Closed-End Funds and Activist Investors: What's the Attraction?

By

Douglas E. Ott, II

Bio: B.A. History and English Literature (2004), Washington University in St. Louis; J.D. Candidate (2009), Mercer University

Email: douglasott@gmail.com

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I. Introduction

This paper offers a basic description of why activist investors are attracted to closed-end funds and how this affects the rights of the closed-end fund shareholders. Part II provides a general description of the closed-end fund structure and a review of the research that attempts to answer why most closed-end funds trade at discounts to their net asset value (NAV). Part III outlines the reasons closed-end funds are attractive opportunities for activist investors. Part III also provides a detailed account of three proxy contests that occurred between activist investors and incumbent directors of closed-end funds: (1) the activists failed in their contest and there were no positive effects for shareholders as a result of their efforts; (2) the activists failed in their contest and there were positive effects for shareholders as a result of their efforts; and (3) the activists were successful in their contest and were able to enact measures that benefited shareholders. These real-life examples illustrate the motivations of the activists (e.g., return on and of their investments, concern for shareholders' rights) and also the problems that seem inimical to closed-end funds (e.g., unitary boards, conflicts of interest, fund shares that trade at large discounts to NAV). Part IV argues that, contrary to the feelings of the managers and directors of closed end funds, activist investors can be a desirable element for all investors in the targeted closed-end funds as they may be able elect directors that are more independent and are often able to decrease the discount to NAV just with an announcement of a proxy contest.

II. Background

A. What Are Closed-End Funds?

A closed-end fund is similar to a mutual fund in that it has an asset manager or asset management firm that manages a portfolio of assets according to the fund's investment objectives and policies. [1] The similarities end there. Unlike an open-end fund, the closed-end fund is organized as a public company whose shares trade on a stock exchange. The closed-end fund has a fixed number of shares available for direct purchase only at the initial public offering. Furthermore, a closed-end investor can only redeem shares by selling them in the market. In contrast, open-end funds are described as such because they allow new investors into the fund on a continual basis and allow shares to be redeemed at NAV.

After the initial public offering for a closed-end fund, investors may purchase shares only from an existing shareholder. Because investors can only purchase or sell shares of the closed-end fund to other investors, the NAV of the fund is usually not accurately reflected in the share price. In fact, the market price of shares of closed-end funds can and often do trade below NAV, which means such funds trade at a discount. If the market price of a closed-end fund happens to be greater than NAV, it trades at a premium. Open-end funds do not suffer the problem shares trading at discounts because their investors can always purchase or redeem shares at whatever the current NAV is.

According to a report from Merrill Lynch published in March 2007, 71% of closed-end funds traded at discounts, with the average discount being about 5.8%.[2] The fact that most closed-end funds trade at substantial discounts has puzzled researchers and analysts.[3] "The fact that two identical assets could trade at different prices contemporaneously goes against the no-arbitrage assumption and Efficient Market Hypothesis."[4]

B. Why Do Closed-End Funds Trade at a Discount?

"Like casinos and snake oil, closed-end funds are a device by which smart entrepreneurs take advantage of a less sophisticated public."[5]

Evidence shows that new issues of closed-end funds generally begin trading at a premium and usually trade at a discount after a few months. The reason closed-end funds begin trading at a premium is because of the commission the firm underwriting the new fund receives. The premium generally persists for two or three months while the price is supported by the underwriting firm. After the underwriting firm has fulfilled its role, the premium usually turns into a discount, which is why it is so difficult to provide a rational explanation for why an investor would invest in a closed-end fund initial offering when there is the near certainty of share-price underperformance.[6]

Additionally, there is no clear reason why most closed-end funds continue to trade at a discount. Some say that high management fees and other expenses are the culprits for a discount.[7] For example, Gemmill and Thomas have found that higher management expenses are directly linked with lower fund returns.[8] Gemmill and Thomas have also found that the larger the board of directors and the smaller the representation of outside directors, the higher the management expenses of the fund.[9]

Related to high management fees is the common phenomenon of closed-end fund families and complexes using unitary boards, a board structure in which the same group of directors serve on multiple or all the boards of the funds managed by the same investment manager. The Investment Company Institute has argued the unitary board is a more efficient arrangement, but a high level of dependence upon management by directors can lead to approval of higher than necessary management expenses.[10] Gemmill and Thomas reason that large boards which do not have external connections allow managers to charge higher expense ratios.[11] Nevertheless, boards can control expenses by re-negotiating the management contract on a regular basis, but this is a difficult proposition for funds with unitary boards as this would be akin to biting the hand that feeds them.

Further explanations for persistent discounts are unrealized appreciation in assets, illiquid securities in the portfolio, taxes, portfolio turnover, and poor fund performance.[12] Also, because closed-end funds trade like stocks, almost all the factors that influence stock markets can influence whether closed-end funds trade at a discount or premium: investor sentiment, political occurrences, currency issues, and simple supply and demand.

III. Attracting Activist Investors

Regardless of the reasons why a closed-end might trade at a discount, there are a few activist investors who are attracted to these funds. Phil Goldstein of Bulldog Investors and Arthur Lipson of Western Investment are perhaps two of the largest activists in this niche area of investing. Benchmark Plus and Karpus Management are two other managers that pursue similar investment strategies.

