‘My Fund Wants To Pay Distributions In Shares; Is This Good Or Bad?’

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Chuck Jaffe, in this bonus episode of The NAVigator podcast interviewed John Cole Scott, chief investment officer at Closed-End Fund Advisors and executive chairman of the Active Investment Company Alliance. Read the Q & A below as John again helps Chuck Jaffe answer audience questions, this time going into the nuts and bolts of how funds work to answer a complex inquiry about proxy votes, distribution decisions, and how investors should view and respond to these actions.

John Cole Scott

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

CHUCK JAFFE: Today it’s time for your questions to be answered, but not necessarily by me. Because well, when it comes to closed-end funds, and we’ve got another question on closed-end funds, the expert, nobody better to talk to than John Cole Scott. He is the chief investment officer at closed-end fund advisors, CEFadvisors.com and CEFdata.com, the latter a great site to go to if you’re looking for information on your favorite closed-end funds, but he’s also the founder and executive chairman of the Active Investment Company Alliance. And I’ve got a great question here today from Rich in Orchard Beach, Maryland, and I don’t have the answers so I'm bringing John Cole Scott in to do it. John, great to have you back on Money Life.

JOHN COLE SCOTT: Great to be here.

CHUCK JAFFE: So let's jump into this question from Rich in Orchard Beach, Maryland. He says, "Hi Chuck, thanks for your coverage of closed-end funds. Here's a situation that maybe you could clarify for me. I am baffled at ASG, the Liberty All-Star Growth closed-end fund. They keep offering to pay dividends in shares instead of cash, and I'm confused about where these additional shares are coming from. It is closed-end, are we reducing the share value with the new share issuance? In August ASG sent out a proxy where they wanted to change the number of shares they are allowed to issue from 60 million to 200 million." He's now quoting from the proxy, "To approve an amendment to the growth fund's articles of incorporation, increasing the number of shares of capital stock the growth fund is authorized to issue from 60 million shares of common stock, par value 10 cents per share to 200 million shares of such stock." Rich writes, "It's not clear to me whether this diluted my shares or not. How the heck can the par value be 10 cents a share? It seems different from a company issuing new shares because the book value of the company is just spread across the new number of shares. In this case it seems that they're selling new shares and raising capital to increase the assets under management. I haven't found any clear commentary on this and it might be a good question for John Cole Scott or someone in The NAVigator segment. I like the idea of a smaller fund, but this is only three times the size and anywhere near the amount of growth in assets under management that some open-end funds have. I've done well with ASG, but overall it's mostly sideways since February." So John, he called for you, how unusual is this? Because this is a little bit of inside baseball that in my experience, yes, I could have answered it for him, but it's the kind of thing if you're not reading your proxies and you're not doing the rest, you probably won't notice. And not noticing is not necessarily a bad thing here, is it?

JOHN COLE SCOTT: It is. His first question was how can a fixed-capital structure change the number of shares, and I think the concept is that the everyday buying and selling of a closed-end fund between people on the exchanges doesn't impact the share count. There still are things that can reduce the shares by tenders, you can increase the shares by secondary offerings or rights offerings, there's dividend reinvestment plans. And in this case there's funds that offer dividends, especially equity funds, in stocks, sometimes mostly, sometimes a clear choice to investors. And that definitely increases the number of shares, but in our experience the dilution is not significant and that individually should not be a huge issue.

CHUCK JAFFE: Is that more a personal choice? We've talked about how many investors want to get their closed-end fund income stream in cash. So if he's looking at it and he's being offered shares, with your stocks and whatever you've got in your portfolio it's easy to shut off. With this, is there a benefit or any disadvantage to how you take your dividends?

JOHN COLE SCOTT: I agree. To me distributions for closed-end funds, which are often called dividends, are expected to be in cash. That's the base case for income-focused investors. We talked to managers, especially the equity managers in the space this is more common, and they seem to say, "Well, if we offer it in shares, we have more shares after then we had a year ago and that's a good thing." And honestly, I don't care how many shares a closed-end fund has, I care how its performance is after cost and what we can get out of it for clients. And then the option and the distribution, not my preference. I think the easiest thing to do is if you're an investor that came for cash and the fund you're buying is not giving you the cash you want, thank goodness you can trade any day of the week you choose and find those funds that have a history of not doing that and you're able to pick up more of an investment akin to your goals. And then those that don't care can be in that fund, and generally I would expect a wider discount with more stock than versus cash is offered.

