Muni Discounts Keep Defying Gravity; Sizing Up Fixed-Income Risk And More

Friday, September 22, 2023

Chuck Jaffe, in this 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 returns to The NAVigator, noting that the discounts on muni funds have continued to get wider. He notes that the average discount for a closed-end muni fund stands now at 12.5 percent compared to their 10-year average of just under 5 percent, and talks about what is discouraging investors from heading into munis now. He also compares muni funds to BDCs and discusses how investors should size-up current risks in credit before ramping it up in their portfolio. Plus, he discusses AICA's upcoming Fall Roundtable in New York.

John Cole Scott

Funds Discussed:

NZF- Nuveen Municipal Credit Income Fund (NZF) (cefdata.com)

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 muni closed-end funds and why they're surprisingly cheaper now than they were just a short time ago, 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. And by the way, before we finish this episode, we'll talk about an event that the Active Investment Company Alliance is doing, so no matter which area of that you fall into, well, they're doing something for you. But if you're looking for excellence beyond indexing, The NAVigator is going to point you in the right direction. And somebody who we look to for direction when it comes to closed-end funds, John Cole Scott, he's president of Closed-End Fund Advisors in Richmond, Virginia, which is online at CEFAdvisors.com. We're about to dig into funds using the firm's research, which you can do yourself at CEFData.com. John is also the chairman of the Active Investment Company Alliance, which you can learn about at AICAlliance.org. John, let's get busy.

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

CHUCK JAFFE: I want to start with muni funds. We're going to go in a couple different directions today. It's been interesting, with anything fixed income, which is a lot of closed-end funds, in this high inflation, high-rate environment the picture keeps changing, and muni funds I would have thought would be holding up in this environment but the discounts keep getting wider. So maybe they're holding up, but on paper they're not, right?

JOHN COLE SCOTT: I was on about a month ago talking about how quarter end they've only been wider at the end of the month twice since I was a junior at William & Mary, and they're 1.5% wider than then. And if you really think about that, with about a week or so to go in this quarter, 12.5% discounts versus the 10-year average of 4.9%, so about 8.5% extra wideness, but it's not a story that's unfamiliar to the investors or even logic. Dividend cuts have been pervasive, the average fund is a 26% dividend cut, which includes some funds with little cuts, some funds with larger cuts, and really the story comes down to two parts of a closed-end fund; they have investments, which produce yield in this case, and they often employ leverage, which has a cost. In the bulk of our relationship, leverage was cheap, bonds were yielding higher, and it was completely additive in every scenario that logic dictated, but it's been really tough with the yield curve, with the cost of leverage coming in faster and higher than the slow sludge of replacing bonds in a higher rate environment, raising the coupons at the portfolio level.

CHUCK JAFFE: So we're watching an interesting play as it's happening. Of course here on The NAVigator and in your business we're always talking about closed-end fund and business-development companies, and one of the logical alternatives for somebody who's looking at munis would be BDCs. So let's do a quick comparison.

JOHN COLE SCOTT: Really the assets of a BDC are generally floating-rate loans, kind of like the senior loan bucket of traditional closed-end funds, but what they have is a lot of fixed-rate leverage, so their dividend increases have been, for the index we have, a one-year 13%. We've had some funds with far higher numbers, but that's a great weighting there. If you think about BDCs and munis, if you try to look the quarterly NAV movements, because you only have one NAV every quarter for BDCs, and of course you've got a bunch for any muni fund, it's about a 15% 18-year correlation, that's as far back as we can get good data, which reminds you that these were very different parts of the investor appetite. Private venture loans in a fund that's a permanent capital, stable capital base, that you can buy for yield, fully taxable dividends typically, versus federally tax-free duration bonds that help build hospitals and freeways and all the other things that go into muni credit.