Managers at Bulldog Investors and Western Investment are attracted to closed-end funds because of the ability to make "very attractive risk-adjusted returns" by identifying funds trading at a discount and then working to close or narrow the gaps between intrinsic values and market prices.[13] First, activist investors typically want to see a discount to NAV in the double-digits. However, Phil Goldstein of Bulldog Investors has stated that he will accept a lower discount if the probability of a liquidity event – an event that will decrease or eliminate the gap between NAV and share price – has increased.[14] Second, the activist will look at the shareholder base. Goldstein has said, "[T]he more institutional the better, because they're more likely to be purely economically driven and less likely to blindly support management."[15]

Third, such activists will then focus on the directors and management of the closed-end fund to try to predict how receptive or resistant they will be to calls to reduce the discount to NAV. For example, Western Investment has invested in several closed-end funds that have unitary boards where the same directors serve on other boards for the same investment manager. When embarking upon a proxy fight, Western Investment often uses this fact to show that the directors and management do not have shareholders' interests at heart. No doubt the activists are mindful of the fact that research suggests that unitary boards result in increased expenses, which leads to the natural conclusion that a more independent slate of directors will help to decrease the discount at which the target fund's shares trade.

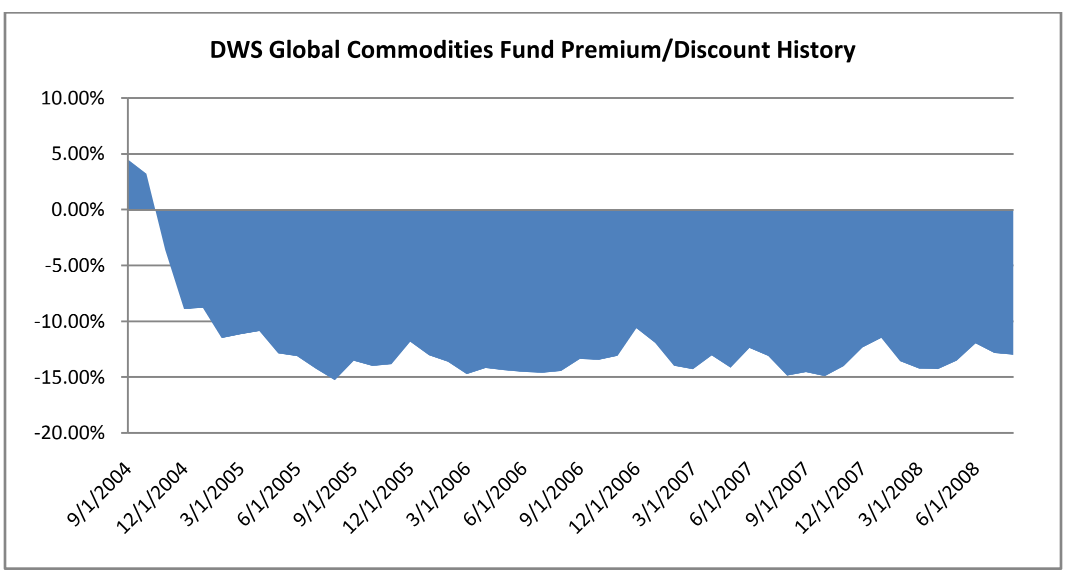
Fourth, once activists have identified and established a beneficial ownership of 5% in a closed-end fund, they will send out press releases, send letters to the board, and send letters to shareholders. The communications will describe the large discount to NAV and the proposals of the activists to correct the discount. The most common proposals to correct the discount are: periodic tender offers, share repurchases, increasing fund distributions, open-ending the fund, or, most drastically, liquidation of the fund.

A. DWS Global Commodities Stock Fund ("GCS") Proxy Contest

1. The Activists' Argument

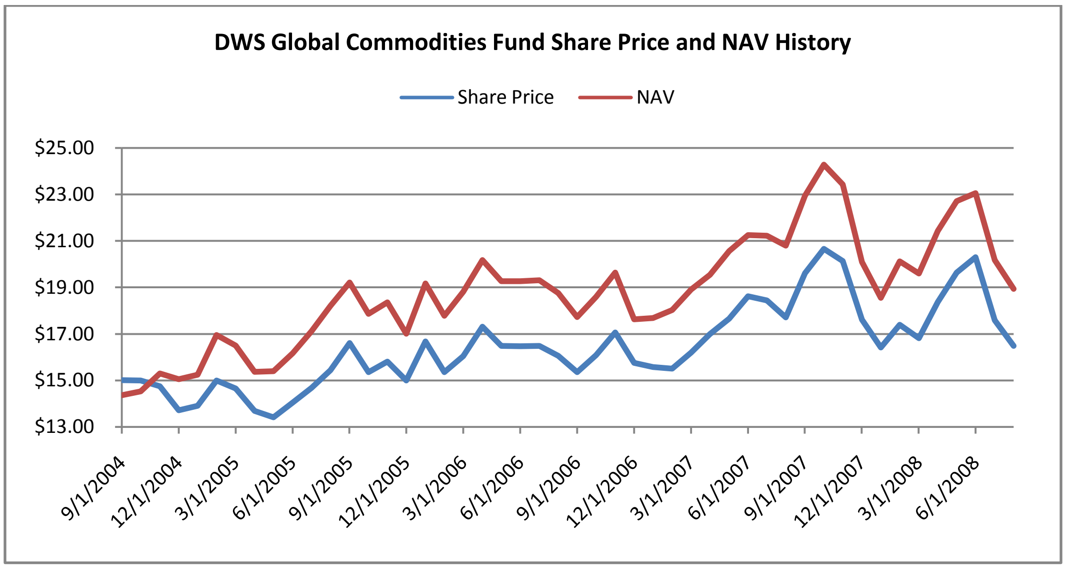
In 2008, Western Investment and Benchmark teamed up to address the problem of GCS shares trading at a persistent discount to NAV. Between January 1, 2005 and June 30, 2008, the discount averaged 13.3%, and was as great as 16.6% in August 2007. This discount even persisted despite six previous tender offers by GCS to purchase back shares that were all oversubscribed and despite the fact of very strong NAV performance. Figure 1 illustrates GCS's historically problematic discount to NAV.

