2023 Year In Review: Closed-End Funds Bounce Back, But Leave Room For More

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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 does his annual forecast for the year ahead, noting that he expects closed-end funds to outperform the general equity markets, and he expects a mild narrowing of discounts from current average levels of roughly seven percent, noting that bond funds should benefit from changing interest rates. He also looks at shareholder activism, yields and more, before picking a few funds that he expects to be stellar performers in the new year.

John Cole Scott

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CHUCK JAFFE: John Cole Scott of Closed-End Fund Advisors is here, we're looking ahead to what's going to happen in the closed-end fund space in 2024, 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 will point you in the right direction. And today, well, it's going to point you in the direction of the future, and the one who is leading that search to the future is John Cole Scott, he is the president at Closed-End Fund Advisors in Richmond, Virginia, which is online at CEFAdvisors.com, and we're going to be digging into their data, which you can do for yourself at CEFData.com. John is the chairman of the Active Investment Company Alliance, which has everything you need to become a better investor and to become more knowledgeable about the closed-end fund space. Go to AICAlliance.org for more information. John of course was here last week reviewing his picks for 2023, John Cole Scott, Happy New Year. Welcome back to the NAVigator.

JOHN COLE SCOTT: It's great to be with you, Chuck. And again, Happy New Year.

CHUCK JAFFE: Let's look and see, because, well, is it going to be a happy new year in the closed-end fund space?

JOHN COLE SCOTT: You know, I actually never have a crystal ball, if you weren't surprised, but we do make educated guesses about where we think things will go in the next 12 months for our clients and for our audience. And I do believe, and the key will be diversified, that a diversified closed-end fund portfolio will beat the general equity markets, even the equal weight. Though some people might argue the equal weight might beat the bigger, but we don't know that future either.

CHUCK JAFFE: So the basic forecast for the year ahead is that closed-end funds will again outperform the general markets as measured by an equal weighted stock portfolio. That's good news. Now that's outperformance on a general basis, let's talk about yields.

JOHN COLE SCOTT: Yeah, so with closed-end funds you can forget it's the NAV, it's the discount, it's the yield, so we do believe there is a bigger risk to those equity-based risks, those where basically managers and boards give you longer term performance, and we do believe that that's not the cash flow, a bond fund or office rents. We also expect more what I'll call fake yields in 2024, and it's not the worst thing but funds can pay whatever they want but long term NAV performance has to fuel NAV yield or the math never works. Those two issues are going to be prevalent in 2024.

CHUCK JAFFE: Now we don't want to give you a complete softball, and people should know you and I are recording this before the turn of the year, so we don't know what kind of January effect we're going to have, we don't even know for sure if the Santa Claus rally is in effect because it's not completed until the first two trading days in the new year, but January Effect this year?

JOHN COLE SCOTT: I think it's going to be positive. I think it'll be fueled more from the credit funds because the math is good on their balance sheets, but the January Effect was tremendous in 2023. It's normally about 4% when it's up on an average year, I don't even know if we'll hit the four, but honestly anything that can do 1.5-2% is positive when the average annual return is 8%, so we think a muted January Effect based on where we sit.

CHUCK JAFFE: So a muted January Effect. Of course the thing that a lot of people may care about almost as much as they care about returns is what's happening with discounts?

JOHN COLE SCOTT: Yeah, so discounts at year-end are right around 7% for our 15-sector index, that's the hundred ticker symbol largest funds that we use to benchmark the structure that we deal with for our clients, and really, August 31st of '21, it was an average slightly positive for the basket of funds. And as we talked last week, we don't see bunch of movements '23, but for '24 we really think there's a good chance for mild discount narrowing, and so I do believe we can see about half of that come to fruition because I think over half the funds are bond funds and I do expect most bond funds to have more tailwinds than headwinds in 2024.

CHUCK JAFFE: We'll take that, that's a positive. And again, another positive, so thus far in looks pretty good. Now activism, that's an interesting case, because of course shareholders, on the one hand they want the best, on the other hand, activism, do you want to jump in there? So what are you expecting from activist investors this year?

