



John Cole Scott provides opening remarks for the second Day of the 2021 AICA Tax Free and Tax Advantaged Income For Investors event along with a preliminary educational session.

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John Cole Scott, Founder and Executive Chairman of the Active Investment Company Alliance opens the second day of the 2021 AICA Tax Free and Tax Advantaged Income event with opening remarks and with a preliminary discussion on closed-end funds. Read the transcript below to hear what Mr. Scott had to say to kick off day two of this event.



John Cole Scott

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[Tax Free & Tax Advantaged Income for Investors - AICA \(aicalliance.org\)](https://aicalliance.org)

John Cole Scott: Thank you for logging in to day two of AICA's Tax-Free and Tax-Advantaged Income for Investors session. We had a great day one with munis and preferreds, we have gotten those sessions to the transcriber and videographer and have already submitted to them for approval from the speakers' organizations. Our hope is we'll be able to release those on October 11th, that's our current timeline for you as a replay attendee should you have missed that session.

We also want to take just a quick moment to mention this is an Active Investment Company Alliance event, we're a Nonprofit Trade Association that's meant to encompass the entire

universe of closed-end funds, BDCs, interval funds. From fund sponsors to users and creators like myself and our fireside chat coming up in a little bit, as well as the service providers which gain a lot of perspective into the inner workings of how closed-end funds operate. Whether it's the attorneys that help create products with approval from the SEC, or the lenders to closed-end funds because leverage is a very big part of it, to proxy firms which help with the annual issues facing all closed-end funds.

We are recording this as of yesterday like I said, and we definitely would like you to use the question and answer feature in the system. I'm going to do an educational session, I'm going to maybe go a touch slower than yesterday based on some feedback from one of our contacts. And so I'll let my co-fireside chat know we might start a couple minutes later so I can make sure we can get that done.

But again I couldn't do this event for both live and replay content without our AICA members and sponsors, thank you for everyone involved. We also for those who don't know, have a new membership director, came on board this month, early September, that's helping to grow and advance AICA's mission for all the content creation going forward. With that I'm going to share my screen. I'll say if the screen is too small for you to view, definitely feel free to click that upper righthand corner box and it should make it bigger for you.

So I would like to make sure we have the base knowledge of what is a closed-end fund. It's one of the four closed-end fund structures in the US under the current 1940 Act, but it really highlights that fixed capital or stable share count for investors. Active management is essentially the core of almost every strategy that's really in the sector and of use for investors. And that listed closed-end funds, the biggest part, the oldest part of the market definitely giving people access to buys and sells with the listing on the exchanges. That does of course create discounts and premiums.

What's nice about the history of closed-end funds, to me at least as a closed-end fund passionate person, is they've been listed for 128 years. The first fund was the Boston Personal Property Trust, and the first leveraged fund was an infrastructure fund, Railway and Light Securities Fund back in 1904. So over 100 years of levered closed-end funds in the US markets. It's also worth noting these funds, there's a good group in London and Toronto, and even as far as places as New Zealand, has I think 10 or maybe 9 closed-end funds.

As I mentioned, because of the separation of net asset value, the assets at the fingertips of the managers that create the performance and dividends for investors, there's the listing which is the way we trade them. The other benefit, again should be common to everyone here, but we always like to make sure people are aware that it's a passthrough entity. The investment company structure is a single taxation for dividends versus dual for like a C-corp. If you buy any publicly traded company, there's two levels of taxation. And really one of the cool things about them as we talked about in yesterday's sessions, they have preferred shares for leverage or other leveraged features like revolvers, and TOBs, and so many different types of leverage especially since the Great Recession.

I do like to remind myself, this is almost as much for me as for you guys, that closed-end funds are a wrapper, not an actual sector. Because we often talk about how are closed-end funds doing? And then to remind you on the other side of the coin for closed-end funds, the non-listed version which feel more like an open-end fund, you can inflow daily and generally can get 5% of the shares tendered quarterly. So they can generally be 60-80%+ level three or private assets, have been around since 1989 but have definitely grown since 2007. There's about 182 strategies and \$91 billion in assets under management.