CHUCK JAFFE: Normally when you and I talk we have a whole bunch of topics, but in this case you kind of said, "Hey Chuck, is there anything you want to dig into?" and there is. In this environment, as we're talking about munis and BDCs, well, both on The NAVigator and then more generally on my show *Money Life* there have been a number of private credit experts, folks talking about basically going out the risk scale, and what's interesting to me at this point is that there is a lot of interest particularly when it comes to doing that through closed-end funds. But investors don't have a lot of information on risk-adjusted returns, and we've got money market funds paying 5% right now, so how do you size up whether it's private credits, junk bonds, the things that are at the riskier end of the spectrum, that if you look at the yield numbers and you look at the discounts you're going, "Now's the time to buy," but if we were looking at risk-adjusted returns we might go, Is it worth it?"

JOHN COLE SCOTT: So I'll dig a little bit into both munis and BDCs, it's going to be a little deeper into munis because there's so much more to dig into, but in our CEFData.com Daily File, which is for our paid subscribers, sortable, malleable, tons of granularity, there's 73 national funds. The most recent data we can pull, about an average cost of leverage about 3.7%, and an average coupon of 4.6% and change. However with data, not everyone gives me the same data in the same time frame, the average earnings for these funds with a 7/31 date, the freshest available across the market, is about 4.3%. You might hear me talk a lot about, "What if we take leverage and discounts, what's the manager have to earn to fuel the policy set by the board?" that's the leverage adjusted NAV yield, right now it's about 3.2% for the universe. And again, where is the leverage relatively cheaper? Where are the earnings yields relatively higher? Are there examples of sifting beyond discounts, beyond a named manager necessarily to find something that seems to be the right path? And we really came down to two funds that are interesting examples that we think exemplify probably the right guess of a good footing for munis. One's a Nuveen fund, NZF, large discounts, 17%, $4 billion fund, very liquid, a 4.8% yield with dividend coverage slightly higher than the policy. But what's I think important, and coming to your question, it's only 64% investment grade because it's 24% unrated. And a lot of retail investors might go, "Oh my goodness, these are unrated bonds," but I'm sure on your show you have muni managers all over the world or the US that go, "We love unrated bonds because that means we get to roll up our sleeves and decide what it's worth and do the active management," which is beautiful in closed-end funds. And then a 12% high-yield sleeve, which is relatively high for closed-end funds.

CHUCK JAFFE: And so when you're making a case for a fund, in this case NZF, but you could have given us some other examples, it's not that somebody should say, "Hey, I want to throw everything that's in my safe sleeve there," but it's that given the way the fund is structured you're not going, "Okay, hold it," you've extended out the risk scale to where Fed makes a change or any of those other things, you're going to wind up getting whipsawed."

JOHN COLE SCOTT: Yeah, and also there's duration here, these are levered long bonds, and so if you think that we're going to have way more rate increases than the dot plots showed this week, then maybe you should be thoughtful on the 17% discount being not as lick your chops attractive. But again I also want to give Nuveen props, it is tough to be in this environment, but they give us last month-end average cost of leverage, and in my research it's the only fund sponsor I'm seeing it from, which helps us understand the nature of the investment. You don't see that at other sponsor websites, and so we super appreciate getting more data to help make that decision from a leader in the industry.

CHUCK JAFFE: And now let's take the time we've got left to talk about the Active Investment Company Alliance's Fall 2023 Roundtable. It's a little bittersweet for me to do this, John, because every roundtable that AICA has done, I have been there. I would be at this one but I'm going to be on my honeymoon. If it were pretty much any event but my honeymoon, I would be there, and I can think of a lot of reasons for anybody else who's not on their honeymoon to go. Why don't you try to convince the folks who are not going to be on their honeymoon, why they should be there.

JOHN COLE SCOTT: It's our third year in person, we've been doing these events in some shape or fashion for five years, you've been part of so many of them. We're going to have nine panels, seven CE credits pending. The morning session is really the closed-end fund managers talking, different panels, market, great Q&A. The attendee base is heavy institutional investors, products to closed-end funds, and those advisors regionally that want to learn more and dig in. Lunch time's going to have two interval fund panels, and in the afternoon we have these really special and uncommon in the for-profit closed-end fund environment, four panels, we're seeking to cover activism is one panel, institutional investors, which is normal for us, but also a future of closed-end funds with some great speakers firming up their approvals as we speak, and then another one looking from the regulators, the lenders, and independent board members, which is another layer of people that look at these funds. And it's just a really wonderful time to bring community to closed-end funds, it won't be live replayed but we will have replay content available after it's compliance approved.

