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Interview With Thomas J. Herzfeld
Founder, Thomas J. Herzfeld & Co.

At the Center of the Closed-End Fund Universe

by Lawrence C. Strauss

AFTER A BRIEF STAY IN HIS FAMILY'S TEXtile business, Thomas J. Herzfeld discovered his true calling in the late 1960s at an unlikely venue: a New York brokerage firm's training program. A session on closed-end funds fascinated him because "they offered investors the opportunity to buy assets at a discount." Now 62, Herzfeld has been pursuing that opportunity for 40 years, becoming one of the nation's foremost experts on the subject. The author of several books, including *Encyclopedia of Closed-End Funds*, now advises institutional and retail clients on his favorite topic.

Unlike open-end mutual funds, closed-ends have a fixed number of shares that trade on an exchange. The share prices typically trade at a discount or a premium to their underlying net asset value, depending on investor sentiment about their assets. In contrast, investors in an open-end fund buy and redeem shares directly from the fund. That can force the portfolio manager to sell some holdings to raise cash for redemptions or to buy more if new money flows in. Closed-end managers needn't worry about any of that. In all, closed-end funds oversee $312 billion, compared with $11.4 trillion in mutual funds and $485 billion in a new rival: exchange-traded funds.

Based in Miami, Herzfeld founded Thomas J. Herzfeld & Co., a brokerage specializing in closed-ends, in 1981, and launched a similarly focused money-management arm, Thomas J. Herzfeld Advisors, in 1984. The firm oversees about $100 million in assets. The Managed Portfolio I, a separate-account program created by the advisory firm in 1987, invests in bond and stock closed-

Brian Smith for Barron's

"The way closed-end funds now make payouts is very complicated and could have investors running into trouble." Thomas J. Herzfeld

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"My interest in Cuba stems from being in Florida for three decades and being immersed in Cuban-American culture. Many of our friends, clients, neighbors, and school buddies of my children are Cuban-Americans, and they have shared with me their experience."

end funds. It has a cumulative total return since inception of 509%, net of fees, versus nearly 400% for the S&P 500.

Herzfeld also runs the novel **Herzfeld Caribbean Basin Fund** (ticker: CUBA), which invests in companies with direct and indirect ties to Cuba and has gained more attention in the past year as Fidel Castro's health has deteriorated.

For more about Herzfeld's start, his views on pricing and activists, as well as other topics—including some closed-ends he likes and some he doesn't—read on.

Barron's: **We're told that as a kid in school, you weren't at the top of the class.**

Herzfeld: I was probably near the bottom, barely graduated from high school and only was admitted to college thanks to some favors [owed] to my father.

And then you studied to be a textile engineer?

Yes, the school I attended, the Philadelphia College of Textiles & Science, now Philadelphia University, was primarily known for its textile engineering and chemistry programs. They did, however, offer a few business courses, which I managed to take.

Anyone have a big influence on you?

There was Bob Parry, a Ph.D. candidate at the University of Pennsylvania who was teaching courses in money, banking and economics. He later became president of the Federal Reserve Bank in San Francisco. He had quite a large influence on me.

What did you do after college?

I went into the family textile business, but that didn't last long. Then I went off to Wall Street as a trainee with Reynolds & Co., a brokerage firm, and I applied to business schools. I started at the Bernard Baruch School at City College of New York and then my Army reserve unit was called up briefly, so I never continued.

When did you get the bug for closed-end funds?

Reynolds had a very formal training program where they brought in professors and experts, including lectures on open-end and closed-end funds. I found it fascinating that closed-end funds offered investors the opportunity to buy assets at a discount, and I was captivated by that right from the beginning.

In those days, relative to the open-end fund business, closed-ends were small, right?

Yes, you could almost keep track of them in your head. There were 60 funds with $8 billion in assets, and I probably became the leading expert on the subject for no other reason than I was the only one interested in it. I used to give lectures to get accounts.

Let's talk about the history of closed-end funds, which in the U.S. date to the 1920s.

That's right in the U.S., but they really date to the late 19th century. There were closed-end funds formed in England and Scotland to invest in the New World, both the U.S. and South America.

What about in the United States?

Closed-end funds proliferated in the 1920s, especially in 1929 just before the Crash. They were leveraged, and they were able to buy shares in each other. There were people who were using one fund's assets to take control of another fund. After the Crash, most of them went bankrupt. In the recovery years and to this date, closed-end funds were never able to attain attention and size, relative to the mutual-fund industry.

Why?

Well, mutual funds advertise, and closed-end funds basically do not.

Are they are restricted from advertising?

No, it is just a matter of who is going to pay for it. Whose money would they spend to advertise a closed-end fund? But with open-end mutual funds, the managers are allowed to spend shareholders' money to advertise and grow the funds.

Are exchange-traded funds a threat?

It depends on how you define a threat. In terms of the discounts to net asset value, many thought that the ETFs could cause the discounts in closed-end funds to widen. I would say it is more common now to find closed-end-fund discounts narrowing because of the introduction of similar ETFs.

