

Everyone would like to have a free lunch. However, mainstream finance tells us that there is no such thing. According to the efficient market hypothesis, no investor in the market should be able to make easy money on a consistent basis; that is, a free lunch should not be allowed. Yet, there are numerous market anomalies that persist time and time again. One such anomaly is found in a class of securities known as closed-end funds. Closed-end funds sell at prices below their true values and hence present continuous bargains (a “free lunch”) to investors.

## Introduction

Closed-end funds are one of the three basic types of investment companies (the other two are mutual funds and unit investment trusts). Mutual funds are open-end funds in the sense that the funds stand ready to accept money at any time and will redeem shares from current stockholders at the “net asset value” of the fund (that is, the market value per share of the securities the fund holds). Alternatively, a closed-end fund begins when management raises a certain amount of capital, say \$100 million, and buys a portfolio of securities which it will manage according to its charter, and then issues a fixed number of shares, say 10 million that are worth \$100 million at initiation. At this point, the price of the shares issued matches the net asset value of the securities initially acquired. However, something remarkable happens shortly thereafter. The shares issued (now trading on organized stock markets such as the New York Stock Exchange and the London Stock Exchange) start to sell at prices that deviate from their net asset value. Usually, their prices are below their net asset value and are said to trade at a discount, while sometimes they sell for more than net asset value and are said to sell at a premium.

Like other types of investment companies, closed-end funds provide exposure to the underlying asset class, region or sector but usually at a discount. They are also great diversifiers since a portfolio containing a certain number of funds, say 100 funds, might hold up to 5,000 distinct underlying securities. However, the distinguishing characteristic of a closed-end fund is the discount relative to net asset value. Buying a fund at a discount gives shareholders an advantage in a couple of important ways. First, there is a greater return on equity from any dividend or interest payments distributed by the fund since the cash received would be a return on a discounted price. Second, if market sentiment improves, the shareholder participates in increasing asset prices as well as a simultaneous narrowing of discounts. In this case, the investor is earning a positive return on changes in net asset value as well as on price increases of the closed-end fund. The total return to the investor is a combination of both net asset value and discount returns. Discounts also offer a layer of downside protection especially when holding deeply discounted funds.

## Gramercy’s Closed-End Fund Strategy

Gramercy manages several closed-end fund strategies which differ only with respect to their benchmarks and certain portfolio constraints required by individual clients. The Global Optimization Strategy (the “Strategy”) has three funds under management: (1) the Global Optimization Fund managed against the MSCI ACWI Net USD Index; (2) the Gramercy Global Optimization Fund managed against the MSCI ACWI Gross USD Index; and (3) the Gramercy Emerging Markets Equity Fund managed against the MSCI EM Gross USD Index. All three funds have the same investment philosophy and are managed with the same investment process. In general, the Strategy seeks to outperform its benchmark by investing in a controlled portfolio of closed-end funds. The portfolio is selected by an optimizer which limits tracking error that stems from over/under exposure to any one country,

region or sector relative to the benchmark. The Strategies have been used to manage the assets of pension funds and other institutional investors since August 1997.

The following illustrates the basic idea behind the Strategy: The Strategy buys closed-end fund Y at a substantial discount, say 20%, with the expectation that its discount will narrow. Presumably, Y was selected not only for its discount, but also because of its underlying exposure to the respective benchmark. One year later, (just as expected) the discount of Y narrows to 5%. At this point, Y is liquidated by selling shares in the market and the proceeds are reinvested in a second closed-end fund, Z, having exactly the same security profile in its portfolio with a relatively deep discount to net asset value.

The result of the liquidation of Y is a 15% increase in the value of the portfolio over and above the net asset value of the portfolio, and since the net asset value of the portfolio follows the benchmark, the Strategy has outperformed the benchmark by that amount. Note that the Strategy has earned 15% over the benchmark regardless of the price movement in the benchmark. Additionally, the portfolio currently sits with a new closed-end fund, Z, which will be liquidated at some future point presumably at a narrow discount – anticipating a similar switch with a third closed-end fund over the next period. Naturally, if the net asset value of the benchmark moves up in the same period, the investor captures that as well.

This simple example illustrates two key ideas about Gramercy’s investment Strategy. First, the Strategy controls exposure of the portfolio to the benchmark at the net asset value level. This is implemented through constraints on portfolio choice (country, region and sector relative to the benchmark). Second, the Strategy demonstrates superior fund selection while keeping the portfolio exposure as close as possible to that of the benchmark. The Strategy selects funds whose discounts will narrow quickly and by a large margin. This fund selection is implemented through an expected return model which uses discounts on closed-end funds as well as other factors as predictors of future return.

## Current Opportunities in Closed End Fund Investing

One way for investment managers to earn superior returns is by timing the entry point into a strategy. In the case of closed-end funds, entry time is right when discounts are deep. Where are we now in the discount cycle and is this an opportune time to invest in a portfolio of closed-end funds? The evidence suggests that this may very well be the case!

