Closed End Funds

# Open your portfolio to CEFs

In the last issue I addressed the potential discount mechanism that exists in Closed End Funds (CEF). The discount occurs when the price that you pay for the CEF is lower than the Net Asset Value (NAV). The NAV is the actual value of the fund if you take all assets and subtract liabilities if the funds were liquidated. The price is what you pay for the CEF in the open market.

There may be long term benefits of owning CEFs purchased at a discount when comparing paying full NAV for an investment.

Assume you have $100,000 to invest in two investment and the annual income for each investment is 5 per cent. Investment A sells at NAV which is $10.00. Investment B sells at a discount of 20 per cent to the $10.00 NAV ($8.00). In both cases we are taking the 5 per cent yield as income.

Investment A will have $100,000 in capital generating $5,000 a year in income. Investment B was purchased at a 20 per cent discount ($100,000/$8) which represents $125,000 working for you at a $10 NAV. Investment B will generate $6,250 in annual income ($125,000 x five per cent).

Now let's look at the income stream generated over twenty years for both investments. At $5,000 per year Investment A will generate $100,000 in income. Investment B will generate $125,000 in income over the same twenty years. This excludes any potential capital gains for either investment.

For income-seeking investors, CEFs may provide the opportunity to generate income to help meet retirement income needs. To see if CEFs are a fit for your situation, you need to speak with and advisor who is familiar with CEFs, their mechanics and taxation.

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# Banker's acceptances explained

If you invest some of your cash holdings into a money market instrument called a banker's acceptance, what exactly is it you're buying? Here are the essential facts.

A banker's acceptance is a money market instrument issued by a corporation, issued at a discount to mature at par, with a maturity date from several days up to one year.

As an example, suppose a major blue-chip company needs to raise $80 million for 95 days. The company surveys various investment dealers and finds that the interest rate it faces paying is a little too high when the only security it offers is just its own good name and credit reputation. The company decides to attach a major bank's guarantee of repayment to the issue.

The corporation proposes to its bank that the bank guarantee repayment of the issue in the event the corporation defaults, in exchange for a fee. The bank knowing the corporation has every ability to repay the issue, agrees, accepts the fee, and provides the guarantee. What was a commercial paper issue up to that point is now a banker's acceptance.

The bank wins by getting a fee for a low-risk guarantee. The company wins because investors are now willing to accept a lower interest rate on the paper because it is now less risky.