VettaFi's Islam: ETFs Give Closed-End Investors Easy, Ready-Made Portfolios

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Chuck Jaffe, in this episode of The NAVigator podcast interviewed Roxanna Islam, associate director of research at VettaFi. Read the Q&A below as Roxanna says that exchange-traded funds that invest in closed-end funds give investors diversified portfolios – and all the benefits of investing deeply in the closed-end space – in a one-stop shopping wrapper. Islam says that investors worry about high fees in ETFs of closed-end funds, noting that CEFs tend to have higher expense ratios on their own, and the added layer of costs for the ETF sponsor can feel heavy, but she notes that fund sponsors recognize the issue and tend to keep the additional costs low. Meanwhile, ETFs covering nearly all style boxes and assets of the closed-end universe can provide diversification and professional management, and she provides examples of ETFs for listeners to consider.

Roxanna Islam

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

CHUCK JAFFE: Roxanna Islam, associate director of research at VettaFi is here, we're talking about exchange-traded funds that buy closed-end funds now on 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 we're looking in the direction of Roxanna Islam, associate director of research at VettaFi, which brings together all sorts of varieties of research resources that investors can use and that you can check out at VettaFi.com. The firm is on Twitter @Vetta_Fi, and Roxanna is on Twitter too using just her name, @RoxannaIslam. And of course to learn more about closed-end funds, business-development companies, and interval funds generally go to AICAlliance.org, the website for the Active Investment Company Alliance. Roxanna Islam, welcome back to The NAVigator.

ROXANNA ISLAM: Yeah, I'm glad to be back.

CHUCK JAFFE: This is a subject that is near and dear to my heart because I love closed-end funds and I love ETFs. But there are schools of thought about, "Hey wait, if you're buying an ETF, how does that work with discounts and all the rest? And is it the right way to hold it?" And I've heard people go in all directions, so let's just start with your overview on ETFs buying closed-end funds. Because there's a bunch of different things you can do and they can be effective tools, but they're not necessarily what you think you're getting when you buy a closed-end fund, right?

ROXANNA ISLAM: Yeah, so within my current role at VettaFi I'm more of a generalist, but I worked as a closed-end fund analyst several years ago so it's still an area that I follow relatively closely compared to others that consider themselves generalists. And when you think about the average investor or advisor, they're typically also generalist investors, they're not always familiar with closed-end funds but they're usually familiar with ETFs. I think we all know what ETFs are, but just in case, it's basically a basket of securities that buy and sell like a stock. So it can hold almost anything, stocks, bonds, alternatives, even closed-ended funds, so there's a really big difference between the two in popularity and I think that's important to underline. Closed-end funds are much smaller in their assets, so if you look at a large closed-end fund like PDI that has less than $4.5 billion in net assets compared to a large ETF like SPY, the SPDR S&P 500 ETF, that has about $378 billion in assets. And then you also have to consider the premium-discount volatility with closed-end funds, so that's an attractive feature to some investors but it's also intimidating and difficult to deal with if you're not as familiar with closed-end funds. So I think why not combine the two and put closed-end funds in an ETF wrapper? Because that actually helps get those closed-end fund distribution rates out to a wider range of investors. And so there's at least five different ETFs of closed-end funds that we can about later, but on average these have a distribution rate of around 7% to 12%. And the ETF is obviously a weighted average, so it means there are individual closed-end funds out there with much higher distribution rates so a lot of investors ask, "Why not just buy one of those?" And you know, there's obviously nothing wrong with buying the individual closed-end fund but these ETFs provide diversification benefits, so they're not just appropriate for the investors who are uncomfortable with direct investment in closed-end funds like I mentioned earlier, but maybe you're already a closed-end fund investor and you have a handful of favorites, you can supplement your portfolio with an ETF of closed-end funds and get some additional yield and some added diversification.

CHUCK JAFFE: Yeah, there's a lot there. The worries that people have when it comes to closed-end funds in ETFs are twofold. One, because they are a fund of funds, you're taking a high expense item, closed-end funds typically are not low expense ratio items unlike a lot of classic mutual funds, and you're adding a little bit of extra fees on top of it to have the fund of funds wrapper, the ETF wrapper. And then the other side is a lot of people buy closed-end funds for their discounts, and you have to make sure there if what you're trying to do is buy big distributions at bargain prices, that the ETF is not necessarily buying a lot of things that are trading at premiums. In other words, that they're following the same methodology you want, right?

ROXANNA ISLAM: Right. So I'll start with fees. So I think fees are maybe the primary concern for many, because as you said, funds of funds have that extra layer fee, so individual closed-end funds aren't even that cheap themselves, like if you look at an individual closed-end fund, fees can be 1.5% or 2% or even more. So when you look at some of these passive ETFs of closed-end funds, the management fee for all of these is around 0.5%, so for example, in an ETF like PCEF, which we can go into a little bit later, has a management fee of 0.5%, and then it has the acquired fund fees of 1.49%, and then the total expense ratio is 1.99%. So really the ETF wrapper itself doesn't have to add that much to the existing fee. And then to address that other factor about discounts, I think it depends on the type of ETF you invest in, the type of strategy. We can go over some of those strategies, but depending on the index or whether it's actively managed, you can sort of get around those issues with the discounts and premiums.

