Ironclad protection of Closed End Mutual Funds against market volatility

I have been in the capital market for over 30 years, investing in both liquid and illiquid capital markets including — frontier markets. Volatility and illiquidity creates both risks and opportunity in every market — across frontier, and developed including the deep and matured US capital markets. Those of us who have been around for some time are well aware of the fact that in many occasions fundamental and technical drivers in the capital markets diverge materially.

In many cases, technical factors materially supersede fundamental factors. In order to effectively navigate in choppy markets and mange risks and decisively turn risks into opportunities for skilled managers. However, in order to execute and maximize benefits to the investors no other investment vehicles matches the imbedded structural advantage of closed end fund's (CEMFs) or investment vehicles that include ALL patient and long term investors!

Trying to time the market perfectly, and over trading is always a recipe for disaster for even professional investors. If you evaluate the long term success of most legendary investors including Warren Buffet, Charlie Munger, Peter Lynch, John Bogle, Bill Miller, Benjamin Graham, and Carl Icahn you will find two common factors: **(a) laser sharp fundamental analysis (security selection), and (b) a long term investment plan to execute the strategy (asset allocation & market timing). Obviously plans may change due to a material events in (a) - an event risk!.** Therefore, an experienced manager require investment flexibility to execute the investment plan. All these legendary investors either had access to long term capital or investment vehicles that allowed them to execute proprietary long term investment strategies that has contributed to their stellar performance.

During the peak of the financial crisis in August of 2008, Citigroup stock tanked and traded close to 1 dollar, S&P 500 was down over 40% (total disconnect from fundamentals), and financial institutions collapsed left and right. I have experienced firsthand the pain of devaluation of asset value both for investors and myself. My entire investment team and I at Citigroup satisfied hundreds of millions of dollars of margin calls and investor redemptions forcing us to realize losses absolutely at the bottom. All these assets were fundamentally very strong however they had certain liquidity triggers (a structural flaw). Our fundamental analysis was precise, stress tested, and accurate however technicals, sentiments, and pure panic prevailed over all fundamentals. We obviously failed to estimate the structural risks imbedded in the investment vehicles, that has little to do with the quality of assets we owned. I myself have lost over USD 3 Million for being invested in my funds and Citigroup Stocks (company compensation plan). After I left Citigroup, and was permitted to trade on my own personal account (2009), I recovered ALL my losses (2 years) and had material gains by 3 year, using the same skills and investment discipline but **WITHOUT** any structural risk in my portfolio.

The short term change in sentiment, and technicals has nothing to do with long term fundamentals. The assets we traded were highly liquid with bid/ask spread (a measurement of liquidity) of 5 basis points or less. However, during the peak of market stress other than T-Bills, every high quality assets gaped in some cases over 5%, never seen before since late 80's.

One life lesson, I have personally painfully learned is that - never take liquidity for granted or underestimate the risks that we take on for shorting liquidity or structural risks. This risk is universal and more so in less liquid markets in Bangaldesh, and valid for even for the highest quality Fixed Income assets (other than US Treasury Bills and Bonds) or even for the best global equity/ stocks like Amazon, Apple, GOOGLE, MasterCard, and Microsoft that I personally own.

In Bangladesh, due to limited liquidity generally long term investors can **materially** benefit from investing in any listed closed end mutual funds (CEMFs) managed by any asset manager provided portfolio details are readily available for analysis. **Liquidity option provided by Open End Funds may be great for underlying T-Bills and cash equivalent assets, but certainly NOT for risky assets including Stocks in Bangladesh. Price of liquidity is also transitional and can be very expensive (for Investors) in turbulent markets. Liquidity option provided by Open End Funds can cause material loss to all investors including long term investors in Open End Funds. This is due to the fact that early existing investors can materially adversely impact long term investors in the same fund, especially when adverse sentiments kick in. All market participants must be aware of the reality that shorting liquidity (liquidity option for Open End Funds) is a very risky proposition and can directly impact buy-sell decisions bypassing the discretion of even a highly experienced portfolio manager. In even small spike in volatility events, shorting liquidity also can facilitates a material systematic risks and hamstrings portfolio managers to take advantage of temporary and short term market dislocations.**

