Matisse's Boughton: Closed-End Funds Represent A Compelling Value Now

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Chuck Jaffe, in The NAVigator podcast, interviewed Eric Boughton, chief analyst at Matisse Capital, a firm that manages portfolios of closed-end funds. Read the Q & A below as Eric explains why outsized discounts make most closed-end funds attractive potential investments now, noting in this interview from 'Money Life with Chuck Jaffe' that nearly every type of fund represents assets currently on sale. Still, Boughton notes that discounts by themselves are not a reason to buy, saying investors need to understand leverage and assets before taking a chance on higher-risk areas like master limited partnerships and more.

Eric Boughton

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

CHUCK JAFFE: Hi, it's Chuck Jaffe, host of The NAVigator podcast. I'm also host of money Life with Chuck Jaffe, and the upcoming interview is from that show, but since it's all about closed-end funds we wanted to make sure you got a chance to hear it. And we're talking closed-end funds now on the Money Life Market Call. Welcome to the Market Call everybody, the part of the show where we talk with experienced money managers about how they do their job, what they look for and what they're looking out for, what they see happening on the markets and how it shapes their decisions and how they put it all together. Today my guest is Eric Boughton, he is portfolio manager and chief analyst at Matisse Capital. Matisse Capital is a firm that runs portfolios of closed-end funds and they also run a couple of mutual funds that invest exclusively in closed-end funds, and if you want to learn more about what they do, whether it's private accounts or closed-end funds or more, MatisseCap.com is the website. Eric Boughton, thanks for joining me again on Money Life.

ERIC BOUGHTON: It's great to be here, Chuck. I appreciate coming back.

CHUCK JAFFE: We talk about closed-end funds occasionally on the Market Call, my audience kind of wishes we would do it more but there aren't that many folks like you, where you are focused exclusively or pretty much exclusively on closed-end funds. So when we start with methodology here, it has to be a little bit different. It can't just be what do you look for in a closed-end fund? It has to be why closed-end funds, and then what makes a closed-end fund stand out to you?

ERIC BOUGHTON: Right. I am one of the few geeks that really loves closed-end funds, as you mentioned along with some of your listeners. Closed-end funds are pretty great vehicles for investing. They are a way to get professional management. They're a way to get instant diversification and often attractive cash distribution yields to the end investor. Those qualities really make them attractive for individuals. They also have this key feature where you can purchase them very often at discounts to what they're actually worth. That has been the key to our approach at Matisse Capital when we invest in closed-end funds.

CHUCK JAFFE: But not all discounts are created equal. There's got to be something specific that you want to see along with, "Hey, nice discount."

ERIC BOUGHTON: Yeah, we're looking for a lot of things and I think the closed-end fund space is great because investors bring a lot of different ways of looking at it. They might invest in particular closed-end funds because they want to get exposure to one sector of the market such as REITs or foreign stocks, even stocks in one particular country. And they also might look at closed-end funds as providing a way to get leverage in the marketplace, because many closed-end funds use leverage in a way that can't really be done with other vehicles. They might be looking for closed-end funds trading at big discounts as an opportunity to trade them frequently, or they might be looking for closed-end funds that they own for a long time, they love the manager, they love the space. Many different ways to skin that cat, but as I said, the thing we focus on the most is discounts.

CHUCK JAFFE: Speaking of discounts, when you were last on the show with us after we had gotten into pandemic mode, which in the closed-end fund space would have been after everybody got crushed. I mean, nobody suffered more than the closed-end fund space. And at that time that had widened discounts to where you pretty much said, "Throw a dart," because there's almost nothing you can't hit that would be a buy because everything was so cheap. Well now we've seen closed-end funds pick up dramatically as the market has come back and we've seen discounts narrow, so what's the situation now in terms of how many of the offerings are worth buying?

ERIC BOUGHTON: Yeah, I remember that time quite well. Pretty recently of course, but yeah, it was a pretty hard time in March of this year. And as you pointed out the stock market was down 20%, and many closed-end funds were down 25-30%. On March 18th, discounts on the average closed-end fund hit a level that exceeded the last financial panic back in 2008. Apple was a $1 trillion company and 3-4,000 people every day were dying from COVID. Fast-forward to today, the pandemic continues, 5-6,000 people are now dying from COVID-19 daily, but the stock market has set new record highs, Apple is the first $2 trillion company, and the major fund indexes are now up 22-30% just since the end of March.

