Sit Invest's Doty On Muni-Bond Discounts And How They Will Be Trimmed

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Chuck Jaffe, in this episode of The NAVigator podcast interviewed Bryce Doty, senior portfolio manager at Sit Investment Associates. Read the Q&A below as Bryce says that muni-bond closed-end funds using leverage, where the cost of their borrowings are effectively wiping out returns given current conditions, are more interested in keeping fees high than making money for shareholders, which is one reason why his firm has become a more activist shareholder. With the average muni-bond discount at roughly 13.5 percent – more than three times its historic norms – Doty says it should be easy for shareholders to narrow the discounts and turn profits, but it will require the Federal Reserve cutting rates and/or fund managers selling losers and reducing the negative carry of their leveraged positions.

Bryce Doty

The podcast can be found on AICA's website by clicking here: https://aicalliance.org/alliance-content/pod-cast/

CHUCK JAFFE: Bryce Doty, senior portfolio manager at SIT Investment Associates is here to talk about investing in muni bond closed-end funds, it's time for 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 will point you in the right direction. And today it points us towards Bryce Doty, senior portfolio manager at Sit Investment Associates, where his team manages nine billion dollars, of which about two billion is in closed-end fund of funds for separate accounts. You can learn more about the firm at SitInvest.com. And 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. Bryce Doty, great to have you back on The NAVigator.

BRYCE DOTY: Yeah, thanks for having me, Chuck.

CHUCK JAFFE: These are really interesting times in the muni space, and particularly the muni closed-end space. Because on the one hand you can look at fixed income and kind of go, "Yup, it's kind of fixed at this point," on the other hand we've seen what's been happening with discounts, we have lots and lots of interest rate pressure as we watch the inverted yield curve get ready to un-invert and all those other sorts of things. So first give us a general view of what you see happening in the muni closed-end space and what you're gravitating towards or away from.

BRYCE DOTY: Yeah, in the muni closed-end fund space you've seen individual investors that dominate this universe of course vote with their pocketbook and sell shares. The discounts have widened to 15% and even wider, so that tells you just how unpopular they've become, where you can now purchase some of these muni closed-end funds literally 15 points below where the underlying bonds are actually trading in the bond market. They've really fallen out of favor and there's some common sense reasons for that, you mentioned one in particular is that this inverted yield curve is really hurting the yield on their funds on the portion of their assets that are leveraged. So while all yields seem to be going up around the world, you have these muni closed-end funds actually cutting dividends, and you can understand how frustrating that has to be to shareholders.

CHUCK JAFFE: If I'm investing in it as an individual investor, when I'm frustrated I'm going to say, "What's my excuse to get out?" Maybe this is when I do tax-loss selling and the rest. But as a fund manager, for you is it about, "Yes, I'll do tax-loss selling," or is it about, "I'll get active"?

BRYCE DOTY: It started as the former and it's becoming the latter. What we look at, we're sophisticated bond managers, we understand positive carry and negative carry, you don't want to have negative carry. And here we see these muni bonds that are held in a portfolio are earning about four to 4.5% tax free, which is pretty attractive, but the funds then go and borrow money to buy more municipal bond funds. Unfortunately they're paying more than what they're getting, so why would you do it? No one with any common sense would do that. So for example, let's say there's a hundred million in a fund of just customer assets earning 4%, and then they borrow another $50 million to buy more bonds at 4%, except that $50 million, their interest expense on the borrowing is variable and it's gone up to 5%. It's just bizarre, who would ever do that? You'd normally just pay off the debt. But what they've done is they are earning 4% on a hundred million, negative 1% on $50 million, their average yield, the weighted average yield is about 2.3%. It's lousy, it doesn't make any sense. They should just pay down the leverage, the debt, have a hundred million earning 4%, and have that be tax free. But they don't want to because here's the catch, they charge a management fee on the $150 million, if they reduce the debt, they also reduce the assets and that reduces their management fee. So their incentives are not aligned with ours, and that's the rub, that's where there's going to be some friction.

CHUCK JAFFE: You have actually stepped into that friction, there are some 13Ds on some funds that you have gotten active in. Normally when people think of active investors they're thinking of, we want the fund to go to an open-end fund like convert, we'll capture the discount and whatever. But is that your aim, or is your aim, "Hey, we're activists and what we're trying to do is to get you to get rid of the leverage. We're fine staying here, we're not worried about you staying a closed-end fund. We're not even worried about capturing the discount so much, just get out of negative carry"?

