



Three Decades of Data and Change Give a Glimpse Into the Future

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Chuck Jaffe, in The NAVigator podcast, interviewed John Cole Scott, chief investment officer at Closed-End Fund Advisors and the founder and executive chairman of the Active Investment



Company Alliance. Read the Q & A below as Chuck revisits with John, data used by his father, George Cole Scott in writing *Investing in Closed-End Funds: Finding Value and Building Wealth*, and gives his take on what's important for closed-end fund investors in the coming decade.

John Cole Scott

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

CHUCK JAFFE: John Cole Scott, chief investment officer at Closed-End Fund Advisors. Founder and executive chairman of the Active Investment Company Alliance is here, and we're talking a legendary book that was written thirty years ago by his father, and how things have changed in the thirty years since, today on The NAVigator. Welcome to The NAVigator from the Active Investment Company Alliance, where we talk all-weather active investing and plotting a course to financial success. The AICA is a unique industry organization because it represents investment firms, creators of closed-end funds, users, and investors. The NAVigator looks at all aspects of investing in closed-end funds and business-development companies. If you're looking for excellence beyond indexing, The NAVigator is going to point

you in the right direction. Joining me again today is John Cole Scott. He is the executive chairman of the AICA, but he's also chief investment officer at Closed-End Fund Advisors, and having that position means he inherits a legacy, literally and figuratively. Because his father, George Cole Scot, wrote a book, the research was all done in 1990, thirty years ago, the book was actually published in 1991. The book is *Investing in Closed-End Funds: Finding Value and Building Wealth*. Oh, by the way, I've spent more than thirty years writing about the financial services industry. It's still the best book on closed-end fund investing, which is why George Cole Scott, John's father, was for years a source of mine, and why now I also understand and respect where John is coming from. But John was looking at the research, he found some interesting things. If you want to learn more, you can get more information about Closed-End Fund Advisors at CEFadvisors.com. You can learn more about the Active Investment Company Alliance at AICAlliance.org, and John Cole Scott's on Twitter @JohnColeScott, but right now he's here. John Cole Scott, Happy New Year. Welcome back to The NAVigator.

JOHN COLE SCOTT: Happy New Year, Chuck. Great to be here.

CHUCK JAFFE: This is a very interesting walk that's not quite down memory lane for you, because you were not even a teenager thirty years ago when you father was working on the book. Though I know, because I wrote books when my kids were that age, that you were impacted by him writing it because there's no way in the house that you can't be impacted. But let's get some perspective, because although closed-end funds were not an enormous part of the investment world then, and they are not necessarily an enormous part now, a whole lot of things have changed dramatically in the last thirty years.

JOHN COLE SCOTT: Yeah, absolutely. If you think back to the universe of funds then, there were two hundred and forty-five closed-end funds. As I was thumbing through the book, there's actually a list of all these funds, thankfully, in the back of it. Or it would be impossible to remember thirty years ago of history. I see a couple things very, very interesting. Nuveen, which is a powerhouse closed-end fund player, at its peak, had a hundred and sixty-some closed-end funds, about a quarter of the listed universe. After a bunch of mergers, they're down to about sixteen percent of the universe, or seventy and change funds. They only had fifteen funds and six percent of the universe back in 1990. What's interesting, there's a lot of managers and specialty shops. There weren't a lot of brand name managers. A ton of country funds. If you think about country funds in the nineties, it was the only way that a U.S. investor

could access closed-end funds. A lot of people that learned about them when I was a teenager, currently the many retired investors that knew closed-end funds way back when, were very focused on international investing. Back then, we had thirty two country funds, which is thirteen percent of the universe at the time. Basically twelve country funds left. We looked at multi- country funds, the regional funds. There were twelve back then, but now there's thirty four. The universe of funds is now five hundred, so roughly double.

CHUCK JAFFE: Right.

JOHN COLE SCOTT: We see a lot more of focus on multi-region funds versus individual funds. Another fascinating thing, there was twenty-one investment grade bond funds. Now with twice as many total funds, there's only twelve. We had thirteen government bond funds, but only three have survived today. And convertible bond funds, there was oddly eight, and there's ten today.

CHUCK JAFFE: Even there, it's not necessarily that the funds have all survived. It's that that space lost most of its participants and has new ones, right? Because ultimately, it's not that the industry has doubled, there's been more activity than that. But there's also been a winnowing, where traditional funds close down.

JOHN COLE SCOTT: Yeah.

CHUCK JAFFE: Closed-end funds can closed down, but typically what happens is they open-end and they go off, and somebody realizes and grabs the discount. Wasn't there a lot of shareholder activism that was involved in getting rid of those old things? And then the market restarted and came back with new issues to replace and in some cases, grow the industry, right?

JOHN COLE SCOTT: That is a very common and sexy thing to talk about in closed-end funds. But you're right, there's only eighty of those initial two hundred and forty-five funds currently exist in the market today. But over twenty years, there's been about fifteen IPOs a year, which is just under three hundred. We get about twice that many, we call them, deaths; basically when a closed-end fund no longer exists. The biggest cause of deaths in the last eight years where we have our own data business, I can pull granular data, seventy percent of the deaths were mergers. Only twenty-five percent; twenty percent liquidations and five percent open-ending, were typically the activist led activity. So three out of four changes to the fund no longer occurring, are just natural things like converting to a REIT or operating

company, a ticker symbol change. Yes, it's happened. The universe has gotten smaller. It actually peaked with six hundred and twenty-seven tradeable funds, and we've seen basically with the IPOs out there, more of a concentration. What's interesting, is for a five year periods, 2000-2004, fifty-three billion raised and a hundred and two funds. 2005-2009, forty-four billion raised, with sixty five funds. So a nice increase in the average size. 2010-14, forty-two billion raised, eighty-two funds. The last five years, only twelve billion raised in forty funds.

