MarketWatch

Portfolio Insights by Brett Arends

Oct. 10, 2011, 12:33 p.m. EDT

How Wall Street scammed Mom and Pop — again

Commentary: Investors in this year's fund IPOs should be protesting

By Brett Arends, MarketWatch

BOSTON (MarketWatch) — The question isn't why some people are "occupying Wall Street" in protest right now.

It's why so many others aren't.

Among those missing? How about all those investors who got suckered by Wall Street this year in the disastrous initial public offerings of closed-end mutual funds. Their investments have been absolutely massacred by fees and poor performance.

Their total losses — hard to believe — total about $1 billion. Many of these investors are regular Moms and Pops.

Thomas Herzfeld, who's been following closed-end funds for decades, says the losses are the worst he can ever remember.

BCX **14.34**, +0.42, +3.02%

Think of all those who got hustled by their brokers into the BlackRock Resources & Commodity Strategy Trust (NYSE:BCX) back in March. So far they've lost $260 million — nearly a third of their entire investment. In six months.

Or those who got conned into buying the ING Emerging Markets High Dividend Equity Fund (NYSE:IHD) in April. So far in just five months they've lost $143 million – or 36% of their stake.

Or what about those who were talked into the Brookfield Global Listed Infrastructure Income Fund (NYSE:INF) ? They only cut the checks at the end of August, and they already down 25%. In six weeks.

IHD **13.05**, +0.24, +1.87%

IHD

Don't worry about the water cannon. These people already got hosed.

"These are

the largest losses I've seen in new issues of closed-end funds I could ever remember," says Herzfeld, chairman of Thomas J. Herzfeld Advisors.

In total, the Closed-End Fund Association lists 13 fund IPOs between January and August. The total raised was more than $5 billion. And so far investors have lost an average of 22% of their money.

To be sure, many investments have fallen in the last six months or so. But investors in closed-ends have been hit much harder than most. And this was no accident.

To understand just how Wall Street took these people for a ride, you need to understand closed-end funds.

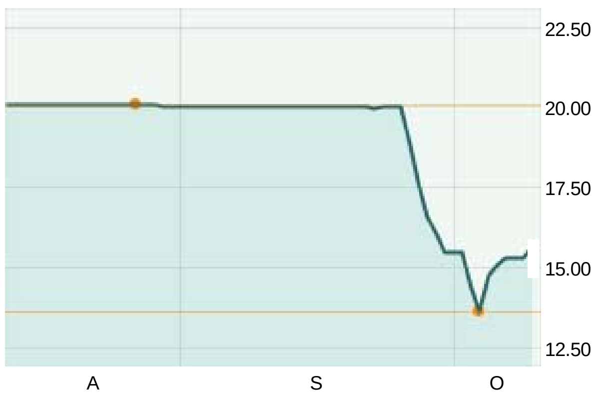
They are curious hybrid investments. They are mutual funds that trade on the stock exchange like company stocks. They issue a set number of shares in the IPO, and after that investors buy or sell their fund shares through a broker.

Here's what investors often don't realize, or fully appreciate.

When you invest in the IPO of a new fund, the first 5% of your money typically goes straight into the pocket of the brokers selling the fund. Brokers love these IPOs. The effective commission is huge. They make a mint.

INF **15.58**, +0.30, +1.96%

INF



So if you buy into a new fund at $20 a share, the broker pockets $1. So already the underlying net asset value of your shares is down to $19 — before the fund has even begun operation!

The second thing investors don't realize? Shares in these funds typically end up trading on the stock exchange for less than their net asset value.

In other words, while new investors are handing over $20 per share for a stock only worth $19, there was probably a nearly identical fund on the exchange that they could have bought for maybe $17 a share.

Why didn't the broker recommend the $17 share instead of the $20 share? Gee, I don't know, but I guess I should mention that on the $17 share he doesn't get that juicy $1 fee.

The third thing investors don't realize? Wall Street typically hustles these funds at, or near, the peak of the market. That's when it's easiest to sell them. When Wall Street sells you an emerging market closed-end fund, it means there is a lot of appetite out there for emerging markets. That's usually a sign that emerging markets are getting too warm.

Oh, and one more thing investors typically don't realize: These fund shares are incredibly volatile. In a market panic, that fund's $19 in net assets may fall to, say, $15. But the shares, which you bought for $20, will probably plummet to $12 or even lower.

That's what happened to ING's Emerging Markets High Dividend Income Fund. It launched at $20 in April.

Herzfeld told me he was buying it last week for his clients at prices as low as $11.30 (when the underlying value was $13.70).

I asked the Closed-End Fund Association about these IPOs. A spokesman replied that closed-ends "should be considered an investment and not a trade," and that the adviser and investor should purchase them as part of an asset allocation plan. Ideally, he added, “if the investment is an IPO, then there should be a discussion about the history of IPOs and how it should be taken into account.” Among the issues for an investor: Whether the fund will get marketing support and analyst coverage after the IPO.

Closed-end funds, as a general rule, are a great buy in a panic — and a terrible buy in the IPO. Wall Street likes to sell you the opposite story — for obvious reasons.