MatisseCap's Boughton: Discounts Are At Record Levels, Buys Are Everywhere

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Chuck Jaffe, in this bonus edition of The NAVigator podcast, interviewed Eric Boughton, portfolio manager at Matisse Capital. Read the Q & A below as Chuck and Eric discuss how the current market turmoil has pushed discounts to levels even greater than seen in the financial crisis of 2008. While he expects some dividend cuts, he does not think any distribution reductions should discourage investors. 'Nearly everything is a buy,' Boughton says, though he notes that investors will need a strong stomach for risk to consider the hardest-hit areas of the market.

Eric Boughton

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CHUCK JAFFE: Hi, it's Chuck Jaffe, host of The NAVigator podcast from the Active Investment Company Alliance. When I'm not doing The NAVigator, I host Money Life, a one-hour show available every weekday. Tuesday on Money Life, we were discussing closed-end funds with Eric Boughton of Matisse Capital in a segment we call The Market Call. Because it covers your favorite subject, closed-end funds, here's that interview as a bonus edition of The NAVigator. Enjoy. Eric Boughton, portfolio manager and chief analyst for Matisse Capital is here, and we are talking about investing in closed-end funds today on The Money Life Market Call. Welcome to The Market Call everybody, the part of the show where we talk with experienced money managers about how they do their job. What they're looking for, what they're looking out for. What they see happening in the market right now, and how that is informing their decision making. We find out what they particularly like, maybe what they're moving away from, and ultimately we finish off by putting them to your test with a little bit of Hold It or Fold It. My guest today is Eric Boughton, he's portfolio manager and chief analyst at Matisse Capital, which runs mutual funds that invest in closed-end funds. To learn more go to MatisseCap.com. But Eric's been on the show before, just never on The Market Call. He was with us back last fall when we did Money Life from the Active Investment Company Alliance Conference in New York. At that point, we had talked about bigger, broader issues, and we kind of said, "Hey, at some point we want to put it to work." But we never knew that we'd be putting to work in these kind of crazy circumstances. Crazy just societally, but also particularly interesting and different in the closed-end fund space. So I'm very pleased that we get to have him back. Eric Boughton, good to have you back on Money Life.

ERIC BOUGHTON: Thank you, Chuck. It's a pleasure to be here.

CHUCK JAFFE: So we always start with methodology, but in this case, I almost can't start with methodology without also saying you've got to let us know how that plays in with everything that's going on now. Because the closed-end space almost always represents assets that are on sale, but boy is the sale big now. So let's talk about your methodology, and then what you see happening and how it's mixing with the current market.

ERIC BOUGHTON: This is indeed a crazy time, Chuck. You got that exactly right. Closed-end funds are always very interesting for the investor, especially the individual investor looking for cash generation, steady income, and the ability to buy assets cheap. And not only are the underlying assets cheap here with the market down so much, but closed-end fund discounts have widened to record levels. We haven't seen these kind of discounts since 2008. And indeed on March 18th here recently, the closed-end fund universe traded at a twenty-one percent average discount to its net asset value, which is about six or seven percent wider than it ever got in 2008. So it's been a very interesting time to be a portfolio manager in this space, nearly everything is a buy.

CHUCK JAFFE: Wow, nearly everything is a buy, but it's going to be interesting because you and I know, and anybody who's been watching the space knows that we are going to see -- we have to see some closed-end funds start to cut their dividends. It's not going to be paying thirty and forty percent dividends if the market were to resume its fall from where we're at right now. So are we at a time when -- I know from our talks back at the AICA event, that discounts really matter to you, and that yields really matter to you. If we wind up seeing companies saying, "Hey, we're going to shorten up our yield, because look at how out of whack it's gotten." Is that actually going to be okay? Or are those going to be the ones that say, "That's how you distinguish the buys from the non-buys?"

ERIC BOUGHTON: Frankly, I think, Chuck, that for most closed-end funds, the upcoming announcements, the all but inevitable announcements of a distribution cut, will not be met with any further discount widening, in my opinion. I believe that the market is that cheap that investors as a group will overlook that evidence in a similar way that they're overlooking deteriorating coronavirus numbers. So if you look at increased cases, the stock market bottomed and has gone up in the face of a worsening condition, it's quite similar with closed-end fund discounts. One they get to the washout level they hit on March 18th, from there forward, in fits and starts, they should narrow as a group.

