John Cole Scott provides opening remarks to Day 2 of the March Virtual Event "AICA Spring Closed-End Fund Roundtable".

Wednesday, March 16, 2022

John Cole Scott, Founder and Executive Chairman of the Active Investment Company Alliance opens Day 2 of 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

To view the rest of the conference events and panels go to:
https://aicalliance.org/aica-event/cefroundtablespring2022/

John Cole Scott: Good afternoon, John Cole Scott, founder and executive chairman of the Active Investment Company Alliance. We want to welcome you to day two of our Closed-End Fund Spring Roundtable. For those that aren't as familiar with AICA, AICA is a two and a half-year-old nonprofit trade organization focused on the closed-end fund, business-development company, and interval fund ecosystem. Which includes membership and involvement of fund sponsors that create the funds, product sponsors, firms like my Closed-End Fund Advisors that uses them to build products and investment solutions for investors, as well as service providers like our members Bancroft Capital involved in the IPO market, and Skadden, a corporate counsel for many high-quality closed-end funds and other fund structures.

When we launched AICA in the fall of 2019 formally, we knew we wanted some high-quality content to highlight the wonderful offerings of our ecosystem. We partnered with Chuck Jaffe, long-time, about a 10-year host of *Money Life* and we have a 10-minute standalone podcast, the lead segment of his Friday show called *The NAVigator*, where we're able to highlight many users across the entire ecosystem. We've recorded 141 of those sessions to date and we've had over 200,000 downloads, a great start in AICA's early life as it grows to connect high-quality contact for financial advisors and the investors that they serve.

As you may notice, you get to attend our events for free. And to let you know, no one pays to be on stage at AICA events, we are an invite-to-speak model. Our entire financial model is determined by membership, long-term engagement from high-quality companies to create the resources to educate you, to answer your questions, and to listen to what may improve the ecosystem going forward. The reason we created the AICA was to offer this blended solution of non just one component of the ecosystem but all. We are excited to have done eight virtual events on the Remo platform, and one off the platform, since Covid started. But looking forward to fall of 2022, we have a New York event in mind, at least one day, November 16th, the day before the ICI Closed-End Fund Conference. Feel free to reach out to us about being involved in the content planning or other aspects.

We're also working with our new executive director Mike Taggart to build a great relationship with Kaya. It's early in its beginnings, but expect to hear great things throughout the year as we find another high-quality organization we have synergies and ways to partner. During each session we have told each moderator to carve out 10 minutes for Q&A, so please take advantage of that. Ask your questions during the session and as appropriate it could come up during the session or definitely at the end as available per each speaker's perspective.

The tables at Remo are something that makes it a little bit more interesting and dynamic than simply another Zoom or Goto, Webex meeting. We hope that you spend some time between sessions or after saying hello to somebody you either know or would like to know, connect with them about different topics or interests in the closed-end fund ecosystem.

We also remind people that we're able to donate at any time to our event. As we don't charge, if you really find our stuff valuable it does help offset the cost to produce these events. They are not free but we're happy to do them as part of our commitment to education. And there will be a survey after, please take the survey, it helps us do a better job. And with that, I just thank you for being here, look forward to today's second session and let's get started with the intro presentation.

So this is meant to help us go through some of the details of closed-end funds, some introductory concepts so that you have more time to dig into the actual perspective of the managers and focus less on the structure. These will be PDFed and available for people after the session, but I want to remind you that the key components of a closed-end fund are the fixed capital or stable share count, an active portfolio manager, and for the funds we talk about today, they're all listed on an exchange. And for perspective, they've been listed there for 128 years, and loving history, the Boston Personal Property Trust was that first closed-end fund IPO in 1893. Closed-end funds are able to employ leverage, so I reached out to the archivists at the Stock Exchange, and they told

me that the 1904 Railway and Light Securities Fund was the first levered closed-end fund which again has been around for over 115 years.

Because these funds have both a net asset value, typically calculated daily for almost every fund, and a market price that calculates every time that a share is exchanged on an exchange, they can trade at below or above net asset value creating discounts or premiums. Like many other structures they're a tax-advantaged structure, so closed-end funds can pass out more dividends than other regular operating companies because there's no taxation at any level as long as they follow the general rules of the 1940 Act to be a registered investment corporation. And as I mentioned earlier, they can have leverage in various forms. Leverage has gotten wonderfully diverse and there's been a lot of positive work to create better leverage in the last 10 or so years to give more opportunities for different types of investments to be properly levered for enhanced income opportunities.

I always like to remind people, and honestly this slide reminds me not to hopefully say it during any of these sessions, closed-end funds are not an asset class, they're an investment structure or wrapper. And so you could technically put the same guts in other ways into the market, especially like in a hedge fund structure where there's no limits to level three assets or non-listed investments, but that's one of the benefits of the closed-end fund. We're not going to cover them in this session, we'll have a separate session for interval funds and tender offer funds at the end of April. But we want to remind people those have been around since 1989, but they've grown a fair amount since 2017 just recently surpassing, since the last time we did this slide deck, the $100 billion assets with $106 billion.

