John Cole Scott Answers Questions on Closed-End Fund Basics

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Chuck Jaffe, in The NAVigator podcast, interviewed John Cole Scott, chief investment officer at Closed-End Fund Advisors and executive chairman of the Active Investment Company Alliance.

John Cole Scott

Read the Q & A below as Chuck asks John questions from The NAVigator audience about closed-end fund basics and future content of the podcast.

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

CHUCK JAFFE: John Cole Scott, chief investment officer at Closed-End Fund Advisors and the founder and executive chairman of the Active Investment Company Alliance is here, and we're taking audience questions today in The NAVigator. Welcome to The NAVigator from the Active Investment Company Alliance, where we talk all-weather active investing and plotting a course to financial success. The AICA is a unique industry organization because it represents investment firms, creators of closed-end funds, and users and investors. The NAVigator podcast looks at all aspects of investing in closed-end funds and business-development companies. If you're looking for excellence beyond indexing, you've come to right place because The NAVigator is going to point you in the right direction. Joining me again today is John Cole Scott, he is chief investment officer at Closed-End Fund Advisors in Richmond, Virginia. He's also the founder and executive chairman of the AICA. You can get more information about the AICA at AICAlliance.org. You can learn more about John Cole Scott and his firm by going to CEFadvisors.com or CEFdata.com. John's on Twitter @JohnColeScott. But right now he's here, John, good to have you back on The NAVigator.

JOHN COLE SCOTT: Always great to be here, Chuck.

CHUCK JAFFE: This week we're going to try to answer three questions quickly. We've been getting a lot of response to The NAVigator because quite honestly I think the audience is going, "Closed-end funds, they sound interesting. I want more." I could have come at you with some higher end questions or some entry questions. We're going to do the basics today. At some point down the line we'll come back with the higher end ones. We start with a question we got from Kristy in Seattle. She said, "Chuck, I've been intrigued by the recent guests you've had talking about closed-end funds, but I'm not sure I've ever heard you discuss the basics of what closed-end funds are, how they work, how they're different, and what their advantages are. It would be good to do a primer for your less knowledgeable listeners." So John, let's go back and do that thumb sucker, because there are people here and they think they get it but maybe they don't. So closed-end funds, what are they? Why are we doing them?

JOHN COLE SCOTT: Closed-end funds are a diversified portfolio that's selected by an active manager and produces typically a daily net asset value, which is a result of the managers work, but the unique thing comes in a couple of places. First is, their common stock is listed on an exchange, so New York Stock Exchange or NASDAQ, and then it trades at a market price. There's no direct connection between the market price and net asset value, which creates premiums when the price is above and discounts when it's below. That's different than an ETF, which generally trades around net asset value because of the arbitrage components of it. The other thing is that closed-end funds are allowed to lever, like with preferred stock, but even more traditional credit and other investments. That's because many of the funds have focused on the past in income investing. So imagine buying a five percent bond and then borrowing thirty-three cents on the dollar. So you have a $1.33 in the market and you can buy more of those five percent bonds. It means the yield can be higher. The other thing that's interesting is because it's that fixed capital structure, remember if it was an open-end fund, every day money could come in and new shares could be created or money could come out and shares could be redeemed. That doesn't happen every day in a closed-end fund. It's a fixed capital structure, which means the manager can buy less liquid things.

CHUCK JAFFE: So advantages in terms of the ability to buy things at a discount. The ability to add leverage and more. That's ultimately what somebody's looking at. Yes, it's the same kinds of assets, but again, a slightly different chassis. In other words, we're still talking about an investment vehicle, it's just a different chassis. The difference between driving a Volkswagen, and driving an Audi, and maybe driving a Porsche to some extent.

JOHN COLE SCOTT: It is, and it's actually the original collective trust, which we've heard a few of our speakers talk about. It came to the U.S. in 1893, and there's still the oldest tenured fund in the U.S. is a 1927 fund, General American Investors. Then there's a 1929 fund, Adams Express, which just celebrated ninety years and kind of a cool track record there too.

CHUCK JAFFE: Now we're going to move to a question from Pete in Charlotte, North Carolina. He says, "Chuck, all the talk about closed-end funds got me looking at some and I'm about to make my first purchase. I think it will be CII." Now he didn't say it, but that's the BlackRock Enhanced Capital and Income Fund, "Which is trading at a small discount and which has a distribution rate of six percent. Should I think of distribution rate as like the yield on a stock? If so, I'm looking at a closed-end fund that has what amounts to a six percent dividend yield, and I am thinking about it really as an income play even though it owns only stocks. That feels kind of weird to me, but I hear talk about closed-end funds as a source of income and that's what I'm looking for here. Before I take the plunge, tell me if I have it close to right because I don't want to make a mistake."

