Closed-end mutual funds keeping their options open

By David Hoffman InvestmentNews - April 25, 2005

NEW YORK - The closed-end-fund industry continues to reinvent itself, keeping alive a small corner of the market frequently overlooked by investors. The latest evolution involves the development of closed-end funds that employ covered-call-option strategies.

"Those are income-producing strategies, most often done without leverage, that's a direct response to people's concerns over interest rates," said Alexander Reiss, an associate covering closed-end funds for Ryan Beck & Co. Inc. of Florham Park, N.J.

But the funds - designed for a sideways market - carry some risk. The most obvious is that if the stock market goes up, the fund is at risk of losing the stock if it rises above the strike price of the call, said Donald L. Cassidy, a Denver-based senior researcher with Lipper Inc. of New York.

That would result in poor performance for the fund, he said. Despite such risk, closed-end funds that use covered-call strategies have had very successful recent launches.

The February launch of the NFJ Dividend, Interest & Premium Strategy Fund by Newport Beach, Calif.-based Allianz Global Investors, a unit of Allianz AG of Munich, Germany, raised $2.5 billion, the largest initial public offering in the history of closed-end funds.

That fund uses a complicated options-trading strategy known as indexed covered calls.

Other recent launches of funds that use covered-call strategies include those of the ING Global Equity Dividend and Premium Opportunity funds, offered by ING Investments LLC of New York, which raised $1.7 billion in a March 29 IPO; and the Nuveen Equity Premium Opportunity Fund by Nuveen Investments LLC in Chicago, which raised more than $1.3 billion Jan. 27.

Those three were phenomenally successful launches for closed-end funds and accounted for nearly three-quarters of the total assets raised by such funds in the first quarter of this year, when 14 launches brought in $7.44 billion, according to Lipper Inc. in New York.

The first quarter of 2003 saw 17 funds come to market for a total of $12.39 billion, but none of the funds issued that quarter utilized a covered-call strategy.

The first closed-end fund to use the strategy was the Madison/Claymore Covered Call Fund, which raised $260 million on July 28, 2004. Madison Asset Management LLC, a subsidiary of Madison (Wis.) Investment Advisors Inc., is the fund's investment manager, and Claymore Advisors LLC, an affiliate of Claymore Securities Inc. of Lisle, Ill., is its investment adviser.

Other fund companies are planning to come out with more covered-call funds. For example, Eaton Vance Corp. of Boston, already a player in the niche, plans to launch another covered-call closed-end fund soon.

Closed-end-fund-industry experts, however, said they don't believe that covered-call funds will be able to help the industry - which currently totals about $215 billion in assets - to grow for much longer. The market can't move sideways forever, they said.

Some have suggested that if the market's next move is up, closed-end funds - which fairly or unfairly have become closely associated with income - could lose the momentum that has been building since 2002. That year saw 78 closed-end-fund IPOs come to market, totaling more than $16 billion in proceeds, according to Lipper. None of the four years before that saw more than 42 such launches or more than $7.5 billion in total proceeds.

Closed-end funds performed particularly badly in 2000, when only eight IPOs came to market, totaling $456.8 million in proceeds. That year, some industry observers predicted that closed-end funds might disappear.

Charles Lieberman, investment strategist and chief economist with Advisors Financial Center LLC in Paramus, N.J., suggested that the reason sales of such IPOs didn't take off until the market went south is the industry's belief that such investments have to be sold; people don't go looking for them.

It wasn't until investors started looking for income - and closed-end funds started to focus on income-producing strategies - that brokers saw a reason to sell closed-end IPOs, he said.

Douglas Ober, the Baltimore-based president of the Closed-End Fund Association Inc. of Kansas City, Mo., admitted that new issuance may slow down if interest rates rise, but he said he doesn't think such funds will ever disappear. As the last few years have demonstrated, it's a cyclical industry, he said.

"Closed-end funds have been written off probably 100 times, yet we have been able to thrive" said Mr. Ober, chairman and chief executive of two closed-end funds: Adams Express Co. and the Petroleum and Resources Corp., both in Baltimore.

Ryan Beck's Mr. Reiss added that closed-end-fund issuers have gotten more creative over the years. When the environment has been right, they have come out with funds that focus on such investments as preferred stocks and municipal bonds. He said he's confident that if it appears covered-call funds may fall out of favor, the industry will come up with something else that will appeal to investors.

Mr. Cassidy agreed that closed-end-fund issuers have become more creative over the years. That plays into one of their strengths, he said, because there are actions you can take with closed-end funds that you can't with open-end mutual funds or exchange traded funds.

Using a strategy that utilizes covered-call options is one example, Mr. Cassidy said. Such a strategy would be difficult to employ in a mutual fund, he said.

What the next strategy will be is anyone's guess, Mr. Cassidy said.