FIGURE 1



Though Western Investment acknowledged that though GCS performed well, when accounting for the discount to NAV, GCS performance lagged behind its benchmark index. Since inception, GCS's annualized return was 16.53% compared to a return of 20.95% for the benchmark.[16] This is an underperformance of 442 basis points. Figure 2 illustrates the underperformance of GCS share prices compared to the NAV of GCS.

FIGURE 2



In regards to the tender offers, Western Investment noted in its September 2008 proposal that stockholders tendered over 62.55% of outstanding shares in response to GCS's most recent tender offer.[17] Despite this large response, GCS only accepted 5% of tendered shares for payment.[18] Western Investment viewed this as evidence that stockholders wanted to sell their shares at 98% of NAV and that stockholders also agreed with Western Investment regarding the need for action to correct GCS's discount to NAV. However, the Board only authorized management to make open market purchases of up to 20% of GCS's outstanding shares, an amount that was less than one-third of the shares tendered in July 2008. Western Investment said this response was "wholly inadequate"[19] and also suggested that such a tepid response was because the incumbent directors were too beholden to GCS's investment manager, Deutsche Investment Management.

Western Investment noted that each GCS director was a director of 133 other funds in the DWS fund complex and was skeptical that a director could be truly independent while serving on the boards of so many other funds for the same investment manager.[20] Members of the GCS board collected on average over $200,000 in aggregate annual fees for their services on the 133 other DWS boards. Additionally, Deutsche Investment Management Americas Inc. received over $2 million in fees from for its service as the GCS's investment manager.[21] Because of these facts, Western Investment felt that the directors were too beholden to the investment manager so that they would not take any action that might benefit stockholders if it would negatively affect the fees collected by GCS's investment manager. Western Investment asked rhetorically, "[I]n light of the fees collected by members of the Board and Deutsche Investment Management, what incentive does this Board have to make decisions that would reduce assets under management?"[22]

Another factor that suggested that the interests of the directors were not aligned with those of the stockholders was the lack of ownership of shares by the directors. Of the thirteen GCS directors, only six owned shares of GCS, which represented less than 1% of the outstanding shares.[23] In contrast, Western Investment owned 11.29% of outstanding shares, which is strong evidence that Western Investment's interests were better aligned with other stockholders.

Thus, with a severe discount to NAV, fund performance lagging its chosen benchmark, and a management that seemed more beholden to the interests of the investment manager rather to the stockholders, Western Investment embarked upon its proxy fight to elect its own slate of "independent directors who are willing to listen to shareholders and take decisive action even if that action may run counter to the interest of GCS's investment manager."[24]

2. GCS Directors' Response

In response to Western Investment's proxy solicitations, GCS attempted to convince its shareholders that Western Investment's actions were "an attempt by a group of hedge funds to take control of your long-term investment for their short-term gain."[25] Furthermore, GCS stated that Western Investments proposals were merely "designed to result in a quick trading profit, [and] would involve significant expense and disruption of the Fund's investment program."[26]

Responding to Western Investment's specific proposals on how to fix the extreme discount, GCS first claimed excellent performance, notwithstanding the discount. GCS wrote to shareholders, "Since inception, the Fund has outperformed its peer group on both a NAV total return basis and on a market total return basis through August 31, 2008."[27] Since inception (Sept. '04), GCS delivered a total NAV return of 106.55% while the total market return has been 80.22%.[28] However, this excellent performance is only possible by ignoring the negative effects of the discount to NAV.

Second, GCS wrote that the closed-end structure had helped contribute to its returns because it allowed GCS to remain fully invested in the markets and to respond more quickly to market conditions without having to worry about the redemptions an open-end fund might encounter.[29] Third, GCS addressed Western Investment's suggestions of turning GCS into an exchange-traded fund (ETF) or exchange-traded note (ETN), open-ending GCS, or liquidating the fund. GCS argued that any of these actions would be complex, lengthy, and involve significant costs that would be borne by GCS.[30]

Fourth, GCS claimed that Western Investment's and Lipson's interests were not aligned with GCS shareholders. GCS called attention to Lipson's statement in an SEC filing where he says he had hedged out the commodity exposure and is just "playing the discount to narrow."[31] Fifth, GCS argued that if Western Investment's nominees were elected to the Board, they would have conflicting loyalties because they would owe allegiance to GCS and also to the Western Investment funds.[32]

This fifth and last concern of GCS regarding the conflicting loyalties of Western Investment's nominees is unfounded. It is true that two of the five directors Western Investment nominated held positions in Western Investment,[33] but this does not necessarily mean there would be conflicting loyalties. In fact, by virtue of their very substantial investments in GCS, it is arguable that the interests of the two Western Investment nominees were more aligned with the other GCS shareholders than the incumbent directors who had little to no personal money invested in GCS. Additionally, all five of the Western Investment nominees did not sit on any of the other 133 boards in the DWS fund complex like the incumbent GCS directors.

