



## Choose Your Weapons: Arming Yourself Against Rising Rates And Recession

Friday, September 30, 2022

Chuck Jaffe, in this episode of The NAVigator podcast interviewed John Cole Scott, chief investment officer at Closed-End Fund Advisors, the chairman of the Active Investment Company Alliance. Read the Q&A below as John discusses and compares floating-rate and senior loan funds with preferred-securities funds, noting that floating-rate funds are a tool for



John Cole Scott

combating high and rising interest rates, while preferred equities are a good weapon for battling a recession. As a result, investors in today's complex market may want to "split the ticket," using both types of funds to bolster their portfolio; he looks at the characteristics of each asset class, and has fund suggestions in each category for investors to consider.

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

**CHUCK JAFFE:** John Cole Scott of Closed-End Fund Advisors and the Active Investment Company Alliance is here, and we're about to discuss preferred securities funds versus floating-rate loan funds, welcome to The NAVigator. This is 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 is 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, joining us again, John Cole Scott, he's chief investment officer at Closed-End Fund Advisors in Richmond, Virginia, online at CEFAdvisors.com, and we're about to dig into some funds using the firm's research, and if you want to dig into their research yourself go to CEFData.com. John is also the chairman of the Active Investment Company Alliance, and you can go to AICAlliance.org to learn more about closed-end funds, interval funds, and business-development companies. John Cole Scott, great to have you back on The NAVigator.

**JOHN COLE SCOTT:** Always good to be here, Chuck.

**CHUCK JAFFE:** You know, John, any place but The NAVigator, if the first sentence is, "Hey, we're going to talk preferred securities or floating-rate loan funds," pretty much everybody goes, "Oh, well, that's too boring to talk about, I'm going to turn that off." But here at The NAVigator, that's exciting stuff. And it's particularly exciting right now because, well, quite honestly, people are looking for yield and they're looking for something that they feel is going to be somewhat secure, where they're getting a really good price. And that's a lot of what you're seeing in the preferreds and with senior loans, right?

**JOHN COLE SCOTT:** It is. I mean, they are both really good uses, the investments in both groups of securities of the closed-end fund wrapper. They're not that liquid, it's a good use of leverage, the leverage is very cheap for both types of funds, yet they're very, very different. Because preferred equity, their dividends tend to be tax advantaged, usually a lot of qualified dividends for investors, and they're more of a fixed coupon payment, so there's a duration typically around four right now for that sector. And then senior loan funds, the dividends expect to be all regular income, they're a floating-rate dividend stream and they have generally better recoveries than high yield, but you know, they're not a duration asset, they're mostly in the non-investment grade. So they're really good uses of the wrapper and they're both trading relatively wide like many funds in our purview, and we really think it's a great way for investors to consider the concern of going after rates keep rising, you would want to lean overweight senior loan funds, and if you're worried about a future recession you'd want to overweight preferred equity.

**CHUCK JAFFE:** Let's talk about that. Why each one for each situation? Why is inflation right for senior loans and recession right for preferred equity?

**JOHN COLE SCOTT:** So for senior loans, most of their leverage tends to be fixed rate and the bulk of their investments in those funds tend to be floating rate, they tend to reset every 90

days, sometimes sooner, and as rates are trending higher like they've been for the last six months, you see the net investment income at the fund level going up. And we've seen many funds in that group actually increasing their dividends in the market. And these are the types of loans in this sector of many larger companies that you may have heard of, but the loans themselves are very illiquid and really benefit from that closed-end fund fixed capital structure. And then you go and look at preferreds, and if you really think interest rates are going to keep going higher, the duration of the preferred funds being a four and change is going to hurt the net asset value of those holdings a little bit more. But then again, the benefit is, we don't know which direction's going to truly win out, and so the preferreds offer you that ability to have half the duration roughly of muni bond closed-end funds and still they both have similar dividend profiles of seven and high change to eight and mid change for the sector.

**CHUCK JAFFE:** Again, the important part here is that you're getting that kind of yield on a great discount, ultimately how close do these investments come on a total return basis when you factor in the discount and what that really means you're getting the yield for? How close do they come to actually being able just on a yield and discount basis to beating inflation?

