John Cole Scott Reviews A Rough Quarter For Closed-End Funds

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Chuck Jaffe, in this episode of The NAVigator podcast interviewed John Cole Scott, president of Closed-End Fund Advisors, the chairman of the Active Investment Company Alliance. Read the Q&A below as John digs into his data to give a recap of the third quarter for the closed-end fund industry, noting that municipal bond funds and REIT funds particularly took it on the chin, with the entire categories being down during the period by 10 and 7 percent respectively.

Business-development companies were the top category based on average returns, but senior loan funds were the can't-miss asset class, with all of the funds there being up in the third quarter.

John Cole Scott

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

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CHUCK JAFFE: John Cole Scott of Closed-End Fund Advisors is here and we're reviewing what happened to closed-end funds during the third quarter, 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'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 it's bringing us back in the direction of John Cole Scott, president at Closed-End Fund Advisors in Richmond, Virginia, which is online at CEFAdvisors.com. We're about to dig into the firm's research, and you can do that yourself at CEFData.com, and John is also the chairman of the Active Investment Company Alliance, which you can learn about at AICAlliance.org. John Cole Scott, great to chat with you again.
JOHN COLE SCOTT: Always good to be here, Chuck.
CHUCK JAFFE: So this is the 47th consecutive quarter that you at Closed-End Fund Advisors have done a quarterly overview, a quarterly review, and we want to just dig in and see what happened. So let's start with asset flows in closed-end funds.
JOHN COLE SCOTT: Yeah, so over the course of the 60-minute session, we'll cover 65 slides, we're going to cover the highlights, the most timely pieces here. And so the listed closed-end fund universe is about $315 billion in gross assets, the listed BDC universe, about $130 billion, a look at interval closed-end funds, $85 billion, the non-listed private BDC market's about $155 billion, and when you bring that together with traditional funds, if you combine listed closed-end funds, interval funds, roughly $400 billion or 58% of the assets, and then the total BDC marketplace is $285 billion in investments, that's 42% for just over $700 billion in total universe assets. And again, it's worth noting this year, though it's been said before, zero IPOs, three closed-end fund deaths, and 12 mergers.

CHUCK JAFFE: And we should point out, as you talked about this being in a slide and part of a presentation, this was part of a presentation that you made this week, it is available to folks by going to CEFAdvisors.com/quarterly. So we're going to keep picking at more of this, and we maybe put it out of order, but if you want to get in and be watching or check out more of what John is saying, that's where you're going for more information. Okay, so now we know what's been happening with asset flows, what about total return?

JOHN COLE SCOTT: Yeah, so the average closed-end fund, which includes BDCs in our index, is up 2.4% total return for this third quarter, however they're still up 6% year to date, and on a one-year basis, +13%, about 70% of closed-end funds had negative quarterly returns and 89% of the funds ended below the net asset value or at a discount. But let's talk about some of the sectors that were winners, BDCs still only 86% of the funds where it had positive returns for the quarter, but they averaged 7% in the third quarter and they're up about 20% year to date, this is all total return. MLP closed-end funds, 93% were positive for the quarter, they averaged 3% and up 11% year to date. And the senior loan sector, another great winner, 100% of funds were positive on the quarter with an average 6% quarterly return, up a total return of 14% year to date.

CHUCK JAFFE: Well, that's our winners on total return, what about our losers on total return?

JOHN COLE SCOTT: So it shouldn't surprise investors based on previous conversations but the muni bond sector, 100% of funds were negative on the quarter at -10%, and that's roughly their year-to-date returns, also -10% total return. The REIT real asset category, every fund in the sector was off an average 7%, and they're off 5% year to date. And then a big basket of US equity, international, covered-call funds, 91% of these funds were negative on the quarter, a 4.5% pullback, however that group being equity based is up 7.5% year to date.

CHUCK JAFFE: Now as we pointed out, we were discussing total return. Anybody who is a fan of closed-end funds is also wanting to look at net asset value, the NAV in NAVigator here, so were there winners and losers? Were they the same winners and losers when we were looking at fund performance by NAV?

JOHN COLE SCOTT: Great question. Some same, some different in the rankings. Senior loans up 3.5% NAV, MLP up 2.5%, but preferred up 1% NAV, duration asset getting hit on discounts. Losers, utilities and infrastructures off 9.5%, REIT real asset off 8%, muni off 7.5%, but convertible bond funds, the more equity side of bond, down 5% NAV. And those differences in two groups is the discount movement between the asset classes because that connects to the total result.

CHUCK JAFFE: Okay. Now of course what a lot of investors would tell you they're most interested in isn't necessarily total return or NAV, it's what kind of payout am I getting, what's happening with yields? So what was the yield trend?

JOHN COLE SCOTT: Yeah, so we tracked the press releases, about 7% of releases were positive for closed-end funds, about an average 11% increase, and when you benchmark it versus the previous year average which is 9%, it's positive. About 6% were decreases, a 7% average distribution cut versus that same one-year average benchmark of -11%, both of those trends are improving. Almost 70% of funds have changed their policy both up or down in the last two years, 44% have been cuts, an average of 15% in that period, 25% increase and an average 12%, and 31% have had no change in the last two years.

CHUCK JAFFE: And what kind of current yields should I be expecting?

JOHN COLE SCOTT: So looking at current yields is the forward-looking story versus the previous was the reverse, equity funds averaging 8.5%, but a one-year dividend growth weight of -2.5%, mostly because equity funds are generally down, but the three-year up 12%. Taxable funds, bond funds up a 10.8% indicated yield, dividend growth weight 6% one-year, 10% for three-year. Munis, they're currently looking at a 4.8% dividend rate, the one-year growth is -21% and the three-year, -26%, but it's worth noting that munis are federally tax-free, their tax equivalent yields are roughly 7-8% for many high-income earners. And of course the last sector we cover, listed BDCs, the debt BDCs about 10.7% yield with a one-year dividend growth rate of 12%, three-year of 18%.