3. Outcome of the GCS Proxy Fight as of February 2008

Despite concerted efforts to convince GCS shareholders to vote for Western Investment's slate of directors on October 13, 2008, none of the nominees received a sufficient number of votes to be elected as director. Thus, the GCS board announced that "in accordance with Maryland law and the Fund's bylaws, the incumbent Directors … will continue in office until such time as successors are elected and qualify."[34] Since the unsuccessful October 2008 vote, Western Investment has reduced its stake in GCS to about 10.4% of outstanding shares.[35]

B. Cohen & Steers Select Utility Fund ("UTF") Proxy Contest

1. The Activists' Initial Filings

In the summer of 2007, Bulldog Investors started to purchase shares of UTF, finding it attractive for several reasons. First, relative to other Cohen & Steers funds and to similar closed-end funds, UTF was trading at a high discount of 14%; second, Bulldog Investors saw a sophisticated shareholder base that would likely be amicable to shareholder proposals; and lastly, Bulldog Investors could hedge out as much utility sector risk as they wanted.[36] Figure 3 illustrates UTF's historical discount to NAV. Figure 4 illustrate the underperformance of UTF share prices compared to the NAV prices.

FIGURE 3

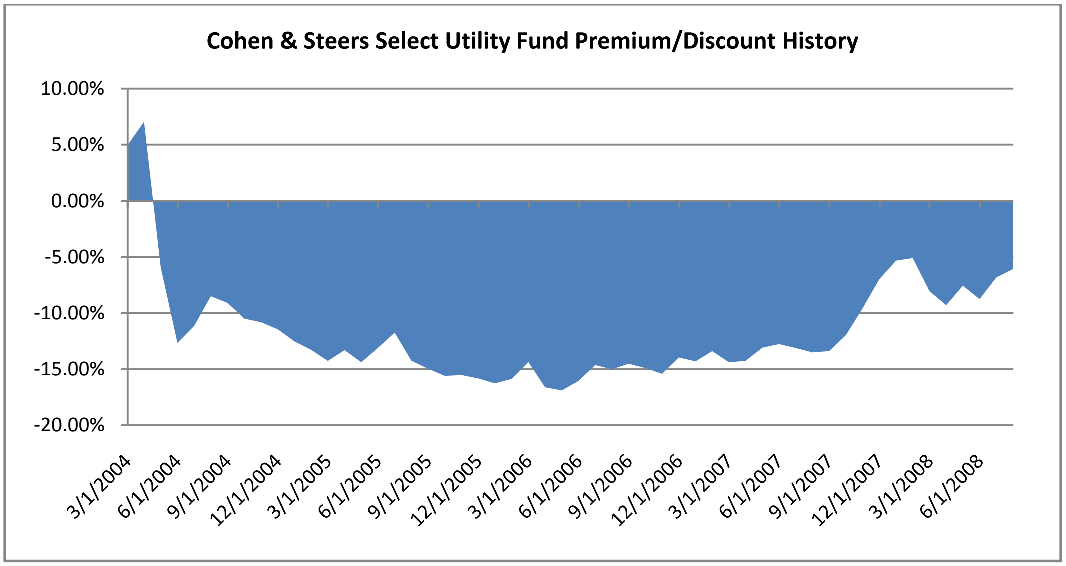
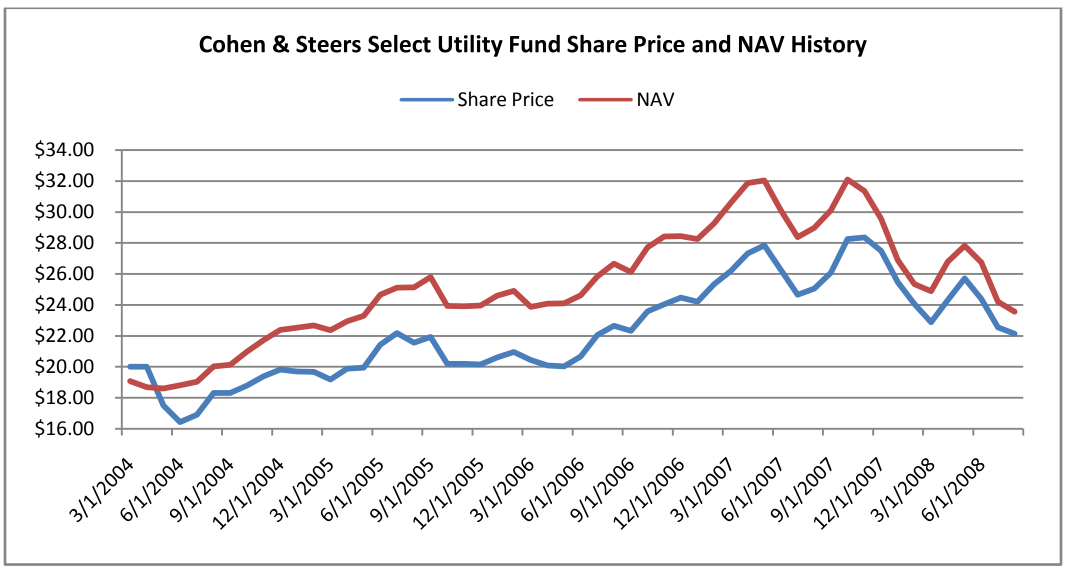


