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RESEARCH FUNDAMENTALS

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The Closed-End Fund Market, 2008

Key Findings

- **Total closed-end fund assets were $188 billion at year-end 2008.** Closed-end funds, which are a type of investment company, generally issue a fixed number of shares that are listed on a stock exchange or traded in the over-the-counter market.
- **Bond closed-end funds accounted for more than half of all closed-end fund assets.** Bond funds have traditionally accounted for a majority of closed-end fund assets. At year-end 2008, bond closed-end fund assets were $113 billion, or 60 percent of closed-end fund assets. However, assets in equity closed-end funds have grown from 26 percent at year-end 2000 to 40 percent of all closed-end fund assets at year-end 2008.
- **At year-end 2008, there were 643 closed-end funds.** The number of closed-end funds decreased in 2008, after several years of steady increases. Since year-end 2000, the number of closed-end funds has increased by 161 funds. Equity funds accounted for 61 percent of the increase in the number of closed-end funds over the period.
- **Closed-end fund investors tended to have above-average household incomes and financial assets.** An estimated 2.0 million U.S. households held closed-end funds in 2008. Households that owned closed-end funds tended to include affluent, experienced investors who owned a range of equity and fixed-income investments.

What Is a Closed-End Fund?

Closed-end funds are one of four types of registered investment companies, along with mutual (or open-end) funds, exchange-traded funds (ETFs), and unit investment trusts. Closed-end funds generally issue a fixed number of shares that are listed on a stock exchange or traded in the over-the-counter market.[1] The assets of a closed-end fund are professionally managed in accordance with the fund's investment objectives and policies, and may be invested in stocks, bonds, and other securities. The market price of closed-end fund shares fluctuates like that of other publicly traded securities and is determined by supply and demand in the marketplace.

Closed-end funds offer a fixed number of shares to investors during an initial public offering. Closed-end funds also may make subsequent public offerings of shares in order to raise additional capital. Once issued, the shares of a closed-end fund are not typically purchased or redeemed directly by the fund. Rather, they are bought and sold by investors in the open market.

Because a closed-end fund does not need to maintain cash reserves or sell securities to meet redemptions, the fund has the flexibility to invest in less liquid portfolio securities. For example, a closed-end fund may invest in securities of very small

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companies, municipal bonds that are not widely traded, or securities traded in countries that do not have fully developed securities markets. Closed-end funds also have flexibility to borrow against their assets, allowing them to use leverage as part of their investment strategy.

Closed-End Fund Assets Decreased to $188 Billion in 2008

Total closed-end fund portfolio assets decreased by $125 billion in 2008, leaving the combined assets of the nation's closed-end funds at $188 billion (Figure 1).[2] The decline in assets in 2008 reflected a substantial decrease in U.S. and international stock values, declines in prices on municipal and corporate securities, and a contraction in outstanding auction market preferred stock issued by closed-end funds.