CHUCK JAFFE: So we're seeing good growth there. Give us a little bit of perspective in terms of that yield growth over time, because obviously over the last couple of years we've watched interest rates pop, so I want to kind of know, have the closed-end funds kept pace?

JOHN COLE SCOTT: Yeah, so it's really important, remember the yield is the current policy of the board that's based over NAV, but then actually you buy and sell it at market prices, so discounts on NAV are very important. For the previous quarter and versus today, the REIT real asset funds have a 1% higher yield, which means like if a seven is now an eight, not 1% like a penny on a dollar, and BDCs are 40 basis points less, but that's because they're up so much, their dividends are growing but their market price has grown faster. If we go back to a really interesting time period, February 19th, 2020, we actually recorded a podcast, I was in the Abrdn offices in New York on muni funds that day, the average fund right now is showing an indicated yield of 2% higher than that pre-Covid pullback, because NAVs are down, discounts are wide even with the mix of all the flows. MLPs are only off 20 basis points, REIT real assets up over 400, senior loan up over 300, convertible up also over 300 basis points. It tells you how we're down on NAV, wide on discount, even with everything we've been through since pre-Covid.

CHUCK JAFFE: So here you are, you started to bring discounts into the conversation, that is the other big selling point around yield as well, so where are discounts now? Because we keep talking about how they are so wide right now, that's really been a historical truism for this quarter, wasn't it?

JOHN COLE SCOTT: It is. So for the whole universe, they've only been month-end wider 5% of the time since 1998, we use 25-year data at CEFData.com for the quarter-end. Equity closed-end funds, only 12%, taxable bond funds, 16%, and we alluded this could happen the last time we spoke, but muni closed-end funds have never been wider, 0% of the time wider, and almost 1% wider than the '08-09 month-end pullback. And if you think about all these discounts, wider times than right now, it was tech bubble crash, 9/11, it was Financial Crisis, the energy '15-16 recession, which wasn't the worst but still noticeable, and Covid, and that really tells us that the pricing is very, very steep with a lot of tailwind optimism of the next 12 months.

CHUCK JAFFE: I don't want to get too lost in the weeds on jargon, but given the distortion, if you will, when it comes to discounts, do we have a similar distortion when it comes to performance expectations? In other words, what's happening with these assets relative to the asset classes? How are closed-end funds doing when it comes to correlation with the assets they own?

JOHN COLE SCOTT: Yeah, so I mean, you do have to consider the NAVs that make sense for you, the asset allocation that makes sense for you, we do that for our separately managed account clients, but I find it fascinating, some similar tax-driven investments are very disconnected over time. We have 18-year quarterly NAV data, MLP funds, only 33% correlated to munis, preferreds only 52% correlated to munis, munis only 16% correlated to

BDCs, BDCs only 39% correlated to REIT or real asset funds, and then BDCs and senior loan funds, some might argue kind of the same thing, only 48% correlated, and then covered-call funds are very common for tax-driven investors, 55% correlated to BDCs and 44% correlated to munis. It's a great chance to know that you can diversify the guts by being in more than one sector, and we use more than one manager to build our client portfolios.

CHUCK JAFFE: Yeah, what that really means is, if you're going to diversify your closed-end fund portfolio, you're going to get the real benefits of diversification.

JOHN COLE SCOTT: It is, and you should note discounts sometimes move the same direction for the weirdest of funds because the retail market is what the retail market is. But we think if you've got good entry point, manage what you're doing with thoughtfulness, you can create a much better experience than being one fund and one sector.

CHUCK JAFFE: And lastly, one of the reasons that people go into closed-end funds is they're hoping that there's going to be a situation, and activist investors sometimes get involved and say, "Hey, this discount's a little too wide, let's do something about it. Let's capture our money." What's been happening with activism?

JOHN COLE SCOTT: So we did add a new slide this quarter on activism and activism followers flows, and the increase flows this quarter were the high-yield bond sector, the multi-sector bond sector, preferred and REIT real asset, and the decrease in flows or the pullback was in US international equity and senior loans. Looking at the 13D filings, which is the general way to catch the activist work, there were 23 in the quarter versus 13 on average for the previous year, but there's been 59 year to date, definite heavy year of 13Ds for the environment. And we talked about activists and the followers that often quietly work, not with them, but vote because they do their work as professional investors, it's about $18 billion in assets, and the biggest are Saba at $2.3, Karpus and Sit at $1.8, and 1607 Capital, also here in Richmond, at just around a billion.

CHUCK JAFFE: John, really great stuff. The quarter flew by, this flew by as best we could to get it all in, we'll talk to you again soon. Thanks for joining me again on The NAVigator.

JOHN COLE SCOTT: Always great to be here, Chuck.

CHUCK JAFFE: The NAVigator is a joint production of the Active Investment Company Alliance and Money Life with Chuck Jaffe. Yup, that's me, learn about my hour-long weekday show at MoneyLifeShow.com or wherever you get your favorite 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, on Facebook and LinkedIn @AICAlliance. Thanks to my guest John Cole Scott, president of Closed-End Fund Advisors in Richmond, Virginia, chairman of the Active Investment Company Alliance. The firm is online at CEFAdvisors.com and CEFData.com, John's on Twitter @JohnColeScott, and we have a link in the show notes to the portfolio we were discussing so that you can get all the information and take a good look at what's in there. The NAVigator podcast is available every Friday, be sure not to miss that or any episode by following us on your favorite podcast app. We'll be back next week, and until then, happy investing everybody.

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