VettaFi's Islam Talks The Benefits Of An Index Of Closed-End Funds

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Chuck Jaffe, in this episode of The NAVigator podcast interviewed Roxanna Islam, associate director of research at VettaFi, which developed the the S-Network Composite Closed-End Fund Index and other benchmarks for the closed-end fund space. Read the Q&A below as Roxanna discusses the construction of indexes of closed-end funds and the benefits to using them over individual issues, as well as how passive investing in the space has held up against active management during the rough start to the year.

Roxanna Islam

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

CHUCK JAFFE: We're talking with Roxanna Islam, associate director of research at VettaFi about the S-Network Composite Closed-End Fund Index, 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's going to point you in the right direction. And today we're looking at the S-Network Composite Closed-End Fund Index with Roxanna Islam, associate director of research at VettaFi, which among other things, is the successor site to Alerian. So if you're wondering, wait, I've heard the name before and I can't quite place it, it's VettaFi. And you can learn more about the firm at

VettaFi.com, on Twitter @Vetta_Fi. You can also learn about business-development companies, interval funds, and closed-end funds at AICAlliance.org, the website for the Active Investment Company Alliance. Roxanna Islam, thanks for joining me on The NAVigator.

ROXANNA ISLAM: Yeah, it's always good to be here.

CHUCK JAFFE: Roxanna, as we get this started, help folks understand what we're talking about because you guys have a couple of indexes but we're talking about the S-Network Composite Closed-End Fund Index and we need to know a little bit about construction. Because you can build an index for just about anything, but then you can cut it into different pieces and there's a lot of different types of closed-end funds, is everything in here? Or how is this one built, what does it focus on?

ROXANNA ISLAM: So we actually have a few closed-end fund indexes in our universe but this is one of our primary indexes, it's actually a composite index that tracks closed-end funds that produce a taxable yield. One of the primary ingredients for it is it has to include closed-end funds with over $100 million in assets and it has some further screens related to fees and premiums. For example, the fee can't be over 1.25%, the premium can't be over 20%, and this includes taxable yields. Like I said, this is investment-grade fixed income, high-yield fixed income, equity-option income, it does not include any of the municipal closed-end funds. And the way this index is constructed, I think there's some advantages here, particularly in this sort of environment that we're seeing, just because you have investors out here that are so worried about distribution cuts with the rising rates and also what that could do valuations. Because this is a rules-based index, it does weigh constituents based on total net assets, and it applies a larger weighting to funds that trade at discounts and a smaller weight to those that trade at a premium. I know there's a lot of exceptions to why something trades at a premium or at a discount, but in general, premiums are more sensitive to valuation deterioration after you see distribution cuts ,which I think makes the weighting scheme of this index even more advantageous during this sort of environment.

CHUCK JAFFE: Now we should point out that the index we're talking about is the underlying index on the Invesco Closed-End Fund Composite ETF, ticker symbol PCEF. Help people understand why you want to own an index of closed-end funds, or an index fund of closed-end funds as, opposed to saying, "Let me pick and choose and go get the discount that's best here in that yield"?

ROXANNA ISLAM: One of the most obvious advantages when you have an index or an index-linked product is the diversification benefits, and I think it's pretty obvious to most people but it's definitely worth repeating. Especially when we're in this sort of environment and you're seeing people more concerned about having those distribution yields cut in a rising rate environment, I think we look at the history of this index and see how that reacted in the past, it illustrates some of those diversification benefits very well. For example, I can look at the time period between 2015 to 2018 when we went through that other series of interest rate hikes. It's pretty interesting to look at because you actually see the prices fall and the discounts widen in the early days before the interest rate hikes even kicked in because a lot of that was based on sentiment, and then later on you see the distribution cuts follow. But if we calculate for the absolute value of dividends for our index, they weren't down as much as I think a lot of investors think, and I think that does surprise a lot of people. On average they were down roughly 7% in 2016, maybe another 4% in 2017. And so yes, I know investors don't want their distributions cut, particularly because a lot of people use closed-end funds as income instruments, but relative to what you expect, I don't think it's as bad as you think. Especially if you look at the average yield as a percentage relative to index prices, it's actually pretty impressive how the 12-month yield has held up over the past few years. During that time period that I mentioned, yields did fall a little bit over 100 basis points during that time, but really it's been able to stay near its 10-year median range which has been in the mid-8% range.