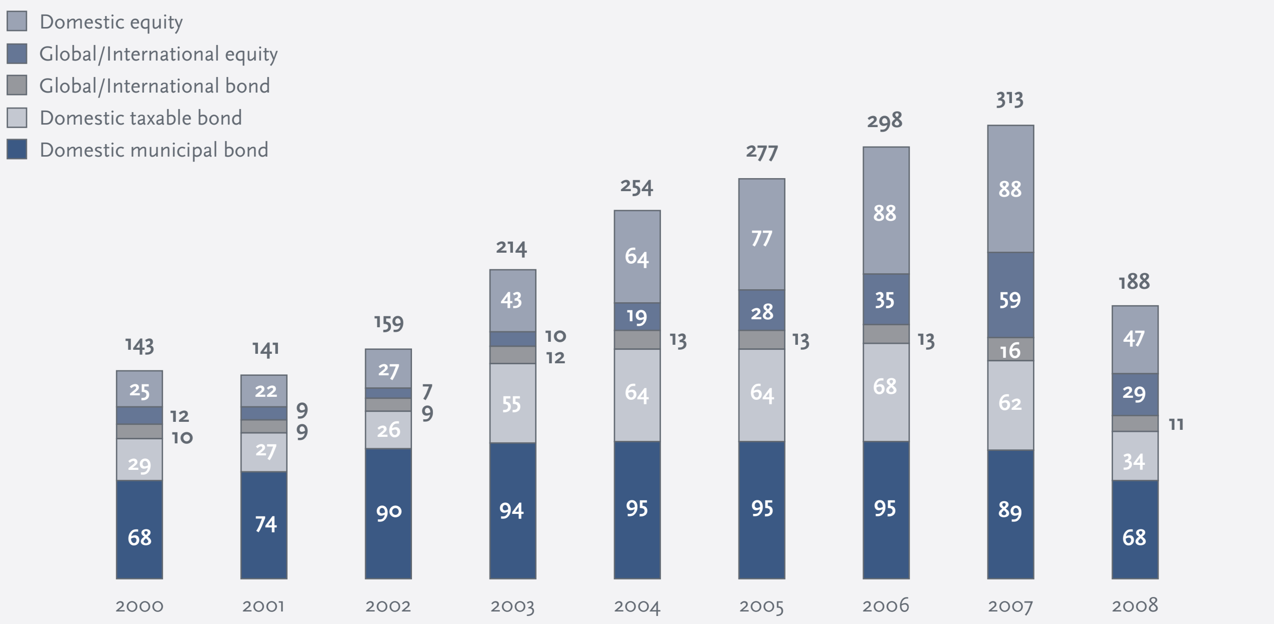
Historically, bond funds have accounted for a large share of assets in closed-end funds. In 2000, 74 percent of all closed-end fund assets were held in bond funds, while 26 percent were held in equity funds (Figure 1). At year-end 2008, assets in bond closed-end funds were $113 billion, or 60 percent of closed-end fund assets (Figure 2). Equity closed-end funds totaled $76 billion, or 40 percent of closed-end fund assets. These relative shares have shifted a bit over time, in part because issuance by equity closed-end funds exceeded that by bond closed-end funds from 2004 through 2008.

There was little issuance of new closed-end fund shares in 2008. Proceeds from issuance of closed-end funds totaled only $329 million (Figure 3). The issuance of global and international equity closed-end funds represented 61 percent of the $329 million in total net proceeds. Closed-end bond funds accounted for most of the remaining issuance.

Figure 1

Closed-End Fund Assets Decreased to $188 Billion

Closed-end fund assets by investment objective, billions of dollars, year-end, 2000–2008

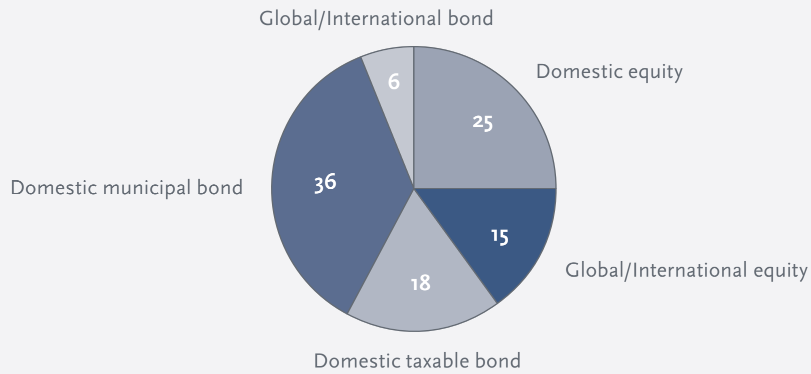


Note: Components may not add to the total because of rounding.
Source: Investment Company Institute

Figure 2

Bond Funds Were Largest Segment of Closed-End Fund Market

Percentage of closed-end fund assets, year-end 2008



Total closed-end fund assets: $188 billion

Source: Investment Company Institute

Figure 3

Closed-End Fund Share Issuance

*Proceeds from the issuance of initial and additional public offerings of closed-end fund shares, millions of dollars, annual, 2002–2008**

		Equity		Bond	
Year	Total	Domestic	Global/International	Domestic	Global/International
2002	$24,911	$9,191	$18	$15,701	$0
2003	40,963	11,187	161	28,582	1,032
2004	27,867	15,424	5,801	5,613	1,028
2005	21,266	12,559	6,628	1,955	124
2006	12,332	7,691	2,584	1,724	334
2007	31,192	5,973	19,870	2,654	2,695
2008	329	8	200	121	0

**Data are not available for years prior to 2002.*
Note: Components may not add to the total because of rounding.
Source: Investment Company Institute

Number of Closed-End Funds

The number of closed-end funds available to investors decreased in 2008 after several years of steady increases. At the end of 2008, there were 643 closed-end funds, up from 482 at the end of 2000, but down from 664 at year-end 2007 (Figure 4). The increase in the number of equity funds accounted for 61 percent of the increase in the total number of closed-end funds during this eight-year period. Equity funds made up 34 percent of the total number of closed-end funds at year-end 2008, compared with 26 percent at year-end 2000. Bond funds, however, were still the most common type of closed-end fund. For example, municipal bond funds represented 40 percent of all closed-end funds in 2008.

