



Payout policies on U.S. closed-end funds

Doseong Kim ^{a,1}, Yura Kim ^{b,2}, Kyojik Roy Song ^{c,*}

^a Sogang University, 35 Baikhum-ro, Mapo-gu, Seoul 121-742, Republic of Korea

^b Kookmin University, 77 Jeongneung-ro, Seongbuk-gu, Seoul 136-702, Republic of Korea

^c Sungkyunkwan University, 53 Myeongnyun-dong 3-ga, Jongno-gu, Seoul 110-745, Republic of Korea

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ABSTRACT

This paper investigates the impact of adopting a minimum dividend policy (MDP) or a share repurchase program (SRP) on closed-end fund discounts and the difference of the two payout policies. Using the data from the U.S. equity funds, we find that funds adopting an MDP significantly reduce their discounts at the announcements of the policy, but funds adopting an SRP do not. We also find that funds with an MDP earn higher NAV (net asset value) returns than the market during one or three years after the adoption, whereas funds with an SRP do not. After controlling for other determinants, we document that the funds with an MDP trade at lower discounts than other funds without any payout policy, while the funds with an SRP trade at higher discounts. These findings are broadly consistent with the signaling argument. However, the discount reductions for MDP funds are not explained by changes in agency costs measured by fund size and expense ratios.

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1. Introduction

Persistent discounts on closed-end funds have been a main concern to investors and fund managers. Arbitragers can make profits by liquidating (or open-ending) funds through proxy fights after accumulating fund shares when the funds trade at large discounts.³ Since liquidation or open-ending is related to the job security of fund managers, the managers have taken some strategic actions to reduce the discounts. Common practices to decrease the discounts in the industry are that the funds implement a minimum dividend policy or (and) a share repurchase program. While prior studies on closed-end funds have investigated each payout policy in isolation, they have not compared the choice between repurchases and dividends. In this paper, we compare the effects of a minimum dividend policy (MDP hereafter) vs. an open-market share repurchase program (SRP hereafter) on fund discounts. We investigate whether fund managers are successful in reducing the discounts by adopting either an MDP or SRP. If the payout policies decrease the fund discounts, we then try to explain how the adoption of an MDP or SRP can change the fund discounts based on existing theories.

Recent evidence shows that many closed-end funds adopt aggressive dividend policies in order to decrease their discounts.⁴ A minimum level of cash dividends for the closed-end funds with an MDP normally ranges from 6% to 12% per year. The minimum dividend is met through investment income and realized capital gains, with any shortfall being covered by a distribution of fund capital in an extreme case. The dividend payment, using the proceeds from liquidating the fund assets, is accounted as a tax-free

* Corresponding author. Tel.: +82 2 760 0497; fax: +82 2 760 0440.

E-mail addresses: doseong@sogang.ac.kr (D. Kim), yurak@kookmin.ac.kr (Y. Kim), roysong@skku.edu (K.R. Song).

¹ Tel.: +82 2 705 8861.

² Tel.: +82 2 910 4564.

³ Refer to Bradley, Brav, Goldstein, and Jiang (2010) about activist arbitrage.

⁴ Refer to Johnson et al. (2006) and Wang and Nanda (2011) about minimum dividend policies.

return of capital. Another policy often taken by the closed-end funds to address the wide discounts is the SRP. A typical fund has permission to repurchase 5% to 25% of its outstanding shares. The funds tend to make announcements of the SRP on an annual basis and typically continue the program after the initial announcement. Therefore, there would be a whole series of repurchases over many years if the initial announcement is a credible signal.

Previous literature has attributed several factors, such as investment sentiment, managers' ability, agency costs, arbitrage, and illiquidity, to the existence of the closed-end fund discounts.⁵ A few studies have investigated the impact of payout policies on the discounts. For instance, Porter, Roenfeldt, and Sicherman (1999) find that funds adopting an SRP decrease discounts by 1.3% on the announcements of the open-market repurchases and further, the effect of the SRP on the discounts is temporary. Johnson, Lin, and Song (2006) find that funds adopting MDP experience reductions in discounts, trade at smaller discounts than other funds, and earn greater excess returns following the adoption. They argue that their findings are broadly consistent with the predictions of dividend signaling models. Even though these studies investigate the impact of MDP or SRP on fund discounts, they have not investigated how the two payout policies are different. We try to fill this void in this research. Based on the signaling or agency costs argument, we examine whether the two payout policies of closed-end funds are substitutes or different.