We're going to focus today on the more equity side, the energy side of closed-end funds for tax-advantaged income. And kind of touch in the fireside chat and a little bit of the intro in the covered-call sector. They are definitely newer, the muni and the preferred sectors are so well established versus the MLP and covered-call sectors are roughly 15 years established in smaller pieces. But the reason we put these sectors together in this event was they are also really useful parts of a diversified income portfolio for individual investors looking for a paycheck after they've retired or stopped working.

We'll just look at the height difference between any blue line and any green line, there are some specific answers here of course. Actually I'm going to go to the equity one for today. The 5.7% blue line for MLP funds is the average indicated yield as of last quarter end, but the manager because of leverage and wide discounts only has to hit 4%. And so if you think about the MLP index being almost twice as much as the leverage-adjusted NAV yield, I think there's a strong thesis for MLP funds. While it's been a very hard five-year experience, or even six-year experience, there's a lot of capacity for growing cashflows as I think you'll hear on the panel this afternoon from the managers themselves. And there's a lot of chance for recovery and healing in the pricing, because you'll see in a minute that the MLP index we have is definitely showing the pain of the shareholder base. And I think just looking at any MLP index versus the underlying cashflow needed to pay out the current yield for an MLP closed-end fund is a very powerful thing.

Covered-call funds, they typically are trading well and they have almost no leverage so there's not much difference there. There you're just looking for generally a lower beta equity investment, often between 0.7 and 0.85 is common in our research and review, and typically 25-65% return of capital. And then we find a lot of them also are able to pass on long-term gains or qualified dividends, so that if you're a 25% or higher marginal tax bracket, there's less tax friction for you as an investor. And they really do balance out the preferred equity and the muni portfolios in our experience.

Dividend changes are constant, same chart as yesterday so I'm just going to say it's available on the replay. But the key is that every sector tends to have increases and decreases over every rolling period we look at. Really hammer that down, just to say that the turning point of growth in dividends is I think growing. I think in a year, year and a half we should see a very positive three-year, which still has a 2:1 negative ratio. But I think it used to be a 4:1, and so I do see it as a growth there in what's going on. This is from yesterday's slide, so if you want to review it you're welcome to, this drives a lot of the preferred and muni interest in the sector.

This is from our covered-call index. If you're not familiar, CEF Data has 35 indices, we do update them on our website daily. We reconstitute and rebalance quarterly, so that'll be happening tomorrow for every index. And we have started that index in 12/31/2016, but we've been archiving the data since June 30th, 2017. So what I'd like to say it's similar to yesterday, discounts are narrower by about 3%. Yields are down in percentage terms, but the dollar amount of the index has grown from about \$1,100 and change to \$1,800 and change. Matching the general growth from the last four years of equity markets. Dividends are up because performance is up. And it's actually a much bigger increase than even preferred equity yesterday. But if you look at it it makes a lot of sense because it's been a very good market for equity investing.

This is a discount history for 15 years. I thought our system was broken this morning when I tried to get a 20-year chart and remembered there's actually no covered-call funds with a 20-year history. And that reminds me of how much the sector has grown and advanced since 2006. It reminds me of where we might be thinking of the current growth and the future of closed-end funds, and what we'll be looking at 10 years from now with the current history. But generally speaking like I said, we're in the higher end of discounts.

There have been higher levels. I would say it's probably harder to justify large premiums for covered-call funds because the underlying assets are generally very liquid, and you're really getting that tax-advantaged structure and that lower volatility in our work for our clients as the benefit of the universe and just picking those opportunities. But as you know in a sector there's peaks of premiums and valleys of discounts which we'll discuss in our next fireside chat, and that's where I think the opportunity can actually lie.

So this again I want to spend a moment on because it is important. The master limited partnerships, if you see it there's no way to sugarcoat this, had a very rough time pre-Covid. Covid was a very perfect storm for so many reasons. Oil prices went negative for those that weren't watching the news in March of 2020. But if you look at it, the roughly \$1,000 index value on June 30th of '17 really has been almost halved, but we're at a 14% wider discount. The income is down by 62% in dollar terms. I was doing some quick math and this takes an educated guess, but probably if you were to want to put a guess, put in your calendar 2036, I'm figuring this index will be back to \$1,000. But in doing so it will have grown 100% in total return. I do expect to get that 14% back at a discount, and I do expect the dividends to roughly double over the next five years. That's an opinion and a guess, definitely not a guarantee.

