40 Closed-End Funds, A Million Ways To Build A Portfolio

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Chuck Jaffe, in this episode of The NAVigator podcast interviewed John Cole Scott, president of Closed-End Fund Advisors, chairman of the Active Investment Company Alliance. Read the Q&A below as John discusses portfolio construction and the many factors that go into a diversified safe and solid separately managed account with closed-end funds and business-development companies as the primary focus. He details a diversified tax-sensitive income fund, discussing the many factors that went into selecting each security for it, and how his focus on certain key elements excludes some securities that other closed-end investors might gravitate towards. Plus, a tribute to the late Don Cassidy, best known for his time at Lipper and the Retirement Investing Institute.

John Cole Scott

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CHUCK JAFFE: John Cole Scott of Closed-End Fund Advisors is here, and we're talking about portfolio construction using 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 at Closed-End Fund Advisors in Richmond, Virginia, which has all of its information online at CEFAdvisors.com, but you can also dig into the firm's research yourself by going to CEFData.com. John's also the chairman of the Active Investment Company Alliance, which you can learn about at AICAlliance.org, which has tools for you if you want to learn more about closed-end funds, business-development companies, and interval funds. John Cole Scott, let's get busy.

JOHN COLE SCOTT: Always great to be here, Chuck.

CHUCK JAFFE: So this is an interesting one because we had you on giving us an update about everything, but now we want to talk less fund specifics and less industry and more how you build a portfolio, and specifically for you, you've got a tax-sensitive diversified income portfolio in mind. Help everybody understand that when we say things like diversified tax-sensitive income, okay, that sounds good, but it's not a fit for everybody, and you gotta know what's in it to know if it's the right fit for you.

JOHN COLE SCOTT: At Closed-End Fund Advisors, we're a highly customized income-focused separate account firm, there's lots of ways to build and use closed-end funds, and over time with our high granularity and data reporting we've been able to really extrapolate really unique methodologies to give clients really useable, durable, and yet customized options. So we've created this portfolio because you could just buy a muni bond portfolio, but a few years ago duration's a headwind, yields aren't that high, we believe that diversification and reducing credit risk is such a powerful thing and so we really look into our data. Start always with asset allocation, that's the NAV, that's the rails that you run on, and we really look to build a portfolio at the starting point of the relationship with our clients and then to make the adjustments over time. Blending our trifecta analysis, which is that NAV analysis, so think manager, the guts, we go into discount analysis, relative, comparable, and absolute, and then dividend analysis, which is the hairiest and hardest thing that we do, because it's very complex with a lot of different data points. We try to both get dividends that are durable at the portfolio level, and in this case, thinking about that 37% federal tax bracket and how we can give them, in our opinion, a durable, long-term income portfolio.

CHUCK JAFFE: How do you manage this? People are paying you to run a separately managed account, what goes into managing it?

JOHN COLE SCOTT: So just looking at this portfolio, the starting point is yield because this is really income-centric, it has a 9.1% indicated yield. But again, always remember closed-end fund yields are moving targets, but it's a good starting point. We then decide that with that federal tax bracket it blends to about an 18.5% tax friction, which is a backwards looking estimate. Very inaccurate for one fund, but in a diversified portfolio, typically very accurate, and that is typically less than the qualified dividend rate, which is our measurement stick for success for this portfolio. And we would say that because you should re-invest a little bit of the portfolio, the payout yield as we define it is about 8% a year, possibly higher if you have a larger account with us. Because our fees go from 1% down to about 60 basis points, so if you give us a larger block of money, we can pay you more money because it's easier to do that at that level. What I really say, what we think that you'll be receiving a year from now when you do your 1099 review, 25% ordinary dividends, but those are the hairiest and the ones that are actually at your highest marginal tax bracket, but we're able to blend also 22% qualified dividends, 10% long-term gains, 25% return on capital, and I have to know that that's the hairiest one to estimate because it can change dramatically from year to year, so it's the most less precise answer. And then 18% muni bond dividends, even though the portfolio is 25% munis, because as you might appreciate, munis are the lowest yielding thing we do, that's the blended allocation in dollar terms.

CHUCK JAFFE: And what people may pick up in there if they were thinking about it, is that that's not every asset class. So you're looking at certain things that have to be in the closed-end funds or the BDCs that you buy, and then there are certain other things that you just won't buy, right? So help us understand what it is that makes it that this is a risk I'll take and that's a risk I won't.

