Matisse Capital's Boughton on the Benefits of Buying Funds of Closed-End Funds

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In this bonus edition of the NAVigator podcast taped at the AICA Boot Camp and Round Table in New York City on November 6th, Chuck Jaffe interviewed Eric Boughton, chief analyst at Matisse Capital. Read the Q & A below as Chuck discusses with Eric about which investors might prefer a fund of closed-end funds rather than a few individual holdings and why, but also discusses discounts, and more.

Eric Boughton

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

CHUCK JAFFE: Hi, it's Chuck Jaffe, host of The NAVigator podcast. I attended the Active Investment Company Alliance closed-end fund, business development company, interval fund Boot Camp in New York City on November the 6th. While I was there I did several interviews with closed-end fund experts for Money Life, my radio show and podcast. We're bringing those interviews to you as bonus episodes of The NAVigator, enjoy. We're back to wrap up Money Life at the Active Investment Company Alliance meeting in New York. I'm pleased right now to be joined by Eric Boughton, he is chief investment strategist with Matisse Capital. They run the Matisse funds, which are traditional mutual funds that invest in closed-end funds, and then they also use closed-end funds for separately managed accounts. Eric was part of the panel that I was moderating here. Eric, thanks for taking a little extra time to join me on the show.

ERIC BOUGHTON: It's great to be here with you, Chuck.

CHUCK JAFFE: So we've talked with a couple of other folks today for the show, about closed-end funds and capturing the discount and everything else. For you I've got a slightly different question, which is my audience has a choice, they're now learning about closed-end funds through our NAVigator segment and more, and if they want to go out and buy, they can go pick a couple of closed-end funds, or they can pick a fund like yours. I'll pick a professional manager to go buy closed-end funds for me. What are the benefits? And I know you're going to tell me there's benefits to doing it the way you guys do it, because that's your reason for living, but what are the benefits to both? Who should really say, "Okay, I want to go seek out a fund manager." And who, adding one or two is okay on your own?

ERIC BOUGHTON: Yeah, thanks for the question, Chuck. I think investing with a manager, your first step is to really ask the question, "Is the manager worth the fee?" So when you invest with our fund at the Matisse Discounted Closed-End Fund Strategy, you're paying a one and a quarter percent expense ratio, which you do not face if you buy the closed-end funds on their own. So the first question for us is, "Can we hurdle that expense ratio, and return alpha for investors?" And if so, what confidence can investors have? And I think it all begins with the question of where you think alpha comes from in the closed-end fund space. So if you're an individual investor looking to purchase closed-end funds on your own, if you believe that your return or excess return is going to come from your ability to pick a particular sector, to time the market, to pick a hot manager, etcetera, then more power to you and you should do that. However, if you believe our approach, that alpha in the closed-end fund space really comes from capturing discount movement, then to do that on your own requires a lot of attention. It requires real focus and a willingness to trade daily if needed, to capture discount movements. The reason is that you never know when discounts are going to move, so a closed-end fund could sit at a particular discount to its net asset value for days, weeks, months. But when that discount widens out, you need to be ready. You need to be ready to purchase it, and most individual investors simply don't have the wherewithal and capacity to watch the market that closely. And that's where hiring a manager like Matisse to build you a diversified portfolio of closed-end funds can really come into play. I'd say the diversification is another thing to comment on. If you're an individual investor buying two, three, four, five closed-end funds, you may not have a sufficiently diversified portfolio. By hiring us within our fund, you're able to buy thirty, forty funds all in one shot.

CHUCK JAFFE: At the same time, there are some investors who are kind of like my dad. I told the story of my dad here today, of when my dad went and bought his first closed-end fund. He bought it on my recommendation, and he bought it because he was looking for a high-yielding instrument that was doing it through equities, and it was the right kind of strategy for him and it made a lot of sense. And for him, we had to get him over the hump of, "Wait, the market's tanked. The discount's grown. What's happening to my fund?" Because all he was really looking for was the income production. Now we've talked earlier in the day on this show with Bill Meyers from Nuveen, who was saying, "Yeah, worry about the asset class more than you worry about the discount." So as much as the benefits of professional diversification are a reason to go get a mutual fund, if somebody's mission is, "Hey, I'm looking for that yield piece, and I can go find it and I can buy it on sale at a discount," do they really need to be trading? Or wouldn't that put them so that the purposes of their closed-end fund investments are different than the purposes of Matisse's closed-end fund of closed-end funds?

ERIC BOUGHTON: Sure, that's a great question. I think if people are not out for alpha, if they're out for example, for income production, they can certainly do it on their own more easily. It's much easier to predict a closed-end fund's distribution and yield, than it is to predict the movement of a closed-end fund's discount. And the yield is much more reliable over time. Many funds pay regular attractive distributions to NAV, which is the reason that many investors like your father are interested in the space. I would say however that it's important to watch out. As I mentioned in the panel, it's important to watch out for funds that when they cut their distributions, investors in these funds can experience a sharp and sometimes permanent decline in the value of their investment. So that's something to be aware of when searching for that yield on a closed-end fund.

CHUCK JAFFE: You know we talked about discounts and I know it is not as simple as bigger is better for you, so explain what is better when it comes to discounts? What is right sized versus what is either too big, or awkward, or problematic?

ERIC BOUGHTON: That's a complex question, but one that has a very simple answer at the base. And it is as you said, bigger is better. So if you go back, we've done lots of work on this, analyzing what happens when you buy funds at discounts. If you blindly buy all closed-end funds at discounts back to 2005, you would have returned an annualized nine percent just from investing in those funds. And if you had only invested in closed-end funds trading at premiums to their net asset value, you would have experienced a negative two percent annualized return. So the first part of the answer to that question really is that bigger is better. Beyond that, we look at a fund's onus to Oracle discount pattern, funds will tend to revert back to their average discount over time. And when that changes suddenly, when a fund suddenly trades at a much bigger discount compared to its average, is when we are really most entrusted in purchasing it. We look at a lot of different factors in determining when a discount is attractive.

CHUCK JAFFE: And what are we seeing now given current market conditions? I mean, not quite a year ago when the market was tanking, discounts were getting huge and investors were bailing out, perhaps because they didn't understand that, "No, no, no, you want to go in when the discounts are huge." But how much have they narrowed? And how attractive is the closed-end space right now?

ERIC BOUGHTON: So discounts as you pointed out, blew out in December of 2018. Quickly recovered and have now returned, I would say, close to their long run averages. However that average is made of different extremes. It turns out that international funds currently are much more attractive than their long-term average, and because of this reason, they still feature more prominently in our portfolio. So I'd say the lesson to this is that even when the discount climate is normal, I would say as it is today, there are still a range of attractiveness levels on those discounts. Certain sectors are going to be more or less attractive at certain times.

CHUCK JAFFE: And what would be the attractive sectors right now?

ERIC BOUGHTON: So as I mentioned, international equity is probably the single most attractive sector in terms of a fundamental sector-wide situation. MLPs and energy funds are also more attractively discounted today than they normally are.

CHUCK JAFFE: Eric, great stuff. I look forward to chatting with you about it again, but thank you so much for taking the time.

ERIC BOUGHTON: All right, Chuck. Much appreciated.

CHUCK JAFFE: That's Eric Boughton, he's portfolio manager and chief analyst at Matisse Capital. Learn more at MatisseCap.com. We will be back to wrap up today's show, our coverage of the Active Investment Company Alliance meeting, and tell you what's coming tomorrow right after this message.

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