CHUCK JAFFE: So let's dig in and talk about a couple of ETFs, you said we could do that. What I want to do is I want to maybe dive in and talk about some ETFs that show us the range and depth of what we can do with closed-end funds in ETFs. In other words, let's cross a couple of lines here and look at different types of things.

ROXANNA ISLAM: Yeah, so there's just five that I'm going to talk about today, so those are PCEF, YYY, XMPT, CEFS, and FCEF, so that just sounds like alphabet soup but I'm going to dive in a little bit deeper now. So let's start with the active ETFs, so you have CEFS, which is the Saba Closed-End Fund ETF, and then you have FCEF, which is the First Trust Income Opportunities ETF. Because these two are active ETFs, they do have the advantage of expressing market views more rapidly, which you know is not really a bad idea in the sort of environment that we're in, and CEFS is unique because it not only generates high income but it also uses short hedges to protect against rising interest rates. And Saba itself is also a very well-known closed-end fund investor, so they have some very interesting and insightful views on the space. FCEF is also pretty unique because it recently changed its objective in 2022 and now it can invest in ETFs in addition to closed-end funds. And so obviously you have these two and they're more expensive than their passive counterparts. If you look at CEFS for instance, it has a management fee that's over twice as much as its passive counterpart, but it's had a pretty impressive and stable dividend history, so personally I don't think you're paying those fees for no reason. And then if you look at the passive ETFs, I think this is where it gets really interesting because it's not just a matter of tracking a different index, they have completely different strategies here. So first of all, we have PCEF, which is the Invesco Closed-End Fund Income Composite ETF, this is the oldest and largest ETF of closed-end funds. It actually tries to provide a comprehensive view of the taxable closed-end fund universe, which is basically everything except municipal closed-end funds. The index excludes certain closed-end funds, for example, ones with fees over 1.25% for new holdings and over 1.5% for existing holdings, so that's partly what contributes to this fund's lower fees. And then it also excludes ones that trade above 20% premiums, and it does give the ones with largest discounts greater weight, so that's sort of what you asked about earlier, how would you manage that? So this is actually reconstituted and rebalanced quarterly, and so that definitely helps, you don't have to worry about the discounts deviating as much. And then if you look at YYY, this is the Amplify High Income ETF, so this one, it provides high current income but does this by selecting only 45 closed-end funds, and that's compared to the 120 or so in PCEF. And this one weighs its constituents by ranking and scoring various factors like discounts, [inaudible], volumes, and then distribution rates, and it actually gives twice as much weight to distribution rate, so that's probably why this ETF has the highest distribution rate out of its peers. But it's also rebalanced semi-annually, so in a way it's a bit more passive and it also deviates from a PCEF strategy. And then lastly I'll mention XMPT, that's the VanEck Closed-End Fund Municipal Income ETF, this is a passive ETF that tracks an index of federally tax-exempt municipal closed-end funds. And so this tracks an index made by the same index provider as PCEF so I'm not going to get too much into the strategy but the weighting methodology is similar, it gives a heavier weighting towards the ones with the largest discounts, and it basically just covers the part of the market that PCEF is missing which is the municipal closed-end fund.

CHUCK JAFFE: And we should point out, you go for closed-end funds in many cases for the yields, and the yields here are impressive even against some very popular, well-known ETFs that are investing in junk bonds and limited partnerships and the rest, right?

ROXANNA ISLAM: Yeah, so if you look at passive ETFs like PCEF and YYY that I mentioned, I'm going to use rounded numbers, they currently have about a 10% and 12% yield respectively. And if you look at midstream ETFs like AMLP, also very popular for income investors, it has about an 8% yield, and then high-yield corporate bond ETFs like HYG have a 5.5% yield, high-dividend ETFs like VYM have yields close to 3%. So they just have significantly higher yields than some of these other income [inaudible] asset classes, and I think most people who are listeners here know that investors should consider closed-end funds for income. So it's not really new news but I think why not do it with the help of an ETF? As I said before, it's easier, more hands-off approach to closed-end fund allocation, or it can serve and supplement and diversify your [inaudible] allocation. And you know, as we talked about just now, the good news is investors have several options when it comes to ETFs, you can have active, passive, total market, municipal market, so even though there's only five we talked about, they're all completely different strategies.

CHUCK JAFFE: Roxanna, great stuff. Thanks so much for joining me on The NAVigator to talk about it.

ROXANNA ISLAM: Yeah, thank you.

CHUCK JAFFE: The NAVigator is a joint production of the Active Investment Company Alliance and Money Life with Chuck Jaffe. And yes, that's me, I'd love it if you check out my hour-long weekday show on your favorite podcast app or by going to MoneyLifeShow.com. To learn more about interval funds, closed-end funds, and business-development companies be sure to check out AICAlliance.org, the website for the Active Investment Company Alliance, on Facebook and LinkedIn @AICAlliance. Thanks to my guest Roxanna Islam, associate director of research at VettaFi, check out their tools at VettaFi.com, on Twitter @Vetta_Fi, and Roxanna's on Twitter @RoxannaIslam. The NAVigator podcast is new every Friday, next week we'll come to you from the Morningstar Investment Conference in Chicago. Be sure to join us for that, but in the meantime, happy investing everybody.

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