NAVigator Bonus: Finding A Balance Of High Yield And Risk In BDCs And Closed-End Funds

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Chuck Jaffe, in this bonus episode of The NAVigator podcast interviewed Will Rhind of GraniteShares. Read the Q & A below as Will talks about balancing high yields against risk in the GraniteShares High-Income Pass Through Securities ETF, a fund that invests entirely in business-development companies and closed-end funds. Rhind discusses why the fund currently favors closed-end funds slightly, how he believes it is miscategorized by the 'stack-and-rank services' like Morningstar, and talks about a few investments and why they pass muster with the fund's methodology.

Will Rhind

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

CHUCK JAFFE: Hi, it's Chuck Jaffe, host of The NAVigator podcast from the Active Investment Company Alliance, and I'm also the host of a weekday podcast called Money Life with Chuck Jaffe. On Tuesday, March the 16th, we featured Will Rhind of GraniteShares in our Money Life Market Call. Because the interview was focused on the GraniteShares HIPS US High-Income ETF which invests entirely in closed-end funds and business-development companies, we wanted to make sure you got a chance to listen in. So here it is as a bonus episode of The NAVigator podcast. Enjoy! Welcome to the Market Call, the part of the show where we talk with experienced money managers about how they do their job, what they look for that informs their buys and sells, what they see happening broadly in the market, and how they are putting it all together. Now my guest has been on the show before, Will Rhind is chief executive officer at GraniteShares, but the last time he was here he was talking about the GraniteShares XOUT US Large Cap ETF. Today we're going to focus on a different GraniteShares product, it is HIPS, ticker HIPS, it is the GraniteShares US High-Income ETF, which basically devotes its portfolio to business-development companies and closed-end funds. If you want to learn more about the firm, it's GraniteShares.com. Will Rhind, thanks for joining me again on Money Life.

WILL RHIND: Chuck, thank you for having me. Pleasure.

CHUCK JAFFE: So we always start with methodology, and in this case I have two questions about your methodology. One is the obvious, okay, we need to know what goes into, what are you looking for in a BDC, what are you looking for in a closed-end fund? But also we need to know why BDCs and closed-end funds? There are plenty of funds that are designed to deliver high-income, but most of them are doing it with junk bonds and other thing rather necessarily than BDCs and closed-end funds. So why this space, and then what do you do to make your money in this space?

WILL RHIND: Great question. So let's start with the ticker code, the ticker code is HIPS and HIPS stands for High-Income Pass-Through Securities. So the clue right there is in the name, and what we focus on is a section of the market that some of your listeners will be very familiar with, but for a lot of people looking in the income space it's not the first thing that comes to mind. And pass-through securities, immediately what they have that sets them apart from say, regular dividend paying stocks or bonds, is they're not subject to corporation tax. So automatically you're situated from a better perspective in terms of income generation, they have to by law distribute substantially all of their income to shareholders. So the idea behind HIPS is that in today's interest rate environment, I've talked about an income crisis that we're experiencing here in the country, you simply have to generate a higher level of income than perhaps you've been used to in the past. And the traditional strategies, i.e. dividend paying funds and/or junk bonds, they're just not going to get you there in terms of real after-tax income. And so we've got to go to somewhere like pass-through securities to generate that level of income that we're going to need. And so the idea behind HIPS is it's one of the highest yielding ETFs in the market, but the idea is to generate a high level of income. But crucially my three most important things for income investors is, number one, it's about the amount of income, i.e. the yield that's generated, the consistency of that income, and then lastly, the tax efficiency of that income, and that's what we're trying to do with HIPS.

CHUCK JAFFE: So if it's all about the yield, we're talking closed-end funds, where does the discount play in? How do you factor in discounts, because obviously in 2020 we saw this massive widening of closed-end fund discounts? For some people that signaled, it's a great time to buy, everything's on sale. For others that signaled, ooh, there could be some trouble here. So how do you parse things about like that when yield is your primary focus?

WILL RHIND: Yeah, so great question. We're looking for securities that have a high level of income, that's obviously most important given that we're running an income ETF. But the second most important thing is we're looking for low volatility in the sector. So what we do is we start with a portfolio of 60 securities, so at this time it's equally weighted amongst closed-end funds, BDCs, REITs, and MLPs, and then we're selecting securities with the highest level of income and the lowest volatility in their respective sectors. Then we bring those all together to form the final portfolio under the minimum variance model. And so with the closed-end funds you're exactly right, another factor that we look at which is specific to closed-end funds is the discount. So we want to look at when we're buying closed-end funds or selecting closed-end funds that are trading at a discount to their NAV, and that was something obviously that we saw a lot of last year. So with those four, the aim is to give diversified portfolio across those four sectors so that, yes, you are generating a high level of income but you're diversified across multiple income streams.

