

## FLP Discounts: Closed-End Funds Provide Market Data to Support Discounts for Lack of Control

*In order to help quantify the discount for lack of control for interests in family limited partnerships (FLPs), ComStock Advisors has studied the discounts observed on publicly traded closed-end funds. This article summarizes our findings. A summary of the data can be found in the tables at the end of this article. We obtained market prices and net asset values from the December 31, 2008 closing price listed by the Closed End Fund Association ([www.cefa.com](http://www.cefa.com)).*

Investments in closed-end funds share certain characteristics with limited partnership interests. Closed-end fund investors, like limited partners, cannot control investment decisions or distribution policies nor can they force a liquidation of the fund. Since units of closed-end funds are traded on public exchanges and the over-the-counter market, this lack of control can be reflected in the market prices of the units, which often trade at discounts to their net asset value. Other factors that can contribute to discounted or premium prices for closed-end funds include the distribution policy of the fund, the relative performance of the fund, the risk level of the portfolio, unrealized capital gains or losses and the reputation and performance of the fund manager.

Because valuations of FLPs are often done for gift and estate tax purposes, it is important that valuation reports contain solid rationale and market data supporting the discounts applied. The discounts observed on publicly traded closed-end funds can provide useful evidence regarding appropriate discount for lack of control to be applied to minority interests in FLPs, LLCs or other entities that serve as asset holding companies.

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## Discounts by Fund Type

**General Equity Funds.** For the 191 general equity funds included in our analysis, the median discount from net asset value was 16.6%, with an interquartile range of 8.7% to 20.1%. This is greater than the median discount of approximately 10% that we observed at the end of 2007. Discounts for funds investing in convertible securities and specific sectors were generally lower than the broader category. Discounts for funds investing in real estate were significantly greater than other general equity funds, with a median discount of 27.0%. Real estate funds are generally highly leveraged. We observed that increased fund leverage in certain fund classes corresponded with increased discounts from net asset value.

**Global Equity Funds.** For the 52 global equity funds included in our analysis, the median discount from net asset value was 11.3%, with an interquartile range of 8.0% to 17.1%.

**Taxable Bond Funds.** For the 117 taxable bond funds included in our analysis, the median discount from net asset value was 10.3%, with an interquartile range of 3.9% to 15.8%. Funds holding international bonds traded at the largest discounts from net asset value. Funds investing in BBB corporate bonds traded at a median discount of 6.8% from net asset value. This is less than the median discount of 10.8% that we observed at the end of 2007, indicating the drop in the market price of BBB corporate bond funds is due to the decline in the net asset value of the funds, not in an expansion of discounts. It should also be noted that discounts on BBB corporate bond funds were at the upper end of their range at the end of 2007. Typically, these funds trade at an average discount from net asset value of 6% to 7%. The 10 funds investing in U.S. mortgages traded over a very large range of discounts – from a 6.1% premium to a 22.1% discount.

**Tax Exempt Bond Funds.** The largest category of funds is those that invest in tax exempt bonds. Discounts on these funds have increased from a median of approximately 9.5% at the end of 2007

to a median of 15.1% at the end of 2008. The increase in discounts appears to reflect the economic conditions facing certain states and potential trouble for municipal issues. The discounts are largest for Michigan, with Florida close behind. It is true that the underlying value of the assets held by these funds has likely declined, but the market price of the funds have dropped even more, reflecting investors' concerns with these assets. This contrasts sharply with unleveraged general & insured municipal funds, which primarily invest in either municipal debt issues rated in the top four credit ratings or in municipal debt issues insured as to timely payment. Five of the six funds in this category traded at small premiums to reported net asset value.

## Distribution Policies

Closed-end mutual funds are generally taxed as Regulated Investment Companies (RICs). Special tax treatment is accorded to RICs, which treats their income as nontaxable at the entity level, provided that they meet a series of detailed Internal Revenue Service requirements. To be taxed as a RIC, a fund must distribute at least 90% of its investment company taxable income, with certain adjustments, plus 90% of its net tax exempt interest income. Similar rules are provided with respect to distributions of capital gains.

Historically, equity funds with managed distribution policies have tended to trade at a smaller discount to net asset value than those without managed distribution policies. The consistent income stream a fund with a managed distribution policy offers shareholders is an attractive feature to investors. Investors looking to obtain high distributions often bid up the price of such a fund, thus bridging the gap between the fund's market price and its net asset value. As a result, the discount at which the fund trades decreases, or the fund may even trade at a premium.

At the end of 2008, this differential between funds with and without managed distribution



policies appears to have evaporated. For some funds, it is possible that maintaining distributions requires a sale of fund assets. The sale of assets into a down market is not desirable and also leaves such funds with fewer investment assets with which to generate future returns.

## Application to FLP Valuations

Because they are actively traded on public exchanges, closed-end funds provide market data to support the quantification of the discount for lack of control for FLPs holding marketable securities.

