John Cole Scott provides welcoming remarks to the March Virtual Event "AICA Spring Closed-End Fund Roundtable".

Tuesday, March 15, 2022

John Cole Scott, Founder and Executive Chairman of the Active Investment Company Alliance opens the March 2022 AICA virtual event with opening remarks and with an introductory educational presentation on the topic of the event. Read the transcript below to hear what Mr. Scott had to say.

John Cole Scott

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John Cole Scott: Good afternoon, John Cole Scott, founder and executive chairman of the Active Investment Company Alliance. I want to welcome you to day one of our Closed-End Fund Spring Roundtable. We're going to have six sessions over two days in the afternoon. You're going to be able to mingle and connect with people on the Remo platform before, between, and after sessions. Please feel free to invite anyone to attend that's not already in the audience. I want to remind people what AICA is. AICA is a nonprofit trade association that's two and a half years old, that focuses on closed-end funds, BDCs, and interval funds. To date with our partner Chuck Jaffe, we have 141 recorded podcasts and I've tracked 200,000 downloads of those audio recordings. But for those that don't prefer the audio podcasts, we do transcribe each podcast so it's available as a Word file and on our website for your review under *The NAVigator* section.

AICA is a 16 member organization, we are working hard this year to double that number by December 31st to 32 member organizations. Those membership dues, across the diverse landscape of partners, of fund sponsors, of products partners, as well as service providers allow us to create content like this where it's invite-to-speak for the people on stage and it's free to attend for you, the attendee. We also work to quickly get these sessions approved by compliance to post on our website as well as transcriptions available for replay access for a while and eventually public access for all. Because the point of AICA is advisor-centric high-quality diverse content on the ecosystem that we cover.

I'll say that we've been doing virtual content for a while, since August of 2020. But we are excited for the next closed-end fund session will be in person in New York City on November 16th, the day before the ICI Closed-End Fund Conference. Look for more information over the summer. We also are working on a relationship with CAIA because our focus and mission aligns well with their focus and mission as a professional organization. Hopefully you'll see that progress and grow over the coming months. During the sessions, please do your Q&A during the session or at the end. They're meant to be lively and we've told every moderator to make sure each panel has time for your questions to make sure your attendance is best received for your benefit.

And this is our eighth time on the Remo system, hopefully you're getting used to it and enjoying it. Also not as a moderator this event, but we want to welcome formerly Mike Taggart, our executive director, helping me lead the day-to-day executive functions of AICA. If you are interested to learn more or want to Zoom call with us, let us know, we'll be happy to connect with you about how AICA can partner with your organization to be involved in everything we cover. And again, I'm going to now share my screen. We have an intro session that we basically modify each time with some fresh data to make sure each of your time is spent more on the manager's perspective than the guts of closed-end funds. We want to make sure people understand that a closed-end fund is a fixed-capital structure with an active manager and the bulk of them are daily liquid on an exchange.

I do love to talk about the history of closed-end funds. They're 128 years old. Actually, 129 years almost. It was the fall of 1893 that the Boston Personal Property Trust was listed based on my best references, and the first levered closed-end fund was 1904, an infrastructure fund, the Railway and Light Securities Fund. And because of supply and demand, emotion, sentiment, fear or greed, closed-end funds can trade at both a discount or a premium to their net asset value. Just like other investment structures and other funds, they are a tax-advantaged structure which means there's no taxation at the entity level if they follow the rules, which most of them do, and allows for higher distributions than other securities to shareholders. And again, because they can have leverage, sometimes preferred shares, even credit lines or other interesting, diverse ways to have more gross investments for income investing, they tend to have higher yields as well.

Even I make this mistake sometimes. We try to remind ourselves and all that closed-end funds is a structure, not an asset class. It's a wrapper around investment guts and you could have similar guts in other investment wrappers but the advantage is the closed-end fund has that public access and investor liquidity. Even though today's session does not cover non-listed fund, we like to remind people they're not new, they've been growing since 2017 pretty dramatically. Since our last session have crossed the $100 billion in assets. We pulled that from our database on 3/14/22.