FIGURE 4



In a joint filing agreement with several others, Bulldog Investors filed their first 13D on October 9, 2007, stating an ownership of 6.1% of the outstanding shares of UTF.[37] Six weeks later, Western Investment filed their own 13D stating an ownership of 7.6% of total outstanding shares, having started their purchases in 2004.[38]

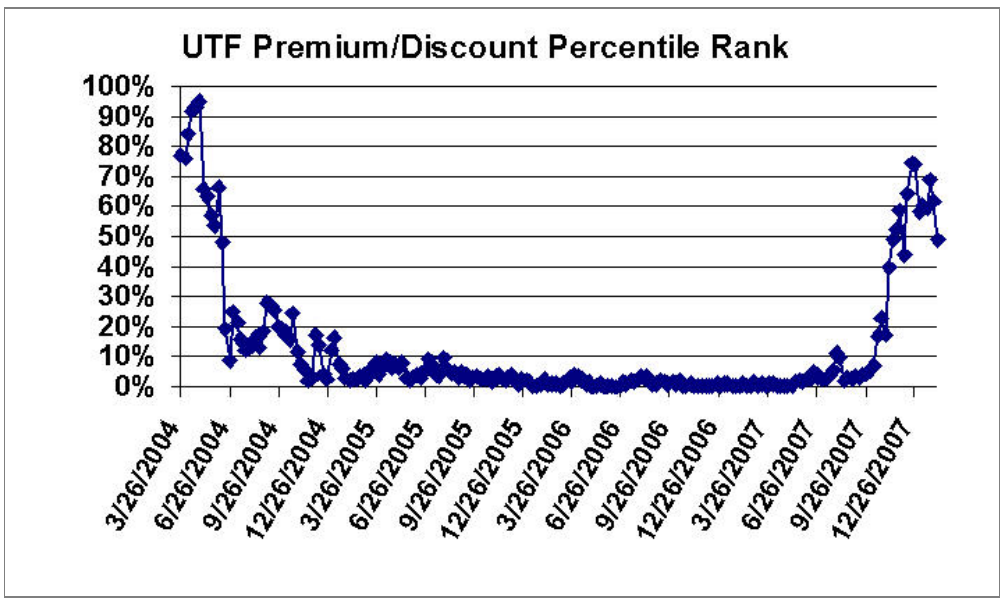
Western Investment then filed proxy solicitation materials on January 22, 2008 for the election of three nominees as directors at the 2008 annual meeting of stockholders.[39] In their filing, Western Investment included a letter to the UTF board in which Western Investment criticized actions of the directors of UTF as "shareholder unfriendly measures that serve to entrench the Board."[40] The UTF board enacted these shareholder unfriendly measures after the initial 13D filings of Bulldog Investors and Western Investment. Judging from the timing of the measures, impeding the efforts of the activist investors from successfully nominating and electing new directors seems to have been the objective of the UTF board.[41]

More specifically, the UTF directors adopted three measures. First, the directors amended the by-laws of UTF regarding the procedures for nominating directors to the board.[42] The changed procedures required shareholders to provide notice to UTF a full four months in advance if they wished to nominate directors for election. Shareholders who nominated directors would also have to provide an even larger amount of information about themselves and at the request of the Board, provide updates to a previously acceptable nomination notice, or risk having their nominees disqualified. Second, the UTF directors amended the by-laws to restrict shareholders from calling a special meeting. Western Investment wrote, "The Board has practically disenfranchised shareholders by requiring a prohibitive threshold of over 50% of the Fund's outstanding shares to call a special meeting of shareholders."[43] Finally, the UTF directors opted into Sections 3-804(b) and (c) of the Maryland General Corporation Law regarding the determination of the size and composition of the Board. By opting into these provisions, the directors appointed by the UTF board could serve for the remainder of the three-year term without being elected by shareholders.[44] Western Investment was worried that this would give the UTF board further opportunity to manipulate the size and composition of the board without input from shareholders.[45]

2. The Activists' Arguments

For Western Investment, the two main problems with UTF were the discount to NAV and the liquidity crisis in UTF's auction-rate, preferred shares. The NAV discount was in the double-digits. Also, of the 655 publicly traded U.S. closed-end funds registered with the Securities and Exchange Commission at the time, during the period from January 14, 2005 through July 20, 2007, UTF ranked in the worst 1% for 36% of the weeks and in the bottom 10% for 100% of the weeks, as illustrated in Figure 5.[46] The improvement in the discount to NAV in the second half of 2007 were most likely due to Western Investment's and Bulldog Investor's large share purchases and overtures to their fellow shareholders.

FIGURE 5



In regards to the preferred shares, investors like Western Investment who had purchased UTF's preferred shares at $25,000 could not sell those shares for any price above $20,000.[47] Despite these problems that negatively affected common and preferred shareholders, UTF directors had failed to make any meaningful efforts to correct them. Western Investment cited several reasons why the UTF directors failed to act. First, the then current outside directors of UTF had clear conflicts of interest and could not serve the shareholders of UTF. For example, each of the outside directors received six-figure annual fees for serving on a total of 21 other funds in the Cohen & Steers fund complex.[48] It is not difficult to foresee that most directors in this position would be unwilling to take an action that would benefit shareholders if it also meant harming the entity from whom they received their substantial paychecks.