Following Johnson et al. (2006), we argue that an SRP as well as an MDP can serve to signal the future performance of the funds. The funds adopting an MDP guarantee some percentage of a minimum dividend, which can be very costly to fund managers since managers' compensation is tied to the net assets of the funds. Therefore, it is hard for closed-end funds to adopt an MDP if the fund managers do not have confidence in their future performance. In contrast, the decision of actual repurchases belongs to fund managers even after some funds adopt an SRP. If they do not make repurchases, managers' compensation would not be affected by the SRP, which is less costly to managers. Even though fund managers do not anticipate higher portfolio returns, they can adopt an SRP as an attempt to reduce discounts. If actual repurchases do not follow the adoption of repurchase policies, the announcements of SRP cannot be a credible signal. Accordingly, we posit that an MDP is a stronger signal than an SRP. This implies that funds which experience large discounts and anticipate higher future NAV returns would adopt an MDP in order to convey a strong signal to the market as to their future performance. As long as discounts and future performance are related, we expect that the discounts would decrease at the announcement of an MDP. We also posit that the funds adopting an SRP would experience smaller changes in discounts and perform worse than those adopting an MDP if an SRP makes a weaker signal.

From the perspective of agency costs, closed-end funds can decrease their discounts since the adoption of an MDP or SRP improves managerial incentives. Johnson et al. (2006) acknowledges that their signaling theory and the agency arguments are not mutually exclusive. Wang and Nanda (2011) argue that some funds are too large relative to the investment opportunities and abilities of their managers, and moreover, investors would be better off with the return of some of the fund's capital. However, managers have little incentives to reduce the fund size since their compensation depends on the size of the fund assets. Payout policies force fund managers to return some portion of the capital if their performances are not sufficiently improved after adopting the policies. Ross' (2002) simple model also shows that fund discount increases with agency costs measured by management fees. We argue that an MDP serves as a stronger commitment than an SRP since an SRP offers fund managers the discretion about timing and the number of shares to be actually purchased. Accordingly, we posit that an MDP serves to decrease agency costs more than an SRP does.

Both signaling and agency costs perspectives predict that an MDP would be more successful in decreasing closed-end fund discounts than an SRP. The discount reductions can be explained by the improvement of future performance in the signaling argument, while they are related to the decreases in fund size or expenses in the agency costs argument. We argue that these two perspectives might not be mutually exclusive in order to explain the impact of payout policies on fund discounts.

We test our hypotheses using a sample of 159 closed-end equity funds (1300 fund-years), which have been traded over the period of 1993–2007 in the U.S. markets. Of the 159 funds, 18 funds (11.3%) have only an MDP, and 79 funds (49.7%) have only an SRP, whereas 16 funds (10.1%) have both an MDP and SRP over some of the sample period. Of the sample funds, 46 funds (28.9%) do not adopt either payout policy over the sample period. We first find that funds adopting an MDP or SRP are traded at about 50% higher discounts than the average of all equity funds one month before the announcements. Therefore, these funds have a strong incentive to reduce their discounts. We then investigate whether adopting an MDP or an SRP decreases the fund discounts around the announcements of the two payout policies. At the announcement week, the funds adopting an MDP experience a 2.97% decrease of discounts on average, while the funds adopting an SRP reduce their discounts by 1.12%. The difference is statistically significant at the 1% level. We also compare discount changes one month before to one month after the announcements to changes in the average discount of all equity funds in order to control for investor sentiments. The changes in discounts for funds adopting an SRP are not significantly different from the average change, whereas those for funds adopting an MDP are significantly different. These indicate that funds adopting an MDP decrease the discounts successfully, while funds adopting an SRP are not successful in reducing discounts, even temporarily after controlling for investor sentiments.

We then do a performance test using NAV returns of the funds over one year or three years after the funds adopt the payout policies in order to test the signaling hypothesis. The funds adopting an MDP perform better than the market, while the funds adopting an SRP do not. Using multivariate regressions, we also find that the funds with an MDP are traded at lower discounts after controlling for other determinants of discounts during the sample period. Yet, funds with an SRP trade at higher discounts even after they adopt the share repurchase program in order to reduce discounts. The discount reductions and the performance of MDP funds are broadly consistent with the signaling argument. However, a caveat is needed to interpret the results. The adoption of an MDP gives

⁵ Refer to Cherkas (2012) for a recent survey of the literature on closed-end funds.

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