WELLS CAPITAL MANAGEMENT

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Closed-End Fund Strategies

The World at a Discount – The Case for International Equity Closed-End Funds

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Executive Summary

Many institutional investors emphasize local investments, exhibiting a home-country bias. However, with more than half of the world's total stock market capitalization defined as international equity, international equity assets merit a meaningful allocation.

Investing in a portfolio of international equity closed-end funds (CEFs) can mitigate some of the risks found in traditional international equity investing and provide competitive risk-adjusted returns and diversified international exposure across countries, regions, and industries.

1. CEFs at deep discounts

When purchasing individual stocks, an investor pays full market price. However, most CEFs sell at a discount to the sum of their stock constituents or their net asset value (NAV). The discounts widen and narrow over time, providing price-sensitive opportunities to trade them and additional return. Since dividends are paid on the full value of the stocks, owning a discounted portfolio also increases the effective yield.

2. Reduced idiosyncratic risk

By investing in a pool of funds, one obtains exposure to a wider range of styles, market caps, and stocks. In other words, there is a sampling of large cap, small cap, growth, value, core, and specialty investing. This much broader diversification sharply reduces the risk of an individual stock, sector, or country adversely affecting the portfolio's overall performance.

3. Unique and repeatable source of alpha

Investing in multiple international CEFs can provide a unique and repeatable source of alpha relative to a traditional international equity portfolio, which over longer periods of time may provide additional diversification benefits.

4. Reactive rather than anticipatory investing

This investment approach is not based on macro-economic bets, earnings forecasting, or any predictions, rather reacting to what the markets present. Robust quantitative models identify historically large discounts for subsequent qualitative evaluation. One then buys what is out of favor and sells what is in favor, which is reflected by changes in discounts. Sell candidates, for example, are characterized by narrowing discounts to NAV. This discipline, with specific numeric discounts as buy/sell targets, enables consistency of results leading to higher risk-adjusted returns.

The following pages elaborate on the points made above and how a plan's asset allocation may benefit from adding exposure to a portfolio of international CEFs.

The CEF universe, a retail-dominated sector, is relatively modest in size with net assets approximating $145 billion as opposed to over $11 trillion represented in the MSCI EAFE Index. There are only a few institutional managers that invest in international CEFs and those who do typically have limited asset capacity. Institutional investors usually outperform the less-competitive retail segment thanks to robust processes and technology investments that can spot market anomalies. They employ teams of full-time professionals devoted to quickly acting on these discrepancies using sophisticated trading platforms. Additionally, only a few analysts in the U.S. and United Kingdom research CEFs, further adding to the inefficient nature of the universe. As a result, institutions with enough available capacity can be extremely successful investors because they are nimble enough to trade in retail-sized cash flows and move more quickly than the goliaths of the industry.

1. CEFs at deep discounts

CEFs are related to the more familiar open-end mutual funds but differ in a number of important ways, including share issuance, capital structure, and price determination. Open-end mutual fund prices are determined solely by their end-of-day NAV. On the other hand, CEFs have a fixed number of shares, making the price of a CEF subject to market demand and investor sentiment—allowing them to be traded at a premium or discount to stated NAV. However, as a whole, CEFs generally trade at a discount. As shown in Figure 1, the net assets of our proprietary international CEF universe are valued at $142.5 billion on a standalone basis, but the total market capitalization of these funds is $130.9 billion, leaving an $11.6 billion discrepancy or total discount.

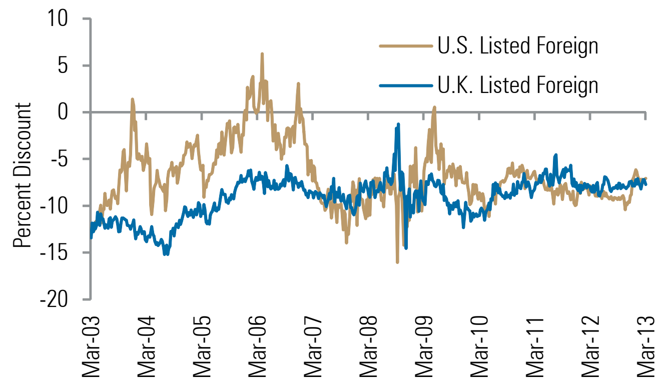
Figure 1: Unclaimed Shareholder Value

Asset Class	Market Cap ($ billions)
U.S. Listed International	$50.1
U.K. Trusts and Offshore	+92.4
Total Net Assets, U.S. and U.K.	142.5
Total Market Capitalization	-130.9
Discount Value	11.6