JOHN COLE SCOTT: So it's a fund that we know pretty well. BlackRock has a whole bunch of funds in that category, just like Eaton Vance does. I would say the key things there is it's a distribution, which does not mean it's necessarily income from dividends. It's an option overlay or covered call fund, which does produce some extra income and it generally reduces the volatility of the portfolio. What I like about that sector, it's a way that closed-end fund managers have taken equity exposure and allowed for basically monthly distributions, that over long periods of time, the equity markets can be fueled by net asset value. So the one thing I'd tell him to just think about is, can the net asset value performance, the managers work, continue to fuel the net asset yield? And I don't know this individual, but we would say that type of fund could make sense for many investors.

CHUCK JAFFE: I think the biggest holding in that fund, which I looked at to make sure I was telling the right fund name to go with the ticker, is Microsoft. He's looking at a fund that owns big blue-chip stocks. It's got some other big blue-chip names in there. But again, should he be thinking of this, because of the way it's structured, as more of an income play rather than a stock play?

JOHN COLE SCOTT: I would say it's unfortunately both. Because if the stocks in the portfolio were to go down fifty percent, there'd be a likelihood of a dividend reduction because it'd be hard to pay six percent on half the assets. That'd be a twelve percent yield. But the yield can go up at as the assets go up. So it's not a bond, but they've taken an equity investment and made it feel kind of like a synthetic bond, though it's not like you have a default and you wait in line for your money. It's a way to get consistent cashflow from a product designed for retired investors that want more than just bonds.

CHUCK JAFFE: That's a good way to put it. A way to get consistent cashflow, especially for those retired investors who want more than they could perhaps get out of bonds. I think that may be the part that Pete needed to hear to help him make the decision. Pete, let us know how it turns out. For anybody out there by the way, who wants to send us questions, we'd love to get them. "I'm sorry, but all questions must be submitted in writing." You can send them to the Active Investment Company Alliance at TheNAVigator@AICAlliance.org. One more quick one. This one's from Charles in Philadelphia, and he said, "Chuck, can't you arrange to have John Cole Scott just tell us about a good closed-end fund each week?" I should point out Charles had heard you be on my show in the past and I think acted on some things that you said. But this isn't the closed-end fund of the week, this is The NAVigator. Explain why.

JOHN COLE SCOTT: Because as much fun as I've had on your show for years, and years, and years, and you're always welcome to have me on to talk about my for-profit, my goal was to create a forum for everyone to get together. Whether it's the institutional buyers, people that may disagree with me. Whether it's the actual creators of funds. We've had attorneys that actually do the work at the SEC. We've had indices of closed-end funds. We're going to have some UITs of closed-end funds. We have lots of interesting topics. The point is to do a flashlight on the entire ecosystem to educate on all aspects. And while my livelihood is closed-end funds, I was born owning them, I'm not the only version of them and I'm not the only slice of them.

CHUCK JAFFE: Ultimately, we will have weeks where we focus on a fund or two and give people some insight into how certain funds work. But again, it's about more than trying to pick the fund of the week.

JOHN COLE SCOTT: It is, because I can teach them to fish and then they can find their own funds.

CHUCK JAFFE: John, next time you're on and we're taking questions, we'll take some that are a little more sophisticated, because we're getting a lot of them. Again, send your questions to TheNAVigator@AICAlliance.org. John, look forward to our next conversation.

JOHN COLE SCOTT: Thank you, Chuck.

CHUCK JAFFE: That's John Cole Scott, chief investment officer at Closed-End Fund Advisors. He's on Twitter @JohnColeScott, online at CEFadvisors.com, and to check out individual funds, CEFdata.com. He's also chairman of the Active Investment Company Alliance, and to learn more about closed-end funds and business-development companies, go to AICAlliance.org. The NAVigator is joint production of the AICA and Money Life with Chuck Jaffe. I'm your host, Chuck Jaffe, and you can learn more about my show at MoneyLifeShow.com. The NAVigator podcast is available for you every Friday. On behalf of the Active Investment Company Alliance, this is Chuck Jaffe saying, thank you for joining us. We look forward to chatting closed-end funds with you again next week.

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TheNAVigator@AICalliance.org

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