Closed-End Fund Advisors' Scott On The Funds He Is Using Most For Clients Now

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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 discusses what he is seeing in the market now by delving into four of the investments he is using the most and weighting heavily in client portfolios. He notes that the recent bank collapses actually made a few of his favorites more attractive – because the market got angry at the financial sectors, driving prices down – but he also explains that his favorites have more going for them than just a big discount.

John Cole Scott

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

CEFAdvisors will be holding their 46th consecutive closed-end fund, business-development company, and interval fund research call for the second quarter of 2023 on July 19th at 2PM Eastern Standard Time. Register to attend live or for the replay at CEFAdvisors.com/quarterly. The session is approved for 1.5 hours continuing education credit.

CHUCK JAFFE: John Cole Scott of Closed-End Fund Advisors is here and we're talking about some of his favorite 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 is brought to you by the Active Investment Company Alliance, a unique industry organization that represents all facets of the closed-end fund industry. It runs from users and investors to fund sponsors and creators, and if you're looking for excellence beyond indexing, The NAVigator's going to point you in the right direction. Joining me today, as he typically does at the end or beginning of every quarter, it's John Cole Scott, who is president at Closed-End Fund Advisors in Richmond, Virginia, which is online at CEFAdvisors.com, and we're going to dig into some of the firm's research, which you can do yourself at CEFData.com. John is also chairman of the Active Investment Company Alliance, which you can learn about and use to learn more about closed-end funds, business-development companies, and interval funds by going to AICAlliance.org. John, let's get busy.

JOHN COLE SCOTT: Great to be here, Chuck.

CHUCK JAFFE: Now that little intro that I gave before we played the music probably has some of our audience excited because they're thinking we're about to give away your absolute favorite funds, but that's not quite what I'm asking you to do today. Now normally in these chats at the end or beginning of a quarter we're doing the state of the closed-end fund business and we finish with a few picks, but for giggles and because the industry and the market has kind of been range-bound for most of this last quarter, I figured it was a good time to find out what you like and why you like it. And I'm not asking for your favorites, because for you I know that would be like trying to figure out which is your favorite child, I know you only have the one, but if ever you have more you would not want to choose between them. But I really want to know, it's about the funds you use the most and that you take the biggest positions in for clients, those are the funds that we should be talking about, why you're there now. Because you are an active investor, and by the way, if they don't live up to your expectations, they won't be there when we do this in a quarter or two.

JOHN COLE SCOTT: Absolutely. One thing I love about the size of our firm is we are large enough to have good people and to work with wonderful clients, but we're small enough we can trade pretty much anything in a day with no more than one or two pennies of slippage max in our experience. So I first want to talk about a BDC, it's not a newbie, it's actually 18 years old, it's Hercules Capital, HTGC, it's an over $3 billion dollar BDC, it's an internal management which makes the fees usually a little fairer as an expense ratio, we track that expense ratio around 2.5% of gross non-leverage expenses. It's currently supporting about a 10.5% yield, has 10% dividend coverage, and raised the dividend in the last couple of months. One of my favorite things, because it's not just a more plain vanilla BDC lending, its average yield on investments right now is 14%, really fueling that dividend. And when I think about it, it was trading at a 48% premium back in February, and it wasn't our largest BDC investment, but then did something happen in March? A couple banks had some issues, the market was a little big angry, well, people thought that this BDC was the posterchild for bankruptcy for BDCs, and the beautiful thing is the permanent capital structure of BDCs and the fact that it was low leverage and well managed, it went down 30+% to a 9% or 10% premium, normally sports a 20, 30, 40%, and we doubled and tripled our exposure for clients, because we loved it on February 22nd, we really loved it at the end of March. And so I'd like to say we love this portfolio position for our clients, we normally use 48 BDCs in a portfolio, but this is our overweight because it's still not expensive and it proved it could handle a problem.

CHUCK JAFFE: Well, and those problems aren't really done. That's the side I think people have forgotten about it, but I don't think they're over with, so that gives you some hope that it'll also continue to handle that problem as it shifts itself out.

JOHN COLE SCOTT: It is, and they have 20% dividend coverage, which is not a perfect data point but it really tells you they've got some cushion for any bumps and bruises to maintain that dividend yield, which is what a lot of investors really expect from the fund.

CHUCK JAFFE: Okay, so that's Hercules Capital, HTGC, and of course that's on the BDC side of things. But closed-end funds, which functionally BDCs are closed-end funds, but still a little bit different, so let's move over to closed-end funds.

JOHN COLE SCOTT: And again we actually are picking a closed-end fund that converted from a non-listed BDC, so this is more of an event-driven decision at our firm, it is FSCO, it's a $1.3 billion dollar, the guts are almost essentially BDC-focused, but it's in the now listed closed-end fund structure with a daily NAV and the different rules on leverage and expense ratios. What we liked about it is when it listed shareholders wanted out, that's the reason for the direct listing, it's sporting a very wide discount, around 30%. And so our take is we believe it's at least a median-level BDC guts quality-wise, but it's really cheap because people are angry at it, with that you're currently getting a 12.6% yield and a 3% cushion over their yield.

And really, the last three months, because it's a little different than its peers, it's the best NAV and market price performance in its peer group of loan-based credit funds.

CHUCK JAFFE: So again, that's FS Credit Opportunities, FSCO. What's something else you're looking at right now?

