Sit Funds' Doty: Banking Woes Are Creating Closed-End Opportunities

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Chuck Jaffe, in this episode of The NAVigator podcast interviewed Bryce Doty, senior portfolio manager at Sit Investment Associates. Read the Q&A below as Bryce says that the problem at the heart of the current banking crisis is not a default problem, but rather is a logical outcome from how quickly the Federal Reserve raised interest rates. He expects it to keep impacting the value of fixed-income securities until things stabilize; that in turn will create more opportunities for closed-end fund investors who should benefit from good yields now and additional returns when widening discounts narrow once the banking industry and investors are less worried about insolvency.

Bryce Doty

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

CHUCK JAFFE: Bryce Doty, senior portfolio manager at Sit Investment Associates is here, he's a fixed-income money manager in the middle of a banking crisis. Oh yeah, we have stuff to talk about now on 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's 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 Bryce Doty, senior portfolio manager at Sit Investment Associates, which has about $15 billion in assets under management but about $9 billion of it is in taxable bonds, with about $2 billion of that in closed-end fund of funds for separate accounts. You can learn about the firm and what it does at SitInvest.com, and to learn more about business-development companies, interval funds, and closed-end funds generally go to AICAlliance.org, the website for the Active Investment Company Alliance. Bryce Doty, welcome back to The NAVigator.

BRYCE DOTY: Thanks for having me, Chuck.

CHUCK JAFFE: As I said during that introduction, The NAVigator is all about all-weather active investing. Well, there are more than a few storm clouds right now, especially in your neck of the woods. So tell me, how do we ever get back to sunny skies? And how bad is this storm if you're a closed-end fund investor and sentiment is going out the window, and you're looking at discounts getting wider and maybe much wider from here?

BRYCE DOTY: Right, the storm clouds that are out there right now cut both ways for closed-end bond fund investors. For people that are just investing in stocks and bonds, these storm clouds are pretty daunting. You've got the Fed in a box, they caused part of the problem that's plaguing banks right now. Yet if they reverse course, they still have an inflation problem. So for an investor it's like, well, where do you hide? And the closed-end fund market has proven to really do well during these circumstances. I remember when we first started managing closed-end funds about 25 years ago, we would dread these periods of volatility knowing that the individual investor, there'd be a stampede for the door. Everyone's trying to get out and these discounts would just widen, and we were just so nervous about it. But now we almost look forward to it because those are the times when you can really make some decent money. Especially when you take into account that closed-end funds are the only ones that don't have to deal with withdrawals. The banks are having massive withdrawals, regular mutual funds, ETFs, they get hit with withdrawals all the time. But the closed-end bond funds, they take the cash flow that they're getting and they buy everything cheap. It's almost like going back to *Trading Places* where Eddie Murphy at the end is like, "Buy! Buy!" And they're the only ones, they're literally the only ones that can do that, sit back and do that. So

not only do you get them really cheap because the discounts are wide, but you know they've been putting in really cheap bonds into their portfolio.

CHUCK JAFFE: At the same time, you're a bond fund manager and you know the struggles the bond market is facing right now, which no one's really talking about in the wake of the Silicon Valley Bank story, they're looking at bank failures. But what happens as an offshoot of this is that a lot of paper has been devalued or made a lot cheaper. So for a fixed-income manager, how much of this is a day-to-day, moment-to-moment struggle and how do you expect that story to play out? Because I need it to play out well if my closed-end funds own fixed-income securities.

BRYCE DOTY: Well, there's two really critical components to that question given what's going on with banks. The first one is, I'm going to just warn people right away to watch out for the preferred closed-end funds, because we looked at a few this last week and some have 5-7% exposure to Credit Suisse, just that name. So I would kind of warn people off about that. Now a lot of other investment-grade bond funds, we saw they had almost no exposure to the regional banks that are in the news. Now granted the holdings are old but they're typically quite stable, so we like the investment-grade funds right now because you can get 7% yield, a weighted average quality of A. I'd stay away from the high yield, and the bank loans, and the preferreds. And the reason for that is the second part about your question, is as a bond manager, because we're also buying $7 billion worth of bonds, is it's a minefield. You have to really be careful as to what you're buying out there because of the contagion effect that can come out of this First Republic mess that, we think if First Republic goes down you're going to have a lot of A-rated bank bonds plummet in price, and that creates a whole other second derivative problem to all the other banks that own each other's bonds, so it's not a surprise that we saw today there's a coalition of banks trying to come in and prop up First Republic. The thing that I worry about is that if it's not a government, an FDIC, or a Fed-supported solution, I'm not sure if it's going to hold. So as a bond manager there's some good news that we've had here, we've actually just sold more bank bonds and we're getting down low. Now the other industrial bonds and things like that are holding in, consumer bonds, consumer goods and things like that are all doing quite well, so you simultaneously have these really high-quality safe sectors and then you've got these occasional landmines that you have to worry about in the banking sector.

CHUCK JAFFE: We need to point out that we're recording this on the 16th after the market is closed. Everyone needs to know the timing because by the time people hear this, First Republic could have resolved itself for better or worse. But let's talk about that resolution here, because separate from propping up First Republic, we're watching regulators whose solution to this point has been, "We'll make sure everyone is whole." If there is building pressure, shouldn't the Fed just go, "Hey, you know what, we may hate inflation levels but let's reverse that last 50 basis point hike, take a step back and give everyone a breather. I mean, we can revisit rate hikes down the line"? Wouldn't that solve the problem?