Figure 4

Number of Closed-End Funds

Year-end, 2000–2008

	2000	2001	2002	2003	2004	2005	2006	2007	2008
All closed-end funds	**482**	**492**	**545**	**584**	**619**	**635**	**647**	**664**	**643**
Equity closed-end funds	**123**	**116**	**123**	**131**	**158**	**193**	**204**	**230**	**221**
Domestic	53	51	63	75	96	121	129	137	127
Global/International	70	65	60	56	62	72	75	93	94
Bond closed-end funds	**359**	**376**	**422**	**453**	**461**	**442**	**443**	**434**	**422**
Domestic	329	349	397	426	431	411	410	400	389
Taxable	109	109	105	129	136	131	134	131	129
Municipal	220	240	292	297	295	280	276	269	260
Global/International	30	27	25	27	30	31	33	34	33

Source: Investment Company Institute

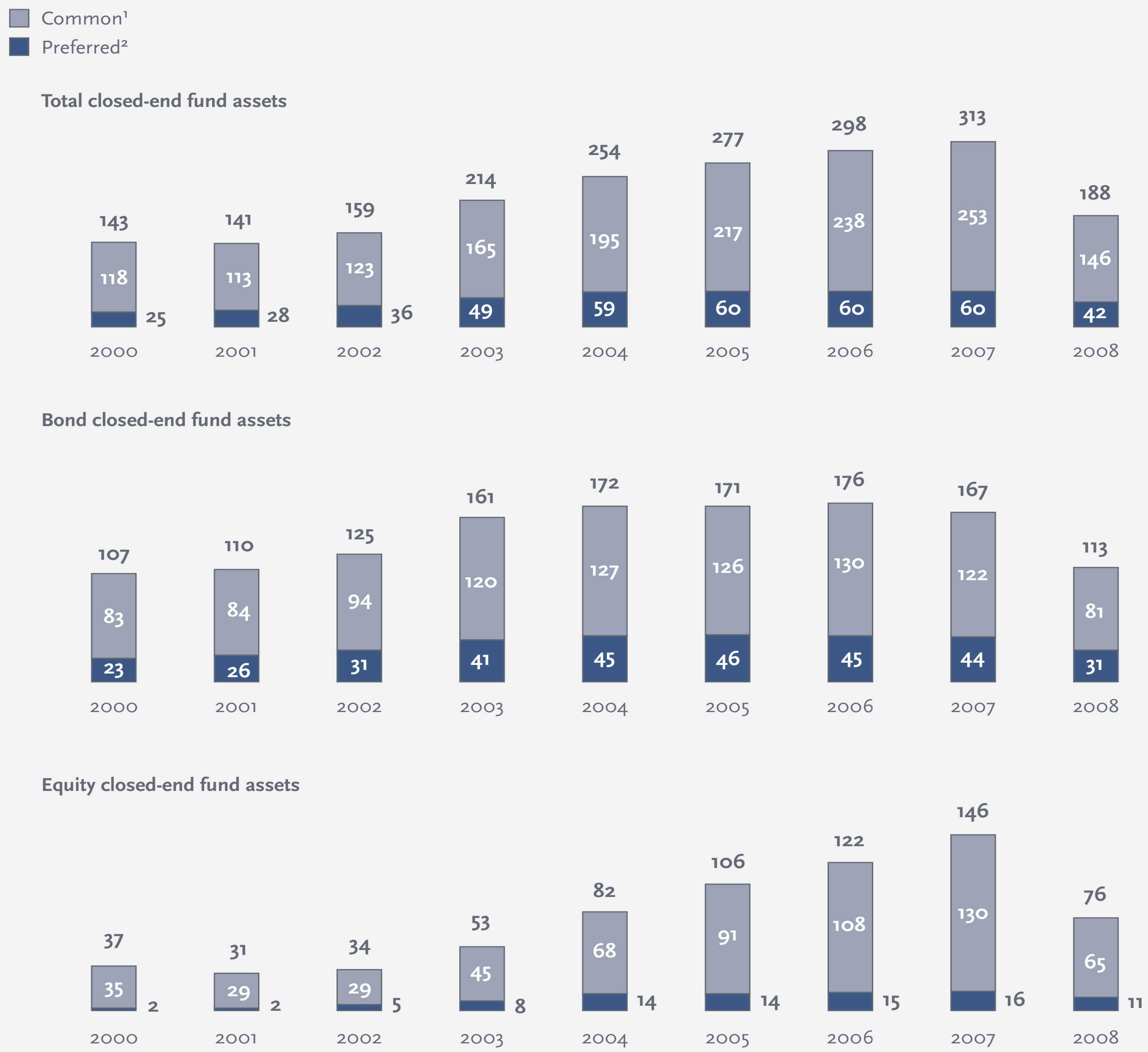
Closed-End Fund Preferred Shares

Closed-end funds are permitted to issue one class of preferred shares in addition to common shares. Preferred shares differ from common shares in that preferred shareholders are paid dividends, but do not share in the gains and losses of the fund.[3] Issuing preferred shares allows a closed-end fund to raise additional capital, which it can use to purchase more securities for its portfolio. This strategy, known as leveraging, is intended to allow the fund to produce higher returns for its common shareholders. At year-end 2008, 22 percent of the $188 billion in closed-end fund assets were preferred shares (Figure 5). Bond closed-end funds accounted for nearly three-quarters of outstanding preferred share assets.

Figure 5

Bulk of Closed-End Fund Total Net Assets Was in Common Share Classes

Billions of dollars, year-end, 2000–2008



[1] All closed-end funds issue common stock, which is also known as common shares.

[2] A closed-end fund may issue preferred shares to raise additional capital, which can be used to purchase more securities for its portfolio. Preferred stock differs from common stock in that preferred shareholders are paid dividends, but do not share in the gains and losses of the fund.

Note: Components may not add to the total because of rounding.

Source: Investment Company Institute

Closed-End Fund Auction Market Preferred Stock

In the early 1990s, closed-end funds began issuing a type of preferred shares referred to as auction market preferred stock (AMPS).[4] By early 2008, closed-end funds had outstanding AMPS with a total liquidation preference of approximately $64 billion.[5] AMPS is a type of stock that pays dividends at rates set through auctions run by an independent auction agent. Dividend rates typically are reset through auctions held every seven or 28 days. Typically, investors submit bids through a broker-dealer, who submits them to an auction agent. Bids are filled to the extent shares are available, and sell orders are filled to the extent there are bids. All filled bids receive dividends at the new set dividend, or market clearing, rate.

