CEFA's Scott: Rate Uncertainty Creates Value In Muni Bonds

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Chuck Jaffe, in this episode of The NAVigator podcast interviewed John Cole Scott, chief investment officer at Closed-End Fund Advisors, chairman of the Active Investment Company Alliance. Read the Q&A below as John says that today's rate uncertainty has created attractive entry points for some municipal-bond funds because they are trading at big discounts and, in many cases, have gone through a dividend cut, thereby reducing the potential for another cut moving forward. Scott doesn't minimize the pain the muni funds have experienced this year, but notes that investors who are brave enough to double-down should be rewarded as the rate cycle plays out, although he cautioned against looking at yield as the selling point rather than combining yield with discount and net asset values to determine the best opportunities.

John Cole Scott

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

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education credits. Get more information at AICAlliance.org. Use the code AICAVIP30 to get 30% off your registration. See you there.

CHUCK JAFFE: John Cole Scott of Closed-End Fund Advisors is here, we're diving into how muni funds look in light of the latest Fed rate hike, this is 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. Joining me today, John Cole Scott, chief investment officer at Closed-End Fund Advisors in Richmond, Virginia, which is online at CEFAdivsors.com. And we're going to dig into funds using the firm's research, you can do that yourself at CEFData.com John is also chairman of the Active Investment Company Alliance, which you can learn about at AICAlliance.org. John Cole Scott, it's great to have you back on The NAVigator.

JOHN COLE SCOTT: Always good to be here, Chuck.

CHUCK JAFFE: We, on The NAVigator, try to cover as much ground as we can, but if we were going to weight our coverage towards any sector, well, the muni fund world would get more coverage than the rest because it is the most prolific area for closed-end funds. And of course in a rising-rate environment with more hikes likely, well, bond funds in general, muni funds in particular, have certainly been affected. So help us understand, because munis are a bedrock of a lot of investors' portfolios, and right now it feels like the bedrock's going through earthquakes.

JOHN COLE SCOTT: Absolutely. So if you look back the last 14 months since the end of August of '21, the average muni's down about 38% and a price return about 32% total return, and they're sitting right now at about a 10 and change discount and a 5.3% yield. Going back those 14 months they were sitting at a 1.6% premium on average and a 4.3% yield. But the average fund is down 20% in dividends in dollar terms because of the increased leverage cost, and it's the hairiness of the NAV's being pulled down when the durations are often well

over 10 for this sector of funds. And so it's been a very hard experience for this large bucket of funds that's very attractive to many income investors.

CHUCK JAFFE: Is the quick solution, look for funds that have much shorter duration? Because that's certainly working in most areas, but it's not the sweet spot necessarily for the closed-end fund world.

JOHN COLE SCOTT: So there are some funds, there's a few lower or light-leveraged funds with some mid-single digit duration exposures, there's some that really manage the portfolio with swaps and hedges to get you eight and change durations. We feel that when you're using munis for the bulk of the exposure, you want that duration exposure because we're marrying it with senior loan funds or equity funds or BDCs. And so we are blending to maybe a duration of two to three at the portfolio level, we're comfortable seeing an 11 to 15 duration for an individual holding because it's not the only position we own.

CHUCK JAFFE: A lot of people are talking about how the market is going to react when the Fed finally says, "Hey, maybe we don't have to have another jumbo rate hike." Now that may not happen during 2022, it may be 2023 before we see that, but is the worst over in your opinion for where muni funds are? Or is this not a great entry point because we still have so much rate uncertainty on the horizon?

JOHN COLE SCOTT: The answer there is never a simple yes or no. I would say for the right funds it's a very attractive entry point because large discounts cushion uncertain futures, and there are funds that investors may still own because of quality management and a good dividend experience to date. And yet I'd argue that there's a lot of risk in that current experience, a lot of opportunity in the funds that have recently frustrated or hurt certain investors. There have been numerous dividend cuts the last couple of months that add up to 20% to almost 40% in notional terms, and that is a very hard experience, and there's a small number of funds that have basically cut almost nothing the last three years and have paid a consistent dividend so far.

CHUCK JAFFE: We hear a lot during market times like this about, "Hey, it's a buying opportunity," etcetera. But does a muni fund, especially after say, it has gone through a dividend cut, and what is likely to happen to the discount when that happens, does a muni fund actually become more attractive to somebody who hasn't been there once they hear about a dividend cut?

