NAVigator Bonus: Discounts Are At Widest Levels In Years, Hunker Down And Buy

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Chuck Jaffe, in this bonus episode of The NAVigator podcast interviewed John Cole Scott, president of Closed-End Fund Advisors and the chairman of the Active Investment Company Alliance. Read the Q&A below as John discusses the historic level of deep discounts he is seeing in closed-end funds and how that translates to buying opportunities now. Closed-end funds have seldom seen bigger discounts in the last quarter-century, Scott said, and says the current level of yields are helping to confirm the current opportunity despite the beating that closed-end funds took a year ago. 'Buying after carnage is such a good closed-end fund decision,' Scott says, 'You should be uncomfortable with the last three to 12 months of the fund you are buying today, because if it looks bad, it should look better later.'

John Cole Scott

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 is here, and we're talking about where the closed-end fund business is now through the first half of the year in a bonus edition of 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 to John Cole Scott, president at Closed-End Fund Advisors in Richmond, Virginia, which is online at CEFAdvisors.com, and we're about to dig into the funds' research, which you can do yourself at CEFData.com. John is also chairman of the Active Investment Company Alliance, which you can learn about at AICAlliance.org. John Cole Scott, it's great to chat with you again.

JOHN COLE SCOTT: Great to be here, Chuck.

CHUCK JAFFE: So we have gotten through the first half of the year, and you and I try to talk at least once every quarter, but when you get to a certain point, kind of like closed-end funds the way you check in on stocks with earnings reports, you kind of want to get through the season and then go, "Okay, where are we and what have we gotten to?" And it's a really interesting time in closed-end funds, because if I am a discount buyer every light is flashing green right now, isn't it?

JOHN COLE SCOTT: Many funds are at deep discounts in historical ways. We just recently held our second quarter closed-end fund BDC and Interval Fund Research Call, and I wanted to give a couple of highlights from that. Right now the universe is about $730 billion in gross assets, and that breaks down to about $400 billion in the listed closed-end fund and interval fund market, and about $280 billion in the BDC, both the listed and non-listed market, and the non-listed side's been growing fast as we've chatted before. Discounts, they are so wide, you mentioned how wide they were, 93% of the month's end since 1998 they've been narrower than they are today, and so that's very attractive. And that may say sound silly, silly wide, but munis are 99.3%, only two month ends since I was a sophomore at William & Mary have closed-end funds been cheaper at month end.

CHUCK JAFFE: That's a big buying signal, but of course you also want to be a discerning buyer, you want to try to make sure that you're not just being fooled by the discounts, right?

JOHN COLE SCOTT: Absolutely, and that's why our firm really goes into comparable discounts, relative discounts, and absolute discounts. Again, one's to yourself, one's to your peer group, and one's to your actual NAV. And then there's times, like for many BDCs investors that start from closed-end funds like we did 10 years ago, have trouble buying premium BDCs, but there are many reasons why that's true and often a 10-15% premium can be a better deal than a 10-15% discount in the same universe, in the same week.

CHUCK JAFFE: You have other takeaways. Again, as we've turned the corner towards the later stages of the year, what else is going on that people should be knowing about if they're looking at closed-end funds?

JOHN COLE SCOTT: Yeah, so the next item is really to let people know where the yields are; taxable funds have an equal weight yield of 9.2%, and muni funds, tax-free, 4.4%. But we wanted to dig under the hood a little bit and look at dividend growth the last year, for the universe it's actually almost flat, so it sounds like you would have very boring work in your portfolio, however dividend cuts are down over 1%, in fact over 2% from a year ago for US stock funds and world stock funds. The reason is, Chuck, those are equity-based yields and equity returns were down last year, so those have to come down because they're not bond payments, they're just realized gains over time. And munis down 22%, over 200 cuts in the last year in that sector, however, senior loans, BDCs, REIT real assets, and MLP funds, the yields are higher by over a point or around a point. Very good to have thought strategically a year ago where to put your closed-end fund portfolio.

CHUCK JAFFE: And if you didn't do that a year ago, are you too late to join the party now?

JOHN COLE SCOTT: No, because discounts are attractive, and as long as you take your thesis of what you think will happen, so right now we're overweighting munis again because their leverage is probably topping off, there could be some more rate increases, but I think there's less in the future than in the past. I mean, that makes sense to me at least. And the fund sponsors are likely going to convert some of that leverage to variable and will have very good discount math once dividends can go up again, but it could be mid to late '24, possibly sooner, possibly longer. But buying after carnage is such a good closed-end fund decision, you should be uncomfortable with the last three to 12 months of the funds you're buying today, because if it looks bad, it should look better later. That's the closed-end fundedness that's often attractive to the discount buyers.

CHUCK JAFFE: Yeah, well, closed-end funds are the classic, "Hey, the market's putting it on sale." I mean, literally the market is putting it on sale, so if you are a for-sale buyer, this is the time to get in, is when it's the most uncomfortable.

JOHN COLE SCOTT: Yeah, absolutely. And again, just thinking about players in the space, we just updated who's the biggest holder, the largest activist active holder is Saba Capital, and a lot of people that own these funds are aware of Saba, they have a much better marketing team than I do even though I've got the podcast, and they've been busy. And just for perspective, they're just about $1.8 billion in closed-end fund exposure, US listed, and they've got $700 million or 40% of that in BlackRock, $347 million in Franklin Templeton, that's 20%, and $178 million in Nuveen, that's about 10%. And of course, that's not their only positions but that's where they're focusing, they are large players but there's a lot of funds they're involved with and we expect a very busy activist season next year.

