Your Questions Answered With John Cole Scott Of Closed-End Fund Advisors

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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 answers listener questions about whether premiums and returns of capital are as bad for investors as they are often cracked up to be, on whether interval funds are worth the illiquidity risk, and if the reasons why individuals buy closed-end funds means they are better used as short-term investment tools. Plus, our host asks a question that came up for him as he watched the AICA chairman on the stage at the group's recent Business Development Company Forum in New York.

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

CHUCK JAFFE: You have questions about closed-end fund investing, and so do I, let's get some answers from John Cole Scott of Closed-End Fund Advisors, 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, president at Closed-End Fund Advisors in Richmond, Virginia, which is online at CEFAdvisors.com, and as he talks about the data that his firm produces, you can dig into that for yourself as well 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, welcome back to The NAVigator.

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

CHUCK JAFFE: I want to start with my question before we get to a couple of audience questions, and my question comes directly out of the Active Investment Company Alliance BDC Forum which was held in New York City on Wednesday, June 11th. And you at that event were on a panel with Mitchel Penn, who's managing partner at Oppenheimer, he did an interview for The NAVigator from the event, you guys were talking about investment prospects for BDCs. He was asked to provide a few favorite BDCs, and of course you provided a few options as well, and you periodically have given us your investment ideas here on The NAVigator, but watching the session from the audience, I was struck by something and I had a question. Because Mitchel is as knowledgeable about the BDC space as anybody out there, and I'd say the same for you, but he's an analyst, he's analyzing funds that Oppenheimer will put on a buy list, and you are an investor, you're analyzing funds and actively putting them into or out of portfolios, you're moving things around pretty dynamically. So I'm curious, how do you see the roles, analyst versus investor, as different? And what are the differences and how do they apply to investors?

JOHN COLE SCOTT: Absolutely. So at a basic level, all the analysts I speak to, they generally cover about 25 funds, versus investors like CEF Advisors that use them for client portfolios, they cover pretty much 45, I'll say all the liquid non-broken funds. And also, from my understanding, I'm not in their seat, but they pick great managers, they do their financial models every quarter, they model leverage and earnings and all the important data points that we also collect at CEF Data, but they're not as tactical because they're not making daily trades. And so just through, whether it's Mitchel or other analysts we're friends with, when bad things happen they basically don't dramatically change their lists in a day or a week. Versus at CEF Advisors, Chuck, if you're my client, if something goes down, we can rotate to a better upside, capture a tax loss, is there a reason to sell or add to the sector? I'm growing my BDC exposure or I'm lowering it based on the asset allocation decisions, the research we do at CEF Advisors, just like the other 10 or so firms in the space. And so for example, TSLX, he mentioned is one of his top picks, and an audience member who's a data client, who has our data, goes, "Well, they're at the top end of their 52-week price range." And the answer is, yes, TSLX is a wonderful example of a high-quality manager that should be regarded as a benchmark for great behavior and credit underwriting and ROE, which is return on equity, but generally speaking in our firm we're not buying the top of the 52-week range, we're looking to wait for a tactical investment at a reasonable price for any BDC.

CHUCK JAFFE: So now that we've got that one out of the way, I want to get some questions we have from listeners to The NAVigator. The first comes from Al in Orchard Park, New York, who writes, "Hi Chuck, I have some questions about closed-end funds because I never owned any until I started listening to the show, and now I bought one or two and they look very good to me, but I also have questions because the more I know about them the less I think I know. I'm afraid I'm making a mistake by doing this. I know that premiums are supposed to be a bad deal, but funds that trade at a premium can issue new shares and grow the fund, so a premium is not necessarily bad, or is it?" He's got more questions, let's start with that one.

JOHN COLE SCOTT: So I would say that he is correct. A fund at a premium, especially a fund that generally trades at a premium, can do a really beautiful thing of an ATM or an at-the-market offering, to drip new shares in the market, slowly growing the fund at a general not detriment to current shareholders, which is a positive factor. However, if you think about it, and again I recognize a passive holder, a more active holder like a firm like ours, we're always looking for the best spot tax, appropriate, not just selling to sell for any reasons, but the premium often leads to the potential when there's a market turmoil, so most recently April of this year, or other time periods we've talked about where the downside pricing direction of a fund relatively expensive to itself or its peer group is almost always worse on the downside. The short answer would be maybe, if he ever sells it eventually bounces back up, and that is possible, but to me when the average basket of closed-end funds moves over 20% in a three-year period, you should be willing to make asset allocation and entry point decisions, if not as actively as CEF Advisors, reasonably active as an individual investor.

CHUCK JAFFE: That answer probably fits very well and dovetails into Al's second question. So again, from Al in Orchard Park, New York, he continued with, "The funds that I bought, I bought to be long-term investments. My plan is to hold them until I either get paid the discount or I think there's something better out there." And he notes parenthetically, "In my investing history, that doesn't happen very often." I don't know whether he means there's not something better out there or he doesn't sell very often because he thinks there's something better out there. He goes, "Or I could sell them if they have a loss near the end of the year when I can do tax-loss harvesting, but that means I have a lot of reasons to sell them, so should I even be thinking about them as long term? Shouldn't I just be sizing them up to see if they can narrow the discount soon? And shouldn't I plan to get out of them quickly? If they're not long-term investments, maybe I don't want them after all."

