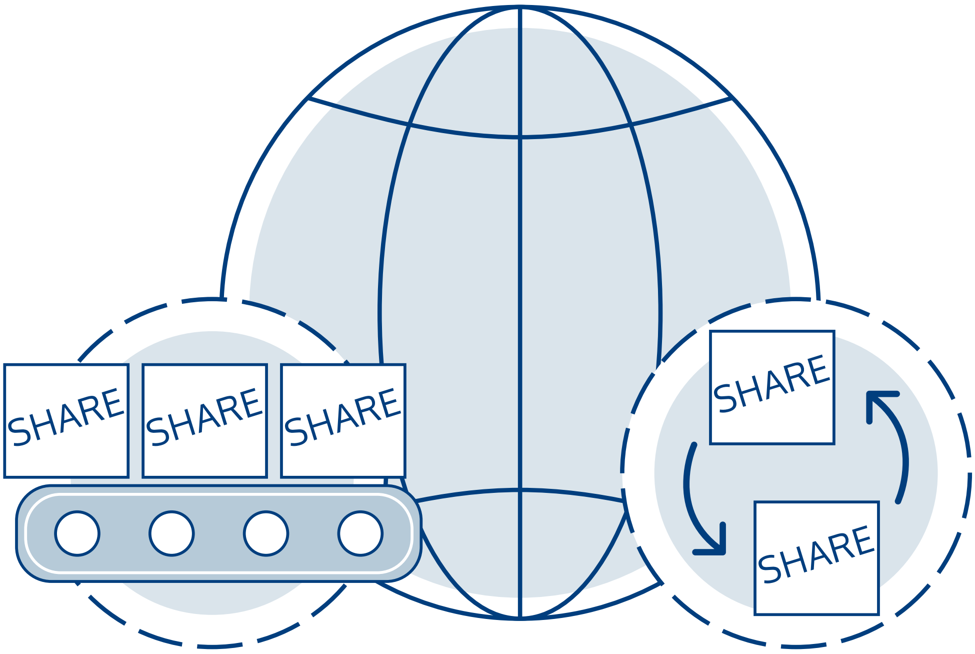

MAGELLAN EXPLAINS: Open-ended & close-ended funds

There are a number of listed and quoted funds on the ASX and these funds can either be open-ended or closed-ended. It's important to understand the difference as your investor experience will vary in either fund type.

CLOSED-ENDED FUNDS

Let's start with closed-ended funds, such as **Listed Investment Companies (LIC)** and **Listed Investment Trusts (LIT)**.

A closed-ended fund is one where the number of **units** or **shares** on the market is **fixed**, similar to any company that is listed on an exchange. It cannot continuously issue or redeem existing units and, like a company, it can only issue new shares or units through corporate actions that include a placement, rights issue, dividend reinvestment plan, share purchase plan or through a takeover of another company or trust.

What this means for investors is that because the supply of shares or units is limited, investors have to trade with each other in the **secondary market**. Therefore they set the price of the unit or share, just like a company's share price is set by the market.

The underlying value of each share or unit in a LIC or LIT is known as the **Net Asset Value (NAV)**. This tells investors what one unit or share in the fund is worth based on the value of the underlying assets less any liabilities in the fund. This is the reference point for investors to know the true value of one unit or share.

When they compare the share price to the NAV, investors can then determine if the fund is trading at a **premium** or a **discount**. If the share price is higher than the Net Asset Value, then the unit or share is trading at a premium. Conversely, if the share price is lower than the NAV, the unit or share is trading at a discount.

Liquidity is another factor that needs to be taken into account with closed-ended funds.

Liquidity refers to how easy it is to buy or sell a share or unit on an exchange. With a closed-ended fund, liquidity will depend on both the number of buyers and sellers as well as the relative demand for the share or unit. In one scenario, a share or unit might have a high demand but low liquidity if buyers and sellers disagree on the price. Without agreement on a price, there's no transaction. Alternatively, there might be an agreement on the price of stock or unit, but low liquidity if there are only a few buyers or sellers in the market. Conversely, where a close-ended fund has reasonable scale and there is matched demand from buyers and sellers, then liquidity can be high.

OPEN-ENDED FUNDS

Let's now look at open-ended funds, such as **Active Exchange Traded Funds (Active ETFs)** or **Index Exchange Traded Funds (Index ETFs).**

An open-ended fund is one where, in addition to investors trading with each other on the exchange, new units can be created in the fund as new investors buy in. Similarly, if investors exit, then units can be cancelled. The fund grows and contracts based on investor activity plus investment returns.

In the first instance, investors can still buy or sell from each other in the secondary market. However, if there is more **demand** for investors wanting to buy units or less supply for investors wanting to sell than what is available on the market, then additional liquidity can be provided by the fund itself as investors can buy from and sell units to a fund. With some open-ended funds, liquidity is provided by authorised market participants, known as **'market makers'**, rather than the fund itself. This means that regardless of demand, there will be liquidity and the ability to buy and sell units with ease.

Finally, unlike a closed-ended fund, because supply is not limited and investors can transact with the fund itself, the price of the unit reflects the **underlying value** of the investments in the fund, not what the market thinks it is worth. This equates to premiums and discounts being minimised, with the unit price generally trading very close to the Net Asset Value of the fund.

WHAT TO LOOK OUT FOR IN BOTH FUND TYPES

In summary, both closed- and open-ended funds can be a great way to gain exposure to a professionally managed portfolio of stocks in a single transaction on an exchange.

Some things that investors commonly look for in a LIC and a LIT are whether they have regular disclosure of their NAV so that investors can compare the NAV to the share or unit prices to determine if they are trading at a premium or a discount to their NAV. The next is whether the LIT or LIC has sufficient scale to provide liquidity for investors to either purchase or sell shares or units. The last is whether or not the LIC or LIT has a standing on-market buyback programme whereby the company or trust buys back its shares or units where it is determined that doing so would be in the interests of the fund's investors.

Active and Index ETFs will generally trade very close to their NAV, which is very appealing to some investors. However, they are unable to offer some features that are unique to closedended funds, like providing a discount on their Distribution Reinvestment Plans or targeted cash distributions on an annual or semi-annual basis.

Whilst we have touched on the structures that investors can own on the exchange in this article, it is important for investors to understand not only the dynamics of these structures but also the underlying investments that are held by that structure to ensure that they align with their objectives and that they have full transparency on what assets they own.

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