AICA’s Scott: Closed-End Fund 2.0 Is Off To A Strong Start

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Chuck Jaffe, in this episode of The NAVigator podcast interviewed John Cole Scott, chief investment officer at Closed-End Fund Advisors and the chairman of the Active Investment Company Alliance. Read the Q & A below as John says that 20 investment firms have launched 30 new funds under the 'Closed-End Fund 2.0' format since 2019, and the results and opportunities are promising. While the new funds show an average discount over 7 percent, the new structure returns the funds to net asset value after 12 years, which means that some of these funds are long-term bargains right now; he names four of the 2.0 funds that look particularly attractive to him now.

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 from Closed-End Fund Advisors is here and we’re talking about the latest in closed-end fund 2.0, including a few funds you might want to look at for your portfolio, 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'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. Joining me today, John Cole Scott, the chief investment officer at Closed-End Fund Advisors in Richmond, Virginia, which has really helpful research tools online that you can use at CEFdata.com. You can also learn more about the firm at CEFadvisors.com. And John is the chairman of the Active Investment Company Alliance, which you can learn about at AICAlliance.org. John Cole Scott, it's great to chat with you again.

JOHN COLE SCOTT: It's always good to be on the line.

CHUCK JAFFE: Now John, I've had guests on The NAVigator talking about closed-end fund 2.0, but not you. Basically it's an evolution of the closed-end fund that is actually creating some potentially different and interesting investment possibilities. But first, let's give everyone a bit of a refresher course on closed-end fund 2.0 is what?

JOHN COLE SCOTT: So the 2.0 structure is that the manager pays the load and they generally have a 12-year term. So you come out day one at the generally $20 net asset value with no friction from the IPO process and you know down the line if you choose to buy and hold you'll get net asset value. No guarantee on what it will be, but there'll be no discount at the end of the relationship and shareholders can vote to convert it to a perpetual fund or end its life that day. And there's been 30 funds through the end of '21 that are in this new structure that we've been analyzing and watching in the current market.

CHUCK JAFFE: People are going to hear, wait, there's no discount at the end. But there's plenty of discount at times in the middle, which is part of what's interesting here. And beyond the no discount at the end, this is like any other closed-end fund, it is not necessarily like an interval fund. It's got all the regular liquidity you'd expect, all those other things, it's just got a termination date.

JOHN COLE SCOTT: It is. So there's 20 sponsors that have come to market, and sometimes people will say, "Closed-end funds, we don't like them, the expenses are high." We tend to look at the gross non-leverage expense ratio to really understand what that is, and the average fund in this group is a 1.16 average expense ratio. Other times people say, "Closed-end funds, they're too small, they're harder to trade." Well, one benefit of basically having one IPO a month in this more modern structure is the average size is $1.14 billion in assets, it's basically two and a half times bigger than the average IPO from 2003. We also looked at the holdings, and 58% are level two and 5% on average are level three, with a fifth of the funds having level three assets of 15 plus percent, which is the stuff you really couldn't or shouldn't put in an active open-end fund or an ETF. And then the leverage, the big part of most closed-end funds, 24 of the 30 are levered at average 22%, and the leverage is not expensive, it's averaging 93 basis points of the NAV on an annualized basis. So we find these funds right now are trading on average 7.5% discount, they're all term trust, they're yielding on average 7.5%. They're diverse in their assets and their approach, and they're on average 5% wider than their peer group average discount. So they're attractive in this market, but as you know it's been a really rough weird market for all investments, especially closed-end funds.

CHUCK JAFFE: It has been. So 20 sponsors making 30 new funds since late last year, how does that compare to traditional closed-end funds? And is it a case where we should expect that going forward the majority of closed-end funds will be 2.0 structure the way these days it's much more common to see an ETF than it is a traditional mutual fund?

JOHN COLE SCOTT: Probably. And I'd say it's just because I think it forces the fund sponsor to really have a convicted idea to take on the cost of bringing the fund to market versus having a sales force that can get the fund sold. And then it does require them, because of the nature of the structure, to support it through its life because the shareholders all get a vote at the end of the structure whether you did a good job over a long period of time. But again, they have to recoup that initial cost of bringing the fund to life, so I really like this structure. We use funds as you know, old funds, new funds, medium age funds, we don't really care the age of the fund for our client portfolios. But I'll tell you, when you're really thinking about picking discount spots in this market, and you can pick a 10-15% discount in a term fund versus a non-term fund, it's a healthy decision to give it a strong consideration.

CHUCK JAFFE: So many people, including many guests we've had on The NAVigator talk about how discount is a massive part of buying closed-end funds in of course the hope that a discount will narrow. Well, in this case you know for sure that the discount is going to narrow. It's going to narrow in 12 years, but it's going away. So that is like guaranteeing that if you buy something now, you will get paid off that discount amount, it's coming back to you.

