VettaFi's Islam On The ETFs That Are 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 and Chuck dig into the active and passive exchange-traded funds that invest in closed-end funds, looking at the choices, the new funds, and the options investors have for buying ready-made portfolios of closed-end funds thanks to the simplicity of ETFs versus the chores of building their own portfolios. She notes that the active ETFs have some potential that the index-oriented versions have seemed to be missing in current market conditions.

Roxanna Islam

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

CHUCK JAFFE: We're talking ETFs that invest in closed-end funds with Roxanna Islam, head of sector and industry research at VettaFi, 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 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 we're looking at a different way to own closed-end funds with Roxanna Islam, head of sector and industry research at VettaFi, which has terrific tools for helping you dig in and do your research and your evaluations on all sorts of investments, it's VettaFi.com for more information. And if you want to size up closed-end funds, interval funds, and business-development companies generally, well, check out AICAlliance.org, the website for the Active Investment Company Alliance. Roxanna Islam, it's great to have you back on the NAVigator.

ROXANNA ISLAM: Yeah, it's great to be back.

CHUCK JAFFE: We're talking about ETFs that invest in closed-end funds, and of course ETFs and closed-end funds both trade on exchanges, they're both amalgamations of investments, put a bunch of things in, et cetera. Help us understand why somebody says, "I could own closed-end funds directly or I could own ETFs of closed-end funds." Why would somebody be evaluating a fund of funds and coming up with a positive potential comparison?

ROXANNA ISLAM: There's a lot of overlap between the two, between ETFs and closed-end funds. Like you said, both trade on exchanges like stocks, which means they're priced throughout the day, both are wrappers that allows investors to buy securities in a single package, closed-end funds do mostly focus on income, but there's also lots of dividend ETFs and other income-producing ETFs. There's some key differences between closed-end funds and ETFs, closed-end funds have those fixed number of shares, ETFs have that creation-redemption mechanism, so they don't have that premium-discount volatility that people either love or hate with closed-end funds. ETFs, they were once considered an alternative product but now they've become these traditional mainstream products while closed-end funds tend to have more of a niche following, so when you combine closed-end funds into an ETF wrapper, you do open up accessibility to more of those mainstream investors who are more comfortable looking at an ETF rather than something like a closed-end fund.

CHUCK JAFFE: In terms of investors turning to ETFs of closed-end funds, you could get a passive ETF that invests in closed-end funds, basically tracks an index, you can get active. If you're looking for closed-end fund representation in your portfolio you're typically going to be an active investor, so how and why are folks using closed-end fund ETFs, ETFs of closed-end funds?

ROXANNA ISLAM: To start with I want to take a quick look at the ETF of closed-end fund universe, so there's passive products out there like PCEF, XMPT, YYY, these are the more popular funds. PCEF and XMPT, they're ETFs that benchmark certain parts of the universe, so PCEF is the Invesco Closed-End Fund Income Composite ETF, and that's representative of the taxable closed-end fund universe, and XMPT is the VanEck Closed-End Fund Muni Income ETF, and that's representative of the tax-exempt universe. These have more assets out there than their active peer, so PCEF has about $725 million in assets, XMPT has about $232 million. Then there's also YYY, the Amplify High Income ETF, that's passive but doesn't really benchmark a universe, it focuses more on income, that one has about $420 million in assets. So typically when you're looking at a passive ETF of closed-end funds you're essentially trying to capture that universe, maybe you're using it as some sort of a core holding, you're essentially trying to take out some of that risk in single stock picking or single closed-end fund picking. And then when you look at active ETFs of closed-end funds, this is a niche space within a niche space, so there's a few here but they're much smaller in assets. So you have CEFS, that's the Saba Closed-End Funds ETF, that's the largest of the active ones with $164 million in assets. You have FCEF, First Trust Income Opportunities ETF with $27.8 million in assets, and then we have a new one that just launched, it's the Calamos Closed-End Fund Income & Arbitrage ETF, ticker CCEF. So that one just launched this month in January 2024, and that's interesting because active is an area where a lot of these issuers and fund managers can make the most difference when it comes to ETFs of closed-end funds, especially considering that there's already a large ETF, PCEF out there, that benchmarks the universe, so it's not really efficient to create multiple products of the same thing, even though that does happen a lot in the ETF world. It is easier to differentiate yourself as an issuer, a manager, with these active ETFs of closed-end funds, where you can be more nimble in finding those higher distributions and really try to beat on yield. And while CCEF doesn't have relevant performance data yet, the other two active products, they're actually outperforming their passive peers on a one-year total return basis. I think given that there's still some looming uncertainty in the economy in the markets, so I think we'll see more of these investors turn to active. Excited to see what's in store for the space, not just for ETFs of closed-end funds but in the broader active management arena.