JOHN COLE SCOTT: For activism, and it really depends what happens, but as we opine what's likely to happen in the universe of funds, especially some of the equity funds, we do expect more larger tenders, and we define that as over 20%, so 90-99% of net asset value. But we also feel that funds will both be doing preemptive buybacks and dividend increases, sometimes quietly negotiated by 13 filers, sometimes by 13D filers, we do expect some mergers. We might opine potentially fee compression, because I argue with fund sponsors when investors who've had terrible results share a little pain, it's a positive bullet point to improve the long-term success in the future. And again, it's also worth talking about the funds that two activists own; BRW, which is a Saba fund, it's like a six and change discount, which is slightly wider than our index of bond funds, and I would say it's overpaying the dividend but that's allowed by any board. And then there's SPE, the original fund taker-over by Bulldog, it's an almost 18% discount, and so some of the quiet conversations at our conference last month was would Phil need to worry about Saba in the new year with his discount being pervasive? I don't know, we'll leave that to a year from now to see what happens. That's where we think activism will be in 2024.

CHUCK JAFFE: Awesome, that's a pretty good take. Overall returns, if you combine everything, what's your outlook?

JOHN COLE SCOTT: Yeah, so we really think that one reason we go back to, Chuck, we have 30 to 40 ticker symbol portfolios, 10+ sectors, bets are 2-4% usually, I always tell my prospects five means I'm betting the farm, and these are diversified baskets. So I do think we'll get good results, but there's always going to be sectors that surprise you in both directions, but I do think investors need to be thoughtful about where they are in their asset allocation and their tax basis. And then remember, the last two years we could do tax loss selling seven times for our client. We told them we'd like one more time at the end of '23, didn't happen, they're fine with it, but be thoughtful with when you can get those returns and book the losses and still ride the gains.

CHUCK JAFFE: So you mentioned in there that there are going to be places for outperformance and underperformance, so what are your sector picks and pans for the year ahead?

JOHN COLE SCOTT: The sectors that we think had the best footing are infrastructure, covered call funds, muni bond funds, and multi-sector bond funds, and we also have a few sectors we think might underperform our crystal ball approach, the high-yield, the convertible, the REIT, maybe not the real, that's a bucket of funds but there's some different nuance there, and then general US equity funds that just gain broad based exposure to regular common stocks.

CHUCK JAFFE: Now before I get to your picks for the funds that you might want to be looking to especially this year, business-development companies, technically they're not closed-end funds but we treat them like they are because they basically function like a closed-end fund. What's your outlook for BDCs in 2024?

JOHN COLE SCOTT: So much success in the structure, August of '21 an 8.5% yield, no dividend coverage, small dividend coverage. This year we've grown to 30% dividend coverage for the index, up 25%+ returns on the year, allocations surpassed that, dividends grew 10-15%.

Well, next year's going to be a little bit trickier, they're not expensive, but I expect them to reserve more of their dividend coverage for problems and to give them some flexibility through whatever might happen. And BDCs after strong results can go down quickly, but we're still in them heavily, I just think you've got to be thoughtful, tactical, and be willing to not sell emotionally.

CHUCK JAFFE: Let's now try to make sure we get some funds that people will be thinking about thoughtfully and that they'll be committed to, and so what are your picks for the year ahead?

JOHN COLE SCOTT: It's a relatively boring fund, it's DIAX, the Nuveen Dow Dynamic Fund, it's about a 13% discount, more than double its three-year, almost at the bottom of its range, wider than its peer group average. It yields a little over 8%, but there's no leverage, it's more on the value side, hence Dow in its name, it's under the Nuveen masthead but it has almost half the beta of the S&P 500, of its NAV, which is the data that we can analyze with the manager, and I think a very comfortable place to have more tax-sensitive dividends and less worry about equity downside without worrying about any bond exposure.

CHUCK JAFFE: So that's DIAX. What else have you got for us?

