Closed-End Funds Provide A Better Balance Between Liquidity And Returns

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Chuck Jaffe, in this episode of The NAVigator podcast interviewed Erik Herzfeld, president of Thomas J. Herzfeld Advisors. Read the Q & A below as Erik says that investors are sacrificing returns for liquidity when they choose traditional mutual funds and ETFs instead of closed-end funds. The issue – which arises due to the structures of the different fund types – is a problem because most investors never even consider it; Herzfeld notes that most investors would be willing to trade liquidity – to lock in for longer – if it meant for better returns from fixed-income on long-term investments.

Erik Herzfeld

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. And before we get started on today's podcast, I wanted to let you know that the Active Investment Company Alliance, sponsor of The NAVigator, is hosting a virtual event September 29th and 30th covering the advantages of using closed-end funds for exposure for tax-free municipal bonds, preferred stocks, master limited partnerships, and more. You can even learn the ABCs of closed-end funds from AICA chairman, John Cole Scott. The event is for individual investors, institutional investors, financial advisors who can earn four continuing education credits from it, and for

anyone even remotely interested in closed-end funds. Thanks to the generous support of Alliance members, registration is complementary. Claim your spot at the conference and get full details on the full agenda and lineup of speakers by registering at AICAlliance.org. Erik Herzfeld, president of Thomas J. Herzfeld Advisors is here, and we're talking about the balance between liquidity and returns 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. And today it's pointing us in the direction of Erik Herzfeld, he's president of Thomas J. Herzfeld Advisors, a money management firm that is known for its strong and dedicated use of closed-end funds. You can learn all about what they do by going to Herzfeld.com. To learn more about closed-end funds, interval funds, and business-development companies, go to AICAlliance.org, the website for the Active Investment Company Alliance. Erik Herzfeld, welcome to The NAVigator.

ERIK HERZFELD: Thank you so much, Chuck. It's great to be here.

CHUCK JAFFE: This is a really interesting subject that I think a lot of investors don't quite understand. But what we're about to discuss is really the difference between standard traditional mutual funds, and exchange-traded funds, and closed-end funds when they operate in the same space. So you, as your job, you're looking at all types of funds, trying to figure out what is best for your investors and your clients. And one of the things that you have to do all the time is balance liquidity versus returns. Most people don't even think about that, they just look at what's the asset class and what's it going to get me? So explain why there is this balance and why liquidity particularly factors into the equation for you.

ERIK HERZFELD: That's exactly right, Chuck. If you think about liquidity as something people only think about when things are really bad, they don't think about it when things are going well. For instance in this environment that we are right now, there's been tons of liquidity and pretty much all assets have been going up. The last 10 years, you could have invested in anything from baseball cards to NFPs to single stock, common stocks, and you've done well. That's what happens when the Fed has a firehose of liquidity, everything goes up.

And I think one of the things that investors need to pay specific attention to is can they do better with returns by giving up some liquidity to get returns? And I think that's really something that's critical of importance.

CHUCK JAFFE: But explain how that works, giving up liquidity for returns. Is it simply I'm going to say, 'I want to own something in a closed-end wrapper versus a traditional fund wrapper?" Or is it I'm going more towards alternative investments and other things within that closed-end fund structure if I'm pursuing one versus the other?

ERIK HERZFELD: That's a great point, Chuck. You could think of it this way. If you look at the PIMCO universe of funds, they have ETFs, open-end funds, closed-end funds, they have a lot of different products and a lot of times they have different products managed by the same asset managers. For instance, Dan Ivascyn and Alfred Murata, they manage the PIMCO PIMIX Total Return Fund, and they manage PDI, which is basically the same fund in a closed-end fund wrapper. And even though these two funds, the mutual fund is $142 billion of assets under management, and the closed-end fund is $2 billion, they ultimately do more or less the same thing but the returns are drastically different. For instance, in May 2012, PDI was launched, the closed-end fund, and it's done 13.2% return annualized since May 2012 versus 6.7% in the mutual fund. Now why is that massively different? Well, as you recall in 2018, 1940 Act was amended, 22e-4, to basically not allow for anything more than 15% to be an illiquid asset. So you can think of it as PDI being the closed-end fund version can be in less liquid assets, and over time those less liquid assets generate far higher returns because the mutual fund must have much more liquid assets to meet that requirement. So if you're a $5 billion pension fund, of course PIMIX is the right fund for you. But if you're an individual or an investor that has a few hundred thousand or even a million dollars, the closed-end fund over time has done almost double what the exact same fund in the mutual fund has done.

CHUCK JAFFE: In that sacrifice between liquidity and returns, is there also a change in the risk profile? In other words, that period that you cited, the lifetime of that closed-end fund has been in market conditions that have been pretty favorable. Would there be more downside risk if we were to get into a significant downturn or protracted bear market?