Source: WellsCap Proprietary Systems, 3/31/13

A CEF's discount fluctuates, and average discounts differ between the two primary markets where CEFs are sold—London and New York—due to varying asset composition and different shareholder bases. However, one characteristic common to both markets is cyclicality, or some form of reversion to the mean. A disciplined team can add value independent of market direction by monitoring discount and premium spreads and looking for opportunities where these spreads are outside historical ranges. This important characteristic allows an investor to navigate disparate markets and to add value even in times of rapidly declining markets. Through the discount value, cyclicality, and constant monitoring, an investor can realize value above and beyond the normal growth of the underlying assets.

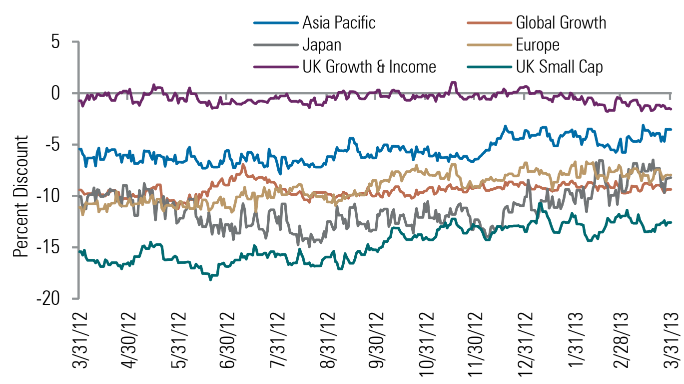
Figure 2: WellsCap International Closed-End Fund Comparisons



Source: WellsCap Proprietary Systems, 3/31/13

Peer universes allow investors to properly compare one CEF to another. In U.K.-traded funds, for example, peer universes include Asia, Japan, Europe, U.K. growth & income, U.K. small cap, and various regional and specific country funds. Each specialty has its own peer universe and discount characteristics. Figure 3 reveals that average levels of discounts vary widely among markets. Moreover, there is meaningful discount volatility in each market, allowing ample opportunity for a disciplined team to trade temporary dislocations.

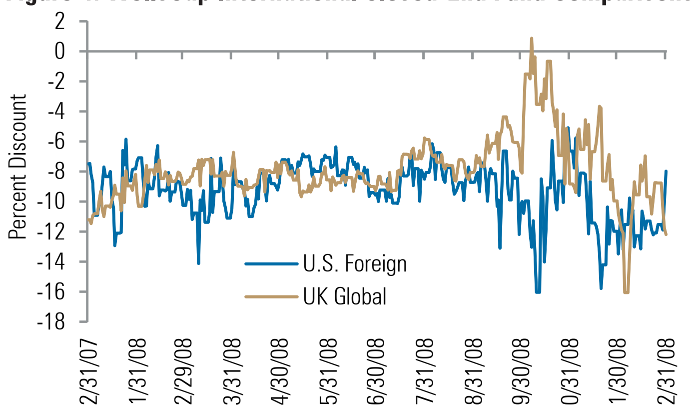
Figure 3: U.K. Domiciled Funds Daily Discounts



Source: WellsCap Proprietary Systems, 3/31/13

A particularly exciting opportunity occurs when similar assets on different exchanges and in different markets diverge sharply in relative prices. As seen in Figure 4, global funds in London and New York traded at similar discount levels through most of 2008. In September, though, discounts on the U.S.-traded funds suddenly and sharply diverged from the U.K. funds, when there was pronounced capitulation by the U.S. retail investor base during the credit market and financial industry crisis. As a result, one successful strategy was to sell the U.K. funds at 3% to 7% discounts and buy the U.S. analogues at discounts in the mid-teens. It may seem counter-intuitive that plummeting markets are attractive, but widening discounts lead to portfolio rebalancing which then lead to greater upside potential while also providing a cushion on the downside.

