RiverNorth's O'Neill: 'Tis The Season To Go Discount And Bargain Hunting

Friday, December 9, 2022

Chuck Jaffe, in this episode of The NAVigator podcast interviewed Steve O'Neill, who co-manages the closed-end fund trading strategies and oversees the closed-end fund analysts at RiverNorth. Read the Q&A below as Steve says the timing is right for closed-end fund investors looking for big discounts that will likely be shrinking right after the turn of the year as the tax harvesting process plays out. O'Neill discusses how the big discounts amount to extra gravy for investors hungry for better yields.

Steve O'Neill

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CHUCK JAFFE: Steve O'Neill, portfolio manager at RiverNorth is here, and nothing says the holiday season like bargains and discounts so that's what we're going to talk about now on 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. Today I'm joined by Steve O'Neill, who co-manages the closed-end fund trading strategies and oversees the closed-end fund analysts at

RiverNorth. You can learn more about those strategies and the funds and the firm at RiverNorth.com. You can also learn more about business-development companies, interval funds, and closed-end funds generally at AICAlliance.org, the website for the Active Investment Company Alliance. Steve O'Neill, thanks for joining me on The NAVigator.

STEVE O'NEILL: Thanks Chuck, happy to be here. Fan of the podcast.

CHUCK JAFFE: We are talking discounts right now, and here we get to the end of the year where we're likely to see some things moving because there is tax-loss selling and other things happening. Just give us a basic setup for, is this the time when investors should be bargain hunting? And if so, where?

STEVE O'NEILL: Sure. If you're thinking about timing closed-end funds and being a tactical trader the in the space, 'tis the season. When we manage portfolios of closed-end funds, oftentimes we want to have a maximum level of closed-end fund exposure around Thanksgiving, and anything after that is gravy. And because there's such a seasonal pattern in closed-end funds where there's a lot of tax-loss selling in the fourth quarter, advisors are selling in November hoping to get back in in December, or they're being a little bit lazy and people are selling in December and then they repurchase in January. But that selling pressure pushes discounts wider in the fourth quarter, that creates the opportunity, the lack of supply in the new year allows discounts to narrow again, combined with potentially some demand from investors putting new capital to work. But you asked the question, is it a good time of the year? Yeah, I think seasonally it's a great time of the year. And then you just look at the space, not every tax-loss selling season is the same. This year I think we're particularly lucky because you really can pick any asset class out there, whether that's munis, equities, or taxable bonds, and you can find attractive double-digit discounts.

CHUCK JAFFE: One of the areas with the biggest discounts has been a lot of the new funds. I mean, good news for the closed-end fund industry, you're growing. Interesting to watch as a lot of the IPOs have, well, I don't want to say struggled, but they certainly haven't got narrow discounts, do they?

STEVE O'NEILL: You know, every investor when you're making a closed-end fund investment, I think your listeners know first and foremost you want to like the asset class. Every closed-end fund is going to be different, a muni is a very different beta profile than an international equity fund. But if you're trying to look for a theme or a place to go hunting, Chuck, I would agree with your point, the recent IPOs are really interesting. And aside from the discounts, which are attractive, what makes these unique is that really any fund issued from late 2018 till today has a term on it. And so that's different from a perpetual fund which never is required to offer investors liquidity at net asset value, but the closed-end funds that were issued in the past couple years all have terms. And if you look at the 2020 to 2022 average, the term is about 11 years, and the discount on that peer group, which is call it two dozen funds, is right around 11%. And so you just do the simple math, 11 divided by the 10 years, that's 1.1% of annualized alpha. Now this group of funds represents munis, hybrid funds, equity funds, and so again the first thing you want to do is pick your asset class. But then from there, looking at this peer group, I just think it's a unique situation and time where you have what are many large closed-end funds with very good liquidity trading at mid-teens discounts. You take that discount, divide it by 10, there's a number of funds in the market today that have 1.7-1.8% of annualized alpha. And if you start with the view that you want this asset class, you want that exposure, it's kind of hard to beat that tailwind from alpha. And I think it's unique because, just to be frank, the timing of these issues was terrible in terms of capital market cycle, in the sense that the bond market and the equity market's peaked. And so the investors in these funds they don't like them because their experience has been poor, but if you're on the other side looking in you're going to say, "Well, there's nothing really inherently wrong with these funds," these are in fact very attractive funds. But that's a contrarian view compared to what the average investor experience was in that fund, but that creates the opportunity. I think most of these discounts are going to go to par, but a 15-16% discount going to 10%, that really enhances the potential return as we go into 2023.

CHUCK JAFFE: And a 15-16% going to 10%, enhancing the return for 2023, again if these were funds that were issued with 11-year terms, if they simply pay their regular income stream and you hold them to term they will eventually go to par. So that's your benefit of being a long-term investor too, right?

STEVE O'NEILL: Oh, for sure. Again, we all know that it's hard to hold onto anything for 10 years, and I think the alpha's going to be frontloaded. I think what's going on right now is just excess supply, everybody has a loss to harvest and these discounts are in my mind a little bit silly. Yes, you're 100% right, if you hold this to the termination date you're going to get that 1.5% annualized alpha. But our prediction would be that these discounts narrow a lot faster and they start to look more like their peer group averages because the closed-end funds that were issued recently are trading in kind of the penalty box, just them narrowing towards the peer group average, which don't include terms, is a meaningful increase. Now if they started trading even better because they have the term, that's going back to that analogy, just additional gravy on top.