What do you attribute that to?

Activists and takeover traders now can buy closed-end funds at deep discounts and hedge their market risk by selling short ETFs, which actually helps the valuations of closed-end funds. In terms of competing with them for new money, we are seeing both closed-end funds and ETFs created. And closed-end funds have certain advantages over exchange-traded funds.

Such as?

Investing in thinner markets, less liquid markets or foreign markets. Also, they can use leverage and they are continually managed, whereas ETFs aren't managed actively, although this is changing.

There's been a lot of issuance recently in the closed-end market. What kind of impact has that had?

It is quite a business for the underwriters and the advisers. It is a very profitable underwriting business. As new funds are created, advisers are getting more and more captive assets, which create advisory fees. So it is a very good business for those people who bring them to market and manage them. From the investor's point of view, many of the new closed-end funds are similar to existing funds. Before investors jump into a new issue, they should see if there is something the same or similar that is trading at a discount to net asset value.

Let's talk about your interest in Cuba and the closed-end you run, the Herzfeld Caribbean Basin Fund, as a way to invest in that country.

My interest in Cuba stems from being in Florida for three decades and being immersed in the Cuban-American culture. Many of our friends, clients, neighbors, and school buddies of my children are Cuban-Americans, and they have shared with me their experience. We understand Cuba and the future of free Cuba; it seemed like an excellent idea to form the first fund.

How big is that fund now?

About $16.5 million. The market value is higher because it is trading at a premium.

How many holdings does it have?

About 75. We are broadly diversified but we have really a two-pronged investment strategy. When we formed the fund, we realized that it would be impossible to predict when the embargo with Cuba would be lifted. It is still unpredictable even 14 years later. So we sought to identify companies with operations in the Caribbean that we believed would do well, even if there were no change with U.S. trade with Cuba. We also sought companies that we believe would get significant increases in business once the embargo was lifted. That was the first phase and we are still in that phase now. [Holdings include **Trailer Bridge** (TRBR) of Jacksonville, Fla., with operations in the U.S., Puerto Rico and the Dominican Republic, and **Cuban Electric** (CGAR.PK), an American company that Castro confiscated.] Once the embargo is lifted, then we will change the strategy to seek direct investments in Cuba.

For those investors interested in closed-end funds, what's your advice?

We analyze 20 to 30 variables when we are making our investment decisions. But to begin, it is discount, discount, discount. We like to buy a closed-end fund that is trading at a wider-than-average discount to its own range—and also a wider-than-average discount to its peers. And then we look at the other 20 or 30 variables, including performance, income ratio, anti-takeover provisions, windup provisions, lifeboat provisions, liquidity of the portfolio and liquidity of the fund shares. We also consider the attitude of the fund's management concerning the fund's discount, the track record of the management handling the discount and payout policies. Are they invested in in-favor or out-of-favor issues? The most controversial area of the closed-end business currently relates to distributions.

Could you elaborate?

The entire way that closed-end funds are now making payouts is very complicated and very controversial and probably could have investors running into trouble if they don't understand the payout process and composition of the payout.

How about an example?

Managed payouts prescribe a fixed monthly or quarterly distribution rate or specify that distributions be based on a formula, such as a particular percentage of NAV, perhaps 8% or 10%. Before such high-payout policies were introduced, the way most closed-end funds made their payouts was to take the net income per share and distribute that in the form of a quarterly dividend or monthly dividend. For tax reasons, the funds also distributed to shareholders the realized long- and short-term capital gains, usually once a year. Now, that was confusing in itself, because for a typical equity fund, the net income per share is often only 1% or 2% or 3%. So if closed-end funds were just to pay out the net income per share, the investors would be getting a 2% to 3% yield in many cases.

Herzfeld's Picks...

Fund/Ticker	Recent Price	Discount To NAV
Central Securities/CET	$29.05	−12.05%
Castle Convertible/CVF	26.20	−9.34
Claymore Raymond James SB-1 Equity/RYJ	20.10	−10.59
Adams Express/ADX	15.03	−13.17
Templeton Dragon/TDF	26.83	−15.34
Western Asset Emerg Mkts Debt/ESD	17.68	−13.29
Western Asset Emerg Mkts Inc II/EDF	13.20	−9.28
LMP Capital and Inc Fund/SCD	20.59	−10.75

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Fund/Ticker	Recent Price	Discount To NAV
Tri-Continental/TY	$26.23	−5.72%
Eaton Vance Mgd Divers Eq Income/ETY	19.80	−2.08

Sources: ETFConnect.com; Herzfeld Advisors

How do you define a closed-end fund's net income?

It is basically the interest and dividends the fund receives, minus the expenses to run the fund. Many of the data companies publish closed-end yields that include the capital-gains distributions, along with the dividends from net income per share. That is very misleading, because people would get, say, a distribution of which 2% or 3% was from net income. But up to 7% may be from capital gains or other sources, and they may think they're getting a 10% yield. The SEC and the funds have made significant efforts to clarify the composition of the distribution. But still, many investors confuse distributions with yield. Further complicating the matter is that some funds also supplement their payouts with return of capital.

