ELSEVIER

Journal of Economics and Business 57 (2005) 388–410

Journal of Economics & Business

Closed-end country funds and the role of exchange rates in pricing and in determination of premiums and discounts

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Received 21 April 2004; received in revised form 16 February 2005; accepted 22 March 2005

Abstract

This paper investigates the relationships between fund returns and exchange rates and between premiums/discounts and exchange rates for European closed-end country funds over the period 1992 through 2003. It focuses on the effects of the adoption of the Euro and its exchange rate implications for the pricing behavior of Euroland country funds. Significant effects are found: fund returns are most affected by exchange rate returns while premiums/discounts are most affected by volatility of exchange rate returns. In general, a depreciation of the local currency (a strengthening of the U.S. dollar) decreases fund returns more after the adoption of the Euro than before. However, introduction of the Euro reduced volatility impacts on premiums/discounts. Thus, it appears that U.S. investors, in a portfolio context, gained from weakened volatility effects but lost from intensified effects of exchange rate changes.

JEL classification: E44; F02; G15

Keywords: Country funds; Premiums and discounts; Exchange rates; International investments

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0148-6195/$ – see front matter
doi:10.1016/j.jeconbus.2005.03.001

1. Introduction

Closed-end country funds have expanded rapidly in recent years as U.S. investors continue to attempt to diversify their portfolios internationally. Inability to access certain foreign equity markets, lack of liquidity, and other market imperfections have increased the popularity of closed-end country funds for investors in many markets.

Underlying portfolios of foreign assets in closed-end country funds (referred to as country funds hereafter) are packaged into shares and traded on U.S. stock exchanges. Their capitalization is fixed, making the number of outstanding closed-end fund shares fixed. Thus, a fund's price is a function of the supply and demand for the underlying shares in the fund and should reflect the fundamental value of underlying assets. Without market imperfections, a fund's price should converge to its underlying net asset value (NAV) after translating local prices into U.S. dollars.[1] However, this does not always appear to be the case, and country funds' prices typically diverge from their net asset values, that is, country funds trade, on average, at discounts (where fund prices are less than NAVs).

A little studied aspect of country funds pricing has been the role of exchange rates. Because local currency NAVs must be translated into U.S. dollars to compare prices and NAVs, fund prices should be influenced by exchange rates. This paper extends earlier country funds literature by focusing specifically on the effects of exchange rates on the pricing of country funds and on the premiums and discounts at which the funds are traded. Second, the impact of adoption of the Euro on fund pricing and on premiums/discounts is studied.

The introduction of the Euro in January of 1999 provides a unique opportunity to assess the effects of changing foreign exchange exposure faced by U.S. investors by studying country funds for Euroland countries. Theory indicates that stock prices reflect expectations of future cash flows and incorporate risk premiums. Both fund prices in the U.S. and NAVs in local markets will depend on variances of such fundamentals. The adoption of the Euro should be associated with increased currency stability, possibly reducing volatility of macroeconomic fundamentals. A reduction in the variance of exchange rates should be an attractive investment feature for European funds to U.S. investors, compared with other regional (e.g., Asian or Latin American) funds.

However, exchange rate influences were not eliminated for U.S. traded closed-end country funds because the Euro/dollar exchange rate continues to allow exposure. With the advent of the Euro, the exchange rate effect is the same for all Euroland country funds from the perspective of the U.S. investor. Based on country funds for those countries that became a part of the Euro block, the paper investigates exchange rate influences of the adoption of the Euro, an event which made exchange rate effects regional rather than national. A regional currency perspective may differ significantly from a national currency perspective. For example, since Germany is the dominant country in the Euro block, the currency change from marks to Euros would not be expected to significantly impact country fund prices for German funds. For the other countries, however, the Euro should have reduced exchange rate uncertainty making the funds for those countries more appealing.

[1] NAV is defined as the market value of the securities held by the fund less the liabilities, divided by number of shares outstanding.