CHUCK JAFFE: Interesting. And like I said, the idea that discounts will not widen as dividends are cut, has that happened in the last fifteen, twenty years? That didn't happen in 2008 that I recall, did it?

ERIC BOUGHTON: In 2008 the market didn't get as cheap as it is today, but in general, we saw some of the same dynamic where funds cut their distributions and did not see their discounts widen from those levels. There were a few cases of course where funds cut their distributions and their discounts widened, but that was the exception rather than the rule back then as well.

CHUCK JAFFE: Okay, so now we have to piece this back together because you said almost everything is a buy. So in an environment where you can kind of throw a dart and know that you're going to hit something and win a prize, what's the biggest prize? What's the one that you aim for? What are the characteristics right now that separate the "everything's buyable" from the "but I really want to buy these"?

ERIC BOUGHTON: That question Chuck, it's back to our methodology that I'll now sort of get back into. Our process involves buying closed-end funds that are the most attractively discounted out of all the closed-end funds in the universe. And in normal times, that means that we're typically buying closed-end funds at ten to fifteen percent discounts. And we look at those same closed-end funds historically, and maybe they trade at five to ten percent discounts, so their ten to fifteen percent discounts are attractive to us by and large. Today, a week and a half ago, we were buying closed-end funds at twenty to forty percent discounts. It comes down to our view of what the discount's going to do after we buy the closed-end fund. What is our upside and what is our downside? So on the upside for us, and for any investor who buys highly discounted merchandise, the biggest upside is clearly that the closed-end fund's discount will narrow substantially going forward. So to get your reward, you want to get a sense for how narrow that closed-end fund discount could be. And I think the historical trading pattern of that closed-end fund provides an excellent clue as to your reward. Interestingly enough, it also provides a good clue as to your risk on a discount level. So if you buy a fund at ten percent discount to its net asset value, that's all well and good. But if you look at that fund historically and find that investors have routinely paid fifteen, twenty percent discounts with that fund, with much the same setup, much the same manager, etcetera, then a ten percent discount suddenly doesn't look so good. You have a risk that that fund's going to widen. There are other factors of course that lead to discount movements. Such as you mentioned, distribution changes. Such as bad or good performance from a manager. Such as a sector coming into or out of favor. The other risk-reward that you have that is especially in evidence today, is sector and leverage. So I want to get into that a little bit, and one of the ways that that is most evident today is in the MLP closed-end fund space. So a lot of your listeners are interested in that one, so I'll dive into that a little bit if you'd like.

CHUCK JAFFE: Please.

ERIC BOUGHTON: So MLP closed-end funds, as listeners know, MLPs are typically pipeline operators, sometimes other upstream or downstream operators in the energy space. The underlying MLPs are having problems. They are facing customers who, with twenty-dollar oil, can't afford to drill anymore. They are facing customers with balance sheet issues. And they themselves, the MLPs, typically have a good deal of leverage themselves. So what's happened is, the MLP -- the broadest index of MLPs has fallen something like sixty percent in the past year. And that has wreaked havoc on closed-end funds that invest in these MLPs because the closed-end funds themselves are also levered. So when you have leverage on top of leverage, closed-end funds have on average have declined about eighty percent that invest in the space over the past year. And the vast majority of them will not come back due to the simple math that an eighty percent decline requires a four hundred percent gain to get it back. So investors who are investing in the space need to understand that the rule will be that no MLP closed-end fund will get back anywhere near its previous high. That doesn't mean that they're poor investments from today, but the investor has to be very careful. So with new money today in MLP closed-end funds, if you can buy closed-end funds trading today at fifteen to thirty percent discounts to their net asset value, which is typical for the space right now. If MLPs turn around and these funds remain levered, you can achieve a very large return. A double is not out of the question over the next couple of years. So this is the kind of investment where the reward is apparent, and the risk is also apparent because these closed-end fund MLPs could essentially lever out of existence. There was just an announcement today that one closed-end fund MLP is scheduling to liquidate. That's the Duff & Phelps Select MLP Midstream Energy Fund, ticker DSE. So that fund is in the process of liquidating, and it will return a very low NAV to shareholders.

