



Answers on Cash-Flow Generation, Tax-Loss Selling and More

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Chuck Jaffe, in The NAVigator podcast, interviewed John Cole Scott, executive chairman of the Active Investment Company Alliance. Read the Q & A below as Chuck discusses with John some of the nuts and bolts of closed-end fund investing, tax-loss selling and where to expect good opportunities this year, cash-flow generation and more.



John Cole Scott

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CHUCK JAFFE: John Cole Scott, founder of the Active Investment Company Alliance is here and we're answering your questions about closed-end funds today in 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, which is a unique industry organization in that it represents 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, that's what we're trying to point you in the direction of here on The NAVigator. My guest today is John Cole Scott, he is founder and executive chairman of the Active Investment Company Alliance, he is also the chief investment officer at Closed-End Fund Advisors. If you want to learn more about Closed-End Fund Advisors, CEFAdvisors.com or CEFData.com, great stuff for researching individual closed end funds. The AIC Alliance is online at AICAlliance.org. John's also on Twitter, he's @JohnColeScott, but right now he's here. JCS, great to talk to you again.

JOHN COLE SCOTT: Good to be here, Chuck.

CHUCK JAFFE: So we have questions, which is not a surprise because we've been talking a lot as The NAVigator debuted, about closed-end funds. I'm going to try to get to three questions, two from audience members and one related to a question that I recently answered on my show Money Life with Chuck Jaffe. We start with a question from Steve in Royal Oak, Michigan. He says, "Dear Chuck, I like the new material you've added on closed-end funds. I've never bought one, but I have looked at them in the past and I can see the benefits. I've read and heard on your show from people who say that the real purpose of most closed-end funds is to provide regular cashflow. I can see how that happens with closed-end funds, but not every type of closed-end funds, like with some stock funds or even the Saratoga BDC you talked about recently." That by the way would be Saratoga Investment Corp., where we talked with Chris Oberbeck. "I'm nearly retired and I see myself as wanting to have some investments that generate cashflow for me in retirement. Could I build a small portfolio of closed-end funds to do that? I like the idea of buying these assets on sale, and do I need to diversify and have a lot of funds in this part of my portfolio? Or is it okay to buy one or two that are diversified?" John, which types of funds are going to allow him to get cash-flow generation?

JOHN COLE SCOTT: Essentially almost every closed-end fund, eighty-five percent of them have monthly or quarterly distributions on a taxable side of equity and bond that's often between seven percent and nine percent annualized. And then from muni bonds, it's typically between four and five percent annualized. And then for BDCs, we're kind of a hybrid closed-end fund structure, it's typically between seven and eleven percent annualized. He does make a really good point, because for bond funds it makes sense. The manager buys bonds, he often leverages his portfolio and buys more bonds with cheap money, and he collects income from his bond investments and pays them out typically monthly to shareholders. And you can expect over time to get the net investment income from that sector. I will point out he mentions Saratoga, which is a debt focused BDC. It is definitely listed in a lot of systems as a quote/unquote "equity", but that is because it's an uncommon structure. The bulk of their work is actually lending out money and getting paid back, and so it in many ways works very much like a traditional taxable bond fund. The part where it gets, I won't say interesting,

but equity funds. So think about a group of funds that buy U.S. or global stocks, many of them will do an option overlay. That option overlay does two things, it allows actual increases in the income of the portfolio and it often reduces the volatility, two things that income investors like. However you have to remember that it's not the same thing as a bond fund, and equity markets go up and down. And so that's where we really try to remember a key point for any closed-end fund investment, especially an equity focused one. That the leverage adjusted NAV yield, which takes out discounts and leverage, tells you what the manager has to do to fuel that dividend policy of the board. At the same time, the NAV performance of the portfolio on a total term basis should meet that NAV yield. Obviously not all the time, but over long periods of time, like three, five, ten years. Does that start to answer his question, Chuck?

CHUCK JAFFE: I think it more than starts to answer his question. Just one little part, quickly. When is he properly diversified? If he's simply saying, "I want to have this portion of my assets that generates cash-flow," how many closed-end funds does he need to do it?

JOHN COLE SCOTT: So there's fourteen primary sectors, I would argue you should have one to two per sector. Our portfolios tend to be twenty-five to forty names, and so I'd say deciding which of those sectors you want to be in. And so I'm going to guess it's going to be fifteen to twenty positions minimum.

CHUCK JAFFE: So that might suggest that he wants to use a fund of closed-end funds?

JOHN COLE SCOTT: There's a handful of them, yes. But there's also passive indices as we've talked about, and there's some active open-end funds. There's a whole lot of UITs that cover the space with various approaches as well.

