CEF Advisors' Scott On How The '23 Hot Start Changes The Closed-End Landscape

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Chuck Jaffe, in this episode of The NAVigator podcast interviewed John Cole Scott, president of Closed-End Fund Advisors and the chairman of the Active Investment Company Alliance. Read the Q&A below as John and Chuck discuss how closed-end funds responded to the year-end rally and then the sharply bullish January, examining which sectors and fund types came out ahead and where the opportunities appear to lie now. He's got details – and fund picks – across various sectors and asset classes on where to look for continued growth and income as the rally continues to take shape and play out.

John Cole Scott

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CHUCK JAFFE: John Cole Scott of Closed-End Fund Advisors is here and we're talking about the market's holiday rally and hot start to 2023 is playing out in closed-end funds, welcome to 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 brings us back in the direction of John Cole Scott, president at Closed-End Fund Advisors in Richmond, Virginia, which is online at

CEFAdvisors.com. And well, when John is here we typically talk about some of the firm's research, you can dig into 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: Now we were talking at the end of the year, but we were doing it before the 4th quarter wrapped up, and of course we wound up seeing a January trifecta; a Santa Claus rally for the market, a good start to January, both in the first five trading days and the whole month, and closed-end funds had been particularly sensitive all throughout 2022 to every market move. Tell us how that's continued and what's setting up thus far this year.

JOHN COLE SCOTT: Sure, and before we start into our how we view January, I just want to remind your audience if they're not aware, our firm holds a quarterly research call. It's on our website and you can download the 60 data slides for free without any registration to help you out and give perspective on where we ended the year. But for 2023, average closed-end fund is up 12% year to date market price total return, and it's up 7% net asset value, that's a solid 5% discount narrowing for the universe and that's basically double the average January Effect that we usually see most years. It's also interesting to look back to the end of third quarter, because December was tough but not a bad quarter for a 4th quarter, closed-end funds are up almost 20% since September 30th, and that's 5.5% discount narrowing. And so the January Effect as you mentioned, is definitely full in force. When we dig a little deeper, it's interesting because the munis, a third of the universe, the discount has narrowed less than 1% this year because even though rates are higher, there's still a lot of concern for I would say the dividend cuts that have been pummeling that sector. Preferreds, they've narrowed 4%, again less duration, a little less cuts in that sector but still some pain. Equity funds have only narrowed 2%, and taxable bond funds have narrowed 4.5%. When we looked in the January data, 10% of the universe cut their distribution 10% or more, so we talked about all of the dividend cuts from '22, we said we didn't think they were done. They're not as large for many cases as during '22, but they're still significant.

CHUCK JAFFE: If I'm a shareholder, the discount narrowing is good, that means that we're getting closer to net asset value and I'm making some extra returns. But if I'm a buyer, in other words, if I'm looking at funds to buy now, would I be more likely to say, I want to go towards muni funds or I want to go to equity funds, where discounts did not narrow as much, because that's where I'm still likely to find the bigger bargains?

JOHN COLE SCOTT: Yeah, and we looked into where yields are and the fact that there were dividend cuts last year, last month. But right now, if we look at our index where it's the seven most liquid funds in 15 groups, so a nice 100-fund equal weight litmus for the closed-end fund universe, the average discounts narrowed to 3.4%, leverages blending to 25%, and we're showing a 9.2 yield. Well, go back a year ago, January 31st of '22, it was a tighter discount, a 1% discount, leverage was a little less, 23%, but we only had a 7.9% indicated yield, now the yields are 16% higher. And we looked for the dividend growth rate for all hundred funds in that index, it's slightly positive. So as long as you are diversified, you are dollar neutral in yield, but the indicated yields are higher than a year ago because NAVs are much more beat up. Sometimes people think the best yields are from wide discounts, that's always true, but a medium discount and a beat up NAV is also a large yield.

CHUCK JAFFE: Let's talk about what sectors have outperformed this year, and as we get into February, if you think that outperformance can continue. Or if you're going the other way, they've outperformed but you want to not gravitate towards them now that they've gotten hot.

JOHN COLE SCOTT: The average is up 12% year to date, everyone should be happy with a one-month return of that amount. The REIT real estate sector's up 17% but still down 10% on a one-year total return basis, and convertibles are up 18% and again down 11% on a one-year total return. So they had wonderful months but they are the great feature of closed-end funds that the contrarian investor can find spots. And I would say that while we always would love to invest in the past when things were wider, those are still both very attractive sectors in our opinion for our thesis on the year. And then just for perspective, BDCs are up 11% but only down 2% on a one-year basis, and we're in the middle of BDC earnings season so we should see some cool movements for the better funds in that sector. And then remember, munis are up 6% year to date but they're still down 13% on that one-year basis, and we're seeing some real fat discounts there. Remember I said they didn't narrow as much as the others. And taxable bond funds are pretty similar, 11% up, they're still down 8% on a one-year basis.

