The Analyst's Guide to Closed-End Funds

The first Closed-End Fund in the United States was founded in 1893, which was the same date as the first US Commemorative Coin ever minted,The Columbian Exposition Commemorative (pictured above).

Source: Public Domain

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<u>Q&A Interview with Rajeev Das, CFA, Portfolio Manager / Head of Trading of BullDog Investors</u>

<u>NOTE</u>: The opinions expressed in the question and answer interview are only those of the interviewee, and do not represent the opinions of *The Analyst's Guide to Closed-End Funds*.

Mr. Das serves as a Principal of Bulldog Investors. He is currently a director of the Mexico Equity and Income Fund Inc. He is also Vice-President and Treasurer of Special Opportunities Fund, Inc. Mr. Das is a Chartered Financial Analyst (CFA). He received a Bachelor of Arts in Economics from the University of Bombay in 1989 and a Master of Arts in Economics from New York University in 1999.

Question 1. Talk about Bulldog Investors Investment Management.

Rajeev Das: Bulldog Investors is a registered investment advisor now in its 25th year. The firm was founded in 1994 by Phillip Goldstein, a former engineer for New York City and Steve Samuels, a former stock broker with Dean Witter. The firm is value activist in its approach with a focus on cefs, small caps, and SPACS. Bulldog identifies securities trading below what we believe is a "fair and attainable exit value" for investors. After staking a position in a publicly traded security, we will approach management and initiate discussions with the goal to enable shareholders to exit their investment at a fair price.

Question 2. Discuss Bulldog's "synthetic" investment process. Bulldog is known for using an "event-driven approach to identify undervalued investments." Describe and elaborate on the concept of "event-driven approach to identify undervalued investments."

Rajeev Das: Since Bulldog is an activist we are quite happy being the catalyst to bring about an event that boosts valuations for investors. Our process consists of identifying investments trading at a discount to what I call a "fair and attainable exit value." This is different from NAV or private market value because it also considers, in addition to valuations, the interests of other shareholders and other stakeholders, including possibly intransigent management, and importantly it also takes into account the probability of being able to effectuate change. For example, in a cef, the exit value may maybe at a price below net asset value, let's say where a cef may offer to do a tender offer at a 2% discount to NAV, to defray costs for those investors not tendering. Or for example a BDC in liquidation, the exit value maybe markedly lower than the Book Value reported by management, as many of the loans in the portfolio do not have a public market and so a sale may result in mark downs from fair valuations provided by the Board of Directors. So "a fair and attainable exit value" is a more realistic valuation, which one would expect to receive in an exit, than NAV or Book Value.

For a discounted closed-end fund with an underlying portfolio of publicly traded securities, the NAV is published daily so an investor has a good handle on valuation. The challenge is in gaming how much of the discount can an investor recover and how quickly, since any actions taken by management to reduce the discount, say a conversion to an open-end fund or a higher distribution will result in lower fees for management. So, management will be reluctant to take any actions. To that end we study the shareholder base closely, the articles and by laws of a fund, the reputation of management- how have they behaved in the past towards dissident shareholders, and liquidity and valuation methodology of the underlying portfolio if a CEF or BDC.

Some things to look at-shareholder base- institutional vs retail- most dissident support will come from sophisticated institutional shareholder. Most retail shareholders won't bother to vote and those that vote will support management.

All institutional shareholders aren't the same- just because a shareholder is an institutional shareholder does not mean they will support an activist. There are institutional shareholders that may need exposure to an asset class or geography and would like to have a cef product around that provides that. However, they may not like a very wide discount and so would support partial measures to reduce the discount (this goes back to what I said above regarding what's "attainable"). Full NAV may not be attainable as these shareholders would not support that, but a partial exit at a narrow discount would be acceptable. So, an investor must handicap how large the tender offer would be, at what level, how many shareholders would tender thereby effecting pro-ration, and what discount would the shares trade post tender to arrive at a reasonable estimate of "fair and attainable exit value."

All activists aren't the same- While Bulldog is a pure activist pushing for the highest possible exit value in all situations, there are some institutional shareholders that see activism as a marketing tool. They follow a rules-based approach, focused on items such as limited tenure for directors, and portfolio turnover. How much quantifiable value this adds to shareholders is unknown, but it works well for them when marketing product to their underlying clients.

Articles and By laws of a fund- Since Articles and Bylaws of a corporation or CEF are drafted by lawyers hired by that corporation or cef they tend to favor management. So, when analyzing a funds corporate governance, one looks for road blocks- advance notification requirements, director qualification by laws, majority vote required in contested elections, shareholder ownership restrictions. For Director Qualification by laws, a country fund may have onerous requirements for dissident directors including specific country experience or knowledge and residency requirements as well as limitation on other directorships. Often current directors are exempt from such requirements. A majority vote requirement in a contested election is an almost impossible hurdle. Since turnout in a proxy election is probably around 60% of eligible shares, a winning dissident would require over 80% of the vote to get elected. Of course, conveniently, if no contestant receives over 50% of the vote, the incumbents stay on as director. Some CEFs also limit ownership by a group. For example, DNI a cef, has a 5% ownership limitation by any one group.