In my opinion the best way to gain exposure to stock market in Bangladesh is CEMFs. Provided an investor follow the steps below: (a) Carefully evaluate the Net Asset Value of a CEMFs that seems attractive, (b) Evaluate detailed portfolio list and valuations of underlying instruments, (c) Evaluate the premium or discount factor (if justified or not), and finally (d) Evaluate the qualifications and the track record of the Fund Manager. All these factors are equally important. Once you have made your decision to invest, you must ensure that you only invest a portion of your liquid assets, and second, always invest for at least 3-5 years of investment horizon so you increase the likelihood (probability of your desired returns).

Unfortunately in Bangladesh, many actively managed closed end mutual funds (CEMFs) trade at a material discount to NAV indiscriminately!

This is primarily due to lack of knowledge among many general investors. However, many experienced institutional investors are fully aware of this arbitrage and have selectively invested in CEMFs in funds managed by LR Global to exploit this investment opportunity and greatly benefited from these investments.

Assuming that, (1) NAVs **CEMFs** are accurate transparent, (2) any investor can evaluate, and analyze underlying holdings to make rational investment decisions - CEMFs are most likely the best investment for investors who require instant **sustainable** diversification, active management, and **prefer to be insulated from day to day market volatility**. For example, if blue chip holding of any CEMF is underpriced (already trading at a 10% discount to the fair value) and the NAVs of CEMF is trading at a deep discount (over 20%); **assuming this is the case there are NO other attractive alternatives in Bangladesh to gain access to prime underlying assets than via selected CEMFs, directly by arbitraging the mispricing of almost 30% e.g. - 10% underlying and 20% additional on CEMFs.**

CEMFs are also listed and traded in the exchanges providing secondary liquidity to investors (at price) while preserving the long-term investment flexibility to the portfolio managers (key driver for performance), and **not triggering potentially a massive sale in assets at the wrong time in illiquid markets — unlike structural risk triggered by exiting investors in Open End Funds.** Nevertheless, CEMFs shares are **NOT** highly liquid, therefore **NEVER** buy or sell when the instrument is thinly traded **relative to the size of your trade. I strongly believe this illiquidity is temporary and short term — at least for transparent CEMFs will trade close to NAV as investors realize the greatest arbitrage and investment opportunity — realized by some opportunistic investors already.**

It is obvious and needless to state — assuming Net Asset Values are accurate, managed by a professional asset manager —CEMFs should not be trading over +/- 10% (above or under) Net Asset Value in most regular market scenarios. Finally, asset managers also play a very important role and in fact play the most critical role in ultimate performance. However, anyone pitching you short term unsustainable gains in any investment opportunities or any funds are most likely only misleading investors.

I can guarantee you that - short term outsized projections are for casinos and not investors who cares for consistent, sustainable, and predictable outperformance.

CEMFs provide material flexibility and edge to fund managers, and investors to buy assets cheap during market stress and can materially outperform the market over a medium to long term period, CEMFs can materially outperform the market vs Open End Mutual Finds with same asset manger owning identical portfolios. The sole reason for this is when you are short an option (liquidity option) there are material structural risks as I myself have experienced in 2008 even in a deep matured market. **Consequently, assuming all other factors identical, CEMFs alone can outperform Open End Funds due to structural benefits. This is especially true for Bangladesh due to generally illiquid markets and lack deep institutional investor base.**

In summary, any professional and experienced investment manager (in CEMFs) can seamlessly execute on all three drivers for performance including additional structural advantage: (1) security selection, (2) asset allocation, and (3) market timing/risk management for 1 & 2 above. CEMFs have obvious and material structural advantage over and above all 1, 2, & 3 and that is why most successful Mutual Funds (except for Money Market Funds) are in closed form globally. This is even more important for markets like BANGLADESH, since most of the Open Funds have not encountered any material stress and launched after the market crash of 2010.

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