The Good, Bad, And Ugly Of Closed-End Investing From 2020

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Chuck Jaffe, in The NAVigator podcast interviewed John Cole Scott, the founding chairman of the Active Investment Company Alliance. Read the Q & A below as Chuck and John compare 2020 to unusual years from the past, look at the best and worst performing investment areas for closed-end funds from this year, and look ahead at the opportunities ahead in 2021.

John Cole Scott

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 reviewing 2020 in closed-end funds 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's 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 joining me to do that pointing, it's John Cole Scott, who

not only runs the Active Investment Company Alliance but who's the chief investment officer at Closed-End Fund Advisors in Richmond, Virginia. Which has helpful research tools online for you to use, you can find them at CEFdata.com. You can learn more about the firm at CEFadvisors.com, and about the Alliance at AICAlliance.org. You can also follow John on Twitter @JohnColeScott. John Cole Scott, happy New Year, welcome back to The NAVigator.

JOHN COLE SCOTT: Happy New Year to you, Chuck. Always great to be here.

CHUCK JAFFE: I'm saying happy New Year, of course we're talking and we're airing this interview before the New Year's here, but we can't wait to get out of 2020 for every reason outside of closed-end funds and investing. But in closed-end funds, man, what an interesting year. I mean we say this is a year that's been like no others in terms of life, kind of a year like no other in terms of closed-end funds, right? Such a divergence from the best performing to the worst performing sectors. So much of a mixed bag this year, have you ever seen one like this?

JOHN COLE SCOTT: I wish I had my data capabilities back in 2008, but you might remember we started our work there with our partner in '08 and had a weekly spreadsheet of 29 data points with no history. So I'd like to think that we didn't have as crazy of a year in '08-'09, but the fact that this has been such a different year and that we're expecting duration issues and interest rates ticking higher but weren't certain of equity markets. And then munis did well because rates are going to be low until my daughter's in grad school, she's 10, I'm joking but she's young now. Energy funds which we thought couldn't be a better buy and had so many fundamental reasons and were hated, somehow got blown up and hated more. And then things like the NASDAQ went up so much, you can't believe it's true if you were to think about that on March 23rd. So absolutely, what a crazy interesting year for discounts, dividends, and many of the sectors we work with.

CHUCK JAFFE: It also is a really tough year for investors to judge closed-end fund performance, because a lot of closed-end fund managers were facing really difficult choices, particularly when the market was tanking in February and March. They were in a situation where if they didn't cut their payouts, they could wind up seeing their net asset value get hammered. But if they cut their payouts, they could upset investors because a lot of investors are using closed-end funds almost exclusively for their income. So we saw some funds that really took it on the chin because they hadn't cut dividends, we saw some funds that really

upset their investors because they had. That rock and a hard place, is that now over? Is everybody recovering from that, or is that a situation that comes up again, and maybe again and again anytime the market gets into trouble?

JOHN COLE SCOTT: I've been doing our quarterly webinars for our clients at closed-end fund advisors for almost a decade, and reviewing the quarterly changes in numbers and magnitudes for that long, and basically 3-5% of funds reduce their dividends every quarter is the expectation. What we saw differently was the numbers were much higher, more like 6, 7, 8% were cutting, and the cuts were two, three, four times bigger. Such a big magnitude of difference. So if we were to imagine a closed-end fund being one thing, you have the underlying investment, sometimes equity, sometimes bonds. You've got leverage, has a cost to it. Then you've got management costs, the manager and their team. So the management fees are coming off, the equities are going up or down, the income from bonds are coming in, and they're paying it out after their costs of leverage. So some of the things that happened this year let people de-lever because assets fell so hard. So you had forced selling in the March panic time period, not by the force of the 40 Act rules, but to pre-empt the risk of breaching that rule. So a lot of these funds have way less gross assets to give investors income. The good news is interest rates went down, and so things that didn't get hit hard actually rose their dividends because their interests costs allowed more net investment income. So it really reminds you of the two sides of closed-end fund investing, the guts, which is the sector and the manager, and the closed-end fundedness we talked about, which is the expense ratio, the types of leverage, whether they're earning their distribution, whether it's a reasonable number. Now sometimes distributions are higher than they should be because it's one way to reduce discounts is to have a slightly overpayment, which in some ways if you understand that, is a small regular tender. And why with our work we generally tell people, like I just put a client to work, eight and a half portfolio yield, our fees are 1%, we're going to pay him 6% a year, we're going to re-invest 1.5% because I'm not perfect, markets are unknown. You need to think about reinvesting some of your yield in closed-end funds because they move around consistently over time.

