The Role Of Closed-End Funds In The Changing 60-40 Portfolio

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Chuck Jaffe, in this episode of The NAVigator podcast interviewed Patrick Galley, chief executive officer at RiverNorth Capital Management. Read the Q & A below as Patrick discusses how closed-end funds fit into the standard 60-40 stocks/fixed-income mix as a way for investors to get more from the bond side of the equation without actually changing their broad asset plan. He also discusses how current market times, with the threat of rising interest rates and inflation mixing with lingering discounts from the market meltdown of early 2020, make for interesting opportunities now as both a closed-end fund investor and for fund sponsors.

Patrick Galley

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

CHUCK JAFFE: Patrick Galley, chief executive officer at RiverNorth Capital Management is here, and we're talking about why closed-end funds are particularly attractive in these confusing times, 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 if you're looking for more direction on closed-end funds and business development companies, check out the Alliance at AICAlliance.org. Now today on The NAVigator I'm joined by Patrick Galley, he is the chief executive officer at RiverNorth Capital Management, the chief executive and chief investment officer for the RiverNorth funds. You can learn more at RiverNorth.com. Patrick, thanks for joining me on The NAVigator.

PATRICK GALLEY: Thanks Chuck, for having me.

CHUCK JAFFE: The closed-end fund space has been one of the most interesting places to watch over the last year plus, because oh my goodness, did it get crushed when we had the market freefall early in 2020. It has since seen a significant closing of discounts, but how much is this a time we're getting to a heyday for closed-end funds should thrive? Or is this a time where you're going, wait, now more than ever we have to be doubly careful because these times are so tricky?

PATRICK GALLEY: I think you're spot on. Closed-end funds, they oftentimes are confusing to investors, and obviously with the past year we've gone through a pretty volatile period of time. As you were alluding to in March of 2020, discounts got to really record levels that we only saw once before and that was during the Great Financial Crisis in October 2008. And then after that with the Fed coming in and lowering rates, you had net asset values of closed-end funds really rally as the underlying assets recovered. Risk assets rallied, net asset values appreciated, but what lagged was actually the market prices of closed-end funds. And so really in our opinion for most of 2020, discounts remained really attractive. Despite prices appreciating, the discounts remained attractive, and up until really first quarter of 2021 we haven't seen those discounts make a big move. We had over a 3% discount narrowing across the board in the first quarter of 2021, and discounts are now narrower than the long-term average. But that said in our opinion, with the Fed having committed to a low interest rate policy, this is a time where closed-end funds should thrive. And we think discounts still have room to run and go narrower and frankly, could even go back to the premiums we saw in 2012 as investors are reaching for yield and searching for yield opportunities.

CHUCK JAFFE: As we move towards a premium, I would imagine that there are not too many closed-end fund managers who are particularly concerned about, hey, we're at a premium. I

would imagine that at the height of the troubles in 2020 there were a whole bunch of folks who were worried about, wow, look at how wide our discount has gotten. So how much on any day-to-day, week-to-week, month-to-month basis does discount factor into the thinking of a manager? And should it factor into the thinking of the manager?

PATRICK GALLEY: Yeah, and RiverNorth's a little bit of a hybrid situation. While we are a manager and an advisor to closed-end funds that we sponsor ourselves, our basis of our investment strategy at RiverNorth is actually opportunistically trading the closed-end fund space in first place. So we are one of the largest, if not the largest institutional investors trading the closed-end fund space inside our various vehicles. So we're kind of two-fold on the closed-end fund space being that we're a manager of closed-end funds but we're also an investor in the closed-end fund space, so our policy on the closed-end funds discounts are day-to-day, I would even say second-to-second as we want to be value buyers. But then as a manager of our closed-end funds, we do track them. Obviously because I think of our other perspective of being investors, but it's something that we know is part of the total return. And that's ultimately what the investors can get back, is the market price total return not the net asset value total return, so we try to maximize the net asset value total return as much as possible. If the market price is languishing, meaning that the discount is wider, that's not necessarily beneficial to the investors. So we try very hard to keep those discounts narrow as well, and we are strong believers that managed distribution policies on closed-end funds help narrow discounts on a long-term basis versus maybe a stock buy-back plan or a tender offer which tend to be more temporary in nature.

