Parametric's Milner: Closed-End Funds Are Reaching A Point Of 'Great Opportunity'

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Chuck Jaffe, in this episode of The NAVigator podcast interviewed Mark Milner, senior investment strategist at Parametric Portfolio Associates. Read the Q&A below as Mark says that a lot of asset classes of closed-end funds have now reached double-digit discount territory, "which historically has been a good opportunity to buy closed-end funds," noting that current discounts allow investors to add to their portfolios or rebalance into funds creating greater value for their money. Milner does worry that year-end tax-loss harvesting in 2022 will be higher than in years past as a result of the large market drawdown earlier this year – but is hopeful that the compelling values will convince investors to reinvest the proceeds of those sales back into closed-end funds, which would help to minimize the potential impact all of that money movement.

Mark Milner

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CHUCK JAFFE: Mark Milner, senior investment strategist at Parametric is here, we're talking about how closed-end funds are responding to the changing rate and market environment 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 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 taking a measure of the market for closed-end funds with Mark Milner, senior investment strategist at Parametric, Parametric Portfolio Associates, which you can learn about at ParametricPortfolio.com. You can also learn more about business-development companies, interval funds, and closed-end funds by going to AICAlliance.org, the website for the Active Investment Company Alliance. Mark Milner, thanks for joining me on The NAVigator.

MARK MILNER: Glad to be here, Chuck. Looking forward to a spirited conversation today.

CHUCK JAFFE: Mark, for those members of our audience who don't necessarily know Parametric, we should point out that they are one of your tools of choice. That Parametric has a suite of closed-end fund strategies that people can access in separately managed accounts. So you are a big investor and consumer of closed-end funds, and of course this is an interesting time for the markets and the way closed-end funds have been responding. So let's look back a little bit. How has this year, which got off so badly for both stocks and bonds, how has it generally been for you as you're sizing up closed-end funds?

MARK MILNER: It's certainly been interesting, I guess would be a positive way to phrase it, but really just challenging in general. Closed-end funds certainly exhibit no unique characteristics that save them from the downward trending market that we've seen overall here in 2022, and it certainly correlates highly with domestic equities, especially in high volatility periods and drawdowns like we've had this year. So really you've seen closed-end funds, despite what their underlying holdings might be, react very similarly to domestic equities which of course we know has been challenging so far this year.

CHUCK JAFFE: Closed-end funds reflect market sentiment, and right now the investment sentiment has been very negative. Are we seeing that in wider discounts? And do we have an expectation that if we can see any sort of rally heading into the end of the year that we'll see closed-end funds snap back? Or is it more with all of the dour forecasts that are saying this thing's going to bottom out maybe in the first quarter of next year; no, it's bad and it's going to get worse as we head towards 2023?

MARK MILNER: Yeah, let's start with maybe the bad news and then work towards the positive. So I guess the bad news is we're still going to see that same sort of correlation environment play out as long as markets continue to be volatile and continue to just be poor performers. Hopefully we don't have a repeat of the horrible returns that we saw in September, but maybe if we see some positivity as we approach year-end that would be a nice thing. But by and large, closed-end funds won't do anything different than the broad domestic equity market. Next let's talk about discounts, obviously we're sort of at a wide discount environment right now. Depending on your asset class, we've seen discounts widen anywhere between 600 and 700-800 basis points since the beginning of the year. A lot of asset classes are now in 10+% discount territory, which historically has been a good opportunity to buy closed-end funds, and we still think that's the case. And of course we as institutional investors are continually buying closed-end funds, and we think this is a great opportunity to continue to add to your portfolio or rebalance into closed-end funds that maybe are trading at a higher discount that you would not have purchased previously, certainly capture some of that value and add that to your portfolio. The one thing to worry about in the short term, at least as we approach year-end, is of course tax-loss harvesting. We would like to imagine that we're going to see some higher tax-loss harvesting than we would see in previous years just due to the large drawdown throughout the year. Our hope would be as closed-end fund investors that people would use that opportunity to rotate into other closed-end funds or better options within the universe versus just taking it out and moving to cash or moving it to a different asset class. So that's really our hope as we're approaching year-end, obviously a slightly elevated tax-loss harvesting season, at least compared to the last few years. But the impact I think is really going to be overall market driven, so hopefully we'll maybe see a mid-term rally, a Santa Claus year-end rally, and things turn positive as we turn into 2023.

CHUCK JAFFE: Let's talk just a little bit about the way that discounts are playing out, because as somebody who manages a portfolio of closed-end funds you have to look at discounts the way a value investor tries to decide, "Hey, is something a good value?" I talk with value investors all the time who are very careful to say, "We've seen a market get beaten up, but that doesn't make everything cheap." Here we are talking broadly about closed-end funds, and yes, you've got a lot more that are in the double-digit discount range. How do you discern which is the bargain and which is the closed-end fund equivalent of a value trap?