Since mid-February 2008, all auctions for closed-end fund AMPS have failed.[6] The failed auctions have not been caused by defaults under the terms of the AMPS or credit quality concerns with fund investments, but rather simply because there were more shares offered for sale in the auction than there were bids to buy shares. Prior to the failures, if more shares were tendered for sale than purchased, broker-dealers typically would enter the auction and purchase any excess shares to prevent the auction from failing. Broker-dealers provided this liquidity even though they were not required to do so. As a result of a series of pressures on their balance sheets (e.g., write-downs due to the subprime mortgage crisis), broker-dealers stopped participating in the auctions. After a few auctions failed, all subsequent auctions for closed-end fund preferred stock failed. Preferred shareholders appeared to become concerned about the liquidity of their AMPS, and many sought to sell their shares. This move by preferred shareholders increased the imbalance between purchases and sales, making it difficult for the auction market to resume functioning.

In light of these events, closed-end funds have taken a number of steps to replace their AMPS with alternative forms of leverage. They have, among other things, obtained bank loans and lines of credit, issued tender option bonds, engaged in reverse repurchase agreements, and issued extendable notes to replace AMPS while maintaining leverage. In addition, the closed-end fund industry is trying to issue a new type of preferred stock known as puttable preferred stock. Industry participants are developing puttable preferred stock to permit redemption of AMPS while maintaining leverage for the benefit of common shareholders. Puttable preferred stock is similar to AMPS in that it is expected to pay dividends at variable rates, and sell orders will be filled to the extent there are bids. Unlike AMPS, however, rates will be set through remarketings run by one or more financial institutions acting as remarketing agents (rather than through auctions); and if there are more sell orders than bids, a third party, commonly referred to as a liquidity provider, will be contractually obligated to unconditionally purchase all puttable preferred stock.[7] This new type of preferred stock has been referred to as Liquidity Protected Preferred (LPP), Variable Rate Demand Preferred (VRDP), or Liquidity Enhanced Adjustable Rate Securities (LEARS). These instruments are similar, but not identical, to each other. It remains to be seen how the market for the new puttable preferred stock will develop.