BRYCE DOTY: You know, that's a good distinction. We're not raiders, we're not trying to bust up funds, but we do enjoy a little common sense, and it would be nice if they would just treat shareholders as they would like to be treated. They would never do this to themselves, they would never intentionally destroy the yield of a fund just so they can pad their pockets with some extra management fees, they would never tolerate that from anyone else. And as far as the discount goes, the discount would naturally narrow if the yields went up and they increased the dividend. It would from, let's say a 15% discount, to maybe 10%. We're not looking to necessarily close the whole gap, but obviously whenever a fund increases their dividend and they start to earn more yield that's more competitive with the rest of the marketplace, that's going to create demand for those shares. That's what we're looking to capture. We want the income and we want some normalization and common sense to make the fund more appealing.

CHUCK JAFFE: You and I are recording this on November the 10th and Bloomberg this morning came out with an article talking about how Wall Street managers are piling into closed-end funds on discounts, talking about by the way that the average discount on a muni bond closed-end fund is now 13.6%, the highest in about 15 years, and the historical average is closer to 4%. As you look at the muni market now, in these conditions, will it be that there's such a good bargain that demand will be what narrows the discount? Or is it something else that's going to make it that those who capture the discount at this wide rate will wind up profiting and seeing it narrow?

BRYCE DOTY: The narrowing is usually triggered by something, so it's what will unlease the pent-up value, to have it go from the 13.6% discount back to historical 4-5% discount. And it's either going to happen by the Fed eventually cutting rates, and that would produce positive carry on the leveraged portion of the fund and therefore once again allow them to increase dividends. But that's such a long time, why lose so much money between now and then? I would think that anything they could do now to reduce that negative carry and enhance the return would accelerate the capture of the narrowing discount. What they'd have to do is sell some bonds that are at some major, major losses, but the people in these funds don't like paying taxes or they wouldn't be buying them, so having some losses that you could use to offset future gains just makes a lot of sense. Clearly the only possible reason that they haven't done this already is because they don't want to see a reduction in their management fees, but we need to see an uptick in the dividends before you'll see those discounts snap back.

CHUCK JAFFE: Is the expectation that market conditions should help us see that uptick in dividends and we should see that snapback? I mean, I know you are in this for the long haul, but for the person who is looking at it now and who has one or two closed-end funds or a muni bond closed-end fund in there somewhere, how long is this fight?

BRYCE DOTY: That's the real question. Eventually it's going to happen one way or the other. the yield curve will normalize and the ship will right itself, but it could take so long that it's like why get in right now? So I think that's why the discounts are so wide, people are like, "Well, I'll wait and see. Show me the dividend, show me the money, and then I'll get in." We think that sometimes that's just too late, so if I were an individual investor I'd do half now or a third now. That's why my friends and family don't like me, okay? Every time they ask for investment advice I say, "Well, you should do a portion of it now, that's what professional investors do." Well, the market goes up, they're like, "Why didn't you tell me to do all of it?" It goes down, they're like, "Why did you tell me to do some of it?" But that's what they should be doing, they should take a bite out of it right now, because if things change quickly, which we think it really could, it wouldn't take much for these funds to sell. Even just 10% of their portfolio would have a huge pop on their income, so you don't want to miss that, but you don't want it just sitting there waiting for two years for the market to correct itself either. So that's why we would start averaging in now, and that's why we are getting very involved early.

CHUCK JAFFE: And Bryce, no matter how your family feels about you, we think you're great and we're always happy to get a chance to chat with you. We're all in, even if we're only supposed to be partly in when it comes to investing. Thanks so much for joining me on The NAVigator.

BRYCE DOTY: Thanks again 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, that's me, why don't you check out my hour-long weekday podcast by looking at MoneyLifeShow.com or by searching wherever you find great 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. They're on Facebook and LinkedIn @AICAlliance. Thanks to my guest Bryce Doty, he's senior portfolio manager at Sit Investment Associates, where he and his team run nine billion dollars, of which two billion is in closed-end funds of funds for separate accounts. Go to SitInvest.com for more information. The NAVigator podcast is new every Friday, be sure not to miss an episode by subscribing or following along on your favorite podcast app. And if you like this podcast, leave a review and tell your friends because that stuff really does help. Happy Thanksgiving, everybody, we'll see you again next week and happy investing.

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