

# Discussion on “Why Do Aggressive Payout Policies Reduce Fund Discounts: Is it Signaling, Agency Costs, or Dividend Preferences?”

By Wang and Nanda

Lu Zhang

University of Michigan  
and NBER

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- 1 Shares of closed-end funds trade at a discount relative to their NAV
- 2 Managed Distribution Policies (MDPs) oblige the payout of a certain percentage of the NAV each year (median = 10%)
- 3 MDP funds trade at a lower discount or even a premium, whereas non-MDP funds trade at a severe discount.

*Why?*: Distinguishing alternative hypotheses on the discount-MDP relation

# Hypotheses

- 1 *Signaling*: MDPs as a costly signal for future NAV performance
- 2 *Extant agency costs*: Funds too large to manage given managerial abilities and investment opportunities
- 3 *Prospective agency costs*: Discounts arise from free cash flows
- 4 *Dividend preferences*: Investors have strong preferences for dividends and prefer MDP funds

Comment 1: The extant agency costs hypothesis = decreasing returns to scale, based on technology

# Strategies

Different predictions on the performance and discounts of MDP funds

- 1 Signaling/extant agency costs:
  - More aggressive MDPs = stronger NAV performance
- 2 Prospective agency costs/dividend preferences:
  - More aggressive MDPs  $\neq$  stronger NAV performance

Comment 2: Free cash flow problems  $\downarrow \Rightarrow$  the NAV performance  $\uparrow$

# Strategies

Different predictions on MDP adoption and shareholder activists

- 1 Agency/dividend preferences:
  - Aggressive MDPs = shareholder activists
  - Build-up of institutional ownership prior to MDP adoption
- 2 Signaling:
  - Aggressive MDPs  $\neq$  shareholder activists

Comment 3: Decreasing returns to scale not related to shareholder activists

Comment 4: Shareholder activists  $\uparrow \Rightarrow$  the pressure for signaling  $\uparrow$

# Strategies

## Different predictions on MDP adoption and fund size: Part I

- 1 Agency costs/dividend preferences:
  - MDP adoption = a decline in fund assets
- 2 Signaling:
  - MDP adoption  $\neq$  a decline in fund assets

Comment 5: If MDP increases NAV performance, why do the agency costs hypotheses imply a decline in fund assets?

Comment 6: MDP can reduce fund assets if the signal is too costly

# Strategies

## Different predictions on MDP adoption and fund size: Part II

- 1 Dividend preferences:
  - MDP and raising new capital compatible
- 2 Signaling/agency costs:
  - MDP and raising new capital incompatible

Comment 7: Probably anything goes in the dividend hypothesis

Comment 8: If MDP is a worthwhile signal, raising capital is conceivable

A comprehensive empirical analysis on the effect of MDPs on the closed-end fund discounts

Evidence hard to interpret because of the non-mutually exclusive nature of alternative hypotheses — be mindful of hypothesis-mining!

- 1 Motivate empirical tests from a tightly constructed model like Berk and Green (2004) with more easily refutable hypotheses
- 2 Report the evidence/downplay the link to various hypotheses