CHUCK JAFFE: Do you worry at all if you get a notice like the one that Rich got, where they're saying, "Hey, we want to change our dividend. We want to pay in shares instead of paying in cash"? Do you worry at all what that says to the viability of the distribution continuing?

JOHN COLE SCOTT: Well, I mean equity funds, the distribution is just manufactured of paying out gains over time. And so if the equity fund is a US fund or foreign fund or sector fund, as long as the NAV, NAV performance needs to fuel NAV yields in an equity fund. That's the quick and dirty way of saying, this appropriate, or this is aggressive, or this is conservative. And so I wouldn't worry about the sustainability of this, I just feel like the opportunity to do the shares in stock seems to be more of just a benefit to the fund sponsor. And honestly, they're getting paid a management fee in almost every case to do the work, so they already have the financial benefit. I feel like these funds, if they're going to pay distributions, should be primary in cash because that's the need and the expectation from investors.

CHUCK JAFFE: You know, one of the things that happens in closed-end funds perhaps more than in other parts of the investment world is that you wind up with shareholder fights. You get activist investors who come in and they want to try to get a fund up from a big discount towards its net asset value or what have you. Does any of the authorizing more shares, do anything that impacts those kinds of fights, is there anything that somebody should be worried about that, hey, what this really is about is more about control?

JOHN COLE SCOTT: I don't know if it's about control, I would just say it's about when shareholders are less satisfied with a fund, whether it's the structure, or the manager, or the guts, they tend to give it a further armlength of a discount versus itself and its peers. And that of course in itself makes it more susceptible to activism because a wider a discount the more potential alpha is available to their investors. And so I would just say that really looking hard, whether you're the fund sponsor or the board, or even the investors looking at them, this isn't the worst thing in the world. I could give you 10 more things I would avoid before this, but I would definitely say this is a little thing fund sponsors do. It tends to make them have a few more assets, it doesn't really dilute in a horrible way investors. But to me it's just kind of distracting from the work I think they should be doing, and I find it to be the behavior that we don't totally penalize but we give a little bit wider discount range for funds that do this more than others.

CHUCK JAFFE: And Rich was worried about the par values of the share. Par values to me, if I've got to find an importance to them I might be looking in the bond world, I wouldn't be looking in the stock world, I really wouldn't be looking in the closed-end fund world. But I could be wrong, am I?

JOHN COLE SCOTT: Again, and I don't want to get on the footing of being a 40 Act attorney or the board of directors of a fund, but in my experience that's more of a placeholder. This is not taking a $10 stock and diluting it 99% for every new share issued. The way I've seen it used is more of placeholder, and just basically they have to have a value there just like you used to have to mail in a penny back in the days to get your free music from Columbia House or BMG.

CHUCK JAFFE: And last I've got to ask, because Rich is holding onto the fund and collecting his dividend, which is in the 8% range, but do you like the Liberty All Star Growth Fund, ASG?

JOHN COLE SCOTT: Absolutely. So when you look at the fund, the NAV performance over the last five years has been top in its peer group, so he's experienced that, as well as share price. If you look at the dividend characteristics, it's rather tax advantaged if it's in a taxable account, so there's a lot of benefits there. As I analyze the dividend from an equity fund, it's a good, solid number. The only thing I'll say is it's trading right around par, it's down from a premium of around 10%. It does just go just kind of occasionally, so it's a little expensive. But that's normal for the fund and the market's kind of expensive. So again, if you like those features, it's a good way to access it, the manager's proven to do very well in the environment we've seen recently.

CHUCK JAFFE: Okay, but in your case it's a hold. If we were going to the [inaudible] of quick and dirty as we do at the end of our Market Call segment, it would be a hold for you?

JOHN COLE SCOTT: It is, because at its tiny discount I'd be more likely to buy something at a 3-5% discount. But I don't own the fund, so maybe he has a huge embedded gain he doesn't want to pay taxes on. But absolutely, I would not be adding to it currently.

CHUCK JAFFE: There you go. John, thanks as always for doing this. We appreciate it, we'll talk to again soon.

JOHN COLE SCOTT: Always happy to be here, Chuck.

CHUCK JAFFE: That's John Cole Scott, he is the founder and executive chairman of the Active Investment Company Alliance, the chief investment officer at Closed-End Fund Advisors, CEFadvisors.com and CEFdata.com. On Twitter @JohnColeScott. And if you want to send a question for me or for him, Chuck@MoneyLifeShow.com.

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