Closed-end funds (“CEFs”) have long been effective investments for investors who seek the traditional advantages of open-end mutual funds and who also appreciate the unique advantages that closed-end funds can provide.

Closed-end funds can play an important role in a diversified investment strategy. Not only do closed-end funds offer investors the potential for generating capital growth and income through investment performance, dividends and distributions, the manner in which they trade may present an investor with the opportunity to purchase shares at a discount to the value of the fund’s assets.

In recent years, closed-end funds have evolved to include a variety of sectors and structures to accommodate the objectives and risk tolerance of a wide range of investors.

What Is a Closed-End Fund?

Unlike open-end funds, CEFs have a fixed number of shares outstanding and do not issue or redeem shares to meet investor demand. Like other publicly-traded securities, the market price of CEF shares fluctuates and is generally determined by supply and demand in the marketplace.

Typically, a closed-end fund trades in relation to its underlying net asset value (NAV). A CEF’s NAV is the market value of all securities owned in the portfolio plus all other assets, minus liabilities and divided by the total number of shares outstanding. The share price of a CEF may be above (at a premium) or below (at a discount) its NAV. For example, if the market price of a fund share is $18 and its NAV is $20, then the CEF is selling at a discount of $2 per share (or 10%). On the other hand, if the market price is $21, the CEF is selling at a premium of $1 (or 5%).

Advantages of Closed-End Funds

Efficient Management

Since they do not need to manage inflows and outflows of assets, closed-end funds can generally remain fully invested at all times. In contrast, open-end funds must manage continuous cash flows. For example, if the shareholder of an open-end fund wishes to sell shares of the fund, the mutual fund will redeem shares at NAV. Also, open-end funds generally offer new shares on an ongoing basis to new investors.

Ability to Leverage

Many CEFs may issue senior securities or borrow money to “leverage” their investment position. This strategy gives these CEFs the potential to enhance yield and to offer higher levels of current income in comparison to most open-end funds.

Premiums and Discounts

At any given point in time, a CEF’s share price may be above or below its underlying NAV. These premiums or discounts may be the result of such factors as the demand for the
Taxable U.S. Bonds
These CEFs focus on high-quality instruments, such as Treasuries, government agencies and investment-grade corporate bonds, all of which generate interest income that is taxable by the federal government. Others may add lower-grade high-yield bonds into the portfolio, which provide attractive rates of return at somewhat higher levels of risk.

Municipal Bond
Municipal bond CEFs seek to pay income exempt from federal income taxes (and, in some cases, also exempt from state or local income taxes). These CEFs invest in bonds issued by state and local governments and agencies. Professional managers monitor bond ratings and credit quality, and usually seek to broadly diversify the portfolio and avoid adverse events or defaults that might impact a given sector, region or issuer. Many municipal bond closed-end funds make use of leverage to enhance their return potential.

Sector and Specialty
These CEFs focus on stocks of a particular industry such as banking, media, natural resources or health care, or on specialized securities such as preferred stocks or convertible securities. They can offer a way for investors to participate in the fortunes of an economic sector, industry group or specialized security, while reducing risk through diversification.

Global and International Equity
CEF(s) offer counterparts to the mutual funds that build globally diversified portfolios of stocks or fixed income instruments. CEF(s) that diversify portfolio assets among U.S. and foreign securities are called “global,” while those that focus on non-U.S. investments only are considered “international.” Some CEF(s) specialize in emerging market securities, which can be highly volatile and somewhat illiquid under adverse market conditions. Since CEF(s) are not forced to sell assets from their portfolios to meet redemptions, they may offer special advantages over open-end funds in such markets, as well as access to markets that are difficult for open-end funds to invest in given their liquidity considerations.

Single-Country
There are single-country funds specializing in stocks traded in countries such as Korea, India, Mexico, Spain and Germany. The closed-end fund structure gives the portfolio manager the freedom to devise a long-term strategy and hold positions through periodic declines, which may impact stocks in these markets. The goal of most single-country funds is to produce superior capital appreciation over holding periods of several years.
**Floating Rate**

The floating rate CEF is a timely alternative for investors seeking the potential for high current income. These CEFs have underlying securities with rates that are structured to reset as interest rates move up or down so that investors can take advantage of these movements. These funds may offer investors a “hedge” against rising interest rates.

