ACTIVE INVESTMENT COMPANY ALLIANCE
Excellence beyond indexing

AICA To Broaden Investor Access To Closed-End Funds, Business Development Companies

Sophisticated retail investors have known for a long time how closed-end funds and business development companies can provide them with safe, dependable access to less liquid but higher yielding asset classes than are typically available through mainstream investment products.

Veteran closed-end fund analyst, publisher and data provider John Cole Scott recently launched the [Active Investment Company Alliance] in order to broaden this base of knowledge, allowing providers of investment products and services within these markets a multi-faceted platform for reaching and educating potential investors, while providing those prospective investors the tools and information they need to get up the knowledge and confidence curve with investment vehicles and asset classes they have not been previously exposed to.

Today we have Steven Bavaria, author of [The Income Factory] and a long-time user and advocate of closed-end funds in his writings and personal investment strategy, interviewing AICA founder John Cole Scott. Scott is Chief Investment Officer at Closed-End Fund Advisors and also founded CEFA's Closed-End Fund Universe, a data service covering all US listed closed-end funds and BDCs.

Bavaria: John, for our readers who may not be as familiar with closed-end funds, could you describe some of the features that make them attractive to many investors?

Scott: Many closed-end fund investors are particularly attracted to the idea of having active professional management within a fixed capital structure, so long-term investors don't have to be worried about a constant inflow and outflow of funds, often at just the wrong times, forcing portfolio managers to make inopportune buy-sell decisions in order to provide instant liquidity to fund investors. This avoids the sort of "run on the fund" risk that investors face with traditional open-end mutual funds, where a relatively few investors panicking and redeeming their shares when markets are depressed can sometimes force fund managers to liquidate what would otherwise be valuable long-term holdings.

Closed-end funds also offer investors an opportunity to take advantage of cheap, institutional leverage, since large funds and other institutional investors often have access to less expensive funding sources than private retail investors, especially investors using IRAs or other tax-deferred vehicles that can't be easily leveraged. Closed-end funds are generally allowed to leverage themselves up to 50% of their equity capital. Being able to borrow at 2% or 3%, as many funds have in recent years, and re-investing the proceeds at 6-7% or higher, can often add an additional 2% or more to the overall yield on the fund's equity. This is the "financial alchemy" that allows a closed end fund whose asset class (high yield bonds, preferred stocks, convertible debt, utility stocks, etc.) may pay a "natural" (i.e. unleveraged) yield of 5, 6 or 7%, to distribute, as a result of leverage, a dividend yield of 8 to 10%.

Of course, if you manage to buy that fund at a 5% or 10% discount to its net asset value, as smart investors can often do, then you have 100 cents on the dollar of assets working for you that you only had to pay 95 cents or less for. That boosts your yield even further.

Bavaria: It is sometimes said that closed-end funds offer thoughtful investors an opportunity to "monetize liquidity" by deliberately trading off liquidity they don't really need for higher yields and returns. Can you explain this idea for us?

Scott: Liquidity is one of many risks that investors face in making investment choices. Investors can choose to avoid or minimize liquidity risks by sticking to blue chip stocks or to large index or other mainstream mutual funds and ETFs that hold the stocks of broadly traded companies. They know they will always be able to liquidate their holdings either instantaneously at a readily determined market price or through overnight redemption at net asset value from the mutual funds. But there is an opportunity cost to be paid for confining your investment choices to highly liquid securities and asset classes.

As noted above, investors in closed-end funds cannot redeem their shares at their net asset value from the fund itself, the way traditional open-end fund investors can. Closed-end fund investors have to sell their shares in the market, at whatever price the market puts on them at any moment, which may be more or less than the actual net asset value of the fund. For taking this liquidity risk, however, closed-end fund investors can earn the higher yields described above, which are not available to traditional open-end fund investors.

This raises the question for many investors, especially those with a long-term horizon, of how much liquidity do they really need, and is it worth giving up 2 or 3% over the long run in order to get it. Buy-and-hold investors with 20 or 30 year horizons, like those investing for retirement, may well decide that they can afford to live with the short-term volatility and lack of immediate liquidity of many high yielding investments in order to re-invest and compound their returns at the higher rate. This trade-off, some illiquidity in the short term in return for higher income and greater returns a decade or more later, is what we refer to as "monetizing liquidity."

Bavaria: You have said that you expect AICA to be "more than just a trade association." What do you mean by that?

Scott: Our goal is to raise the bar beyond just representing closed-end fund and BDC sponsors and managers, although we certainly expect to welcome them and serve their needs. But beyond that we want to be an educational organization that empowers entire new groups of investors to achieve the knowledge base and level of confidence needed to participate in closed-end fund vehicles of various kinds and the asset classes they represent.

We want to be a mecca for discussion forums, podcasts, webinars and conferences, with rich content about investment options that many retail investors have never had a chance to be exposed to in a meaningful way.

Bavaria: Closed-end funds, by their nature, are ideal vehicles for holding less liquid, higher yielding and more complex asset classes. Will you be showcasing various asset classes in your educational forums?

Scott: Yes, we have already launched The NAVigator, AICA's new podcast series (http://thenavigator.libsyn.com/) which will feature professional investment managers and other experts on asset classes that are uniquely suited to the closed-end structure. One of our first podcasts focused on credit and alternative structures that have previously been largely confined to institutional investors, but are now finding their way into the retail sector through closed-end vehicles. (http://thenavigator.libsyn.com/alternative-investments-find-a-new-and-expanding-platform-in-closed-end-funds).

Credit investing, because it is more predictable and returns are more dependent on cashflows than on market appreciation, is uniquely suited to being held in closed end funds. Similarly other high yielding asset classes, like master limited partnerships, high yield bonds, preferred stocks and convertible bonds, and many others that we will be featuring in future NAVigator podcasts.

Bavaria: So it sounds like you have high hopes for AICA?

Scott: Yes, we think our timing is right and there is a terrific demand, among retirees and those who are planning to be retired at some point, for higher yielding vehicles of the sort that the closed-end fund and BDC industry has been generating for many years. Our mission is to broaden the knowledge base and help many retail investors achieve the level of confidence they need to participate in this arena, one that institutional investors have successfully been involved in for generations.