John Cole Scott's Crystal Ball View of 2022 In Closed-End Funds

Thursday, December 30, 2021

Chuck Jaffe, in this episode of The NAVigator podcast interviewed John Cole Scott, chief investment officer at Closed-End Fund Advisors and the executive chairman of the Active Investment Company Alliance. Read the Q & A below as John Cole Scott returns to the podcast this week and turns his lens forward, giving his 2022 projections for discounts, new funds, shareholder activism and more, and including some funds he says are well-positioned and constructed to benefit from the economic conditions that lie ahead.


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 back and we're gazing into the crystal ball to give you his forecast for 2022, welcome to The NAVigator. This is 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, 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 that direction that we're pointing is towards the future. Because joining me again, John Cole Scott, who not only runs the Active

Investment Company Alliance but who is chief investment officer at Closed-End Fund Advisors in Richmond, Virginia. And I always would tell you when John's on the show that they've got helpful research tools online that you can use at CEFdata.com. But if you haven't been for a while, well, make sure you go as we get into the new year because that data now is going to include 10 years of research because the website and the firm are crossing into their 10-year anniversary. So CEFdata.com, to use those research tools, CEFadvisors.com to learn more about the firm. And oh, by the way, the Active Investment Company Alliance is online at AICAlliance.org. John Cole Scott, it's great to have you back on The NAVigator.

JOHN COLE SCOTT: Always enjoy chatting funds with you, Chuck.

CHUCK JAFFE: John, we are looking to the year ahead and your fearless forecast for what's coming. And the thing that everybody will want to talk about anytime we're looking at projections and ideas about the future, let's start with what's going to happen with discounts.

JOHN COLE SCOTT: Well, right now currently discounts are around their net asset value or very little large discounts as we talked about last week and some premiums. I really believe that there'll be at least a 6% widening for the entire universe in '22, because while there's a lot of funds set for the environment, investors eventually get shaky and they'll want to sell some of their shares.

CHUCK JAFFE: Does that mean that one of the strategies people should enter the year with is wait for that discount to widen, keep some powder dry, look for those opportunities and buy if the discount gets that wide?

JOHN COLE SCOTT: My approach is hard to be a tactical dry powder investor. We tend to be nearly fully invested for our separate account clients because we're income focused and they need their checks every month. But I definitely recommend following your relative and comparable discounts, and look for peer or similar funds that can give you a little bit of extra discount as appropriate for your needs.

CHUCK JAFFE: Let's move from discounts to the risk picture, because well, one affects the other. But so many people turn to closed-end funds looking for input on their bond portfolios, and there are different types of risk that might become into play in this environment. So what are you looking at?

JOHN COLE SCOTT: When we look at the different risks, we really would say that '22, while there's always concern for credit risk, there's a lot of that is generally low for most funds, for most investors. I think 2022 will be much more of a duration risk, that risk will be real. Doesn't mean to avoid all of those funds, but understand their duration profile and how it may impact your net asset value and future dividends.

CHUCK JAFFE: And is that because with the Fed having telegraphed three rate hikes and potentially having more, that we're just going to see so much rate movement that that's going to heighten the volatility and make rate risk and duration risk that much more difficult to navigate?

JOHN COLE SCOTT: It is. I believe it'll see leverage costs ink a little higher over the course of the year. And while there's four parts investment generally for one part leverage, the investments will eventually catch up. It's a bit of a clip on the front end and then the average muni bond fund is about a nine and change duration. It's not the only area where there's duration, but the yields now are in the low to mid-fours. It's just a lot of duration risk for the take home-yield in my opinion.

CHUCK JAFFE: We spend a lot of time on The NAVigator talking about activism. So what's your view on the activism picture for 2022?

JOHN COLE SCOTT: With discounts so narrow and some good provisions protecting some of the funds that have chosen to, I think it'll be a lot less. I'd say less than half of the successful campaigns for tenders or liquidations or mergers or other of those factors in '22 will be far less impactful to your closed-end fund portfolio.

CHUCK JAFFE: Activism is one portion where people are getting involved and getting busy, another is we've seen a lot of new funds. How's the IPO scene looking to you?

JOHN COLE SCOTT: We've had one IPO per month in 2021, and I don't know how they're going to do it but I think they're going to find a way to get more than one IPO out in a month, so I'm expecting 13 to 15 IPOs. And not only more funds but larger funds, say 10 to 15% in bigger size. Because the closed-end fund structure is so well suited for today's environment and there's a lot of interest from broad-based investors and advisors.