I leave this slide just to give you the broad understanding of where these funds are. There's $339 billion in assets, at the end of the year they were at a two and change discount which was somewhat low. They've widened as I'll show you a little bit in a future slide, but again that'll be discussed a bit in the topics today. And they were yielding an average 6.55% and were employing 24.4% leverage with most of the leverage being in the non-equity funds. Because leverage is usually used, 99% of the time in my experience, to enhance income and not just to make it more of a bull market case for an equity exposure.

Other sectors I think are worth highlighting because they really exhibit the structure well are BDCs, which are a closed-end fund combination with an operating company, and we'll have an event covering those in June. I think the high-yield bond market, because there's lots of other options, but it's really helpful to buy illiquid bonds and to lever them appropriately with closed-end funds. And then even better for senior loans, those trade even less generally than the high-yield bond market. And I'd say preferred equity another fixed-income category, you'll hear about them as well today, again really I find when you can have fixed-income focused exposure or level three exposure and then prudently leverage it, the closed-end fund wrapper can be a tremendous opportunity for investors.

This chart is trying to synergize 10 years of average discounts by asset class. I think the takeaway here is that the discounts is very elastic for all asset classes but there's some that generally trade wider and some that generally trade narrower to themselves. And so I'd like to think that if you're shopping for sectors or ticker symbols when things are going down, it's

potentially more prudent to focus on those that have generally narrower discounts or tighter discounts. And when things generally sell, as you'll hear on the panel that we'll talk about on the third panel today, a lot of things go down at the same time and it's really often easy to pick up a dislocated muni bond fund, a preferred equity, as an emerging market bond fund or a US equity fund as well.

This chart I think hopefully highlights, if you're newer to funds, and we find about a third of our attendees are new to our sessions and educational opportunities, you have both discounts for many funds and leverage for many funds. So the blue line here is for a peer group, so not one fund but every fund that we classify in our data business, and the average indicated market price versus if you take out the impact of discounts and leverage, what the manager has to blend to fuel that. When there's a wider discrepancy between them, there's a combination of wider discounts and more leverage. And so for perspective, you can see that while convertible bond funds yield 7.3%, they only have to 5.6% at the manager level because of both some discounts and leverage. And that's pretty much the similar story across all these equity sectors.

And these are the fixed-income sectors. I find it's even more magnified in many ways. You'll often hear me and even others talk about the muni bond closed-end fund as the purest version because there's less shenanigans that can go on. It's leveraging actively managed bonds that can be very liquid or very illiquid, depends on where you are in that market. And the leverage tends to be very cheap and that sector tends to both trade at discounts and premiums historically, and so it really kind of proves the structure in a powerful way. My point here is that for that average 401 yield at year end, we're getting one percentage more federally tax free than what the underlying manager was producing based on the coupons of this average bond.

And I think that's a really powerful thing. That's 33% more income just to deal with the leverage of the fund and the volatility of the market price. Because if you haven't discovered it yet, and I've done closed-end funds for a very long time, that they can be very volatile but we'd like to remind people that the volatility isn't always necessarily the risk in the way we think of it. At my firm we think of volatility as losing dividends and losing corpus, and the volatility of the market price is simply trading opportunity to be fearful when others are greedy and greedy when others are fearful.

Dividend changes, they happen every single quarter, they happen in different ratios for different sectors. We have two dividend charts to try to gain the perspective of it's hard to build a portfolio that doesn't receive dividend changes. If you build them right, in our experience, by asset allocation overweights and by fund analysis overweights, you can typically create a tailwind of more dividend growing stories and dividend headwind stories. Because you do need to have a diversified portfolio, no one sector is known to be the best performer because the events of any given year are unknown until the year is over. But I want to remind you that even in the same sectors, you'll see some funds increase and decrease their distributions because boards are another layer of perspective you need to understand for closed-end funds.

The managers and their team does the investment work of the NAV, but the boards set the policy that gives dividends to your investment account, helps fuel your retirement or the retirement of your clients if you're a financial advisor. And so I just want to let people know that it's very

common to have these changes. It's important to learn how to react to them. And we find that you should have a plan how to react to them and a plan for the dividend goals of your portfolio. And that should assist you in whether you are buying more because the discount widens. You might even sell some because the discount narrows. Or just hold your position because while it was a small enough move it doesn't dramatically change what you're doing.

This is less graphical, but I do think really helpful. In the last three years it's swinging back. We do this quarterly in our quarterly research call for Closed-End Fund Advisors. Please keep an eye out in your email for a session in about, I guess a month from now we'll be holding that session through the end of whatever happens this month. But we really track the growth rate of dividend policies, we also look at a two-year lookback and how will it have changed it, or there's been managed distribution levels versus ones without. Those levels don't always protect you because a lot of them might say X percent of net asset value, and so as net asset value goes up your dividends are growing, as it goes down your dividends are waning.