The overview, and again the sad thing is these slides update quarterly so I have some stats I've manually updated through yesterday because it's been an interesting year, but just a lay of the land where assets are. There was about $339 billion in assets a year end with an average yield of 6.55% and an average leverage of 24.4%. The largest section is muni bond funds, followed by BDCs which we think of as a sector of closed-end funds but we'll handle in a June event because it is somewhat different, just like our interval fund event will be end of April. I don't want to go through every piece here, but I want to remind you that these slides are interesting. They'll be PDFed and linked on the agenda page tomorrow and we'll be happy to make sure they make it to the replay video as well.

I wanted to spend a moment talking about the average discounts and premiums. Right now, as you'll see in a second, we are relatively wide levels outside of true panic environments. But the average level historically has been rather tight over most time periods. Think a 3-4% discount over 20 years is a normal number for most funds and right now we are seeing discounts wider than that. Though to be fair, if we had done this session towards the end of November, discounts were relatively narrow because they had come off a really successful recovery from Covid. Discounts do change every year. This is an average per year but meant to just remind you that it's important when you invest in closed-end funds to do asset allocation decisions first, and then in our experience, discount decisions second. I recommend doing both because either alone can create some challenges to successful investing in closed-end funds.

A lot of people are surprised by the yield, and I'll say at some levels many funds can pay whatever they want, but we try to normalize the yield by a peer group, we think about discounts and leverage. And so this chart here for equity sectors tries to basically normalize. The blue graphs is what you get as the average market price yield year end, it's higher now. And the silvery green graph is if you back out discounts and leverage, what the manager has to return to meet that market price yield. It's again traditionally lower, and when there's discounts and high leverage it's a lot lower and can hopefully help you understand why there's some sectors where it maybe the green graph is too high that could lead to dividend cuts. And there are other sectors like the MLP sector recently where that number in our opinion has been really, really low, and has continued to lead to increases as the market seeks to recover from being through a couple of painful periods in the previous time.

So for debt sectors, again there's usually more leverage there, generally less discount and more leverage for those sectors. But again want to remind you though, when people see even year-end as senior loan fund, 6-7%, the manager had to do 5.0% to blend to that. And muni bonds at 4.1%, the manager had to blend to 3.1%. So a point of extra income versus what the portfolio would need to do to fuel the dividend policy set by the boards of these funds.

Dividends are constantly changing. We try to visualize this with two quick slides. This one both does increases and decreases in the previous quarter and the previous one-year. Because we think it’s important to know that dividends are changing and fund sponsors react to sector movements differently. And so while you see some consistently in the way some boards handle the market changes, think increased leverage costs or increased bond yields, in the same pathway you will see a divergence in the way different sponsors handle it. And then some managers do tend to overpay a little bit, which as long as you recognize that is not always a bad thing, it could be a great way to get a tender offer off of a net asset value. I know from prepping for tomorrow’s institutional panel, one of the topics that I’m sure will be covered by our great panel tomorrow afternoon.

It’s not as pretty as a slide, but when you look at the dividend growth from a three-year basis, we really see that the negatives have been significant when they were negative but the positives are growing. This was again through year end, we’ve actually seen more net positives this year for dividend increases then decreases. Again, the bulk of these slides we update quarterly and you can catch them and more in our, I believe it’s April 21st or 22nd quarterly research call for Closed-End Fund Advisors. Feel free to keep an eye out for that on the AICA website and email as well as our website.

But I want people to understand that dividend changes, sometimes a dividend cut happens and the market price rallies back towards NAV because the market was expecting a worse cut. So it’s not always avoid the cuts, but it’s plan for what’s normal and decide, in our experience, what you should do if there’s a cut. And in our work for our clients, it’s really a mix of do we sell, do we buy more, or do we hold? And it really depends both on the client investment objective as well as how the market reacts to the announcement and then the other opportunities for investments that are similar for client needs.