**JOHN COLE SCOTT:** The dividends tend to grow, I mean, the inflation we've had is very high and so the dividend growth rate is yet to hit the six, seven, eight, and nine numbers that have been the peak of what we're seeing. Dividend growths in the sectors have typically been four-five, a few higher but I would say go for a little bit lower. In the last six months interest rates has been a strong story, a lot of the preferred equity funds are down 11 and change, and a lot of these senior loan funds are down four and change. And the main difference, it's not credit, we're still in a healthy economy so far, it is the duration profile of the preferred guts going down further than the prices of loans. Loans are down off par, but they are not being impacted negatively by the rise of rates.

**CHUCK JAFFE:** So again, we're looking at preferreds for recession and senior rates for inflation. I know you didn't come here without having a name or two that are exemplars of the space, things that you like in each space.

**JOHN COLE SCOTT:** It is, and we dug into our database at CEFData and we tried to find decent size funds for liquidity for your audience so they don't worry about trading. We looked for less volatile NAV on the funds, and then both wide discounts absolutely, wide

discounts relative to themselves, wide discounts versus peer group averages, and we also did dividend coverage and reasonable cost of leverage. For the preferred equity side we came up with JPS, that's the Nuveen Preferred and Income Securities Fund, again just shy of an 11% discount, just north of a 7.7% yield, and it has duration profile of 4.3, and it's a great way to add that type of security to your portfolio. And just for perspective, the leverage is pretty reasonable at 38% which is pretty normal for that sector. For the loans side we looked at BGT, which is the BlackRock Floating-Rate Income Fund, and again, 11% discount, a 7.1% yield, less leverage, 28 and change percent, and again its duration is 0.21. So when you put those together, if you were to split the ticker per se, you have roughly half the loans investment grade, half the loans non-investment grade, you do get a nice micro diversified portfolio, and I think it's a great way to consider an income allocation in this market. And because of the wide discount and modest leverage, for every dollar in your investment account you have exposure to \$1.50 of manager assets.

**CHUCK JAFFE:** And like you said, as you say splitting the ticket, well, in one portion of that ticket you're trying to make your portfolio recession proof, and in the other portion of it you're trying to make your portfolio inflation proof. There's one other thing I wanted to jump back in on, because you talked about comparing the discounts now to their historic discounts. And obviously there's never a guarantee that like, hey, if the discount's wider than normal it's just going to go back to where it usually is. But that's always part of the hope, it's always part of the thinking. So we know that closed-end funds in general have been hit pretty hard as this market has turned down, how wide are these discounts compared to normal? Because you talked about where the discounts are but you didn't make that comparison for us.

**JOHN COLE SCOTT:** It is. The discounts have come down basically 10% for many of these funds. Each of these funds, and actually their sectors in general in the last three years, have been trading above net asset value. These are both funds and sectors where the net asset values are lower volatility, and we especially looked for the funds with the higher discount volatility. Because one thing we do for our clients, or our prospects or the advisors we work with, is we really try to take the concept of volatility and disconnect it from pure risk, and talk about the dividend risk and the NAV risk, and that the volatility you get in this period of the pullback in closed-end funds is an opportunity. Just like when things are looking really--

they were at premiums last December when I think I was on your podcast, and things are very tight and expensive, you should be making decisions to rotate risk off the table because the tailwinds have helped you, you don't want to jump into the headwinds.

**CHUCK JAFFE:** Really interesting, John. So again, BGT, JPS, the tickers for them and for more in the preferred space and the senior loan space or the floating-rate loan space, check out CEFData.com. John Cole Scott, thanks so much for joining me on The NAVigator.

**JOHN COLE SCOTT:** Always happy to be here.

**CHUCK JAFFE:** You've been listening to The NAVigator, a joint production of the Active Investment Company Alliance and Money Life with Chuck Jaffe. And yes, that's me, and you can learn all about my work and my show at MoneyLifeShow.com. To learn more about closed-end funds, business-development companies, and interval funds go to AICAlliance.org, the website for the Active Investment Company Alliance. They're on Facebook and LinkedIn @AICAlliance. Thanks to my guest John Cole Scott, chief investment officer at Closed-End Fund Advisors, which is online at CEFAdvisors.com, and which makes its research tools available to the public at CEFData.com. He's also the chairman of the Active Investment Company Alliance 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. Until then, happy investing everybody.

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