



Finding Big Discounts Is Hard, But Closed-End Funds Remain Attractive

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Chuck Jaffe, in this episode of The NAVigator podcast interviewed John Cole Scott, chief investment officer at Closed-End Fund Advisors and the executive chairman of the Active Investment Company Alliance. Read the Q & A below as John says that with strong recent



performance, 'getting big fat discounts continues to be hard,' but he says that shouldn't dampen enthusiasm for closed-end funds and business-development companies. He cites opportunities in energy, real assets, and real estate funds, and notes that narrower discounts make this a time to consider non-listed funds, which tend to be less levered and volatile in the choppy market conditions we're likely to see moving forward.

John Cole Scott

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CHUCK JAFFE: John Cole Scott, founder of the Active Investment Company Alliance is here, let's talk about closed-end funds and business-development companies, this is The NAVigator. Welcome to 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's brought to you by the Active Investment Company Alliance, a unique industry organization that 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, The NAVigator's

going to point you in the right direction. And today, well, pointing us in a lot of directions is going to be John Cole Scott, who not only runs the Active Investment Company Alliance but who is chief investment officer at closed-end fund advisors in Richmond, Virginia, which has really helpful research tools online for you to use at CEFdata.com. You can learn more about the firm at CEFadvisors.com and about the Alliance at AICAlliance.org. John Cole Scott, great to have you back on The NAVigator.

JOHN COLE SCOTT: Great to be back, Chuck.

CHUCK JAFFE: I know you use closed-end funds, you're all about closed-end funds, they're the core of your philosophy. But for our audience on The NAVigator, well, it includes some guys who are die-hards like you, but it also includes people who they're trying closed-end funds, they're using closed-end funds for a piece of their portfolio and more. And throughout the crazy market that we've had for the last, now really 18 months, where we went through a sudden deep bear market and then have had a monster of a rebound, the talking points on closed-end funds haven't always been great. It was, "Look at how big the discounts have gotten." "Look at how much they got crushed in the downturn." "Look at how much they've closed that, but have they come all the way back in the upswing?" So I've got a basic question, if I'm a closed-end fund investor right now, if I'm trying to use them more, am I happy? Because the talking points don't always seem that way, but I think the data probably tells a slightly different story.

JOHN COLE SCOTT: Definitely a great, great question. So as we keep going back to the pre-Covid highs for discounts or dividends, we are in a total return basis still about 15% past that. Really we matched it in the late fall, and we really started making progress after the election. Discounts are about 1.5% narrower than pre-Covid level and still about 1% narrower than three and five years ago. So the simple answer is, getting big fat discounts continues to be hard, but at the end of the day what we like about the closed-end fund structure is that resiliency of recovery if you're patient. We always go back at the firm for our clients of multi-sector, multi-manager, we don't know what's going to happen but we try to build a portfolio over the right rails and then react to things as they happen. It's also interesting, BDCs, which are a closed-ended management company, got hit especially hard in Covid and they're in the middle of another earnings season and the numbers are just phenomenal. They're trading rather well with good data coming out from many of the

managers, talking about why their loans are focused on tiny U.S. businesses, average loan size is between \$10-25 million dollars, these are not ginormous loans for companies you've heard of.

CHUCK JAFFE: In terms of where we go from here, don't get me wrong, if performance has been good that's great, but what people who are buying closed-end funds most like are those big honking discounts. So if we don't have those, what do we have to recommend closed-end funds going forward? What's going to be the reason why somebody should say, okay, in this next stretch where we're going to see by most accounts, more volatility, a little less uncertainty, maybe rising inflation and rising rates. Why should somebody who's gotten this far in closed-end funds take the next step and keep going?

