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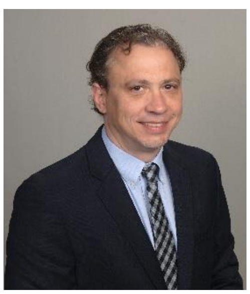
In The Closed-End Discount Cycle, Now Is The Time To Be Buying

Friday, February 4, 2022

Chuck Jaffe, in this episode of The NAVigator podcast interviewed Rob Shaker, portfolio manager at Shaker Financial. Read the Q & A below as Rob says that the market's recent struggles have re-started a cycle and repetitive pattern that closed-end fund investors should recognize and take advantage of. It starts when excessive selling pressures – which the market experienced in January – results in 'excessive selling' that widens discounts; once those selling pressures ease, the market rebalances and restores equilibrium, and investors take advantage of the bigger discounts to snap up bargains, which then completes the circle by raising prices and narrowing discounts to more normal levels. Shaker says investors should be at the buying point now, particularly for bond funds.



Rob Shaker

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CHUCK JAFFE: Rob Shaker, portfolio manager at Shaker Financial Services is here and we're talking about how closed-end funds have been reacting to recent market volatility, 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 it is pointing us towards Rob Shaker, he's portfolio manager at Shaker Financial Services, ShakerFinancial.com, the website to learn more about the firm and about him. He's been on The NAVigator a number of times, Rob Shaker, it's great to chat with you again on The NAVigator.

ROB SHAKER: Yeah, it's good to talk with you again.

CHUCK JAFFE: Rob, the market, well, at the end of 2021 but also more importantly perhaps through the first month of 2022, has been a lot more volatile, moved in directions people aren't used to, and that has had an impact in terms of what's going on with closed-end funds. So explain where you think we are and where we're headed from here generally in terms of market pressures and what they're doing to the closed-end fund investment cycle.

ROB SHAKER: Well, there's lots of peculiarities about closed-end funds. One I think is most particular is their reaction to overall general selling pressures in the market. This is one of the things that we study a lot over at Shaker Financial, strategies to deal with them, and it's sort of a structural situation. We call these generic widenings when selling pressures from the overall market spill into closed-end funds and creates widening across the board in both bond and equity funds. For the most part we find that these come in three general phases and it's all temporal in nature, they will sort of pass through. But the first one is when excessive selling pressures come in and they cause a widening across the board. This is what we see when there's real selling pressures and you have markets going down a percent or two a day, and you start to see the general media talking about concerns in the market place, correction, these types of things that we saw in January.

CHUCK JAFFE: We have to go through that. We're now through January. The next step becomes what?

ROB SHAKER: The next step we're looking for, after you get that first one is the restoration, sort of equilibrium of buying and selling pressures. Because while there is always some type of reason given and the media saying the rates are rising or people on the border of the Ukraine, there's always one fundamental aspect to a correction or market selling, and that is there are more sellers than buyers. And it sounds simple but that's really what it becomes. When you have more sellers than buyers, typically markets go down. This is where I think you find the real interesting aspect of the closed-end fund difference here. How we like to explain it to people is let's take the difference between what happens when you have excessive selling pressures in closed-end funds to that of mutual funds or ETFs? Also they're main diversified units people use to craft portfolios. When you have excessive selling pressures in a mutual fund or an ETF, you're basically sort of selling that back to the company and what happens is it's a redemption, they have to sell it. But that's sort of a thing that just goes through the process. It's different in closed-end funds, because of their fixed-capital structure, there's a certain amount of shares and that doesn't change. When you have excessive selling pressures in the closed-end fund space, you don't have redemptions. Instead you have dislocation in price vis-a-vis NAV movement, and the funds will widen and widen and widen and widen until we reach that equilibrium and restoration.

CHUCK JAFFE: So what you're saying right now is that we're at that time where people should be looking for better discounts? That the discounts have widened because we got the selling pressure. We haven't restored equilibrium yet, we're going to take some market movement before that happens. So this is the time, and I know you and I have talked about it in the past, discounts are what you are looking for. So is the point where you're finding it easier to find a lot of buys right now?

