

Illiquidity and Closed-End Country Fund Discounts

Abstract

In a simple model of segmented markets and exogenous liquidity shock, the closed-end country fund premium is negatively affected by the illiquidity in the host market where shares of the country fund are traded, and positively affected by the illiquidity in the home market where the underlying assets are traded. To the extent that expected and unexpected liquidity affects asset prices and returns, the closed-end country fund premium should reflect the difference between the illiquidity of the fund shares and its underlying assets. Using the Amihud measure of illiquidity, we examine the model prediction for U.S.-traded single country closed-end funds, and find a strong association between the fund premium and illiquidity in both the host and the home markets. Moreover, this relation is much stronger for funds investing in emerging markets where market segmentation is more likely to be binding. These funds are also more sensitive to the systematic liquidity factor, providing additional evidence that the country fund premium may be partially explained by the liquidity risk premium.