John Cole Scott provides welcoming remarks to the 2021 AICA Income Spotlight event along with a presentation on "ABCs of CEFs".

Thursday, June 17, 2021

John Cole Scott, Founder and Executive Chairman of the Active Investment Company Alliance opens the 2021 AICA Income Spotlight event with opening remarks and with a primer on CEFs. Read the transcript below to hear what Mr. Scott had to say to kick off this event.

John Cole Scott

To view the rest of the conference events and panels go to:
AICA Income Spotlight Summer 2021 - AICA (aicalliance.org)

John Cole Scott: All right, good afternoon, John Cole Scott with the Active Investment Company Alliance. I want to thank you for coming in on a nice, bright, sunny day and doing some closed-end fund content with us. Really glad, this is our fourth time using this platform, we get really good feedback. But because every session is different and every attendee is different, please before you go home or soon after, click the survey link so that we can really get your active and recent feedback for what we're doing right and where we can improve.

AICA is a non-profit trade association that's about to turn two, I started it two summers ago. And really was balanced on the concept of fund sponsors, product creators, and specialist firms like my company Closed-End Fund Advisors, as well as the service providers that balance the content that's focused across all three of those groups of companies. And then to only focus on things that I'll say file an N2 filing, closed-ended management companies. That is a closed-end fund, a business-development company, an interval fund, or a tender offer fund. And we seek to produce high-quality content to really help educate financial advisors and the investors that they serve with a focus on independence and an invite to speak model.

This panel really came from one of the conversations we have with our clients about how do we maintain regular income for them with a probable increasing of inflation pressures and probably interest rates soon after? We decided real assets and credit funds were a nice balanced approach to the investments, plus lots of great speakers and presenters in that group of closed-end funds. During the sessions there's a Q&A functionality, please feel free to click on it and submit your questions. We have dedicated 10 minutes to every session, making sure each moderator knows that your questions and the why you're here today is of real importance to us at AICA.

We really cannot produce these events without support of our membership. We really are focused as a member-driven model for financial resources. We also, because we want anyone who's willing to and able to, there's a donation button on the website and at the event should you find this valuable. We chose to make it free for all but donations are welcome from anyone at any size and any amount. If you have any issues from a logistical perspective, Katherine or Jennifer should be at the AICA support table, center left. And if there's a technical issue with the platform, first try refreshing your browser, switch to a computer, go to Google Chrome, those are often the best. But otherwise if it's more complicated, click the question mark arrow on the lower left and the people at Remo should be able to help you as well.

We do want to make use of this platform, it's more than a webinar, I have a slide deck coming up for the ABC's of Closed-End Funds. But really the intentional break will give you a chance if you need to grab a cup of coffee, use the restroom, but also mingle the tables. Double-click to pop around, turn on your mic, turn on your camera, feel free to meet somebody for the first time or catch up with somebody you haven't seen in a while. If you want to, there's a profile button on REMO, upper righthand corner, probably has your first initial in a circle. Feel free to add a photo, headshot, a LinkedIn profile . If you're in business-development or sales, you can add a scheduling link to your calendar, just make use of this platform. We plan to use it for many, many years to come, even when we come to in-person events.

Don't forget we have a weekly podcast, we're really, really close to 100 podcasts. It comes out every Friday, *The NAVigator*, we have a direct link to it from inside the floorplan. We also have a direct link to our fund screener on the AICA Alliance website and the 30 plus closed-end fund indices we developed at my firm. We could not do this event without sponsors. Sponsors include my firm, Closed-End Fund Advisors, NASDAQ, and Broadridge. So if you enjoy the event today, please feel free to clock on their logos, check out their websites, they have representatives at the event that would love to interact with you in a meaningful way. As I mentioned, feel free to use the survey, it is really, really important. So with that, I'm going to go ahead and launch the presentation. Share my screen, click the right one this time and we should be good.

