2022 Year In Review: Promising Opportunities Arise From Tough Times

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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, the chairman of the Active Investment Company Alliance. Read the Q&A below as John and Chuck take a look back at the challenging times experienced by the closed-end fund industry this year, noting that all the news wasn't bad despite slower-than-expected growth for the industry and bigger-than-anticipated losses on the market. John's basket of five funds for 2022 that came out ahead of the market, like many parts of the industry, is poised to rebound in the new year.

John Cole Scott

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

CHUCK JAFFE: John Cole Scott of Closed-End Fund Advisors is here and we're reviewing 2022 in closed-end funds 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. Joining me today, John Cole Scott, chief investment officer at Closed-End Fund Advisors in Richmond, Virginia, which has online information at CEFAdvisors.com, and if you want to dig into the firm's research and data, well, that would be CEFData.com. John is also chairman of the Active

Investment Company Alliance, which you can learn about at AICAlliance.org. John Cole Scott, happy holidays, welcome back to The NAVigator.

JOHN COLE SCOTT: It's always fun being with you, Chuck.

CHUCK JAFFE: Happy holidays, and next week we'll be saying Happy New Year, but it hasn't been a happy this year necessarily for investors. A year ago you and I were looking ahead, so let's take a look back right now at 2022, the good, the bad, and the ugly.

JOHN COLE SCOTT: Sure, so a year ago there were 505 closed-end funds, and that number's now down to 498. A year ago 76% of the funds were levered, that's nudged slightly to 77%. And the leverage figures have gone from 29% on average up to 31.4%. The average closed-end fund per our 15-sector index is down about 18% year to date. But I do want to note the non-listed segment of our universe, the interval funds are only down on average 2.5%, so definitely a better experience for those investors this year. A year ago there was way more premiums, a third of the funds were at premiums, now it's only 14%. And the dividend growth rate, not horrible but it's down 6.3% on a one-year basis. And if you exclude munis and preferreds where you get typically the largest cuts, it's only down 3% and discounts widened 9%. And a year ago the indicated yields were 6.6%, and now even with dividend cuts on average, the indicated yields are 8.6%.

CHUCK JAFFE: That's the basic industry stats, what about how investments performed?

JOHN COLE SCOTT: Got it. So munis again, one-year performance, market price -25% on a total return basis, 16% on NAV. Again, a significant discount widening, we talked about this last year as a risk. Preferreds a little better because of lower duration, -20% versus NAV of -13%. Kind of the outlier which we hoped for but we didn't know why. MLP funds up 26%, and what's crazy is the NAVs are up almost 24%, so barely any discount narrowing in the large gains there. And almost the inverse, REITs and real asset funds were down 25% but the NAVs were down 25%, so basically no discount moves in the carnage in that sector. And we always love talking about senior loan funds and high yield because there's a lot of options and a lot of good managers in the closed-end fund space, and they tend to perform differently. Senior loans were down 14% market price and only 6% on NAV, and high yield was down 17% on market price and 13% on NAV. And you can't forget about BDCs, they're the closed-end fund cousins, they're only down 7 and change percent year to date, 14% widening but

they had 10% average dividend growth. Because as you may know from our sessions together, high fixed levered, highly variable loans, very focused on dividends to investors.

CHUCK JAFFE: Now we have a lookback on how the funds themselves were doing, let's put you to the test. Because a year ago you and I sat here, did this, we talked about a couple things you expected. For example, you were really focused on duration risk.

JOHN COLE SCOTT: I was. So we really were thoughtful, we were overweighting preferreds, underweighting munis, overweighting, again, the senior loans, MLP, we really built our client portfolios for duration risk and leverage cost increases. We had no idea what was coming but we were definitely correct with both duration risk being a problem for '22 and increased leverage costs. We thought that activism would go down because there'd be less discounts and less problems, and I wouldn't say it's down, it's actually differently stable, as in there's still lots of building shares by the known activist investors that I believe will be more impactful to the proxy battle season next year. So definitely wasn't quite correct on activism. IPOs, I had the audacious thought that we could get more than one a month, and we ended up with only four. After February, the IPO window basically closed, BlackRock got a small target term muni out at the end of the year, kind of limping the IPO market back to health. But there were two direct listings, one very small, and one billion and change dollar fund that's unique to see such a large fund direct listed from a non-listed fund to a listed. So I was wrong there. But then BDCs, I said we'd have two or three come out, and honestly we had two listed but they weren't large, and we had three huge growth in the non-listed. So if you allow me to correct myself and say non-listed BDCs, I was basically correct.

