Taggart Says Investors Can Find The Devil Is In Merger Details

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Chuck Jaffe, in this episode of The NAVigator podcast interviewed Mike Taggart, founder of Taggart Fund Intelligence. Read the Q & A below as Mike joins Chuck to discuss current trends in closed-end fund mergers, and while he says that most deals benefit shareholders and management alike, he raises concerns about those times when consolidations and investment-mandate changes aren't great for a fund's owners. Taggart cites two affiliated funds that have been going through transitions, NexPoint Strategic Opportunities and Highland Income, as examples, noting that the former has been in the process of converting to a REIT for year, while Highland Income is currently proposing to morph into a diversified holding company, a move that has drawn scrutiny from activist investors; Taggart says the cases highlight the importance of shareholders reading their fund's documents to learn the benefits and downsides before approving a fund's change.

Mike Taggart

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

CHUCK JAFFE: Mike Taggart, founder and chief executive officer at Taggart Fund Intelligence is here, and we're talking closed-end fund mergers 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. Joining me today, Mike Taggart, who at one time was the head of closed-end fund research for Morningstar but who now runs Taggart Fund Intelligence, an analysis firm that covers the closed-end fund industry, and you can learn more about what they do at TaggartFundIntelligence.com. To learn more about closed-end funds and business-development companies and interval funds generally, check out the Active Investment Company Alliance website, AICAlliance.org. Mike Taggart, thanks for joining me again on The NAVigator.

MIKE TAGGART: Hey, thanks for having me, Chuck.

CHUCK JAFFE: Mike, it's been interesting watching the closed-end fund industry over the last couple of years. Because while everybody's been talking about the new entrants, the story that's gone under the radar has been consolidations, there's been a lot of companies merging. What's been going on? What's behind that trend?

MIKE TAGGART: Chuck, when I started looking at closed-end funds back in 2010, there were something like 650, and now there's 464, and that's net of all the new entrants. Some of that was liquidations, most of that was funds merging. The way I try to explain it to people is this, you create a bunch of funds and then overtime they kind of look the same. It's like going out to a car lot and every single vehicle on the lot is the same make and model, and the only thing you have left to choose from is the color. Relating that to closed-end funds, you end up with a bunch of fund that are basically doing the same thing, especially in the municipal space, then the only thing that differentiates them is their discount. So to kind of get people's attention back on the fundamentals, it's good to consolidate them and maybe update their investment mandates, that sort of thing.

CHUCK JAFFE: That sounds great as a general rule, but are there times when these deals are maybe not so friendly for shareholders?

MIKE TAGGART: Yeah, I think in generally they're definitely friendly for shareholders because you get a bigger scale, so your expenses go down as a percentage of net assets because of scale, especially if there's a management breakpoint fee. And also they're bigger funds, they have more shares, there's better liquidity when you're trading them in the marketplace, right? Those are the two big benefits for shareholders, but there are times I think when things are kind of a little wonky. I mean, it's rare, usually the case is pretty straightforward. Our industry, the management teams, the fund boards, they tend to do the right things for shareholders just in general, but even beyond consolidations like this from what I've seen. But yeah, we've had a couple questionable situations over the past year in my opinion, and actually their affiliated funds, that are questionable.

CHUCK JAFFE: Let's talk about what those questions are. What are these situations? Give us the specifics.

MIKE TAGGART: Yeah, sure. So these weren't really mergers, these were more involving investment mandate changes. Last August we had a fund, NexPoint Strategic Opportunities Fund, and this August we have Highland Income Fund, and the advisors are affiliated, the funds share a common portfolio manager. The NexPoint fund has ever since last August has been in the process of converting to a REIT since shareholders approved this idea, and the Highland fund is proposing a conversion right now to a diversified holding company, and this is the similar playbook to what the NexPoint fund did. And when you look at the NexPoint experience, even though the shareholders then approved the idea, investors now clearly don't like this idea. The discount's at between 35-40% right now on that fund. Right now it's kind of stuck between being a REIT, it's invested as a REIT, and it's still registered as a closed-end fund. Even though it applied to be de-registered, that can take forever. So it's kind of stuck in this middle ground and there's no general appeal to it right now.

CHUCK JAFFE: What about the Highland Income Fund?

MIKE TAGGART: So the Highland Income Fund right now is proposing to convert from a closed-end fund investing in equity and credit securities of real asset firms to a diversified holding fund, it would take controlling interest in private companies in a couple of different industries. So think Berkshire Hathaway but without Warren Buffet, right? And that's a radical transition and investment mandate, that's something we don't normally see. We've seen funds transform their investment mandates and then we've also seen closed-end funds convert to a different structure, but it's really hard to remember a situation where we've had a fund simultaneously attempt to change both its mandate and its structure. Now we've had situations where you have an equity-focused closed-end fund and it converts to an open-end fund and maybe the equity mandate's broader than what the closed-end fund had had, but that's very similar because they're still an equity. And then when it converts to an open-end fund, shareholders can still get out at NAV.

CHUCK JAFFE: Why is management for this? I mean, what does management see that you don't either seem to agree with or that maybe I'm missing?

MIKE TAGGART: It looks like it's just something that they want to do, frankly. They have three general arguments for the conversion and I would argue that all three can be achieved within closed-end funds. One is that, well, diversified holding companies often trade above their book value. Well, guess what? So do closed-end funds, it's called trading at a premium. Another thing they state is that the new structure would allow them to be more transparent and they can do quarterly update calls. Well, guess what? Closed-end funds do quarterly update calls. So I think shareholders should just be asking themselves ahead of the vote, why is management really proposing this? What's really going on here?