Reputation of management- how management has behaved in the past is extremely important- are they concerned about their reputation and will they do the right thing for shareholders or will they use shareholder funds to defend themselves.

liquidity and valuation methodology of the underlying portfolio if a CEF or BDC- how liquid is the underlying portfolio- if a cef must sell shares to fund a tender offer, will that have an adverse effect on NAV. How is the underlying portfolio marked…? based on market quotes or fair valued by the Board.

Bulldog has established itself in the Closed-end fund arena. For example, Bulldog is the Lazard World Dividend & Income Fund's second largest holder with just under 9% of shares. Discuss some of your other CEF investments.

We are the largest shareholder of AKP, a California muni bond fund which we first started purchasing in October 2017 at about an 11 discount. The cef is currently in liquidation and has halted trading at less than 1% discount. In 2018, the board of directors announced they were seeking a new advisory contract between Alliance, the investment advisor and the Fund. Bulldog opposed the new contract and asked for a liquidity event for shareholder. In addition, Bulldog also nominated 3 persons to the Board. The fund made several attempts to push through the new advisory contract, adjourning the shareholder meeting to buy more time, but eventually realized the futility of their task. In February 2019, the Board announced the funds liquidation.

We are also the second largest shareholder of NTC, a Connecticut muni fund run by Nuveen. Nuveen recently announced a merger between NTC and NVG, a national muni bond fund. As a sweetener, they also announced a 10% distribution to NTC shareholders. The discount has narrowed to 8% from 11% on the news and in from over 16% at the start of the year. We think this merger makes no sense at all. NTC shareholders originally bought shares for income exempt from federal tax and CT state income tax. To force a merger into a national muni fund is unfair. We think a merger into the open-end CT mutual fund that Nuveen manages makes more sense. Shareholders will continue to receive tax free income and those that wish to exit can do so at NAV. We plan to oppose the merger and vote against it.

We also like VTA, a cef run by Invesco, focused mainly on leveraged loans. The fund has been the target of activism by a New York Hedge fund, which has nominated 4 dissidents to the board. One of the nominees is Art Lipson, an activist investor himself. With recent market weakness and the possibility that lower rates may lead to dividend cuts on a variable rate portfolio, the discount has widened out to almost 14%. Things should come to a head at the annual shareholder meeting usually held in August or September. We think an exit around 8% discount is quite likely in the next 6 months or so- While you wait you receive a dividend of almost 7%.

Question 3. ***The first closed-end fund was issued in 1893. Why do you think closed-end funds have been around for so long? In your opinion, what does the future hold for closed-end funds?***

Rajeev Das: Closed-end funds do offer certain structural advantages. Since assets in a cef are permanent capital managers are free to invest without having to worry about redemptions. This theoretically should result in superior performance. Cefs, unlike their open-end cousins can leverage. Typically, cefs borrow at low short-term rates and then put the money to work to earn higher rates of return by investing in longer duration investments or riskier asset classes. The spread that they earn could mean higher returns to investors though leverage can be a double-edged sword. CEFs were also popular because they allowed investors access to markets that were otherwise unable to them. So, for example in the late 80s we saw numerous emerging market funds issued. But most of these markets are now accessible to investors, either directly or via other products like ETFS.

Probably the most important reason for the longevity of cefs is the uninterrupted fee stream they offer the manager. Unlike an open-end fund where exiting shareholders redeem shares, thus reducing AUM and fees, shareholders looking to exit must sell shares in the market. Thus, managers' income stream is not affected. Hence managers are keen to keep running cefs and loath to take any actions that would interfere with this income. However, shareholders are much savvier now than ever, and poor performing funds with high expense ratios, will find themselves under pressure from activists.

Question 4. Do SEC rulings affect your investments in closed-end funds? What are the advantages of closed-end funds for activist investors? What are the disadvantages of closed-end funds for activist investors?

There are several advantages- one is the look through diversification provided by cefs. To be effective as an activist one must take large positions. Larger positions mean more risk- however with a cef, risk is mitigated by the fact the cef portfolio itself consists of several different investments. The 40 Act also requires a shareholder vote on the assignment of an advisory contract. This gives shareholders a tremendous amount of leverage. With the pace of consolidation increasing in the asset management space, this could be an important source of alpha for shareholders. The 40 Act also gives shareholders the ability to terminate the advisory contract. While this is a difficult threshold (requiring a 40 Act majority), it is not impossible, especially if it is a smaller CEF with a concentrated shareholder base.

A major disadvantage is the 3% rule limiting a fund to no more than 3% ownership of another fund. This rule is currently under review by the SEC.