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 and Chuck look back at how the closed-end fund industry bounced back from the challenges of a terrible year in 2022, and how his forecasts from a year ago played out. He came out on the winning side of the ledger in his forecasts, but especially with his basket of five funds selected as likely winners for 2023.

John Cole Scott

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CHUCK JAFFE: John Cole Scott of Closed-End Fund Advisors is here and we're looking back on 2023 before we close the door on it, 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 joining me today, and again next week, it's John Cole Scott, he's president of Closed-End Fund Advisors in Richmond, Virginia, which is online at CEFAdvisors.com. We're going to dig into some of the firm's research, and you can do that for yourself at CEFData.com. But John is also the chairman of the Active Investment Company Alliance, and if you want to learn about closed-end funds, business-development companies, interval funds and more go to AICAlliance.org. We will be talking with John this week, looking back on '23, next week we'll get his forecast for '24. So in the middle of that, John Cole Scott, Happy New Year!

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

CHUCK JAFFE: Mostly I think we can look at this and say this was a pretty good year, and that's a little bit maybe unexpected in a world where it was the Magnificent Seven that got all the headlines and did most of the driving. It was a challenging year, but not necessarily a non-rewarding year for closed-end funds, right?

JOHN COLE SCOTT: Yeah. Again, not quite at the end but near the end, and we're almost double the average return for the year, but of course last year I was optimistic because we had terrible results for most everything last year and no matter what you were in.

CHUCK JAFFE: Yes, so last year as you've looked ahead you were expecting that this year would be good. I don't know that anybody called 2023 accurately in terms of how it was going to do, but the numbers worked out in your favor, explain how.

JOHN COLE SCOTT: So the average closed-end fund, and we use our 15-sector equal weight index for these analyses, was up a little over 15% so far in 2023. And again, I'll measure that outlook of being better than general equity markets against an equal weight S&P 500, which is up about 11%, and so very pleased with that. Of course not the returns you saw on the NASDAQ or those top large companies in the US. And it's interesting, because while discounts had a volatile year, whether it was March or August or October, the end of the year, some big movements, they're only about 1% difference than three months ago and 1% difference than 12 months ago. This wasn't really a discount year, it was a NAV year, so I think I got that call correct.

CHUCK JAFFE: <ding> Yes, I think you got that call right as well. And of course your next prediction from a year ago was that we would see a January Effect and that it would be a big one, and you were right on that one too, weren't you?

JOHN COLE SCOTT: I was still proven righter than I expected with January of this year being over 10% for the average closed-end fund. Our research shows in the last 12 years the average up month is about a 4% positive for the January Effect, and so I'll be happy that we were locked and loaded last New Year's Eve for our clients and hopefully the rest of the market was too.

CHUCK JAFFE: Well, we will still give you credit <ding> for that one. One that unfortunately you won't get credit for was you talked about year-end discounts and where they would be, and they moved kind of in the direction you wanted them to, but I don't know that we can give you credit for this one, can we?

JOHN COLE SCOTT: No, about a year ago discounts were seven and low change, now they're six and high change. It was better but it's not enough to be given any positive credit for it. And I also said the CEF 2.0s would actually catch up, almost two thirds of their deficit to their peers, and we saw a little improvement but not nearly enough to get credit for that as well.

CHUCK JAFFE: Unfortunately on that one <buzzer>. Next thing you talked about a year ago at this time, you were looking at the average yield and how you expected that to return.

JOHN COLE SCOTT: Yeah, so we thought that we'd end up basically dividends probably somewhat stable. We thought that we'd have NAVs rise, discounts narrow, which that math makes the yields go down. We're in maudlin for about a 7.5%, and right now it's basically almost 10% and last year it was around 10% as well. What's fascinating is that our index, which has some dividend cuts of course in it, a weighted 1.4% increase, only 20 CEFs cut over 5%, 25% increase over 5%, and almost half just literally had no change during the year, which can be common with the way some boards handle their fund's exposures. So I'll say I got it wrong, but it wasn't nearly the type of wrong I would dislike, which would be lots of dividend cuts. The dollars are actually slightly higher, just not the math showing indicated yields now.

CHUCK JAFFE: Well, we can say it this way, you were wrong <buzzer>, but in terms of the investor and how the investor felt, kind of felt so right <ding>.

JOHN COLE SCOTT: The key is, as long as you were diversified and not in two sectors.