Most recently, one industry participant took steps toward issuing Municipal Term Preferred Shares (MTP), a new type of preferred stock with mandatory redemption at the end of a stated term that will pay a fixed-rate, tax-exempt dividend. Like puttable preferred stock, issuance of MTP would permit a closed-end fund to redeem its AMPS while maintaining leverage for the benefit of common shareholders.

Competition in Closed-End Fund Industry

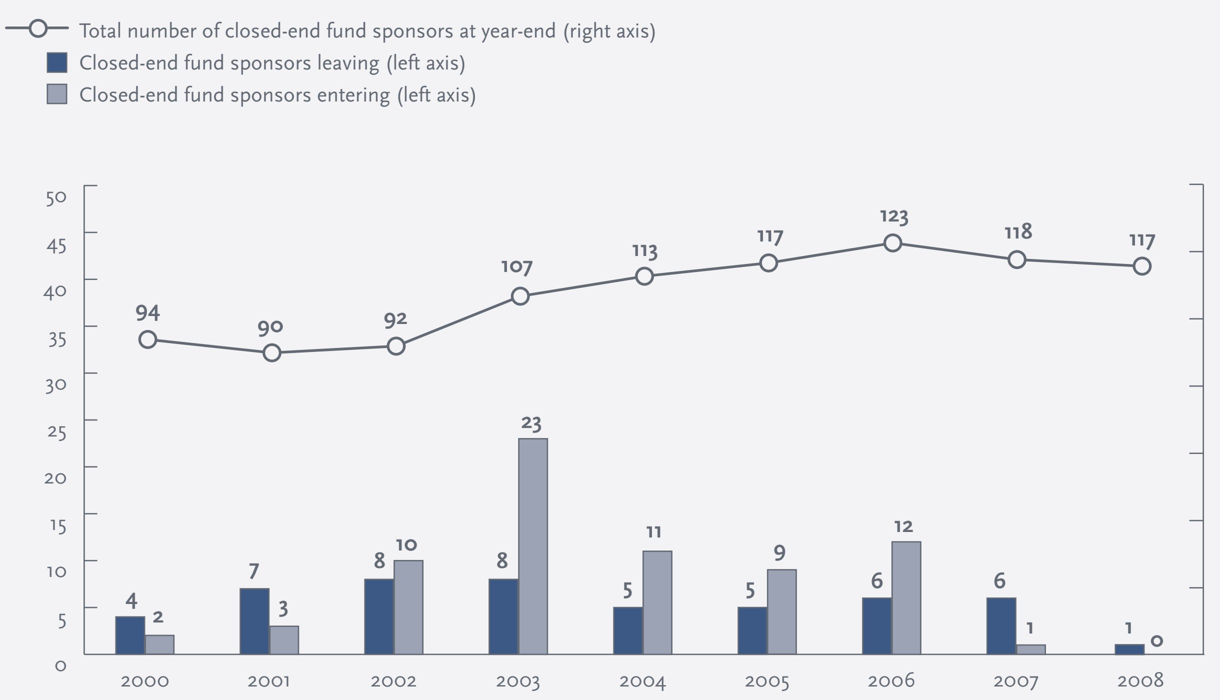
The number of closed-end fund sponsors increased for several years, peaking in 2006. At year-end 2008, there were 117 closed-end fund sponsors, up from 94 in 2000, an increase of 24 percent (Figure 6).

