Opportunity Partners Case
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1. Evaluate the investment philosophy of Opportunity Partners. What is their approach to generating investment returns? Would you invest in Opportunity Partners? Why or why not.

Opportunity Partners invests primarily in closed-end funds, specifically pinpointing funds trading at a discount in the hope that the discount will narrow. Their investment strategy is straight-forward; since NAV and the price of a stock is both publicly available and a known amount, they know when the stock is at a discount and they invest appropriately. Once they have determined the fund is trading at a discount, they can liquidate the fund and take those potential earnings/profit from the sale to purchase another fund that is selling at a discount.

As a general practice, Opportunity Partners do not fully hedge their closed end fund positions as they are pretty optimistic that over the long term markets will go up; they don't operate with a short horizon. Instead, they hold a diversified mix of CEFs and take on the inherent risks that comes with NAV. In very rare cases and especially during crises (most of which are unavoidable), NAV may drop at the same time that the discount widens, which is disastrous for a portfolio in the short term. However, if the fund and its shareholders are willing to ride out those storms, they are able to recover from those (potential) losses.

However, it isn't as straight-forward as identifying the funds that were trading at the largest discount to the NAV. The principal money manager, Goldstein decided to become an active value investor having gained the trust of his board by generating positive returns during the first few years of the fund. To do so, he brought other shareholders on board to help him build a good network, and to check his biases (both internal and external) about particular funds to make sure he was making the right investments.

I would invest in Opportunity Partners because they have demonstrated a great deal of success following this investment strategy. While past performance does not equate to future gains, I am aware of this phenomenon and have trust that Opportunity Partners will be successful. I was impressed by Goldstein's willingness to check his biases by working with others in his network, especially considering that he is a successful and experience arbitrageur. I understand that investing in closed-end funds is not a riskless venture, since I don't have an infinite horizon, but most closed-end funds generate positive returns and have a lot of opportunity for success.

2. Why does the Mexico Equity and Income fund have a closed-end structure? If you were starting a fund today would you prefer an open or closed end structure?

Mexico Equity & Index Fund (MXE) was a closed-end fund that invested in equity and debt securities issued by Mexican companies, holding positions in different industries including cement, communication, entertainment/media, financial groups, food, beverage and tobacco. In the 1990s, these types of "country funds" were particularly popular, and allowed investors to capitalize on emerging markets and other growth economies [2, pg. 2]. At their IPO, they listed six million shares at $12 per share on the New York Stock Exchange, and in the early 1990s, the MXE share price and net asset value (NAV) increased steadily and often traded at a discount to NAV.

There's many reasons that MXE might have started as a CEF. One argument for choosing a closed-end over an open-end structure is that it allows investment managers to go after "illiquid" or heavily sought after assets; in MXE's case, things like entertainment and media, tobacco, etc. In open-end funds, managers are often preoccupied with how to trade when investors redeem shares all together because this forces them to liquidate the fund's investments. In contrast, a CEF manager doesn't worry about any potential price impacts of "forced" sales, and they have more flexibility to choose the most attractive stocks to them.

Another reason that MXE might have chosen a CEF structure is that CEFs usually follow a similar pattern. When a new closed-end funds are initially brought to market, they typically trade at a premium and then move to a discount over time, with the average closed-end fund trading at a discount to NAV. Indeed, in the early 1990s the MXE fund often traded at a discount to NAV [2, pg. 3]. During the devaluation of the Peso in the mid-1990s, MXE was not immune to the crisis in the Mexican economy, and the fund's share price and NAV declined; however, six months after the devaluation, MXE was able to rebound quickly and go back to trading at a premium to NAV of up to 40%. A CEF has a better ability to recover quickly from economic hardship.

If I were starting a fund, I would prefer a closed end structure. Since a CEF has a fixed number of shares that are only offered during the IPO, investors cannot freely redeem shares when they choose, so it helps mitigate the problems that come with sentiment bias. In addition, a fund manager has more flexibility than an open-ended fund to leverage investment vehicles to build the fund's portfolio; they might issue preferred shares or debt, which open-end funds cannot.

CEFs also often trade at a lower price than the total sum of assets, especially when those securities are out of favor; on average, the discounts are about 10%. In addition, CEFS are sold at a premium of about 7% on average. A CEF is an attractive investment vehicle because it has a known stock price (which is set at the IPO), a known NAV (since this is publicly available information), and as a fund manager, you are able to sell it at a premium, knowing that irrational investors will be chomping at the bit to get into an IPO for a new fund.

3. What explains the patterns in Exhibit 2 and Exhibit 4? Why is there a time varying discount/premium? Why is there a discount at all? Why does that premium vary across funds?

