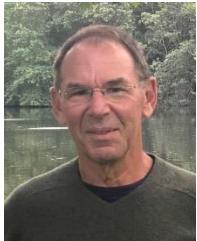




Steven Bavaria On How The 'Income Factory strategy' Copes With Current Conditions

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Chuck Jaffe, in this episode of The NAVigator podcast interviewed Steven Bavaria, author of "Inside the Income Factory" on SeekingAlpha.com. Read the Q & A below as Steven says that current market conditions have shown the value of focusing on income streams rather than the value of the underlying securities, allowing investors the peace of mind that comes from generating cash-flow and putting that money back to work buying at a discount. Bavaria noted that when a manufacturing company builds a production plant, they don't worry about the resale value of the factory but instead focus on its output; he says investors should act the same way,



focusing less on the fluctuations in value of their investments and more on getting consistent, above-average yields, which provide a comforting cash stream that makes tough times – like the first quarter of this year – much easier to stomach.

Steven Bavaria

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

CHUCK JAFFE: Steven Bavaria, developer of the Income Factory investment strategy is here and we're talking about investing for income while rates and inflation are on the rise, 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 will point you in the right direction. And today we are heading in the direction of Steven Bavaria, who may be best known for his work in Seeking Alpha, where he developed the Income Factory Strategy which ultimately became the basis for his 2020 book *The Income Factory: An Investor's Guide to Consistent Lifetime Returns*. You can find him easily by searching for his name and/or 'Income Factory' on Seeking Alpha, but right now he joins us on The NAVigator. Before we jump in, a reminder, to learn more generally about closed-end funds, interval funds, and business-development companies go to AICAlliance.org, the website for the Active Investment Company Alliance. Steven Bavaria, welcome back to The NAVigator.

STEVEN BAVARIA: Thanks Chuck, it's a pleasure to be here.

CHUCK JAFFE: Steven, before we jump in and find out how people should be investing in these times, we need to know the underpinnings of the Income Factory strategy. So lay it out for us.

STEVEN BAVARIA: Well, the Income Factory, Chuck, is based on a simple idea. When Ford Motors builds a plant it doesn't worry about the plant's resale value because it's not in the business of selling plants, it focuses on its output. How many cars and trucks does it produce, and how does it increase that output going forward? We take the same approach to our investing. Our portfolio is our 'Income Factory' and its job is to produce cash. Total return is total return whether you earn it as appreciation or as cash distributions, so we try to get as much of our total return in the form of cash as possible. This is for psychological reasons as much as financial, because when markets are down we're still getting our river of cash, and we can reinvest and compound it at bargain prices. And frankly, that makes it a lot easier to sleep at night for most investors than having to sit and only get 1 or 2% dividends on their growth portfolios while they're wishing, waiting, and hoping for the market to give it to them.

CHUCK JAFFE: When you're looking for those investments, what percentage of a portfolio is closed-end funds, interval funds, and BDCs?

STEVEN BAVARIA: Primarily most of it, or even all of it for many investors. I think closed-end funds and other high yielding credit-oriented types of funds. BDCs are a great example.

You're buying the equity of a company but the company is a very transparent virtual bank basically, so you can easily see where your income's coming from and you can measure whether the interest and dividends, mostly interest on a BDC, that are coming in are enough to pay your distributions. So it's easy to run coverage ratios. The same is true of a closed-end fund, where it's very transparent, and closed-end funds tend to be geared towards producing income. So they're perfect for the kind of Income Factory investors who want to see their cash every month and reinvest it themselves and create their own growth that way instead of being dependent on the market.

CHUCK JAFFE: We are in an environment that is making income-oriented investors crazy. Because you've got inflation, a much higher bogey to try to keep pace with, if you even have any hope of keeping pace with it. You've got rates rising, which means that bond prices are falling, so at least while you go through the transition your bond funds don't look so good. And then you've got a stock market that has been more volatile and has been taking a step back. So how has it played out with the Income Factory strategy during the start of this year?

