Key takeaways:

• It’s important to distinguish the packaging from the contents when evaluating investment options. Closed-end funds (CEFs) represent a particular kind of packaging, but you will want to assess the contents when considering CEFs for client portfolios.

• CEFs are offered across a range of asset classes, including fixed-income, diversified, real estate, and niche equity strategies.

• Global investments, income-oriented offerings, and other specialized strategies dominate the CEF universe.

• Structural features of CEFs—especially the freedom from daily investor redemptions—allow for unique benefits, driving diversified sources of risk and return for investors.
Closed-end funds (CEFs) represent a niche category in the investment world. In terms of assets under management (AUM), the U.S. market for CEFs is about $250 billion in 2019, while U.S.-based open-ended mutual fund and exchange-traded fund (ETF) assets are well into the trillions.¹ Given their smaller footprint, many advisors and investors are unfamiliar with CEFs and how to use them in portfolios to effectively capture their distinctive benefits. In this discussion, we'll look at CEF options from an allocation standpoint.

**Suited for a satellite allocation**

When you're evaluating investment options, it's important to distinguish the packaging from the contents. *Closed-end fund* (CEF) is a distinction that applies to the packaging of an investment. It doesn't, on the surface, tell you anything about the contents—the asset class, the investment strategy, or other key characteristics like yield, risk profile, investment process, or how a particular CEF compares to its peers in the same category.

An assessment of CEFs for allocation purposes, therefore, starts by evaluating exactly these qualities and characteristics. To start, you'll find that CEFs are available in a range of asset classes:

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1 Sources: 

2 Closed-end funds are similar to mutual funds and exchange-traded funds (ETFs) in that they professionally manage portfolios of stocks, bonds or other investments. Unlike mutual funds and ETFs, which continuously sell newly issued shares and redeem outstanding shares, most closed-end funds offer a fixed number of shares in an initial public offering (IPO) that are then traded on an exchange. Open-end funds can be bought or sold at the end of each trading day at their net asset values (NAVs). Because closed-end funds and ETFs trade throughout the day on an exchange, the supply and demand for the shares determine their market price; closed-end funds' and ETFs' market prices may fluctuate through the trading day and those prices may be higher or lower than their NAVs. Closed-end funds, mutual funds and ETFs charge investors annual fees and expenses. All of these products may use leverage to enhance their returns, which can magnify a fund’s gains as well as its losses. Closed-end funds typically do not have sales-based share classes with different commission rates and annual fees. All three vehicles seek to deliver returns based on their investment objectives, but none of them are FDIC insured. The Revenue Act of 1936 established guidelines for the taxation of funds, while the Investment Company Act of 1940 governs their structure. Aberdeen Asset Management does not provide tax or legal advice; please consult your tax and/or legal advisor.
Fixed-income CEFs.
Options for fixed-income CEFs range from international or global bond strategies to domestic high-yield, bank loan, and other credit strategies, as well as some municipal bond funds. You’ll find that the options trend toward higher-income and specialized strategies.

Diversified equity CEFs.
CEF offerings in equities are most frequently centered on income-oriented and global strategies.

Real estate CEFs.
You’ll find a selection of specialized real estate CEFs, another income-oriented asset class, and find that many of the choices are global mixes.

Other niche and specialty CEFs.
Beyond these traditional asset-class offerings, the universe of CEFs includes other highly specialized investment choices such as single-sector or single-country funds.

Key words: specialized, income
As you become more familiar with the universe of CEFs, two things will stand out: the specialized niches and strategies of CEFs, and the dominance of income-focused approaches. CEFs, broadly speaking, are most suited toward satellite allocations—the investments in client portfolios meant to complement and diversify the core, traditional stock and bond holdings.

In fact, you’ll likely notice that those core investments are generally absent from the CEF space. Traditional large-cap core equity and diversified bond investments are rare in the CEF universe. Instead, you’ll find distinctive strategies best suited for diversifying the sources of risk and return in client portfolios.