**Important Considerations**

**Leveraging**

As a means of enhancing return, many fixed income closed-end funds may issue senior securities or borrow money to “leverage” their investment position. There is no assurance that a fund’s leveraging strategy will be successful. Once a portfolio is leveraged, the net asset value and market value of the common shares will be more volatile. While a common investment practice by many CEF managers, leverage cannot assure a higher yield or return to the holders of the common shares.

**Covered Call Writing**

A CEF employs a covered call strategy to enhance yield potential.

A covered call option written on a security grants the buyer of the option the right to buy stock that the option writer owns at the option strike price. In writing covered calls, the option writer gives up appreciation potential above the strike price of the option. However, the option writer receives a premium for giving up that appreciation potential. Since the option writer already owns the underlying stock, the shares or cash equivalent can be delivered from the writer’s account. Regardless of whether the option is exercised or it expires, the writer of the option keeps the premium paid by the option buyer.

As a CEF writes covered calls over more of its portfolio in order to enhance distributions to shareholders, its ability to benefit from capital appreciation becomes more limited.

**Dividend Adjustments**

Investors considering CEFs should be aware that dividends may be adjusted up or down depending on market conditions and other factors. A decrease in the dividend may occur when individual portfolio securities mature in a period of declining interest rates, causing reinvestment at lower rates. Conversely, a dividend may be increased when individual portfolio securities mature in a period of rising interest rates and reinvestment is at higher rates.

Callable bonds held in a portfolio can also impact dividends. Bonds can be prepaid or called away by their issuers in advance of their stated maturity date. This often happens when interest rates are lower than they were when the bonds were issued.

If a bond is called during a period of declining interest rates, reinvestment will necessarily occur at lower interest rates.

A CEF’s leveraging strategy also needs to be considered for its potential impact on dividends. When a CEF’s borrowing costs are higher than expected, exceeding earnings on related assets, or when the spread between borrowing costs and the amount reinvested narrows, the fund’s dividend may come under pressure. Conversely, a CEF’s dividend may benefit when the fund’s cost of borrowing decreases.

**Managed Distributions**

A managed distribution policy is an investment company’s commitment to common shareholders to provide a predictable, but not assured, level of cash flow. This distribution policy typically takes the form of a regular fixed cash payment or a payment based on a percentage of a CEF’s assets, generally on a monthly or quarterly basis.

**Duration**

Duration is an important concept to consider when investing in CEFs with exposure to bonds. Duration is a basic measure of interest rate risk. It can help predict the likely change in the price of a bond given a change in interest rates. For example, the longer a bond’s maturity, the longer its duration because it takes more time to receive full payment. The shorter a bond’s maturity, the shorter its duration because it takes less time to receive full payment. In a closed-end fund, duration allows for the effective comparison of bonds with different maturities and coupon rates.

**Alternative Minimum Tax (AMT)**

Investors in tax-exempt CEFs need to be aware that if they are otherwise subject to AMT, income from these funds may not always be tax-exempt. Investors should consult their tax advisors if they are subject to AMT.

**Market Risk**

As with any publicly traded security, the price of a fund’s shares will fluctuate with market conditions and other factors. If shares are sold, the price received may be more or less than the original investment. CEF shares are designed for long-term investors and should not be treated as trading vehicles.

**Interest Rate Risk**

Generally, bonds will decrease in value when interest rates rise and increase in value when interest rates decline. This means that the net asset value of a fixed income CEF will fluctuate with interest rate changes and the corresponding changes in the value of a fund’s bond holdings.
Credit Risk
Lower-rated bonds carry a greater degree of risk that the issuer will lose its ability to make interest and principal payments. This could impact a fund’s net asset value of dividends.

Measures of Performance
To judge the performance of a closed-end fund, an investor should not simply look at yield alone. The best measure of performance in a perpetual closed-end fund is total return—that is, the changes in a fund’s actual market price plus all fund distributions over a given period.

Take the Time to Understand Your Potential Investment
CEFs are managed according to a variety of investment mandates. For example, they are available as diversified equity funds, taxable U.S. bond funds, municipal bond funds, sector and specialty funds, global and international equity funds, single-country equity funds and floating rate funds.

Before investing in a CEF, investors need to understand and evaluate some of the special considerations and risks associated with CEFs.

It is important to note that a fund’s use of derivatives, such as covered call options, may reduce a CEF’s returns and/or increase volatility.

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