WallachBeth's Trading Director On CEF Liquidity And Execution

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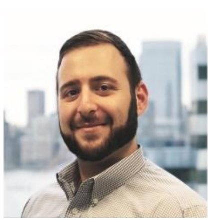
Chuck Jaffe, in this episode of The NAVigator podcast interviewed Michael Beth, director of trading at WallachBeth Capital. Read the Q&A below as Michael says that for all of the growth in the closed-end fund space, the amount of trading done each day is relatively small compared to other investment vehicles, which creates challenges for investors to get efficient execution on trades. Beth notes that conditions can make it so that an investor trying to buy a fund at a 10 percent discount could see as much as one-tenth of that benefit wiped out if 'the implicit cost of execution' meets with poor execution.



Michael Beth

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

CHUCK JAFFE: I'm talking with Michael Beth, director of trading at WallachBeth Capital, about the importance of liquidity and execution in closed-end fund trades, this is 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, 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 we're looking in the direction of Michael Beth, director of trading at WallachBeth Capital, a firm that provides what the investment world calls backroom office solutions, the nuts and bolts of trading. Most importantly. of trading efficiently. To learn more about WallachBeth, it's the name of the firm, go to WallachBeth.com. And to learn more about business-development companies, interval funds, and closed-end funds generally go to AICAlliance.org, the website of the Active Investment Company Alliance. Michael Beth, welcome to The NAVigator.

MICHAEL BETH: Hey Chuck, thanks for having me. Appreciate you having me here.

CHUCK JAFFE: Let's set some background here. Because on the one hand, closed-end funds and investors that have them, they don't trade the way people are trading ETFs and moving the SPDR and things along those lines. On the other hand, that makes them more of a trading challenge. So let's help people understand, A, what closed-end fund investors are facing, and B, the importance of reducing friction. I mean, it's not quite as simple as Benjamin Franklin saying, "Beware of little expenses. A small leak will sink a great ship." Most people don't understand necessarily how much friction we have and what those leaks amount to.

MICHAEL BETH: Definitely. The one thing I would note is the CEF universe has grown tremendously over the years. There's about $199 billion of notional in the market right now across 400 plus funds. But of that notional, only $600-800 million of daily turnover. So that just shows you that there's less than 1% of the overall notional trading each day. Some things that tend to impact the closed-end fund market compared to, let's say open-end such as ETFs, would be the lack of accretion redemption mechanism. So that does cause a trade at either a premium or a discount. What we try to do is we try to go and navigate this market that does not have as much liquidity and connect the different types of exchanges, ATSs, other alternative trading venues, and sniff out that hidden liquidity.

CHUCK JAFFE: What does that amount to? Is it about whether or not I can get a trade, get a trade at the right price? Is this where I've got some closed-end fund that is not necessarily moving much, and I get it as an individual investor it may not be an enormous amount. But whether it's me or an institution or an advisor who works with closed-end funds, is it really about making sure we can get our trades or is it about making sure we can get our trades without having to suddenly pay a lot more to get them done because we happen to own something that's not really liquid?

MICHAEL BETH: As I mentioned, these closed-end funds are trading at a premium or a discount. Not everyone's looking sell at deep discounts, not everyone's looking to buy at high premiums. So what tends to happen is that liquidity becomes very fragmented, where certain people in the market are looking for liquidity at different times. Which is really important to be able to find the different types of counterparties that would be interested in taking the opposite sides of those trades. So on our end, we basically connect the dots between wealth managers, loan-only funds, other institutional types of proprietary traders, and basically have people with different views that will be able to transact against each other. So we do this a couple different ways, one way is just natural liquidity. We personally talk to these different types of counterparties and we connect the dots between them, and with the enhancements of technology over the years we've been able to create different types of crossing engines and things like that. In addition, wholesaler liquidity is so important. Wholesalers tend to have access to most of the retail liquidity out there and they typically run single-dealer platforms to basically layoff that liquidity to the rest of the market, so it is really important to be checking there as well as the different types of ATSs and exchanges. Initially it was really just the NYSE and the NASDAQ, right? If you talk years and years ago. But nowadays there's 13 plus lit exchanges, 50 plus ATSs, and you could say there's a lot of places to go with your stocks. Our goal is to basically look at venue history, see where symbols have been trading, and basically aggregate those venues together.