I wanted to remind people that the largest bucket of closed-end funds is the muni bond fund market. It is probably in a basic level, a simplest and purest version of a closed-end fund investment. You have an active manager, again a wide, vast assortment of muni bond investments, some are liquid, some are illiquid. You’ve got relatively low fee structure, relatively cheap leverage, and the math can be very powerful for an income investor with a tax problem. And so just for example, we use this to show the different tax equivalent yield of MUB versus if you took away the discount and leverage in the sector, that adds higher yield, the tax equivalent still solid. And then when you add the discount and leverage component, it’s not uncommon for a high tax bracket investor to be between a 7-8% tax equivalent yield, and that’s really hard to find when you see the always potential risk for credit losses across other investment sectors.

However the challenge is durations tend to be 8-11 and with a backdrop of interest rates rising, it’s hard to be a buy and hold investor here. We think you have to look at the emotional disconnect that happens in this sector to take some trading spots for your benefit. But this is still a great use of the closed-end fund structure, and if you’re not familiar with, take some perspective to learn more. And I would remind people that even muni bond closed-end funds are the common stock listing of an investment company that’s value or net asset value is derived by bonds but has a similar volatility or could. In fact even in March of 2020, the beta of the muni bond sector was higher than the S&P 500 because of all the unknowns happening during two years ago.

And so I think one conversation we've had, it's good to mention on this slide because investors who are often very conservative, is to remind you that in our opinion that risk is being a forced seller of an investment you don't want to be. Risk is dividends destroying your future payout level because you picked a few funds that paid too much and slashed their dividends, so some thoughtfulness and diversification are helpful, and is true reduction of NAV long term. And I would say the volatility of closed-end funds, while some people if you follow MPT stats will say are risky. I'd really say that it's much more likely that's just entry and exit points for those that focus on it.

We sit now, and I ran this yesterday, much wider than an average 7% discount, and we're negative 6.8% as of yesterday's close. It's very uncommon to go much wider. Doesn't mean it can't, but I want to let the audience know that if you're a closed-end fund investor right now entry points are rather attractive historically on a 20-year basis. And so that hopefully gives perspective to where we are.

I want to remind people that the different sectors disconnect from each other. This is a NAV correlation matrix we updated regularly. We've had sizeable IPOs last year. These are some recent IPOs, and as of year-end how they traded, this is one of those charts again we update quarterly. There's been some BDC listings that are interesting and I think powerful to consider as well. And then this we actually updated from a podcast with data as of yesterday we did last week for *The NAVigator* for AICA. These are the recent CEF Data 2.0 IPOs, just organized by sector. It's something where you can grab it on the replay slides or email TheNAVigator@AICAlliance.org and we can send you a version of this for funds that you know eventually discount will go away, and we think should be part of your regular go-to toolkit for closed-end fund investing because they had no loaded IPO and they eventually will come back to NAV in the future. And some of these are 9, 10, 11 years away, but it's worth nothing that these maybe more attractive than perpetual funds because those don't necessarily go back to NAV.

This was just a quick look at the asset allocation for the CEF Data 2.0 watch list we have. Mergers are common. They've been more regular since 2012 but seem to happen almost every year as funds get repurposed and smaller funds merge into other funds become larger funds, which generally narrows discounts, reduces expenses, and assists in getting more investors interested in the sector. People talk a lot about liquidations, open endings, or deaths or conversations, they've been common since we started tracking this. Again, pretty high last year, but again I'd say still 8-14% is a normal number and would expect that going forward because there's always movement in a sector with over 500 listed funds in the sector.

Early to be thinking about it, but tax-loss selling pressure. This slide will be updated next quarter through the last year. But I definitely would think about tax-loss pressures as you plan for the fall even though it's March. You can do tax-loss trading throughout the year, but I think this year we'll see probably expect to see above average tax-loss pressures based on the fundamentals currently at work. And with that I'm going to un-share my screen and just to keep it simpler, I'm going to invite the next panel which is a fireside chat with Marc Loughlin and Grayscale. People may ask, this is not an ETF, but what it is is access to crypto at a discount. It's something with closed-end funds being highly focused on alternative investments. It felt appropriate to bring to our audience, and hope you find it as timely as I do.

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https://AICalliance.org/