CHUCK JAFFE: With that kind of recovery, how much more challenging has that made it for someone like you who's looking to buy closed-end funds? Opportunity still there for you?

ERIC BOUGHTON: Absolutely. Absolutely the opportunity is still there. So even though the stock market has set new highs, most closed-end funds are still far below their levels of last year so the underlying net asset values have bounced, but closed-end fund discounts overall that we pointed out were at incredible levels in March, they remain at very attractive levels. Just to put some numbers around that, back at the end of March the average discount was 8.6% for a U.S. traded closed-end fund, and today that's still very large at 7.9%, and that is still more than one standard deviation cheaper than the long-run average discount of 5.0%. And furthermore, when you look at bond closed-end funds, those discounts have narrowed somewhat from the end of March. Nearly everything else in the closed-end fund space is at a bigger discount today than it was at the end of March, discounts have widened. For example, the 191 non-bond closed-end funds in the universe trade on average at a 12% discount, which is two standard deviations cheaper than their long-run average.

CHUCK JAFFE: Wow. And if my audience doesn't understand exactly what a standard deviation it, understand it's a significant magnitude of difference, and for you, there's a lot of money for that in terms of what you're getting cheaper. Now my audience knows, not just because they've heard you before but because we do The NAVigator, which is all about closed-end funds, that closed-end funds do kind of all run in packs, you have little groups. Here's an area that these are certain types of fixed-income funds, and these are certain types of equity funds, and what have you, and they do tend to all move very much in sync with each other. So are there specific areas within the closed-end fund space right now that are much more attractive than others? And are there some that you are avoiding or can't go to at all at this point?

ERIC BOUGHTON: Sure, I can highlight just a few areas that I'd say typify the attractive parts of the closed-end fund marketplace. The first is foreign stocks, systematically I'd say those are the cheapest area, the average discount is 14% in that group compared to their 8% long run average in that group. So investors in their rush to buy the S&P 500 seem to have abandoned foreign stocks. They seem to not be able to get enough of the S&P 500 at 26x earnings while the EAFE is at more like 18. Closed-end funds are a unique way to play potential reversal in these valuation differences, especially in that foreign space. Another attractive area that we would look at, especially for investors with the right risk tolerance and a positive view of the sector, would be MLP closed-end funds. Baack in March we mentioned closed-end funds in the MLP space traded at that time at a 15% average discount, today that discount has widened out to 24%.

CHUCK JAFFE: Wow.

ERIC BOUGHTON: So the underlying NAVs on the funds have bounced back quite a bit during the same time, many of them are up 50% or more since March 31st, but that still leaves most of these funds at less than half of their 2019 levels. So we would hesitate to make it a recommendation just because it's such a volatile sector, but any investor with a positive view on MLPs would do well to carefully consider investing in MLP closed-end funds today.

CHUCK JAFFE: What about areas that you're avoiding?

ERIC BOUGHTON: I'd say there's good discounts across the closed-end fund space, as I mentioned the entire universe is one standard deviation cheaper than it usually is. There are a subset of closed-end funds which seem to have run up based on their attractive looking cash distribution yields, that's always a theme but I'd say it's more of a theme today. So if you're looking at a closed-end fund that promises to pay you back double digits, look at it carefully, especially look and see if it's at a big premium to its net asset value, or if its discount is narrower than it usually is, or if its run up a lot in general. That could be a fund that's prone to decline if and when it needs to cut that attractive looking distribution.

CHUCK JAFFE: Now we're going to find out how you feel about some closed-end fund specifics, the ones that my audience is interested in. It's Hold It or Fold It time with Eric Boughton, portfolio manager and chief analyst at Matisse Capital. Go to MatissaCap.com to learn more about their funds and all about closed-end fund investing and much, much more. You know how Hold It or Fold It works, we're a little bit late getting here and we want to try to get as many in as possible, so we're going to jump right in. Starting with a request we got from Rich in Orchard Beach, Maryland and Andrew in Cary, North Carolina, it's a fund that has been on the waiting list long enough that it's actually changed ticker symbols. They asked about RIF, it's now RMRM, the RMR Real Estate Income Fund.