STEVEN BAVARIA: I think it's actually confirmed our strategy and reinforced my confidence in it to be perfectly frank. You're right, there's a lot to be worried about in the market right now, inflation being only one part of it. If I look at the first quarter for example, we just reviewed a couple of our model portfolios for our "Inside the Income Factory" subscription service, and we found that our total return was a negative, it was around 6%. Which was not very different than the total return on the S&P 500 during the first quarter. But where the S&P 500 was only paying a dividend of about 1.3% per year, our model portfolios, the two of them, one was paying 8%, the more conservative one, one was paying 9%. So we were collecting 8 and 9% in cash on a per annum basis, and reinvesting it at the bargain prices available in the closed-end fund and other markets over the last three months. So I felt a lot more comfortable as an Income Factory investor in that environment than I would have been if I were only collecting 1.3% and watching the market take my prices down. Because they were Income Factory prices as well, we were taking paper losses but we were collecting our 8 or 9% and reinvesting it. So psychologically I think it was easier, and has been easier to endure this volatility than it would have otherwise been. As far as inflation goes, you're right about bond portfolios, but bond portfolios that are investment grade, 10, 20, 25, 30-year government bonds, they're going to get pounded as rates come down and they're a terrible

investment, let's be honest. And people, it's like hedging your portfolio by tying a big boulder to it. But secured loans of the sort that we hold, or that we own through funds that own senior loans or own CLOs that invest in senior secured floating-rate loans, their coupons are going to rise over time as rates rise because they're floating rate. And even high-yield bond funds, which we also believe in because you can collect now 9% or more in many really high-quality closed-end funds that are in high-yield bonds, high-yield bonds are only four and five-year terms most of them. So if you've got a portfolio, you're already getting 9 or 10%, you're not getting the 2% of an investment-grade portfolio, and you're repricing. A quarter or 20 or 25% of your portfolio every year is being repriced at an even higher rate as you replace those bonds with newer ones. So I'm not so worried about duration, and inflation, and interest rate risk in our portfolios because we don't have the long-term fixed rates that typical bond portfolios do. I like to talk about our portfolios as credit portfolios. We're paid to take credit risk, not to take interest rate risk.

CHUCK JAFFE: That also means that right now, where you're not taking interest rate risk, you're going to stay fully invested. You're going to take all of that cash and you're not going to keep powder dry, you're going to be fully reinvesting into this market, especially because those discounts are widening, correct?

STEVEN BAVARIA: Absolutely. Again, having 8-9% or so yields coming in constantly in cash, that is our way of hedging. To take money and move it to the sidelines and hold it in cash is a very risky thing. People say, "Oh, I'm protecting my principal." Well, if you're in this for the long-term, if you're investing, I'm retired by my parents lived to be in their 90s, so I'm investing with a 25-year horizon, and if I were 45 or 35 I'd have an even longer term horizon. So the ups and downs of the market, people aren't even going to remember them five or 10 or 25 years from now, but they will be suffering if they've taken money out and put it in cash instead of reinvesting. So it's just much better to be reinvesting at bargain prices, growing your income faster than ever during downturns because you're able to compound at higher rates. History has shown that time in the market is much more valuable than timing the market, and times like this are proving it frankly.

CHUCK JAFFE: And last question, you talk about taking credit risk, having the time in the market, not trying to do too much that's too fancy. But with everything that's going on and the credit risk that you're taking, are you changing the makeup of the portfolio at all? Leaning

more towards high yield? Or do you want to put a little more towards equities? Is there anything of that? Or no, we're weatherproof and this is just weather.

STEVEN BAVARIA: Perfect question. Actually, at times like this and for the last few months, I've been more inclined to move from equity into credit-risk portfolios. I don't buy high-growth stocks, I tend to buy utilities and other income type stocks. But even there, I feel more confident going into credit right now than I do stocks. Because credit, it's like a horse race, when you're investing in credit you're betting on the horse to just finish the race, all the companies have to do is stay alive and pay their debts. When you buy equity you're betting on the horses to win the race or place or show, they've got to excel and grow. So it's much easier to win the bet in times like this by just betting on corporate America to stay alive, muddle through and pay its debts than the bet that it's going to excel and thrive and grow. I mean, it may excel and thrive and grow, but if I'm making my 8 or 9 or 10% on credit, I'm not going to miss the fact that for a couple of years I've missed out on equities, because during the other years when equities are dropping I'm still getting my 8, 9, 10%.

CHUCK JAFFE: Steven, really interesting. Thanks so much for joining me to talk about it.

STEVEN BAVARIA: A pleasure, thank you Chuck.

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