CHUCK JAFFE: People hear you talking about moving things around, and at the end of the last year there was tax-loss harvesting going on, you were doing a lot of it, we talked about it on The NAVigator. And it raises a question, because I know fans of The NAVigator like closed-end funds, but how much should they like them? I mean, if you're buying stocks, you're not really diversified if you have five or six or 10 stocks. But if you have five or six or 10 mutual funds, you might be over-diversified depending on what you're trying to do. Closed-end funds, more specialized than general purpose mutual funds, but help people understand, how many closed-end funds do you want and here do you start to go, "This is getting a little bit hard to manage"?

JOHN COLE SCOTT: So at a basic level we believe in being a fundamental investor first and then using the closed-end fundedness second. So asset allocation decisions, how much muni, how much energy, how much foreign, how much different part high-yield senior loan, these are investment decisions where then you can go choose so many different structures. That always starts the conversation of our work for clients, and then we're picking the spots, the fund. And we've always talk about it's more than discount and yield, it's manager analysis, it's dividend risk, and it's relative comparable, and absolute discounts not just a fat discount, and we look at real yields versus manipulated yields. Now we'll buy wide discounts and fake yields if they're good total-return stories not income stories. And we do find that many investors tend to have less than 10 funds because they like to really follow them and know them, or investors seem to have 75-80 plus funds because they're so worried about one bad decision. Our portfolios tend to be more 25-35 closed-end funds, we don't like to put less than 2% in a regular closed-end fund and smaller allocations to MLPs and BDCs because they're more volatile. But again, we can do that with higher numbers for two reasons, one is our software gives us granularity at the guts and the closed-end fundedness of the allocation. We don't know what's going to happen, and if we like different managers, we don't know which one's going to have a discount pop or widening and we can react to that for our clients in a way that we couldn't if we only had our 10 best funds.

CHUCK JAFFE: Now of course we need to talk about building a portfolio. I don't think you've ever come on without having a couple of fund ideas, so let's talk about what you're looking at right now and is it new? Is it a new idea because the market's done so well in January? Or is it an old idea that's playing out and keeping going?

JOHN COLE SCOTT: First with all of those huge dividend cuts this month in munis and preferreds, I wanted to look in those sectors, and the first fund is CXE, it's the MFS High-Income Muni Trust. But just for clarification, it's still 60% investment grade and 25% non-rated bonds, so it's not a pure high-yield muni. It's sporting a 12% discount, a 4.2% yield, 40% leverage, but the last three months the NAV is up 14%. But like I said on the show a month ago, it's a 16 duration, and I'm comfortable with rates currently stand, buying that fund at a fat discount. The preferred fund is NPFD, it's the Nuveen Variable Rate Preferred Income Fund. It cut its dividend 13% last month, it's sporting almost a 10% discount, a 6% yield, and a 12% three-month NAV total performance. What I like about it is it cuts the yield possibly too much, the leverage-adjust NAV yield is just a hair under 4%, and preferreds that are being put in the portfolio are generally over 4%, so this is a nice dividend growth story later in the cycle. We then went back to one of the same funds I liked a month ago, MEGI, it's the MainStay CBRE Global Infrastructure Fund, it's still at a 14% discount, it's an 8.5% yield with a third leverage, and it's up 17% on a three-month NAV basis, but very attractive in the market and it is currently in ownership from Saba alone, an activist in this space. We then wanted to round it out with a senior loan fund, we like that sector right now. The loans are cheap, the discounts are cheap, but the double discount in our experience, BGB is Blackstone Strategic Credit Fund, it's a 10 and mid-change discount, it's a 9% yield with 36% leverage, in the last three months it's done almost 6% NAV performance. And finally, BDCs are different than closed-end funds but cover them actively, we have our UIT product. We still like TSLX that we talked about a month ago, but the current best in our opinion today BDC is Oaktree Specialty Lending, that's OCSL. It's around net asset value but we find that very cheap to where Oaktree can take the portfolio. It just had a reverse split and a merger, corporate actions that I find confuse investors and have widened the discount. It currently is at a 10 and mid-change yield, 49% leverage, and its NAV is up 5% in the last two quarters. It's a great way to get illiquid private loans, and again, it's an example of a zero discounted premium in my opinion as a great, cheap deal today.

CHUCK JAFFE: John, really interesting. Thanks so much for joining me on The NAVigator to talk about it, we'll do this again soon.

JOHN COLE SCOTT: Always my pleasure, thanks Chuck.

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 all about my hour-long weekday podcast by going to MoneyLifeShow.com or by searching wherever you find great 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, president of Closed-End Fund Advisors in Richmond, Virginia and the chairman of the Active Investment Company Alliance. The firm is online at CEFAdvisors.com and you can dig into their data at CEFData.com. John's on Twitter @JohnColeScott. The NAVigator podcast is available every Friday, be sure not to miss that or any episode by following or subscribing to us on your favorite podcast app. We'll be back next week with more closed-end fund talk, until then, happy investing everybody.

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