But why we like these funds is because we think the energy story is strong, that the fund sponsors are being dynamic and reactive to what the market is looking at. And that there's still a high amount of return on capital in distributions and we can use those to give our clients higher after-tax yield. But again, I'll use this chart as an example, we don't make any one sector typically over 15% of a portfolio unless you're in a very high tax bracket and then munis can extend beyond that because they're such a large part of a tax-free or tax-advantaged income program.

This is that discount chart, and I don't expect us probably to get back to 10% premiums being normal, but to me it would make a lot of sense for these things to trade between a 5% discount and a 5% premium as a normal range going forward versus what we've got in the past of 25%

discounts and 30% premiums. But again this is just thinking about the discount history that we've had for every fund in this sector.

This is from yesterday, for benchmark purposes you can see these slides in the replay. And we'll get these out to you because I can approve them for compliance purposes as soon as we're done, the base benchmark of those. When you really think why we add the covered-call funds and the MLP funds versus just credit instruments for investors, really it's the correlation story. The fact that we get some low correlations pushes us into different sectors as a diversified manager of portfolios, and we really run this as a way of adding that value of trying to let the portfolio zig and zag in different ways at different times.

Like yesterday, just wanted to touch on we really have three models that we work with, typically between 30 and 50 positions max in a portfolio. I think pre-Covid that was probably 40, but we diversified because Covid was such an intense event. And where for different tax levels. This is a lot of data but want to just say that we basically look to diversify and balance duration, beta, and after-tax income based on a one-year or three-year review of the dividend holdings. You see it's a three-year in this report. So basically this model, which we run for folks as a starting point, is about 6.3% after-tax yield for a 25th marginal bracket and the regular 15% long-term gains and qualified dividend rate. And this way we're able to put some bigger taxable fixed-income funds and still keep that number normal.

If you're a higher level we use 12.1 on our system, and that's again basically more exposure to munis, more thoughtful on the taxable fixed income but still try to stay diversified, keeping that number to about 5.8% after-tax yield for investors. Still about 1.4% over the average yield for the muni funds right now, which is a relative based for any after-tax or tax-focused portfolio. And then we do run just a pure fixed-income version of that. Not my preference because I love to be diversified and choose where I go, but some people will want us to have a more pure fixed-income mandate and we look to optimize that. Where we're typically doing 5.4%, still one point over munis after-tax yield.

IPOs really are the future growth of the sector, we'll touch on that in the next talk as well. But in general there's bigger funds, more coming out. We'd love to get more than 12 in a year, we'll see how it goes. It's hard to get more than 12 in a year the way it works currently in the market. I think the months we've had two have not been as successful for both funds involved. But they've been trading well, both versus IPO price and for discounts versus the indices and benchmarks we use. I'm going to actually decide to expand this chart a little bit more to cover the entire version 2.0 of closed-end fund offerings. If you're not familiar, we've covered it in a lot of other AICA content.

Mergers are part of the nature of them, want to just remind people they're normal. Liquidations, people sometimes get excited they're going to really accelerate. And again only once has there ever been in '14, and back in '07 there was about 650 closed-end funds. It's a very small number of actual deaths, which are typically open-ends, liquidations, or conversions to ETFs, or in theory to conversions to another fund structure or a holding company which could happen this year for one fund.

We're getting close to tax-loss selling season. So it's really hard not to talk about tax-loss selling season when you talk to tax-advantaged and tax-free income focused investors. You can be more thoughtful on these trading opportunities if you're in a taxable account in a high bracket, attempting to make sure you're offsetting the short-term gains with short-term losses. But the movement is real, everyone knows it's there, we've talked about it for my entire career. But I just want to make sure that we are probably stepping into a 2-4% general movement of the actual discounts around any net asset value changes between November-December and January-February. It's a very almost every year event, but I will remind you that in 2017 to '18 we actually didn't get it because it's not guaranteed.

And that's it, I'm going to un-share my screen.

Recorded on September 30, 2021.

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<https://AICalliance.org/>

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