Roxanna Islam, CFA, CAIA-Associate Director of Research @VettaFi on Opportunities in ETFs of CEFs

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Roxanna Islam

Roxanna Islam sat down with Jane King on August 3rd, 2023 for a NAVigator Interview and discussed the Opportunities in ETFs of CEFs.

The podcast can be found on AICA's website by clicking here:
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Jane King: Roxanna Islam is an experienced equity analyst with 12 years in the investment industry, with in-depth knowledge of macro trends with a background in transportation, logistics, and electric vehicle industries. She's also the associate director of research and head of sector and industry research at VettaFi, and in this role Roxanna is responsible for research on the ETF market with a focus on sector industry and also thematic ETFs. So Roxanna, great to talk to you and learn about ETFs and closed-end funds. Let's just start with that, defining ETF and a closed-end fund, and what's the difference and why would somebody choose one over the other?

Roxanna Islam: Yeah, sure. So first of all, great to be here. There's a lot of similarities between ETFs and closed-end funds, ETFs are generally more well known than closed-end funds though. And right now there's actually a lot of exciting things happening in ETFs, you have a lot of different types, you have active, you have single stock. So these are mainly passive products which track an index and are typically used as long-term core holdings, and because of this they have lower expenses than say, a closed-end fund would.

So closed-end funds, generally lesser known by the average investor, but they do have some interesting features that make them very attractive. So first of all, you can buy them at a discount, sell them at a premium so there's a lot more interesting supply-demand dynamic behind them.

They tend to be typically actively managed, so they typically produce large distributions and many investors use these for income rather than growth or total return.

Jane King: Oh, interesting, okay. And so why would you put an active closed-end fund into a passive ETF wrapper? And how does that work exactly?

Roxanna Islam: Yeah, so a lot of people ask about this, because when you're putting closed-end funds into an ETF wrapper you're looking at a fund of funds structure and it does have that extra layer of fees. But first of all, I think anytime you put any sort of investment into an ETF wrapper, the main thing you're getting there is diversification. So if you are an investor, for instance, that's interested in closed-end funds, you can basically get a weighted average exposure to the closed-end fund universe, which means you may be sacrificing some outperformance but you're also protected a bit on the downside

So for example, if you see a manager cut distributions across its family of funds, you may be a little bit more protected from that if you're investing in an ETF of closed-end funds where there's a diverse range of holdings within your ETFs. So this can open up, it's typically a specialized space to a broader set of investors, but on the other hand if you are a more experienced closed-end fund investor it's still kind of useful to have some of these ETFs of closed-end funds as a type of core holding so you sort of have this safety net of distributions available rather than attempting to predict distribution cuts of price movements for instance.

Jane King: So what would be the available options then for ETFs or closed-end funds?

Roxanna Islam: Yeah, so with ETFs of closed-end funds there's actually only five of these out there, they're actually very different from each other. There's two of these that are active ETFs, so I'm not really going to go that much in depth into those. They're pretty small compared to the others as well. So for reference, these are CEFS, which is the Saba Closed-End Funds ETF, and FCEF, which is the First Trust Income Opportunities ETF.

There's actually three traditional passive closed-end fund ETFs. So the first is XMPT, which is the VanEck Closed-End Fund Muni Income ETF, so this one represents the municipal bond closed-end fund market. I think this one appeals to a very specific type of investor who wants that exposure to municipal closed-end funds, and the other two I think are more for investors that are interested in the option of gaining access to the broader closed-end fund universe.

So the first of those is PCEF, which is the Invesco Closed-End Fund Income Composite ETF, this is the oldest and largest closed-end fund ETF and it actually attempts to benchmark to the taxable closed-end fund universe while excluding some of the closed-end funds with larger premiums or with higher fees. Also it's rebalance and reconstituted quarterly, so all of that sort of replicates active management while still putting it in a passive wrapper.

And its closest comp is an ETF called YYY, which is the Amplify High-Income ETF. So this one's a little bit different, instead of trying to replicate to the broader closed-end fund universe, this one has a primary objective of monthly income. So in contrast to PCEF which holds about 120 different closed-end funds, this one holds only 45 closed-end funds and it weighs them slightly differently so that it emphasizes the distribution rate a little bit more. So this is why this one has a slightly higher distribution rate than PCEF, it's sitting at about the low 12% range compared to PCEF which is in the mid-10% range.

Jane King: Oh, my goodness. So a lot of options, which is great, but it's also kind of confusing to learn about these different options out there. Are you finding investors are becoming more cautious? We've had a pretty good year so far with the stock market, are you finding though as we head into the second half of the year people are getting a little more cautious?

Roxanna Islam: Yeah, so it's an interesting year, and I think maybe the past few years have all been sort of interesting years, but this year's sort of seen two competing sides to a story. So on one hand you have a lot of interest back in those tech stocks, there's also AI, people are a little bit more interested in crypto and some of those thematic funds out there that were really out of favor over the past year. At the same time, we're seeing some signs of weakness in the stock market and the economy, so we do have some investors that are sort of pivoting and looking a little bit more at fixed-income and other income generating products instead of those growthier equity segments.

So many of these individual closed-end funds, they actually have distribution rates of 7-12% range, and then we have these passive ETFs of closed-end funds I mentioned that I have rates of 10-12%. And if you think about it, that's higher than a lot of these other income-generating ETFs out there like the MLPs and the high-yield bonds, so I think for cautious investors who are looking to get a little bit away from growth and into something that's income-oriented, I think these are some good options, especially if investors want to take a more familiar route and use ETFs. So both PCEF and YYY actually are good ways to take a hands-off approach to accessing some of that yield in the closed-end universe without actually becoming a closed-end fund expert yourself.

Jane King: Yeah, very interesting. And 10-12% is not bad, it's a nice steady income that you can bring in. Roxanna, thank you so much for joining us and sharing your expertise.

Roxanna Islam: Thank you. Thank you so much for having me.

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