CHUCK JAFFE: And you seem a little skeptical, so what's really going on?

MIKE TAGGART: Well, I want to say, Chuck, this is all my opinion, it's based on my experience in the industry, looking at data, reading their filings. My opinion as an analyst, and other people, like they do, have different opinions, but I just think it's a deal that's great for the managers and bad for shareholders. So first, its discount right now is at 25%, so that's demonstrating that they don't know how to properly support a closed-end fund, right? You have the portfolio manager, there's some questionable history there, and as you're aware, perception becomes reality very quickly in this industry. You have illiquid securities in the portfolio that tend to lead to wider discounts for the fund, so they could be doing things like that to narrow the discount on its own. And then the proposal would allow the managers upon conversion to water down shareholder protections that afforded to them under the Investment Company Act, the 1940. So they can water down the independent board members, they can add leverage, all of this is in the proxy, especially pages 20 through 22 of what could happen in terms of the shareholder protections. And I think shareholders need to read those pages and they also need to bear in mind the NexPoint experience.

CHUCK JAFFE: Is there an alternative? All too often in anything financial, when management gets its idea, the shareholders have it crammed down upon them. Now in closed-end funds we do have dissident shareholders who get their dander up and sometimes make a pretty significant difference. Is that what you have to hope for here? Or is there something else that shareholders could at least do or think about?

MIKE TAGGART: Yes, you brought up the dissident shareholders. So when I was preparing, when I found out that I was going to be invited on and I was preparing for this, I put together some ideas. And then subsequently, one of the activists, Phil Goldstein at Bulldog filed a 13D with a letter, and I think shareholders should read that as well. But aside from that letter, one thing to do is to think about replacing the portfolio manager and to think about making the portfolio filled with more liquid securities, because I think those two actions alone would narrow the discount significantly. And if they really wanted to do this conversion, if there's just some compelling reason to convert this, another potential way to do this would have been to say, "Look, we're going to convert back to an open-end fund," because it was an open-end fund prior to 2017. That gives investors the opportunity to get out at NAV, "And then after that, we'll propose a conversion to the diversified holding company," or do a tender offer in there, something like that. And then the other radical solution would have just been, if they really wanted to do right by long-term shareholders, liquidate the fund. I mean, the thing's trading at a 25% discount. I don't say that lightly, I'm not in favor of liquidating funds. I'm not even in favor of doing a tender offer, I don't think tender offers work either to control discounts. But in this case given the radical proposal to convert the fund, along with the 25% discount, it would probably make better sense for shareholders, liquidate the fund, give them the money back, and then let them decide what they want to do with it.

CHUCK JAFFE: Wow, liquidation is the ultimate out there step. We don't really see that too much.

MIKE TAGGART: Right, it is. And I want to be just absolutely crystal clear here, I'm not a supporter of fund liquidations, like I said, I don't even like tender offers generally. I'm opposed to both 99% of the time because I don't think they are in the interests of the average shareholder, I think there are a lot of costs involved and few benefits. But this is just one of those 1% situations where I think the fund's investors should be given some alternative other than, one, radically alter everything about your investment, or two, live with a fund that doesn't perform in the marketplace. And when you have a management team that either can't or won't effectively support their funds in the secondary market, when there's no real evidence that they've even tried, they've done the opposite, they've stocked the portfolio with illiquid securities, they have a portfolio manager with kind of questionable character. And then when their fund's discount is extraordinarily wide in what's arguably the best market environment we've even seen in the past decade, and their only solution is to just utterly transform shareholders' investment, and then you can look at another attempt that they had to transform a fund where they've destroyed shareholder value in the marketplace. The points I just ran through, when you add them up, I don't think it's good for the average shareholder or our industry in fact. I mean, we need and we have fund management teams and boards that actively support their funds, they educate people about closed-end funds, they might tweak their approaches if necessary, they might consolidate their funds with the benefits I mentioned earlier. Overwhelmingly I think they do the right thing for their shareholders. So it's kind of paradoxical if Highland shareholders do vote to convert the fund, I think it would actually be beneficial to the closed-end fund industry because we'd be ridding ourselves of a fund that's kind of a bad apple in my opinion.

CHUCK JAFFE: Mike, it's really interesting. We'll check back with you down the line to see how it's all playing out or maybe how it should play out depending on what happens next. Thanks for joining me on The NAVigator.

MIKE TAGGART: Hey Chuck, thanks so much for having me, appreciate it.

CHUCK JAFFE: The NAVigator is a joint production of the Active Investment Company Alliance and Money Life with Chuck Jaffe. And yes, that's me, I'm Chuck Jaffe and you can learn all about my show on your favorite podcast app or by going to MoneyLifeShow.com. To learn more about interval funds, closed-end funds, and business-development companies check out AICAlliance.org, the website for the Active Investment Company Alliance. They're on Facebook and LinkedIn @AICAlliance. Thanks to my guest, Mike Taggart, the founder and chief executive officer at Taggart Fund Intelligence. If you know the firm's name, you can learn more about him, and the firm, and the work he's doing at TaggartFundIntelligence.com. The NAVigator podcast is new every Friday, ensure that you don't miss anything by subscribing via your favorite app. We'll be back again next week, and until then, happy investing everybody.

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