Sabino Investment Management, L.L.C.

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HOW TO IMPROVE FIXED INCOME RETURNS WITH CLOSED-END FUNDS©

Types of Investment Companies

There are two types of investment companies. Table 1 below summarizes the differences. Most people are familiar with the open-end fund, commonly referred to as a mutual fund. The number of shares of a mutual fund will increase or decrease, depending on whether the fund has net sales or redemptions. An investor who wishes to purchase shares will buy at a price equal to the net asset value (or NAV) if it is a no-load fund. Net asset value is the market value of the fund's portfolio divided by the number of shares in the fund. If it is a load fund, investors will buy at a price equal to the net asset value plus a sales charge which is often five percent of net asset value. When investors wish to redeem their shares, they notify the fund and receive the net asset value per share less any redemption fees.

Table 1: A Comparison of Open-end and Closed-end Funds

CHARACTERISTICS	OPEN-END	CLOSED-END
# of Shares Outstanding	Constantly Changing	Set at initial offering and remains fixed
Public Offering	Continuous	One time
Redemption by issuer?	Yes	No
Redemption Price	Net asset value (sometimes less a redemption fee)	Not redeemable by issuer
Where shares are bought and sold	From the investment company, underwriter, or dealer	On an exchange or over-the-counter
Relation of purchase price to net asset value	Purchase price = net asset value +sales charge (none if a no-load fund)	Set by supply and demand. Price may exceed net asset value (trading at a premium) or may be less than net asset value (trading at a discount)
Buying or selling costs	For load funds, there is a sales charge on the purchase. For no-load funds, there is no sales charge on the purchase. There may be redemption fees upon the sale.	For both purchases and sales, there is a commission on the trade.

Many investors are not familiar with closed-end funds although they offer a proven way to improve investment performance. Closed-end funds are issued through an initial public offering. The investors who purchase through the initial public offering will buy at an offering price that exceeds the net asset value. The difference is the underwriting discount, which goes to the securities firms that sell the fund. If an investor wishes to buy or sell shares of the fund after the public offering, they must do so by placing an order on an exchange such as the New York Stock Exchange. After the public offering, stock brokerage firms are less enthusiastic about selling closed-end funds because commissions are lower than underwriting discounts. Without anyone pushing them, the closed-end funds typically will drop in price and eventually trade at a discount to net asset value. While this may be bad news for the original investors, it creates an opportunity to outperform the market for those who purchase certain funds.

The Advantage

Fixed income returns can be improved with closed-end funds in two ways. If the fund is purchased at a large enough discount to net asset value, the yield of the fund will be higher than the yield on the underlying securities in the portfolio. Thus, the investor receives a higher yield without additional credit risk. Secondly, if closed-end funds are purchased when the probability is high that the discount to net asset value will decline, the investor may realize additional capital appreciation.

On October 22, 1999, the John Hancock Investors Fund (JHI) had a net asset value of $20.28 per share but sold at a price of $16.875. The price represented a discount to net asset value of 16.8%. Table 2 below illustrates the difference in yields between the individual bonds, a hypothetical mutual fund, and JHI. If an investor had purchased the individual bonds in the fund, the yield would have been 7.98%. If a mutual fund with the same bonds had been purchased and the operating expenses of the fund were the same as for the closed-end fund, the net income based upon net asset value would have been 7.16%. Because JHI was selling at a 16.8% discount to NAV, the price was 83.2% of NAV and the net income based upon the market price of JHI was 8.60%. Thus, the income yield of JHI was 62 basis points higher than the yield on the underlying bonds without any additional credit risk.

Table 2: Three Alternative Fixed Income Investments
Using John Hancock Investors Fund as an Example

	Individual Bonds	Open-End Fund	Closed-End Fund
Yield of Bonds	7.98%	7.98%	7.98%
Operating Expenses		0.82%	0.82%
Net Income Based Upon NAV		7.16%	7.16%
Discount to NAV			16.80%
Price as a % of NAV			83.20%
Net Income Based Upon Price			8.60%

The 1998 annual report for John Hancock Investors Fund showed that the average discount to NAV at the end of the prior five years was 4.4%. The highest discount to NAV at the end of any of the prior five years was 9.0%. At a discount of 16.8% to NAV, the probability was high that the discount would revert towards the mean. As of June 28, 2002, JHI sold at a discount to NAV of 6.2%. Thus, investors in JHI have received both a higher yield and additional capital appreciation that investors in the individual bonds and mutual funds were unable to attain.

Leverage

Some of the taxable and most of the tax-exempt closed-end bond funds utilize leverage to enhance returns. As of December 31, 2001, the Van Kampen Municipal Income Trust had net assets of $440.6 million. The capital of the fund consisted of $165 million from preferred shareholders and $275.6 million from common shareholders. The dividend rate paid to preferred shareholders is reset every 28 days through an auction process. Because the preferred dividend rate reflects short-term interest rates, the average rate in effect on December 31, 2001 was a low 1.41%. The fund is able to capture the yield spread between the short-term rates paid on preferred shares and the interest rates on municipal bonds with longer maturities.

Bond fund shareholders benefit from leverage when interest rates are stable or declining and the yield curve is steep (long-term rates are higher than short-term rates). If interest rates rise or the yield curve flattens, the return for common shareholders will be reduced. If the yield curve flattens to the point where there is no significant yield spread, bond funds are likely to reduce leverage by redeeming the preferred shares. Preferred shares are generally redeemable at par at the option of the funds.

Other Considerations

Closed-end funds, like mutual funds, offer smaller investors a means of obtaining adequate diversification in their investment portfolios while keeping transaction costs low. Typically, if an investor wishes to select individual stocks or bonds, he would have to invest a minimum of $100,000 to obtain an adequate level of diversification while keeping transactions costs reasonably low. This can be accomplished with less capital in a closed-end fund because of the diversification in the underlying securities in the fund's portfolio.

Last but not least, investors in closed-end funds benefit from professional management. The best investment managers often beat the market by only a few percentage points each year but when these marginal effects are compounded over several years, there can be a substantial difference in results.

References

Anderson, Seth Copeland, "Closed-end Funds Versus Market Efficiency." *Journal of Portfolio Management*, Fall, 1986.