CHUCK JAFFE: Let's change from those new funds to the biggest category of closed-end funds, which is munis, and you talked a little bit about bond funds. Muni funds, like a lot of bond funds, they have suffered for sure this year. But I've had a lot of guests on my show *Money Life* talking about how the bond market is really positioned to do well in 2023 even as we're just seeing rates stabilize, that stability will be a big help. As you're looking at muni closed-end funds, is there a risk there that people are overlooking? Or is this a case of, yeah, stabilization of rates, even if we don't wind up seeing massive changes till the end of 2023, should be a driver.

STEVE O'NEILL: You touched on something that's important which is there has been a change in sentiment, negative use towards duration peaked in October, and that sentiment has changed as rates have come down and the forward curve looks to be gradually declining out there in 2023. And so sentiment has changed, and you can see that in terms of bond prices and yields coming down, you can see open end-mutual funds having positive flows again in the bond space. But you're not really seeing that positive sentiment change in discount, and so I think that creates the opportunity. A muni bond fund is a A, AA bag of bonds that has a +10 year duration, and so that's the first decision, do I want this asset class exposure? Do I have room for this investment in my portfolio? What's my risk budget for duration? And so when I think about a risk budget for duration, I think most of us have one, whether we're individual or institutional. If you've got duration in your portfolio, we think it makes a lot of sense to look at munis because they're such high quality and they're trading cheap relative to treasuries. But if you can buy that at a discount which is 10% or higher, I think that's really interesting. And that's something that investors might say, "Hey look, I kind of missed this recent rally in bonds." Which is true, market prices are up, net asset values are up across the board, but discounts really haven't changed, and in many cases they're wider. And so when you look at the space, yeah, muni bonds are still down 20-25% total return, sure they're up maybe 10% off of the lows, but when you look at the discounts it's just really interesting to be able to buy into such an imbalance on supply and demand. And everyone's so pessimistic about fixed income in the closed-end fund space, they're still able to buy wide discounts, and so we think that's the opportunity. If you've got a duration budget, we really recommend looking at muni closed-end funds as a way of filling that exposure.

CHUCK JAFFE: As we go through the seasonal impacts, you've got the tax-loss harvesting, you've got people putting new money to work, et cetera. You typically see closed-end funds get a little bit of a pop at the beginning of the year. Once we get some normalization, we've gotten through the seasonal effect, what is your outlook for closed-end funds generally in 2023?

STEVE O'NEILL: Well, I'm glad you asked that question, Chuck. That gives me an opportunity to talk about the risk. Before I go there, let me just repeat what I said earlier, which is seasonally this is a good time to buy closed-end funds. And the reason for that is that discounts are typically wider than normal because there's supply imbalance, everyone's harvesting their tax losses, and then in January that incentive disappears in the new calendar year and discount tend to narrow. So timing wise, discounts look really good, but people are looking for investments, not a 2-3% on a discount narrowing. And so when you think about what makes a good investment, what makes a good closed-end fund? First and foremost, people want distribution, and so that kind of goes to the risk. You think about what's the outlook for closed-end funds in 2023? Well, I think it's easy to say that discounts can narrow from their wide base today, but what are discounts going to do for the remainder of the year? Now certainly the Fed will have a big impact on closed-end funds because closed-end funds use leverage and that leverage cost can squeeze the spread that investors can earn, but I think you really have to have a good understanding about distribution stability. We talked about munis, that's probably the place where investors are going to be the most sensitive because there's the least spread, a high yield bond fund can absorb a lot more of a rate rise because the spreads on the assets are meaningfully wider than the cost of the liability. On the muni side, the spread is not as big, and so investors should in our view expect distribution cuts in 2023. But the question is, what would investors be happy with? You look at muni funds today, and look across fund sponsors, a levered muni bond fund can yield about 4%. Some funds are yielding more than that, which is probably indicative of a future cut. Some funds are yielding less than that, that's probably indicative of a fund that's getting ahead of the rate move and lowering the distribution rate now, and so you might actually have a distribution increase if the fund's yielding less than its peer group average. But the investor in closed-end funds, let's say you buy a muni fund at a 10% discount, that level of discount can absorb some distribution changes from here, but investors will really need to be focused on that future distribution rate because that will guide demand going forward. If the dividend's stable, then that can lead to discount narrowing. If the fund's keep death by a thousand cuts, it might be hard for the discount to narrow much beyond 10%. But I also think it's hard to imagine discounts widening out a lot more because where we are today is almost about as good as it gets for large liquid bond funds, specifically munis, 10% discounts in that space look really attractive.

CHUCK JAFFE: Steve, great stuff. Thanks so much for joining me on The NAVigator to talk about it.

STEVE O'NEILL: My pleasure, 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 by going to MoneyLifeShow.com or by looking for us on 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 Steve O'Neill, portfolio manager who oversees closed-end fund trading strategies at RiverNorth. You can learn more about the firm and its funds at RiverNorth.com. The NAVigator podcast is new every Friday, ensure you don't miss an episode by going to where you get the good podcasts and following us there. We'll see you again next week, and until then, happy investing everybody.

Recorded on December 8, 2022

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