JOHN COLE SCOTT: Well, a couple of things. So on the interest rate sensitivity side, you get preferred equity funds and municipal funds, where they're still attractive on an absolute basis versus their non-closed-end fund peers, that's where you're going to see more net asset value pain if we have an inflation or duration event like the Taper Tantrum. But really it goes back to many of the sectors that are available, and whether they're equity sectors or bond sectors, have less interest rate sensitivity at the portfolio level. So think durations, high-yield durations I believe globally are on a five or a six right now for bonds, and many of our portfolios have blended durations of two to three. And so the active management and sector selection is where you're going to find a lot of the most important work to be done. And as we talked about our interval fund event at the end of March, which is now in replay mode if you'd like your audience to listen to it, this with narrowed discounts is the time to consider these non-listed opportunities because they generally are less leveraged, less volatile. The only tradeoff we always talk about is you can't sell them during the day, it could take time to get out. So I think that's the thing to focus on now, the recovery and the fact that dividends can go up because leverage cost is very, very cheap right now. Some of the more recent IPOs, a handful of them have leverage costs under 1%, and that's very powerful if you can't get discounts to have the spread between borrowing lower interest rates short and investing medium longer. And not just duration bonds, but loans and other interesting investments.

CHUCK JAFFE: Help everybody understand this, if you've got those super low rates for leverage, does that ultimately mean that if funds that are in that situation wind up being in the market's sweet spot, that basically that's a significant goose to returns? I mean, if you're

looking at it and you see that leverage rate being really low, you'd be thinking, this is going to be positive if we're in the right investments, correct?

JOHN COLE SCOTT: Yes, but if you want to think about where it could be bad, last year we had preferred and munis raising their dividends because their costs were down. Positive for pretty much every investor you can think of. If we were to have a flatter curve or rates rising faster than stable levels which are more normal for the United States economy, that's where, nothing's perfect, but you could see some problems. But yes, having the funds manage their leverage. Leverages aren't an on and off switch, it's a dynamic part of the portfolio. Many of the best investment managers that we work with manage the balance sheet, the right hand side, the investments in the left hand side, the leverage equally because they're both very important for long-term total return.

CHUCK JAFFE: So what's your outlook? Again, we've got these interesting conditions, super interesting if you're using closed-end funds to generate income in an environment where income is hard to come by. How optimistic are you for say, the rest of the year? Because we're at that spot where there are a few people going, "Sell in May and go away," is not necessarily bad advice in this market.

JOHN COLE SCOTT: One of my clients called me up the other week and goes, "Hey, we're up a lot. We're up like 20% this year." He had some overexposure to energy and really, "Should we raise some cash because it feels expensive?" And my pushback on this investor was, "Well, what are you going to do with it? Do you have a plan for it?" And I've always felt that it's really hard to short or to pause if you're an income investor, because you need to live off it. Either you go short something or you raise cash and wait, you have to be generally right twice. If you had bought pre-Covid, you would have made money. We didn't know that but that's factually true. If you had bought in November of '07, pre-Great Recession, a year and a half later you had made positive performance. And every situation is different, I think the most important thing to do is to build the asset allocation to what makes sense for your personal needs, and then be willing to make changes. Sell narrow discounts to some wider, rotate in sectors that seem like they've fully recovered and look for opportunities in places like there's still some opportunities in energy and real assets and real estate funds that they still feel attractive because they're just not historically expensive and they're not as sexy as the FAANG stocks.

CHUCK JAFFE: John, great stuff as always. Thanks for joining me to talk about it.

JOHN COLE SCOTT: Always great to be here, Chuck.

CHUCK JAFFE: The NAVigator is a joint production of the Active Investment Company Alliance and Money Life with Chuck Jaffe. I'm Chuck Jaffe and to learn more about my hour-long weekday podcast go to MoneyLifeShow.com or check it out on your favorite podcast app. To learn more about closed-end funds and business-development companies go to AICAlliance.org, the website for the Active Investment Company Alliance. They're on Facebook and LinkedIn @AICAlliance. And if you have questions about closed-end funds, send them to TheNAVigator@AICAlliance.com. Thanks to my guest, John Cole Scott, the chief investment officer at Closed-End Fund Advisors in Richmond, Virginia, the founder and executive chairman of the AICA. His firm is online at CEFadvisors.com and CEFdata.com, and he's on Twitter @JohnColeScott. The NAVigator podcast is available every Friday, please subscribe on your favorite podcast app and join us again next week for more closed-end funds. Stay safe everybody.

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