CHUCK JAFFE: It's a strategy that's been in place for a while, and it has tended to be a little feast or famine. You've had times when it's been top 10%, such as year-to-date this year. You've had times when it's been near the bottom of its peer group, if you're using Morningstar as your measuring agency, like last year. Is there a reason why either the investments that you're holding the structure, what have you, maybe it's the peer group that the performance is rocky at times and better at times than the competition?

WILL RHIND: This is a big bug there of mine and a lot of my fellow peers in the industry, that if people are looking at what I call stack-and-rank services like Morningstar, the data providers, they obviously make their money in terms of categorizing you in a particular way.

So if you look at our particular fund, in this case HIPS, we're put into a category which we don't think represents what HIPS actually does. So in other words it's in an asset allocation category, and somebody looking for income is not going to find HIPS in that particular category. And so this is a big problem that affects a lot of people in the industry, including us, and therefore the funds that you're being ranked against are funds within that category. And if it's not the right category then you're either going to do very well or you're going to do very poorly but that's fundamentally completely out of your control. So what I focus on with HIPS is the level of income that we generate. So currently we generate just over 8% per annum, that's completely net of fees obviously, so that income is net of any fees. And so from that perspective it really adds a good complement to any portfolio or any strategy where people are trying to generate income on a consistent basis.

CHUCK JAFFE: Let's talk about examples of where you're going with the fund. If yield is what matters most, although you want to get a limit on volatility, which you've noted is another key concern for you, what's a posterchild for the methodology on the closed-end side and on the BDC side?

WILL RHIND: Yeah, so maybe coming back to the performance that you mentioned, last year was like a tale of two halves. So you obviously had the first half of the year where the market sold off very aggressively, and a high-level income fund like HIPS sold off, there's no exception to that. I think where I would try and make the point is that when you compare it to other pure play income generators, so if it was a pure play MLP strategy or a pure play BDC strategy, HIPS would have most likely done better on the way down. In other words, less of a drawdown. But when the market recovered in the backend of the year, a lot of these pass-through securities, they really do well in a market recovery situation because of their level of income but also the sectors that they're exposed to, in particular coming back up. So in terms of the portfolio right now, we have a number of securities in each particular sector, but I'd say the balance of focus for the fund definitely last year focused or shifted more to the closed-end fund space and that's the dominant sector that we hold right now in the fund.

CHUCK JAFFE: And what would be a good example of the kind of closed-end fund that passes muster for you?

WILL RHIND: Yeah, so on the closed-end side in terms of poster child would be Apple Hospitality REIT. Again, given that we are a strategy that's about generating income, this was one particular security that last year stopped paying its distributions. And so obviously in an income fund it's very difficult if you have one of your constituents that stops paying out any income. And obviously for people that may not be familiar, this is a REIT that owns hotel properties, so major brands like Marriott, Hilton, Hyatt, etcetera, and obviously everyone I'm sure understands what happened with hotels last year. But nevertheless, that's why we have this methodology within HIPS, that's why we have an index and rules that are based around the security selection. So when we have a security that's not paying any income, when there's a rebalance, that last rebalance we went through was actually the end of the year last year, those kind of securities would be eliminated and new ones will be put in that do pay a higher level of income.

CHUCK JAFFE: In this case Apple Hospitality REIT, APLE is a poster child for the methodology. It's not a poster child for, "Hey, this is what we're going to have in this fund." It's, "This is what we're going to wind up kicking out of this fund."

WILL RHIND: Exactly.

CHUCK JAFFE: What's one that is in the fund that kind of exemplifies what you get on the good side?

WILL RHIND: On the good side, or at least an example of the kind of security that we'd have would be something like Golub Capital BDC. And again looking for any pass-through securities, but if it's in the BDC space, something with a high level of income but with a low volatility respective or relative to its sector and the other securities in the portfolio. So that's GBDC is the ticker code.

CHUCK JAFFE: Yeah, so GBDC, Goleb Capital BDC. Well now we're going to get your quick and dirty take on some closed-end funds and BDCs that my audience is particularly interested in. And well, we're talking about investing, that's always important. We're having that conversation with Will Rhind, the chief executive officer at GraniteShares, which runs HIPS, the GraniteShares HIPS, which is as you pointed out, High-Income Pass-Through Securities US High-Income ETF. Learn more at GraniteShares.com. Quick and Dirty is where we take our audiences request for opinions on various securities. We're going to start today with a request we got, and I have to point out when we start dealing with BDCs and closed-end funds, it's not necessarily all the people who write in all the time, it's a lot of new folks.