ERIK HERZFELD: Yes, that's a very good point. It depends on really what your risk horizon is. And as you mentioned, anything in the last 10 years has pretty much gone up. So it's difficult to say how would PDI do the prior 10 years before that? But I think the ultimate

thing is you have to ask yourself is, "What is my investment horizon?" Is it the next 10 years? Next five years? Or next one year? And classically we're taught if it's a very short amount of time, you need to be in things that are more liquid. Closed-end funds as you know have unfortunately the dubious task of trading at premiums and at discounts. So currently PDI's at a premium, but that's not always the case. So if you're looking for a long-term investment, what I like to say is decide on how much liquidity you're willing to get to offset higher returns. The closed-end fund has the ability to go into less liquid because it doesn't have that 15% distinction. It can load up on things that are less liquid, and over time, obviously using leverage which we haven't talked about, but those two things really, really will drive higher return.

CHUCK JAFFE: Does it function effectively as a slight change in the asset class? In other words, as you're building client portfolios or as our audience perhaps is doing it on their own, do you want to have exposure to both? So even though it's the same fund in the same space, of course you could do it with other products as well but would you want to say, "Okay, I want to put this amount of money into this asset class, and I want to split it between the more liquid and the less liquid"?

ERIK HERZFELD: Actually you would think that's the case but in reality it's not. So I'll give you another example. BKLN is a leverage loan fund by Invesco, they manage the fund, it's a $6.5 billion leveraged loan ETF. Now for them since this rule came out, the 22e-4, basically this rule in the 1940 Act said that you have to have no more than 15% in illiquid assets that can be sold within seven days. So for them to basically check that box, they have to have a large amount of cash, and currently have about 10% in cash, and they have to have enough assets to be liquid. Now as you know, leveraged loans, loans reset every three weeks. How can really think of the idea of having a $6.5 billion ETF that at the spur of the moment if everybody hit redeem on it, how would that actually take place? That's something for the SEC to grapple with. They've come out with a lot of different papers and working papers and they're pretty much on top of it. But in reality the returns aren't going to be as good. You're much better off going into a senior loan or a leveraged loan closed-end fund that can use all the cash, and in fact use leverage because it doesn't have to check that box of having to be over 15% in illiquid assets. So you're basically sacrificing quite a bit of return to go into an ETF or a liquid product, and in most cases, lots of investors unfortunately they don't use ETFs

for what they were designed for. ETFs were designed for daily active trading, and in fact people actually don't use them that way. I would say that if you're a daily active trader and you want to be able to get in and out every day then ETFs are perfectly for you. But unfortunately we have a lot of clients that come to us and they are long-term investors, and I look at their portfolio right away and they've got mutual funds and ETFs, and it makes me shake my head.

CHUCK JAFFE: And they don't in many cases have closed-end funds at all, which would also make you shake your head because of course you like closed-end funds. I guess the last question in the limited time we have left is can you find these examples basically across all asset classes? Or is it very specific ones? If you're talking large cap stocks, you're not really talking liquidity issues anywhere. If you're talking certain bond categories, there are liquidity issues automatically. So it's really not an across the board issue, it's more look for where liquidity can give you an advantage, correct?

ERIK HERZFELD: One hundred percent correct, Chuck. If you think about it, the most liquid instrument in the world is a T-bill. You have the most liquidity and the least amount of returns. If you need that type of liquidity, then you're essential bank or you're a sovereign wealth fund. If you're everybody else, you should not be investing in T-bills because you don't need that type of liquidity. In fact, you should be going further out into the risk spectrum and you should be giving up liquidity to get returns. I always think back to when I was a kid, my grandmother and grandfather gave me US savings bonds. They come literally in a paper form, and you have to wait 30 years for you to cash it. I don't even know if they still issue these things.

CHUCK JAFFE: They do.

ERIK HERZFELD: To me that's the most illiquid piece of paper I've ever held but it's the safest, so if you're only think about safety and liquidity. And unfortunately a lot of times people will say, "I want to be safe. I want to have AAA." But you're paying a lot of liquidity in terms of foregone yield to get that when you don't need it. There's a lot of different ways. If I told you that if I tied your money up for five years in something AAA and I was willing to give you 1% of the year higher for that, you might say, "You know what, that's great. I just want to be in AAA. I'll take the extra 1% and you can tie me up for five years." So that's getting into the private equity, risk-reward alternatives, but people need to think about giving up some

form of a liquidity to get higher returns. Closed-end funds provide that, and that's really what I'd like to leave with. Is that closed-end funds are the right place for you if you have a longer-term view and you're not a sovereign wealth fund and you're not exiting $10 million at the push of a button.

CHUCK JAFFE: Erik, really interesting. Thanks so much for joining me to talk about, let's talk again down the line.

ERIK HERZFELD: Thank you very much, Chuck. It was great to be here.

CHUCK JAFFE: The NAVigator is a joint production of the Active Investment Company Alliance and Money Life with Chuck Jaffe. Yep, that's me, and you can check out my hour-long weekday show on your favorite podcast app or at MoneyLifeShow.com. To learn more about interval funds, closed-end funds, and business-development companies go to AICAlliance.org, the website for the Active Investment Company Alliance. They're on Facebook and LinkedIn @AICAlliance. Thanks to my guest, Erik Herzfeld, president of Thomas J. Herzfeld Advisors. Learn more about him and the firm at Herzfeld.com. The NAVigator podcast is new every Friday, ensure that you don't miss anything by subscribing via your favorite app. And if you like us, please leave a review, they really do help. Until we are together to do this again, happy investing everybody.

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