ABC's of CEFs

The goal here is to just give you a quick overview of closed-end funds in case you're new so we can make sure the presentations are most useful to you. All right, always fun.

So what is a closed-end fund? It's under the 1940 Act or the Investment Company Act, which includes open-end funds, includes ETFs, and unit investment trusts. They have a fixed-capital structure, active management, and majority of them are listed on exchanges and trade daily. I've looked this up in my father's book from 1990, they've been around since 1893, 128 years. The first one was called the Boston Personal Property Trust. I actually reached out to the New York Stock Exchange about the actual month and date of the IPO and the archivists couldn't look it up, I guess it was too many years ago. I then was curious to learn the first leveraged closed-end fund, one of the unique features initially of the closed-end fund structure, was a Railway and Light Securities Fund back in 1904.

Funds trade above or below net asset value. I always say that they're related to but disconnected to NAV and the manager and fund sponsor control NAV, and I would say that investors and to some degree boards control market prices. And that movement over time varies, it varies based on sentiment, fear, greed, and many other factors that you may have learned about or could learn about through time. As a registered investment corporation, it is a tax-advantaged structure, there's no taxation at the structure level. Dividends are paid to shareholders for most closed-end funds regularly, and then of course based on the type of dividends and your tax situation, you would pay taxes or your clients would pay taxes.

They can use preferred shares as leverage, they also use other types of leverage, leverage has become very diverse since the Great Recession. And again, sometimes people say, "How are closed-end funds doing?" Or, "What's the best closed-end fund?" And the challenge is that the closed-end fund structure is a wrapper and not a sector, and so a muni bond fund and an emerging equity fund act very differently but technically can both be closed-end funds. And they weren't very popular or very prevalent when I started working at the company but exist as long as our company has, tender offer interval funds are growing, these are the non-listed funds. If you have a question about them, we have a replay conference with four panels in replay mode on the AICA website currently, you can catch up there.

So this is the broad universe of 528 funds. We do include business-development companies as a closed-end fund both major group and the debt-focused, which is most of the funds in that grouping, as a peer grouping in our dataset and in our work for clients. They are a hybrid structure between closed-end funds and operating companies but to me act very, very similar in the important ways; active management, publicly listed, and a fixed-capital structure.

Most closed-end funds in the United States have a yield focus, and you can see different levels here, current indicated yield for a peer group for the current discount. Of course this was as of quarter end, we're getting close to a new quarter. If you like these types of slides, we do a very detailed quarterly session at CEF Advisors that we invite anyone to attend and ask questions.

Yield is a big part and a simple way if you're newer to closed-end funds. The indicated yield is the blue line here. But if you take away the impact of leverage and discounts, that kind of lighter green line, I would argue it's roughly what the manager has to blend to meet the dividend policies set by the board. And when there's more discount and/or more leverage, it's a wider difference. And I think that's probably one of the ways you can get more income out of a closed-end fund portfolio than a non-closed end fund portfolio, and so that's an important feature and function. This is the chart for debt sectors, and this is the chart for equity sectors. Equity sectors tend to have less leverage so usually there's less difference in the magnitude between the two parts.

I'm going to just make sure there's no questions but if you have one feel free to do it. This is meant to be an introductory session, I do want to make sure I didn't miss any.

Dividend changes are common, both increases and decreases. I pulled this one slide from our deck and I'd say really I'm going to focus on two areas, the muni bond sector, the largest sector of closed-end funds and the senior loan sector are a really well designed sector for the closed-ended structure because they both in the last year had significant numbers of increases and decreases. And that reminds me that it's really important that some trends impact the whole sector but you can't forget different boards or fund sponsors handle the market differently. Some build up reserves and have a cushion based on their estimates for a portfolio performance from their funds. Some pay out exactly what is available every month and have small increases and decreases regularly over time. And then some potentially overpay because it's one way to reduce the discount and can keep activists at bay. It's important that those distributions aren't always bad because they come out of net asset value, but just be thoughtful if a big yield is in your face it may not be a real yield. There are some incentive reliefs that allow closed-end funds to pay almost anything it desires.

