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What To Expect From Closed-End Funds In A Rising-Rate Environment

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Chuck Jaffe, in this episode of The NAVigator podcast interviewed Mike Taggart, founder and chief executive officer at Taggart Fund Intelligence, the recently appointed executive director of the Active Investment Company Alliance. Read the Q & A below as Mike talks about his research into how closed-end funds have performed in rising-rate cycles, and also looks at how senior-loan funds perform, noting that the closed-end fund structure can make it harder for senior loans to live up to their narrative as being a plus asset when rates are going up.

Mike Taggart

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

CHUCK JAFFE: Mike Taggart, founder and chief research officer at Taggart Fund Intelligence is here and we're talking about what happens to closed-end funds when the Federal Reserve hikes interest rates, this is 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 close-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 points us in the direction of Mike Taggart, who has added official duties at the Active Investment Company Alliance. He's taking over the executive director role from John Cole Scott who is now executive chairman. But like John, Mike has made his name doing research in the closed-end fund space, and you can find that research now on Substack.com. It's TaggartFundIntelligence.Substack.com. But to generally learn more about closed-end funds, interval funds, and business-development companies go to AICAlliance.org, the website for the Active Investment Company Alliance and the other new web home of Mike Taggart. Mike Taggart, great to have you back on The NAVigator.

MIKE TAGGART: Hey Chuck, thanks for having me.

CHUCK JAFFE: Mike, you wrote an interesting piece that folks can go to Substack to find that took a look at what has historically happened and what we can expect to happen with the Fed raising rates when it comes to closed-end funds. It's attracted a little bit of interest, let's broaden out the audience for it. Tell us what your research showed.

MIKE TAGGART: Yeah Chuck, thanks. I looked at the 2004 and 2015 rate hike period, last two times, and what happened to closed-end funds in general. And right now one of the narratives out there seems to be, oh, and it makes sense, right? Like oh, closed-end funds aren't going to do well in a rising rate environment because they're leveraged, blah, blah, blah, that sort of thing. And that's not really the case because what matters is not the frontend of the curve but the spread. And so when you look back, I looked at what I called anticipation periods, which were like the six months leading into both of the prior rate hike periods, plus the current period. Because assuming that they raise in March, the Fed raises in March, I looked at what's going on now. And you see that historically closed-end funds have sold off in price because like I said, investors are anticipating bad things are going to happen. But as is so often the case, the fear of what's going to happen is worse than what actually happens. And so then I looked at the one-year period after the Fed initially hiked rates, and in across the equity category, multi-assets, taxable credit, and municipal, in both periods median returns, double-digit returns on price in both periods. So again, it actually turned out to be pretty good. The one exception there would be municipals in 2015, they were still positive total return but it was 70 basis points essentially.

CHUCK JAFFE: When we look at a rising rate period, is that a time when people should be saying, "Hey, in my closed-end funds let's be careful about things like leverage," along those lines? Do we wind up seeing a difference not just between asset classes but between investment strategies?

MIKE TAGGART: So I looked at the categories to get a sense of did equities perform better than taxable credits or whatever, and you don't really see anything that's significantly different or sustainable that you could say, "Well okay, this will be sustainable in the coming period." But the general picture is that again the median returns were double-digit positive in the one-year period after the Fed hiked rates the last two times. Is it going to be different this time? Probably slightly. But the anticipation period that we're in right now, the prior anticipation periods, this period looks on both performance and how the discounts are performing, looks very similar to 2004. Especially if you look at the discount charts, it's kind of scary. But in terms of leverage, 80% of closed-end funds, I think it's more like 85% these days are leveraged, so I didn't make a distinction between leveraged funds and unleveraged funds, I just looked at all of them.

CHUCK JAFFE: Okay. People of course turn to closed-end funds for income, so they're going to want to recognize what's happening with their income relative to rising rates and maybe relative to inflation. Should they be worrying?

