Sit's Doty Sees Current Market Creating A Sweet Spot For CEFs

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Chuck Jaffe, in this episode of The NAVigator podcast interviewed Bryce Doty, senior portfolio manager at Sit Investment Associates. Read the Q&A below as Bryce says that the market's troubles this year have set closed-end funds up to be in a sweet spot, able to generate additional returns that traditional mutual funds and ETFs can't get investing in the same spaces. Despite those potential benefits, Doty acknowledges that most investors shy away from closed-end funds for a lack of understanding, and also miss out on the benefits of running closed-end funds as a portfolio or bucket of money rather than as a single investment or two that's part of a larger portfolio.

Bryce Doty

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

CHUCK JAFFE: Bryce Doty, senior portfolio manager at Sit Investment Associates is here, and we're talking about closed-end funds for these times now on 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 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 will point you in the right direction. Today we're looking at closed-end funds with Bryce Doty, senior portfolio manager at Sit Investments Associates, which may be best known for its open-end mutual funds, but which also runs about $1.7 billion in closed-end fund of funds for separate accounts. You can learn more about the firm and all it does at SitInvest.com. You can learn more about business-development companies, closed-end funds, interval funds and more at AICAlliance.org, the website for the Active Investment Company Alliance. Bryce Doty, thanks for coming back to The NAVigator.

BRYCE DOTY: Thanks for having me, Chuck.

CHUCK JAFFE: I want to start with where closed-end funds are in this market, and what happens when you, who are dealing with people in separate accounts, are talking to them about closed-end funds. Quick story here, went to get my haircut, always talk with my barber Gene Franco about investments, he's talked about what he wants to do with some money he's got to put aside, where he's very nervous of course about the market because the market has sucked. There's been no safe haven, stocks and bonds both down in the first half of the year, recovering somewhat, but only somewhat. He's describing what he wants, and I'm thinking, you need to be putting some money into closed-end funds. You need the safety, security, buy it at a discount, know that the portfolios going to be not changing all the time, all the things that we consider benefits. And his response, "But I don't understand how closed-end funds work." I think this is an ideal time for people to consider closed-end funds. Of course, I understand them. How tough a sell are they right now? Because the discounts get wider when things get bad, they look ugly at certain times, but boy, this would seem to be the time where folks want to gravitate this way and the mass audience still doesn't want to go.

BRYCE DOTY: I agree. When the yield is this attractive, it's high enough to get people's attention or willingness to learn something new. And the more they learn about closed-end funds, the more they realize that they do understand 80% of what closed-end funds are already. So you have to move from the familiar to the unfamiliar as you walk through and educate people on things. For example, both open-end funds and closed-end funds, as well as ETFs, are all 40 Act type funds. The SEC oversees all of them in a very similar manner. The biggest difference between an open-end fund and a closed-end fund is that when you want to get your money back, you sell your shares on the exchange much like an ETF, rather than going to an open-end mutual fund and just asking them to send you your money. The result is that when there is a lot of selling pressure out of an ETF or a mutual fund, they have to go and sell all of the bonds or stocks that are in the fund, and that can create a problem there at the fund level. But doesn't create a problem for you except for the fact that maybe the share price is going down as they're selling all these securities to get people their money back. Similarly in the closed-end fund, what we saw earlier this year, especially in bond funds, where I think it's really attractive with the yields being up around six and seven percent right now, you saw people afraid of rates going up, the Fed raising rates and bond prices going down, and people were selling their closed-end funds. Again, they sell their shares on the New York Stock Exchange, and that drove those prices down. So let's think about the fund. The fund itself didn't have to sell anything, its bonds were still held, still earning interest, and so there's the difference between an open-end fund and a closed-end fund. The open-end fund had to sell its underlying bonds, the closed-end fund did not. So when there's problems in the marketplace and everyone's trying to sell their stocks or bonds or this or that, you've got these closed-end funds that have normal cash flows coming in from principal and interest payments, and they are the ones that have the source of liquidity and cash to buy these undervalued securities out there. They don't have selling pressure on them, so that really helps the fund itself, and yet a lot of investors kind of panicked in the first half of this year. Drove down the shares of everything, stocks, bonds, everything including closed-end funds. As a result right now, you can get a fund at these six and seven percent yields, on an investment-grade quality bond fund. We just think that's a very attractive opportunity right here.