Figure 4: WellsCap International Closed-End Fund Comparisons



Source: WellsCap Proprietary Systems, 3/31/13

2. Reduced idiosyncratic risk

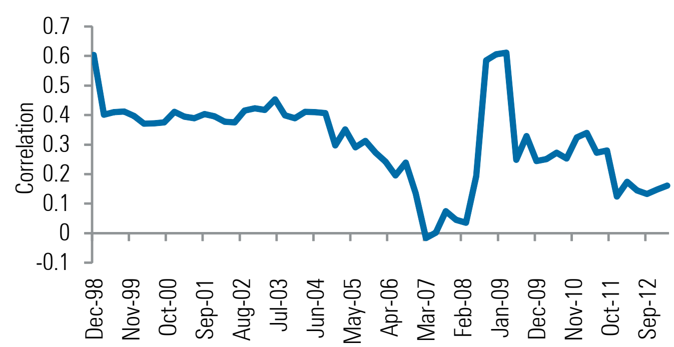
In conventional international equity investing, a portfolio manager builds a portfolio with, say, 20 to 200 plus stocks that reflect the investment philosophy, whether small cap growth stocks in Japan or U.K. large cap stocks. In any case, there is an overarching theme that defines the strategy. Investing in multiple CEFs is unique and is essentially a fund-of-funds strategy, minus the additional layer of fees typically associated with conventional fund-of-funds. With this type of fund-of funds investing, a portfolio manager selects a wide variety of CEFs, perhaps 40 to 70 of them, which in aggregate may contain as many as 2,000 individual stocks. This layer of diversification, especially when implemented globally, ensures a wide representation of styles, regions, asset classes, and industries, significantly reducing the impact of one failed stock. In an individual portfolio, one failed stock with a 5% weight can decimate a full year's performance. With a fund-of funds strategy, this idiosyncratic risk is reduced substantially with deliberate diversification across funds, leading to a positive impact on risk-adjusted returns.

3. Unique and repeatable source of alpha

Traditional international equity managers attempt to outperform a benchmark or index by deviating from the sector and/or country weights or through superior stock selection. A quantitative international closed-end fund-of-fund strategy, on the other hand, generates a unique kind of alpha by investing at a discount to net asset value. Simply stated, it capitalizes on the inefficiencies within the CEF marketplace.

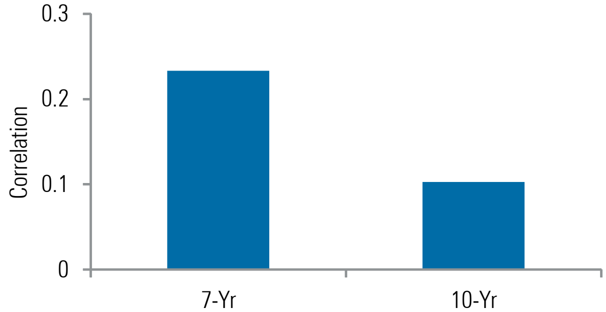
As a result, the excess return from investing in international CEFs exhibits low correlation with other, more traditional international equity strategies. As shown in Figure 5, the correlation of the excess return of the WellsCap International Equity CEF strategy and the EAFE Large Cap Core peer median to the MSCI EAFE Index has remained relatively low on a rolling five-year basis. Over longer periods (see Figure 6), the diversification benefits are even stronger as witnessed by a correlation of 0.23 and 0.10 over the last seven- and 10-year periods, respectively. This method adds value by investing at a discount, coupled with the NAV performance of the underlying funds. This approach differs significantly from most international equity managers, and is an effective complement to them.