JOHN COLE SCOTT: So you may not be surprised that we've been cautious on the markets, but our firm is not really a market timer, we don't really hold cash, we really rotate and keep our clients fully invested. One of our favorite funds we really like more on the equity side is CPZ, it's a Calamos fund that I have talked about before on the show, and it's not surprising it's one of our largest positions. It's about a half billion dollar fund but it really proves its active management with over 200% turnover, and it has an 11% yield right now, but because of discounts and small leverage it only has to do 7.5% economically to fuel that. We always worry a little bit more about equity funds and their dividend policies when they're too high because you're basically just passing out past or future gains, and the really neat thing, it's a 15% discount and it's only 20% leveraged, and the average cost of leverage with all the recent updates is 2.5% because they have some fixed and low-cost leverage baked in. And it's basically mostly long-term gains, qualified dividends in the portfolio, which is tax advantaged, so it's basically a QDI-like experience with an income focus. And because the NAV is a long and short, as you've had the manager on the show before, we don't have to be bullish to want this fund in the portfolio because they're going to be thinking about ways to make some money or reduce the downside through whatever hiccups happen going forward.

CHUCK JAFFE: So that is CPZ, Calamos Long/Short Equity & Dynamic Income Trust, and we have had the manager, Matt Freund on the podcast more than a few times. We've got time for one more.

JOHN COLE SCOTT: Sure, and this one really starts more as an asset allocation decision, we really are pro, this year, infrastructure and utilities, and so there's an abrdn fund, ASGI. Again, another half billion dollar fund, it's turnover is around 100%, proving active management pivoting through the last year of different markets. As you might now, it's almost 25% privately invested now, one of the benefits of a closed-end fund is you can use level 3 and private assets in the portfolio, unlike ETFs and open-end funds, and it's got a 0.6% beta versus the S&P 500 of its net asset value, the thing we care about, in the last two years, proving less volatility than an equity fund. And basically its one-year NAV performance is second out of 12, and that tells us that it's not just a wide discount because it's not performing well, the challenge is it's a newer fund, some people are upset with newer IPOs, and maybe because the yield isn't as high as some of the other funds in the sector that I'd argue over-yield to support the discount or actually go to very high premiums for a fund, it's a very healthy entry point at 15%. And so it's both the manager we like, it's a sector we want to be in, and we love the NAV, and we love the probable narrowing of discounts over time, and that's why it's a really good anchor to an income portfolio.

CHUCK JAFFE: And you mentioned private credit, it's a subject that has been coming up a lot with various experts who I talk to, about just how attractive they find that market right now. And is that something that you're leaning into? Because there is kind of a bit of a theme on a couple of these; Hercules Capital, FS Credit Opportunities, and then going into private credit with ASGI, you're doing a lot of stuff that's financially tied.

JOHN COLE SCOTT: It is. I mean, these are all funds that could not be in another fund structure, they're really using the best of the closed-end fundedness. I'll tell you, I really like their ability to do that. And whether it's private equity or private credit, we like active management being in that market, because with a stable capital structure of an interval fund, a BDC, a closed-end fund, you're never forced to sell positions because of leverage issues or market craziness because you've really built a portfolio that's meant to be durable, and so it allows you to often catch equity investments or credit investments from other structures in panic periods. And I would say the best use of a close-end fund is those private pieces that can be used, as well as cheap and tactical and appropriate leveraged when it's income-focused.

CHUCK JAFFE: And because we've identified these as funds that you like, and because you said you won't sell them, right, in that last answer, for some of the things like, oh, a leverage issue or what have you, we do need to let people know what you would sell them for because you may decide to sell them long before we ever talk about them on this podcast again. So what would be the thing that would drive you out of any of these? It's not necessarily specific to one or the other, any investment can have issues, but what would be the thing that would make you say, "Hey, the next time we're talking about my favorites, these are no longer on the list."

JOHN COLE SCOTT: It is. So if the 30-ish discount of FSCO went down to 5% or 10%, there might be more attractive funds that maybe we like a little better relative to the entry point, but that supposes where the other funds are, I would say that's much more likely to be a discount thesis. ASGI, it would probably be if we started not liking the way the portfolio was performing in the market and it had a median discount versus a wide. So it's not just discounts, as we always talk about, Chuck, we do like to look at the NAV, look at the dividend policy, and we decide, is it the right place? For CPZ, if we were at maybe a market bottom or it felt like a bottom the way it does sometimes in the market, we might rotate out of it to another more long-focused fund, maybe a Calamos fund or BlackRock fund that is more not hedged, because we don't want that hedging if we feel we're at the bottom. And so that's really the decisions, it comes both from how does it fit in the portfolio, how does it work for our clients, and is there discount tailwind or discount headwind? Is the dividend right for the markets that we see coming or we already played the thesis? Like we underweighted preferreds and munis, they got kicked in the nuts, and maybe a few more kicks to come, but now we're not overweight but we're back to more moderate weight to clients because there's so much pain experience, there's more tailwind than headwind probably going forward in those sectors.

CHUCK JAFFE: John, really great stuff. Thanks as always, we'll talk to you again soon.

JOHN COLE SCOTT: Always a pleasure.

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, and you can learn all about my work and my show by going to MoneyLifeShow.com or by searching for the show wherever you find your favorite podcasts. To learn more about closed-end funds and business-development companies go to AICAlliance.org, the website for the Active Investment Company Alliance, on Facebook and LinkedIn @AICAlliance. And if you have questions about closed-end funds, send them to TheNAVigator@AICAlliance.org. Thanks to my guest John Cole Scott, president of Closed-End Fund Advisors in Richmond, Virginia, the chairman of the Active Investment Company Alliance. His firm is online at CEFAdvisors.com and CEFData.com, and he's on Twitter @JohnColeScott. The NAVigator podcast is available every Friday, be sure not to miss that or any episode by following or subscribing on your favorite podcast app. We'll be back next week, and until then, happy investing everybody.

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