JOHN COLE SCOTT: This portfolio has 40 different listed positions, six of them are BDCs for that 6% allocation, but there's 15 different peer groups. Yes, the largest is muni, MLP, and then a hybrid balanced category which has some interesting options when you look through at the guts and where the dividends can be classified. And we think about 24 different closed-end fund sponsors, not including the BDCs, which are kind of specialized, only 13% in Nuveen funds and five different peer groups, and only 8% in BlackRock funds and three different peer groups, and at this highest level, the largest allocation is the 4.5%. We have five funds at 3.5% and two funds at 4%, this is not an overweight sector, overweight fund sponsor, it is diversified, that's that diversified piece we really want to talk about. And 11 of the 34 are term funds, we love term funds all else equal, but we can't just shop for term funds because we're building the right portfolio for this mandate. And like I said, it's 25% munis and 6% BDCs, they're the most different things in my ecosystem, but blended together on the front end and managed through volatility and market cycles are a beautiful companion because they tend to zig and the other one zags. I did some math just for your audience, because it's hard, almost 8,000 holdings, this is definitely the definition of no idiosyncratic risk, and yet you know why every closed-end fund is in the portfolio.

CHUCK JAFFE: How do discounts factor in? Because you didn't put 'em first.

JOHN COLE SCOTT: It's a 12% absolute discount, that's the purest most common version, not so uncommon in this relatively wide period for closed-end funds. But if you do it versus the 5-year average for the holdings, it's about 4.5% wider, which is that relative discount, again going back to the fact that this is not the lofty times in closed-end fund evaluations. But even, because this is of course part of our process, a 4% wider comp discount. And for those that don't know our dataset as well as you and I might, comp discount means, okay, asset allocation for your portfolio, the same as the peer groups in a whole dataset, what's the average for high yield? The average for muni versus our weighted average for our allocation in that same peer group, and that's a nice stance to be. And yet sometimes you can give up manager performance for wide discounts, it's basically only 70 basis points worse NAV performance on a one-year basis for this allocation, and that often happens. I like that to be positive in a regular portfolio, but when I'm tax-driven, you've got to compromise somewhere, nothing can be perfect.

CHUCK JAFFE: What about leverage? Because that's a factor for some people.

JOHN COLE SCOTT: Leverage, it's a beautiful part of the closed-end fund structure, and it shouldn't be in every fund but it should be available to most funds. The weight of leverage here is 28% because it is diversified, and what that means with a 12% discount and 20% leverage, you can buy that one dollar for $0.88 – this is the historical closed-end fund math my father talked about in his newsletter in the nineties – and the manager invests $1.28. Again I'll say, you don't me to build a portfolio like this, we just have the tools, the time, the resources, and the drive, but if you did a version of this yourself, one dollar in your account is $1.46 of manager exposure, and that's the basic reason why a 9.1% yield can come from these asset classes, because the manager's blending to six and change because of that combination. Expenses sometimes get hammered, and I just want to say this portfolio with 6% BDCs, the highest expense ratios in my world only have a 1.16% weighted. Again, this is gross asset non-leveraged expense ratio. Leverage is important, but to me, a separate analysis, and especially for credit funds with higher leverage, it's hard to ignore the cost of running the fund and not include the gross assets that are there.

CHUCK JAFFE: John, before we go, I want to take a moment to talk about somebody who you and I found out recently he had just passed away, but he's somebody who had a lot of influence on the closed-end fund industry. His name was Don Cassidy, and when I first met him he was working as an analyst with Lipper, and he was there guy who was talking to me about closed-end funds. He left and started the Retirement Investing Institute and did some things there, but he was always about income portfolios and closed-end funds and the rest, and I know that you and he had a special relationship.

JOHN COLE SCOTT: First my father and he were very good friends, he got to Lipper in 1990, my dad's newsletter in 1988, obviously run in the same circles. He actually funds a little bit of money early in my career to have me go out to the AI chapter at Denver and do a one-day two-track event, educating the folks. He loved teaching individual investors how to be empowered, how to go in a contrarian viewpoint, whether it was closed-end funds or something else, he wasn't closed-end fund only like I am. We did some work together, in retirement he did some project work off of our data, and I had a quick opportunity to chat with his widow today and tell her how much he meant to my father, to me, and I would argue, this industry. And for those that didn't know him, he was a quiet giant with a big heart but always looked to make everyone's experience better, so I just can't thank him enough for what he gave me at my young age in my career.

CHUCK JAFFE: John, great stuff as always. Sad that we had to end on the note with Don Cassidy, but I know that there's a lot of people out there, especially your friends listening in the closed-end fund industry, who they're aware now that Don unfortunately has passed. We'll talk to you again soon, John, thanks for joining me.

JOHN COLE SCOTT: Always a pleasure, Chuck.

CHUCK JAFFE: The NAVigator is a joint production of the Active Investment Company Alliance and Money Life with Chuck Jaffe. Yep, that's me, learn about hour-long weekday show at MoneyLifeShow.com or wherever you get 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, on Facebook and LinkedIn @AICAlliance. Thanks to my guest John Cole Scott, president of Closed-End Fund Advisors in Richmond, Virginia, chairman of the Active Investment Company Alliance. The firm is online at CEFAdvisors.com and CEFData.com, John's on Twitter @JohnColeScott, and we have a link in the show notes to the portfolio we were discussing so that you can get all the information and take a good look at what's in there. The NAVigator podcast is available every Friday, be sure not to miss that or any episode by following us on your favorite podcast app. We'll be back next week, and until then, happy investing everybody.

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