It’s Open Season on Closed-End Fund Activists. How Fund Holders Can Win—and Lose.

By
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The Templeton Global Income fund frustrated investors for years. Despite star manager Michael Hasenstab at the helm, the closed-end fund returned an average of 0.3% annually in the past decade, versus an average 7% for peers in global income. Also frustrating, its shares rarely traded close to the fund’s underlying net asset value, or NAV. The discount averaged 11% in the past three years.

Investors have caught a break, however, thanks to Saba Capital Management, a hedge fund shop run by activist investor Boaz Weinstein. Saba amassed a 20% stake in the Templeton fund and recently won four contested board seats. It has been pressuring the board to take actions to boost the share price. Its moves have paid off: The fund has returned a total 4.5% this year as its share price improved, and the discount to NAV has shrunk to 4%.

Tactics like Saba's have long infuriated mutual fund companies; no one wants a hedge fund threatening a coup. Now, with some help from Congress, the playing field could tilt in favor of closed-end funds and their company sponsors, due to a bill recently introduced in the House. That could work against the interests of fund investors.

The Increasing Investor Opportunities Act, introduced in June by Rep. Anthony Gonzalez (R., Ohio) and Rep. Gregory Meeks (D., New York), includes two measures that could make it much tougher for hedge funds to pressure closed-end funds and win proxy fights. One proposed change would lift the current 15% limit on closed-end-fund ownership of illiquid private funds, such as venture-capital and private-equity funds. A second measure would prevent activist hedge funds from acquiring more than 10% of a closed-end fund's shares.

A spokesman for Gonzalez declined to comment. Meeks didn't respond to requests for comment.

Proponents of the changes say they would expand access to private markets for retail investors. They also say hedge funds are exploiting gaps in securities laws at a cost to long-term shareholders, saddling them with tax liabilities, higher fees, and forced fund liquidations. The bill would eliminate a "loophole that activist investors have used to extract short-term profits at the expense of retail investors," the Investment Company Institute, or ICI, said in a recent statement.

Hedge funds and portfolio managers who invest in closed-end funds say that mutual fund companies are simply trying to protect a pool of assets and fees from shareholder interference. Most retail investors don't vote their shares in proxy contests. That may leave fund boards largely free to pursue their own agendas.

"Activism plays an important role, and if this bill passes, it will become more difficult for activists to threaten or create changes," says Matt Buffington, a portfolio manager at Dryden Capital, an activist hedge fund.

Gregory Neer, a portfolio manager with Relative Value Partners, an advisory firm that invests in closed-end funds, agrees. "The ability for investors to pressure funds is beneficial to all shareholders," he says.

Closed-end funds have long been popular with investors due to their high yields and steady distributions. Many use leverage, borrowing money at market rates to boost payouts. They also generate income with options strategies and investments in high-yielding areas of the stock and bond markets.

But the funds have structural drawbacks. Expense ratios are steep, averaging 2.1%, according to Morningstar Direct. And since the funds have a fixed number of shares outstanding, prices reflect market demand for both a fund and its underlying assets. Funds usually trade at a discount to NAV. While it is attractive, in theory, to pay 90 cents for a dollar of assets, investors might never see the extra dime.

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Hedge funds aim to exploit this inefficiency, buying closed-end funds at below-market value. They then pressure fund boards to take steps to lift the funds' prices. The playbook is straightforward: accumulate a stake, win board seats, and then force a fund company into a tender offer, whereby it agrees to repurchase shares at nearly full price.

If that fails, a hedge fund might try to replace a fund's manager, orchestrate a liquidation of the fund, or get it converted to an open-end fund—moves that could also pay off with the share price rising to parity with the NAV. Firms like Saba have also taken over funds entirely.

Giving closed-end funds freedom to own more private securities could throw a wrench into the strategy. Tender offers work only if a fund can liquidate most of its holdings at market prices. Because venture-capital and private-equity holdings generally don't trade publicly, their pricing isn't transparent. "When closed-end funds invest in illiquid things, it protects them from activism," one activist manager tells *Barron's*.

Removing the cap on private-fund ownership is "in line with a legislative agenda of getting retail investors more access to private investments," says Thomas DeCapo, an attorney for the mutual fund industry.

And capping activists at 10% of a fund doesn't stop them from mounting proxy campaigns. "Nothing about this is antidemocratic," he says. "It doesn't stop a majority of investors who are unhappy or want change. It stops one investor from using its economic power, with other people's money, to basically force changes on everybody else."

Investor advocates see it differently, however, saying fund investors could wind up paying higher fees for funds that hold more-opaque investments. "It's just another fund-of-funds structure, and those are notoriously high-fee," says Tyler Gellasch, head of Healthy Markets, an investor-protection group.

Individual hedge funds technically can't own more than 3% of a closed-end fund, under ownership restrictions in the Investment Company Act of 1940. But they skirt the rule by building stakes through affiliated entities, creating enough of a critical mass to force changes at a fund through proxy voting.

The ICI—the mutual fund industry's lobby—has tried to persuade regulators to crack down on hedge funds. In a submission to the Securities and Exchange Commission last year, the ICI argued that hedge fund campaigns often consume a fund's resources, trigger tax liabilities for long-term investors, and result in the forced selling of securities to meet a hedge fund's demands for a tender offer. A fund's expense ratio could increase if it is forced to buy back shares and its asset base shrinks.

