John Cole Scott provides welcoming remarks to the 2021 AICA Tax Free and Tax Advantaged Income For Investors event along with a presentation on “ABCs of CEFs”.

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John Cole Scott, Founder and Executive Chairman of the Active Investment Company Alliance opens the 2021 AICA Tax Free and Tax Advantaged Income event with opening remarks and with a primer on CEFs. Read the transcript below to hear what Mr. Scott had to say to kick off this event.

John Cole Scott

To view the rest of the conference events and panels go to:
[Tax Free & Tax Advantaged Income for Investors - AICA (aicalliance.org)]

John Cole Scott: All right, good afternoon and welcome to AICA’s Tax Free and Tax Advantaged Income For Investors event being held the first kickoff of our fall programing. We have scheduled, for those that like to program in advance or plan in advance, an event every month through June of 2022. There is information in the weekly email for AICA, as well as you’ll see pages loading on the Events page about a month or six weeks before each session. I want to make sure if you have any issues with Remo, if you’re here probably not. But if you know someone having trouble, there’s a Remo support link in the lower left. We also have some of AICA's folks at our AICA support table for questions, logistics, or just want to meet who else is involved in the organization.

Many of you probably know about AICA, but the short answer is I started AICA two years ago to be a dynamic and invite-to-speak model of content. We work with Chuck Jaffe and Money Life for a hosted sponsored podcast, *The NAVigator*. Our 115th episode is being recorded tomorrow and comes out every Friday morning both in his show and our standalone *The NAVigator* podcast available anywhere you listen to podcasts or on our website. We will also be recording this and transcribing this, and once it's approved by compliance from the presenters you'll be able to access this in replay mode.

The presentation I'm about to give, kind of an intro of closed-end funds and a little bit of an angle on how my advisory firm works with income-focused, tax-driven investors is also going to be PDF'd and available to you as well. Please during all the sessions feel free to ask questions in the question box, you can see them there here. I'll be keeping an eye on that as is any of the moderators or folks involved. Please be sure to, if you want to change tables during the event you double-click on the tables, you can go between conversations. Feel free to turn your mic on, turn your camera on and say hello to people you know or people you would like to be introduced to.

We could not put out these events complimentary without the membership revenue and dues of our supporting members, we appreciate them so much. But we also do have an invitation-to-speak model, so not everyone speaking here is a member. We do seek diverse and high-quality content for you, our audience. With that, the next event just a real quick plug is October 14th, it's an analyst and Seeking Alpha author event. Page should be up early next week for registration and hopefully you can attend and be part of that session as well. So with that I'm going to share my screen and go into the session. If you're having trouble viewing the screen, click the big box, the little square in the upper righthand corner, it'll make the slides bigger.

ABCs of CEFs

So basically, what is a closed-end fund? It's one of the four investment structures in the US. The key caveats of it are it's fixed capital, that's the relatively stable shareholder base, the shareholder count. It's actively managed, which you'll learn from active managers today. And yet when they're listed on the stock exchange, whether it's NYSE or NASDAQ, they have access for liquidity as an investor pretty much every day of the week. But you trade at a market price versus net asset value, and so you have to be thoughtful on supply and demand, fear and greed, and how patient and diligent you want to be in your trading.

They do have a long, established history for those that don't know. I always like talking about that it's 128 years, the first closed-end fund was Boston Personal Property Trust. The first leveraged closed-end fund was 1904, the Railway and Light Securities Fund. I have checked with the archivist at the stock exchange and we don't know the actual IPO month to truly celebrate those two events but we can just celebrate the years.

Because there's a disconnect between market price and net asset value, they can trade above or below, and at premium or discount. The investment company structure is a passthrough entity like MLPs and REITs, basically there's no double taxation, it allows a very great way for investors to have an income focused portfolio. And they often are levered, more leverage is typically in the muni bond or taxable fixed income space, but even some sector funds and other funds, some funds use leverage, average is about 25%. We see equity funds often, if they're levered, 5-30%, bond funds, 25-40%, and BDCs about 40-50%, sometimes 55% with some of their special leverage that doesn't count as regulatory leverage.

