



VettaFi's Islam On The Struggles/Potential Of ETFs Buying Closed-End Funds

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Chuck Jaffe, in this episode of The NAVigator podcast interviewed Roxanna Islam, head of sector and industry research at VettaFi. Read the Q&A below as Roxanna says that cautious retail investors have been looking for safety and yield, and that while closed-end funds have traditionally filled that bill, investors in ETFs that buy closed-end funds have been avoiding a lot of the struggles by turning elsewhere to invest. She believes that could be changing however, as



investors recognize the bargains that closed-end funds represent, particularly in ETFs of CEFs, where investors get diversification at a reasonable price.

Roxanna Islam

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CHUCK JAFFE: Roxanna Islam, head of sector and industry research at VettaFi is here, we're talking about how ETFs that buy closed-end funds have been holding up in this market, welcome to The NAVigator. This is 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 which 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 points us in the direction of Roxanna Islam, head of sector and industry research at VettaFi, and you can learn more about the firm and its suite of tools that will help make you a better investor at VettaFi.com. To learn more generally about closed-end funds, interval funds, and business-development companies go to AICAlliance.org, the website for the Active Investment Company Alliance. Roxanna Islam, welcome back to The NAVigator.

ROXANNA ISLAM: It's good to be back.

CHUCK JAFFE: So these have been the proverbial interesting times for closed-end funds, the market has been going up but it's been a market that hasn't been broadly rallying. Closed-end funds meanwhile have kind of struggled through this, we've seen discounts widening and the rest, but what investors are looking for is pointing a lot of them to closed-end funds. Of course if they're not that familiar with them, they're going to turn to fund of funds, or in this case, ETFs of closed-end funds. How have they been holding up in these conditions and what are the trends you're seeing generally for ETFs of CEFs?

ROXANNA ISLAM: So first of all, I think the macro environment right now is really important in how it's changed the way that people think, because we're both consumers and investors, right? So as consumers we've experienced months of higher prices on groceries and gas and other everyday items, and there's some other factors like higher housing prices and student loan payments resuming, so there's just a lot going on that's been eating away at our savings. And then as retail investors now, we're maybe also growing a little bit more cautious because

of the stock market, maybe a possible recession, and so combine that with less money in our wallets, we might be looking for some safer investments or maybe investments that provide additional income. So I think a big question is why invest in something like a closed-end fund when there are technically some safer things out there like fixed income or maybe some of those dividend investments? Like you said, closed-end funds have had a difficult year to rising rates, we've seen returns suffer, distributions have been cut and discounts have widened, so it's just been rough all around, but we can hope that this is just a short-term market fluctuation and some closed-end funds may be better positioned than others to withstand this environment and maintain those high distributions until returns start improving. But the question is, which ones? And I think that's the really difficult thing to predict. That's when we can start looking at ETFs of closed-end funds, and both passive indexed ETFs and active ETFs have their advantages in this sort of environment. Passive ETFs, they offer diversification benefits, and that's mostly by softening the effects of distribution cuts and providing a comparatively stable distribution stream through market downturns. And then when you have active closed-end funds, these also offer higher distributions as many experienced fund managers may be better at selecting those closed-end funds.

CHUCK JAFFE: There are different flavors of ETFs doing closed-end funds the same way there are different flavors of closed-end funds. How are you deciding, other than maybe your own portfolio needs, don't want to be taxable or something, where you want to go when it comes to ETFs that are buying CEFs?

ROXANNA ISLAM: There's not really a specific right answer, I think it depends on the investor. As I said, there's a place for both active and indexed here in my opinion, and it really depends on what you're looking for. So there are four ETFs of closed-end funds that focus on taxable closed-end funds, you have PCEF and YYY, which [inaudible], and then you have FCEF [inaudible] and CEFS, which are active. So if you look at PCEF, that's the oldest and largest ETF of closed-end funds, and so many investors they use this to just replicate the taxable closed-end fund universe. Distributions here match those of its holdings, so those distributions have seen some minor variance over the past few months, but because of that diversification among its 100+ holdings, the annual distribution rate on an absolute basis has remained pretty stable, it has even seen some increases despite some of its top constituents cutting those distributions by 20-30%. And then if you look at YYY, which is also

an index ETF, it focuses a little bit more on income and it has 45 or so holdings, so less than half of PCEF, this one uses a managed distribution policy, so distributions are more stable, they're still diversified but maybe not to the same extent. And if you look at the active ETFs of closed-end funds, those also have those level distribution payments, so those have weathered the environment pretty well also. I think the main issue with maybe all of these, you do have that lackluster total return compared to the broader market that we discussed earlier, but on the other hand, you do have those high, relatively stable distributions. So if you believe that the market environment may not last much longer, I think it may be worth withstanding some of that market volatility and receiving distributions with the hope that the returns will eventually improve.

CHUCK JAFFE: From that perspective, I would imagine that it would be easier to choose an ETF of closed-end funds to build a portfolio than it would be to choose a whole bunch of individual closed-end funds to build my portfolio. And at the same time, I could understand why somebody might say, "Hey, this is the yield that attracts me. I'm going to go buy that fund and that other fund." So when it comes to traditional funds and ETFs, it's pretty easy, are you doing it for tax efficiency or are you doing it for other reasons? But when it comes to closed-end funds versus ETFs of closed-end funds, is somebody gaining other than that sort of stability and a little bit of softening and maybe some built-in diversification? Is somebody getting a significant benefit by being in the ETFs as opposed to just trying to do it themselves?

ROXANNA ISLAM: Those are the major benefits, but the big benefit of any ETF is that [inaudible]. Obviously it is a big risk, if you think are a good stock picker or fund [inaudible], it may be better to pick your own securities versus using an ETF, because you might be missing out on some of those higher performing closed-end funds or some of those higher distributions. But as I said, it's a tradeoff, you're more protected on the downside because of the diversification, so I think it really depends on the investor and how confident they are in the environment. I know there's also people who use these ETFs as core closed-end fund holdings, and then they pick individual closed-end funds with a tactical approach on top of that.

CHUCK JAFFE: Yeah, so core and explore. You could do core and explore with closed-end funds the same way you might do it with traditional funds or ETFs. Interesting, and ETFs of

closed-end funds are still a relatively new and young development, do you see more offerings coming down the pike?

ROXANNA ISLAM: Yeah, I think I see more coming down the pipe, especially in the active space. I think in the passive space, I think PCEF does have a bit of market dominance there. I definitely see more space in the active arena as we have more experienced fund managers select some of these closed-end funds and create active products out of them.

CHUCK JAFFE: Roxanna, really interesting stuff. Thank you so much for joining me on The NAVigator to talk about it.

ROXANNA ISLAM: Yeah. Yeah, it was great, Chuck.

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