

CALAMOS[®]

Closed-End Funds 101

Closed-End Fund Definition

A closed-end fund is a publicly traded investment company that can invest in stocks, bonds and other types of securities, based on its investment strategy, and raises capital primarily through an initial public offering (IPO) by issuing a fixed number of shares. After the IPO, the issuance of new shares is closed to investors and the fund is listed and traded similar to a stock on a stock exchange. Unlike open-end mutual fund shares which trade with the fund sponsor, closed-end fund shares are traded with other investors just like a stock. However, unlike a stock, a closed-end fund share represents ownership in a portfolio of securities that is actively managed by an investment manager.

Closed-End Fund Investors

Typical investors of closed-end funds are seeking a product that not only provides regular income to meet current obligations, but also provides the potential for long-term total return. Closed-end funds are well-suited for investors seeking greater diversification for the income-generating portion of their portfolio.

Closed-End Fund Benefits

- > Closed-end funds provide regular cash flow, typically monthly or quarterly, to help shareholders pay current obligations.
- > Closed-end fund shareholders can trade the fund just like a stock by placing market orders, limit orders, stop orders or short sales along with the ability to trade the fund throughout the day rather than just at the market close.
- > Closed-end funds have the ability to apply leverage, depending on the market environment, by either borrowing capital or issuing preferred shares in order to enhance distribution levels and performance.

- > Closed-end funds have the ability to be fully-invested and invest in less liquid markets due to the fact that investment managers do not need to account for subscriptions and redemptions.
- > Unlike open-end funds, closed-end funds do not require a minimum investment and do not charge marketing and distribution fees.

Closed-End Fund Terminology

Discount/Premium. Unlike open-end mutual funds that are purchased and sold at the fund's net asset value (NAV), a closed-end fund is bought and sold by its market price, which often times differs from the fund's net asset value. If the market price is greater than the NAV, the closed-end fund is said to trade at a premium. Conversely, if the market price is below the NAV, it trades at a discount. Factors that affect the discount or premium include, but are not limited to, the fund's performance, the fund's distribution rate, desire for the fund's investment strategy, and the current market environment.

Distribution Rate. A ratio that measures how much a closed-end fund pays out in income each year relative to its market price or otherwise stated as how cash flow is generated for each dollar invested. The distribution rate will play a major role in determining whether a closed-end fund trades at a premium or discount. For instance, one can expect that a closed-end fund that has a higher sustainable distribution rate than its peers will, more than likely, trade at a premium.

Distribution Policy. Closed-end funds distribute income earned from interest or stock dividends to shareholders typically on a monthly or quarterly basis. Realized capital gains are also distributed to shareholders. Short-term capital gains are typically included in the monthly distributions while long-term capital gains are paid once or twice a year. At times, closed-end

funds may use return of capital in order to maintain a steady distribution.

Closed-end funds utilize either a Level Distribution Policy or a Managed Distribution Policy. In a Level Distribution Policy, the closed-end fund intends to make monthly distributions at a level rate established by the Board of Trustees. A Managed Distribution Policy is similar but instead of paying long-term capital gains only once or twice a year, it pays them as part of the monthly distribution.

Leverage

A closed-end fund has leverage when the common shareholder has more than 100% of his or her investment exposed to the performance of the fund. A closed-end fund applies leverage by borrowing at short-term rates and investing the additional capital in the strategy of the fund with the goal of achieving higher long-term returns. The difference between the higher longer-term returns and the short-term rates, net of borrowing costs, supports the total return and distribution of the fund.

Common types of the leverage include lines of credit, auction-rate preferred securities (ARPS) and variable-rate demand preferred shares (VRDP). Lines of credit are considered debt financing and closed-end funds that use this source of leverage are required to have a debt coverage ratio of 300%. ARPS and VRDP shares are considered equity financing and closed-end funds that use this source of leverage are required to have a debt coverage ratio of 200%.

Interest Rate Swaps

An interest rate swap is a liquid financial derivative instrument, essentially a contract, in which two parties agree to exchange

interest rate cash flows. Swaps are commonly used in closed-end funds for hedging purposes in order to minimize the risk of rising short-term interest rates. Closed-ends employ leverage by borrowing at short-term interest rates. Short-term interest rates are floating rates that increase the closed-end fund's cost of borrowing when they rise. Interest rate swaps are used to manage the borrowing costs associated with leverage activities by allowing the closed-end fund to "lock down" an attractive fixed rate. In this case, the closed-end fund will pay a counterparty (often times an investment bank) a fixed rate and will receive a floating rate. The closed-end fund will use the floating rate it receives to pay interest on the loan. Therefore, the cost of the leverage to the closed-end fund is only the fixed rate.

Types of Strategies

There are over 600 closed-end funds available to U.S. investors. Many of them offer strategies with exposure to a single asset class while others invest in multiple asset classes in an attempt to balance risk and reward.

Types of closed-end funds include:

- > General Equity Funds
- > Specialized Equity Funds
- > Preferred Stock Funds
- > Convertible Securities Funds
- > World Equity Funds
- > U.S. Mortgage Bond Funds
- > Investment Grade Bond Funds
- > Loan Participation Funds
- > High Yield Bond Funds
- > World Income Funds
- > National Muni Bond Funds
- > Single-State Muni Bond Funds

CLOSED-END FUND SOURCES

calamos.com
cefconnect.com
closed-endfunds.com
capitallink.com
ici.org

CALAMOS®

2020 Calamos Court | Naperville, IL 60563-2787
800.582.6959 | www.calamos.com | caminfo@calamos.com

© 2012 Calamos Holdings LLC. All Rights Reserved. Calamos® and Calamos Investments® are registered trademarks of Calamos Holdings LLC.