Two other directors of particular interest were Mr. Cohen and Mr. Steers, who served as officers of UTF and as Co-Chairmen and CEOs of Cohen & Steers Capital Management, Inc. ("Cohen & Steers"), the manager of UTF. Western Investment wondered, given their ownership position with Cohen & Steers (which collects fees based on total assets under management), how willing Mr. Cohen and Mr. Steers would be to take actions that might reduce the discount to NAV of UTF or otherwise benefit stockholders if such actions would also reduce the fees that Cohen & Steers collects?[49] Again, Western Investment felt the conflict here was too great and that Cohen and Steers exerted an undue amount of influence on the other directors.

Western Investment's solution to the problems of UTF was the election of their nominated directors who, once elected, would address excessive discounts to NAV by selling some of the assets under management and using those proceeds to repurchase common shares trading at a discount and redeem preferred shares.[50] Since Western Investment's nominees represented the largest ownership interest in UTF, they felt that the nominees' interests were more clearly aligned with shareholders' interests of receiving the maximum value for their investments as opposed to the incumbent directors who had obvious conflicts of interest due to their earning six-figure salaries from UTF's management.[51] Management is typically loathe to redeem or repurchase shares because this severely reduces the management fees they receive, based on the assets in the funds.

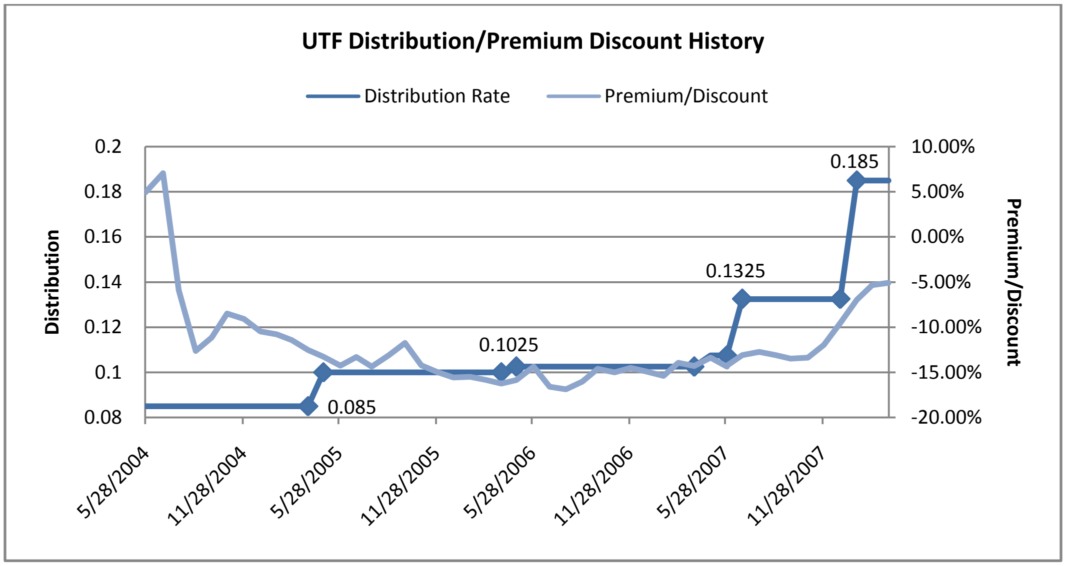
3. UTF Directors' Response

In response to the activists, the UTF directors had only three reasons why shareholders should vote for the incumbent directors. First, UTF noted that it out-performed the S&P 1500 Utilities Index and the S&P 500 Index for the one- and three year periods ended December 31, 2007. UTF failed to mention it had underperformed the Utilities Index since inception. Second, the directors argued they had increased the UTF's distribution level five times since the fund was launched in March 2004, which they felt demonstrated the director's "commitment to achieving the fund's investment objective and long-term interests of all stockholders."[52]

Third, the directors described the dissident shareholders as hedge fund speculators looking for a quick profit and that their strategies were not designed to enhance long-term performance. The directors failed to provide any empirical evidence supporting their statement that Western Investment's solution would not enhance long-term performance. However, the UTF directors did provide anecdotal evidence of Western Investment's motivations. For example, the UTF directors described to shareholders a telephone meeting on December 19, 2007, in which Art Lipson of Western Investment allegedly told them, "I'm not interested in long-term solutions; the long-term is the Directors' problem."[53] The UTF directors also said Lipson was dismissive of the fund's performance and history of distribution increases and the potential damaging consequences of reducing the fund's assets.[54]

Furthermore, the UTF directors claimed that they had been responsive and engaged in regards to UTF's discount to NAV, contrary to the claims of the dissident shareholders. According to Figure 6, the UTF directors claimed that their actions of increasing the distribution levels helped narrow the fund's discount to NAV.[55] This may or may not be the case as the discount also started to narrow beginning after the announcements of the dissident shareholders.

