

**Do Derivative Instruments Play a Role in Managerial
Performance Hypothesis? - The Closed-End Funds Case**

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ABSTRACT

When compared with open-end funds (OEF), it is possible to say that the most distinguishing feature of closed-end funds (CEF) is the fact that CEF have a finite number of shares which causes their actual share prices to stray from their net asset values (NAV). Such deviations from NAV are called premium, when share prices are greater than NAV, and discount vice versa.

This premium/discount phenomenon is often referred as “the CEF puzzle”. A vast amount of literature has devoted a long lasting attention to the understanding of CEF puzzle. We observed that two groups of research have attempted to explain the puzzle, one following a traditional (rationality-based), while the other, a behavioral (irrationality-based) approach.

Traditional approach claims that discounts mainly stem from agency costs, tax liabilities and the illiquidity of assets in the portfolio¹. Excessive management fees, poor future NAV performance and ineffective fund organization may pave the way for discounts in accordance with agency problem approach (Dimson & Minio-Paluello, 2002). Capital gains tax liabilities associated with fund assets may also reduce the liquidation value of the fund, which in turn cause discounts (Lee, Shleifer, & Thaler, 1991). Large amounts of restricted stocks in the fund portfolio arguably may be overvalued in NAV calculation and this misvaluation may call for discount (Lee, Shleifer, & Thaler, 1990). Behavioral approach, however, focuses on investor sentiment hypothesis, which represents noise trading. Accordingly, rational investors prefer CEF selling at discounts because of noise traders who make systematic forecasting errors irrationally.

Bearing all of these approaches in mind, we prefer to carry on the agency cost strand of traditional approach but from a managerial performance point of view, since Turkish CEF are exempted from any tax requirements and forbidden to invest in illiquid assets. We support the hypothesis that discounts reflect market expectations of CEF managers' future performance. Under the managerial performance hypothesis, discounts are attributed to investors' rational expectations of the inferior investment skills of CEF managers. This assumes that investors obtain sufficient information to form expectations regarding the future investment decisions of the manager (Chay & Trzcinka, 1999).

On the other hand, literature shows that derivatives are useful tools that allow investment managers to utilize information better, manage risk and reduce transaction costs, which in advance, makes us suppose that portfolios whose managers use derivatives should demonstrate improved performance relative to non-users (Koski & Pontiff, 1999).

Melting all in a pot, we intend to test that the market price of CEF shares reflects investors' expectations of the CEF's managerial performance in the future while anticipating a stronger negative relation between the discount of derivative user CEF and its future NAV performance than non-users'.

Our results reveal a significant and positive relation between CEF premiums and future NAV performance. However, we find that this relation seems not to be more explicit for derivative user CEF than non-users.

Keywords: Closed-end funds, managerial performance hypothesis, net asset value, derivatives, discount/premium.

Topics: Finance, Management

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