As with any investing generalization, there are exceptions, and one exception to the satellite viewpoint may be retirees and other investors who have a higher need for income from their portfolios. Because of the range of income-oriented offerings among CEFs, you can find strategies suited for a core allocation for income-seeking investors.
Traditional large-cap core equity and diversified bond investments are rare in the CEF universe. Instead, you’ll find distinctive strategies best suited for diversifying the sources of risk and return in client portfolios.
The freedom from daily redemptions

We noted earlier that you need to distinguish between packaging and contents, but, actually, the two are related. Like open-end funds and ETFs, CEFs have certain structural characteristics that make them an optimal vehicle for particular strategies.

One of the key benefits of an open-end mutual fund is that the supply of shares can change every day to meet investor demand. Investors who want to purchase shares can send their funds directly to the mutual fund company, which then creates new shares; likewise, investors can redeem their shares directly from the fund. While this is a benefit for investors, and it keeps the market price of a mutual fund in line with the value of the underlying holdings, it also means that mutual funds must keep a supply of cash on hand to meet daily redemptions.

Now consider how being closed-end enables the reverse: CEFs do not have to meet daily redemptions from investors. That single feature—freedom from daily redemptions—opens up advantages that drive the particular benefits of CEFs:

**CEF can invest fully, avoiding cash drag.**

Unlike open-end funds, CEFs do not need to keep cash on hand to meet daily redemptions. In other words, they can fully invest assets, eliminating the effect of a cash drag in rising markets.

![Net cash as a percentage of assets](image-url)

Source: Morningstar. Net cash as a percentage calculated as of 3/31/19. For illustrative purposes only.
CEFs can capture a liquidity premium.
With a fixed set of shares, CEF portfolio managers have more latitude to invest in stocks or bonds that have less liquidity. Illiquidity is a proven source of higher returns, but only for investors who can tolerate the accompanying risk. If there's a chance you'll have to sell shares on demand, illiquid securities can have serious downsides. For instance, illiquid bonds may be hard to sell on short notice but come with a higher yield-to-maturity for investors who can buy and hold with certainty. 3

CEFs can use leverage without the threat of unwinding.
Freedom from daily redemptions also opens the door for CEFs to use leverage—typically a moderate amount—without having to face the short-term risk of having to “unwind” or exit the leveraged positions to meet investor redemptions. Like the liquidity premium, leverage comes with certain risks—it’s not a free source of extra returns—but the closed-end structure allows portfolio managers to manage that risk with more control. As a result, it’s common to find CEFs, especially those with fixed-income strategies, using some amount of leverage to amplify returns or yields.

Revisiting the CEF footprint by asset class and strategy
With these three benefits in mind, it may make more sense now why CEFs have a specialized footprint. The freedom from daily redemptions is a powerful tool that allows CEF portfolio managers to navigate very specific risks—liquidity and leverage in particular—and to be fully invested, avoiding the cash-drag effect that most mutual funds have to manage.

How CEFs compare to open-end and ETF peers
With these core differences in mind, let’s look at how CEFs compare to open-end and ETF peers in the same categories or asset classes:

Where CEFs differ
• Higher risk. On typical measures of risk, such as the standard deviation of returns or downside capture, CEFs tend to be on the higher end of the spectrum for their categories.
• Higher return. As they use their structural advantage to invest in securities with lower liquidity, or to use leverage in some cases, CEFs also tend to have higher average returns than category peers over long periods.
• Higher yields. The dominance of income strategies in CEFs is no coincidence; in broad terms, you’ll find higher average yields among CEFs than category peers, partly due to the use of moderate leverage.

