Wall Street Managers Pile Into Closed-End Funds on Discounts (1)

- AQR, D.E. Shaw and Saba are among firms looking to profit
- Firms are betting on mean reversion or pursuing activism

By Vildana Hajric, Katie Greifeld and Yiqin Shen

(Bloomberg) -- Money managers ranging from Boaz Weinstein's Saba Capital Management to AQR Capital Management are pouncing on historic dislocations in a normally sleepy corner of the investment world.

The firms are buying what are known as closed-end funds, which invest in cash-generating assets like junk debt, muni bonds, or even stocks that pay dividends. They're typically pitched to retirees looking for regular income, but with bond yields jumping, many individual investors have seen the value of their holdings drop, and are looking to bail out.


Boaz Weinstein

Their mass departures are translating to bargain prices, which are drawing hedge funds. Closed-end funds are publicly listed, and their shares can trade at less than the value of the assets they hold. Those discounts are outsize now: municipal bond closed-end funds, for example, were trading at an average 13.6% below their assets at the end of October, the highest in at least a decade-and-a-half and well above a historical average of 4%, according to data from Matisse Capital.

"For a firm that eats, sleeps, and breathes discounted CEFs, this is the most compelling entry point we've seen in 15+ years," Matisse's Nik Torkelson, whose firm invests in and researches closed-end funds, wrote in a note.

The big discounts are drawing quantitative investors like AQR who bet the anomalies will disappear over time. Other hedge funds, like Saba Capital, are pursuing an activist strategy they've used for years, pressing fund managers to take steps like liquidating products to generate gains for investors.

The bargains exist across asset classes: for the average closed–end fund in the US, the discount stood at 8.94% at the end of October, and while these figures can swing around, they are often smaller. In October 2013, the average discount was 6.29%, and in October 2003, 1.73%, according to data compiled by David Cohne at Bloomberg Intelligence.

And many discounts are much bigger than the average: About $121 billion of closed–end funds are trading at 15% below their asset value or more, Saba's Weinstein said at a conference last month. In the US, closed–end funds manage about $250 billion, according to the Investment Company Institute, a trade organization for money managers.

Closed–end funds are designed to allow asset managers to sell shares in a fund and use the proceeds of these offerings to buy assets that rarely trade. The manager in theory never needs to pay back investors, allowing the firm to buy illiquid assets, like long–term muni bonds, without worrying about struggling to sell them off at a future date.

The higher interest on these bonds can translate to higher dividends for investors in the fund compared with more liquid assets. Many closed–end funds also borrow to boost their dividends even more.

Those who want to pull money out of the fund will sell shares to other investors. That's different from open–end mutual funds, the more common type of instrument, where an investor looking to exit redeems their shares with the fund manager, which gives them cash.

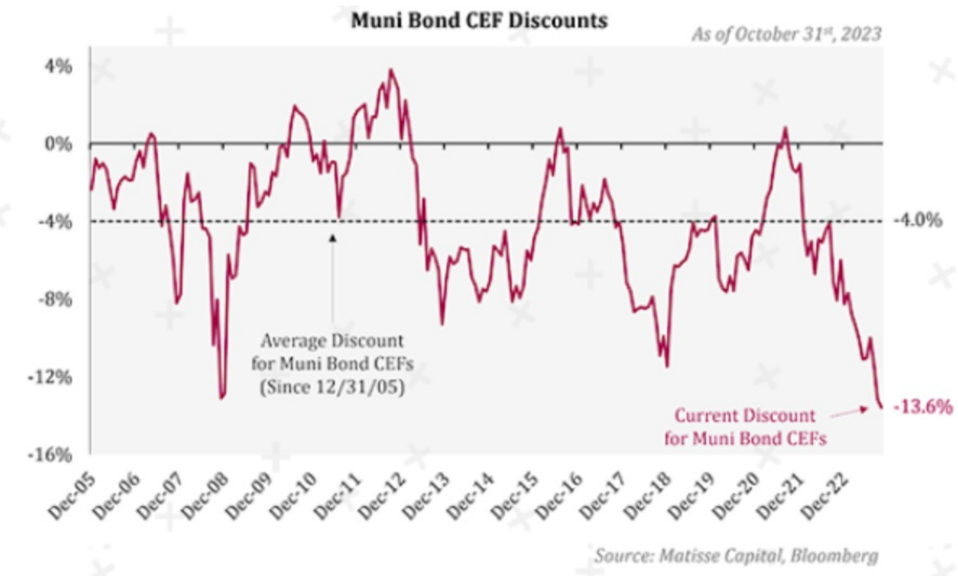
Large closed–end fund discounts are usually a sign of heavy selling from individual investors that are looking to get out fast. Closing the gap between the price of the shares and the value of the assets is part of what hedge fund managers are looking to profit from.

"There's a lot of opportunities," said Phillip Goldstein, co–founder of Bulldog Investors, which pursues activist strategies in closed–end funds. "Assuming that the discounts persist, I would expect activism to increase."

Activists often battle funds publicly. In March, Saba's Weinstein posted on X, the platform formerly known as Twitter, a recommendation that investors buy Canada's Citadel Income Fund. The fund, unrelated to Ken Griffin's Citadel, was trading at about a 30% discount to its asset value, which Weinstein ascribed to "awful performance." Its price fell around 32% last year, and even accounting for dividends, it had lost about 1.6% annually since its launch in 2005.

Saba negotiated with the fund, and in September, posted that the fund was offering a cash redemption for 70% of its units. This week, Citadel Income Fund said its unitholders approved a resolution to redeem another 7.19 million shares. Its discount has shrunk to about 8%, Bloomberg data show. A representative for the Citadel Income Fund didn't respond to email seeking comment.

Weinstein's firm runs a $130 million closed–end funds ETF (CEFS) that buys up vehicles trading at discounts to their net–asset values and hedges exposure to rising rates. It has gained about 9% this year through Thursday's close, including dividend payments.



Source: Matisse Capital

The potential gains have drawn the eye of some investors. The market value of positions held by AQR Arbitrage, the arbitrage affiliate of AQR Capital Management, jumped to over $190 million by the end of June from about $44 million a year earlier.

The firm has become much more active in the space because current discounts are compelling both compared to their historic levels and in absolute terms, according to Michael Schwert, managing director at AQR Arbitrage. The money manager is pursing "mean-reversion trades" which bet the dislocations will revert over the mid-to-long term, he said.

D.E. Shaw & Co. built positions in at least four closed-end funds in the second quarter, including in BlackRock Innovation and Growth Term Trust (BIGZ), BlackRock ESG Capital Allocation Term Trust (ECAT), BlackRock Capital Allocation Term Trust (BCAT) and Neuberger Berman Next Generation Connectivity Fund (NBXG), according to data compiled by Bloomberg.

D.E. Shaw declined to comment.

Meanwhile, the $34 billion Naperville, Illinois-based money manager Calamos Investments in September filed paperwork with the Securities and Exchange Commission for an actively managed closed-end-fund ETF that would also invest in CEFs "trading at attractive discounts."

Closed-end funds can trade at significant discounts for years. Activists looking to pressure the fund managers need to make sure they have enough clout, according to Goldstein.

"You've got to have a big enough position that they know that there is a threat if they ignore you, that you're not just going to go away," Goldstein said. "That's why we call ourselves Bulldog Investors – we're tenacious."

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(Updates to add 'Read more' section. An earlier version was corrected to remove a table describing CEF discounts as being the widest since 2003.)

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