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Class of 1929

Evan Lorenz and Fabiano Santin write:

You have money to invest, but stocks are trading near all-time highs and investment-grade bonds, half of which are rated a single notch away from junk, yield a measly 3.7%. Closed-end funds, quoted at commanding discounts to the market prices of their respective portfolio assets, at least offer the value-minded, bubble-phobic investor a fighting chance. Adams Natural Resources Fund, Inc. (PEO on the New York Stock Exchange), Central Securities Corp. (CET on the NYSE American) and Templeton Global Income Fund (GIM on the Big Board) are three such funds under the *Grant's* lens. Each trades at a deep discount to net asset value; none uses leverage to boost returns (or losses).

Adams Natural Resources Fund came into the world in the sunset of the Coolidge administration, January 1929, as the Petroleum Corporation of America. Despite the inauspicious launch date, the fund had a good start to the Great Depression: "Considering that approximately 85% of the Corporation's funds were invested prior to October 24, 1929, the fact that its investments in other companies at the quoted closing prices at December 31, 1929 showed a depreciation from cost of only about 3%, which has been more than made up by net income after providing for the dividend paid on December 31st, is very satisfactory," then-president John H. Markham, Jr. wrote in the very first annual report.

The Adams fund specializes in energy and other natural-resources stocks. As of Dec. 31, integrated oil and gas (32.4%), exploration and production (25.9%) and chemicals (14.4%) made up the fund's biggest sector bets; the top three holdings were Exxon Mobil Corp. (18.9%), Chevron Corp. (12.6%) and DowDuPont, Inc. (4.9%). Adams targets a distribution of at least 6% each year—over the past 12 months the payout is equal to 7% of the current share price. Using no leverage, PEO looks to underlying investment income and capital gains to pay shareholders. The portfolio holds $523 million of assets. The stock trades an average of $1.8 million's worth a day.

Adams has generated a compound annual return of 5.2% over the past 10 years vs. 5.9% for the energy component of the S&P 500 (both include reinvested dividends). A decade ago, however, PEO traded at a 10.5% discount to net asset value vs. 17.5% today, only slightly below the 20.6% discount plumbed in the depths of 2008. Hold the discount constant over this period, and PEO would have slightly outperformed big-cap energy stocks despite an annual management fee of 0.79%. Since 1984, shares have returned a compound 8.1% per year, including reinvested dividends.

The bet on PEO today is buying a beat-up sector at a discount. The S&P has risen by 7.2% since year-end 2017, but the energy stocks in the index are down by 7.6%. PEO is an opportunity to participate in a potential oil bull market (*Grant's*, March 10, 2017). You would equally participate in an oil bear market, naturally.

"There are a lot of people [who] are calling for the demise of oil and gas because of electronic vehicles, and I think that is silly," Adams Funds CEO Mark E. Stoeckle tells us. "We concentrate on high-quality companies. We invest along the spectrum of energy. Rather than an energy fund that will pile into E&P [exploration and production] right now, say, or pile into service, we are a diversified fund that will give you exposure to energy without the risk of piling into one or two specific industry groups. . . . We've been through difficult times and been through good times, and we've come through each of those times. I think it is because of good risk management and good exposure to the energy and materials complex."

Central Securities Corp. is another member of the closed-end fund Class of 1929. It debuted in the especially inauspicious month of October. Since 1973, the fund has been managed by Wilmot H. Kidd, who holds 10.4% of shares outstanding and is the largest individual shareholder. (The Endeavor Foundation, run by Kidd's wife, owns an additional 34.9% of shares.) CET's net assets foot to $877 million, and the shares trade at a 16.1% discount to its latest net asset value. Despite the 0.88% expense ratio, Central returned a compound 14.1% over the past 40 years ended 2018 vs. 11.5% for the S&P 500 (both including reinvested dividends).

The fund invests mostly in common stocks, but also buys bonds, convertibles, preferreds and others. Its focus is on capital growth, not income. "Market participants have different time horizons: some focus on seconds, minutes and hours; others focus on months and years; and still others focus on multiple years," Kidd wrote in the 2018 annual report. "Central invests with a long-term view and does not trade actively."

In 2018, Central turned over only 8% of its portfolio (it added three securities and shed seven) to end the year with 36 holdings. Dividend payments vary considerably depending on net investment income and realized gains, which are substantially distributed to CET shareholders. The current dividend yield is 5.0%. Daily trading volume averages $850,000.