CHUCK JAFFE: Which de facto means you are kind of playing the role that in the stock exchange used to always be played by a market maker. You're the one who's trying to make sure that there is liquidity whether there's really demand for the shares that are out there or not.

MICHAEL BETH: Exactly, that's where we fit into the market. So while we don't play the sense of a traditional market maker, we're the ones who on an agency-only basis are looking for the buyers and sellers, understand their motivations, and are able to connect them to basically have good success. Because at the end of the day, if you're trying to buy something at a 10% discount but all of a sudden you have to pay a full spread that could be upwards of a 100 best, you're losing 1% on that trade right away.

CHUCK JAFFE: What are the strategies that you use to optimize execution? You've talked about some of them, but if somebody is putting in an order and they want it to go through efficiently and they're dealing with something that is not particularly liquid, what are you going to wind up doing?

MICHAEL BETH: It's really important to protect the order from information leakage. The way we do that is by accessing ATSs where we can actually go and intelligently navigate within the spread. Because when you're looking at a, let's say 100 basis point-wide spread, something that we can do is we can check at those different price points within that 100 basis points. So that does not display your order, it does not take from the lit screen, but the only dissemination of market data is that there was a trade that happened within the spread. So we're basically able to hide clients' order sizes, we're able to quietly access the market, and we provide anonymity every day to our clients so that no one knows who's really taking the other side of the trade. Another tool that's really been helpful is basically replicating more of the proprietary trader workflow, where they're looking at trading versus a discount or a premium, and they usually do that by checking the correlation to an ETF. So what you can do there is let's say you're trading a high-yield closed-end fund, you can then reference that versus an example of a high-yield ETF, and you can basically trade on a relative offset basis. So just to explain what that means is that as the reference security increases or decreases in value, you will synthetically adjust your limit so that you won't get run over if all of a sudden there's this big change in the reference price but the subject hasn't moved yet. So it's a good way to protect your order flow, and that's something [inaudible].

CHUCK JAFFE: Are there also liquidity problems? People mention it with certain types of funds, things like interval funds where they don't trade often, but when they do trade does it become a problem? Or is that, hey, we've opened up a liquidity gate, so it's not a problem because we're in the window?

MICHAEL BETH: Yeah, actually we take this approach to all more illiquid securities that are infrequently traded. The way we look at it is that liquidity events happen sporadically and you just need to be there to be able to access them, because at the end of the day for any trade or for liquidity to be available there needs to be buyers and sellers. So it's really important to basically have a counterparty or a trading partner that you can trust and rely on to be there for you to provide you market color and when these different types of events occur.

CHUCK JAFFE: The cost of execution doesn't come out in an expense ratio, it's a transaction cost so it's friction. And doing it improperly could mean a difference of, as you pointed out, 100 basis points, 1% annually if you add it up over all those trades. So this is straight off the top, right off your return, if you're not trading efficiently, somebody's paying for it. But oh by the way, they usually don't know that they're paying for it.

MICHAEL BETH: That's what refer to as implicit cost of execution, and that's something that everyone's trying to mitigate every day. As we've seen, it's been really talked about in the news a lot, talking about adverse selection and not actually trading at the prices you would like to, to basically get that liquidity. So there's always that tradeoff between decay in basically the alpha that you're looking for as well as in market impact, so of course the longer it takes for you to trade, the more likely that the alpha will decay. However, on the adverse side, if you do try to trade very quickly, there might not be enough liquidity in the market. So once again, that's why I have to reiterate that it's always important to have a trusted partner who can help you with that type of market color to run pre-trade analysis and basically help you plan how you're going to execute your trade.

CHUCK JAFFE: Michael, really interesting. Thanks so much for joining me on The NAVigator to talk about it.

MICHAEL BETH: Thanks Chuck, it was really great being here.

CHUCK JAFFE: This has been The NAVigator, which is a joint production of the Active Investment Company Alliance and Money Life with Chuck Jaffee. And yes, that's me, you can learn all about my hour-long weekday show at MoneyLifeShow.com or by going wherever you go to find your favorite podcasts. 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, Michael Beth, he's director of trading at WallachBeth Capital, and you can learn more about the firm and what it does at WallachBeth.com. The NAVigator podcast is new every Friday, we hope you'll ensure that you don't miss anything by following us on your favorite podcast app. And if you like us, please share us with a friend because we'd love to have more of you here next week. And until then, happy investing everybody.

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