This is not a pretty chart but we use it at the firm to really think about the trends at the dividend level out of our CEF dataset. And basically I'll just say that trends are improving but that literally there are some funds with so many changes in a given year that 78 funds out of just about 500 really increase and decrease over a 12-month period. And that really hammers home the point to me that a closed-end fund portfolio, the dividend polices are polices not promises. It's a great way to fuel your retirement but you need to be thoughtful on how to analyze it before you buy the fund, and manage the potential risk of a cut during your exposure to them. And if there is a cut, decide, do you add more, do you maintain your position, or do you have to sell the investment for your needs? Those are decisions that we regularly make for our clients.

Discounts, the other key feature for closed-end fund portfolios. This is a 20-year chart, this is as of the end of last quarter. Really showing that there are periods of discounts, but there are also are periods of very narrow discounts like we're in today and even potentially some small premiums over the last 20 years. When we looked at it at the end of the quarter, closed-end funds I would say were moderately narrow, kind of in the middle of the pack, about many months either side of them. Ran the data this morning, yesterday's close, we're sitting at about a 1.8% discount on average for closed-end funds, which only puts it to where you've got about 35 months in the last 20 years that had a narrow discount.

Again, this is my opinion here but I would say that while discounts are always going to move around. There's a lot of need for yield and there's a lot of low-cost leverage that can be very attractive in many sectors, and there's just a lot of competition for what's available. And while we'll always have some unknown happen that makes markets move on the downside eventually the way they always have, I would say that there is some room for narrowing further. But definitely the easy discounts of '15-16, or fall of '18, or March of 2020 are no longer a tailwind. We're kind of in a neutral to a slightly overvalued for the average fund. Which is why I think you need to be a little more tactical both in your selection of a fund and in your management of a fund in your portfolio over time.

IPOs, very healthy. There's right now one fund every month and they're raising large amounts of money. An improvement to the structure where the client no longer pays the sales load, and many of the funds have a 12-year term, and so at the end of 12 years you're able to choose to get out net asset value or vote the fund to become a perpetual or permanent fund. Those two things really allows for two things to happen. One is the interim NAV, net asset value, is the NAV you get as an investor. And it also means that the fund sponsor, because they're paying that load, have to be really excited about the success of the IPO as well as the investment strategy. And then they have to service and support that fund for 12 years to have it become a potentially perpetual fund like most closed-end funds are. And I think there's nothing that's perfect but it's a really powerful opportunity to improve the funds available for firms like us and investors like you.

Mergers have been so common since about 2012, they seem to keep coming at us. They refocus the portfolios, they make them larger, some very large ones in recent time. And again, they are common but they just happen regularly. Typically 20 a year is the long-term average. People think that activism or other parts of closed-end funds are killing the structure. And really going through long periods of times, yes, there are funds that no longer exist, they liquidate, they convert to an ETF, they open end. But really the average is eight a year. And so it does happen, it's not to be ignored, and sometimes it's funds that just really need to be refreshed. Sometimes you'll see instead of a death, you might get a merger or other things that can repurpose the structure.

Even though it's summer, it's a very pleasant day here in Richmond, Virginia. It's hard not to at least mention to folks about tax-loss selling season and the fact that it happens almost every year. We measure it here with a 14-sector large bucket of funds, and so there's actually even wider moves if you look at where it's actual reason for tax-loss selling pressure. But it's really important to note is that basically every year except for 2017 was a significant amount of potential alpha if you could time the entry and exit from tax-loss selling pressure. And we do update this slide every year during the second quarter.

That is basically it. With that I'm going to take us out of presentation mode and then let Mariana Bush come up and start the next presentation. Thank you for your time, I'm so glad you're here. Enjoy your day.

Recorded on June 17, 2021.

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https://AICalliance.org/