CHUCK JAFFE: Let's talk a little bit about the last decade in closed-end funds, because thirty years is a lifetime for most investors, but ten years has really set up the market the way we know it today, right?

JOHN COLE SCOTT: Agreed. In those last ten years, we had BDCs, which when my dad his wrote his book, only one BDC existed; Capital Southwest, a 1971 operating company took advantage of the 1980 regs and became a BDC. Now there's about fifty listed and fifty non-listed, a hundred billion dollars in assets in an area that was only one little name thirty years ago. Interval funds just came around in the nineties but really picked up five years ago, now have fifty-eight funds and about thirty-five billion in assets. So those areas have taken some of the growth from the other areas. But like we're saying, the last ten years, we looked for income funds. Because even though there's non-income focused funds, I did a little of my own research thirty years later. Where are the income paying funds? Bond and equity, six percent are larger field, at least ten percent of leverage and pays monthly or quarterly. They average about an 8.8 yield, and their ten-year market price average return is about 8.7 percent a year. So it's interesting that they're producing their performance from their cashflow over time.

CHUCK JAFFE: As you forecast out the next ten years, how much is the past prologue, how much is, "Oh, no, everything will be different"?

JOHN COLE SCOTT: People often say, "What's your favorite?" and I go, "What's your goal?" Because you can't forget about risk and taxes whenever you build a portfolio. But to qualify an account like an IRA then you don't worry about taxes but risk is always a component. So I think as we look into what's been out there, I will say that when I built my high-income portfolio in 2006, it was hard to get to an eight and change yield that I liked. Now there's been so much growth in assets that use leverage, like CLOs, and BDCs, and MLP funds, that

we're able to yield nine to ten very easily in the universe because the average fund yields eight and a half. And so just interesting to me, when you think about the next ten years, I have a funny feeling that the next ten years won't be the same ten-year performance for the S&P 500. Happy to be wrong, but doesn't feel like you get twenty years of that. So we definitely like to lean in to areas where we see opportunity for less risk, and some actual discounts will still be there to help us with the cashflow we need.

CHUCK JAFFE: The closed-end fund business looks so much different today. If we're still doing The NAVigator ten years from now, and Lord knows, I hope we are. Where is the growth coming? Because you talked about IPOs, IPOs are very different now than they used to be. In the old days, you might have been willing to buy a closed-end fund IPO. Today, many people say they don't want to buy closed-end fund IPOs because there's so much leverage involved in a new closed-end issue. So what are the changes that you think will come to bear in the next decade that the last thirty years have been leading up to?

JOHN COLE SCOTT: One is the average cost of leverage for the levered funds, is like 3.2 percent inferred rate. So levered funds are average levered thirty percent, which is nothing compared to mortgage REITs, and banks, and other levered products. It's very benign. We looked at the expense ratios and backed out leverage, it's only 1.5 percent non-levered expense ratio. So their active management, the average fund is seventy percent turnover. The managers are changing their mind, and so I feel like they're as a whole doing their job, tilting for you. If you want the exposure of the market, you shouldn't be in a closed-end fund. You want to be exposed to a sector and a manager with cheap leverage, you should be. If you want to take ninety-two cents and buy a dollar thirty of assets, so basically one dollar in your account controls a dollar forty in a managers portfolio, closed-end funds are the right way to do it. Then the fact that the discounts move, on a ten-year basis, the average low for this universe was a seventeen low. We've had some bumps in the last ten years, but we'll probably have another set of bumps in the next ten years. As you know, we had the first ten year period without a recession in the U.S. history, and I expect we'll have one before the AICA turns eleven. Now the average premium high was 8.8 premium, so that's twenty-eight percent peak to valley for a portfolio of funds. You need to be trimming your gains and stepping into your losses where it still makes investment sense to me, no matter the market.

CHUCK JAFFE: John, great stuff. I have more questions, I don't have more time. But luckily, we know that because you're the executive chairman of the AICA, we'll get a chance to chat with you again in The NAVigator down the line. Thanks for joining me.

JOHN COLE SCOTT: So glad to be here, Chuck.

CHUCK JAFFE: John Cole Scott is chief investment officer at Closed-End Fund Advisors. Learn more at CEFadvisors.com. Dig into his database at CEFdata.com, and follow him on Twitter where he is @JohnColeScott. He is also founder and executive chairman of the Active Investment Company Alliance, and The NAVigator is a joint production between 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. To learn more about closed-end funds and business-development companies, go to AICAlliance.org for the Active Investment Company Alliance. They're on Facebook and LinkedIn @AICAlliance. The NAVigator podcast is available every Friday, thanks so much for being here. Happy New Year! We look forward to talking with you more throughout 2020.

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Click the link below to go to the home page of Active Investment Company Alliance to learn more:

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