CHUCK JAFFE: We've had a lot of discussion out in the financial world about how the classic 60-40 stock to bond allocation does not work, and how investors should consider different asset classes, different allocations. Some people would say make it 75-25 or 80-20. Others would say stick with 60-40 but change the assets that you're holding so that you're getting more out of your fixed-income. For you where so many of the closed-end funds are yield-oriented instruments that people hold for the reasons that they're trying to generate, is this a case where you would expect that the folks who are having this conversation, who are saying, "Alter the way you think about 60-40." Is there a reason why I hear them talk about dividend paying stocks, I hear them talk about maybe you should go to junk bonds, but I don't

hear them saying go to closed-end funds. Because every time I hear the discussion I'm thinking, there's part of your solution.

PATRICK GALLEY: Well, obviously we're biased. We're strong believers that anytime anybody's thinking about their asset allocation, they should be looking at closed-end funds to see if they can find that asset class in a closed-end fund wrapper at an attractive discount because they can generate excess return by buying it attractively in the market from a discount perspective. Meaning if you buy it for example at a 10% discount and it narrows to 5%, no matter what the asset class is, you've outperformed presumably that asset class by 5% points just because of the wrapper that you bought it in versus buying it in an open-end fund or an ETF. In doing what we do, we're also believers that you have to be opportunistic. You don't own a closed-end fund portfolio all the time, discounts do ebb and flow and you need to be opportunistic. But if you can maybe rotate that between ETFs and open-end funds, and maintain the same asset class exposure and stick to that plan but filter in closed-end funds to provide maybe excess total return, that's a way to outperform the market in what we believe to be a good risk-adjusted way. And it's not just focused on the yield of the closed-end funds, this is focused on the total return opportunity that closed-end funds offer.

CHUCK JAFFE: You're always looking at opportunities, and one of the things that RiverNorth has done is you've partnered with a couple of other money managers, DoubleLine and MacKay Shields among them, but you're also looking at various markets. And I know that RiverNorth has a private fund, a SPAC arbitrage fund. SPACs, an area that you and I are going to do a second interview that's going to be talking all about the SPAC world. And there's not much SPAC exposure in the closed-end fund space, but I'm curious if you think that that's coming and if closed-end would be a way to play an asset class like SPACs or any of the hot asset classes? Or if playing hot asset classes can't really work with closed-end funds because it requires a lot more activity, a lot more trading in and out than closed-end funds typically have?

PATRICK GALLEY: I think that's a great question. I think there are some closed-end funds already, one of ours included, that has SPAC exposure. So I would say it's not even nothing new and it's not necessarily taking advantage of the recent craze. But frankly as closed-end fund investors when we think about a closed-end fund and think about how it can trade at a discount or a premium to that net asset value; if you look at a SPAC, and it's a portfolio of

cash sitting in a trust with a two-year life as a maximum, and it can trade at a discount or a premium to that cash value, that becomes very interesting to us as closed-end fund investors even. So there's a corollary there and we do think it makes sense in various folks portfolios. I would strongly encourage investors in SPACs to not view SPACs as a SPAC post what's known as the de-SPACing, once the merger occurs with the private company. In our opinion, that company is no longer a SPAC, it is a publicly traded operating company, and that has a different risk profile than owning the SPAC when you have a portfolio of cash sitting in trust. So the exposure to SPAC, there's obviously three I think now, ETFs out there, all of them have a different type of take. Some of them actually own post-merger companies and stuff like that, so there's different risk profiles for each of them. But yeah, we think that they can make sense inside a closed-end fund portfolio and even other wrappers as well.

CHUCK JAFFE: Patrick, it's been a pleasure talking with you. Thanks so much for joining me on The NAVigator.

PATRICK GALLEY: Thanks Chuck, for having me.

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