JOHN COLE SCOTT: So in some ways they can be, the only caveat being you shouldn't ignore concepts, like at our firm we start with the trifecta analysis, analyze the discount, analyze the dividend, analyze the NAV, then be thoughtful on asset allocation. So even if you ignore the first three, which are very important, sometimes you're going to be overweight US versus international, sometimes you'll be overweight high-yield versus senior loan, sometimes you want to be overweight energy versus utility, and that is an opinion, but there are data points you could analyze to lean into that outcome, which means that generally most investment portfolio should be nudging at the minimum over the course of time, at least based on our premise of investing. And so I would say that, yes, we have tools and time at CEF Advisors, we have to overcome a management fee to be of value to our clients, but in our work from our longer portfolios, we've often been able to do about 2% after fees over a passive basket, not every client, not every time period, but longer like 10-15 plus years. So by being active you should be getting extra return, but also by being active you're seeking better return, but you also can be thoughtful on trading short-term gains for taxes and also harvesting losses for a tax benefit.

CHUCK JAFFE: One more question from Al in Orchard Park, New York, he asks, "How do I know for sure if a closed-end fund is returning capital? Is there an easy way for me to look at a fund's yield and see that it's not real, that some of it is me getting my money back and drawing down the fund? I'm definitely drawn to big yields, and I don't think I've bought anything that has been paying me back my own money, but I'd be upset if I bought my next fund tomorrow and then learned that the payout was fake."

JOHN COLE SCOTT: First off there's the two year ago comment of return of capital that's detrimental is not as common, it's easy to navigate a course around them, because of activism we've talked about regularly on this show that there is overpayment distributions, the goal would be how do you calculate that as an investor or an advisor supporting your clients? We would argue that leverage-adjusted NAV yield for a sector versus a benchmark expectation is a starting point. We look at the NAV total return over the time periods it makes sense to you to measure a manager to see if they're actually performing independent of distributions for a number that makes sense to you. You then can look at the 1099, if you've held it for over a year, to see if there was return on capital. But at a basic level, if there is excess returns and if you paid a reasonable discount, it is a tailwind with one caveat I've said probably, I won't say a hundred times during the show, but at least 15, re-invest a portion of the dividend, and generally speaking for a diversified mix of the 20 or so funds, it's going to be about 15% back into the corpus, take out the rest as potentially durable income, but you can currently not take everything from most funds, and you shouldn't avoid funds overpaying if they're good funds at reasonable discounts that fit your asset allocation mix for that part of your portfolio.

CHUCK JAFFE: Let's now turn to a note we got from Charlie in Snohomish, Washington, who wrote, "Hi Chuck, we met when you spoke at an AAII meeting in Bellevue," that would have been in 2019, I want to say. And he said, "And I've been listening ever since but I've never written before. I work with a money manager financial planner." Are they all one thing? That's one term he used together. "And the latest thing he recommended I buy is an interval fund. Are interval funds worth the risk? Limited liquidity, higher costs in exchange for higher returns and diversification, I assume I can get diversification in other ways, so is it really just higher returns? It's the first time I've ever really questioned anything he has suggested, but I am thinking this is a good idea for him but not so great for me. What do you think?" He didn't tell us exactly what was being suggested, because he said that his advisor had suggested two interval funds, but one of them is one where we have had the manager here on The NAVigator, that being the BlueBay Event-Driven Credit Fund, that's what he called it. It's the BlueBay Destra International Event-Driven Credit Fund that is one of the interval funds. So interval funds, worth the risk?

JOHN COLE SCOTT: Part of it comes down to where does it fit in the portfolio? The why yes for interval funds, they are, as you've talked about, there's manager that we fit in baskets, they usually live in private funds with less transparency, higher fees, a well-built interval fund is a good piece of part of a portfolio that you're rounding out with traditional regular stocks and bonds, even the more esoteric closed-end funds in that wrapper. The why not would be too much in it, not the right manager in a wrapper, worry about being stuck in it, which can happen, so you should not put the short-term money in interval funds. We use it actively at CEF Advisors in a very beautiful way, for the right manager. We do own the CREDX fund, it's a great fund. As I think about, and I don't know the question fully, as you don't, which share class is the advisor selling? And so at a basic level, you and I both know some advisors work on commission, some work on building fee-based portfolio where the fee at the fund level is independent from the compensation of the advisor. Generally I'm pro finding an advisor building you an annual fee you can live with and he builds you whatever things should be in it, whether it's an ETF, a closed-end fund, a BDC or interval fund, and then has disconnected that compensation. So if it's commission share class, I'd be very thoughtful on why is that the relationship you have? And if it makes sense, just know that, but the fee-only share class can be a very powerful one, it's a little bit lower cost to you, there's no backend fees and whatnot that can happen. Because an interval fund is operationally in that way like a regular open-end fund, there's A, B, C, I, and other share classes, and so at a basic level we generally keep interval funds, when used for clients, no more than 2-3% per position, and no more than 15-20% per account, because sometimes people have to replace a car, buy a refrigerator, or deal with a child that needs extra expenses that wasn't in their 12-month plan.

CHUCK JAFFE: John, great stuff. Love getting the questions, love getting your answers. Thanks as always for coming on The NAVigator, we'll talk to you again soon.

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, and yes, I'm Chuck Jaffe, you can learn more about me and my show at MoneyLifeShow.com or you can find my hour-long weekday podcast wherever you look for your favorite podcasts. Now 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. And if you have questions about the closed-end fund industry, send them to TheNAVigator@AICAlliance.org. Thanks to my guest John Cole Scott, president of Closed-End Fund Advisors in Richmond, Virginia, the chairman of the Active Investment Company Alliance. His firm's online at CEFAdvisors.com and you can dig into their data at CEFData.com, and John's on X @JohnColeScott. The NAVigator podcast is available every Friday, make sure you don't miss an episode by following or subscribing on your favorite podcast app. We'll be back next week with more closed-end fund talk, and make sure you don't miss any of the bonus episodes we did from AICA's BDC Forum, so check 'em all out, make sure they're there in your podcast app. We'll be back next week with new stuff, and until then, happy investing, everybody.

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