically occur only once per day, after the markets close for the day and after the fund's new NAV has been determined.

Conversely, closed-end funds issue a fixed number of shares, usually via an initial public offering (IPO). Those shares are listed on a stock exchange and may be traded at any time during the trading day. One benefit of this feature is that the investment manager has a relatively stable pool of assets with which to work; the risk of any strain on liquidity as a result of a rush of redemptions or a sudden influx of new purchasers is eliminated.

[1] NAV is equal to the total value of the fund's cash and investments (assets) less accrued fees, expenses and any other liabilities, divided by the total number of shares outstanding.

MARKET PRICING

The market prices of closed-end funds are disseminated through and available from all of the established financial media outlets. Investors seeking to buy or sell a CEF have the flexibility to determine at what time and at what price they would like to execute the transaction. As a result, the market price of a given fund is driven by supply and demand, and is likely to differ from the fund's NAV on any given day. The market price of any closed-end fund is likely to be at a premium to, or discount from its current NAV.

Not only can a CEF trade at a discount to its NAV, funds often trade below their IPO price. When considering the purchase of a closed-end fund on its initial public offering, you will have access to the fund's prospectus, in which you can find detailed information about the manager, the strategy and the risks of the fund. In addition to reviewing that information, we encourage you to compare the new fund with any similar funds that are already trading. Does the promised yield seem to be in line? Are other funds trading at a discount to their NAVs? Are they below their IPO price?

UNDERSTANDING THE RISKS

Closed-end funds come in many shapes and sizes, but most CEFs are income-oriented. Municipal bond closed-end funds were among the first, and since have been joined by funds focused on Corporate Bonds, U.S. Government Bonds, Agency Securities, High-Yield and Emerging Market Debt among others. Equity-based CEFs might focus on a particular capitalization category, investment style, dividend-paying companies or foreign stocks among others. CEFs specializing in energy sector Master Limited Partnerships (MLPs) have been one of the more common types of new funds.

Each fund has its own particular mix of manager, objectives, and strategy, so any two funds could have significant differences in their risks, price volatility and fees. Below is a brief summary of some of the more common risks to which holders of CEFs may be exposed.

- **Valuation Risk**: The market price of a CEF at any point in time is likely to vary from the fund's NAV. The size of any price premium and/or discount could have a significant impact on an investor's return over time. Any given CEF, even one which might have traded at a premium to its NAV in a particular market environment, could see its price drop to a discount, even if its NAV had not declined. When a particular style of CEF is out of favor with market participants, those CEFs could trade at discounts to NAV for an extended period of time. You have no assurance that either the size and/or duration of a CEF's discount are limited or that, once at a discount, a CEF's price must again be equal to NAV at some future date. You should understand what sort of economic conditions could lead to a premium or discount for a particular CEF. You might ask your advisor about the history of premiums and discounts on similar funds.

- **Market Risk**: The market value of the securities held in any one CEF will have a significant impact on the market price of the CEF. Not even the best investment manager can avoid losing periods. If the particular securities or sector, upon which a CEF concentrates, decline significantly in value, the value of the CEF could decline significantly as well. You should understand the pros and cons of investing in the sector in question. You might ask your advisor how closely correlated this sector was with the overall market in both bull and bear markets.

- **Leverage Risk**: Most, but not all, closed-end funds have the ability to use leverage in an attempt to enhance returns. Industry regulations limit the amount of leverage that a fund can assume, but some funds use leverage much more aggressively than others. When used, the leverage is typically created through bank loans or the issuance of preferred stock. The use of leverage by a fund will likely add to the volatility of the fund's NAV, which would likely add to the volatility of the fund's market price. Leverage will magnify any losses in the fund's portfolio. You should understand the degree to which a particular fund intends to use leverage. You might ask your advisor about what market or economic conditions could cause the use of leverage to be a negative for fund performance.

- **Liquidity Risk**: No assurance can be given that an active trading market will be available for any particular fund. The fact that a fund is listed on a stock exchange does not necessarily mean that sufficient liquidity will always be available. Trades that are large relative to a fund's average daily volume could have an impact on the market value. You should understand what level of liquidity is, or is likely to be, available for a particular fund. You might ask your advisor how large the market price discount got on a historically large price decline, and how long it took for the price to recover.

- **Illiquid Securities Risk**: CEFs are allowed to invest a greater portion of their assets in illiquid investments than are mutual funds. Due to their more stable pool of investable capital, some CEFs may take advantage of that ability. Illiquid securities typically are more difficult to value and may be impossible to sell at any point in time. As a result, CEFs that hold a higher percentage of portfolio assets in illiquid securities may be more volatile than their peers.

- **Manager Underperformance Risk**: Professional management of the fund's portfolio is generally viewed as a favorable feature of CEFs. Nevertheless, the possibility that a particular manager or a particular market sector could hit a rough patch shouldn't be ignored. Newer, smaller management companies, especially ones focused on more exotic strategies, could outperform larger, more experienced managers, but the risk of underperformance is probably also much higher.

- **Equity Securities Risk**: Closed-end funds that invest in common stock and other equity securities are subject to market risk. Those equity securities can and will fluctuate in value for many different reasons. Equity securities tend to decline in value when the overall stock market declines, but they might also decline based on changes in the economy, interest rates, inflation, monetary and fiscal policy, government regulations, consumer confidence and other areas. Factors that directly impact the particular sector or industry group of a given equity security might also cause an adverse reaction in the stock's price. CEFs that focus on a particular sector or industry group could experience greater price volatility, both up and down.

- **Fixed Income Securities Risk**: Investments in bonds and other fixed income securities are subject to interest rate risk and credit risk. The value of fixed-rate bonds in the portfolio will likely decline in value if the general level of interest rates rises. The longer the maturity of a particular fixed income security is, the greater the price change that would be caused by a given interest rate change. Credit risk is the risk of default by the issuer of the bonds.

- **Foreign Investment Risk**: Closed-end funds that invest in foreign securities may involve a high degree of risk. Funds invested in foreign securities are subject to such risks as currency and exchange-rate risk, governmental regulation, policy and taxation, and political, social and economic instability in the particular foreign countries. These risks are more pronounced in emerging growth countries.

- **Derivatives Risk**: Many CEFs are permitted to use options and other derivatives contracts. These products might be used for enhancing income, hedging or increasing leverage. Investors should be aware of whether or not, and in what strategies, the fund's manager intends to use derivatives.

- **Level Dividend Policy Risk**: Some income-oriented CEFs adopt a level-dividend policy, meaning that, if current portfolio income is not sufficient to pay the prevailing rate of dividend, then the manager may dip into capital gains or principal to make up the shortfall. When considering the purchase of a CEF you should understand whether or not the fund has a level dividend policy, and if so, to what extent it's being used.

CEF RESOURCES

Two possible sources for more detailed information on Closed-End Fund are the Closed-End Fund Association (www.closed-endfunds.com) and CEF Insight (www.cefinsight.com). Both sources are clearly proponents of CEFs, but they seem to be otherwise unbiased in their information and timely in updating their data. Links to other CEF sites, including those of fund sponsors, can be found on the above sites as well.

Please do not hesitate to contact your Benjamin F. Edwards investment advisor if you have any questions or concerns.