AICA's John Cole Scott: Expect The Weak To Get Stronger In 2023

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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 says that investors looking for the top sector bets in the new year will want to look at some of 2022's weakest areas, most notably real estate investment trusts 'REITs' and real assets. He also expects international bonds and more to be in the sweet spot. Scott gave his look-ahead for the closed-end fund industry for 2023, and it's a year when he suggests investors take more duration risk, tilt their equity portfolios toward value, dividend, and international funds, and expect to see discounts narrow and yields to fall, though the latter will be driven by some capital appreciation later in the year as the economy and market continue to digest inflation and more.

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 looking ahead to 2023 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. And today it's pointing us in the direction of the new year, and we're going there with John Cole Scott, chief investment officer at Closed-End Fund Advisors in Richmond, Virginia, which is online at CEFAdvisors.com. And if you want to check out their research, well, you can do that at CEFData.com. John is also chairman of the Active Investment Company Alliance, which you can learn about online at AICAlliance.org. John Cole Scott, Happy New Year, welcome back to The NAVigator.

JOHN COLE SCOTT: Happy New Year to you, Chuck.

CHUCK JAFFE: Last week on The NAVigator we reviewed your forecast for 2022, now it's time to delve into the year ahead. And while 2022 was a bad year, are we expecting 2023 to be better?

JOHN COLE SCOTT: I would say that we're expecting '23 for closed-end funds to be better than the general markets, because as you may know, over 60% of closed-end funds are basically credit funds, so they can be muni, they can be fixed income, they can be other credit strategies. And we feel like those funds will perform better in the current environment because we are down on prices across a lot of places, wide on discounts, and duration risk is no longer such a factor.

CHUCK JAFFE: Let's start at the very beginning because everyone wants to know about the January Effect, which is the market typically rebounding in January, but in no place is there more tax-loss selling, which gets a lot of the credit for creating the January Effect, than in closed-end funds. So do you expect the January Effect for the market generally, and closed-end funds in particular?

JOHN COLE SCOTT: Well, we really do focus much more, we make asset allocation decisions for our clients and for consulting clients, but a lot of our work as you know is analyzing the manager, analyzing the closed-end fund wrapper. We saw 3% widening in closed-end funds during this quarter, we do expect the January Effect, and we do think that the current average 9% discounts for closed-end funds will narrow at around next year this time to about a 5%. And if we break that down in another spot, those CEF 2.0, roughly the last 36 months of closed-end funds, we think they'll catch up two thirds of their 5% gap, their current 13% discount to about 8%, which would be a nice tailwind for those newer funds. And again, discounts are a big part of the equation, but also current yields, we think the current yields

run 8.6% will trend down, and we don't believe from dividend cuts, we think from rising prices, to about 7.5% by year-end next year.

CHUCK JAFFE: So in other words, people are getting a healthy payout now, they're going to get the benefit of discount narrowing and some general price increases. It'll bring the current yield down but it'll mean that, hey, you're probably going to have a decent year, and it looks like it'll be enough to outstrip inflation, right?

JOHN COLE SCOTT: I won't be so shy to say it's going to be a boring year and a nonvolatile year, I don't think we're going to go back to those quieter days of recent time, pre-Covid, '18-'19, but I do think that the tailwinds are well set for the funds in our universe to provide a diversified portfolio. Remember, our portfolios are 40 ticker symbols at a time, I'll say minimum in almost every case, 35-45 in almost all cases. So we don't have to one fund or one sector be the answer, it's a portfolio answer for our firm.

CHUCK JAFFE: Well, let's move from what we're expecting from funds that exist to funds that don't exist yet. Last year you were expecting an IPO, not boom, but by closed-end fund standards, a lot of IPO activity. When the market got hairy, yeah, everybody kept their claws in, there were less IPOs. What are you thinking about this year?

JOHN COLE SCOTT: I think we'll end up in this calendar year, in '23, with seven to eight IPOs. I do think that half of those will be munis and target terms because those are kind of the easier core, get the system rolling again fund structures from Nuveen and BlackRock and PIMCO, and maybe a few others. I do think most of the larger IPOs, as we probably get some over a half billion dollars, are the second half of '23. And I don't know what sector exactly because the market will have to give us some runway, but I think we can probably get two taxable bond funds out and two equity income, but I do think income is going to be the focus because investors still value that from the closed-end fund universe. And for BDCs, I can't say we won't get one listed, but I do think there'll be continued growth in the private and non-listed BDCs because they're offering access to a great market with less volatility from high-quality asset managers.

CHUCK JAFFE: What's the trend in activism amongst boards and the folks who are looking always to get involved in funds?

JOHN COLE SCOTT: I do think that there's a good chance that two funds will lose their investment advisory contracts, that's kind of a newer and recent time outcome from

activism. Larger tenders, which we deem over 20% and at least 98% of NAV, I think there'll be five or six of those as defensive or reactionary measures to activism. And again, I've not heard any news on this, but as I chat with folks in the universe I feel that some of those CEF 2.0 funds, where their NAVs are down over 50% or that level of pain, they can share the pain with investors by doing some sort of fee waiver until the discount narrows or the net asset value rises back to a certain level, because I think the only way to get more funds going is to get people comfortable and feel aligned in the market.

CHUCK JAFFE: Let's move from that to how you view the risks of this year. We're looking at market risk, duration risk, credit risk, which ones do you like, which ones should maybe people avoid?

