The Value of Indexes Made Up Of Closed-End Funds

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Chuck Jaffe, in the NAVigator podcast, interviewed Patrick Shaddow who is director of index operations at S-Network Global Indexes. Read the Q & A below as Patrick discusses the merits to and the construction of index funds built entirely of closed-end funds.

The podcast can be found on AICA's website by clicking here: https://aicalliance.org/alliance-content/pod-cast/

CHUCK JAFFE: Patrick Shaddow, director of index operations at S-Network Global Indexes is here, and when you think closed-end funds, you're typically not thinking about passively managed exchange-traded funds. But we are going to talk about where those two worlds come together today in the NAVigator. This is the NAVigator where we talk all-weather active investing and plotting a course to financial success. It's brought to you by the Active Investment Company Alliance, a unique industry organization that represents investment firms, creators of closed-end funds, and users and investors and that's anxious to explore with you all aspects of investing in closed-end funds and business development companies. If you're looking for excellence beyond indexing, well, the NAVigator will point you in the right direction. But today, we're actually talking about excellence through indexing but through indexing with closed-end funds because my guest if Patrick Shaddow. He is director of index operations at S-Network Global Indexes. You can learn more at S-NetworkGlobalIndexes.com. And if you check the website there, you will see they do indexes on all manner of investments, not just closed-end funds but for our purposes here, particularly interested in their closed-end fund indexes. There is also more information @SNet_indexes on Twitter. Patrick Shaddow, good to chat with you.

PATRICK SHADDOW: Thanks for having me, Chuck.

CHUCK JAFFE: We don’t normally think of closed-end funds as a space where you would wind up having passively managed exchange-traded funds but you are bringing the two worlds together at S-Net. So explain how it works.

PATRICK SHADDOW: Yeah, I think it's important to look at each individual closed-end fund particularly and then look at the closed-end fund market in general with the basis of a strong universe. When an investor looks to create an investment in a high yielding instrument like a closed-end fund where the profits of the closed-end fund are distributed directly back through to the investor without paying taxes on those profits, that is called a pass-through investment where the investor gets to recognize the profits of the investment without the investment company first paying taxes on those profits. So as we look at investing in closed-end funds, you get to the point where you have a lot of questions to ask with respect to what type of exposure you want to have. Are you looking to invest in closed-end funds that are buying bank loans? Are you looking to invest in closed-end funds that are buying investment-grade issues, high yield issues, or are you looking to invest in closed-end funds that have an option income strategy that will sell particular options in order to boost the yield, the income, the options of income? As we set off to construct the first fund of funds ETF based off of the S-Network deposit closed-end fund index, we did so with a few key observations in mind. First, the attribute of closed-end funds that they trade at either a discount or a premium to the net asset value. And as we constructed our index, we found it important to overweight allocations to closed-end funds that were trading at a discount to their net asset value, and underweight closed-end funds that were trading at premiums to their net asset value.

CHUCK JAFFE: Let me jump in for just a second because I think that's an important concept. I would imagine that if you hadn’t done that anybody who was looking at it would have said: "Why do I want to buy this?" Obviously, investors are most attracted to closed-end funds that trade at discounts. So if I'm going to get an index of closed-end funds but it's going to put me into something that had premiums, I think a lot of investors might want to avoid it. So it had to be tilted that way. But what you are saying is this wasn’t about popularity or what have you, this was about trying to make sure that the index adequately captures closed-end performance, right?

PATRICK SHADDOW: Yeah, to a certain extent you're right. There are different ways to go about investing in general. You can search for a beta return to the market that would return essentially the same performance of the broad-based market indexes or you could create an investment that is predicated upon an investment thesis that will ultimately outperform the market. So when we created the S-Network composite closed-end fund index, we did so with the intent to have higher returns than the broad market and lower volatility. In order to do so, we created very specific minimum investment criteria. One of those was a look directly at how each individual closed-end fund is trading in relation to the value of all of its individual holdings aggregated up into the net asset value. A couple of other key important factors here are fees. Closed-end funds typically come with high fees. Those fees are dependent upon interest expense, they are dependent upon leverage, and their also dependent upon the management fee. So as we set off to create our index, we wanted to keep an eye on how much these closed-end funds were charging investors that were investing in them. So as we created this index, we created a mechanism that would tie the maximum expense ratio for a closed-end fund to be included in our index to the prevailing interest rate in the market. A couple of other key important facts here are averaging trading volume. Closed-end funds are not known for their high liquidity. So what we wanted to do was create a rule that would only select closed-end funds that were easy to get into and easy to get out of. Our composite closed-end fund index currently yields roughly around 7.85% and is trading at a discount of close to 9%. So if you were to buy the composite closed-end fund index today, you would be receiving about $109 in investments for every $100 that you spend.

CHUCK JAFFE: And we should point out that we're talking about PCEF which is the INVESCO closed-end fund income composite. Also, the XMPT as in exempt, the VanEck vectors closed-end fund muni support income ETF, those are the two right now using the S-Network global indexes. But you guys have more indexes. So the logical thing to expect is that there will be more funds coming in the near future, correct?

PATRICK SHADDOW: Yes. We create indexes here for the primary purpose of creating financial products. Those financial products could be anything from an exchange-traded fund to a mutual fund to separately managed accounts to unit investment trusts.

CHUCK JAFFE: Okay. There is a one-million-dollar question here which is everybody sees the statistics which show that active management does not beat the indexes and what have you and it's why so much money has gravitated towards indexes. What you're creating are passive indexes of closed-end funds but we still have to know if somebody was saying "I want to buy a closed-end fund, are they likely to see that the vast majority of individual funds are not capable of outperforming on a regular basis an index made up of closed-end funds?

PATRICK SHADDOW: Yeah. You know, there is a saying half of all observations are below average and I think that's important to kind of look at here. When you create an index that is comprised of over 100 individual securities, some of those securities that are included in that index are going to outperform the index, and some of those securities are absolutely going to underperform the index. You will receive the weighted average return of the underlying component. Now, with respect to closed-end funds, in particular, there are a couple key things that you've going to keep in mind. Say, for example, you're an investor and you wanted to get exposure to investment grade fixed income issues or you wanted to gain exposure to international developed markets bond issues and you just so happened to select the Voya funds this past year. Voya over the past couple of months cut all of their distributions for all of their funds. So if you were the unlucky investor that picked the Voya funds, you would absolutely be underperforming the market. Now, you might have had success and had a little bit of luck in selecting closed-end funds that would outperform, but the key here is the diversification. The diversification in over 100 different closed-end funds over 15 closed-end fund management companies and over 30 individual different closed-end fund managers. Closed-end funds are typically actively managed and the fund manager is charged with providing returns of that asset value of his closed-end funds in excess of the market while maintaining a high distribution. Folks normally invest in closed-end funds for the primary purpose of increasing their income.

CHUCK JAFFE: Patrick, great stuff. I wish we had more time but I look forward to chatting with you again in the NAVigator in the not too distant future. Patrick Shaddow is director of index operations for S-Network Global Indexes. You can learn more at S-NetworkGlobalIndexes.com and on Twitter @SNet_indexes. The NAVigator is a joint production of the Active Investment Company Alliance and Money Life with Chuck Jaffe. I'm your host, Chuck Jaffe and you can learn more about my show at moneylifeshow.com. To learn more about closed-end funds and business development companies go to AICAlliance.org, the website for the Active Investment Company Alliance or on Facebook and LinkedIn @AICAlliance. And the NAVigator podcast is available every Friday. Thanks for joining us. We'll talk to you again next week

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