Lofty Closed-End Premiums Touch Off Alarm Bells

Prompts one prominent manager to warn investors away from his own fund

Chairman and CEO of Gamco Mario Gabelli speaks in November. *PHOTO: REUTERS*

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Updated Oct. 20, 2016 4:36 p.m. ET

Investors hungry for income have driven up to lofty levels the premiums on dozens of closed-end funds, exposing investors to steep, sudden losses and prompting one prominent manager to warn investors away from his own funds.

Closed-end funds trade on exchanges like stocks and can trade at a discount or premium to the underlying value of the securities they hold. Investors generally buy the funds for their income or because they see value in a fund trading at a discount that may later narrow.

As of Oct. 19, 80 of the 539 closed-end funds sold at a premium, and 15 of those premiums were in the double digits, according to research firm Morningstar Inc. Three traded at no discount or premium; the rest sold at a discount. At the start of the year just 57 traded at a premium.

Closed-end funds overall had nearly $243 billion in assets at the end of September, up from about $219 billion at the end of last year and $128 billion at the end of 2008, according to Morningstar.

Investors in funds with hefty premiums are being blinded by the appealing yields that many of them offer, and likely don't understand the risks, said Maury Fertig, chief investment officer of Relative Value Partners, an investment adviser that focuses on closed-end funds. A scramble for yield—in a world of low or negative interest rates—similarly drove a rally in high-dividend paying stocks earlier this year before they retreated in recent weeks.

Buying a fund with a high premium is like buying a stock with a very high valuation, says Jason Kephart, an alternative-investment analyst at Morningstar in Chicago. "Very significant premiums are likely unsustainable and can collapse quickly if there's a shock to the market," he says. "When something is trading as such an outlier, I think you have to ask yourself why."

Investors who pay these large premiums are essentially betting that when they want to sell other investors will be willing to pay more than the fund's net asset value, experts say. It's a bet that can turn ugly fast.

Take the $178.4 million Pimco Global StocksPLUS & Income Fund (PGP). The closed-end fund now pays a distribution yield of 10.5%, and trades at a 70.2% premium to its net asset value, according to Morningstar.

That's a lofty premium, but it's down sharply from where it was earlier in October. After the market's close on Oct. 3, Pimco announced a 20% cut to the fund's monthly distribution yield, lowering it to 15 cents a share. The following day, the fund's share price fell, which narrowed the premium between its share price and the value of its holdings to 71% from 106%. That means that in one day, investors' shares were worth nearly a sixth less.

Pacific Investment Management Co. declined to comment beyond its press release on the fund's distribution cut, which said that the change "takes into account many factors, including but not limited to, PGP's current and expected earnings, the overall market environment and PIMCO's current economic and market outlook."

Erik Herzfeld, president of Thomas J. Herzfeld Advisors Inc. a Miami investment-advisory firm, says he wouldn't buy a fund at a big premium. "Who's to say it won't go to less of a premium," he says. "There's no sense to buying something at more than its liquidation value unless it's something pretty special."

Any time a fund isn't earning its payout, it's a candidate for a distribution cut, Mr. Herzfeld says.

Other closed-end funds haven't reached such high premium levels, but still command prices that are lofty relative to the value of their holdings. Pimco High Income Fund trades at a 44.2% premium to its net asset value and yields 12.9%, according to CEF Connect, a data service run by Nuveen Investments. After the fund cut its payout for the first time last year, its premium evaporated and it briefly traded at a discount.

Another Pimco fund, Pimco Strategic Income Fund trades at a 27.2% premium and yields about 9.6%, and the John Hancock Tax-Advantaged Global Shareholder Yield Fund trades at a nearly 18% premium, according to CEF Connect.

“If investors are looking for yield—and that seems to be the name of the game—do a little bit of homework,” says Mr. Herzfeld. “A lot of funds have very good yield and are trading at discounts; those are the ones I would focus on.”

Even some fund managers are saying to avoid their funds when they’re trading at a premium.

Gabelli Utility Trust commands a premium of about 21.9%, and a new fund, Gabelli Go Anywhere Trust Combo, trades at a premium of more than 45%.

“Big premiums make no sense and big discounts make no sense,” says Mario Gabelli, chairman and chief executive of Gamco Investors Inc., which runs the funds. “That Go Anywhere fund should not sell at that premium. We are advising people not to buy it.”

In a commentary to shareholders of Gabelli Utility Trust earlier this year, Mr. Gabelli wrote, “It is important to remember that ’Mr. Market’ is a pendulum that swings both ways. As the market moves away from momentum investing and back to basics, we believe that a high premium for the fund is not likely to be sustainable.”

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Corrections & Amplifications:
When Pimco Global StocksPLUS & Income Fund saw its premium narrow from 106% of its holdings to 71% earlier in October, it represented a decline of roughly one-sixth in the shares’ value. An earlier version of this article incorrectly said it was a decline of one-third. (Oct. 20, 2016)