AICA ACTIVE INVESTMENT COMPANY ALLIANCE
Excellence beyond indexing

March 30th, 2020
By Andrew Tanzer

Key Take-Aways from CEF Advisors' Research Call; "Closed-End Funds & BDCs: Discounts, Dividend Risk & Leverage Limits: Putting recent market moves & actions into perspective w/ John Cole Scott"

Founding AICA member, CEF Advisors' CIO John Cole Scott who serves as AICA's Executive Chairman held a timely talk and Q&A on March 23rd. You can read the full transcript and catch the replay at: https://tinyurl.com/CEFBDC2020-0323

Introduction

The average closed-end fund through Friday March 20th is down around 40%. Discounts widened; NAVs and market prices both fell. NAV movements reflect both bear market pricing and a lack of trading in the market, a shortage of bids. Most funds are levered (including 90% of bond funds), and leverage magnifies results on the way up and down.

For those who remember the Financial Crisis, discounts were wider than they ever got on a single day in October 2008. If you're in closed-end funds, your brokerage statements look scary, reflecting a sentiment of fear in the market. Volatility is something we talk about with every client, but I can essentially guarantee you that every client we've brought on in my entire 18-year career has not seen the current level of discounts that we have seen in March 2020.

Remember closed-end funds are not one position; they're diversified and actively managed. Closed-end funds have a fixed capitalization, and apart from breaking 40 Act leverage terms, they are essentially never a forced seller of assets (unlike ETFs and open-end mutual funds, which must sell to meet redemptions), which is very useful in periods like this. Historically, no closed-end fund has ever gone bankrupt, and no BDC debt has ever gone unpaid.

We never know where the bottoms or tops are, but I see signs that the market is oversold. Based on our models, the market is pricing around an 80% cut in dividends for many sectors. I don't see that happening. We're modelling 15% cuts for our portfolios; the average closed-end fund may experience a 20% cut in the next year, though there will be sectors and sponsors who are hit worse. If you stay diversified, haven't margined positions, and aren't forced sellers, you'll be okay in my opinion.

Remember, the fear you feel in situations such as today's is often positive, because other people feel also that fear and when there's no one left to sell, asset prices can recover. I think that pain is going to build the base

where NAVs can stabilize as the market gains more liquidity and discounts can come back towards normal levels. As in '08-09, we will observe a slow narrowing of discounts as time heals wounds.

Investment Perspectives and Strategy

At my RIA firm, CEF Advisors, we build multi-sector, multi-manager portfolios, because we believe no one sector or sponsor is perfect. We focus generally on the income side, with some growth component. We look for sustainable dividends, discounts that are more likely to narrow than widen, and net asset value in sectors that we can overweight. We often like managers who can wander and be active, since that's the point of active management.

In the current turbulent environment, we like munis, senior loans and preferred equity (higher on the capital structure than equity), multi-sector bond fund managers whom we know well, utilities, REITs, and the top 10-15% of BDC managers. Generally, fixed income tends to bounce back much faster than equity funds since there's a floor—what matters is if the income payments continue coming in.

Munis, for example, I think are very attractive now. Muni funds are typically well diversified investments, and I don't see any near-term issues for muni bond distributions at the sector level. If interest rates start to rise again, that usually means the economy is getting healthier. We looked at the correlation of a muni fund's market price to its net asset value over a 90-day rolling period to inform us of how much the current movement is going with or against net asset value. It rarely gets above ninety, but we are there now. When discounts are wide and correlations are up, it's often the bottom; it doesn't mean it's free of volatility, but it's where a bottom can be formed. There is currently a lack of liquidity in the muni market, but that will at some point be resolved.

Retail-oriented BDCs are the exact place to experience high volatility, the highest levels of fear. Coming into this weekend (March 21, 2020), BDCs showed an average 19% yield and a 47% discount. In this environment, when some BDCs are trading at ten to twenty cents on the dollar, I wouldn't bottom fish, but I'd look for dislocations that are significant and where liquidity is not going to be an issue. Quality BDCs have one of the best structures to work through the uncertainty, but I would say stick to top tier and high quality.

