Eaton Vance

Understanding Premiums and Discounts

Similar to open-end mutual funds and exchange-traded funds (ETFs), closed-end funds are professionally managed investment companies holding pools of underlying securities and other investments. Depending on its investment objective, a closed-end fund (and the other funds mentioned) may invest in stocks, debt obligations or currency instruments, among other types of investments.

Closed-end funds raise shareholder capital by selling shares in an initial public offering (IPO) and, thereafter, generally maintain a substantially fixed number of shares.[1] They are, in effect, normally "closed" to new investment. Mutual funds and ETFs, by contrast, are "open-end" vehicles that can issue and redeem shares on a daily basis in response to changing supply and demand. Closed-end funds and ETFs list their shares for trading on a stock exchange and rely principally on secondary market transactions to provide shareholder liquidity. Mutual funds are not traded on an exchange, but instead provide shareholder liquidity through the daily redemption of fund shares at prices based on current net asset value (NAV).

Closed-end fund premiums and discounts

Secondary market trading prices of closed-end funds frequently vary from current NAV. When a closed-end fund's market price is higher than its NAV, the fund is trading at a premium. When the market price is lower than NAV, the fund is trading at a discount. For example, if the market price is $11 and the NAV is $10, the fund trades at a 10% premium. If the market price is $9 and the NAV is $10, the fund trades at a 10% discount.

Unlike ETFs, closed-end funds do not incorporate a mechanism by which market makers and other market participants may earn arbitrage profits by entering into market transactions to buy fund shares trading at a discount (or sell fund shares trading at a premium) and redeem (purchase) an offsetting number of shares in transactions with the fund at prices based on NAV. Such arbitrage trading in closed-end funds is generally not available because established closed-end funds do not typically issue or redeem shares. In the absence of an arbitrage mechanism, secondary market trading prices of closed-end funds may deviate significantly from underlying value as the balance of supply and demand for fund shares fluctuates.

Beyond the balance of supply and demand, the factors influencing closed-end fund premiums and discounts can sometimes be difficult to identify. Many closed-end funds are commonly used as income vehicles and, therefore, tend to trade in part on the level of current distributions they provide. All else being equal, closed-end funds that pay higher levels of regular distributions tend to trade at greater premiums/lesser discounts to NAV than otherwise similar funds that pay out less in current distributions. Among funds with similar distribution levels, those whose future distributions are perceived to be relatively secure will normally tend to trade better than funds whose distributions are considered to be at risk of future reductions.

Other factors that can influence a closed-end fund's premiums or discounts may include:

- The clarity of the fund's investment strategy and future return expectations
- Investors' confidence in the underlying markets in which the fund invests
- Breadth of the fund's ownership and the liquidity of its secondary market trading
- Closed-end fund analyst recommendations to buy or sell the fund
- Whether the fund is actively purchasing shares in the secondary market pursuant to an authorized repurchase program
- Whether the fund is actively issuing new shares pursuant to a shelf registration program

[1] A closed-end fund may issue or redeem shares under certain limited circumstances, which may include: (1) when the fund is trading at a premium to NAV, issuing new shares to existing shareholders who elect to reinvest distributions and issuing new shares into the market using a shelf registration program and (2) when the fund is trading at a discount to NAV, purchasing shares in the secondary market pursuant to an authorized repurchase program.

Funds trading at discounts

Whenever a closed-end fund trades at a discount, investors have an opportunity to purchase an indirect interest in its underlying net assets at less than their current market value. For example, if a fund is trading at a 10% discount below NAV, investors can purchase a dollar's worth of underlying net assets for 90 cents. Investors may acquire a closed-end fund trading at a discount partly in the hope that the market price will move closer to, or even above, the fund's NAV. If the discount narrows over the holding period, the investor will realize returns that exceed what the fund earns on its investments over the same period.

For closed-end funds that pay distributions, a fund's distribution rate based on market price will exceed its distribution rate on NAV whenever the fund trades at a discount. Consider the example of a fund that has an NAV of $10.00 per share, a market price of $9.00 per share and distributes $0.50 per year.[2]

Fund NAV	$10.00
Fund Market Price	$9.00
Fund Distributions	$0.50 per year
Distribution rate at NAV ($0.50 divided by $10.00 = 5.00%)	5.00%
Distribution rate at Market Price ($0.50 divided by $9.00 = 5.55%)	5.55%

Although buying a closed-end fund at a discount may look tempting from both a return and distribution perspective, investors should understand that discounts may not narrow, and may widen, over their holding period in a fund.

Consult with a financial advisor

Working with a financial advisor can help investors assess a number of variables relevant to buying or selling a closed-end fund. For example, studying a fund's trading history can show the historical pattern of discounts or premiums, and how persistent any deviations from NAV have been. Other points of reference might include the fund's distribution rate and total return performance in relation to peers, the outlook for the overall market or a fund's particular market sector, and how well the fund aligns with an investor's overall investment objectives and current holdings.

[2] This example is hypothetical and for illustrative purposes only. It does not consider transaction costs (such as brokerage commissions) associated with reinvesting distributions via open market purchase. It is not representative of any actual closed-end fund product, nor does it represent actual results. Actual results will vary, perhaps to a significant degree.