JOHN COLE SCOTT: Not unheard of from our audience but we did some deep digging, Dan and I chatted really aggressively this week about what we want to look at for next year, but ASGI is the Abrdn Global Infrastructure Fund, it's almost a 16% discount as we speak, it just did a dividend increase and it's going to be a NAV-based dividend increase of 25% for January, it sports a current yield of 8%, it's going to be over 9% once it comes to fruition. There's no leverage, so there's less of that risk, and has the private exposure which gives you access to the goodness of a closed-end fund, and it's about a third less volatile than the S&P 500 as well. And I told you, infrastructure's an area that I think finally will do very well because it has the right footing in the environment we're heading into.

CHUCK JAFFE: And a manager who has been on The NAVigator. But again, the Abrdn Global Infrastructure Fund, ASGI. I know you've got more.

JOHN COLE SCOTT: So there's a senior loan fund, which I like it because it's a term trust, BGB, it's a Blackstone fund. I'll say it's only a 10 and low change discount, I know we've talked about it before but I make these bets regardless of when I've ever talked about them. Moderate leverage, low beta, but it really has currently almost a 10% yield, and if we get the bumpiness, even though senior loans probably cannot do the tremendous success of 2023, they give that sturdiness that I like for credit problems. And then should we ever be wrong about inflation and interest rates, it has basically no duration, it's a beautiful fund for the credit side of your portfolio where taxes aren't going to be an issue.

CHUCK JAFFE: Yeah, that's Blackstone Strategic Credit 2027 Term, BGB. What else?

JOHN COLE SCOTT: So there's a muni fund and it's definitely a weird one, and if you looked at it with regular data you'd say either it's horrible or amazing, but RFMZ is a RiverNorth Flexible Muni Income Fund. It's a tactical blend of individual muni bonds and then closed-end funds that RiverNorth puts in based on sentiment and discounts and where they want to go forward, but it's sported an almost 14% discount. The yield is moderately fake at 7.8%, but I believe it's going to be a great fund to balance the push and pull of the reversion of the bonds and the sector while having a lot of tailwinds. I may not own it for three years in a row, but it's a great year to use this fund as an allocation. It's a more complex fund and not as pure a fund, but I think the best overall returns we'll see next year in this sector.

CHUCK JAFFE: So that's RFMZ, RiverNorth Flexible Municipal Income II. And you always pick five, so there's one more for us, right?

JOHN COLE SCOTT: So we are covering a BDC, and there's so many tough choices in that sector but we went with a quality asset manager that's still a little bruised, that's BCSF, Bain Capital Specialty Finance. It's about an 11% discount when the index is at a premium, it's yielding just under 11%. And I'd say I really got to know the fund, besides being a name brand name, talking to one of their independent board members at a conference about the way they think about work-outs should we get a recession and they have a problem. It really reminded me that no BDC wants a work-out, but if you ever have a loan that goes bad you want a team that can work out the issue. And I'm pleased with their price, and not just to NAV but to their earnings and to the quality of the manager, to navigate through the bumps and bruises. Yet I wouldn't recommend only one BDC ever, but it's my pick for 2024.

CHUCK JAFFE: And again it's BCSF, Bain Capital Specialty Finance. John, the best part about your forecast is that you stand behind them and that about a year from now you and I will be reviewing these, and then we'll talk about what you like for the following year, for 2025. Meanwhile, have a great year. I know we will talk with you again many times during it, but thanks as always for coming to talk with me.

JOHN COLE SCOTT: 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 yes, that is me, and you can learn all about my hour-long weekday show 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 generally check out AICAlliance.org, the website for the Active Investment Company Alliance. They're 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 you can dig into their research at CEFData.com. Plus, he's on Twitter, or X @JohnColeScott. The NAVigator podcast is new and available for you every Friday, make sure you don't miss any of our episodes by following along on your favorite podcast app. We'll see you again next week, and until then, happy investing everybody.

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risks, including the possible loss of principal invested. Closed-end funds frequently trade at a discount to their net asset value (NAV).