John Cole Scott On Closed-End Funds That Can Weather This Storm

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Chuck Jaffe, in this episode of The NAVigator podcast interviews John Cole Scott, President of Closed-End Fund Advisors, the Chairman of the Active Investment Company Alliance. John is back with funds that can fit the bill of giving investors confidence amid the current stock market chaos. After answering audience questions last week, he supplements those answers with three investment ideas, discussing the details of the "trifecta analysis" — covering data points on discounts, yields and net asset values — that he performs on all funds when he sizes them up.

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 from Closed-End Fund Advisors is back. Last week he answered questions on how closed-end funds were performing amid the stock market's current volatility, today he's got funds to consider amid this market turmoil, 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 is brought to you by the Active Investment Company Alliance, a unique industry organization representing 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 will point you in the right direction. Returning to The NAVigator today, John Cole Scott, the president at Closed-End Fund Advisors in Richmond, Virginia, which is online at CEFAdvisors.com, and we're about to dig into their data, and you can do that for yourself at CEFData.com. Beyond his own firm, John is chairman of the Active Investment Company Alliance, which you can learn about at AICAlliance.org. John Cole Scott, let's get busy.

JOHN COLE SCOTT: It's always great to be here, Chuck.

CHUCK JAFFE: Last week we were answering questions, but it's the unusual appearance where you don't also come at us with some investment ideas, and I know you've got some funds that you think it's not that these are flat out buy recommendations, because you would always tell us you own a lot of funds, you build portfolios with a lot of funds, and people need to make sure they're for themselves, but these are things that you believe are in a pretty sweet spot right now and you got the numbers to back it up that may make the audience think, yeah, these are things to consider.

JOHN COLE SCOTT: Absolutely. So we're digging into our trifecta of closed-end fund analysis, but then layering funds that are very, we feel timely for this environment, and we'll go and jump in, but again of course remind people we normally build portfolios of 30 to 45 holdings and these are examples of our research and not recommendations, as you said. The first fund would be DFP, it's a Flaherty & Crumrine Dynamic Preferred and Income Fund, it should be well known by most closed-end fund investors and we're going to dig into the three pieces of that analysis. So the first would be the current discount, a little wider than 9%, which is about 4% wider than a peer group average and about 1% wider than its 90-day average, basically it was 5% wider than a recent discount high for this fund. And then when we think about a longer term approach, there's a peak to valley three-year range we like at CEF Advisors, it's about 35% in that range, and then a newer data point came from a conversation with one of our clients, we looked at the one-year discount downside, where it has been the last year, there's only about three and mid-change downside for it. And also, you know we love discount volatility when we're buying the wide discounts, it's the top half of its peer group.

CHUCK JAFFE: So there's a number of statistics in there, and we're going to have them on all of the funds. Things that I want to point out, and maybe we should dig into a little bit more, that one-year discount downside, what we're talking about there is what you project if things were to get worse. So in other words, if we see discounts widen, you would not project it that it could go down more, in this case, than another 3.8%, correct?

JOHN COLE SCOTT: What that means is in the last 52 weeks, the widest discount this fund has exhibited is 3.8% wider than its current discount, and there are times where this number has a double digit, even a high double digit number, but not today.

CHUCK JAFFE: For you, in any of these statistics, is there ever a red line? Something where, hey, if this isn't here, it's not a possibility for me?

JOHN COLE SCOTT: That is a great question. You know we like to do a multi-factor analysis, where it's a concert of absolute, relative, and comparable discounts, because it's so easy to look at just one of those and not reflect on the combined depth of a valley. The question you're asking is, how common is this discount going to narrow versus widen? And the relative and comparable give you benchmarks for that outcome.

CHUCK JAFFE: So let's move from discount to yield on this fund.

JOHN COLE SCOTT: Yeah, because yield is something you do regardless of discount, but this one right now sports a little bit over a 7% yield, like all the funds we're talking about today, it pays monthly. You know that we love leverage-adjusted NAV yield to back out what the manager has to hit to hit the board's policy, it's about 4.7%, which is relatively low for preferred equity in our research. Zero return on capital, earnings coverage a little over 100%, a 100% of the dividend is qualified dividends, as we like in a preferred fund, and leverage is moderate at 38%.

CHUCK JAFFE: And again, for you, is there a deal breaker? Or is there one where you look and go, wait, if I see this number above this level, I'm always particularly interested?

JOHN COLE SCOTT: So we have talked about, we will buy funds that overpay the dividend, but in this case we look at both leverage-adjusted NAV yield and return on capital data to suggest whether this is a more fundamental yield figure versus an overpayment. In our research, [inaudible 0:05:52] asset class, leverage-adjusted NAV, and ROC, this is a durable, sustainable yield in this current environment.

CHUCK JAFFE: It's a trifecta, so that means you need three things. We just talked yield, we already had talked discount, the third thing is NAV, net asset value.

JOHN COLE SCOTT: Yeah, so basically it's almost 100% preferred equity exposure. It comes in with a mid-duration of five and mid change, we love the gross non-leverage expense ratio at 70 basis points. As you might expect, the NAV beta versus SPY is one third as volatile, something we love for our income-focused clients, and the NAV standard deviation is in the bottom half of the peer group, but remember the discount standard deviation was in the top half, very good to blend those together where you can. And then just for reference, it's been a crazy year, the manager's performance is off 2% year to date, definitely nothing like the S&P 500. And the last thing we kind of think about for every dollar in your account, because the discount to leverage is about $1.50, it's a liquid fund and it trades over a million dollars a day.

