Muni Bonds and Preferred Stocks Are Key Closed-End Income Picks

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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 and John talk about a very popular type of closed-end asset -- municipal bonds -- and one that has been trending, but which has just 13 closed-end options, preferred stocks. Scott covers key investment considerations for each asset class.

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

CHUCK JAFFE: John Cole Scott, founder of the Active Investment Company Alliance is here and we're talking about closed-end funds that invest in muni bonds and preferred securities 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. My guest, well, he's the moving force behind the Active Investment Company Alliance, but he is also chief investment officer at Closed-End Fund Advisors. John Cole Scott has been here many times, but if you want to learn more about his firm, then you're going to go to CEFadvisors.com for Closed-End Fund Advisors. If you want to do research directly into some of your closed-end fund issues or things you're considering, go to CEFdata.com. He's on Twitter @JohnColeScott. If you want to learn more about closed-end funds in general and what's happening at the Active Investment Company Alliance, you're going to go to AICAlliance.org. John Cole Scott, great to chat with you again.

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

CHUCK JAFFE: Today on The NAVigator we're going to do two things. One, you wanted to talk a little bit about the area that, we haven't spent too much time covering it since we started The NAVigator, that is biggest for closed-end funds, that being muni bonds. And I've got an audience question that's kind of related for people who are income oriented. So we'll start with you. In terms of muni bonds, this is where for a lot of people, the rubber meets the road in closed-end funds, isn't it?

JOHN COLE SCOTT: It does. It really is one of the best, cleanest uses of the closed-end fund structure. We can take a sometimes illiquid investment like the muni bond market because a lot of state bonds don't trade very active. You can take very cheap leverage and create a vehicle for investors to gain consistent on-going yield. This way it's completely federally tax-free for the large bucket of national funds, and then states like California, New York, and New Jersey, and some others, have state specific funds which can be completely tax-free in those states.

CHUCK JAFFE: When it comes to muni funds, do you consider closed-end funds an asset class by themselves because you're getting them at discount, etcetera? Or are they completely representative only of the asset class of what they hold? Because if you're saying, "Hey, I can own muni bonds, I can own them in a lot of ways. Traditional funds, ETFs, closed-end funds." Then for someone to say, "While I want to go get muni funds in the closed-end structure," they're basically replacing that they've got, etcetera.

JOHN COLE SCOTT: What I would say is that first off, when you own a closed-end fund, you own the shares of an investment company. You're a common stock owner, so that means that you have market volatility. Volatility goes up and down, people care more about the down. But with this, right now this sector has a hundred and forty-five funds, roughly a third of the listed regular universe. You're getting a 4.2 yield, there's about thirty-five percent leverage in the average fund, but a duration of about 8.7. What that means to me as an advisor who builds portfolios, is you're able to have buckets of guts that the manager puts together of bonds from the past. Now one of the challenges is, because we've been in such a low rate for so long, bonds that were yielding more ten years ago have been replaced with lower bonds, so the average fund has had to reduce it's distribution somewhat significantly. Where else are you going to find 4.2 federally tax-free with essentially no underlying market exposure as a tax driven investor?

CHUCK JAFFE: You're really not. And of course, then add discount to that, and of course anytime you can buy yield on sale, effectively you're getting an even better yield, aren't you?

JOHN COLE SCOTT: It is. Over two thirds of the universe trades wider than about a five discount of the funds in space. There's a handful of premiums because it's a very attractive structure. Like I said, it's always more than the moving parts. Some investors won't care about the discounts and premiums, they only care about the tax-free cashflow. Some people in your audience might go, "I want to try and capture some discounts, let's look for some wider ones that have reason to narrow and then make extra money while we clip tax-free yield."

CHUCK JAFFE: Now lets move to a slightly different area, because I've got an email from Roger in South Carolina who said, "Dear Chuck, I love the work that you're doing now on closed-end funds, but one thing I've not heard you talk about is preferred securities. Is the closed-end fund structure a good or better way to buy and hold preferreds?" Now muni funds, a huge part of the closed-end fund word. Preferreds, a small part of the investment world in general. Good thing to hold in closed-end funds?

JOHN COLE SCOTT: Again, there's thirteen funds in our index that we track the sector with. Right now it's a very popular sector because the yields are coming out of a 6.4% and a high amount of qualified dividend income, or QDI. So the effective after-tax yield is around five, which again, hard to find at a high tax bracket. The average fund in our index is like a four premium. So I'd say it's another place to find active management with leverage, the average fund is about thirty-two percent levered. To pivot through it, the guts don't trade very well. It's another very good use of the wrapper. There's only one fund at a discount right now, there's some, two that trade at ten plus premiums. So I'd say be thoughtful on your entry point, but if you need this yield to solve your income needs, the numbers that are really hard to get other places without reaching for really hairy credits and these things are much less risky at the underlying level. But remember, we've often talked about on your show, closed-end fund investing is two handed investing. The right hand is the NAV, the manager, the sector. The left hand is the structure, it's the discount, it's the being a good steward as a manager to your shareholders. You have to remember both pieces.

CHUCK JAFFE: Yeah. I think a lot of people, whether they're experienced at closed-end funds or not, are not going to be able to say, "I want to get my head around buying any type of asset in a closed-end fund where I'm paying a premium of as much as eight or ten percent."

JOHN COLE SCOTT: No, but a couple percent to me can make sense. Again, one of my favorite things -- recently you had a convertible bond manager on, and convertible bonds are actually more of an equity if you analyze them statistically. Preferred equities are actually more of a duration bond. It reminds us of these hybrid securities in the markets that can be confusing to investors and advisors. It's nice, but again be thoughtful on the premium, but you have a specialty manager that knows the neighborhood, that can weed through the opportunities on your behalf. Again, that's the point of active management.

CHUCK JAFFE: Is that a case as well, if you're looking, you said thirteen closed-end funds in the preferred space. That means if somebody's looking to build a diversified portfolio and get one or two in any area where they're buying assets, it can be somewhat tricky. Hard enough to find one when you only have thirteen to choose from, let alone finding two. Is that one of those cases where maybe you want to split your assets based on structure? If you're going to go preferreds and you can find a closed-end fund you like, okay, you do that, but then you're also looking at a traditional fund or what have you, as a supplement?

JOHN COLE SCOTT: I would argue that the ETF and open-end fund wrapper do very poorly where there's illiquid guts. I would figure much better to split the ticket between listed closed-end funds and individual ownership of the prefereds. Because then you get none of the management fee and you just collect a coupon generally, there's always some risk in any investment. With the closed-end funds, you get liquidity that you can't get with the individual preferred markets in most cases.

CHUCK JAFFE: John, great stuff as always. Look forward to doing this again with you soon.

JOHN COLE SCOTT: Always a pleasure, Chuck. Thank you.

CHUCK JAFFE: John Cole Scott is chief investment officer at Closed-End Fund Advisors. He's the founder and executive chairman at the Active Investment Company Alliance. Learn more about his firm at CEFadvisors.com and CEFdata.com, and follow him on Twitter @JohnColeScott. The NAVigator is a joint production of the Active Investment Company

Alliance and Money Life with Chuck Jaffe. I'm 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. They're on Facebook and LinkedIn @AICAlliance. The NAVigator podcast is available every Friday, please subscribe where you find all of your favorite podcasts and we hope you'll join us again next week.

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TheNAVigator@AICalliance.org

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