Competitive dynamics have prevented any single firm or group of firms from dominating the closed-end fund market. For example, of the largest 25 firms in 2000, only 15 remained in this group at year-end 2008. The share of assets managed by the largest 25 firms has remained fairly consistent since 2000, although the share that the five largest firms managed has increased in recent years (Figure 7).[8] Other measures also indicate that no one firm or group of firms dominates the closed-end fund market. One such measure is the Herfindahl-Hirschman index, which weighs both the number and relative size of firms in the industry to measure competition.[9] Index numbers below 1,000 indicate that an industry is unconcentrated, and index numbers between 1,000 and 1,800 indicate moderate concentration. Index numbers above 1,800 indicate that an industry is highly concentrated. At year-end 2008, the closed-end fund industry had a Herfindahl-Hirschman index of 801.[10] In addition to the low Herfindahl-Hirschman index, it is important to note that closed-end funds compete with other investment products. While there are nearly 650 closed-end funds, there are more than 8,000 mutual funds, more than 5,000 unit investment trusts, and more than 700 ETFs.[11]

Figure 6

Number of Closed-End Fund Sponsors

Entry, exit, and total number of closed-end fund sponsors, year-end, 2000–2008

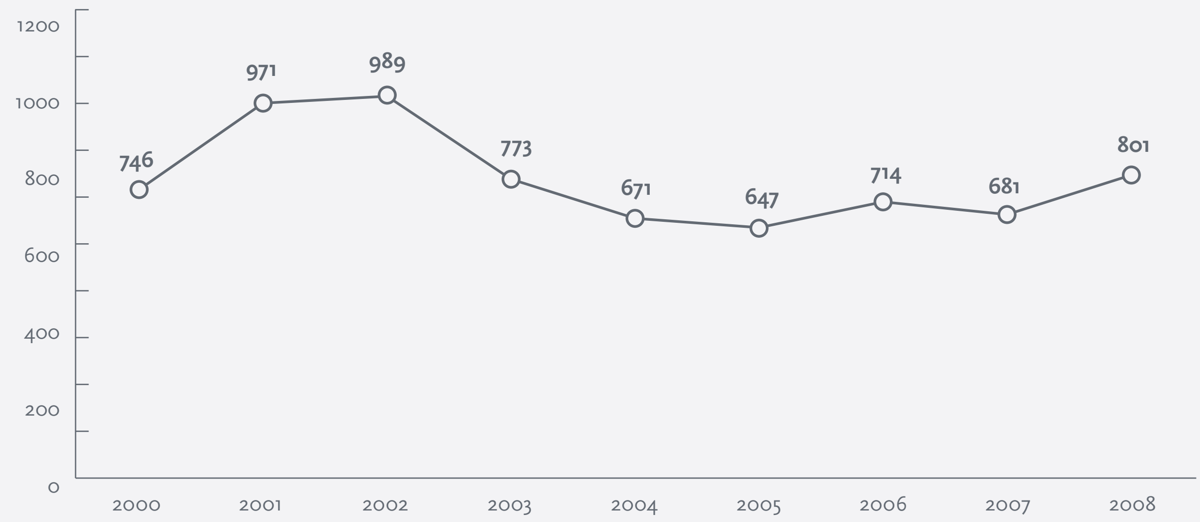


Source: Investment Company Institute

Figure 7

Closed-End Fund Industry Found Competitive

Herfindahl-Hirschman index, year-end, 2000–2008*



Share of Closed-End Fund Assets at Largest Complexes

Percentage of total closed-end fund industry assets, year-end, 2000–2008

	2000	2001	2002	2003	2004	2005	2006	2007	2008
Largest 5 complexes	48	56	56	51	46	46	52	52	56
Largest 10 complexes	65	70	70	66	64	64	65	65	68
Largest 25 complexes	88	90	91	87	86	86	85	85	86

*The Herfindahl-Hirschman index weighs both the number and relative size of firms in the industry to measure competition. Index numbers below 1,000 indicate that an industry is unconcentrated.

Source: Investment Company Institute

Characteristics of Closed-End Fund Investors

An estimated 2.0 million U.S. households owned closed-end funds in 2008.[12] These households tended to include affluent, experienced investors who owned a range of equity and fixed-income investments. In 2008, 93 percent of closed-end fund–owning households also owned stocks, either directly or through stock mutual funds or variable annuities (Figure 8).

Eighty-three percent of households that owned closed-end funds also held bonds, bond mutual funds, or fixed annuities. In addition, 45 percent of these households owned investment real estate. Because a large number of households that owned closed-end funds also owned stocks and mutual funds, the characteristics of closed-end fund owners are similar in many respects to those of stock and mutual fund owners. For instance, households that owned closed-end funds—like stock- and mutual fund–owning households—tended to be headed by college-educated individuals and had household incomes above the national average (Figure 9). Nonetheless, households that owned closed-end funds exhibited certain characteristics that distinguished them from stock- and mutual fund–owning households. For example, households with closed-end funds tended to have much greater household financial assets than either stock or mutual fund investors. Closed-end fund investors were also more likely to be retired from their lifetime occupations than either stock or mutual fund investors.