Figure 5: Excess Return Correlation to MSCI EAFE: Rolling 5 Years WellsCap International Equity CEF Strategy vs. Peer Median



Source: eVestment Alliance, 1/1/94 through 3/31/13

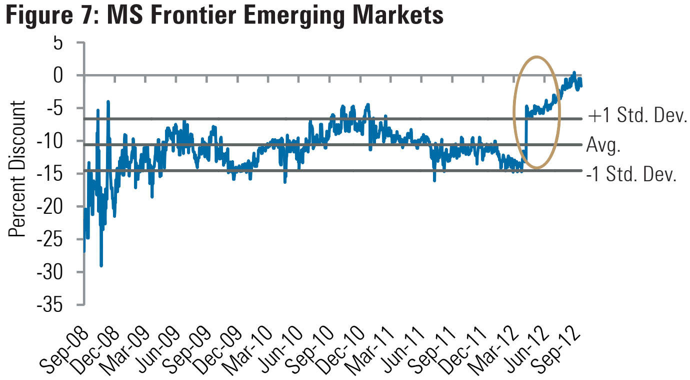
Figure 6: Excess Return Correlation to MSCI EAFE: WellsCap International Equity CEF Strategy vs. Peer Median



Source: eVestment Alliance, as of 3/31/13

Additionally, alpha can be realized through shareholder activism or corporate action. In these scenarios, shares can be sold back to the issuer at full par value, eliminating the discount. An example is depicted in the following chart, when the Morgan Stanley Frontier Emerging Markets Fund announced its intention to convert from a CEF to an open-end mutual fund in May 2012. The value of the underlying shares, the NAV, was unchanged, but the discount was eliminated when the fund converted in September 2012. In this case, each dollar of asset was then priced at one dollar, as opposed to 85 cents before announcement of the fund conversion.

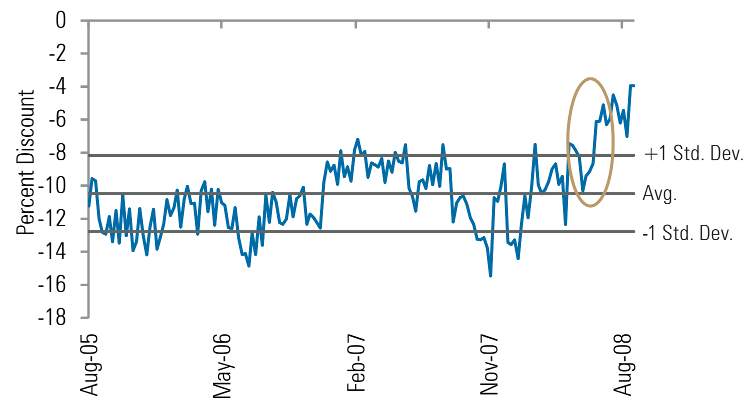
Figure 7: MS Frontier Emerging Markets



Source: WellsCap Proprietary Systems, 3/31/13

Another example occurred in June 2008 in London where the Templeton Emerging Markets Investment Trust tendered 30% of its assets at a 4% discount after a large shareholder actively sought an exit strategy. As seen in the oval shape on Figure 8, the discount was reduced from the over 10% to a low single-digit discount by mid-year 2008.

Figure 8: Templeton EM Investment Trust



Source: WellsCap Proprietary Systems, 3/31/13

4. Reactive rather than anticipatory investing

The disciplined process outlined in this paper is one that has proven successful for over 20 years. Quantitative models can hone in on closed-end funds that have historically wide discounts on an absolute level relative to peer groups, or even relative to their own histories, isolating what is quantitatively "cheap." Conversely, positions are sold when pre-specified targets are breached on the upside. Applying a qualitative assessment on top of the quantitative-driven screen enhances the process by helping to reveal "value traps" or whether historical norms or the current peer group are still meaningful.

Conclusion

The international CEF market is unique in terms of its market size and investor composition. Using an institutional approach to take advantage of market inefficiencies helps mitigate risk, improves downside risk-adjusted returns, and offers several benefits including reduced idiosyncratic risk, a repeatable source of alpha and buying international equity exposure at a discount.