CHUCK JAFFE: So what you've got is, yesterday's investors in these things, they are holding the bag and hoping that they're going to get somehow out of the bag. But tomorrow's investors, it's a different bag and they're buying a different product basically.

ERIC BOUGHTON: It's a highly speculative buy in general.

CHUCK JAFFE: Yeah. Let's move from that. We need to know the poster child for the methodology, or an issue or two that stands out to you.

ERIC BOUGHTON: If you look at the sectors in the marketplace today, what closed-end funds are on sale, what attracts us when we look at the universe according to our methodology based on discounts? And I'll just mention two broad categories that stound out as attractive. Number one, municipal bonds closed-end funds. So municipal bond closed-end funds trade on average at about ten percent discounts today, with some subsectors of the space trading at eleven or twelve percent discounts. These are funds that are high credit rating, and they typically historically trade at two to four percent discounts to their net asset value. So if you think that a high-grade municipal bond is a good investment today at a depressed underlying price, in the closed-end fund space, you can buy those for eighty-five to ninety cents on the dollar. On top of the discount you're getting in the underlying asset class. You're also getting in many cases a 4.5% tax-free yield, and you are getting high-quality funds at great long-term performance. They're run by firms like Neuberger Berman, by Nuveen, by Eaton Vance, that have great track records at picking safe municipal bonds that do well over time. This is the space that stands out to us as the single-most attractive buy on the safe side.

CHUCK JAFFE: Now that we know that, we're going to jump in and find out how you feel about some picks that my audience is particularly interested in. It's Hold It or Fold It time with Eric Boughton, portfolio manager and chief analyst at Matisse Capital. Go to MatisseCap.com for more information. By the way, it's the Matisse Discounted Closed-End Fund Strategy, MDCEX if you're looking for the ticker symbol on their fund of closed-end funds. Hold It or Fold It is where we put our guest to your test. We're going to jump right in because we are late getting here. Now you know that Eric likes some muni funds. We're going to give him one that we obviously think is a softball by putting him back in that space, but Lars in New Providence, New Jersey wants to know about MAV. That's the Pioneer Municipal High-Income Advantage Fund.

ERIC BOUGHTON: The Pioneer Municipal High-Income Advantage Fund is a high-yield muni fund, so they're buying municipal bonds that are a hairier than the ones we talked about earlier. But in exchange for that, you're getting a 15.6% discount to NAV, compared to this fund, which is traded on average at three percent premium to its NAV since its launch back in 2003. You are getting a 4.5% indicated yield, tax-free, and you are getting a fund which has turned in a six percent per year tax-free return back to its launch back in 2003. In addition, you're getting a fund who's NAV is depressed by something like ten or fifteen percent from its recent levels. And we feel that most of those high-yield municipal bonds will come back. It's a little more speculative than the municipal bond funds that we talked about earlier, but it's a buy.

CHUCK JAFFE: That's a buy on MAV, the Pioneer Municipal High-Income Advantage Fund. Next, we talk about MLP funds. Maynard in Phoenix wants to know about Kayne Anderson MLP, KYN.

ERIC BOUGHTON: KYN is the biggest fund in the MLP space. It's going to be a weather vane for the sector. It is about four hundred million dollars in assets, and it trades at 327 here on Monday. It's NAV right now is likely to be about 420, and so it's trading at a substantial discount to that net asset value, more than a twenty percent discount. Like many of the MLP closed-end funds, it has a great potential to bounce back, but in our opinion, it will not come close to its former high. We think as the largest fund it will survive. It's likely to survive. Likely not to go out of business because of its leverage. In fact, the fund company announced recently that they had sold a lot of their portfolio and put their money in cash on their balance sheet to reserve for payments on their debt that they have. So we think it will survive. We think it's likely to do well going forward, but it is highly speculative buy.