CHUCK JAFFE: You know, the interesting thing, for example the IPOs, I don't know that your forecast would have been wrong if it weren't for the way the market turned out. This is that how do you do a forecast, right? When we people were looking at the year ahead, nobody was necessarily thinking great things for 2022, the problem was the market peaked on the first day of the year, and no matter what it did afterwards it was down. And that took all the companies out of the IPO space, it probably took most of the starch out of BDCs, although again you can kind of wordsmith your way to being correct on that one. But that was part of the year that you make the forecast, and then just the market action, had we had a year that was more choppy but wasn't so down, that one might have been right.

JOHN COLE SCOTT: And I would say really the biggest surprise that wasn't directly tied to the market surprise was that non-listed structures had a banner year of giving investors options that did not blow up their portfolio on average.

CHUCK JAFFE: You also, when you were forecasting for 2022, looked at a couple of specific funds. Let's talk about those.

JOHN COLE SCOTT: Yeah, so last year we looked at the MLP fund EMO, the preferred fund PTA, the REIT real asset PGZ, the loan high-yield fund ARDC, and the BDC GBDC, that's a lot of ticker symbol mouthful. But basically as we reviewed on a one-year basis, the market prices on average were only off 3.4% for the basket versus -16% for our index. The NAV was off, just under 2% versus almost 12% for the index. And the discount's still 13% for the basket, and that's still 2.5% wider than the peer group average, but the dividends grew 15% this year. All five funds increased their dividend in the last 12 months, and they're showing indicated yields still of 9.8%. I'm not saying to necessarily go buy this basket from a year ago, but it's not an unattractive basket and it did what I hoped it would do, diversify, dividends, and not be a crater in the portfolio.

CHUCK JAFFE: And while you're not saying to go buy it, there's one more message here for 2022. We will back talking about your lookahead for 2023, but folks have a little bit of work to do between now and then, because although the five funds that you picked performed reasonably well, it wouldn't be hard to have things that you have losses on and you want to tax-loss harvest, right?

JOHN COLE SCOTT: Yeah, it's so amazing, so many investors think if you were to sell Nuveen muni bond A and buy Nuveen muni bond B, that's a wash sale. And that's not true, it's basically you can buy cousins and sisters, sell cousins and sisters, and it's not a problem. We argue, and again we tend to work with larger portfolios because we're highly customized, but if you can grab those tax losses today, do it. Trades are basically free, and so you're able to swap and take those assets. So next April your checking account will be bigger because you can either take gains somewhere else in the portfolio, maybe an MLP fund at a huge gain, you want to rotate, and you can either neutralize or you can grab an asset to reduce future tax liability. It's a simple way to have more money later and closed-end funds are perfect for that opportunity.

CHUCK JAFFE: And what you're also saying here is that functionally pretty much everything you own in the closed-end fund space is not so unique that you can't replace it with something else, at least for 30 days. But I'm curious, A, is that true? And then, B, when people are making these changes, are you moving from fund A to fund B and going back in 31 days so you avoid the wash sale? Or if you said you're going from Nuveen A to Nuveen B, you just hang out in Nuveen B, see what happens, and maybe you go back to Nuveen A if ever you need another tax-loss harvest?

JOHN COLE SCOTT: So our client portfolios are highly customized for beta tolerance, duration tolerance, tax efficiency, discount tailwinds, and dollar denominated income for a client. We'll take close investments for 31 days, we're probably far more likely to do a fresh review in 31 days and look for the opportunity to make that decision like it was fresh capital because we took the asset. I would argue we use a six-month NAV correlation to swapping funds traditionally because we'll find some funds that we didn't realize were as close as they actually are, sometimes not the same fund sponsors, same sector. So the short answer is probably not a need for your audience, but I'd say for the financial advisors in your audience, a great value to offer a benefit to their clients who they're a fiduciary for.

CHUCK JAFFE: And again, get your tax-loss selling done between now and next week when you and I will talk again, and we will get a fresh set of forecasts and a fresh list of funds and more for 2023. John, happy holidays, I'm looking forward to the next conversation already.

JOHN COLE SCOTT: Thanks so much, Chuck. See you next week.

CHUCK JAFFE: The NAVigator is a joint production of the Active Investment Company Alliance and Money Life with Chuck Jaffee. Yup, that's me, you can learn all about my work, my show at MoneyLifeShow.com or wherever you get the good podcasts. 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. Thanks to my guest John Cole Scott, chief investment officer at Closed-End Fund Advisors in Richmond, Virginia, and the chairman of the Active Investment Company Alliance. His firm is online at CEFAdvisors.com and you can check out their research for yourself at CEFData.com. And John's on Twitter too, he is @JohnColeScott. The NAVigator podcast is available every Friday, and we will be back during the holidays next week with a

look ahead to the new year. Make sure you don't miss that or any episode by following along on your favorite podcast app. Meanwhile, happy holidays everybody, and happy investing.

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