FIGURE 6



4. Outcome of the 2008 UTF Proxy Contest

The election for new directors took place on April 1, 2008. The dissident shareholders were unsuccessful in electing their slate of directors.[56] There was also a second proposal from the dissident shareholders: a self-tender program in which UTF would commence a self-tender offer within twenty days of the end of such quarter for 15% of its shares at 98% of NAV if UTF's shares trade at an average discount of more than 7.5% during any calendar quarter.[57] UTF's shareholders did not approve this proposal. After these failures, the dissident shareholders began to sell their shares. Western Investment owned 6.4% of UTF's outstanding shares on May 23, 2008,[58] and was down to 4.9% of outstanding shares by August 7, 2008.[59]

C. Pioneer Municipal & Equity Income Trust ("PBF") Proxy Contest

1. The Activists' Initial Filings

On January 26, 2007, Western Investment filed its first statement of acquisition of beneficial ownership of PBF (formerly known as Pioneer Tax Advantaged Balanced Trust). Western Investment had acquired ownership of 5.7% of outstanding shares and had also made a joint filing agreement with Benchmark Plus which had acquired 3% of outstanding shares.[60] By March 27, Benchmark Plus had increased its holdings from 3 to 4.1% of outstanding shares and Western Investment had increased its holdings from 5.7 to 5.8% for a combined total ownership of 9.9% of outstanding shares.[61]

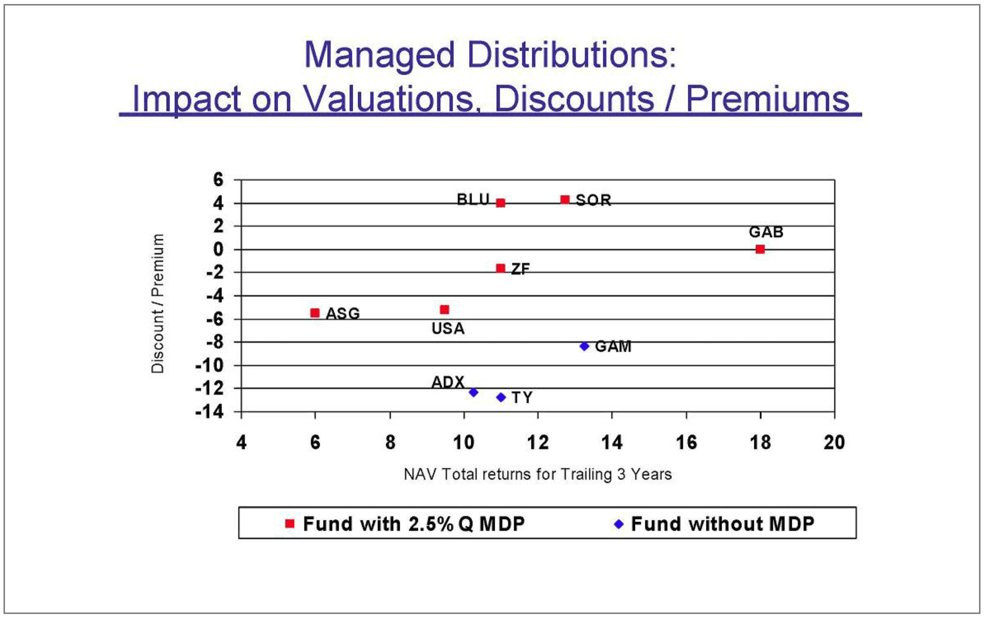
2. The Activists' Arguments

First, Western Investment established their credibility by explaining that that they were one of PBF's largest shareholders. Being a large shareholder, Western Investment was focused on improving PBF so that their investment would prosper, and as a result, the investments of all other shareholders would prosper.[62] Second, Western Investment addressed the problem of PBF's discount to its NAV. Since inception, PBF's share price had traded at a double-digit discount, ranging between 12% and 17%.[63] Western Investment said the excessive discount to NAV was unacceptable, especially given that its persistence over several years. For example, on November 30, 2006, a 13% discount translated to over $62 million of value unavailable to shareholders.[64]

Third, Western Investment argued that the failure of PBF's Board to take action to reduce the discount to NAV was evidence of their indifference to PBF shareholders.[65] Western Investment also suggested that the incumbent Board members up for election were unable to focus their attention on PBF; two of the incumbents each sat on the Board of 81 other Pioneer Funds and the third incumbent sat on the Board of 32 other Pioneer Funds.[66]

Western Investment proposed to fix the discount problem by instituting a managed distribution policy. Western Investment stated that managed distributions policies have a history of reducing discounts (see Figure 7) and argued that distributions might even create support for the fund's common stock in a declining market.[67] Furthermore, Western Investment made sure to point out that a managed distribution policy reduces the manager's profit by potentially reducing funds under management, the key amount upon which the manager's compensation is based.[68] Facing a group of directors that served on the boards of, and were compensated by, as many as 81 other Pioneer funds, Western Investment again asked the rhetorical question, "has the current board acted in the best interest of shareholders?"[69]

FIGURE 7



The shareholder meeting took place on June 8, 2007. Two of Western Investment's nominees – Arthur Lipson and Robert Ferguson – were elected as Trustees of PBF.[70] The backing of two major proxy advisors, Institutional Shareholder Services, Inc. and Glass, Lewis & Co., was certainly helpful to Western Investment.[71] Two months later in August, Karpus Management, Inc. announced ownership of 5% of outstanding shares.[72]