CHUCK JAFFE: So we will learn more about that in future issues of The NAVigator, now let's move to a question we got from Kirby in Tacoma, Washington. He says, "Hi Chuck, I've read your columns for years and started listening to your show a few months ago, this is my first time writing you. You've always told investors to read the prospectus on funds that they buy, but as I started looking at closed-end funds you've talked about on the show, I can't seem to find a prospectus. Am I missing something here? Well, I can answer the basic part of this which is, Hey, Kirby, you're not missing anything because closed-ends funds only issue a

prospectus when they're brand new. But that raises a different question, John. Which is should Kirby be looking to the prospectus, the initial document? Or should be forgoing the prospectus and looking at the annual report? Because with a traditional fund, you always want to review the prospectus, but with a closed-end fund, well, since they only issue one and it's right at the beginning, what do you do?

JOHN COLE SCOTT: For funds like the Adams Funds or General American Investors, where they IPO'd in 1927 and 1929, that may not be an appropriate approach. But for newer funds, I would say that it can't hurt to review it. But when we buy a closed-end fund, we typically wait for the semi-annual report to come out, it's typically seven months and change from the IPO date. The rationale is that it's a very deep document, it gives us a chance to look at actual investments, the schedule investments. It allows us to look at how they've levered the portfolio if it is levered, and you get a handle on the expense ratio that we're going to expect for that fund. You don't get a full annual report until about thirteen months after the IPO, and again I think that it's probably well enough to wait for the semi. And then almost ever fund sponsor, though not required to, has a quarterly fact card. Some even do monthly fact cards that provide a lot of disclosure and perspective on returns and expenses, the benchmarks. But then remember, we have CEFdata.com. So I built a data business that covers every listed and non-listed closed-end fund and BDC. I have ten humans and two programmers, and we endeavor to normalize and unify from a data perspective, what's available on our free public profile pages for every listed BDC and closed-end fund. Again, I won't forget that if a data provider, even ours, is human sometimes, mistakes can happen going to original sources, SEC filings, annual reports, semi-annual reports, calling the fund sponsor and confirming a weird data point never hurts if you're about to make a big decision.

CHUCK JAFFE: We're going to try to squeeze one more question in, and this one really is more a follow-up. I had an investor ask me a question this week about tax-loss selling, and they were talking about it from the perspective of stocks. But there's really no place in the investment world where tax-loss selling, the use of, "Hey, let's sell our losers, recognize a loss, and use it for tax purposes," is used more than in closed-end funds. So it is tax-loss selling season, where should people be looking? And why should they be looking? Why is it more in closed-end funds than other ordinary investment strategies?

JOHN COLE SCOTT: The two main reasons why the closed-end funds, one is it's a very retail driven, emotional driven sector. Because of that, you tend to get the need for the tax-loss selling and the extra selling pressures as we get to year-end. The other reason would be that there's a lot of peer funds. There's more than one Nuveen preferred equity fund, and if one is down, you can sell it and buy the sister fund at washed out rules. And that happens very commonly in many closed-end fund sectors, or even where similar sponsors have a similar fund. And the last reason is remember the yield for taxable funds? Seven to nine percent, even muni's, four to six percent is not uncommon over time. That takes the stock price down over the course of a year, and so it's easier to have a five percent or greater loss if you've collected a dividend of eight, nine, ten percent in the last twelve months. So that's the reason why it's there. And the four sectors we expect it to be most common for as a whole, will be the MLP sector, which is still feeling a little pain to holding water. The CEO loans sector, which is wide discounts. The yields aren't as high, but still some opportunities there for some prices below cost basis in our opinion. And then also international equity, which we have argued the fundamentals for that are positive, but that still have not had as much success in the last year as the other parts of the equity markets.

CHUCK JAFFE: John, really good. I love the questions from the audience. I hope they will write us some more. And I love getting you on the show to answer them. Thanks so much for joining me.

JOHN COLE SCOTT: It's been my pleasure, Chuck.

CHUCK JAFFE: That's John Cole Scott, chief investment officer at Closed-End Fund Advisors, which is online at CEFadvisors.com and CEFdata.com. John's on Twitter @JohnColeScott. John is also the founder and executive chairman of the Active Investment Company Alliance, you can learn more at AICAlliance.org. They're on Facebook and LinkedIn @AICAlliance. The NAVigator is a joint production of the Active Investment Company Alliance and Money Life with Chuck Jaffe. I'm your host Chuck Jaffe, you can learn more about my show at MoneyLifeShow.com. The NAVigator is available every Friday for you. On behalf of the AIC Alliance, I'm Chuck Jaffe saying thanks for joining us, we'll talk to you again next week.

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