Validus' Mark Scalzo Discusses 'Direct Listing' Alternatives And A Massive Discount

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Chuck Jaffe, in this episode of The NAVigator podcast interviewed Mark Scalzo, chief investment officer at Validus Growth Investors, Manager and the portfolio manager for the newly listed Destra Multi-Alternative Fund. Read the Q&A below as Mark discusses the outlook for alternative investing, the process his fund went through in changing its status and becoming one of the few new listings on the New York Stock Exchange this year, and how that conversion and some other factors have led to a discount that is much bigger than average or than most closed-end fund investors would expect.

Mark Scalzo

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

CHUCK JAFFE: Mark Scalzo, manager of the newly listed Destra Multi-Alternative Fund is here, and we're talking alternative investments now in 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, which is a unique industry organization representing 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. And today we're heading in the direction of alternative investments with Mark Scalzo, he's the chief investment officer at Validus Growth Investors, and portfolio manager to the newly listed Destra Multi-Alternative Fund. Now it's newly listed, not newly minted. The fund has been around since 2012, but just January of this year it became listed on the New York Stock Exchange where it trades under the ticker symbol DMA. You can learn more about the firm, Validus, at ValidusGrowth.com, and more about the fund at DestraCapital.com. You can also learn more about business-development companies, closed-end funds, and interval funds at AICAlliance.org, the website for the Active Investment Company Alliance. Mark Scalzo, thanks for joining me on The NAVigator.

MARK SCALZO: Thanks Chuck, it's great to speak with you today.

CHUCK JAFFE: Mark, I started by talking about the fact that you are newly listed. Well, there aren't a lot of new listings this year pretty much of any type, but yours was also a little bit different. So can you talk a little bit about the evolution of the fund and the process, and what a direct listing, which is your process, actually does and means for investors?

MARK SCALZO: Sure, sure. So the fund started as a closed-end non-listed interval fund over 10 years ago, and the idea was really to provide non-correlated income and a diversified exposure to alternatives to high net worth investors. In January we directly listed the fund's common shares on the New York Stock Exchange, meaning that our existing shareholders continued to hold their shares, just in a different format. For comparative purposes, the more traditional way of going public in an initial public offering involves selling shares to new shareholders and raising additional capital. This is usually preceded by several months of marketing to create interest from these new investors and shareholders, but we went the direct route, Chuck.

CHUCK JAFFE: What was the other impetus for doing this? I mean, if you weren't doing it to raise capital and take it to market, was there another impetus that said, "Hey, this is going to make us function better or differently"?

MARK SCALZO: One of the things about a closed-end interval fund structure is that you are required to do quarterly tender offers for the existing shareholder. So one of the things that makes that very difficult as a portfolio manager is that we're investing in a lot of illiquid securities in the alternative space, and that really makes it difficult to manage a portfolio when there's constant redemptions in the fund or the ability for redemption. So the listed closed-end fund structure doesn't allow for redemptions in the same way in that if an individual shareholder wants liquidity, they just buy and sell in the open market.

CHUCK JAFFE: Well, let's move to what it is that you do in the open market, because you're buying alternative investments and alternatives need to be defined, they mean different things to different people. And in fact, you guys and Destra have always referred to the Destra Multi Alternative Fund as *the* alternative closed-end fund. So explain what you mean by alternatives and what makes you think at least that you're that exclusive.

MARK SCALZO: For us alternatives means being non-correlated with traditional asset classes, and so those would be equity, fixed income, traditional asset classes that investors can invest in. I guess the idea of *the* alternative closed-end fund is a little bit tongue and cheek, but really with a reason, there's nothing like our fund as far as we know. From the inception of this fund, it pursued a multi-strategy, multi-asset class approach to alternative investing, really akin to what David Swensen had done at the Yale Endowment for a long time. And the fund started off in a vehicle that in many cases represented someone's entire allocation to alternatives, so we had to cover the gamut. So this endowment methodology usually involves a broad exposure to alternative asset classes and strategies, and as I mentioned, they're not correlated with traditional asset classes. And they're not just real estate and credit strategies, it also involves having usually a healthy allocation to illiquid investments, and that provides some of the non-correlated attribute of the portfolio. Today the fund can invest in almost anything that furthers that mandate of non-correlated income and returns for investors. For instance, the fund will invest in public and private markets, illiquid and liquid positions across real estate, direct private equity, alternative credits, commodities, currencies, infrastructure. We can even hedge different exposures in the liquid markets in our portfolio. So we think this is a pretty unique combination of investments and a unique portfolio that places us kind of in a special position in the closed-end fund universe.

CHUCK JAFFE: In terms of the alternatives that you are buying, help my audience understand what those are and how their performance is not correlated with the rest of the market. Because again, alternatives, you could be doing private equity, you could be doing artwork.