Last week we refocused parts of portfolios into lower-levered, lower beta, easier dividend policies. A quick and dirty method is to sort by yield: The lower the yield, the safer investors think that dividend is because they're not requiring high numbers. If you're currently an owner of funds in the bottom tier, the market is likely telling you it's expecting a dividend cut

We're seeing discounts of over 35%; dividends can be cut, and you can still get through it. Our models right now are for 80-85% of diversified income through the next two years based on a negative 25% GDP next quarter and a 20-25% unemployment rate. Bear in mind that leverage is very cheap today; there has never been a better time for prudent use of leverage in a closed-end fund structure.

If you were going to navigate this storm on your own, I would overweight the sectors I mentioned earlier. Lower beta, lower leverage, lower leverage-to-NAV yield are the types of funds I'd be searching for, and a great way to stay invested and remain comfortable as an investor. On portfolio construction, stay diversified, stay active. If you're an income investor, the yields are immense, and even with 20% haircuts, there's still a lot of cash flow that can survive the future. As an income investor, you don't need to primarily worry about the price movement of the investment; of more concern is the direction of the income. I know the pressure is immense out there; but

avoid panic selling. We can get through this; closed-end funds are the right structure to do so. It may not feel like it at this moment, but the rear-view mirror will look a lot better down the road.

There is a chance that, with so much pessimism in the market, any good news could turn this around quickly. In the past, we've solved hard problems. Markets are pricing as if we can't solve these hard problems, and that we'll live in caves and can never go to the office again. My best guess is that, in a matter of weeks or months, this will bottom out. Clients I have who were buying bond funds in '08 and early '09 are still bragging about the purchases ten years later.

Active Investment Company Alliance (AICA)

In addition to our weekly NAVigator podcast, we are working on a schedule of webinars through the Active Investment Company Alliance with both our members and participants in the sector. If you would like to be involved, go to AICAlliance.org and let us know. Whether you're a product manager, a closed-end fund advisor, an analyst, a fund sponsor, or a service provider, we'd be delighted to hear your story or research and for you to have a seat at the table.

The Active Investment Company Alliance (AICA) is a 501(c)(6) non-profit trade association for listed closed-end funds, business development companies, interval and tender offer funds. Membership will be broad-based globally across fund sponsors (member firm who manages a closed-ended management company, BDC or equivalent), or product sponsors (member firm who manages an investment product: open-end, UIT, ETF, CEF, SMA, LP where the underlying investments are focused on closed-ended management companies, BDC or equivalent) as well as service providers.

CEFData.com makes data for the universe of closed-end funds (CEFs) and business development companies (BDCs) available to its users. This material is not intended to be relied upon as investment advice or recommendations, does not constitute a solicitation to buy or sell securities and should not be considered specific legal, investment or tax advice. This site does not list all the risks associated with each fund. Investors should contact a fund's sponsor for fund-specific risk information and/or contact a financial advisor before investing. Distribution type sourced from CEFdata.com. For specific information about a fund's distribution sources, visit the fund sponsor's website.

The following information applies to closed-end funds and business development companies in general: Fund shares are not guaranteed or endorsed by any bank or other insured depository institution and are not federally insured by the Federal Deposit Insurance Corporation (FDIC). Shares of closed-end funds (CEFs) and business development companies (BDCs) are subject to investment risks, including the possible loss of principal invested. There can be no assurance that fund objectives will be achieved. Closed-end funds and business development companies frequently trade at a discount to their net asset value. NAV returns are net of fund expenses and assume reinvestment of distributions.

This material is presented for informational purposes only. Under no circumstances is it to be considered an offer to sell, or a solicitation to buy any investment referred to on this page. While the information contained herein is from sources believed reliable, we do not represent that it is accurate or complete and it should not be relied upon as such. Past performance is not necessarily indicative of future results. All investments involve risk including the loss of principal. Returns are presented gross of investment management fees and other appropriate fees (i.e. commissions, custodial fees, etc.). © Closed-End Fund Advisors Inc.(CEFadvisors) and CEFdata.com 2020. All rights reserved.

AICalliance.org - Contact@AICalliance.org - (888) 400-9694

Supporting closed-end investing worldwide