JOHN COLE SCOTT: Again, I gave a teaser on this last week on the podcast, but I think it's a good time to be taking that duration risk, I don't think it's the time you need to worry about sifting after you've filtered for funds duration lowest to highest. We're in a good place for the wide discounts and durations to be less painful in the market, because I don't see how we get much higher rate increases, that's my current crystal ball guess. I think credit risk, we do prefer senior loans, their NAVs have outperformed recently to high yield. We think high yield, even though we're not worried about duration risk, we think the senior loan focus is just a safer NAV and credit to be in. Though you've known me for a long time, I've been saying that for probably eight of the 10 last years, and I'm not always right but it's still my core belief for a tough market. And equity risk, we think you really have a lot of opportunity for value stocks in closed-end funds, dividend stocks, international, there's reasons to think emerging markets can have a better tailwind, and even the developed markets of Europe have seen a brighter future than a past.

CHUCK JAFFE: So what are the sectors you're thinking people should lean into? What are the ones they should stay away from?

JOHN COLE SCOTT: I would say that REIT real assets had such a tough year that there should be a constructive trend, and there's some nice discounts, some good product in that space for income investors. We do think that international bonds will outperform because they tend to have higher coupons and are better set for the current environment. Again, the goal would be more than one fund, definitely more than one country. And when we look in the muni space there's just so much anger and dislike of the New York sector, it's a smaller sector,

but if you're looking to do a little credit work it's a great place to find some funds. Be more thoughtful in the trading, but really good value there versus the California and national funds. And then I would say high-quality BDCs, lean to internal management, a strong credit manager, there's capacity to add leverage if there's a problem, to sort out problems, pick up deals, and looking for dividend coverage. I was just doing a focus list for one of our consulting clients, and where our UIT product of BDCs is about 13-14 names, we have a nice seven focus list that we'd like to focus on for '23, where we say we don't know the answer but these are the right names at the right prices for good, stable dividends.

CHUCK JAFFE: So now the part that everybody's waiting for, you always come up with a couple of funds, and of course these would be the funds that you think in the conditions you've described are going to be solid performers.

JOHN COLE SCOTT: Sure, so I'm going to start with the most richly priced to net asset value, TSLX, that's the Sixth Street Specialty Lending, it's a BDC. They're not as well known to your audience because they don't have a regular closed-end fund, but they're at an 8% premium versus a three-year average 22% premium, they're sporting around a 10% yield with a quarterly dividend, and they've got a great history of good work in up and down markets. They have upside equity potential, they're very good at the nitty gritty of being a BDC, and they're well known for doing that work for investors. We then shift to their closed-end fund cousin, the senior loan or the floating rate funds. Eaton Vance has a fund EFT, it's the Eaton Vance Floating-Rate Income Trust, it's at about an 11% discount versus a three-year average of 6%, giving us a currently a yield of eight and low change with a very high amount of variable loans, doesn't even sport a duration figure. I double checked the fact card last night and it's showing a beta versus SPY of its net asset value of 1.5% the last two years, really showing the value of that sector in the closed-end fund space. We'll then shift to munis, there's the MFS Muni Income Trust, MFM, a 14 and mid-change discount, currently giving a 4.5% yield paid monthly, medium leverage at 32%, the duration's 14-10. So when I said be comfortable with duration, this is a poster child for that outcome. We'll then switch to a multi-asset manager, a combination fund at Nuveen, the Nuveen Multi-Asset Income Fund, MNAI, it's at 14 and mid-change discount, giving us a yield of 12%. But what I love about it, if you take out the leverage and the discount, it's a seven and mid-change leverage-adjusted NAV yield, which tells me that 12% is not as risky for an equity-oriented portfolio, and giving

us a nice diversified mix of the different sectors that Nuveen has in this broad marketplace that they have for investors. The last is a CEF 2.0 fund, the only one on this list, it's the MainStay CBRE Global Infrastructure Fund, MEGI. It's a 17 and mid-change discounts, it's a nine and mid-change yield, it's got the right guts I think, global infrastructure to be a nice tailwind for the markets, the leverage profile also is medium, and again it's a manager that has good resources for this work in the marketplace. And I think these are funds that can give you a diversified mix, the blended yield is 8.94% and that's a nice basket to consider for 2023.

CHUCK JAFFE: So again those tickers are TSLX, EFT, MFM, NMAI, and MEGI. Those are your picks. Of course we will talk to you multiple times in the new year, but a year from now we'll be back reviewing them, holding your feet to the fire. We appreciate that you stand up on what you say, John.

JOHN COLE SCOTT: Always happy to do so. Wish everyone the best for 2023.

CHUCK JAFFE: The NAVigator is a joint production of the Active Investment Company Alliance and Money Life with Chuck Jaffee. And yes, that's me, and you can learn more about my work and my show at MoneyLifeShow.com, or check us out wherever you find 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, the one and only John Cole Scott, who is chief investment officer at Closed-End Fund Advisors in Richmond, Virginia, chairman of the Active Investment Company Alliance. The firm is online at CEFAdvisors.com, you can dig into their research at CEFData.com, and John's on Twitter @JohnColeScott. The NAVigator podcast is available every Friday and we'll be back in 2023. Happy New Year, everybody, and happy investing.

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