

The High Cost of High Dividends

Closed-End Fund's Payouts May be a Returned of Capital Which Can Erode Asset Base

Investors who don't read the fine print when buying closed-end mutual funds offering generous fixed-dividend payments may be surprised to learn how the funds pay out so much money.

Take Cornerstone Total Return Fund, a closed-end fund with a set number of shares that trade all day on the American Stock Exchange. While the fund has consistently underperformed the Standard & Poor's 500-stock index and its net asset values has declined about 40% since 2002, its shares trade a premium of more than 30% to the value of its assets.

What gives? The payout from the fund has been a draw for investors. Cornerstone Total Return has paid shareholders a fixed monthly dividend of 17.6 cents a share since December 2003, up from a 16.5-cent fixed distribution rate in 2002. Based on yesterday's 4 p.m. American Stock Exchange share price of \$14.04, that works out to a yield of 15%.

This looks like a good deal, especially in challenging market conditions, but roughly 95% of these payments have been a return of capital, where shareholders take home the fund's principal, not profits. While there is nothing wrong with funds giving investors their money back when revenue streams are thin-provided the source of the distributions is properly disclosed-doing so on a consistent basis erode the fund's asset base.

"Initially, investors may think they're getting all of that money without sacrificing any principal," said Mariana Bush, a closed-end fund analyst at Wachovia Securities. "The Cornerstone Fund is not producing a 15% to 16% total return every year. Some people may think of it as some kind of bond they're buying at par and getting that entire yield. That is not the case."

Cornerstone defends its distribution policy saying it is a long-term strategy to prevent the shares from trading below the value of the fund's asset, like many closed-end funds. "We believe that by moderating the discount structure of the fund and leaving the decision with the shareholders whether to reinvest in the fund or take cash, the managed distribution policy works to the advantage of all shareholders." The fund said in a statement.

Managed distribution policies-which entail cash payouts on a monthly or quarterly basis, usually based on a percentage of a fund's assets-have been credited with improving the performance of many closed-end funds, which have a set number of shares that trade on an exchange like stocks, often at price below their underlying assets. Liberty All-Star Equity Fund, for example, returned part of its capital as a distribution last year, according to filings with the Securities and Exchange Commissions.

But the SEC is taking a closer look at these distributions and has stopped approving new request by funds to make frequent distributions. The SEC wants shareholders to understand that funds that make a return of capital distribution on a regular basis are suffering an erosion of assets that will eventually be depleted, according to an SEC official.

"If the yield looks to good to be true and is way out of line with what similar funds are [offering], then people should ask what the fund is doing to earn that yield," said David Tepper, a principal Tepper Capital Management in San Francisco, who invests in closed-end funds.

By Angela Pruitt, *The Wall Street Journal* – Dow Jones Newswires