JOHN COLE SCOTT: It is. So usually the dividend cut gets some reaction if it's really unexpected, sometimes it takes until investors notice the first dividend is reduced in their account in whatever method they use to tract that. But absolutely, if you don't know how else to analyze a fund after a cut, it's less risk of another near-term cut nine times out of 10 in my experience.

CHUCK JAFFE: You've never come on The NAVigator before without having some funds to talk about. You've got to have a comparison for us. It may not be the good and the bad in this space, but it is definitely going to be, "Here's something with a bigger discount and here's something with a bigger yield," and why they're not created equal.

JOHN COLE SCOTT: For our firm, we base our blended analysis on the manager analysis, that's the trifecta analysis of manager, dividend sustainability, and then discount analysis. We blend those together, there's never a perfect score for any one of those three but we try to get the highest weighted score as appropriate for each client. And with that there's two really well-known managers in this space, there's PIMCO and Nuveen. The PIMCO fund is PML, we're going to discuss, the Nuveen fund is NZF. What's interesting, in August of '21, 14 months ago they had the same indicated yield. The portfolios are a little different but both sport mid-teen durations. Currently the PIMCO fund is trading at a 7% premium, which is low historically, but the Nuveen fund's at a 12% discount. The difference is the dividends are down, and just recently reduced in the Nuveen fund. The indicated yield, which some people think is almost a promise from a bond fund, is 8% for PIMCO, 5.6% Nuveen. But remember, 14 months ago they were equal, the difference is Nuveen's taken a cut as made sense in our experience for the sector and doesn't have a yield that feels unsustainable in our experience.

CHUCK JAFFE: So again, PML, that's PIMCO Municipal Income, NZF, Nuveen Municipal Credit Income. What we're really saying, if I suss it out from your comments, is that there's a high likelihood that an investor who takes a look at those two funds, they're going to see the higher yield on PIMCO and be tempted, with the possible exception of the fact that they're paying a premium to get it, and they're going to see the lower yield on the Nuveen fund and think that is less the bargain. But between the discount and the fact that there's less likelihood of a dividend cut because one has just happened, that's actually the one you're going to want to buy. It's the technical things more than the, "Hey, let's look at the recent performance," that's going to decide it. Right?

JOHN COLE SCOTT: So when we back out leverage and discounts, it's not a perfect datapoint, we call that leverage-adjusted NAV yield, it's on our public profile pages for all funds. If the PIMCO fund chose to match the Nuveen fund knowing that they're not the same animal but they're cousins or close siblings, it's a 40% reduction required to normalize those two. And maybe PIMCO gets a little bit of a bump for it being more active in hedging and more aggressive with its leverage, but it's probably something north of 30% to normalize that relationship, and that would scare me as a closed-end fund investor.

CHUCK JAFFE: In helping people understand those numbers, what do these funds actually have to earn in order to live up to their promises? In other words, they're out trying to get the bonds, somebody's going to look at them and go, "Okay, wait, wait, wait. There's a very different implied promise here." What do they have to earn to be able to deliver what you're saying they're going to deliver?

JOHN COLE SCOTT: So for the PIMCO fund the manager has to blend to 5.8% to fuel the 8%, and the Nuveen manager has to blend to 3.4% to fuel the 5.6%. And even with a slight shift in duration or credit or sector or hedging or just getting extra, again, these are both great managers, they both get access to almost every deal available, that is a dispersion that is just really wide and to me a great teachable moment for closed-end fund investors.

CHUCK JAFFE: Yeah, it's why you need to dig in and look at the numbers, and that's exactly what you've helped us do here. John, it's great to chat with you always, and I know I'm going to see you on November 16th at the Active Investment Company Alliance Closed-End Fund/Business-Development Company/Interval Fund Bootcamp. If folks want more information on that it's AICAlliance.org. So I will you see you there. Meanwhile, thanks so much for joining me on The NAVigator.

JOHN COLE SCOTT: Always a pleasure to be here, 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 learn more about my work and my show 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. They're on Facebook and LinkedIn @AICAlliance. And if you have questions about closed-end funds send them to TheNAVigator@AICAlliance.org. Thanks to my guest John Cole Scott, chief investment officer

at Closed-End Fund Advisors in Richmond, Virginia, chairman of the Active Investment Company Alliance. His firm's online at CEFAdvisors.com and CEFData.com, and he's on Twitter @JohnColeScott. The NAVigator podcast is available for you every Friday, follow along and don't miss one. And until we see you again next week, happy investing.

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