ERIC BOUGHTON: RMRM now called the RMR Mortgage Trust, it's in the process of being converted from a closed-end fund to a mortgage REIT. They closed Monday at $9.99, which was an incredibly shocking 44% discount to its $17.17 NAV. So this discount is extreme, not only compared to the fund's average 20% discount over the past five years, but when you consider that the typical mortgage REIT trades very close to NAV. So even here in the midst of the pandemic the median mortgage trades at only a 12% discount to net asset value. Meanwhile the fund pays a 4% dividend while investors wait for the market to move it back to some semblance of fair value. Just as a thought experiment, consider if the fund's NAV returned to its post-COVID high of $20.02, just back in June, a year from now continues to pay a 10 cent dividend and simply movies to a 20% discount to its NAV, investors at $9.99 would have a 64% gain on their investment.

CHUCK JAFFE: So it's a buy on RMRM, the RMR Mortgage Trust. Rich in Orchard Beach shares our next request with a different Andrew, this one in San Jose, California, both wanted to know about Nuveen Diversified Dividend and Income, JDD.

ERIC BOUGHTON: This one is a global balanced fund that emphasizes REITs, dividend paying stocks, emerging market debt, senior loans, kind of a grab bag of income paying investments, and it's turned in a solid long-term track record with for example a 6.3% at NAV return since it launched in 2003 ahead of most relevant benchmarks. And despite this long-term success, the fund closed on Monday at a 19% discount to net asset value, compare that for example to its five year average discount of only 8%. It also pays a 10% indicated cash distribution yield, which they've cut slightly over the past few months to a sustainable level in our view, so we think it's a buy.

CHUCK JAFFE: That's a buy on JDD, the Nuveen Diversified Dividend and Income Fund. Next for Rick in York, Pennsylvania, it's John Hancock Financial Opportunities, BTO.

ERIC BOUGHTON: BTO, this fund invests in bank stocks. That's an area where there's certainly still opportunity as evidenced by BTO's $23.00 share price, compared to its high over 40 bucks in 2018, and BTO is unique among closed-end funds because it focuses on the banking sector. Now partly because of this uniqueness, investors playing for a bounce in the sector have pushed its share price up to a 6% premium to its net asset value. Based on our observations of closed-end funds sustaining a premium to its NAV is pretty rare, and indeed BTO has traded at an average 8% discount to NAV since inception. To us the discount related downside risk is high enough that investors in BTO might want to consider an exchange traded fund instead.

CHUCK JAFFE: It's a fold on BTO, the John Hancock Financial Opportunities Fund. Next for Charles in Philadelphia, GGZ, Gabelli Global Small & Mid Cap Trust.

ERIC BOUGHTON: Wow, this fund has been swimming against three strong currents ever since it launched in 2014. It invests overseas, it invests in small caps, and it uses a value approach, so investors have pushed the fund to a big discount. So the fund's 2.8% at NAV return since it launched looks pretty meager next to 12% say for the S&P 500 and 17% for the Russell 1000 growth. However it looks okay compared to the 2.7% for the Russell 2000 value and 2.1% for the EAFE Small Cap Value Indexes. Here at Matisse, we're of the opinion that all these three currents could shift over the next decade given the record valuation discrepancies present in the stock markets today. And if that happens, we expect investors will also reward GGZ with a discount quite a bit narrower than the 19% discount at which it currently trades. Some of Gabelli's other closed-end funds for example trade at much smaller discounts or even at a premium to NAV. Meanwhile the fund initiated a regular quarterly cash distribution in 2019 and raised it here in 2020, and that yields 6.9% while you wait for the market to bring it back to its correct price in our view, so it's a buy.

CHUCK JAFFE: That's a buy on GGZ, the Gabelli Global Small & Mid Cap Trust. And last for Dale in London, Ohio, it's IDE, the Voya Infrastructure, Industrials and Materials Fund.

ERIC BOUGHTON: This fund invests in stocks of companies involved in infrastructure development, telecom, utilities, chemical companies, railroads. These stocks have not been market darlings recently but the fund does have a respectable 5% at NAV return over the past five years, which is ahead of a relevant benchmark. It trades at an unusually large discount to NAV at 18% compared to say an 8% average discount since it launched in 2010, and it also pays a 10% cash distribution while the investor waits. So we think this is another buy.

CHUCK JAFFE: So we finish again on a high note. It is a buy on the IDE, the Voya Infrastructure, Industrials and Materials Fund. And now we have one more goodbye to talk about, and it goes like this, Eric Boughton, goodbye. But thanks so much for joining me on Money Life, this was great, always is. Please stay safe and come back and do this with us again down the line.

ERIC BOUGHTON: Will do, Chuck. Thank you.

CHUCK JAFFE: That's Eric Boughton everybody. He is portfolio manager and chief analyst at Matisse Capital, MatisseCap.com, the website for more information.

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