CHUCK JAFFE: That's the important thing. Because I think people would think, if I go the route of an index ETF, I'm going to wind up having a yield that is a lot worse than if I'm just picking and choosing. But here you're getting the diversification and you are getting that yield, and you also have the simplicity and ease of trading that you get with ETFs, that's a little bit different as well.

ROXANNA ISLAM: Yeah, and that's always a point when it comes to an index or an ETF. It's possible that you could always stock pick better, but a lot of people can't, so you are getting a relatively healthy distribution here that's indicative of the asset class. And I should also mention back during the 2015-2018 time period, we did see some rather large distribution cuts in some of these closed-end funds. It wasn't a lot of them but there were quite a few of them that maybe cut their distributions by a third or by a fourth. When you have that averaged into an index of 100 plus closed-end funds with 40 plus different managers, that really doesn't hurt you as much as it would as if you had picked the wrong closed-end fund.

CHUCK JAFFE: That to me, you actually led into where I was going to go, because one of the things that people would be worried about is, oh, if I hold the index, I'm going to hold everything that cuts its dividend. It's not that it has avoided dividend cuts and payout cuts, but it has not been a big problem, the index did not see a lot of suffering on a widespread basis. And that's the diversification playing out, right?

ROXANNA ISLAM: Right, and you know I actually came from a background where I spent some time researching individual closed-end funds. We all know that they aren't always straightforward, even if you have the right earning status and you know how to interpret it, you can't really predict the extent of a cut or when a cut will happen. So even if you have two closed-end funds that hold similar holdings, two different managers probably won't make cuts at the same time. So it's not just measuring that extent, it's also the timing of that is a little bit more spread out. So those are the advantages you get when you're looking at 100 different closed-end funds as an asset class versus just one or two, or one or two different managers even.

CHUCK JAFFE: Are there times, and I get it, you guys are in the index construction business, etcetera, but because of that, are there times when you would say with an index of closed-ends that the index has advantages and times it has disadvantages. Because we're living through a tough market environment right now and this is where active management is supposed to make its grades, this is where it's supposed to pay off to be an active manager because you're not strapped into the market and what the market's doing. At least when we're talking about things like the S&P 500 and total market funds, etcetera. But does the same thing apply? Are there times when you would say, "Yeah, under these conditions, we think the index is superior, inherently superior, and the rest of the time, okay, well, it still depends on the active manager and how well somebody picks things, but this is a time when the index is really the better methodology, here's the time when the index might struggle." And then if that time exists, where are we now?

ROXANNA ISLAM: It's a tough question to answer, because I think obviously there are benefits to the active management, or even stock picking, like I said. If you have the right resources, the amount of time to devote, you certainly could beat an index. However, I do think just the way the index is constructed does give it advantages, especially during these times I would say. And I sort of touched on this before, it's the way that it overweights the closed-end funds that trade at discounts and it underweights the closed-end funds that trade at premiums. If we are going into a period of time where there are distribution cuts, and I think that's not really an arguable point, it is rising rates, there probably will be some cuts. If we are going into this time period, you would want to be a little bit more cautious of funds that trade at higher valuations just because those are a bit more volatile. So just the way that this index is constructed, it does give the investor advantage when it comes to picking closed-end funds.

CHUCK JAFFE: Roxanna, really interesting. Thanks for joining me on The NAVigator to talk about it.

ROXANNA ISLAM: No problems, it's always a great time with you, Chuck.

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, and you can check out my hour-long weekday podcast at MoneyLifeShow.com or by going to your favorite podcast app. To learn more about interval funds, closed-end funds, and business-development companies go to AICAlliance.org, the website for the Active Investment Company Alliance. They're on Facebook and LinkedIn @AICAlliance. Thanks to my guest, Roxanna Islam, associate director of research at VettaFi. Learn more about her, the firm, and the S-Network Composite Closed-End Fund Index at VettaFi.com and on Twitter @Vetta_Fi. Roxanna is on Twitter too @RoxannaIslam. The NAVigator podcast is new every Friday, don't miss anything by following along on your favorite podcast app. And until we do this again next week, happy investing everybody.

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