CHUCK JAFFE: That is new funds or that is new business-development company IPOs, or both?

JOHN COLE SCOTT: To broadly talk about it, that would be traditional closed-end funds. We did have four new BDCs in '21. It would be reasonable in the current environment with so much interest to see a couple, two to three BDCs come out, either a private to public or maybe some sort of other process, but that was my traditional syndicate closed-end fund.

CHUCK JAFFE: Now let's look at what you think people maybe need to do when it comes to their portfolios. What would be the portfolio advice you are giving people as we head into the new year?

JOHN COLE SCOTT: Talking to specific funds that we feel exhibit our goal for the rising interest rates and finding what is an average discount versus the sector that you love or hate to continue into for the last five years is the MLP sector. A fund to consider is EMO. It is a ClearBridge fund and it trades around a 20% discount, a 7% yield. And because of the fundamentals in that sector I think that it would make sense eventually for that yield to trend higher and for the discount to narrow as there's some healing.

CHUCK JAFFE: Okay, that's one fund. And I want to get back to funds, but as you're also looking at portfolio moves that you want to be making, what are the tax concerns and the portfolio moves people have to worry about on income portfolios specifically in a rising rate environment with all the changes that we're seeing?

JOHN COLE SCOTT: So definitely especially in a taxable account for your higher tax bracket clients, stay in touch with what the trends and the dividend characteristics are for your portfolio because you want to make sure that you're not surprised the following April at tax time. And then remember, you don't have to be activists, and quant traders or real active traders, but if you can take the opportunity to occasionally rotate your portfolio, you're more likely to have the occasional loss where you can capture some losses. Because we believe long term you'll have gains and it's great to capture losses when they do happen, like when discounts widen people get a little fearful.

CHUCK JAFFE: Now it wouldn't be a chance for you to look ahead if we didn't talk about some of the things that you're looking ahead and using as tools in your closed-end fund portfolios. So what are a couple of tickers that in your mind epitomize the kinds of things you're going to want to own in 2022?

JOHN COLE SCOTT: Yeah, so in addition to the EMO fund talked a minute ago, also a preferred equity fund that did IPO this year, PTA. It's a Cohen & Steers fund around a 5% discount, a 6.5% and change yield, and a 3.7 duration. You get that lower duration preferred, so we're more akin to selecting those funds now for people than straight munis. On the real estate side there's a fund that has a higher than average debt exposure, it's a Principal Real Estate Income Fund, PGZ, around a 13% discount, just under a 7% yield, and a great chance to ride the trends of real estate both equity and debt in a listed closed-end fund. A fourth fund to consider would be ARDC, that is a loan fund where the manager chooses high-yield loans and CLOs tactically, around a 5% discount, 7% and change yield, and under a two duration profile. And lastly because BDCs are in my universe, I would be remiss to not give you at least one to consider for your portfolio. There's Golub Capital, GBDC. It trades around par, which is relatively wide for it historically, just under an 8% yield, and it's basically weathered a lot of the rough storms in the market and I think a good, attractive entry point in the BDC sector where many of the funds are trading at 5-30% premiums.

CHUCK JAFFE: John, great stuff. And of course an exciting year ahead, but also an exciting year for you with Closed-End Fund Advisors. And like we said, crossing the 10-year anniversary so that CEFdata.com has a lot of new, and interesting, and longer and more detailed track records on there. Thanks so much for joining us. Good luck with what you've got coming and Happy New Year. We'll talk to you again in 2022.

JOHN COLE SCOTT: Same to you, Chuck. Happy New Year.

CHUCK JAFFE: You've been listening to The NAVigator, a joint production of the Active Investment Company Alliance and Money Life with Chuck Jaffe. And yes, that's me and you can learn more about my work and my show on your favorite podcast app or at MoneyLifeShow.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. They're on Facebook and LinkedIn @AICAlliance. And if you have questions about closed-end funds, send them to TheNAVigator@AICAlliance.org. Thanks to my guest John Cole Scott, chief investment officer at Closed-End Fund Advisors in Richmond, Virginia and the founder and executive chairman of the AICA. The firm is online at CEFadvisors.com and CEFdata.com, and he's on Twitter @JohnColeScott. The NAVigator podcast is normally available on Fridays, and that's what we will do when we come back next week. Until then, Happy New Year and happy investing.

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