Create A 'Quasi-Bond' To Get Steady, High Returns Now From Closed-End Funds

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Chuck Jaffe, in this episode of The NAVigator podcast interviewed John Cole Scott, chief investment officer at Closed-End Fund Advisors, the founder and executive chairman of the Active Investment Company Alliance. Read the Q & A below as John discusses what is involved in turning portfolios of closed-end funds into 'synthetic bonds,' delivering consistent returns above what is available in the fixed income markets during times of concerns over inflation, interest rates, and possible tax hikes.

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 talking about building a portfolio of closed-end funds amid today's concerns about inflation, low interest rates, and potentially higher taxes, this is 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, which is 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's it's pointing us in the direction of John Cole Scott, who not only runs the Active Investment Company Alliance but who is the chief investment officer at Closed-End Fund Advisors in Richmond, Virginia, which has really helpful research tools online for you to use at CEFdata.com. You can learn more about the firm at CEFadvisors.com and about the Alliance at AICAlliance.org. John Cole Scott, it's great to have you back on The NAVigator.

JOHN COLE SCOTT: Always enjoy being here, Chuck.

CHUCK JAFFE: Today I want to have you wearing more of your Closed-End Fund Advisors hat than your Active Investment Company Alliance hat. That's because, well, I've been thinking a lot about closed-end funds because I recently added another one to my portfolio. And as I was looking, and I knew what I was trying to do, which was just generate a little bit of income, I found it's not hard to say, "Oh, let me go find a fund," but it's really hard to say, "Let me go find and build a portfolio of closed-end funds." And I think about folks now, and I've been talking to a lot of them about closed-end fund investing, I know a lot of my audience is very interested. But they're not looking at closed-end funds as, "Oh, I'm buying equities or I'm buying bonds," they're looking at them as, "I'm trying to add, usually, an income component to what I'm doing." Now a closed-end fund is not a bond, but if you're trying to put a portfolio together to have bond-like qualities like, "I want closed-end funds to generate income," well, that's not as easy as buying a fund or two. And then you throw in the rate picture, inflation, potentially higher taxes and the rest. So this is what you do, you build clients' portfolios of closed-end funds. How challenging is this environment for that?

JOHN COLE SCOTT: It's always something to worry about. People always think either the market's too high, or it's going to fall further, or interest rates are going to go one direction or the other. One of the models that we have found has been rather successful, and to kind of create that synthetic bond experience you've talk about, where you own a closed-end fund, you own an equity that derives its value from bonds if it's a bond fund. It's Alternative Income 6.1, it's a tax-thoughtful portfolio. Right now it's running about 20% munis, about 15% regular taxable bond funds, about 5% BDCs, 10% preferreds, 10% senior loans, and about 40% equity income. So those like covered call funds, but also could be energy funds or anything that really produces monthly or quarterly cashflow. When we do that, we really are pulling on the levers of trying to figure out how do we consider taxes, sustainable dividends,

and what could happen with either inflation or a pullback? And I like that many of those sectors have relatively low correlations to each other. If you just put your money in munis, you get about a 4.3% yield as of August 25th our index data. But you've got to worry about a 10 duration almost in a muni portfolio, and most people I talk to can't live on 4.3%. Yet, if you were to go up to BDCs, it's an 8.4% yield, but you probably shouldn't put all your money in BDCs because they're venture loans, and they're a little bit more volatile, and nothing's perfect. Finding how to build that together to synthetically get an asset allocation and then flesh out 25 or 30 funds that work as a team really are I think the key piece that we've had success with and what we seek to do. So if that mix comes together, it ends up blending to about a 6.75% yield based on our index data, so to keep it simple and pure to look at. And then the after-tax yield for a 25% bracket is estimated around 5.75%, so that's a usable monthly cashflow. But we can't forget, as we've talked about your show and others have, not every yield is perfect. So we use this interesting data point called leverage-adjusted NAV yield, that looks not inclusive of the leverage and the discounts of a closed-end fund, what the manager has to hit to meet the policy by the board. This portfolio's about a 5.5%. For simple terms you say, let's spend 4% of that, that ends up being about a 5% market yield. And so that's one way our firm takes this hairyness of closed-end funds and goes, "Let's give you five, we'll reinvest 1.75%. Your taxes aren't horrible, your duration's not horrible, we put you in more than one bucket. We don't know what's going to happen but you're going to get paid next month."

