The Other Discount Advantage

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When an investor considers investing in a closed-end fund (CEF) that is trading on the secondary market, one of the attributes of the CEF structure that is often appealing is the ability to purchase shares of a fund at a discount to its net asset value (NAV). Due to the fact that CEFs are equity instruments with shares traded publicly throughout the trading day on an exchange such as the New York Stock Exchange (NYSE), and an investor purchases shares of a CEF at a share price which is independent from the fund's underlying NAV, its share price can trade at a discount or premium to its NAV. Whereas a CEF's share price is traded throughout the day on an exchange, a CEF's NAV is only priced once a day after the market closes. Bear in mind, with open-end mutual funds, investors buy and sell shares at the fund's NAV which is also priced once a day after the market closes. The ability to buy shares of a CEF at a discount to its NAV can potentially enhance an investor's total return, should that share price begin to revert to the fund's underlying NAV, and therefore one of the unique characteristics of the CEF structure is the ability to invest in shares of a fund trading at a discount to its NAV.

While I am also drawn to the CEF structure because of the opportunity to sometimes buy CEFs at a share price which is below its NAV and therefore it is at a "discount to its NAV," particularly when a CEF can be purchased when it is trading at a wider than average historical discount to its NAV, there is another "discount advantage" that is often overlooked by CEF investors but I think is a big plus to the CEF structure. It is the **yield-enhancing opportunity that occurs when buying income-producing assets at a discounted price**. In other words, buying a CEF at a share price which is at a discount to its NAV enhances an investor's yield relative to if they purchased those assets at the fund's NAV. I think I can best illustrate this "yield-enhancing opportunity" with a specific example:

> If an investor purchases a CEF at a share price of $10.00 per share and that fund's NAV is also $10.00 per share the fund is trading at its NAV and not at a discount or premium. Now let's assume this fund pays a distribution of $1.00 per share annually. In this example, the investor's current distribution yield would be 10%. The $1.00 per share distribution divided by the purchase price of $10.00 per share equals 10%.

Now let me show an example of the yield-enhancing opportunity that occurs when buying a CEF at a discount to its NAV:

> If an investor purchases a CEF at a share price of $9.00 per share and that fund's NAV is $10.00 per share then the fund's share price is trading at a 10% discount to its NAV. The fund's NAV is still $10.00 per share and is able to generate the same $1.00 per share in annual distributions. However, because an investor purchases shares in this CEF at the $9.00 share price, their yield is 11.11% and not 10% as in the previous example. The $1.00 per share distribution divided by the purchase price of $9.00 per share equals 11.11%. As you can tell from this example, an investor has significantly enhanced their yield by purchasing this fund at a 10% discount to its NAV.

Currently, there are many CEFs trading at a discount to NAV in the mid-single to high-single digit level and therefore are compelling yield-enhancing opportunities available in the secondary market of CEFs in my opinion. In fact, one category of the CEF marketplace I continue to like is the domestic equity category. Not only does First Trust still maintain a bullish view on the U.S. equity markets, but as of 5/19/14 the average domestic equity CEF was at a 6.52% discount to its NAV, which is much wider than where it was one year ago when the average discount to NAV was only 2.61%, according to Morningstar. Furthermore, investors in domestic equity CEFs can potentially enhance their distribution yields by purchasing funds at these relatively wide discounts to NAV.

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