CHUCK JAFFE: A speculative buy. So if you're already a rich man, that may be the one you want to take your chance on. The Kayne Anderson MLP, KYN. Charles in Sunrise, Florida, I haven't heard from Charles in years, I hope he's still a listener. He sent us a couple of requests years ago. Wants to know about the J.H. Premium Dividend Fund, that's PDT.

ERIC BOUGHTON: Ah, PDT. PDT is a pretty interesting fund. So just as we talked about some funds that are screaming buys right now, investors has pushed up the premiums on certain funds where they perceive that the fund has less risk. The John Hancock Premium Dividend Fund, PDT, trades at a 10.7% premium to its net asset value. Since it launched, it's traded at an average six percent discount. Now why are investors pushing this fund to a premium? Probably because of its yield.

CHUCK JAFFE: For the same reason they're buying toilet paper.

ERIC BOUGHTON: Toilet paper is good. Preferred stocks are good, they yield a lot. So a representative ETF in the space, PFF, yields six percent, while this fund yields 9.6%. Investors are thrilled to get that cash back in what they perceive as a safer kind of investment, and hence an attraction to the investors. But investors seem to be overlooking the risk on this fund. For example, year to date, the sector is down sixteen percent, but this fund's at NAV return -- PDT's at NAV return is negative thirty percent. So we think investors are a little crazy to price this thing at a big premium. Now we're not making a negative call on the sector, but we think PDT is a bad way to play it. Fold.

CHUCK JAFFE: Yup, PDT, that was a fold. Next for Charles in Philadelphia, the Nextpoint Strategic Opportunities Fund, NHF.

ERIC BOUGHTON: Oh, this is one of my favorite names. This is a buy. So this fund trades at less than half of its NAV. That's right, it trades at a fifty percent discount to its NAV. On average since it launched in 2006, it's only traded at an eleven percent discount.

CHUCK JAFFE: Wow.

ERIC BOUGHTON: It just cut its distribution, but it still yields fifteen percent. For the decade ending 12/31/19, its return was twelve percent a year. So the manager, they know what they're doing. This year at NAV, their loss has only been nineteen percent, which is similar to other benchmarks. In addition, this fund stands to benefit from a court ruling that awarded it over sixty-two million dollars, and that's been affirmed at every lower court level and is currently waiting an opinion that the Texas Supreme Court. This fund trades at a huge discount because of investor fears about some other factors, but we think that those fears are misplaced, and this fund will do very well going forward. If the discount persists at fifty percent, we and other large investors will demand a careful liquidation of the fund and the return of NAV to investors. And that's the possibility with nearly all closed-end funds. I should say at this point that nearly everything that we talk about, we own in various of our portfolios.

CHUCK JAFFE: That's a good reminder, but in this case, the other thing that's most important you're buying assets at half price with the potential for them to be made into an open-end fund. Where you capture that, that's what's everybody's looking for. That's why the Nextpoint Strategic Opportunities Fund, NHF, was a buy. Andrew in Cary, North Carolina wants to know about Templeton Emerging Markets Fund, EMF. We haven't done anything international.

ERIC BOUGHTON: International is one of our favorite spaces as well. The average international fund trades at a fourteen percent discount, compared to its seven percent historical discount. It's a small space, there are only thirty funds in the category, but this space is full of buys. EMF, in our opinion, is one of those buys. This fund trades at a fifteen percent discount to its net asset value. Since it launched in 1987, it's only traded at a five percent average discount, and its long-term track record is ahead of the emerging market benchmark. It's a solid buy.

CHUCK JAFFE: We finish on an up note again as we close out with another buy. But of course, you did tell us we were mostly going to see buys, and in this case, we were talking about EMF, the Templeton Emerging Markets Fund. And speaking of good buys, it's come time for us to say our goodbyes to Eric Boughton. But Eric, this was great, thank you so much for joining us. Do this again sometime I hope.

ERIC BOUGHTON: I loved closed-end funds, and I love to talk to your listeners about them. Thanks for inviting me, Chuck.

CHUCK JAFFE: That's Eric Boughton, everybody. He's portfolio manager and chief analyst at Matisse Capital. MatisseCap.com, the Matisse Closed-End Fund, you can learn more about it at the MatisseCap.com website. We'll be back to wrap up today's show right after this message.

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