John Cole Scott On Private Equity's Increasing Role In Closed-End Investing

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Chuck Jaffe, in this episode of The NAVigator podcast interviewed John Cole Scott, president of Closed-End Fund Advisors. Read the Q&A below as John and Chuck discuss how and why investors might pursue private equity and debt using closed-end funds, noting that expansion of the industry and changes in structure adding share classes have made private, alternative investments much more accessible for investors. Scott, who also is chairman of the Active Investment Company Alliance, he says the growth in tender-offer and interval funds is giving investors access to strategies they can't get anywhere else in the regulated-investment world in a form that is more liquid and affordable than investing in hedge funds. He includes two of his favorite funds in the space for investors to consider now.

John Cole Scott

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CHUCK JAFFE: John Cole Scott of Closed-End Fund Advisors is here and we're looking at private equity and debt in closed-end funds, 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 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 it brings us back in the direction of John Cole Scott, president of Closed-End Fund Advisors in Richmond, Virginia, which is online at CEFAdvisors.com. We're going to dig into the funds using the firm's research, and you can do that yourself at CEFData.com. And John is also the chairman of the Active Investment Company Alliance, which you can learn about at AICAlliance.org. John Cole Scott, it's great to have you back to The NAVigator.

JOHN COLE SCOTT: It's great to be here, Chuck.

CHUCK JAFFE: For the longest time with the market it was TINA, "There is no alternative," everybody was going for stocks. Then it became PATTY, "Pay attention to the yield." Now it's also TARA, "There are reasonable alternatives," and a number of other different acronyms that have come there. But for some people, the way they want to be going is private equity and private debt, a different type of asset class, especially in these market conditions. So explain what the trend is with those assets in closed-end funds.

JOHN COLE SCOTT: So up in New York City these guys spoke on a panel of its sub advise forum, really covering these assets inside of regulated funds, and for your audience, those are funds that governed by the SEC and that are generally intended for retail investment purposes. And you know, CEFData, you talked about, we have a little bit of data on the free side, there's some interval fund and tender-offer fund data bled to AICAlliance.org, but the full dataset is 755 closed-end funds, BDCs, interval funds, and tender-offer funds, and the sector has grown to around $635 billion in gross assets, definitely a lot bigger than when we started the podcast a couple years ago. And one thing interesting, I want to drill down a little bit on the interval fund structure for private equity and private debt, the A share class, we talk about that, it might confuse some of your listeners because closed-ended management companies historically were listed with only one share class obviously. But because these are a balance of closed-end funds and open-end funds, they can have different distribution pathways, and that's typically where A is often a retail share class and I is institutional. So looking at these A share classes, there's 64 strategies, and the average minimum is only $16,000, so again, very accessible for these alternative investments. And there's 35 under $5,000 with an average management fee of only 1.34%, that's not as cheap as an active ETF typically or a passive ETF, but definitely I'd argue are great value for active private exposure. And there's some larger funds, there's 24 between $25,000 and $50,000 initial investment, and that fee's

a little bit lighter, about 1.13%. As I think about that, it's easier to have a little bit lighter of a fee when your initial tickets are less and you have less customers to serve. And the average in the A share class is 1.31%.

CHUCK JAFFE: Let me just jump in for a second.

JOHN COLE SCOTT: Yeah.

CHUCK JAFFE: Because you mentioned it's more expensive than the average ETF and mutual fund. The average ETF and mutual fund is not holding much in the way of private equity and private debt, and if they do, then they would not be in the average cost group, they would not be a case where you're going, "I should compare a traditional mutual fund that has some significant slug of its portfolio in private equity." They will not be a low-cost fund under any circumstances, so the cost structure here is actually pretty favorable as I'm hearing it.

JOHN COLE SCOTT: It is, and I will note this is the management fee-only part of the expense ratio. As you know, funds have other fixed fees that can be present, but this is just really what the manager of the assets is compensated for. And you're also completely correct, the closed-end fund structure whether it's listed or nonlisted, is really designed for that stable capital base so the investments can be less liquid and you don't worry about that 15%, seven-day liquidity as a general rule for open-end fund investment companies which are ETFs and traditional open-end funds.

CHUCK JAFFE: The other side here is the interval structure where folks are limited in when they can take their money out is ideal in a private equity world where you don't want to force valuation all the time.

JOHN COLE SCOTT: It is. You really need to have the wrapper of the investment structure, in this case a regulated fund, a closed-ended management company, matching the liquidity of the underlying investments. If you mismatch those, that's where you can get a lot of potential investor pain or fund sponsor pain in tough times. And in balancing out the institutional share class, there's 73 strategies there, and there's 30 that have a minimum of only $50,000 or less, there are 25 that have a one million average, so that's often the advisor level of assets, not individual, those management fees are at 1.42%. And then there's a few over that minimum, only 9 with the initial ticket required over a million dollars, and those fees are lower when there's two share classes offered.

CHUCK JAFFE: If I'm an accredited investor, I have another choice here. It's not one that we talk about much on The NAVigator but that's I could go the hedge fund route.

JOHN COLE SCOTT: You can, and in fact a lot of these private fund asset managers are adding these tender-offer and interval funds. Like Nomura just had their interval fund launch this week, it's their first retail-focused fund, it's different than the type of investment they would offer sovereign wealth funds, ultra-high-net worth, endowments, and pension plans. And it really comes down to there can be institutional owners of these funds, but they're not really designed for that, because typically when you have assets of $500 million and higher you're doing a lot more customized and one-on-one relationships with these asset management firms.

CHUCK JAFFE: Let's talk about performance. Because everybody knows what the stock market did in 2022, but not so many people know what private equity was doing, and I mean, it can move wildly different.