However, the data must ultimately be applied to the particular case at hand. A defensible rationale should draw correlations between the subject FLP and the discounts derived from the closed-end funds. In particular, the following items should be considered:

- Selected funds should be invested in similar underlying assets as the subject FLP. If the FLP holds different types of assets, then the appraiser can develop a weighted average discount based on the composition of a particular FLP portfolio by classifying closed-end fund discounts by security type. In this way, the appraiser can apply the most appropriate discount for the asset mix held by the FLP.
- Even within a category of funds, there may be significant differences between the funds, such as historical performance, reputation of management, fee structure, etc. When large discrepancies are observed in the market data, these items should be investigated and addressed.
- Differences between the FLP and the publicly traded funds should be considered. The FLP might be less diversified or may not be professionally managed. Also, the rights and powers of an investor in a privately held FLP may differ from the rights and powers in a publicly traded closed-end fund. The appraiser should review the partnership

agreement of the subject FLP to identify these differences.

- Whereas an FLP might not make distributions, closed end funds typically do, whether they have managed distribution policies or not. It is common for distributions paid by a FLP to be determined by the general partner. For this reason, discounts for FLPs are generally greater than those observed for closed end funds. Lower discounts to net asset value could be appropriate to apply to a FLP's equity holdings if its partnership agreement specifies distribution levels rather than leaving them to the discretion of the general partner.
- The discounts discussed in this article reflect lack of control. The closed end funds are publicly traded. Conversely, there is often no market for a limited partnership interest in an FLP and the FLP's partnership agreement may place significant restrictions on the transfer of limited partnership interests. Therefore, a separate discount for lack of marketability is typically determined and applied after the application of the discount for lack of control.

Closed-end funds provide a useful starting point for developing discounts for lack of control applicable to limited partnership interests in FLPs that hold marketable securities. However, using this fund data requires that the appropriate funds are selected and that similarities and differences between the selected funds and the subject FLP are thoroughly analyzed. As shown in the data, discounts vary greatly across different fund types over time. The more precise the selection of the comparable funds used in the analysis, the more defensible the valuation is.

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Fund Category	Number of Funds	Premium/(Discount) as of 12/31/2008		
		Lower Quartile	Median	Upper Quartile
<b>General Equity</b>	<b>191</b>	<b>-8.7%</b>	<b>-16.6%</b>	<b>-20.1%</b>
Convertible Securities	11	-0.4%	-8.0%	-11.5%
Core Funds	26	-10.8%	-17.9%	-19.5%
Developed Market	15	-12.5%	-14.7%	-20.7%
Growth Funds	5	-12.5%	-16.8%	-17.2%
Income & Preferred Stock	31	-7.1%	-12.8%	-17.6%
Option Arbitrage/Option Strategic	33	-9.2%	-14.6%	-17.6%
Real Estate	29	-23.9%	-27.0%	-29.6%
Sector Equity	33	5.2%	-13.6%	-17.6%
Value Funds	8	-17.4%	-19.0%	-20.5%
<b>Global Equity</b>	<b>52</b>	<b>-8.0%</b>	<b>-11.3%</b>	<b>-17.1%</b>
Emerging Markets	20	-7.3%	-8.9%	-13.4%
Global	21	-12.1%	-17.3%	-19.1%
Pacific, Excluding Japan	11	-7.5%	-9.4%	-11.0%
<b>Fixed Income - Taxable</b>	<b>117</b>	<b>-3.9%</b>	<b>-10.3%</b>	<b>-15.8%</b>
Corporate Debt BBB Rated	19	-2.3%	-6.8%	-9.8%
Emerging Markets Debt	10	-18.1%	-19.7%	-20.6%
Flexible Income	6	-9.4%	-13.6%	-17.0%
General Bond	9	-4.7%	-11.9%	-14.0%
Global Income	15	-11.9%	-15.7%	-17.7%
High Current Yield Leveraged	26	-8.7%	-12.1%	-15.4%
High Current Yield	5	-6.4%	-7.2%	-7.7%
Loan Participation	17	-2.1%	-3.9%	-10.3%
US Mortgage	10	0.3%	-10.0%	-20.8%
<b>Fixed Income - Tax Exempt</b>	<b>244</b>	<b>-10.3%</b>	<b>-15.1%</b>	<b>-19.8%</b>
California Municipal	18	-11.6%	-17.1%	-20.9%
Florida Municipal	2	-23.2%	-23.3%	-23.5%
General & Insured Unleveraged	6	3.6%	2.7%	1.1%
General Muni Leveraged	59	-9.9%	-13.7%	-16.1%
High Yield Municipal	14	-7.1%	-11.4%	-13.3%
Insured Municipal Leveraged	24	-11.1%	-13.8%	-16.5%
Intermediate Municipal	7	-14.2%	-15.8%	-17.4%
Michigan Municipal	4	-24.4%	-24.7%	-25.0%
New Jersey Municipal	10	-10.8%	-18.7%	-19.8%
New York Municipal	16	-12.8%	-17.4%	-20.7%
Other States Muni	41	-8.2%	-13.7%	-17.0%
Pennsylvania Municipal	7	-19.9%	-21.8%	-23.2%
Single State Insured Municipal	36	-12.5%	-20.9%	-23.2%
<b>Total - All Funds</b>	<b>604</b>	<b>-8.1%</b>	<b>-14.3%</b>	<b>-18.8%</b>