CHUCK JAFFE: When we talk about active investors, we're talking about management style, but in closed-end funds, activism can be important. Are the active managers of funds of closed-end funds being activist investors, trying to add value in those ways at all?

ROXANNA ISLAM: One that's important to point out is CEFS, and that's the Saba Closed-End Funds ETF, so Saba is a well-known activist investor and you just sort of get that benefit with them being an expert in the industry. That's another angle to take a look at, you're not just really trying to track a benchmark, you're really trying to make a difference in that industry and to find the return, to find yield.

CHUCK JAFFE: When we're talking about the active ETFs, what's going on with their expense ratios? Because active normally costs more, passive in a fund of funds is basically a passthrough, are we looking at expense ratios that are tough to overcome?

ROXANNA ISLAM: We sort of see higher fees in all of these products because they're essentially all funds of funds, so even the passive products have higher than usual fees. So even if you look at PCEF that has an expense ratio of just under 2%, and then if you look at something like CEFS, which I mentioned, that has about 2.9% as the expense ratio. So you do see a little bit more with that active management, but as I said, you do sometimes expect that higher return as we've seen in the past year, so you're really giving up some of that expense in exchange for some of that possible return. I think there's a lot of opportunities for active management within these ETFs, you can look at it several different ways; so we're in a year when the market is volatile and maybe not performing well, investors might start looking a little bit more at active management, they might be willing to pay a little bit more for that extra total return or for that extra yield. And then on the flip side, when markets are performing better, I think sometimes as humans we do get a little greedy and we see that broader markets like the S&P 500, they're doing well. "Maybe I can get a little bit better return with that, so let me try to find something else outside the status quo," and then some may even use active as a complement to a core portfolio, so trying to get a little bit of extra return without taking too much risk. I think in these cases it can sometimes be worth the extra fee to take on that active management.

CHUCK JAFFE: It's not really an all-or-nothing choice, is it? You can do both. You can have a core and explore portfolio the way a lot of people do when they get an index fund and then they have stocks around it. You could have an ETF of closed-end funds and then own individual closed-end funds to explore around that, and that would work, right?

ROXANNA ISLAM: Yeah, and you could do that with ETFs of closed-end funds. A lot of people actually use PCEF as a core closed-end fund holding, and then around that they could either use some of the active ETFs of closed-end funds or they can pick individual closed-end funds as well. But yeah, many investors do use PCEF as sort of a core closed-end fund holding.

CHUCK JAFFE: One of the things you track at VettaFi closely is new funds, obviously the Calamos fund is a new fund. Is there much expectation that we will see significant growth in ETFs of closed-end funds?

ROXANNA ISLAM: I think in the active ETF space in general we're seeing a ton of growth. If we look at just last year alone, active ETFs gathered over $130 billion in assets, and that's accounted for 22% of net flows, so total it's above $530 billion for active assets, which is only about 6.5% of total ETF assets. So it's a small but growing portion, and I think that's something to consider. And then looking at specifically at ETFs of closed-end funds, we do have the one new fund, and you know, I don't expect there to be a ton of these, because if you look at it, there's only a handful of these out there in the first place. As active grows, we do see the opportunity to see more of these, especially compared to their passive counterparts, which like I mentioned, there's already some big players in that space, and it may not be as efficient to compete with them and it may be a little bit more efficient to have your own active product out there.

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

ROXANNA ISLAM: Yeah, thank you.

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