JOHN COLE SCOTT: This is a very inhomogeneous peer group, and so all I can say is one of the funds that we've talked about before, one of our members is a private shares fund. And I chatted with their manager last week prepping for this panel, and they actually were positive 0.8% after a 1.9% management fee last year. And I asked them about that because talking to a 40 Act lawyer at Skadden about these private funds, they reminded me that there's been delays in the markdowns of some of the assets because people are scared to go back to market to raise more money. I wanted to hear from an actual manager in this space, and so he said that they actually wrote down a chunk of their portfolio, but they also had additional higher seed rounds later for a chunk of their portfolio, and those two sides actually neutralized each other. And so that reminds me of why the benefit of these funds, and they're different, some are fund of funds, some are individual ownership, are diversification and an active manager making those decisions. But even though there's a challenge of the current environment, goes back to these managers don't have to buy everything, these aren't passive exposure to private equity obviously, that'd be a horrible ETF idea or an index, they are actively selecting the sectors and the funds they want. And remember, they have a chance to work through the problems with them, they're not going to be a forced seller of the assets ever because of that stable capital base.

CHUCK JAFFE: You know, we're always talking about discounts. With private equity, how does the discount work? How do you know how accurate a discount is when you're looking at securities that are tough to mark to market?

JOHN COLE SCOTT: Well, and the benefit would be that there are even more private companies out there and there is more regulated funds with both private credit, private equity exposure, and every one of those boards every period of time has to mark those investments. And so there's a chance in those databases to track how other people are marking those sectors and companies, and whether it's a first-lien loan or second-lien, or what stage is it, was it series A, series B, series C? And that allows trends to unfold in the way we wouldn't even have considered normal 10 plus years ago. And then remember, private equity, which is generally riskier than public equity, is generally safer than venture capital, but with those you tend to get some more upside. And as we always talk to our clients, we overweight listed funds for our clients because we like to be tactical and nimble, but we do add nonlisted funds when there's a good manager and we also want to reduce the volatility of part of the portfolio and we're willing to be committed to a manager in a sector for a while, because you're basically choosing volatility versus liquidity. And I would argue most investors, especially in their qualified or deferred accounts, don't need to have daily liquidity in the entire portfolio, however they probably shouldn't have more than 5% in any less liquid structure in our experience.

CHUCK JAFFE: Ultimately is there a limit, a portfolio size that you consider appropriate? If somebody is going to hear us talking and go, "Okay, I want to expand my closed-end holdings and I want to go in the direction of interval funds or closed-end funds that hold private equity or private debt," is there a limit on how much you're willing to let it be of a portfolio given the sensitivity of the asset class?

JOHN COLE SCOTT: At a basic level, and some custodian have ticket charges for these funds because they have to make some compensation for the tendering process which can happen and more complex than just simply trading a listed equity, so you do need to be thoughtful on whatever charges you would have so check with your custodian first. Outside of that, I always comment that some of these interval funds are really well designed, the fees are reasonable, there's investments you cannot literally get anywhere else in the regulated market, and you could put $2,500 of your grandmother's Roth IRA, or your daughter's, and

that's a very powerful component. I would say that generally would be thoughtful on nonlisted fund exposure over 20-25%, and really thoughtful on any individual holding over 3%, be very convicted and very patient. And I would remind people, this is way more liquid than if you are accredited and you're able to do hedge funds, you actually can get your money sooner than in those relationships, so it's a balance. It's more liquid than the traditional private exposure, just less liquid than the traditional open-end fund and direct listed exposure.

CHUCK JAFFE: I think the audience would kill me if I didn't ask one more question. Namely, do you have any recommendations? Is there an exemplar for the space that you particularly like?

JOHN COLE SCOTT: I'll give two because they're very different. Again, we've had them on before, it's one of the first interval funds we bought for our clients and I own personally, it's PIIDX, and you can get in there for typically $2,500 on the A share class, or if you're an advisor you can typically get in at the institutional class. Just shy of a 10-year track record, we definitely want to get them on there to celebrate their 10-year record of almost 10% annualized for nine years. Didn't go down last year, which reminds me of when I found another interval fund that didn't go down in March of 2020. Find those, and even if it's at 0.3% return it's a positive experience. And another one which does require accreditation but had gained some assets is the Bow River Capital Evergreen Fund, that's EVERX, that does require accreditation but it's close to $300 million in assets and a minimum of $50,000. It's a fund of funds so it has a higher overall fee, but they've done a great job, in our experience, of making good underlying selections and bringing a diversified product to somebody that doesn't have the resources to hire a consultant to actually do the due diligence on hedge fund exposure.

CHUCK JAFFE: And again, that's EVERX, the other one was the Private Shares Fund, PIIVX, and you are John Cole Scott, it's always great to chat with you. Thanks so much for joining me, John.

JOHN COLE SCOTT: Happy to be with you again, Chuck.

CHUCK JAFFE: The NAVigator podcast is a joint production of the Active Investment Company Alliance and Money Life with Chuck Jaffe. Yeah, that's me, and you can learn all about my hour-long weekday show by going to MoneyLifeShow.com or by searching for it wherever

you find your favorite podcasts. To learn more about closed-end funds, interval funds, and business-development companies 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, president of Closed-End Fund Advisors in Richmond, Virginia, which is online at CEFAdvisors.com and CEFData.com, and the chairman of the Active Investment Company Alliance. By the way, he's on Twitter @JohnColeScott. The NAVigator podcast is normally available on Fridays, in fact, we'll be back this coming Friday. The last Friday was Good Friday, that meant it was a good Friday for us to take off. We'll be back this week at the end of the week, and follow along to make sure you don't miss anything. And until then, happy investing.

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