Figure 8

Closed-End Fund Investors Owned a Broad Range of Investments

*Percentage of closed-end fund–owning households holding each type of investment, May 2008**

Stock mutual funds, stocks, or variable annuities (total)	**93**
Bond mutual funds, bonds, or fixed annuities (total)	**83**
Mutual funds (total)	**91**
Stock mutual funds	84
Bond mutual funds	69
Hybrid mutual funds	51
Money market funds	69
Stocks	**80**
Bonds	**28**
Fixed or variable annuities	**44**
Investment real estate	**45**

**Multiple responses are included.*

Source: Investment Company Institute Annual Mutual Fund Shareholder Tracking Survey

Figure 9

Closed-End Fund Investors Had Above-Average Household Incomes and Financial Assets

May 2008

	All U.S. households	Households owning closed-end funds	Households owning mutual funds	Households owning individual stocks
Median				
Age of head of household	49	53	49	51
Household income[1]	$50,000	$110,000	$80,000	$87,500
Household financial assets[2]	$85,000	$375,000	$200,000	$280,000
Percentage				
Household primary or co-decisionmaker for saving and investing:				
Married or living with a partner	62	78	76	77
Widowed	11	5	6	6
Four-year college degree or more	30	58	46	50
Employed (full- or part-time)	64	64	78	74
Retired from lifetime occupation	26	40	22	26
Household owns:				
IRA(s)	40	84	68	64
Defined contribution retirement plan account(s)	52	73	78	74

[1] Total reported is household income before taxes in 2007.
[2] Household financial assets include assets in employer-sponsored retirement plans, but exclude the household's primary residence.
Source: Investment Company Institute Annual Mutual Fund Shareholder Tracking Survey

About the Annual Mutual Fund Shareholder Tracking Survey

The Investment Company Institute conducts the Annual Mutual Fund Shareholder Tracking Survey each spring to gather information on the demographic and financial characteristics of households in the United States. The most recent survey was undertaken in May 2008 and was based on a sample of 4,100 U.S. households selected by random digit dialing. All interviews were conducted over the telephone with the member of the household who was the sole or co-decisionmaker most knowledgeable about the household's savings and investments.

Notes

[1] For additional information, see Investment Company Institute "Frequently Asked Questions About Closed-End Funds and Their Use of Leverage" and "A Guide to Closed-End Funds."

[2] See Investment Company Institute 2009b. The survey has been conducted annually from 1988 through 2001, and quarterly since 2002.

[3] Section 18 of the Investment Company Act provides that preferred shareholders, voting as a class, are entitled to elect at least two directors at all times and to vote along with common shareholders on the remaining directors. In addition, preferred shareholders, voting as a class, are entitled to elect a majority of the directors if at any time the dividends on the preferred shares are unpaid in an amount equal to two full years' dividends on the preferred shares, and continue to be entitled to elect a majority of the directors until all dividends in arrears are paid. Section 18 also requires funds to have at least $3 of assets for each $1 of debt issued and $2 of assets for each $1 of preferred shares issued.

[4] See, e.g., Thomas J. Herzfeld Advisors, Inc. 2008b, 3.

[5] See, e.g., Thomas J. Herzfeld Advisors, Inc. 2008a, 11.

[6] See, e.g., Anderson and Bajaj 2008.

[7] Liquidity providers are expected to be financial institutions, such as banks or insurance companies.

[8] By comparison, the share of mutual fund assets managed by the 25 largest firms is 75 percent at year-end 2008. See Investment Company Institute 2009a.

[9] See Cabral 2000 and U.S. Department of Justice and the Federal Trade Commission 1992 for more information about the Herfindahl-Hirschman index.

[10] For additional discussion of the Herfindahl-Hirschman indexes of mutual funds and other industries, see Stevens 2006.

[11] See Investment Company Institute 2009a for more information.

[12] For additional information on the incidence of closed-end fund ownership across mutual fund–owning households by various demographic and financial characteristics, see Schrass and Bass 2009. For additional information on the Annual Mutual Fund Shareholder Tracking Survey, see Holden, Bogdan, and Bass 2008.

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