In High-Rate Environment, Don't Replace Individual Bonds With Bond Funds

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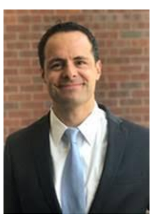
Chuck Jaffe, in this episode of The NAVigator podcast interviewed Mark Asaro, director of investments at Noble Wealth Management. Read the Q&A below as Mark says investors should not think that a traditional open-end mutual fund is a good replacement for individual bonds. Without a maturity date, bond funds don't have the pull toward par of an individual bond. Closed-end funds, however, are immune to dilution from cash flows into the fund, thereby providing a stable yield that investors can bank on, making them a better portfolio mix with individual bonds. Asaro notes that closed-end bond funds work best when the yield curve is upward sloping – as opposed to today's heavy inversion – but notes that there are selective opportunities looking strong now, notably in funds which buy municipal bonds.



Mark Asaro

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CHUCK JAFFE: I'm talking with Mark Asaro, director of investments at Noble Wealth Management, about mixing closed-end bond funds with individual bonds in today's higher-rate environment, welcome to The NAVigator. This is the NAVigator, where we talk about all-weather activating 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 we're looking at ways that investors might rethink their closed-end positioning based on current market conditions with Mark Asaro, director of investments at Noble Wealth Management, which you can learn all about online at MyNobleWealth.com. And if you want to learn more about closed-end funds, interval funds, and business-development companies in general, well, you can check out AICAlliance.org, the website for the Active Investment Company Alliance. Mark Asaro, welcome back to The NAVigator.

MARK ASARO: Thanks for having me back, Chuck.

CHUCK JAFFE: When last you were on, well, you were talking about using closed-end funds as a paycheck replacement system for investors, but that was in May of 2021, and back then the short-term interest rate was 0.13%. Heck, the long-term rate was just over 2%. So obviously things have changed, fixed income in some respects has been fixed. One of the things I know you believe is that if somebody has individual bonds and they want to be changing them in market conditions, a bond fund is not necessarily the right replacement for individual bonds. So explain why a closed-end fund working in conjunction with bonds is what you want to have right now.

MARK ASARO: A lot of advisors and a lot of investors get this wrong, where they are thinking that, oh, since a stock fund is a good replacement for picking individual stocks, a bond fund is a good replacement then for picking individual bonds. And up until just a few years ago, it was very difficult for even the average investor to buy individual bonds, they would have to call Fidelity, call Schwab, call their bond trading desk, and then that person would go and source the bond. Today you can be purchasing bonds just like you would a stock, where you're entering a CUSIP instead of a ticker and hitting a little button to buy. So there is a lot more technology improvement on the bond side, however people still have this anxiety or this stress or this final frontier and not knowing of buying individual bonds, and so they just don't like doing it. And I've run into many, many investors, many, many advisors who just refuse to buy individual bonds so they buy a bond fund. The problem with a bond fund is there is no maturity date, and so without that maturity date you don't have the pull towards par that you would get on an individual bond. A closed-end fund, most of them do not have a maturity date, although there are some kind of closed-end fund 2.0 where you have the 10-year term or the 12-year term and so you do get that pull to par, but for the most part closed-end funds do not have a maturity date either, however they are immune to cash flows into and out of the fund which will eventually dilute you down. Because if interest rates from today, let's call it we're at 5%, go back to 2%, as the interest rates fall your bond price is going to go up, right? And so new money is going to flow into these mutual funds that own bonds, those mutual funds are going to go buy new bonds at the new rate of 2%, and so you as the bond fund shareholder are going to get diluted down to that new yield. There is no locking in of that yield like you would in a closed-end fund or in an individual bond.

CHUCK JAFFE: It's important for people to understand this, that if I had to put an emotion for you on bond funds generally, you hate bond funds, but you love closed-end bond funds. And I point this out because I think for a lot of people they think that the difference between a traditional fund, an open-end fund and a closed-end fund, is really about structure, but in this case you believe there is significant advantage to holding bonds in closed-end funds and there's significant disadvantage to doing it in the traditional bond fund.

MARK ASARO: Correct. So cash flows are a huge drag on mutual funds, and that includes ETFs and other open-end structures where there's daily liquidity, and so you're paying for that daily liquidity through lower performance, lower yields, and that's really self-evident when you look across any kind of sponsor, whether it's PIMCO or BlackRock or Nuveen, you look at their open-end funds versus their closed-end funds and you see a fairly stark difference even when you account for the leverage. When you're buying a stock closed-end fund, there really is no difference between a stock closed-end fund and a stock fund, that one you can kind of chalk up to structure. Whereas a bond mutual fund versus a bond closed-end fund are going to have really stark differences because of the lack of cash flows. So a closed-end bond fund manager can buy significantly less liquid bonds because they know they don't have to meet redemptions. If they know they don't have to meet redemptions, they know they can keep liquidity at a very, very low minimum, right? And so they can buy very illiquid bonds, they can go into other areas of the bond market that a lot of 40 Act open-end mutual funds just can't do it.