CHUCK JAFFE: Well, as an investor, as a small investor or an advisor who's talking to clients, my assumption is you don't mind having an 800 lb. gorilla in the room of shareholders, because that's who gets to throw their weight around and maybe gets to say, "Hey guys, let's narrow this discount. Let's do something that's going to make us all a bunch of money." So is Saba now big enough that as a shareholder, if I'm looking at two funds and I'm trying to decide which one do I want to go with, they both are in an area that I like, they both have attractive discounts, et cetera, but one has Saba there as a big shareholder, does that become a tie breaker for me?

JOHN COLE SCOTT: It definitely can. I would say that you have to also recognize that there are times where an activist investor can get things like green mail and work out a deal where they get bought out in a way that us can't, but I will say their presence and their focus does keep discounts generally tighter because it's a play in the universe. Another place again I think that kind of comes out of this conversation is term funds are another event that usually happens, never guaranteed but often happens, and more commonly in the newer funds, that get a potential exit at NAV at current wide discounts.

CHUCK JAFFE: Well, speaking of term funds, I want to take some time here to go over a question or two that we've gotten specifically about term funds. Because among other thing, well, we did a bonus NAVigator recently with Eric Boughton from Matisse Capital. John in St. Louis wrote me a note that said Eric Boughton talked about closed-end term trust funds that have a liquidation date and he was wondering, why is not stamped on the fund so that it's the ABC Growth 2029 Fund? Because as John wrote, "I don't know if any of the closed-end funds I own have a termination date. And from what I heard Eric talking about, I'd like to be searching for funds with a termination date because it adds value to any fund I can buy at a discount." So let's start with that, because some funds do have a date on them but not many.

JOHN COLE SCOTT: Correct, and again, newer funds, pretty much the last 30 or so IPOs that goes back to I believe late 2018, your fund will have a term structure. In our data file, our ginormous data file, we have all the specific components of that term, but the general thing for these funds will have a liquidity event, and if over X%, vote for a tender or don't tender, they will become a perpetual fund. I could envision, like if a fund were to come out and be liquidable in a March 2020 type of period, there are provisions for the board to extend it under reasonable circumstances. But newer funds, the answer's yes, it's either the name, term trust will be in half the names, or sometimes even the date, and again it's something that institutional investors, we can reach out to these funds and maybe ask them to do that to make it more easy for retail to understand the situation.

CHUCK JAFFE: Well, and another question we got from Rich in Orchard Beach, Maryland, and Rich was talking about how he couldn't really find anything related to CEFData on liquidation dates, and he finds himself put off about not finding about when a term trust terminates. But he also was worried about how real is it when you have a fund that has a condition that allows them to convert to a perpetual trust? Because what Eric Boughton was saying, what Rich was picking up on, what you were talking about was, yeah, a termination date can be a goose to what you're expecting in terms of returns, but do you count it if they can convert to a perpetual trust?

JOHN COLE SCOTT: So I would say in some of the term trusts that happened before this recent CEF 2.0, the language was a little vaguer and kind of it wasn't the way they brought the fund to market. I mean, it was part of the sales pitch to the advisors and their clients but not as focused. It has happened, so you have to consider it. I would argue that any fund sponsor that wants to stay active in the primary and have the advisors willing to offer these funds to their clients would be very protective of not breaching that trust, and we would, if ever given counsel, would suggest that they only do it if it's March 2020 type of behavior, and it's not that it'd get stopped, it just gets delayed 90 days. I would have high confidence in that, because it's the only way new funds will get created eventually when the IPO market re-opens.

CHUCK JAFFE: So there it is, it's really there to be an escape clause in case of an emergency. It's not mean to be, "Hey, we can get out of the deal we set up."

JOHN COLE SCOTT: Well, I'll put it this way, if any fund sponsor does this and then a Saba or Bulldog or other activist investor is engaged with them in the future, it's going to be a marketing bullet point that's going to be not positive for the fund and very positive for other people voting and be hard to defend management in that behavior.

CHUCK JAFFE: So there you go. The answer, Rich in Orchard Beach, don't worry a whole lot, it's the ripcord there if they have to pull the parachute or hit the ejector button. John, we have to hit the ejector button on this time together, but this is great, always is chatting with you. I know we're going to do it again soon, be well.

JOHN COLE SCOTT: Happy to. Remember, the quarterly replay is CEFAdvisors.com/quarterly, slide deck posted publicly on the website. See you soon.

CHUCK JAFFE: The NAVigator is a joint production of the Active Investment Company Alliance and Money Life with Chuck Jaffe. And yep, that's me, and you can learn all about my hour-long weekday podcast by going to MoneyLifeShow.com or by looking wherever you find your favorite podcasts. To learn more about closed-end funds, interval funds, and business-development companies, check out 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, the chairman of the Active Investment Company Alliance. His firm is online at CEFAdvisors.com and you can dig into their data and research by going to CEFData.com. John's on Twitter too, he is @JohnColeScott. Now The NAVigator podcast is available every Friday unless we trot out a bonus episode like this one, but if you want to make sure you don't miss us whenever we're coming out, the easiest way to do that is by following or subscribing to it on your favorite podcast app. And we will be back on Friday with a new edition of The NAVigator, can't wait to chat with you again then, but until then, happy investing everybody.

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