So what should investors be looking at?

Investors should read the disclosures accompanying their distributions very carefully. In some cases where the fund does not have enough net investment income and capital gains to make the prescribed payout, the fund may pay a return of capital. To the extent that the funds are paying out an amount in excess of their net income per share and/or capital gains, they are basically giving back shareholders their own money.

A fund dipping into its own capital?

That's right; shareholders are getting their own money back. In other words, an investor may look at his brokerage statement or the yield on a quote machine or the yield in a newspaper and think he's getting 10%. But the real yield might be 2% or even less. Further complicating the matter is that many closed-end funds don't have an accurate breakdown of the source of the distribution until the year is over.

We've seen more dissident activity in closed-ends. What's your take on that?

If you can buy a closed-end fund at a discount and force the management to convert it to an open-end fund or liquidate it, you would instantly make a windfall profit.

Because it would convert at the fund's net asset value, right?

Yes. That strategy was adopted by many people who do takeovers, and there is an increasing number of takeovers and activists and raiders in the closed-end-fund world these days. Most of them are formed as hedge funds.

Is that good, bad or in between?

It keeps the management of the closed-end funds very responsive to the shareholder valuation. We ourselves wouldn't take over a closed-end fund that we thought was well-managed just for the sake of liquidating it, nor would we support anyone else doing that.

We tend to support activists if they are trying to increase a fund's valuation. But the advantages of closed-end funds are that, although they may trade at discounts, there is nothing to prevent them from trading at premiums. Quite a number of closed-ends do trade at premiums these days. So if there could be measures put in place that would create an environment for the shares to trade at a premium, that's even better than liquidation or converting to an open-end fund.

What are some closed-end funds you like?

I am buying some of the funds that don't have high-payout policies, because they are basically undervalued relative to the ones that have high-payout policies.

How about a few names?

Some of the older funds, including **Central Securities** [CET]. We own one of the convertible-bond funds, **Castle Convertible** [CVF]. That was one of the first funds I ever bought. Castle has been trading at a persistent discount for a very long time, and the management really is long overdue to take some type of measure to narrow it. We also own **Claymore/Raymond James SB-1 Equity** [RYJ], which is interesting because it has a provision that if it trades at over a 10% discount starting at the end of this year for 75 consecutive trading days, it converts to an open-end fund.

So these funds that you mentioned don't have high-payout policies, relative to some other funds?

That is true for all three. The Raymond James fund doesn't have a high-payout policy. It's at about a 10% discount to net asset value. If it starts trading at wider than a 10% discount continuously later this year, it's going to convert to an open-end fund. But that discount may well narrow. **Adams Express** [ADX] is another older fund that doesn't have a high-payout policy.

What about some other themes?

We're looking at some foreign equity funds. The discounts have widened on a few of them. We recently bought some **Templeton Dragon** Fund [TDF], which is at about a 15% discount to its NAV.

What are you steering clear of?

I am taking profits in funds that adopted high-payout policies. One of the risks is that if they don't earn the high payouts over an extended period, the assets will erode. Furthermore, I don't see any upside in the premium at this juncture, and they are vulnerable. As more and more funds adopt high-payout policies, there will be nothing special about funds paying out 8%-10%. The SEC has just instituted some policies requiring much stricter disclosure about how to present the yield. So once investors become more educated, share prices of the funds with high-payout policies will give ground and the money that comes out of those will go into the deeply discounted funds that don't have high-payout policies.

What have you taken profits on?

We sold **Tri-Continental** [TY], which was our largest position. We did quite well with that one. They've just instituted a new payout policy. We also took profits on **Neuberger Berman Realty Income** [NRI], **Neuberger Berman Real Estate Income** [NRL] and **Neuberger Berman Real Estate Securities Income** [NRO]. NRI and NRO both recently announced 9% payout policies.

What about bond funds?

With bond funds, it's almost always about discounts. We bought a number of the funds involved in the Legg Mason takeover of Citigroup's asset-management unit a few years ago. They were at very wide discounts and we loaded up, partly because we thought Legg Mason would do something meaningful about the discounts. We still own one or two, which are at wide discounts. Our holdings include **Western Asset Emerging Markets Debt** Fund [ESD], **Western Asset Emerging Markets Income Fund II** [EDF], and **LMP Capital and Income** [SCD].

Any short positions you can talk about?

One is **Eaton Vance Tax Managed Diversified Equity Income** [ETY], which did an IPO last fall.

It was the largest IPO ever for a closed-end fund. Why short it?

I sold short a number of these new issues. There are so many similar funds around that often are better values. It's not a bad hedge to be long some of the similar funds at wide discounts and short the new issues. I'm not picking on them. I have nothing against the management. It's just that the numbers work that way.

Thanks very much, Tom. ■