Return of Capital Isn't Always the Bad Sign Investors Believe It To Be

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Chuck Jaffe, in The NAVigator podcast, interviewed John Yesford, analyst at High Dividend Opportunities. Read the Q & A below as Chuck discusses with John, 'return of capital', which many investors worry about as a warning sign that a closed-end fund is struggling or headed for trouble. Yesford explains that, with the right conditions, a return of capital doesn't diminish a good opportunity and talks about what investors should look for and consider to find those situations.

John Yesford

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

CHUCK JAFFE: John Yesford, analyst at High Dividend Opportunities, a marketplace service from Seeking Alpha, which includes closed-end funds and business-development companies among its high income investment picks is here, and we're talking return of capital today on The NAVigator. Welcome to The NAVigator, where we talk about all-weather active investing and plotting a course to financial success with the help of closed-end funds. The NAVigator is brought to you by the Active Investment Company Alliance, which is a unique industry organization that represents all facets of the closed-end fund industry, from users and investors to fund sponsors and creators, to yes, folks who analyze and put out investment picks and newsletters. Today that's where we're going because John Yesford is my guest, he's an analyst with High Dividend Opportunities. Which if you go to SeekingAlpha.com, a well-known website for folks looking for financial intelligence, they have a segment they call their

Marketplace Services, and this is one of those services. If you want to get more information, SeekingAlpha.com or learn more at AICAlliance.org, the website of the Active Investment Company Alliance. John Yesford, good to chat with you.

JOHN YESFORD: Oh, good to be here, Chuck.

CHUCK JAFFE: I love having guys like you on the show because I want to talk with you about return of capital, because it is something that you sometimes address and occasionally you will have investments that make your list at High Dividend Opportunities that are returning capital. People who are new to closed-end funds and BDCs here, return of capital, that's always bad. But it's not always bad. So without getting too caught up in the jargon, can you help my audience understand what return of capital is and how to determine what's good from what's bad?

JOHN YESFORD: Basically what return of capital is, is it's basically a tax term. All it means is that the fund is giving you back money that exceeds their taxable income. As anybody knows who's done their own taxes, there's plenty of deductions to the actual income that you get that reduce your taxable income but you still have that cash. So a lot of funds have various expenses or whatever that aren't really cash that reduce their taxable income, but because they actually generate more cash than their taxable income, they're able to pay you a bigger dividend.

CHUCK JAFFE: As you're analyzing this, does it have to be, let's take a look at how this is going to impact me from a tax standpoint? Or do you not even factor that in and just say, "Look, I'm looking for conditions where return of capital is simply a positive"? It's basically a bonus, an extra, and not a derivative problem.

JOHN YESFORD: Yeah. Basically we do want to see where the ROC is good for us. We want to see things like the net asset value of the fund is increasing. That's often a sign that they're actually paying you more cash than they can, is if the net asset value is decreasing. It gets to be trickier when, for instance, the master limited partnership space with the mid-stream pipeline companies, their share prices have been declining. So they're not actually selling off shares, but just the price of the shares is going down. In that case, you'd look at what the index for the relevant industry would be and as long as your fund's net asset value is keeping pace with what the industry average is, you're probably not getting bad ROC. In a taxable account, you also get the added advantage of any part of your distribution that is designated as ROC isn't taxable until you sell. It basically reduces your cost basis. So it'll give you bigger capital gains down the road when you sell, but you're not immediately taxed on it.

CHUCK JAFFE: When you find ROC and it works in your favor, does it tend to stay there? Or is this a case where it's somehow a bad sign and you can go from the good ROC to the bad ROC overnight?

JOHN YESFORD: It doesn't happen overnight, but anytime you're investing in a closed-end fund, you want to see where the industry is going. If you see the NAV decreasing, you want to figure out why. It could just be that, okay, there's bad sentiment for the industry, so the share prices of everything is going down. In which case, you could be very okay. Typically closed-end funds like to figure out how much they can distribute and then they distribute that much. So if they're overdistributing, they'll keep overdistributing until they can't come up with the cash to do that anymore. If they're not overdistributing, for the most part, they'll be okay. So the ticket there is to look at how the NAV is performing versus the industry average.

CHUCK JAFFE: We've been talking about this in kind of jargon-y terms because you have to.

JOHN YESFORD: Yes.

CHUCK JAFFE: But in many cases, the other telltale sign here is you've got a supremely high yield, the yield is really high. Ultimately the question when you see a super high yield should be, is any of that yield return of capital, right?

JOHN YESFORD: Yes, in a lot of ways if the yield is high that can be a sign that something's wrong. But not necessarily. It just could be that the market doesn't like that particular industry and is driving the prices down, and everything's actually fine. That's in fact, at High Dividend Opportunities, what we look for. We look for companies and funds where market sentiment has pushed the price down but the dividend or distribution is well covered.

CHUCK JAFFE: So give us an example of a fund or a BDC like that.

JOHN YESFORD: The ticker symbol is MIE, it's Cohen & Steers MLP Fund. The sentiment there, and the whole MPL sector, is really bad. The problem is a lot of people don't understand, that for the most part at this point in time, pipeline companies aren't dependent on the price of oil and gas to produce their income. Two or three years ago, more pipeline companies did. They got burned bad and had to cut their distribution and a lot of other stuff. Plus in the past, their practice has been to sell shares to generate the capital to grow the company. Now pretty much all the pipeline companies no longer base the price they charge to move material over their pipelines on the price of the oil or gas, and they're not funding their growth anymore from share sales. So we think that the share prices have mostly stabilized now, and you're not going to see dividend cuts because the share price dropped. So that's why we're recommending a number of them to our members. But those basically have had a couple of really bad years in terms of share price and even some dividend cuts.

CHUCK JAFFE: Yes, but as a high dividend opportunity investor, you're willing to ride out some tough times as long as you're being paid to wait, correct?

JOHN YESFORD: Oh, yeah. Typically from my own account, when I buy into a new position, I'm expecting to see red in that thing for a year and it doesn't worry me if the price goes down. My plan isn't to sell the shares for more money, my plan is to collect the distributions and make a nice income. So in fact, a lot of times if the share price goes down, that makes a better opportunity because I can add more dividends for even less money.

CHUCK JAFFE: And that's why we want to take a look. That's why investors are interested. But it's important to know that difference between, when is return of capital a good thing and a bad thing. John Yesford, thanks so much for helping us straighten that out and educating folks on it.

JOHN YESFORD: You're welcome. Thank you for the opportunity to explain.

CHUCK JAFFE: John Yesford is an analyst at High Dividend Opportunities, a marketplace service from Seeking Alpha, which includes closed-end funds and business-development companies among its high income investment picks. Learn more at SeekingAlpha.com. 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, which is on Facebook and LinkedIn @AICAlliance. The NAVigator podcast is available every Friday, we hope you'll subscribe and come back each week to learn more about closed-end fund investing.

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