But Barry in Tucson, Arizona wants to know about BGB, that's the Blackstone GSO Strategic Credit BDC.

WILL RHIND: Okay, so that's one of our holdings. This particular one is I would say probably at the lower end in terms of the amount of income that it generates, so generating 6.02% as of Friday. But certainly something that's ranked well in the methodology given the fact that it has an income threshold that we like and a lower volatility.

CHUCK JAFFE: And I said it was a BDC, this of course is a closed-end fund. I'm curious because you talked about how right now you tend to be a little more focused on closed-end funds, they seem to be finding the right thing. When you give me the little caution there about, "Well, it's one of the lower earners," does that mean that given the methodology at some point this might be falling off?

WILL RHIND: Well, the reason why we own more closed-end funds at the moment was due to the volatility last year in the market. So closed-end funds relative to the other sectors of the pass-through world had a significantly lower volatility. So the index is very much shifting towards not only high level of income, and 6.2% in this environment by the way is still a high level of income, but shifted much more to the lower volatility side.

CHUCK JAFFE: Okay, so it is a buy. A bit of a cautious buy on Blackstone GSO Strategic Credit, ticker symbol BGB. Next for Fred in Newington, Connecticut, it's Western Asset Emerging Markets Income, EMD.

WILL RHIND: Yeah, so another closed-end fund here, Chuck. This time we've got a distribution rate of 7.45%, so obviously a little bit more than the Blackstone one we just talked about. But that is included in the current portfolio and potentially something to consider with a weaker dollar given its exposure to the emerging markets.

CHUCK JAFFE: So again, we are talking about something where you want to be looking at it for your portfolio, it's Western Asset Emerging Markets Income, EMD. Let's move over to BDCs now, starting with a request from Filipe in Gainesville, Florida. I'll point out, it's the only request he's ever sent in. He sent me one request based on this interview being announced, he wants to know about Bain Capital Specialty Finance, BCSF.

WILL RHIND: This is the second highest distribution rate of the ones that I picked. This one's coming in at a pretty significant 9.08% as of Friday. So pretty high level of income there, but again scored in terms of our index from not only just a high level of income but low volatility relative to the other BDCs in the sector.

CHUCK JAFFE: So low volatility, high income. That's a buy on BCSF, Bain Capital Specialty Finance. Jeff in San Jose gets our next request, it's one of the big BDCs, Ares Capital Corp., ARCC.

WILL RHIND: Yeah, and ARCC, again pretty impressive distribution rate, this time was not quite as high as the Bain Capital Specialty Finance but coming in at 8.62%. So still a very respectable level of income being generated, and of course that low volatility relative to the other BDCs in the sector.

CHUCK JAFFE: So it's good news, making some money on ARCC, Ares Capital Corp. And Jeff in San Jose shares our last request with Richard in Chula Vista, California, they both wanted to know about PSEC, that's Prospect Capital Corp.

WILL RHIND: I know you saved this one for last because coincidently it's the highest level of income on the list here. So this particular BDC is coming in a pretty respectable 9.61%, which is definitely the highest out of the five that we've just talked about. But again, higher level of income and a lower volatility relative to the sector.

CHUCK JAFFE: Well, I didn't actually look to see if I was saving it for last because it had the highest level of yield. But the important thing here is high level of yield but not so high that you're worried about it and taking it off your list. It's still on the list, it's still a BDC that you like.

WILL RHIND: That's right. Yeah, still very much a BDC that we own in the portfolio.

CHUCK JAFFE: So we finish on a high note with another buy, this one on PSEC, Prospect Capital Corp. Well, all we can think about during Quick and Dirty was buys because we had five of them right there. And now we've got one more goodbye to talk about, that's the one where we say, Will Rhind, goodbye. But thanks so much for joining us, this was great. I hope you come back and do this with us again.

WILL RHIND: Thank you, Chuck. Always a pleasure. Thank you so much for having me.

CHUCK JAFFE: That's Will Rhind, chief executive at GraniteShares, GraniteShares.com the website. They're on Twitter @GraniteShares. He's on Twitter @WillRhind and again we're talking about HIPS, the GraniteShares HIPS US High-Income ETF. We'll be back to wrap up today's show.

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