So is this a case where there is a level of discount where you go, if it's trading – and you said average for these is 7.5% – but if it's trading at 10%, if it's trading at 11%, at what point does it become just an overwhelming, you'd be nuts not to buy this and hold it till the end?

JOHN COLE SCOTT: To be fair, we buy funds at 3-6% discount that we find attractive because at Closed-End Fund Advisors we're more than just discounts. We analyze the sector, the manager, the NAV, that's part of our trifecta analysis. We analyze the dividend policy and then analyze the discounts as part of our equation, not the only answer. We're fundamental analysts by nature as you know.

CHUCK JAFFE: Yes, I'm not suggesting that people should do that. Lord knows, we've talked enough about closed-end funds, you and I, but also everyone that we have on The NAVigator, that yes, it shouldn't just be just on discounts. Even the guys who focus heavily on discounts look at other things. But the question I asked is, is there a level where you'd look at this and go, you're selling me dollars at such a big discount that I need to pick them up because like seriously, I can't turn it down. Is there a level that is that compelling for closed-end fund 2.0?

JOHN COLE SCOTT: A double-digit discount in a term fund is a great fishing ground, and there are a handful in that neighborhood. And I was going to highlight a few because people like to hear the things that we actually like the NAV and the discount.

CHUCK JAFFE: Well, let's highlight those. In the time we've got left, let's talk about a couple of funds. And I want to point out, I mentioned John's website everybody, CEFdata.com, great if you're using closed-end funds and you want a really good research tool. But John is going to have the full list of the 30 closed-end funds 2.0. If you're wondering what they are and you want information on them, email TheNAVigator@AICAlliance.org. Email TheNAVigator@AICAlliance.org, you will get the list of the 30 closed-end fund 2.0 that have gone through the John Cole Scott Closed-End Fund Advisors treatment. With that out of the way, John, which ones do you like a lot?

JOHN COLE SCOTT: So we really wanted to bring some diversity here. I mean, ESG and that sector has been kicked in the knees a little bit, but there's a BlackRock fund, ECAT, it's about a 14% discount and a 7.4% yield. It's a little out of favor in the NAV, but I like to think if you have years in your horizon, that it's an actively managed portfolio that will have legs eventually. There's another muni fund brought up by Pioneer-Amundi, it's MIO, about a 10% discount, a 4.3% yield. The only have 29% leverage, we expect them to grow the yield a little bit more through this year, and the duration's relatively low. And they really focus on nichey small credits, not the big broad based ones you might get the larger firms in the space. Another great taxable bond fund is SDHY, it's a PGIM. It's a short-duration fund, another 9.5% discount, 7.5% yield, only 21.7% leverage and a 2.4 duration. They're really good. Prudential, they're really good at managing that part of the market. And then this is one of the older 2.0 funds, it's actually the only quarterly payor in the mix, the rest pay monthly, it NRGX. It's a PIMCO natural energy and resource fund, it has a debt focus but some equity exposure, a 16% discount, a 6.1% yield, only 18 and change leverage. And I like to think unlike some of the MLP funds that we think the discounts will narrow, we know one day this one has to narrow. And if you think about the income, these funds all start going ex-dividend next week, so if you're trying to find entry point and you're an income investor, could be attractive. And this all came about really from one of our members of our events, asking us to focus on IPOs. And I'll let your listeners know, AICA's going to be doing an IPO spotlight going forward for every new IPO. Just to make sure investors have more information after the launch so that they can find them faster and make their list for watching them through the markets.

CHUCK JAFFE: And of course all that will be on the AICA website, AICAlliance.org. John Cole Scott, we always learn so much. Here we learned a couple about the specific investments, but more importantly, the specific reasons why closed-end fund 2.0 is every bit as exciting as we've made it sound for folks who are interested in closed-end funds. Thanks as always for joining me, John. We'll do this again soon I'm sure.

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

CHUCK JAFFE: The NAVigator is a joint production of the Active Investment Company Alliance and Money Life with Chuck Jaffe. And that's me, and you can learn more about my work and my show at MoneyLifeShow.com or on your favorite podcast app. To learn more about closed-end funds, business-development companies, and interval funds go to AICAlliance.org, the website for the Active Investment Company Alliance. They're on Facebook and LinkedIn @AICAlliance. Thanks to my guest John Cole Scott, chief investment officer at Closed-End Fund Advisors in Richmond, Virginia, the chairman of the Active Investment Company Alliance. His firm is only at CEFdata.com and CEFadvisors.com, and he's on Twitter @JohnColeScott. And if you want John's analysis of the 30 new issues of closed-end fund 2.0s since late last year, request it at TheNAVigator@AICAlliance.org. The

NAVigator podcast is available every Friday, we hope we'll see you again next week. And until then, happy investing everybody.

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