John Cole Scott's early Q2 CEF update

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John Cole Scott, President and Chief Investment Officer of CEF Advisors, gives an update on the universe of closed-end funds (CEFs), business development companies (BDCs), and interval funds as the second quarter of 2024 gets under way. Scott provides perspective on CEF performance based on his advisory firm's various equity sector indexes. He also highlights specific funds that are doing well in the current economic environment based on discount, dividend, and manager analyses.

Review CEF Advisors' equity sector indexes and individual fund performance at CEFData.com.

Find here the video interview.

Jane King: John Cole Scott is president and chief investment officer at a registered investment advisory firm and is responsible for the executive duties of running the business. For over 21 years, he has specialized in closed-end funds and business-development company and interval fund data research as well as investing, and John is with me today. Great to have you here.

John Cole Scott: It's great to be with you, Jane.

Jane King: So now the equity market, we've kind of slogged through April. How have closed-end funds been doing in this environment?

John Cole Scott: Yes, you know, we're only three weeks into April and the S&P 500 is down about 6.6%, but we measure the closed-end fund universe with our all-sector equity index. It's down about 5.5%, but the net asset value, which is actually the manager's return, is only down 4.4%, about a third less volatile than the regular US markets. Not surprising, because the closed-end fund world is more likely to have value stocks, dividend stocks, energy, real estate, not the AI and meme stocks that sometimes get promoted in the market.

Jane King: That's right, and we have seen energy do pretty well. In fact, it’s outpaced tech this year, so yeah.

John Cole Scott: It's good to be diversified.

Jane King: It's good, yes. So are there some attractive funds available for investors and advisors to consider in this environment?

John Cole Scott: It is. You know, at Closed-End Fund Advisors we always focus on three things, discount analysis, dividend analysis, and manager analysis or the NAV. And so some funds that are rather attractive and relatively common in our client portfolios are AOD, it's the abrdn Dynamic Dividend Fund. It's at about a 15% discount, it's about an 8.8% yield, its beta versus the S&P 500 is like mid-70s, and its last month's NAV manager performance is only down 3%, so a little sturdier than we've seen in the US.

Another interesting fund, a little bit more volatile but it's the TortoiseEcofin, TYG. It's an MLP-focused fund, a sector that's actually done quite well this year with everything going on in the Middle East. Its discount’s about 18% and its yield’s about 9.5%, but its beta is about 1.09%, so definitely more volatile as you might expect in energy stocks to be right now. But its one-month NAV performance is actually up over 1%, the right direction versus we've seen other places.

And then in a similar vein, we've got the Nuveen REIT Real Asset Fund, it's JRI. It's about a 14% discount, it's a 10.5% yield, again its beta is in the mid-70s. But again it's down 3% in the last month, and that's half the negative return roughly we've seen for the regular US markets this year.

Jane King: Right. So now while these funds have done better when we've seen a down market, what about positions or what you can look for when things, if they should get more volatile?

John Cole Scott: So the good thing about closed-end funds is there's like 25 different sectors, hundreds, 423 funds, and so if you are more concerned about the future, you can still get attractive discounts and funds like FLC, it’s the Flaherty & Crumrine preferred equity fund. So preferred equity, it's not common stock, it's almost like a credit, basically it trades on the exchanges but it's more conservative. Yields about 7%, but as a tax-advantaged yield, usually a lot of qualified dividends in these sectors, and it's got a beta versus the S&P 500 right now of about 0.4. And the last month, it is down about three and change percent, but still if you imagine a tougher forward-looking year, a good place to be.

In the other vein, another really innovative and useful closed-end fund, it’s the Calamos Long/Short Equity Fund, ticker symbol is CPZ. It's basically an actively managed basket of long and short equity, and then convertibles, which is kind of Calamos’ historical focus, and they do light leverage on it. You end up with like a 0.7 beta versus S&P 500, and actually up 1% in the last month. Really those short positions and the asset allocation adding some ballast to investors.

Jane King: That's true, yeah. And it kind of protects you on the downside, it's like a hedge so to speak.

John Cole Scott: It does.

Jane King: So now there's a smaller number of funds that you typically place in client portfolios, but what kind of summary data would you give to investors to give them some perspective on this?

John Cole Scott: Absolutely. So we usually have 30 to 40 listed closed-end funds, we'll use a basket of interval funds to lower volatility, we tactically use BDCs or business-development companies which are a wonderful part of the listed universe. There's only five funds but they're all equity funds, average 15.5% discount. You know, really if you think about the 9.5% average yield, that's almost a little over 2% a quarter of recurring cash flow in your portfolio.

And we have two types of clients, those are really live off of closed-end fund distributions and those that love to see the cash flow and reinvest it because we're buying back in at discounts where we choose, and a wonderful thing to do in this diversified portfolio. People sometimes stress out about leverage in closed-end funds, they go, "Leverage is scary. It's going to magnify. Closed-end funds are volatile because of leverage." Leverage of 23%, it's way less than a bank, way less than all the mortgage REITs I'm familiar with.

It's, I'd say, additive and useful, and really helps you get for every market dollar in your portfolio, your clients portfolio if your financial advisor, $1.46 of manager assets with this example basket. So discounts and leverage really adds the ability for this 9.5% yield, the managers only just have to blend on average 6.5%. So when we talk to investors, not as much today, but three years ago, "How do you do an eight or nine yield? Interest rates are almost zero." Well, because discounts and leverage really magnify the payouts you can get.

Jane King: Yeah. What kind of advice would you give to investors, or final thoughts about what potentially could be a choppy market? It feels like we've got a lot of potential things that could happen this year with elections and all of that, what would you say?

John Cole Scott: Well, we've known each other a couple of years and I still don't know the future, but I know that a portfolio for an older investor, these funds on average, only 40% exposure to what's even in the S&P 500. While this is a wide discount, it's actually 6.5% wider than the peer group average discounts, at our firm we call that a comp discount.

And then we look at discount ranges, because some funds always trade low, some funds always trade high, this basket's at a 20% three-year range, and the three years we've seen have not been fluffy and all positive. And so what I'd say is you've really got to consider, we have to plan for almost every outcome. Inflation is stickier and trends higher, the federal government cuts rates, the Federal Reserve doesn't cut rates, we get a recession, we don't get a recession.

The beautiful thing about a portfolio of diversified closed-end funds, you don't have to have only one answer for only one outcome. You put low-correlation asset classes, you put the right closed-end fund in the right tax environment, and you're willing to rotate. Because these things on average in a three-year period, a basket of closed-end funds moves up and down 15 to 20% around their net asset value, and that's an opportunity to try to take some gains when there's fluff and to get in when there's carnage.

Jane King: Yeah, okay. Thanks, John, always good for somebody to consider this as part of their investment portfolio.

John Cole Scott: It is. And those that want to go a lot deeper, we do a quarterly 60-minute, 60-deck research call, and you can get to that at CEFAdvisors.com/quarterly.

Jane King: Awesome, thank you so much.

John Cole Scott: Great to be here, Jane.

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