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Market segmentation, liquidity spillover, and closed-end country fund discounts ☆

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Abstract

In a segmented international capital market, the illiquidity of a country fund in the market in which its shares are traded affects only the share price of the fund (S), while the illiquidity of its underlying assets in the market in which these are traded affects only the fund net asset value (NAV). In an integrated market, illiquidity in one market can easily spill over to another and affect both the fund share price and its underlying asset value. It follows that the closed-end country fund premium, $P \equiv \ln(S) - \ln(NAV)$, is negatively (positively) affected by the fund (underlying asset) illiquidity in segmented capital markets, but has only an ambiguous association with either fund or underlying asset illiquidity in an integrated market. Empirical evidence for the 8/1987 to 12/2001 period from

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U.S.-traded single-country closed-end funds shows that the fund premium has a negative (positive) association with the fund (underlying asset) illiquidity, and the relation is much stronger for funds investing in segmented markets. The results suggest that illiquidity plays a significant role in explaining closed-end country fund premia.
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1. Introduction

A closed-end fund is a firm that issues shares and uses the proceeds to invest in the shares of other firms. A closed-end *country* fund issues shares in one country such as the U.S. (the share or host market) and invests the proceeds in the shares of companies in a specific foreign country such as Korea (the asset, foreign, or home market). Closed-end funds typically issue and maintain a fixed number of shares. In general, these shares are traded at prices (S) different from the net asset value per share (NAV), which is announced at regular intervals (usually weekly or daily). Defining $P \equiv \ln S - \ln NAV$, the fund is said to sell at a premium (discount) when $P > 0$ ($P < 0$). In what follows, we shall refer only to the fund premium noting that a discount is a negative fund premium.

Closed-end fund premia are often cited as evidence of the limits to arbitrage and of investor irrationality. In an influential paper, Lee, Shleifer, and Thaler (1990) identify four empirical regularities associated with the fund premium: (1) closed-end fund shares are generally issued at a positive premium[3]; (2) they often trade at a negative premium; (3) the premium varies widely over time and across funds; and (4) the share price converges to NAV at liquidation or open-ending.

Theories based on frictions such as agency costs, taxes, market segmentation, and misvaluation of underlying assets have had some success in explaining the first two empirical regularities, but these theories cannot explain the wide variation of fund premia. For example, Bonser-Neal, Brauer, Neal, and Wheatley (1990) find a significant relation between premia on country funds and announcements of changes in foreign investment restrictions, but investment restrictions can explain only large positive premia. Ross (2002) argues that the fund premium is related to management fees and dividends, but Malkiel (1977) finds no correlation between U.S. closed-end fund premia and fund expense ratios. Barclay, Holderness, and Pontiff (1993) examine the relation between block ownership and premia, and Wermers, Wu, and Zechner (2004) investigate the dynamics of premia surrounding the event of management replacement, but neither study explains the wide variation of fund premia. Similarly, explanations based on the investor sentiment

[3]Weiss (1989) and Hanley, Lee, and Seguin (1994) provide empirical evidence of closed-end fund premium at the issuance, and initial price stabilization behavior provided by the lead underwriters. Cherkes (2003) argues that this special feature of buyers paying the IPO costs via IPO over-pricing with the underwriters providing prolonged after-market price support as a supplement to the IPO over-pricing is neither anti-competitive nor predatory. Cherkes, Sagi, and Stanton (2005) contend that the patterns observed in closed-end fund IPO behavior, and the observed behavior of the CEF discount, result from a tradeoff between the liquidity benefits of investing in the CEF and the fees charged by the fund's managers.

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