ACTIVE INVESTMENT COMPANY ALLIANCE
Excellence beyond indexing

AICA Panelists: CEF Wrapper May Need to Swap Terms for Tenders

Despite uncertainty about coming changes to federal economic policy, two panels of closed-end fund (CEF) experts at a recent conference in New York City touted CEFs as the investment vehicle best equipped to withstand any Trump 2.0 shocks to the system.

But with activist investors exploiting wide discounts for CEFs and CEF IPOs having all but dried up, what does the future hold for the closed-end product itself? Several panelists at the Active Investment Company Alliance's (AICA) 2024 Fall Roundtable in New York City said they expect to see CEFs structured with more terms and updated with different fees.

CEFs may also soon incorporate tender offers and/or liquidity to help reign in discounts, some panelists said at the event held in lower Manhattan on November 13, 2024.

The Right Wrapper

Two Roundtable panels — one focused on the institutional investor outlook for CEFs and another on the future of CEFs themselves — framed their discussions largely in the context of the 2024 presidential election outcome. While acknowledging falling interest rates, some speakers expressed doubt that markets will rebound in the way that many expect.

"The possibility of the longer-end of the interest rate curve getting steeper … is a very distinct possibility," said Ryan Paylor, Portfolio Manager at Thomas J. Herzfeld, a 40-year old RIA focused on CEFs. So why invest in CEFs then? Paylor answered that CEFs don't have to deal with the same cash flow issues that mutual funds and exchange-traded funds have to.

"The closed-end fund wrapper is … the perfect wrapper to invest in fixed income," Paylor said. "In the closed-end fund structure, the underlying asset isn't nearly as volatile as the price action is," and because CEFs lack the same restrictions on illiquid securities as other funds do, they have more buying power and flexibility to act on market opportunities, he added.

Discounts are one such market opportunity, and with that in mind, Mark Milner, Senior Investment Strategist at Parametric — a division of Morgan Stanley that manages close to $1.3 billion in CEF assets — echoed previous panelists' endorsement of municipal bond CEFs as a potentially timely play.

Leaning into discounts is "never perfect," said John Cole Scott, President of CEF Advisors and Chairman of AICA. But he said active fund management can make the most of CEFs amid roiling activism and following on 2023's year-long dry spell for CEF IPOs.

Structural Changes to Spur Issuance

Activism aside, most of the market growth is in interval funds, unlisted funds, or exchange-traded funds, Milner noted. CEFs are "not the sexiest asset class," he said. But if you want to IPO a CEF, just look at the funds that are trading at a premium, Milner added. "There's certainly some good hunting ground there."

Ryan Paylor and John Cole Scott urged fund managers to be more proactive about keeping discounts in check — a sentiment echoed and expanded upon by speakers on the second panel discussing the future of CEFs.

After-market research is "really critical" if you aim to drive demand for shares at both the IPO and secondary market levels, said Stephen Minar, Managing Director, Closed-End Funds at BlackRock. He noted that many "2.0" limited-term CEFs have lacked that critical coverage, making them vulnerable to activist incursions. He added that fund mergers have helped address that issue but it has also reduced the number of active CEFs on the market.

"Nuveen continues to prioritize the educating and support of all closed-end fund investors, not just at the IPO primary stage, but throughout the fund's life," said Stephen Davis, Closed-End Fund Product Specialist at Nuveen. "Nuveen has a wealth of resources available to help advisors better understand and navigate the closed-end fund market."

Finbar Ward, an Executive Director at Morgan Stanley Wealth Management, suggested the market wasn't quite ready to reintroduce CEFs without terms (perpetual "1.0" CEFs). "I think that's going to take some time," he said. But he said further rate cuts could help build a cadence for new "2.0" IPOs, which could boost confidence in CEFs and make new structures possible, he added.

Andrew Hall, Senior Managing Director at Nasdaq, noted that funds with the word "term" in the name tend to trade much tighter.

But BlackRock's Minar questioned whether limited terms were working at all, suggesting that term constraints on liquidity hamper efforts to democratize access to private markets, while failing to manage widening discounts. He noted that his firm's target-term trust products aim to solve this problem by providing a "defined life and objective associated with [the term]," rather than simply using terms to act as a discount management tool.

Share repurchases have also helped BlackRock deal with discounts, because "they are accretive to NAV," Minar added, offering backhanded support for a "3.0" model. He also said managed distributions have proven to be similarly "impactful."
Visit AICA's website to view the 2024 Fall Roundtable agenda, interviews, and panel videos.

Resources

Learn more about:

- Mark Milner and Parametric
- Ryan Paylor and Thomas J. Herzfeld Advisors
- Finbar Ward and Closed-End Funds at Morgan Stanley
- Stephen Davis and Nuveen
- Stephen Minar and Closed-End Funds at BlackRock
- Andrew Hall and Nasdaq
- John Cole Scott and CEF Advisors

Disclosure: The opinions of the speakers / presenters are their own opinions and may not be the opinions of AICA. Listed closed-end funds and business development companies trade on exchanges at prices that may be above or below their NAVs. There is no guarantee that an investor can sell shares at a price greater than or equal to the purchase price, or that a CEF's or BDCs discount will narrow or be eliminated. Non-listed closed-end funds and business development companies do not offer investors daily liquidity but rather on a quarterly or semi-annual basis, often on a small percentage of share. CEFs often use leverage, which can increase a fund's risk or volatility. The actual amount of distributions may vary with fund performance and other conditions. Past performance is no guarantee for future results.