BRYCE DOTY: That would, this is not a default problem. We are not seeing widespread defaults anywhere or all these losses, it's purely because the Fed kept rates so low and then just jacked them up so fast, no one could possibly readjust their bond portfolios to avoid the losses. The Lehman Aggregate Bond Index was down 13% last year, its previous worst year ever was 3%, and that caused a ton of problems. How did the Fed not see this coming? And they are the ones that are instigating, so clearly they can reverse it. They wonder why in the seventies it looked like the central banks eased up on fighting against inflation. Rather than understanding that maybe it's because all these higher rates were causing lots of widespread systemic problems, they came away from that period thinking, which is just ridiculous in the first place, right? Using a time period with no pandemic and OPEC and all that kind of stuff that was going on, and they took away from that that, "Hey, we have to really be tough on inflation and stay on top of it, and keep our foot on the neck of inflation." Well, but you just can't do that. Once the inflation genie's out of the bottle, you can't just stuff it back in, you've got to be smart about it. And so the Fed now might have to look at what was done in '08 to give banks liquidity, not to bail 'em out like they're doing with Silicon Bank, but just lending liquidity to these banks by allowing them to once again issue bonds out to three years with a government guarantee.

CHUCK JAFFE: I hate to say where my mind goes during interviews, but as you talked about stuffing the genie back in the lamp, I'm going to a Bugs Bunny, Daffy Duck cartoon from my childhood where Daffy's pushing the genie back into the lamp, and once he does, "Down! Down! Go! Go! Mine!" the genie comes out angry and takes it out on him. That's the scenario we're looking at.

BRYCE DOTY: For sure.

CHUCK JAFFE: Does the real-life non-cartoon version have a happy ending? It doesn't look like there's contagion from the point where Silicon Valley Bank's problems will take other banks down and out, but Silicon Valley Bank presented some unique problems and its case reflects certain symptoms that it was showing, and those symptoms are visible elsewhere. Now there's a worry about whether everybody finds this problem wherever it even lightly exists, and they run away from other banks the way that they did Silicon Valley Bank. That could create a pandemic of bank collapses occurring indirectly because of the first sick patient, right?

BRYCE DOTY: In a way it's a good thing that there was a bank that had trouble that didn't have a ton of individual retail depositors. It's a great shot over the bow saying, "Look, this is an issue," and it shined a spotlight on something that really needs attention. You would see some people make fun of the investors that were making a bet on the Fed pivot saying, "Oh, you just think they're suddenly going to change their mind on inflation? What a fool." And it's not that, it was a mathematical calculation of knowing how under water, not just banks but insurance companies are, and anyone that has to worry about disintermediation. Where they're going to take cash out of a deposit account that's making 0.1% and putting it in a money market to make 3, 4, 5%. And so you knew that it was just a matter of time before the Fed was going to have to put on the brakes. The other calculation that you need to keep in mind when you think about the peak rate on the Fed is when will inflation go below Fed funds? Powell mentioned it only once and no one caught it, that once Fed funds has a positive real rate, then you know you're kind of where you need to be in terms of slowing inflation. And inflation in the second quarter's going to dip below 5%, and the Fed is almost at 5%, so we know that we're at kind of a terminal valuation even without the banking issues. Given the banking issues, it's hard to imagine the Fed being so unaware of the situation that they would continue to push rates higher and higher and higher.

CHUCK JAFFE: Last question. You said this is a good opportunity, but a good opportunity in closed-end funds is typically not something where we can say, "Look at how much money I make in the next quarter or the next year." So how long will it take for this good opportunity to pay dividends, literally and figuratively?

BRYCE DOTY: Yes, so the 7% dividends are juicy, the discounts, we're looking at funds that are around 8% below their net asset value, but they could dip lower. So we're not pulling the

trigger just yet, maybe we'll miss it, but we think that over the next quarter you're going to have a lot of really good opportunities. If you can get a fund at a 7% yield and 10% discount, you just buy it. Even if it's going to go to 12% discount, who cares? You're going to be fine. If you miss it a little bit, there's so much more upside to be had that I wouldn't worry about that either. It's like, "Oh, everything started to come back," and "Oh, I didn't get the exact bottom." That's all right, when these things recover you usually get two to three really strong years. If you have a three-year time horizon, 7% yield, that's 21%, and then you might get a couple percent from price recovery, that's a pretty good deal.

CHUCK JAFFE: Bryce, it's always a great deal when we get a chance to chat. Thanks so much for your time and for joining me again on The NAVigator.

BRYCE DOTY: Thank you.

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, you can check out my show on your favorite podcast app or by going to MoneyLifeShow.com. 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, on Facebook and LinkedIn @AICAlliance. Thanks to my guest Bryce Doty, senior portfolio manager at Sit Investment Associates, which manages $2 billion in closed-end fund of funds for separate accounts and $9 billion in fixed-income investments, and $15 billion overall. Learn about the firm at SitInvest.com and about its funds at SitFunds.com. The NAVigator podcast is new every Friday, make sure you're following along to not miss anything. We'll see you again next week, and until then, happy investing.

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