MIKE TAGGART: I think, Chuck, you hit right on it. And that's the reason that I believe that people in these anticipation periods, they're looking and they're thinking, "Okay look, I'm in a leveraged fund and the cost of leverage is going to go up in a rising rate environment, and that's going to put pressure on my fund's earnings and I need to get out because I don't want my distributions cut." And I don't have any clue, Chuck, where they think they're going to get higher distributions than in a closed-end fund even if it has reduced its distribution. Because a mutual fund in the same asset class, even though it's unleveraged, would still be facing the same pressures, right? So they sell off the shares. But again, if you had the hindsight probability is what I called it, so when you look at 2004, yeah, for all closed-end funds, the median distribution change in the first year after a rate hike, the distribution fell. Well, from the six month period before the rate hike to one year after the rate hike, the median distribution fell about 5.7% in terms of dollar amount of the distribution, and in 2015 it was about 4.5%. So yeah, disappointing, nobody likes to have their distribution rate cut, but it's not like it's a 20 or 30% cut that's coming up. And I think that all plays into the price and what's going on right now in closed-end funds. People think, "Oh my gosh, my closed-end funds is going to cut 20%! I know it is, 20-30% when the Fed hikes rates!" And that hasn't been borne out historically.

CHUCK JAFFE: Let's talk about another place where people are certainly creating expectations for what they want to do, and that is senior loan funds. I talked about the Taggart Fund Intelligence material that you now have up on Substack.com, and it wasn't just that you wrote about rate hikes in closed-end funds, you also were writing about senior loan funds. And quite honestly, you didn't really seem to like them. I mean, you're suggesting people don't believe the hype. So let me have you lay out that case as well. A, what is the hype that people are hearing about senior loan funds in this environment? And why shouldn't they believe it? Because what that article very clearly said to me was, "Senior loan funds, don't go there."

MIKE TAGGART: Yeah, so a couple things, Chuck. After feedback from talking to people, people calling me after I published the first paper, or emailing me, there's a narrative out there and it's kind of a two-part narrative. One is senior loans will perform well in a rising rate environment. And I have no doubt, that's what they're built for, they probably will. But the thing to remember is that when you put an asset into a closed-end fund wrapper, you add two layers of complexity. You add, well, what happens to the NAV when you put an asset into an actively managed fund? But then more importantly for investors it's like what do your fellow shareholders do, because they're going to affect the price, right? And so I don't really have a problem with people investing in senior loan closed-end funds, it's just let's temper the expectation. Because the narrative goes on and it basically says, "Well hey, senior loan closed-end funds in a rising rate environment, look what happened in 2016. You were up like 20% in some of these funds, or more on a price basis, and distributions are set to increase in a rising rate environment just because of the nature of senior loans." And so I think, well, that's getting a little ahead of ourselves. So I went back and I looked at the 2015 period, and what you see is, yeah, they performed really well after the first rate hike. But what you don't see is that prior to the first rate hike they performed horrible during the taper period, which kind of set them up to perform well in subsequent periods. Discounts at the first rate hike were about 11% on average in the senior loan space, and right now they're at 1.5%, so you're not going to get that tailwind this time because there is no tailwind to have really. And then in terms of income security, well, their earnings will do well because of this, that, and the other reason; the funds, the funds themselves, not the senior loans but the actual funds. So it's kind of hit or miss, it was a complete gamble. And more funds actually cut their distribution during the rate hikes from 2015 to 2018, more funds cut and by larger average amounts than funds that had increased distributions in their average amounts. So it's kind of a gamble, there's no free lunch ever, but the narrative that I was increasingly hearing was that this was kind of the place to be. It could still be the place to be in terms of relative to everything else, but the purpose of the article is more like, hey, let's temper our expectations here and let's kind of tamp down the hype a little bit in terms of what to expect going forward from senior loan closed-end funds.

CHUCK JAFFE: Yeah, it isn't a flat out no, but it is for those folks who are looking for a reminder that it's not that easy, and that's what you want to look at. Mike, great stuff, thanks so much for joining me to talk about. Good luck as executive director of AICA in your new role.

MIKE TAGGART: Thank you, Chuck. Thanks for having me.

CHUCK JAFFE: The NAVigator is a joint production of the Active Investment Company Alliance and Money Life with Chuck Jaffe. And yes, that's me, and you can check out my hour-long weekday podcast on your favorite podcast app or by going to 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. My guest Mike Taggart, well, he's the new executive director at the Alliance and he's also the founder and chief research officer at Taggart Fund Intelligence, which is now on Substack at TaggartFundIntelligence.Substack.com. The NAVigator podcast is new every Friday, ensure you don't miss anything by following along at your favorite podcast app. And until we do this again next time, happy investing everybody.

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