CHUCK JAFFE: It's interesting to me as well that even when you can get somebody to say, "Yes, I want closed-end funds," "I'm interested in closed-end funds," and I get this from my audience on *Money Life* all the time, they're interested in adding a closed-end fund, maybe two. They can see the benefit of closed-end fund investing, but they don't necessarily understand the benefits of what you guys are doing when you're building closed-end fund of funds in separate accounts. Why is there a significant benefit to having a portfolio? Why do you want to make sure you're well diversified in closed-end funds? If you have other 40 Act funds carrying the water in certain places, why is maybe not better to say, "I want to have a closed-end fund," but to say, "For this bucket of my money I want all closed-end funds"?

BRYCE DOTY: Well, the value that Sit Investments adds to a portfolio management style within closed-end funds is the ability to pair different funds together and put a basket of funds that will be actively managed depending on how things are going in the economy. For example, there are some very attractive inflation-linked funds, so we moved into those funds in anticipation of the recent spike in inflation. They did very, very well as you can imagine. And you can also add a lot of diversity, because each one of these funds is already diversified. If you put 10 of them together, let's say two mortgage funds, two corporate funds, a couple of government funds, you literally have an array of hundreds if not thousands of different underlying bonds across all of those funds. And we typically will have a portfolio of 25 to 40 different funds, and so you can imagine the degree of diversification that you can get from that. We also have strategies that mix stocks and bonds, where we are looking at a universe of 450 different closed-end funds, and selecting from that group whichever ones we think offer the best opportunity. Another layer of diversification that we like particularly as a source of alpha return that, in this case has nothing to do with the underlying stock and bond markets, are funds that are having some sort of event; like they might be buying back some of their own shares and you can get a gain on the amount of shares that they repurchase from you. There are funds that are trying to grow, and the only way a closed-end fund can grow is to tell its shareholders, "Okay, for every three shares you own you have the right to buy a new share, and we'll allow you to buy that new share at a discount," 5-7% or something below wherever the shares are trading. That's another source of return that you can't get in another type of fund. And it also again is a diversified source of return because it's not dependent on stocks or bonds or economy or recessions or anything like that, it's just another source of return.

CHUCK JAFFE: And thinking of discount as future return is another key way, when you're seeing things go down, you should be thinking of discount. Yes, it allows me to buy in cheap, but it's kind of like I'm getting future return on the cheap, right?

BRYCE DOTY: And that's a huge source of the current yield, is the discount. So with the selling that happened earlier in the year, the share price on the New York Stock Exchange, the market price of closed-end funds went down even though the underlying net asset value per share that the fund says, "Hey, if you add up the value of all of our securities, here's what the share price would be worth," it just gapped out. The selling pressure caused, in some cases, the difference in price to be 10%. It's closer to 7% right now, but for a while, as recent as July, we were able to get funds at a price that was 10% of a discount below what the actual value of the underlying securities were. Well, obviously the lower the price that you're paying, the better the yield, the more income that you get. Because it's going to pay the same dividend, you might as well get it at a lower price, and by default, your yield to you is definitely higher. So that's another great source of income, great source of return. And then when things blow over, when things get better, you'll see that discount narrow back in, so you can get 5-6% from the income on an investment-grade bond portfolio, plus 2-3% more as the discount narrows. And there's other sources of return, so we'll actually actively trade between one fund and another because some funds will have a good day, some will have a bad day, and you can rotate between them. We estimate that that adds another 1% over the course of the year. So the forward 12-month return could easily be double digits, I just don't see the opportunity in a generic bond fund having that kind of return potential.

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

BRYCE DOTY: Thank you 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, you can check out my show on your favorite podcast app or at MoneyLifeShow.com. To learn more about closed-end funds, interval funds, and business-development companies go to AICAlliance.org, the website for the Active Investment Company Alliance. On Facebook and LinkedIn @AICAlliance. Thanks to my guest, Bryce Doty, he's senior portfolio manager at Sit Investment Associates, which runs about $1.7 billion in closed-end fund of funds for separate accounts. Learn more at SitInvest.com. And if you like what you heard, well, he appeared on the August 12th edition of *Money Life* in an extended, big interview. You can check that out at MoneyLifeShow.com. The NAVigator podcast is new every Friday, ensure you don't miss one by signing up and following us on your favorite podcast app. And until we do this again, happy investing everybody.

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