ROB SHAKER: Yes, particularly in the bond space, and one of the main hallmarks of these general widenings in closed-end fund land is the excessive widening in bond funds. I use the example when talking with clients all the time of what happens on that day the market goes down 4%? You have the market going down 4%, people need to sell something in their account, they look at their account and say they have two closed-end funds. One is an equity fund that's down 3%, and one that's a bond fund that's down 1%. Well, in reality the equity fund's only down 3% against the market down 4% is the better sell. But just general nature and habit has people selling the bond fund, even though its NAV is flat on the day, they will push that bond fund down, down 2%, down 3%, creating just this artificial widening. So when the smoke clears, you're looking for those that got pushed back down, those babies that got thrown out with the bathwater. Because they're sitting there at really attractive prices and they will be the ones that bounce back more furiously once those selling pressures subside.

CHUCK JAFFE: So we've got a chance right now to do some buying, and then how long does this cycle last? Because obviously if you're restoring equilibrium you get the buying opportunity and then we'll see discounts narrow again. So buy now while the getting is good, but how long does it typically take until the getting isn't so good?

ROB SHAKER: As a true economist the correct answer to all questions is, it depends. I'm going to start there. And so how long does it take? Well, really it depends. And so far, even though we've had this in the end of January, we actually had our first period of equilibrium and were able to come back a bunch of the way, especially in the bond funds. Even over the last five days we've kind of gained back about half of this, right? And so regardless of when it bounces back, there is always ways to take advantage of it. You can sort of see it coming back. And if you track it you'll see, but in general you can tell just because if there's equilibrium in the overall market it sort of comes back and enters into closed-end fund space as well. But if you take the time to look and find the ones that were most affected and then get into those, what we try and do, we call it double collecting on the way back. If we can get into the ones that were most affected, once they recover back, if we can rotate out of them and go to ones that haven't recovered yet, we're actually able to double collect on the recovery of a general widening. And that way at the end of the day, even though you took that little pain at the front, you wind up better in the long run.

CHUCK JAFFE: For you, is there a sweet spot right now that you would tell people to be looking for a level of discount that folks should be looking for in these conditions? "As we've seen that widening, you'll want to be in here"?

ROB SHAKER: In these types of situations it generally goes to a fund by fund analysis. Overall coming in I'd say bond funds are basically on average trading at around par and equities may be a little bit deeper in the 4-5% discount range. But that being said, each fund is different in itself. And so really if you're going to do the type of analysis and going to try and get the discount captured and really take advantage of these situations, you do have to dive deep enough at least into the individual fund and its historical discount to be able to really decide whether or not, has this one come all the way back, are we now flattish? In general though I would say that closed-end funds as a whole are at least a solid firm level now, they're not over valued at this point.

CHUCK JAFFE: You talked about wanting to be able to get in and maybe absorbing some pain, but how much wider could things get if the market muddles along or maybe goes a little worse before things turn around?

ROB SHAKER: Just a backdrop, the main thing with these is it's not about the market doing well or poor, it's more whether or not it gets that extra boost of irrational selling pressures. There's an irrationality that's involved in any general widening. And so during periods in which the market sort of muddles around and declines here and there, a negative year, the markets have been so well for the past decade it's kind of hard to remember that markets do go down in given years. But as long as it's an organized decline, your closed-end funds shouldn't have this affect. So it's more you're looking for those pressure points and just noticing when the pressure points happen. And if there's one thing I can say, and I'll say this over and over again, when there's those pressure points, when there selling, when CNBC has a *Markets in Turmoil* special, when you're hearing about people talking about the markets just on the regular MSNBCs or Fox News stations, that is not a time to sell your bond CEFs. Chances are they're undervalued. That's the time in which you really want to look for good entry points, but certainly do not sell them just because they're down 2% on a down 4% day.

CHUCK JAFFE: Rob, great stuff as always, thanks so much for joining us. I look forward to talking with you again down the line.

ROB SHAKER: You take care. Be safe.

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 learn all about my hour-long weekday podcast on your favorite podcast app or by going to MoneyLifeShow.com. To learn more about closed-end funds, interval funds, and business-development companies go to AICAlliance.org, that's the website for the Active Investment Company Alliance which is on Facebook and LinkedIn @AICAlliance. Thanks to my guest Rob Shaker, portfolio manager at Shaker Financial Services. Go to ShakerFinancial.com to learn more about him and the company. The NAVigator podcast is new every Friday, ensure that you don't miss anything by subscribing via your favorite podcast app. And if you like us, please leave a review because they really do help. Until we're together again next week, happy investing everybody.

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