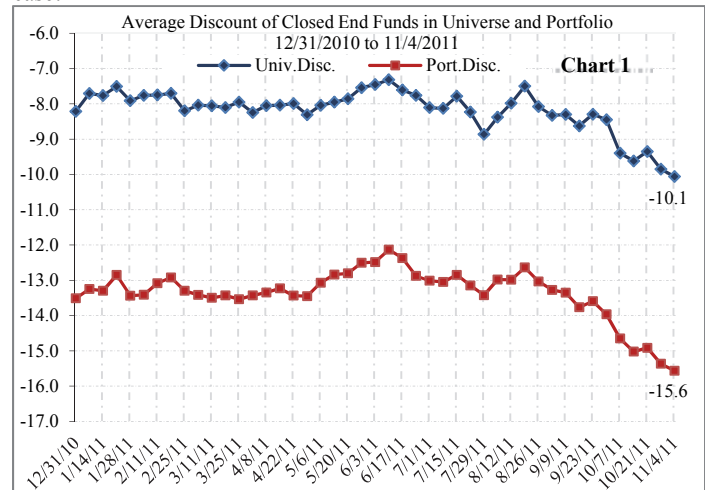


Chart 1 (on page 1) plots the average discount of closed-end funds in the universe (blue line) and in Gramercy's portfolios so far this year (red line). Both indicate that closed-end fund discounts have deepened over the last several months. Since June 10, 2011 the average discount of the universe of closed-end funds is deeper by 2.7% and the discount on Gramercy's portfolio of closed-end funds is deeper by 3.4%. Historically, these discount levels are relatively deep and they may imply a greater future excess portfolio return over the coming periods as the following analysis illustrates.

**Chart 2**

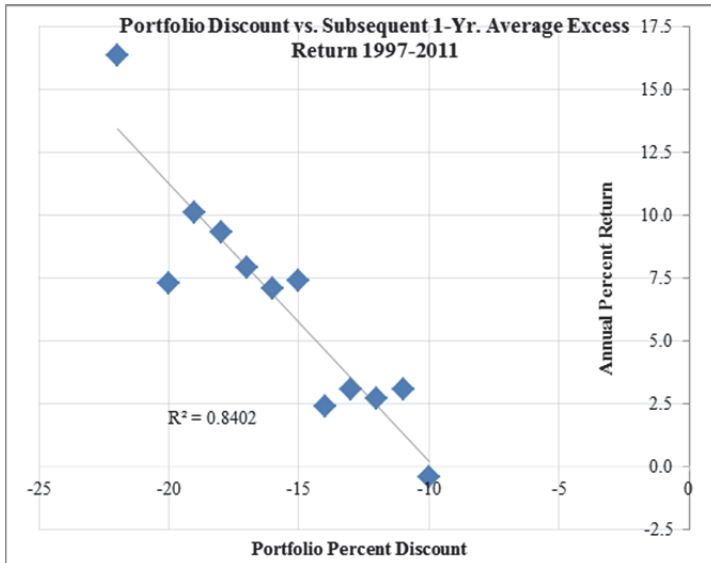


Chart 2 (above) plots the relationship between excess portfolio returns and portfolio discounts from 1997 to 2011. The chart uses 158 months of discount and returns data (starting from the Global Optimization Fund inception date (August 1997)). The data is grouped

into 12 discount bins starting with 10% discount and ending with 22% discount with intervals of 1%. Each point on the chart represents a portfolio discount matched with the subsequent one year excess return of the portfolio. As seen in the chart, there is a high correlation between the magnitude of discounts and the resulting excess returns of the portfolios. The larger the discount, the greater is the realized return in the following year. Low discounts have been major drivers of high excess returns historically.

We can infer from this relationship that at the current discount levels we should expect the portfolio excess return to be around 6.3% for next year. While portfolio discounts could deepen further from here on, the investment team at Gramercy believes that this may be an opportune time to invest in closed-end funds.

**Conclusion**

Closed-end funds are an inefficient asset class where prices can deviate from underlying fundamental value or net asset value. When price is below (or above) net asset value a closed-end fund is said to sell at a discount (or premium). Discounts vary over time and across funds. Over the period 1997 to 2011 the average discount of closed-end equity funds traded in U.S and U.K. markets was 9.75%. The average has ranged from a low of 16.2% in April 2000 to a high of 3.5% in December 2006.

In an efficient market, arbitrageurs would buy and sell securities so prices could not deviate from their underlying values, that is, there would be no riskless arbitrage. But this is not the case for closed-end funds. Mispricing persists precisely because the arbitrage mechanism fails in this market. The naïve strategy of buying a fund and shorting the underlying portfolio, hoping that the discount will narrow, is costly and faces the risk that the discount can widen. However, armed with the correct approach, an investor can profit from this. It involves a good stock selection strategy, as well as a strategy for controlling risk of the portfolio to market, sector and fund specific factors. Portfolios of closed-end funds typically contain a large number of securities and require more sophisticated management techniques.

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