How CEFs are similar
While they are different in some respects, CEFs also share key similarities with open-end funds and ETFs:

• Broadly diversified. Like traditional mutual funds and ETFs, most CEFs are broadly diversified pools of securities. As you evaluate the universe of options, you’ll find that CEFs are less likely to use concentrated positions. Instead, they diversify holdings where possible, looking to generate alpha through other kinds of active exposures.
• Similar tax treatment. CEFs, like open-end funds and ETFs, typically pass taxable gains and losses through to the end investor rather than paying taxes at the fund level. CEFs tend, more often than open-end funds or ETFs, to make returns of capital to investors along with the more typical dividends, interest payments, and capital gains. However, the overall tax treatment, from the investor’s perspective, is similar.

Putting CEFs to work for investors

On the surface, CEFs are distinctive because of the ways that their packaging differs from their open-end and ETF peers. However, once you have a better understanding of the benefits that are enabled by being closed—most notably, the benefit of not having to meet daily investor redemptions—you’ll be able to see differences in the makeup of CEFs.

Among the universe of CEFs, you’re most likely to find investment strategies in niche markets and less-liquid assets, with an emphasis on higher income levels. These attributes can be a benefit to most portfolios as they open the door to diversified sources of risk and return, especially when compared to the core traditional stock and bond holdings in most investors’ portfolios.

For many, CEFs represent a plethora of attractive satellite-allocation options. For those who are especially income-focused, such as retirees, certain CEFs could play a more central role in portfolio allocations. Ultimately, the nature of CEFs opens up to portfolio managers—and your investors—diversified sources of income, risk, and returns.

How to evaluate CEFs for client portfolios:

- **First, determine the asset class.** CEFs are generally grouped into the same Morningstar categories as open-end funds. If the category is not clear, look to the CEF’s stated benchmark.
- **Assess the return characteristics.** Compare the CEF’s historical returns and long-term alpha to its index, and compare it to peers in its asset class.
- **Evaluate risk characteristics.** Take note of the CEF’s historical return volatility and drawdown in bear markets. Determine the CEF’s use of leverage, if applicable, and the overall liquidity of its holdings.
- **Gauge the income level.** Look at the CEF’s historical and current yield, and compare it to peers.
- **Consider the diversification benefits.** Evaluate the CEF’s correlation to traditional stock and bond categories to get a sense of how it would complement other client portfolio holdings.
Important risk disclosure:

PAST PERFORMANCE DOES NOT GUARANTEE FUTURE RESULTS.

Closed-end funds are traded on the secondary market through one of the stock exchanges. The Fund's investment return and principal value will fluctuate so that an investor's shares may be worth more or less than the original cost. Shares of closed-end funds may trade above (a premium) or below (a discount) the net asset value (NAV) of the fund's portfolio. The Net Asset Value (NAV) is the value of an entity's assets less the value of its liabilities. The Market Price is the current price at which an asset can be bought or sold. There is no assurance that the Fund will achieve its investment objective. Past performance does not guarantee future results.

International investing entails special risk considerations, including currency fluctuations, lower liquidity, economic and political risks, and differences in accounting methods; these risks are generally heightened for emerging market investments. Concentrating investments in the Asia-Pacific region subjects the Fund to more volatility and greater risk of loss than geographically diverse funds.

Fixed income securities are subject to certain risks including, but not limited to: interest rate (changes in interest rates may cause a decline in the market value of an investment), credit (changes in the financial condition of the issuer, borrower, counterparty, or underlying collateral), prepayment (debt issuers may repay or refinance their loans or obligations earlier than anticipated), and extension (principal repayments may not occur as quickly as anticipated, causing the expected maturity of a security to increase).

Diversification does not ensure a profit or protect against a loss in a declining market.

Geographic exposures are subject to change.

The Fund's use of leverage exposes the Fund to additional risks, including the risk that the costs of leverage could exceed the income earned by the Fund on the proceeds of such leverage. Additionally, in the event of a general market decline in the value of the Fund's assets, the effect of that decline will be magnified in the Fund because of the additional assets purchased with the proceeds of the leverage.

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