MARK SCALZO: And we can do all those things, if it made sense for our portfolio, but most of what we do requires a lot of due diligence. So there's a higher hurdle for assets that are illiquid or that have limited liquidity, and that you're going to hold for a longer period of time as you can imagine, so we try to leverage our capital basis creatively as we can. For instance, we've negotiated some preferred terms for certain products and strategies in situations where our capital is early in the process of establishing that strategy, and where it's more meaningful to the overall success. So as you can imagine, we can get pretty attractive preferred terms in doing things like that. As an example also, recently we've been utilizing structured notes to provide downside protection for our liquid exposure. Structured notes are really just notes that are issued by a sponsored bank like Goldman or J.P. Morgan, where the performance of the note is determined by some specific underlying index or basket of securities. And so we do our own bottom-up proprietary research on individual stocks, so we're leveraging the experience and that research to construct our own customized notes that have favorable risk-reward characteristics for the fund. Another interesting area that we look at is direct operating company investments, kind of our private equity exposure but we do it directly. We look for situations with asymmetrical risk-reward where we can invest very little capital in each opportunity relative to the size of the fund with the hope that the reward will really move the needle over time. And we look for companies that are trying to solve big problems or meet a big market need. Some of the investments we've made had focused on computer vision, on the Edge, DNA storage, financial education through gamification, and even children's nutrition. So those are some examples, and generally the performance of these individual securities is not as susceptible to whatever the current sentiment in the market is. So you're allowed to rely much more on the underlying fundamentals and performance of the operating business or the strategy rather than letting sentiment drive the day to day price movements.

CHUCK JAFFE: I know that folks who run closed-end funds are loathed to talk about discounts, but we need to talk about yours because at DMA since the listing you guys have not just been double-digit discounts, you've been high double-digit discounts, like in the 30% range. I'm curious, without putting you in a position that managers can't discuss, what you think is driving the discount. And just out of curiosity, do you think it has anything to do with the fact that Morningstar has Destra Multi-Alternative in a category of one? In other words, you are the best fund in your category, but oh by the way, you're also the worst fund in your category. Does that have anything to do with this?

MARK SCALZO: I certainly think it does. I think there are several factors, one you mentioned is important. It's also been a heck of a year to go public, right? 2022 has been a real challenging environment for every asset class.

CHUCK JAFFE: Yeah, good call on that.

MARK SCALZO: Many IPOs and direct listings, I think the average IPO is down something like 48% this year. So we're caught up in a little bit of that, we're this new investment vehicle that not a lot of people understand. I think that's a part of it. As I mentioned before, we didn't go public the normal way, which would involve educating a bunch of new investors in terms of what the fund is and what we do, and why we're unique. So we didn't have a real opportunity to sort of tell that story prior to the stock actually trading on the open market, so we've had to do that after the fact and build buyer interest after the fact. And so that's been a little bit different. Also something I would point out is that before we listed the fund, because of the listing, we had to turn off the tender process that I mentioned earlier, which was the way for existing shareholders to get liquidity. And as a result, there was a little bit of pent up demand once the shares were available to trade by that existing investor base, really just as a part of the normal course of what the advisors for these clients do in managing their exposure for those clients. So that was also a factor. And then finally coming back to your point about the uniqueness of our fund, and there's really no comparable peer group unfortunately, there's no easy and quick benchmark to utilize to get a sense of what the opportunity is for our fund. I don't need to tell you this, but most closed-end funds are single asset class or single strategy, most focus on delivering high yield or exclusively creating NAV growth, but not both like our fund. So all of that makes them easier to understand and easier to benchmark, utilizing more simplistic metrics. So those simplistic metrics really miss the mark, unless you're kind of willing to do the extra work to try to understand what our fund is. That said, we've seen a really interesting uptick in the volume that have been traded in our shares since February. February it was roughly about 9,800 shares a day, and in August it was almost 25,000. So we've seen an interesting uptick and the fund has performed very well this year, as of the end of last week it was roughly on a NAV basis down 2.4% and closed-end funds broadly were down about 14% on the same basis. So I think all of those factors have had an impact, but I think as long as we continue to demonstrate that we can deliver performance on a NAV basis, I think eventually the discount will take care of itself.

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

MARK SCALZO: Chuck, it was great. Real pleasure to be on your show, thanks.

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 show on your favorite podcast app or at 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 Scalzo, the chief investment officer at Validus Growth Investors, and portfolio manager of the Destra Multi-Alternative Fund. The fund trades on the New York Stock Exchange under ticker symbol DMA, and you can learn more about the firm at ValidusGrowth.com, and about the fund at DestraCapital.com. The NAVigator podcast is new every Friday, ensure you won't miss anything by following on your favorite app. And until we do this again next week, happy investing everybody.

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