MARK MILNER: Yeah, it's a good question. Internally at Parametric we have a very rigorous ranking and screening process, and a systematic approach to investing in closed-end funds, and the biggest piece to know with that is diversification. So investing in closed-end funds across the asset class spectrum, whether it's fixed-income side, equity side, and the various sleeves within those broader buckets, I think it's important for any investor, and specifically for closed-end fund investors because you're exposed to those risks, not only the underlying risks of those asset classes but you're exposed to the equity risk like we talked about previously, so having a diversified portfolio is a great way to offset some of that. Additionally as you mentioned with the wider discounts, this is a great opportunity to capture some of that value and move into the higher quality funds, either within the same asset class or pivoting tactically between asset classes, that's certainly an opportunity as well. So I think that's really overall what should be the goal of an income focused closed-end fund investor. And that's one of the other things that I think is worth mentioning as well, is that if you want to day trade closed-end fund or try to trade them for price volatility, you can certainly do that. But really as a heavily retail investor asset class, people are really focused on the underlying income generated by closed-end funds, and year-to-date we have not seen a whole lot of major cuts to distributions, we haven't seen a whole lot of impact to that income, so those cashflow-focused investors that hold closed-end funds are still seeing similar output that they've saw in the previous few years. Now obviously their principal has taken a bit of a hit this year, but for long-term income-focused investors, this is still a pretty good opportunity to reshape their portfolio, capture some of these discounts, and look forward to 2023.

CHUCK JAFFE: I promised at the beginning that we would talk about rate hikes, and I've now waited this long till we actually get there. But we are in an environment where we're seeing rate hikes, where the expectation is, we're not done, and probably not done by a long shot, at least until or unless the Fed changes its opinion. With that looming on the horizon, how dramatically has that impacted, not the discounts so much but the funds themselves? And how confident you are that the investments you're buying can continue to deliver? Has it made them more attractive? Hey, yields are going up. Or has it made them less attractive because when yields rise, bond prices fall, funds get hurt?

MARK MILNER: I think it's important to look at it from two different perspectives. I think the first is what's the underlying sentiment impact to rate hikes? And obviously we've seen that playout throughout the year, dating back to the first quarter, and even before the first rate hike happened. We did some research, and there's other research out there in the market, that a lot of that impact, at least in a sort of slower, steadier rate hike environment plays out very early on in that rate hike cycle. And in fact, even before the first rate hikes begin, that's all obviously sentiment driven as people sell things or reshape their portfolios into that first rate hike, and typically you see that wash out in about a quarter or two. This obviously cycle is a little bit different, especially with these pronounced 75 basis point rate hikes, and depending on when this gets aired, we might see another 75 basis point one as well. So things are a little bit different now, so we're obviously experiencing the impact at least on price as these larger rate hikes have rolled out by the Fed. The other thing to remember, and I think that we like to focus on, is what's going to be the overall impact of leverage on closed-end funds? Obviously it's a big piece of investing in closed-end funds, let's call it about two thirds of closed-end funds employ some sort of structural leverage. It's a tool that most closed-end fund managers are employing. And so as yield-focused or income-focused investors, that cost of leverage is going to be very important. Now, earlier in the year as the rate hikes started to kick off we did some initial research, and we were comfortable with rates somewhere in the 3 to 3.5% range having very limited impact on leverage, at least that's in our estimation. Well, surprise, surprise, here we are and that's where we're at before this potential next 75 basis point hike pushes us up to 4% or higher. So now what's that next step? So when you think about the leverage employed, it's typically one of two ways; either the issuance of preferred shares or some sort of revolving credit facility. With the first one there are obviously six preferred share rates, some of them issue variables, but let's call it somewhere in the four-ish percent range. On the revolving credit side, a lot of the closed-end fund families are a part of larger institutions, obviously think of Parametric's parent company Morgan Stanley, BlackRock, Nuveen, their cost of borrowing is very, very low, so these fund managers aren't paying a huge cost to borrow to then employ that leverage. But what we've seen, and when you look at the data, is that it's typically a 1-2, sometimes even three quarter lag as rates rise to the impact on the cost of leverage for the fund managers. And so that's what we're going to be watching as we go into year-end, and certainly into Q1 of 2023; is there a significant impact to the leverage employed by the closed-end fund managers? As their costs continue to rise, are they going to start deleveraging? Are they going to make changes to their leverage policies? Are they going to start cutting distributions? Those are the things that we're focusing on now and looking forward into next year, and certainly something I think all investors should be concerned about.

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

MARK MILNER: Thank you so much, Chuck. It's great chatting with you.

CHUCK JAFFE: The NAVigator is a joint production of the Active Investment Company Alliance and Money Life with Chuck Jaffe. And yes, I'm Chuck and you can check out my hour-long weekday show on your favorite podcast app or by going to MoneyLifeShow.com. 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 Mark Milner, he's senior investment strategist at Parametric, and you can learn more about him and Parametric Portfolio Associates by going to ParametricPortfolio.com. The NAVigator podcast is new every Friday, ensure you don't miss anything by following us on your favorite podcast app. And if you like us, please leave a review, because they really do help. We'll see you again next week, and until then, happy investing everybody.

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