CHUCK JAFFE: Now let's talk about the good, the bad, and the ugly from 2020. The good, convertible securities funds up more than 30%. Why the strong year and why are convertible securities a particularly good closed-end fund type of asset?

JOHN COLE SCOTT: So there's a couple factors here. So convertibles underline or overweight technology by design, but the NASDAQ outperforming the DOW, the currents of the actual convertible bond market followed higher growth. The bonds converted to equity and we got that upside, and it wasn't financials and utilities, it was the better performing parts of the sector. The other thing is convertibles can be illiquid and misunderstood, so active management works great with convertibles the same way it does for senior loans. So it was a balance of just such a great growth of the stock market, and investors, honestly the discounts are still relatively wide. The five year average for our index is a 5.25% discount, and right now they're just under an 8% discount while being up 30% this year. And sometimes that happens when the NAV does so well. The NAV is up 36% in our index versus 29% for market prices, so it's lagged 7%, which means there's a chance for trending higher. That's the thing, the structure did its job, the managers did their job, but just the market, the actual successful sectors this year tapped in perfectly with converts. And it's not the first year they've done that. Every year the S&P and NASDAQ do well, you should generally expect convertible bonds to do well.

CHUCK JAFFE: Convertibles were the good. The bad would be natural resources funds, they were off about 30%. We expect some volatility there, I don't think we expected that much volatility though.

JOHN COLE SCOTT: Yes. I mean from energy to pipelines to even the credit funds that do very little equity, a lot of just pain in the portfolio. And there was even more pressure on forced selling of assets in the first quarter, did not breach the 40 Act rules. Because if you breach those rules, you can't pay a dividend. And in the U.S. closed-end fund market, dividends are 90% of the outcome for why you buy them for most investors. It's to field a diversified retirement stream of income. The good news is there's even more fear and hatred of that sector than there was in February when I think we first talked about these this year. And again, it's going to take a long time to get back to the total return level you were pre-Covid, even pre-energy blow up of '15. Our index price back in 2016 is 1000, and currently the NAV is 382, and the market price is 339. It's going to take a 200% move to break even from when it [inaudible] back in December of '16. So it's very interesting the pain that we've seen there.

CHUCK JAFFE: And the pain there, well let's get to the ugly, because natural resources funds were off 30%, but the average energy MLP fund lost more than 50%. Some of them lost well more than 50%. Is that something that, well, if you weren't in it and you didn't experience that downturn, is this a case where you look and go, "Okay yeah, that was the ugly, but now look at how attractive the buys are"? Or is that this is beaten down and it's not recovering for a good, long time?

JOHN COLE SCOTT: So part of the way MLPs pre-'15, they traded rather independently of oil prices, and since '15 they've traded basically as if they are the price of oil and they're not. So that has just been one factor that could or should decouple eventually. I would say this, you've got to look at the portfolio. And when the portfolios all have similar names in the energy MLP space, some have more credit than equity and you've got to look at their leverage types and costs because it's higher there than it is for muni bonds. And you've got to look to make sure that the discount you're seeing, sometimes it's impacted by deferred tax liability or DTL, Google it if you need to learn more. But sometimes net asset value is written down more than maybe it should, and you need to equalize that to some degree to look peer to peer, apples to apples because it's another area of complexity. And the good news is they've widened their mandate to more than just the pipelines, there's operating companies in there, there's debt and equity. It's a good place if you believe that we're going to keep pumping oil and natural gas around this country, if you believe that we don't have a recession in the near, near term that's significant. You're getting huge discounts, right now the average discount for the MLP funds in our index are over 20%.