Perhaps CET's biggest risk and reward lies in its largest position. As of Dec. 31, the fund held 22.3% of net assets in (and 23% of the shares outstanding of) the Plymouth Rock Company, Inc., a closely held Boston insurer. Central bought into Plymouth at the insurer's 1982 incorporation. Plymouth is managed by its founder and chairman, the formidable James M. Stone, 71, a former economics lecturer at Harvard University, commissioner of insurance for the Commonwealth of Massachusetts (1975–79) and chairman of the Commodity Futures Trading Commission under President Jimmy Carter. He is the author of a seminal 1973 paper on catastrophic insurance.

Plymouth's return on equity was 14% in 2018; its ROE has averaged 18% over the past 34 years. Central's original $700,000 investment in Plymouth is valued at $170.5 million, or 1.36 times Plymouth's book value. The Plymouth mark appears conservative. Shields & Company, Inc. appraised the shares at a 1.7 times multiple, including a 20% discount for illiquidity. For reference, the insurance component of the S&P 500 trades at 1.7 times book.

CET shares have traded within a 15%–20% discount in the past decade, partly because of the Plymouth holding. The fund has returned a compound 15.4% in the past 10 years, compared with 15.6% for the S&P 500 (including reinvested dividends). Other large stakes include Intel Corp. (5.2% of net assets; first bought in 1986), Analog Devices, Inc. (5.0%; 1987), Coherent, Inc. (4.8%; 2007) and Motorola Solutions, Inc. (4.5%; 2000).

That 16.1% discount to CET's NAV comes with a caveat. Investors would be hit by long-term capital-gains taxes on about $505 million of unrealized profits if the fund were liquidated. For example, if Central sold Plymouth at 1.3 times book, the $170 million in capital gains would be distributed to CET shareholders, who would have to pay taxes on the gains.

After taking taxes into account, the discount would turn into a 6.7% premium for New York City inhabitants (36.5% is the top marginal rate), but a discount of about 2.5% would remain for those who live in Florida (23.8% is the top rate). The discount would be 2% and 11%, respectively, if the external appraiser that valued Plymouth at 2.1 times book were correct—given the insurer's consistently high ROE, we think that such valuation would not be unreasonable. There would be a benefit to those with loss carryforwards. They would be able to offset gains with past losses and possibly not have to pay any taxes in the extreme liquidation scenario, which itself may be farfetched given the limited upside to many shareholders. In any case, the fund manager's long-term track record seems to speak for itself.

A riskier and potentially more rewarding alternative is the Templeton Global Income Fund, which has been run by Michael Hasenstab since 2006 (*Grant's*, July 11, 2014). The fund is the opposite of CET: It reaches for yield, with capital appreciation as a secondary thought. It has returned a compounded 5.5% in the past 10 years (including reinvested dividends) and charges an expense ratio of 0.69%. Daily trading volume for the fund averaged $2.2 million.

At the end of January, GIM had $961.1 million in assets. The fund's biggest currency exposures were the Mexican peso (20% of AUM), the Brazilian real (13%), the Indonesian rupiah (8.3%) and the Argentine peso (4.4%). There were short positions in the yen and euro to the tune of 30% and 37% of assets, respectively. Overall, 61.8% of the fund was allocated to local currency bonds, and shares are priced to yield 7.78%.

Since 2011, the J.P. Morgan Emerging Market Currency Index has steadily dropped. Today it sits near its all-time low at 62.9, falling 42% from the 2011 high. The Templeton fund has followed the downward trajectory of the currency index with a 41.2% drop in share price. Shareholders who reinvested dividends, however, eked out a 6.3% gain over the past eight years. Over this period, the fund has traded down to an 11.0% discount to net asset value from a premium of 12.4%.

"When you look at these closed-end funds, some of them trade at structural discounts—always have, probably always will," Matthew R. Blume, portfolio manager at Pekin Hardy Strauss Wealth Management, tells us. "So, expecting that discount to narrow is not necessarily going to happen. With this fund, it could very well narrow, and it has actually traded at a premium to NAV in the past. We think this is more of a sentiment-driven thing, and we've seen over the last few months that it narrowed some, and we think that there is a potential to narrow further. You get the return of the strategy, but you also potentially get this narrowing of that discount. And the company can actually go in the market and buy those shares to narrow that discount. They do have that mandate."

Concerned with rising interest rates, Hasenstab has hedged the fund, which reported a duration of negative 1.48 years at the end of February. GIM shows a weighted maturity of its holdings at 2.38 years, and a yield to worst of 8.22%. If rates and the U.S. dollar fall—say from the Fed easing—GIM might be a security to own.

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