Then in September, Bulldog Investors announced ownership of 5.78% of outstanding shares, and also suggested that, because PBF was still trading at a discount despite an increased distribution, it would be appropriate to conduct a self-tender offer for all outstanding shares of PBF to allow shareholders to receive full NAV for their shares.[73] If a majority of PBF's outstanding shares were tendered, that would show insufficient shareholder support for continuing PBF in its closed-end format. If that was the case, the tender offer could be cancelled and then the PBF could be liquidated.[74]

After the self-tender offer proposal, Bulldog Investors acquired another 2.5% of outstanding shares, bringing its total ownership to 8.3% of shares outstanding[75], and also announced its commencement of its tender offer to purchase up to 1,500,000 shares of PBF at 95% of NAV.[76]

3. PBF's Response to Bulldog Investors' Proposal to Open-End PBF

Responding to the tender offer by Bulldog Investors, the PBF Board recommended that shareholders not tender shares for the following reasons: (1) the Board said the amount over current market price that the Offer represents was significantly less than PBF's annualized distribution rate of nearly 9.90% based on the Fund's market price at November 13, 2007; (2) the plans of Bulldog Investors to create shareholder value through open-ending PBF would have negative consequences for shareholders; (3) the sale of shares would create a taxable event for shareholders; and (4) the Board said they had already approved a number of actions that had supposedly reduced PBF's discount.[77] The PBF Board also notified shareholders that the newly elected directors, Arthur Lipson and Robert Ferguson, would be tendering their shares held of record or beneficially by them pursuant to Bulldog Investors' tender offer.[78]

After the negative response from PBF, Bulldog Investors announced that PBF's reasons against the tender offer were "nonsensical." Also, in addition to nominating three persons to the board at the next annual shareholder meeting in 2008, Bulldog Investors would present two proposals: (1) to terminate the investment advisory agreement between the PBF and Pioneer Investment Management, Inc. and (2) to change the name of PBF to "The Shareholder Friendly Trust."[79] The last proposal seems to be tongue-in-cheek, borne out of frustration with the shareholder unfriendly nature of PBF's board.

Bulldog Investors also increased its tender offer from 1.5 million to 3 million shares and extended the expiration date from November 30, 2007 to December 14, 2007.[80] On December 17, 2007, Bulldog Investors announced that it had accepted for purchase 2,633,913 tendered shares, which represented approximately 9.175% of the outstanding shares.[81] Owning 17.426% of outstanding shares, Bulldog Investors announced its intention to open-end PBF, thereby allowing shareholders an opportunity to realize the NAV for their shares.

4. A Successful Outcome

Western Investment succeeded in electing its directors to the board of PBF and was instrumental in helping to increase the distributions of the fund. However, the discount to NAV remained and Bulldog Investors took action to eliminate the discount to NAV once and for all by attempting to open-end the fund. After a successful tender offer, Bulldog Investors succeeded in spurring the board of PBF to open-end the fund when PBF and Pioneer Tax Free Income Fund announced that the boards of both funds had approved a plan to merge PBF into Pioneer Tax Free Income Fund, an open-end fund.[82] On September 12, 2008, PBF announced that shareholders had approved the merger of PBF into the open-end Pioneer Tax Free Income Fund.[83] As a result of the hard work by all the activists involved, all shareholders would be able to redeem their shares at NAV after the merger.

IV. Conclusions

Though there are many reasons that may explain why closed-end funds trade at large discounts or premiums to their NAVs, closed-end funds will remain attractive as investment and arbitrage opportunities for a select group of activist investors. As illustrated above by the two examples, identifying a closed-end fund is fairly simple: look for a fund that is trading at a double-digit discount to its NAV and that has a Board of Directors that will likely amenable to working to close the discount gap. The hard part is working to convince directors and shareholders of the need for change.

The work to narrow the discount gap may take months or years and requires significant use of expensive proxy services. Even after expending a large amount of time and energy, there is no guarantee that the activist investor will convince management or win a proxy contest. However, though the activist investor may ultimately fail in convincing management and shareholders, often just the knowledge that an activist has taken an interest and has hinted at a proxy contest will serve to decrease the discount gap and enable the activist to make some sort of return on the investment and allow all shareholders to regain some of the value lost to them.

During the proxy contest, one of the largest issues in the arguments of both activists and fund directors is whose interests are more aligned with the interests of the shareholders. Activists often target the closed-end funds in fund families that have unitary boards. This allows the activist to argue that the attention of the target fund's directors is divided between too many other boards on which they sit. Also, the activists can often argue that the directors of such boards are too beholden to the fund's management from which they receive substantial yearly salaries. The fund's directors on the other hand are quick to describe the activists as greedy hedge funds who are only concerned with making a quick buck.

In regards to whose interests are most aligned with those of the shareholders, the arguments of activists and fund management are both persuasive, but the activists are more persuasive. First, the activists offer immediate solutions to the shareholders of closed-end funds that have traded at substantial discounts for years. Second, the activists acquire a far larger stake than any director of the fund. Third, the activists offer a slate of directors that are more independent because their directors are not dependent upon the fund's manager for a substantial yearly salary and are better able to make decisions that might favor other shareholders while disfavoring the fund's investment manager.

Regardless of the reason why substantial discounts persist for many years in closed-end funds, the problem of the discount remains. Activist investors offer several solutions that can greatly reduce the discount. Though it may be true that such activists are concerned with short-term arbitrage gains, a successful proxy contest can give other shareholders a long-awaited opportunity to sell their shares at a price more representative of full value.

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