CHUCK JAFFE: And that ultimately is important to people as you're trying to generate a cash-building machine that is going to pay this out all the time. That being the case, is it possible to build that portfolio of closed-end funds without saying, "Here's all my money?" Because there are folks out there who would say, "Oh, I could go buy a fund of closed-end funds," or "I could add one or two to my portfolio." But to get the balance that you're talking about and to get the certainty to say, "Wait, I want to buy stuff at a discount, have it produce this kind of yield, have the margin for error/safety that I want." It takes a portfolio but does it also take all my money as it were, it were somebody's who's an average investor?

JOHN COLE SCOTT: It doesn't have to take all your money, especially in a world where commissions are essentially zero for almost every retail investor. Our portfolios tend to be 25 to 40 positions, we've seen some investors with 100 and some with five, and there's

different answers to what's appropriate. I look at the ability to take a portfolio with numerous funds in a sector playing on the team, you don't have to have every one hit the baseball to get around the field and score some runs. That is our approach, but it can be 10%, 20%, 30%. Many of our clients, we're a piece of their overall pie. Some were 80%, some were 20%, it depends on how much they like or need closed-end funds.

CHUCK JAFFE: How do inflation and interest rates fit in? Because you're trying to generate some measure of income at a time where everybody's looking for income. And oh by the way, what your bogies are and what your power sources are a little bit in flux.

JOHN COLE SCOTT: It is, and that really comes down to our general approach is to invest the day we start because we don't know what's going to happen, if you need the paycheck next month. The fact that senior loan funds operate fundamentally different than a preferred equity fund, and munis operate different than a BDC and how they react to the market, and equity income funds act different than taxable bond funds, there is already hedging left and right and a full minutiae of different pieces there in the portfolio that allow you to say, "I don't know what's going to happen." Here's a start. But then as you know, we do expect some tax-loss selling season, and so we expect investors to be watching in November/December for some extra better buys along the way, not knowing what they'll be. We do expect there'll be another proxy season next year, and there'll be some chances to navigate the portfolio in that capacity. And then discounts are narrow right now, but they could go higher, but there's definitely more of a headwind to discounts. But when they go down, they tend to go down in non-logical ways, so you can pick up better quality things at the same beat up price as the beat up things that should be beat up. Rotation is helpful, you don't have to trade every day like a quantitative manager would. But even though discounts are narrow, there's going to be opportunity, you just have to wait and look for it.

CHUCK JAFFE: In terms of waiting and looking for opportunities, we've seen obviously a time period in the last now about 18 months where closed-end funds got hammered, discounts got super wide, we then saw things narrow. So where are we right now in terms of building portfolios that we're talking about, where you're comfortable with the discount but you're not getting bargains or are you getting great bargains? Are there places that you want to be looking for better deals right now? How's it all playing out?

JOHN COLE SCOTT: The better deals are still like an international bond, international equity, and in energy, which is still seeing a lot of just pain from last year even though they're up a lot this year. But remember, funds that are trading well can do at the market offerings or secondaries above net asset value and actually made NAV go up a little bit and become a bigger fund. It's not always bad to be at a small premium as long as your dividend is sustainable and you're actually using, think illiquid stuff like whether it's BDCs or CLOs or private exposure, where you can't get the quality of the manager in an ETF or open-end fund easily. That's where it's okay to pay up a little bit. But not knowing what's going to happen, BDCs, their discounts have widened 5% this quarter but their market prices are up because NAVs went up because it was a good earnings season. So just because discounts are widening doesn't mean you're always losing money. Because discounts are market price with NAV and NAVs move around, not as much as market price, but you can't forget the NAV moves as well.

CHUCK JAFFE: John, really interesting stuff. Thanks so much for joining me on The NAVigator to talk about it.

JOHN COLE SCOTT: Always a pleasure to be here, Chuck.

CHUCK JAFFE: The NAVigator is a joint production of the Active Investment Company Alliance and Money Life with Chuck Jaffe. I am Chuck Jaffe and you can learn more about my work and my show at MoneyLifeShow.com. To learn more about closed-end funds, business-development companies, and interval funds go to AICAlliance.org, the website for the Active Investment Company Alliance. They're on Facebook and LinkedIn @AICAlliance. And if you have question about closed-end funds, send them to TheNAVigator@AICAalliance.org. Thanks to my guest, John Cole Scott, the 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 is available every Friday, please subscribe on your favorite podcast app and join us again next week for more closed-end fun. Till then, happy investing everybody.

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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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