CHUCK JAFFE: That is DFP, the Flaherty & Crumrine Dynamic Preferred and Income Fund. What else have you got for us today?

JOHN COLE SCOTT: Well, not a new fund to this podcast, but ARDC, the Ares Dynamic Credit Allocation Fund comes in on the discount analysis with about a 6% discount, and last fall it was as high as a 5% premium. We did not own the fund back then even though we love this manager and fund. It's a 1% comp discount, a -5% relative discount, showing you that discount falling, its relative Z-stat versus its peer group average for the last six months is a -1%. We look at that range of its discount, it's about a 46%, very healthy historically speaking. It's discount downside is 5%, and again it's three-year discount volatility, like the other fund, is a top 50% discount analysis for volatility.

CHUCK JAFFE: I gotta ask, when we have a fund that goes from trading at a premium, which is where a lot of people don't want to be buying it because they don't want to be paying over, and it gets to a discount, does that make it particularly attractive or does that make it worrisome like something bad had to happen?

JOHN COLE SCOTT: Generally speaking, unless there's been a fundamental change, let's say it yielded 12%, and so they cut the dividend 40%, and that's the reason it went wide, I would argue the entire sector got narrow and this fund had, like we talked about, a lot of taxable bond funds last week, great NAV outcome, great dividend outcome, great discount outcome, it is more likely to trade above its peer group because there's a lot, roughly a third of the portfolio is relatively in the CLO equity and debt space, something you don't get a lot other places. Usually a well-regarded manager with those uncommon assets trade well when they have that trifecta of positive outcomes, so it's not a concern for this fund in that way.

CHUCK JAFFE: And the yield outlook on ARDC?

JOHN COLE SCOTT: So right now the indicated yield is a little over 10%, the income yield is, again, same in line with that just over 10%, its leverage-adjusted NAV yield is just under 7%, very healthy for what it puts in its portfolio, there is zero return on capital in the last year. Another monthly payment, it's all ordinary income, and the leverage, while a touch higher than the last fund is 39%, still well below that roughly 50% maximum you see in most cases for most closed-end funds.

CHUCK JAFFE: That brings us to net asset value.

JOHN COLE SCOTT: This is where we love it. The numbers changed a little bit in the last 10 years, but it's over a third loans, right around a third corporate debt, just under a third CLO equity and debt. Its duration is only 1.2, its gross non-leverage expense ratio is 1.4, but I think it's worth it for a quality manager with good results. Its NAV beta is even lower at 0.25, and again its NAV standard deviation is the bottom half of its peer group, like I said, we look for in funds like this, and year to date it's off just slightly more than 2% net asset value total return. And just like the last fund, I'll say a dollar invested is a $1.45 of manager exposure, and it trades over a million and a half dollars a day.

CHUCK JAFFE: So that is ARDC, the Ares Dynamic Credit Allocation Fund. I know you got a third one for us.

JOHN COLE SCOTT: We do, and it's the GUG, Guggenheim Active Allocation Fund, it really is kind of a blend of these other two funds. Comes in a discount analysis with a wider than 10% discount, almost 2% versus a peer group average, 2.5% versus its own 90-day average, and almost one standard deviation below its peer group normalized six-month relative Z-stat. That same range number we like, as I said before, about a 43% in the three-year peak to valley range, and only a 2.8% discount downside, and it's in the bottom half of its discount volatility in a three-year like we like to use, but I did double check, it is in the top half of its one-year.

CHUCK JAFFE: Again, that is GUG, the Guggenheim Active Allocation Fund. You put it all together, three funds to consider. Again, not flat out go buy this but, John, are these all in current customer portfolios for you?

JOHN COLE SCOTT: They are, and I would say the other thing, they're low correlations to each other, very healthy for a piece of a diversified portfolio.

CHUCK JAFFE: So again, GUG, ARDC, DFP, three funds to consider from John Cole Scott in these market conditions. John, great stuff, we'll talk to you again soon.

JOHN COLE SCOTT: Thank you so much, Chuck.

CHUCK JAFFE: The NAVigator is a joint production of the Active Investment Company Alliance and Money Life with Chuck Jaffe, and I am Chuck Jaffe, you can learn more about me and my show at MoneyLifeShow.com or find it on your favorite podcast app. To learn more about closed-end funds, business-development companies, and interval funds go to AICAlliance.org, that's the website for the Active Investment Company Alliance. And if you have questions, send them to TheNAVigator@AICAlliance.org. Thanks to my guest John Cole Scott, president of Closed-End Fund Advisors, chairman of the Active Investment Company Alliance. The firm's online at CEFAdvisors.com and you can dig into the firm's data at CEFData.com, and John's on X @JohnColeScott. The NAVigator podcast is available every Friday, except for weeks like this one when it's Good Friday, so follow along to make sure you never miss an episode. We'll be back next week with more closed-end fund talk, until then, happy holidays, happy investing.

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