Then a one-year lookback just to keep it a little more granular. But the one I show here is that usually 25 to 50 closed-end funds in a one-year basis have both increased and decreased their dividend policy. And so that reminds me to say that some funds tend to make, and their boards, big changes, think 10% more each way. And some just literally have a model that they use to opine on a good dividend policy and make really granular, often quarterly nudges to their policy based on their forecast for the markets and the underlying investments of their fund. You can't say which one's necessarily right or wrong, but I can tell you that typically the market is more favorable to small changes and more reactive to big changes as you might expect as a rational investor.

People sometimes say with interest rates rising, with yields down from munis, why do you own them? And so there's quick information I want to share here. First, MUB is a well-known ETF in this space, only has a 1.8% yield, but if you're in a very high tax bracket to magnify the tax equivalent yield, takes you three and low change. If you were to take out leverage and discounts and just talk about that leverage-adjusted NAV yield for the sector, that 3.18% I talked about earlier, it gets you to a five and mid-change level. So very compelling and often done because they can buy smaller bonds in the closed-end fund structure, and they can have bonds that previously weren't called and bought at higher rates that are still paying coupon levels to you today.

But then when you add in discounts and leverage, you go from 3.18% to 4.18%, one point higher as I said, but you're in a seven and mid-change rate. And it's really compelling for part of your income portfolio to hedge equity risk with these investments because it's hard to ignore anything at level of tax-equivalent yield in my experience. For perspective, the average closed-end fund yields seven and mid-change, maybe eight in the recent pullback, but you're getting the same taxable yield of the average fund in the universe and you're in a high enough tax bracket. And I think that will drive investor demand for munis.

To try to keep the discount perspective short because we're about to start the first panel, I looked two days at the end of discounts, we're sitting right under a 7% discount for the whole sector. Very few months end at that level, and so it's sure that NAVs will go up and down, which is

independent from what's happening. Discounts can widen but it's very uncommon to widen as much as it has so far. But to be fair, we have inflation, we have interest rates going up during this conference probably, and we have a potential World War. Probably not, but a serious crisis in Europe.

Correlation of funds is important to be thoughtful of, diversification can be very important. This number was less red and more blue pre-March of 2020. IPOs, we've seen a healthy IPO market recently, I think there's some attractive offerings there. These are the ones that we ran last quarter, with their discount as of year-end for market IPO price and discount. We update this chart again quarterly as well. And we decided to put together all of that newer closed-end fund 2.0, these are the funds that have been launched roughly in the last three years. There's no load paid by investors on the frontend and there's typically an eight to 12-year term where you can get out at net asset value if you hold it for that term. And just to talk about the more recently filed funds, we've actually seen some 15-year terms coming to market after a lot of good success with investors being comfortable with that 12-year term.

But that being said, the market has shifted a little bit. There's an average 10% discount and about a 7.8% yield, and when we run the data versus the peer group average, that's the fourth column here, the average fund here is 4.3% wider than its peer group average. Most have negative numbers there. If you want to be in these sectors, and you're a patient investor and you believe in the fund sponsor with the fund, these funds should be extra attractive for your portfolio not knowing what the next few days or months even go for the markets. I think it's a compelling reason to be a buyer of CEF 2.0 funds in the market. And this is the breakdown of those types of funds. Like I said, this will be PDFed and available to people after the session.

Mergers are consistent and normal for funds. Open-endings, liquidations, death conversions picked up a little bit last year, but they happen every single year as well. It's only March but I'd like to talk about tax-loss selling season. It should be I would say a one and change percent wider than average in my opinion, though I'll know more in February of next year. So I can consider adding more of these funds to your buy list as well, though I think there's still opportunities here in the spring.

Recorded on March 16, 2022.

Click the link below to go to the home page of Active Investment Company Alliance to learn more:

https://AICalliance.org/

Disclosure: *Views and opinions expressed are for informational and educational purposes only as of the date of production/writing/speaking and may change without notice at any time based on a multitude of factors. Speaker's/presenter's/author's opinions are their own and may not necessarily represent the opinions of AICA, its Board, or its staff. Materials may contain "forward-looking" information that is not purely historical in nature, such as projections, forecasts, market return estimates, proposed or expected portfolio composition, and other items. Listed closed-end funds and business development companies trade on exchanges at prices that may be above or below their NAVs. There is no guarantee that an investor will be able to sell shares at a price greater than or equal to the purchase price or that a closed-end fund's discount will narrow. Non-listed closed-end funds and business development companies do not*

offer investors daily liquidity but rather offer liquidity on a monthly, quarterly or semi-annual basis, often on a small percentage of shares. Closed-end funds often use leverage, which can increase the fund's volatility (i.e., risk). Actual distribution amounts may vary with fund performance and other conditions. Past performance is no guarantee of future results. This material is not intended to be a recommendation or investment advice, does not constitute a solicitation to buy, sell or hold a security or an investment strategy, and is not provided in a fiduciary capacity. Shares of closed-end funds are subject to investment risks, including the possible loss of principal invested. Closed-end funds frequently trade at a discount to their net asset value (NAV).