CHUCK JAFFE: In these conditions, how many bonds does somebody have to mix with how many closed-end bond funds to be truly diversified on the bond side of their portfolio?

MARK ASARO: I think that's a great question, because it really boils down to the client. For the individual bonds, I want to be holding those to maturity. Those are not positions where I want to be going six months, a year, two years from now and saying, "Okay, well, this guy's in retirement, we're sending him $10,000 a month to live off of, I'll just sell this individual bond." That's not what I want those individual bonds there for. I want those individual bonds there for the income and to hold them to maturity, and so the closed-end piece would really be that liquidity function of providing that $10,000 a month. Now ideally, like we talked about a few years ago, we really want that paycheck replacement system to be covering all expenses. Because if we can get the client to a point where the closed-end bond funds and the individual bonds are producing enough income to support their lifestyle throughout retirement, then we're never drawing down that principal and we're never having to sell either of them. So if we're in that state, then there is kind of ultimate flexibility between closed-end bond funds and individual bonds. However, if we're not being able to meet that expense with income and we do need to sell, in other words, drawdown assets over time, then I want to have a little bit more in the closed-ends just because I have a little bit better liquidity there in terms of exchanged-traded securities and daily liquidity to access that cash. It also goes back to the market environment, what's better right now? Is it closed-end bond funds or individual bonds? If your next question is, well, which one is better right now? Then I would say right now I'm leaning towards individual bonds, only because I can get 6-6.5, even 7+% yield with about 20 years max maturity on investment-grade bonds. In fact, I was just looking at a client this morning who had an average yield to worst of about 6.5% with 9.5 years average to maturity and a BBB+ rated portfolio. And so if I can get 6.5% with BBB+, I don't need to venture into too many closed-end bond funds to make that client's retirement plan work. Now once the interest rate environment turns, one thing I do note is closed-end bond funds work best when the interest rate or the yield curve is upwards sloping, and right now as you know, it's heavily inverted, and so the leverage is moving against you. Once we see the Fed pivot and start cutting the interest rates, then we're going to have that headwind move to a tailwind, and when that happens you're going to see these outrageously large discounts. Muni closed-ends right now are in the 99th percentile in terms of discounts, going back all the way to 1996, that's a screaming buy opportunity. However, if you look at the yields on muni closed-ends, they're currently right around 3.7-4% tax-free. If I go look at individual Colorado muni bonds, I can get 2-4.6% on an individual bond with no leverage. So right now, as I said, it's favoring the individual bonds, but eventually that headwind on the leverage will turn to a tailwind and the yields on those muni closed-ends will jump up higher, as well as the discounts closing, providing you a pretty good total return over our two year period, I think.

CHUCK JAFFE: Which brings us to a last question. Here you are saying that you may like individual bonds better which explains why the mix, but does that also put pressure on you to say, "If I'm going to buy the closed-end fund to make it part of the portfolio and I'm competing with those good yields, then I need to get a great discount"?

MARK ASARO: Absolutely. So the discount today, like I said, is extremely wide. On the taxable side though, they're not wide enough for me to be jumping in there yet. If we do see a recession, credit spreads are going to blow out from here and I think NAVs will fall 10-15% if that's the case. Even with these wide discounts on the taxable bond side, I just don't see enough juice there for me to want to jump in on those just yet. On the muni side, you want to be ahead of the game, you don't want to be waiting for the Fed to start cutting rates to start jumping into muni closed-ends, you need to work ahead of that and say, "Okay, well, maybe six months from today the Fed is going to start to cut rates," or maybe it's a year from today, but it doesn't really matter, I know they're going to do so in the future. And if that's the case, I want to be buying when the discounts are at their widest, which is right now. And so I've been telling a lot of advisors and a lot of my friend investors to look at muni closed-ends and start nibbling in there and start legging in, with a mindset that you're going to do so over a three to six month period.

CHUCK JAFFE: Mark, really interesting. Great stuff, thanks so much for joining me on The NAVigator. Let's do this again in the not too distant future.

MARK ASARO: Absolutely, Chuck. Thanks for having me.

CHUCK JAFFE: The NAVigator is a joint production of the Active Investment Company Alliance and Money Life with Chuck Jaffe. And yes, I am Chuck Jaffe, you can check out my show by going to MoneyLifeShow.com or by searching for it on your favorite podcast app. To learn more about interval funds, closed-end funds, and business-development companies go to AICAlliance.org, the website for the Active Investment Company Alliance, on Facebook and LinkedIn @AICAlliance. Thanks to my guest, Mark Asaro, director of investments at Noble

Wealth Management, which you can learn about online at MyNobleWealth.com. The NAVigator podcast is new every Friday, follow along on your favorite podcast app to make sure you don't miss an episode. We look forward to bringing you more closed-end fund talk next week, and until then, happy investing everybody.

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