CHUCK JAFFE: Let's not hide the fact that this is an event that's mostly going to be attended by folks who want to get continuing education credits and things along those lines, which can help you if you're a financial advisor. It will be attended by some of the money managers and the folks who are essential in the closed-end fund industry, and folks like you who do a lot of research. But there's always one or two individual investors who are just like, "Yep, I put most of my money into closed-end funds, and I'd rather be here than going to a Morningstar event or whatever because I don't get this content any place else." And no matter what you do, if you're an individual investor or you're one of those folks with a CEF credit, if you give a little shout out to my show *Money Life*, MoneyLife30 is the discount code, you can get a discount on your enrollment with that. The event itself, November the 15th in New York City, but you can get early bird pricing if you register by September 30th.

JOHN COLE SCOTT: And one thing we do special, which is a tough financial model, we invite to speak, there's nobody on stage because they gave me a check. We have members who give me dues that speak, but non-members speak as well, and everyone in the room pays something because we feel that the better quality people show up that are committed to spending a few bucks. Trust me, the prices are not expensive, we do subsidizes from AICA's revenue.

CHUCK JAFFE: Again, it is the AICA Fall 2023 Roundtable, not the biggest of financial conferences, but if you're a closed-end fund investor there's nothing else like it. And there's no one better to talk to about closed-end funds, John, than you, so thanks so much for joining me, we'll talk to you again soon.

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

CHUCK JAFFE: The NAVigator is a joint production of the Active Investment Company Alliance and *Money Life with Chuck Jaffe*. And yeah, that's me, and you can learn much more about my hour-long weekday podcast by going to MoneyLifeShow.com or by searching 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, he's president of Closed-End Fund Advisors in Richmond, Virginia and he's the chairman of the Active Investment Company Alliance, his firm is online at CEFAdvisors.com, and then you can dig into their data at CEFData.com, and John's on Twitter @JohnColeScott. And of course, to get more information about AICA's Fall Roundtable, make sure again you go to their website, AICAlliance.org. The NAVigator podcast is available for you every Friday, we'll see you again next week. And until then, happy investing everybody.

Recorded on September 21, 2023

To request a particular topic for The NAVigator podcast please send an email to: TheNAVigator@AICalliance.org

Click the link below to go to the home page of Active Investment Company Alliance to learn more: https://AICalliance.org/

Disclosure: *Views and opinions expressed are for informational and educational purposes only as of the date of production/writing/speaking and may change without notice at any time based on a multitude of factors. Speaker's/presenter's/author's opinions are their own and may not necessarily represent the opinions of AICA, its Board, or its staff. Materials may contain "forward-looking" information that is not purely historical in nature, such as projections, forecasts, market return estimates, proposed or expected portfolio composition, and other items. Listed closed-end funds and business development companies trade on exchanges at prices that may be above or below their NAVs. There is no guarantee that an investor will be able to sell shares at a price greater than or equal to the purchase price or that a closed-end fund's discount will narrow. Non-listed closed-end funds and business development companies do not offer investors daily liquidity but rather offer liquidity on a monthly, quarterly or semi-annual basis, often on a small percentage of shares. Closed-end funds often use leverage, which can increase the fund's volatility (i.e., risk). Actual distribution amounts may vary with fund performance and other conditions. Past performance is no guarantee of future results. This material is not intended to be a recommendation or investment advice, does not constitute a solicitation to buy, sell or hold a security or an investment strategy, and is not provided in a fiduciary capacity. Shares of closed-end funds are subject to investment risks, including the possible loss of principal invested. Closed-end funds frequently trade at a discount to their net asset value (NAV).*