What Is a Closed-End Fund?

Closed-end funds have been around since 1893, more than 30 years before the first mutual fund (also known as an open-end fund) was created in the United States. However, closed-end funds are much less common than open-end funds. There are fewer than 600 closed-end funds on the market, whereas there are more than 7,800 mutual funds available.

Closed-end funds are similar to open-ended mutual funds in that investors pool their money together to purchase a professionally managed portfolio of stocks and/or bonds. They also have dividends and capital gains that are distributed annually. In other ways, they are very different. Closed-end funds actually have more in common with stocks or exchange-traded funds (ETFs), but they are actively managed.

Closed-end funds have an initial public offering (IPO) with a fixed number of shares to sell to investors. After that point, the investment company usually does not deal with the public directly, and any investors who want to purchase shares must do so on a secondary market, such as the New York Stock Exchange. A closed-end fund's investment portfolio is generally managed by a separate entity, known as an "investment adviser," that is registered with the Securities and Exchange Commission.

Shares are bought and sold on the open market, creating a situation in which investor activity does not significantly impact decisions on handling the funds. The market price of closed-end fund shares trading on a secondary market is determined by supply and demand, not by the shares' net asset value (NAV). Although closed-end funds start with a NAV, the trading price may be higher or lower than that value. If the price is higher, shares are selling at a "premium." If the price is lower, they are selling at a "discount."

If you are considering investing in a closed-end fund, there are some things to be aware of. Closed-end funds have broker trading fees and are considered riskier than open-ended mutual funds. They can invest in a greater amount of illiquid securities and can use leveraging methods usually avoided by mutual funds. Because they are harder to sell, they are less liquid than mutual funds. Closed-end funds are generally not redeemable. The investment company does not have to buy back shares to fulfill investor demand. And closed-end funds often charge between 1% and 2% annually for management fees.

Some people consider investing in closed-end funds because they are designed to provide a stream of income, often on a monthly or quarterly basis. Closed-end funds also could provide an important diversification element to their portfolios. Diversification is a method to help manage investment risk, but it does not guarantee a profit or protect against investment loss.

The value of closed-end fund and mutual fund shares fluctuate with market conditions. Shares, when sold or redeemed, may be worth more or less than their original cost.

Mutual funds are sold by prospectus. Please consider the investment objectives, risks, charges, and expenses carefully before investing. The prospectus, which contains this and other information about the investment company, can be obtained from your financial professional. Be sure to read the prospectus carefully before deciding whether to invest.

Source: 1) Investment Company Institute, 2014