Income Factory's Bavaria Explains How Closed-End Funds Are An Assembly Line For Payouts

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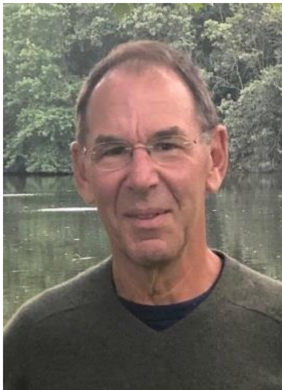
Chuck Jaffe, in The NAVigator podcast, interviewed Steven Bavaria of SeekingAlpha.com – author of 'The Income Factory: An Investor's Guide to Consistent Lifetime Returns". Read the Q & A below as Steven and Chuck talk about how current market conditions should have investors looking to closed-end funds as a way of generating consistent income streams. Bavaria compares closed-end funds to factories, where the company owners are more concerned with the production they get from the workshop rather than the moment-by-moment value of the building. He notes that the strategy is particularly comforting now as a balance to market news and noise.



Steven Bavaria

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

CHUCK JAFFE: Steven Bavaria, author of *The Income Factory* is here, and we're going to talk about why income drives the market right now 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, a unique industry organization that represents all facets of the closed-end fund industry, from users and investors to fund sponsors and creators. If you're looking for excellence beyond indexing, The NAVigator's going to point

you in the right direction. And today, we're not really talking with somebody who is necessarily a fund sponsor, a creator, he is a user and an investor but is perhaps best known as a journalist. Steven Bavaria is the author of *The Income Factory: An Investor's Guide to Consistent Lifetime Returns*. That book came out early this year, just before we got into pandemic mode. He's also known for his work on SeekingAlpha.com. He just launched Inside the Income Factory, which is a new service, so if you go and find his work and his author page on Seeking Alpha, you can learn all about his new service. If you want to learn more about closed-end funds, check out the website of the Active Investment Company Alliance, AICAlliance.org. Steven Bavaria, thank you for joining me on The NAVigator.

STEVEN BAVARIA: Thank you, Chuck. It's a pleasure to be here.

CHUCK JAFFE: Explain why and how income drives the market, and where income is driving it to in these unique conditions.

STEVEN BAVARIA: I think most investors, when you look throughout history, have invested primarily because they want to have income. Income is what provides the value that then the markets eventually in various ways recognize in most securities. When Ford Motor builds a new plant to build automobiles, trucks, other than the accountants, after the plant is built, they never think about its day-to-day, week-to-week market value. They think about how many cars and trucks it produces. I found over my own investing life that that's the way I began to look at my investment portfolio. And the more I thought of it as a factory who's main job was to produce income, where I could then produce my own growth over time by reinvesting and compounding the income, the factory output that it produced. Not only did I produce consistently growing income streams overtime regardless of the market, I discovered that this really worked through the 2008-2009 market crash for example. The more I kept my eye on the ball of how much income I was producing, the less tempted I was to sell out at the wrong times, get off the train and be standing on the station platform when the market train started to take off again. So that's where my own interest in income came from, and it really has worked over the last 10 or 12 years in keeping my eye on the ball and not getting distracted by short-term market moves.

CHUCK JAFFE: When you look at the conditions that we are having right now, has it changed the opportunity set in income? Are there things that you think somebody wants to secure

income and they really want to be there for the long haul, that they have to make portfolio changes now?

STEVEN BAVARIA: It depends what their portfolio was in traditionally, but I'm a big believer that credit, especially at times like this when we don't know what's going to happen. We don't know whether we're in for a long recession or even worse than that, but we know that in times like this defaults are going to increase. That even companies that survive are going to have trouble growing their profits, their earnings, and their dividends, so that I think it's a safer bet to be in the credit markets than in the equity markets in general at times like this. Because all a company has to do is muddle through, stay alive, and pay its debts, and you're going to win your credit bet if you're in the high-yield markets or the senior loan markets, which are markets where closed-end funds provide you a great vehicle for investing in them. A company that muddles through and survives over the next year could be doing very, very well, but it may not be growing, and therefore it stock may not be going anywhere. But as long as it pays its debts, you as an income investor are going to do fine. Especially at times like this, where the markets often price bonds and loans down below their par value, you're getting an even higher return in terms of the yield on your portfolio if you are buying assets at 70-80 cents on the dollar instead of 95 or 100 cents on the dollar. So that's the essence of what my Income Factory philosophy has been over the years. And when markets drop, you're actually increasing your income growth because you're reinvesting and compounding at cheaper prices, and therefor higher than normal yields.

CHUCK JAFFE: In short, these are good times for income-oriented investors to be buying, particularly closed-end funds because they're getting bigger income streams at a discount, and it sounds safer than pursuing dividends. But is this also a replacement for at least some of the bond portion of a portfolio? Because bond yields are low and lousy, and likely to stay there, and investors want or need alternatives.

STEVEN BAVARIA: Yeah, I think you have to differentiate between government and investment grade bonds, which tend to be primarily interest rate bets and not credit bets. When you're buying a government bond or a fixed-rate investment grade corporate bond, where you're making 25-basis points on a government bond, or 2 or 3% at the most perhaps on an investment grade long-term bond, the most you're going to make is your coupon because we're not going to see interest rates. After a 30-year drop in interest rates like we've

had, you're unlikely to see interest rates dropping more, which would give you capital gains. So in most cases when you're buying traditional long-term investment grade bonds, you're kind of locking in low returns if you're buying them at times like this, or losses if you decide you have to sell them later after rates go up, which they're likely to do at some point in the next decade or so. I'm talking about higher yield bonds where you're taking real corporate credit risk. They're shorter maturity, so you're not taking much interest rate risk at all. And with senior corporate loans, which are floating rate, you're taking no interest rate risk but you're being paid for credit risk. In these cases, you're taking credit risk, not interest rate risk, but you're being paid for that credit risk. It's a worthwhile bet and has been over many years. And if you buy them in a closed-end fund structure where you can buy them at a discount, you can also get some low-cost institutional leverage. That means if your natural rate of return, your natural yield is maybe 6% but you're buying it a discount, so you're getting 10% more because you're getting more assets working for you than you've paid for. And you're getting the additional leverage of having taken say, a third of your portfolio in a closed-end fund, and leveraged it at maybe a cost of 2%, and reinvested it at 6 or 7%. So that adds another 1 or 2% to your return, so a natural rate of return on a high-yield bond of 6% can become 8.5-9%. But in a closed-end fund, that's an equity return in what's actually a very stable asset class when you buy it in a highly diversified form. You wouldn't want to buy individual high-yield bonds, but buying a diversified portfolio of them managed by professionals is a very modellable sort of investment which has done well over many, many years.

CHUCK JAFFE: Steve, great stuff. Thank you for joining me on The NAVigator to talk about it.

STEVEN BAVARIA: Oh, it's a pleasure.

CHUCK JAFFE: 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 check out my show on your favorite podcast app or 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. Thanks to my guest financial writer Steven Bavaria, author of *The Income Factory*. Get details on his brand new subscription service Inside the Income Factory from his author page at SeekingAlpha.com. The NAVigator podcast is available every Friday,

please subscribe on your favorite podcast app and join us again next week for more closed-end fun. Until then, stay safe everybody.

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