The activist community's "assault" on the industry has had a chilling effect on product launches, the ICI said, resulting in fewer closed-end funds on the market today than in 2007.

But hedge funds argue that changing the 1940 act would amount to a power grab by mutual funds. "This is all coming from the mutual fund industry, and it's no coincidence that this protects them," says Phil Goldstein, co-founder of Bulldog Investors, an activist that has long targeted closed-end funds. "There are funds with terrible performance and wide discounts. The ICI never says we need a mechanism where shareholders can hold those managers accountable."

Imposing an ownership cap would also make proxy campaigns less economic. Limited to 10%, hedge funds wouldn't own enough shares, with sufficient economic interest, to justify the expense of a proxy contest, which can cost millions of dollars. "If you're limited to 10% and have to spend 2.5% of your assets on a proxy campaign, you'd say it's too risky," says Goldstein. "Meanwhile, management isn't spending anything—just shareholder money. They want to make it economically unattractive to run a proxy contest."

Regulators and courts have expressed skepticism about some defenses that closed-end funds have adopted to prevent shareholder challenges. And, the SEC might not side with the fund industry. Since 2010, the SEC has warned fund companies against using state securities laws to thwart hedge fund takeovers. The SEC dropped its objection to these state "control share" laws last year under its Republican chairman, Jay Clayton. But the new, Democratic chairman, Gary Gensler, might reinstate the SEC's objection—a reason for the industry to enlist Congress to change the law. The SEC didn't respond to requests for comment.

Institutional Shareholder Services, a firm that makes recommendations on proxy voting, says investors should reject fund companies' use of state control-share laws, which limit the voting rights of shareholders. With the SEC on the sidelines, ISS says, "CEF shareholders are denied important voting rights and are subject to management entrenchment."

Opportunities in Closed-End Funds

Closed-End Funds With Activist Stakes

Fund / Ticker	Recent Price	Activist / Stake	Discount to NAV	Distribution Rate / Frequency
Templeton Global Income / GIM	$5.50	Saba Capital Management / 20.5%	3.0%	8.0% / monthly
Miller/Howard High Income Equity / HIE	10.00	Saba Capital Management / 15.2	5.9	5.7 / monthly
Source Capital / SOR	45.20	Saba Capital Management / 9.7	7.4	6.4 / monthly
Invesco Dynamic Credit Opportunities / VTA	11.70	Saba Capital Management / 13.7	4.6	7.7 / monthly
Tortoise Energy Independence / NDP	19.00	Bulldog Investors / 9.8	16.0	17.0 / quarterly

Funds With Fundamental Appeal

Fund / Ticker	Recent Price	YTD Change	Discount to NAV	Distribution Rate / Frequency
Adams Diversified Equity / ADX	$20.20	16.9%	14.4%	6.0% / quarterly
Sprott Focus Trust / FUND	8.10	20.0	9.7	5.8 / quarterly
Royce Global Value Trust / RGT	14.90	11.7	8.5	8.0 / annual

NAV=net asset value

Sources: FactSet, Morningstar

Hedge funds don't always win, but investors might want to ride along as activists build a stake. "When an activist comes in, you usually see an increase in the share price and a decrease in the discount," says Matt Souther, an associate finance professor at the University of South Carolina.

Templeton Global Income's (ticker: GIM) discount to NAV could narrow further if Saba acquires more shares or tries to take over the fund's $743 million in assets. Saba recently took over management of another fund, Voya Prime Rate Trust, which it rebranded Saba Capital Income & Opportunities (BRW). Franklin Templeton and Saba declined to comment. Miller/Howard High Income Equity (HIE) is also in Saba's crosshairs. The fund is a "term trust" with a mandated liquidation date in 2024. It trades at a 5.9% discount to NAV. "In a worst-case scenario, you buy it at a discount and you'll earn an excess return from now to

2024 because that discount will narrow," says Patrick Galley, co-manager of RiverNorth Opportunities (RIV), a closed-end fund that owns HIE.

Other closed-end funds in which Saba owns stakes include Source Capital (SOR) and Invesco Dynamic Credit Opportunities (VTA). Bulldog has built a position in Tortoise Energy Independence (NDP).

Some closed-end funds look attractive on their fundamentals. Adams Diversified Equity (ADX) offers exposure to big tech stocks, trades at a 14% discount to NAV, and is committed to an annualized distribution of at least 6%. "For investors who expect tech to do well, ADX is a good holding," says David Tepper, a closed-end investor and head of Tepper Capital Management in San Francisco.

Sprott Focus Trust (FUND) is another fund he likes. Veteran small-cap manager Whitney George runs it, and his family owns 45% of the shares. It trades at a 10% discount and yields 5.7%. Tepper also favors Royce Global Value Trust (RGT), trading at a 9% discount and yielding 7.9%.

None of these funds has attracted much activist involvement, according to securities filings. But if activists see opportunity, they could pile in and pressure fund management—assuming that Congress doesn't rewrite the rules of engagement.

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