CITY OF LONDON
Investment Management Company Limited

Closed-End Fund Activism – The Balance of Risks

March 2024

In May 2023 we published on the increase in activist stakes in widely discounted closed-end funds (CEFs). To recap:

- *CEF valuations dislocated, becoming highly asymmetric to the upside.*
- *The structural lack of arbitrage capital inherent in this area of capital markets began to correct, and*
- *Closed-end Fund structures offer several levers to drive spread compression in a way that can give higher certainty of outcome than other mean-reversion strategies.*

We have since seen multiple hostile filings in both the US and UK jurisdictions, designed to pressure Boards and Managers of CEFs to return capital close to NAV and collapse the discount.

City of London has been an engaged shareholder in the CEF space for over thirty years. In our experience activism is often less straightforward than it superficially appears. We explore below some of the challenges.

Basis Risk

Exposure to discount spread risk, whilst hedging the beta of underlying portfolios, is an attractive trade at the moment. Discounts are >90th percentile cheap versus history and rebates on the short side have improved. Leveraging this spread exposure has a high probability of generating mean-reversion returns in a reasonable timeframe. Further to that, activism can accelerate the narrowing of discounts and generate a return of principal, permitting performance hurdles to be met whilst allowing retention and recycling of investor capital.

This is complicated by the basis risk of the hedging employed on the short side. Specifically,

- Underlying portfolio information is lagged and imperfect.
- Equity CEF portfolios tend to have high active share and factor biases including small/midcap overweight, value overweight, and mega-cap underweights. This makes hedging with index instruments vulnerable to correlation drift.
- Fixed Income CEF portfolios tend to employ leverage, resulting in markedly higher beta to benchmark that needs to be accounted for when establishing market-neutrality.

This basis risk will usually not be evident when backtesting a best-fit hedge, instead it will present through the P&L at points of volatility and dispersion in broader markets.

Execution Risk

Perhaps more importantly, the process of engagement with Boards and other shareholders has no guarantee of success.

In the US,

- The corporate governance framework usually demands Board replacement, public proxy contests and significant legal expenses. This poses a degree of reputational concern given the inevitable publicity.
- The process can be extended and challenged via the legal process, worsening the economics of the trade.
- The incentive to "buy votes" at unfavourable valuations to improve the odds of a positive outcome can negatively impact expected returns. The odds of this increase if proxy fights drag on, to the disbenefit of later investors.

In the UK,

- The corporate governance framework is stronger, Boards are more independent, and the ability to call meetings and make proposals is more shareholder friendly.
- The engagement process is more constructive and reliant on consensus – Boards will not usually defer to an activist shareholder if they are not acting in the interests of a majority.
- Many shareholders in the UK market are interested in better governance and improved CEF product, as opposed to the one-off "sugar rush" of a liquidity event. For their investors, the ability to generate repeated alpha through discount volatility is a superior long-term proposition.

The Risk of Public Positions

The acquisition of influential stakes in a company is a public process. The requisite filings make it obvious which positions can be "tail-gated" by opportunistic investors who are not obliged to stay in the position as it becomes less asymmetric.

Equally, where an engagement process fails to generate a short-term outcome, the activist position can represent an overhang at a valuation that is not supported by the market. This poses downside risk to the discount if and when an exit becomes necessary.

Our Approach

City of London does not run an explicit activist strategy. We believe in exploiting the persistent inefficiency of CEF discount volatility as a long-term compounding opportunity. That said, we are experienced navigators of the complexities around corporate governance structures in the jurisdictions in which we operate.

As such we welcome the arrival of arbitrage capital to shareholder registers and view it as a natural corrective to the excessively pessimistic valuations we observe. We will support measures that improve long-term outcomes for our investors.

Our Opportunistic strategy offers concentrated exposure to selected event-driven situations. This strategy generated >450bps of positive discount alpha in 2023 against a negative market trend. This strategy seeks to:

- Exploit public trading patterns around activist targets.
- Avoid exposure to activist targets we judge less vulnerable.
- Utilise existing hard liquidity provisions that are non-discretionary.
- Use our longstanding corporate governance expertise to positively influence outcomes in favor of all shareholders.

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