We always like to remind ourselves that the closed-end fund structure is a wrapper, it's not an asset class. So it's hard to answer, how are closed-end funds doing? But my firm Closed-End Fund Advisors does endeavor to do that with some of our indices and perspectives. And just to remind people, there are these non-listed closed-end funds that have been around for a while but have picked up in the last four years. Just updated as of last night, it's 182 of these non-listed strategies and about $90.94 billion in assets.

Want to give a quick overview of this, basically I'm going to highlight these sectors we're covering today. There's 125 muni funds, $70.8 billion currently yielding 4.1% on average and an 8.8 average duration with that 32.15% leverage. And the average expense ratio without including leverage is 99 basis points for a muni fund and the average size is $567 million. The other group we're covering today is preferred equity funds, another duration and credit focused investment. About $12 billion in that area, trading at a slight premium to net asset value, yielding about 6.37%, and again durations as a whole are about 3.7 for the peer group average and leverage is about 31.9%. The expense ratio is a little bit higher in preferred equity, about 124 basis points and the average size is $709 million. So this gives you a sense of the universe, but this is a short session so we're trying to keep moving.

We always like to focus on what creates the generally higher market price yield, and we look at leverage adjusted NAV yield, which takes out the impact of discounts and leverage. Basically saying so for preferred equity funds at 6.4% amount, the 5.1% is actually needed at the manager level to meet the board of directors' policies at 6.4%. And then for munis, the 3.1% fuels the 4.1%. And then just benchmarking against some of the other debt indices as for perspective. That's for tomorrow's slides.

Dividends aren't constant, they react to the market because leverage changes, investments change, nobody can actually predict five years what interest rates will be. They're constant and consistent, you can see in this slide that they're not even the same direction in the groups of closed-end funds, and so just need to be dealt with as part of the experience as the investor that remember dividends are not promises, they are policies. This is a slide we use in our quarterly deck, we'll update it as of end of tomorrow for the October 21st session we're holding, but basically that there are changes over time that should be thought of whether it's in managed distributions or in more active changes to distribution policies.

When people ask, "You know, yields are down right now, so why would I use a closed-end fund for munis as the pure example of tax-equivalent yield?" Right now, this is as of last quarter's end because it's not the end of this quarter, but basically the rates are very, very close. I double-checked them last night. So four and low change yield for a high-tax bracket client really gives you that last column there, the 7.19% or the 7.36% tax-equivalent yield. And I think when you're using these assets you should be pairing them against any equity or credit risk you have, and be very thoughtful on the tax-equivalent focus of what you're getting.

We also in 2016 launched an index part of our research business, our data business, this is pulls from that public page. And I just want to comment, I went back in time, the oldest we can go back is 6/30/17, and that the index value was 1,063, it was a 5.44% indicated yield for those constituents at that time, it was a weighted discount of -2.4%, and in dollar terms it was $57.83 if you could own this index, which we all know you can't own an index but for perspective it's very helpful. Fast-forward to yesterday and the index value is $1,401. Yield's down about one full point, not surprising from both net asset growth and lower rates than four years ago to a 4.45% indicated yield, and the discount have narrowed about 2%.

And the dollars though, and this is the thing I really try to remind investors that it's good to be tactical, it's good to not own things forever if that's your goal, but that the dividends are roughly up 8% in dollar terms over that time period. And in simple terms if you count the dividends you're up about 40%. Now obviously there's a big pullback last year but there's been a very good recovery since then. And this does track both NAV movements and market price movements for the underlying, I think it's the top most liquid regular national muni bond funds.

Putting the discount into perspective, yes, right now the current discount for the entire universe, which is not an index, it's a peer group, is just 0.6% discount and the 20-year median is a -3.2%. So discounts are definitely down 3%, and so there's less tailwind to discounts but you will see muni bonds work very well in the closed-end fund wrapper and can tolerate premiums regularly in their environment. I think the things to be thoughtful of as we think about using them is just making sure you understand that eventually there'll be news that widens discounts.

But the goal is if you're an income investor you can always take losses, rotate in and out of positions, but you're a dividend investor, you need to be focused on the dividends that you're living on in retirement. This is a dispersion on a monthly basis, again kind of reminding you this is a June 30th. It's about the same, and so it'll be the same arrow where we are. We're not below average but we're definitely not the highest we've seen.