Behavioral finance explains the varying discount / premiums for CEFs with the following points:

- CEFs sell at a discount due to the additional risk in holding a position in the fund over its portfolio
- Investors buy fund shares at a premium due to the enthusiasm individual investors have on IPOs
- Discounts on CEFs experience wide fluctuations due to changes in investor sentiments on future returns
- When the fund terminates, share prices rise due to elimination of noise trader risk

Many factors may determine whether a fund trades at a premium or discount to its NAV. Public perceptions can drive the market price of a CEF up or down in relation to its NAV. For example, if the market perceives that a CEF is one of the only ways to invest directly or indirectly in a category of scarce securities, market interest may drive the price up to a premium. On the flip side, a CEF that has large unrealized capital gains may trade at a discount if investors believe they will be subjected to taxes upon the funds realizing a capital gain.

A possible reason for the variability between premiums is that CEFs are publicly traded so supply and demand is different for each fund. This is coupled with noise trader sentiment, which has a random pattern that cannot be predicted precisely/perfectly forecasted by rational investors. There's evidence that strongly indicates that CEFs are held and traded primarily by individual investors [1, pg. 60]; this means that CEFs, more than any other type of fund, are likely to be influenced by sentiment. The unpredictability of opinions of noise traders impounds the resale price risk on assets they trade (like CEFs).

Another reason for the discrepancies between premiums and discounts between CEFs is there are different managers and different investment strategies for each fund. Discounts on CEFs fluctuate with changes in investor sentiment, and it is precisely these fluctuations in discounts that make holding the fund risky and account for average underpricing. A fund manager like Goldstein, who has a demonstrated history of successful investing, might influence investors to follow him and drive the price of the fund up. This is one of the features of a CEF; if discounts were constant, then arbitrage trade of buying the fund and selling short its portfolio would be riskless even for a short horizon investor, and discounts would disappear [1, pg. 63].

4. What should Goldstein do? What are the potential costs and benefits of each of the options that Goldstein is considering?

Goldstein has five options available to him:

1. Full liquidation

Benefits:

- As MXE is liquidated, prices will converge to NAV as a result of arbitrage
- Noise trader risk is eliminated and so will the discount [1, pg. 63]
- Complies with request to quickly deliver NAV to shareholders

Potential costs:

- Shareholders/investors who bought when the fund was more expensive would be forced to sell at a loss
- If the fund has any embedded capital gains, then the investors might have to pay capital gains taxes
- Requires shareholder approval and a vote, which includes mailing and special meeting costs

2. Partial liquidation

Benefits:

- Shareholders/investors can reinvest this distribution rather than taking them in cash, and compound their return as invested capital
- Causes NAV per remaining share to go up, and if the discount remains the same after that transaction, the share price goes up

Costs:

- Leaves investors better off but shrinks the asset base on which the fund operates

3. Large-scale self-tender offer or 4. Large-scale repurchase program

Costs:

- Splitting up of MXE's portfolio piece by piece could favor interests of some stockholders at the expense of others, and would not give all stockholders equal opportunity to promptly realize NAV for their shares
- Could result in higher long term costs for MXE and burden stockholders who choose to remain MXE

5. Converting fund to open end

Costs:

- Potential for unwanted tax consequences from fund's selling shares to cash out departing investors
- The fund would likely receive many redemption requests from investors upon converting to an open-end fund, which may force the fund to liquidate if it became too small to be considered economically feasible
- Would likely result in a substantially higher expense ratio from process which would unfairly burden the Fund's remaining stockholders.

Goldstein should continue with his original plan of liquidation of the fund. Out of all of the available options, it is the one that delivers NAV to shareholders the fastest. While he has to get approval of shareholders, the previous vote only just failed to garner the necessary two-thirds majority (57% of shareholders voted to liquidate the fund); Goldstein attributed some of this to "shareholder apathy" [2, pg. 6] and the results of the vote seem to back his claim [2, pg. 21]:

- 5,764,991 (57.3%) in favor
- 446,014 (4.4%) opposed
- 77,051 (0.77%) abstained
- 3,772,340 (37.5%) did not vote at all

Many of the other options are unattractive and place a lot of burden on the investors; the remaining options either don't give stockholders an opportunity to realize the NAV for their shares or lead to higher long term costs for the stockholders that remain with the fund. Even if they garner the necessary votes to convert to an open-end fund, there appeared to be a general lack of interest on the part of suitable merger candidates [2, pg. 19]; it seemed unlikely they were going to find an existing fund that would pay the price they were looking for.

Appendix

[1] Shleifer, A. (2000). "The Closed End Fund Puzzle." *Inefficient Markets – An Introduction to Behavioral Finance.* Oxford, England, UK: Oxford University Press, pp. 59-65.

[2] Greenwood, R., & Quinn, J. (2008). *Opportunity Partners.* HBS No. 9-208-097. Boston, MA: Harvard Business School Publishing.