CHUCK JAFFE: And let's point out, the funds are off 50+% for the year, but they're up 40% over the last quarter. So if you bought them at something close to the bottom, you're kind of happy, you had a good year in those funds.

JOHN COLE SCOTT: It goes back to a couple things we do, and one of our prospects wanted to be all MLPs because he likes the tax efficiency and he's [inaudible] client. Thankfully the advisor and I talked him out of it and made him like a 10% waiting. Thankfully he was able to put some money in a portfolio in March after the pullback and actually had a good year. But remember, don't let any one sector be the only thing you do, because sectors are never perfect, they have strengths and weaknesses. Their rules, whether it's market rules or congressional rules, or tax policy, or something else that we can't control of foresee like

Covid or other factors, I can't imagine not being diversified in your investments. And to us that's accessing eight to 12 sectors, and 25 to 40 funds typically for a portfolio of only closed-end funds.

CHUCK JAFFE: So now a quick look to the year ahead. Obviously everybody's hoping things will be better in so many ways, vaccine, economy picking up, all those other sorts of things. But from the closed-end fund perspective, a lot of pieces to be picked up, a lot of wide discounts that people could use for their advantage. Do you think we're poised for a particularly strong year given the fact that the economy looks like it's going to pick up, that there's not a lot of people worrying that we're going to see a massive downturn? If the market generally is good, will closed-end funds be better?

JOHN COLE SCOTT: I would say so. Remember, closed-end funds are much more industrial, financial, outside of converts and a few equity funds, very un NASDAQ and S&P 500-like. And so the group of funds, their cost of leverage is very low. Prudential just had an IPO, and their cost of levering short duration high-yield bonds, under 1%. That's a really low cost to borrow, perfect use of the wrapper, these term trusts eventually give you back NAV. Now NAV may not be the 20 bucks it came out at, but the discounts will eventually go away on these funds. And we're seeing large IPOs, successful IPOs and dollar terms where the managers pay the entire load. Nothing's perfect but it creates new product that's reacting to the market. So yes, I think that these are overweight in bonds, overweight value, overweight general recurring cashflows, get through the bumpiness because they're not as loved. For example, high-yield funds have done well, the underlying bonds are priced near par and the average senior loan is priced around 95 cents off par. Way up from the spring but still there's more upside on the guts of senior loan funds and there's more upside in the discounted senior loan funds. But you have to be willing to take 1-2% less yield for that story, and people still have been pushing for the yield and pricing high-yield funds higher. So I think it'd be a great year, but remember, look for when things move up and down, don't forget that you're over NAV but you own market price. And you need to be diversified and just try to be thoughtful and learn from your mistakes and your successes into the new year.

CHUCK JAFFE: John, great stuff as always. Thanks for everything you did for us in 2020, can't wait to talk to you again on the other side.

JOHN COLE SCOTT: My pleasure. Same to you, my friend.

CHUCK JAFFE: The NAVigator is a joint production of the Active Investment Company Alliance and Money Life with Chuck Jaffe. That's me, and you can learn more about my work and my weekday 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, and if you have questions about closed-end funds, send them to TheNAVigator@AICAlliance.org. Thanks to my guest, John Cole Scott, chief investment officer at Closed-End Fund Advisors in Richmond, Virginia, the founder and executive chairman of the AICA. His firm is online at CEFadvisors.com and CEFdata.com, and he's on Twitter @JohnColeScott. The NAVigator podcast will return to its Friday schedule next week. Have a great New Year, we'll talk to you again then.

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To request a particular topic for The NAVigator podcast please send an email to: TheNAVigator@AICalliance.org

Click the link below to go to the home page of Active Investment Company Alliance to learn more: https://AICalliance.org/

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