Preferred equity, a similar story. Different numbers but the yield's down from 7.2% to 6.6%. The premium has expanded from a 0.19% premium to a 3.03% for the index. And the dividends and dollar terms have gone from $81.29 to $101.33, which is a bigger increase in that time period. Again, it should be noted dividends are not guaranteed and this is not investment advice in case you haven't read the disclosures. I am a fiduciary investment advisory representative and need to make sure I cover that.

This is the discount history for preferred equity. Again, a similar story, it's trading about three, four points above the 20-year average. But you can see it's another structure, there's less funds in the mix but that can tolerate premiums on an average basis, it very regularly does that. And I would say if you think about if we get a pullback for whatever reason we eventually do, we often at our firm overweight munis and preferreds because they tend to trade down like high-yield funds and recover just as well if not better on the upside.

When we talk about how we actually take a portfolio beyond munis and preferreds for our clients at closed-end fund advisors, we start by thinking about correlation as part of the backdrop beyond just after-tax yield. And so want to cover that, that there's some places for that. We have three model portfolios just for perspective. I'm just going to say we have one for medium taxes, that's 6.1% in our system, and we basically focus on this is a 7.33% yield as of yesterday with an estimated tax friction of 1.02% at a 25% rate. So that means it's about a 6.3% after tax yield and it's about 60% bonds if you add back in the BDCs, which aren't really thought of as bonds but are 90% loans. And we use our tactical asset allocation, and fund selection, and data resources to produce this type of portfolio that is generally lower correlation, lower duration, and a relatively good after-tax yield.

Imagine you are in a high tax bracket, we actually have one that has more of other similar concepts but at the 37% federal bracket a 6.98% yield comes down to basically 5.78% after tax which is again we think pretty impressive. Again, still a 35% munis and heavy amounts into that sector and a way of doing that for investors. But both this and the last model have equity exposure. We do have one that has no peer groupings of equity funds for people that don't need any equity allocation or choose not to. But it's a little more painful on the after-tax yield, the 6.93% comes down by 1.59% and so you're looking at about 5.6% on average for the after-tax yield but with the duration's about half of what we see in munis and similar to preferreds.

I did want to give a perspective because this work is kind of what drove me to do this presentation, because we want to talk to the managers in the space and see what's going on. This is just the fact that we've had a healthy IPO market. This is historical, it'll be in the replay slides. We've had successful in how they trade, the price versus IPO and the current discounts are actually trading very, very well. This is as of June 30th, this'll be updated next month for our quarterly and these numbers are even better now. But I did want to give you that perspective, that the IPOs are being very healthy and we're very pleased with how the market has improved over time.

Mergers are common. This is a historical review of when funds come together. It seems like it's been a mostly recent thing but it's been a very common thing over time. There's been 10 to 20 mergers most years, and again, a huge number in 2012 and since. This honestly has been repurposing funds, it's reducing expense ratios, it's been able to just give more liquidity so that more investors can participate in the funds.

Deaths, it seems to get a lot of note and definitely part of the universe to cover. But the deaths that are available typically again like I said, they're another consistent, they don't seem to, outside of 2013 and '11 being lower than normal. It just seems like we generally get 6-12 a year and that's a normal number again of repurposing assets, making the universe of funds more salient and interesting for advisors and their clients.

It’s getting close to tax-loss selling season, so I always show this slide in. That includes last year’s movement. It doesn’t happen every year. If you look at 2017-18, also we have the November, and this is the whole universe of our big amount of funds that we use, the bucket, what is a closed-end fund? This is like 90% of the universe and we equal weight it to give it more democratic access, so it’s not just munis being a third of the market and then preferreds being a smaller piece and whatnot. And we do get this movement from November-December into January and February, and I just remind you that we would expect that this year. It’s a great time to be repositioning your portfolio and looking for ways to improve the after-tax performance for your clients.

That is it. I’m going to go un-share my screen, which I’ve done, and we’ll have the editors edit this to the new session.

Recorded on September 29, 2021.

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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