CHUCK JAFFE: You also talked last year about how much volatility you expected, and we certainly had a lot of that.

JOHN COLE SCOTT: The last two years couldn't have been more different from each other and more different than expected, but we had extreme volatility, such a positive January, and then such a kick in the knees in March. June and July, the market was positive again, really moving forward. And then August through October, another "Oh my gosh, the world's going to end," and then everyone was surprised again completely in closed-end funds and the markets in general with tremendously positive Novembers and Decembers. Basically taking a flat year to a double than average year, so I'll take a correct there if it's okay with you.

CHUCK JAFFE: <ding> Just fine by me. The next one, it'll sound funny to folks when they hear us talking about IPOs, but initial public offerings in closed-end funds, a big year would be that you got more than a handful of them, and you were expecting that there be a fair amount of activity in closed-end fund, a bunch of new IPOs. Didn't exactly turn out the way you expected, did it?

JOHN COLE SCOTT: It didn't. I was expecting over half to be munis and more target terms or the simpler, safer, easier, lower term structure, but it's been a drought for the market in that capacity because discounts have been terrible and there's been so much need for the secondary market to narrow before anyone's willing to take the risk on an IPO, both from a cost and from a trading perspective.

CHUCK JAFFE: On that one <buzzer>, although I don't know that anybody missed a bunch of funds that weren't created that probably will be created down the line.

JOHN COLE SCOTT: There are some N-2 filings coming and we do expect something in '24. We can chat about that next week.

CHUCK JAFFE: I was going to say I have a sense that we'll find out about that when we are talking about your forecast for '24. Another thing that you are always going to look at if you're going to evaluate closed-end funds is what happened with activism, and it was an interesting year in terms of activists, wasn't it?

JOHN COLE SCOTT: I'd say that the general consensus, it was tougher than expected for the fund sponsors. There was one fund, GIM, that effectively lost its contract to Saba, it'll become their fund in the new year. And that wasn't as common before, it seems potentially more common, there's a lot more defensive strategies going on at the fund sponsor level, a lot of posturing from some of the activists. And so more tenders as well, some large 20%, even 50% tenders announced, not this year completed but announced in this year, really pushing on the sector. But I well note, we had an activism panel at the conference last month, it's worth a look, but Phil Goldstein reminded us that generally speaking, that activists bring some support to funds. So we probably have wider discounts without them in the space, but

I'd also be curious to think about where these funds would be in the future with these new managers.

CHUCK JAFFE: Still <ding>, we give you credit for having the activism picture completely right. Now one that you did not have right, you were talking a year ago about duration risk and at what point would folks start changing their duration because we had the inverted yield curve and all the rest, and how things were going to play out. It didn't work out the way you expected, did it?

JOHN COLE SCOTT: It didn't. For some reason I didn't understand what was going to happen with interest rates or inflation 12 months ago, but duration risk definitely was still real for much for this year, and that's really what brought us to a neutral performance through 10 months. So you could just say I was 10 months early, but still not quite right.

CHUCK JAFFE: Yeah, I'm afraid 10 months early is also known as <buzzer>, yeah. You talked about the top sectors, and you were calling for REITs, international bonds, New York muni funds, and business-development companies, and you did pretty well on this one.

JOHN COLE SCOTT: I'll tell you how I rated it. REIT real assets, the real assets did a little better than the REIT, there's still some office, it's not the full market but REITs have a bad name right now. Up 10% on the year though, so even an underperformance is not a terrible result. International bond funds, 14%, slightly higher than a blended bond fund index. It's interesting as I decided to call the New York sector out, which is popular with people in the New York City and state that have high tax brackets, the New York sector was up almost twice as much this year than the national muni sector. That's just because of the wider discounts and a little bit of better NAV performance, so not great returns but great relative intra-neighborhood returns. And then BDCs, I wouldn't have imagined that they'd be up almost 27% this year, I just did a client review and that allocation was up 41% this year. I can't promise the future or outperformance but those things were beautiful additions to what we did and I'm very pleased that we had rough winds. I called it a tie but you are a coach, and sometimes a judge, how'd you call it?

CHUCK JAFFE: Well, from a standpoint of that what I have at my disposal, I could have said, "Wrong, sir! Wrong!" But I don't actually think so, because I think that whoever listened last year would have looked, and if they followed what you said, although it wasn't perfect <ding>, they were going to be pretty happy with the results, so I'm going to give you credit for that one. And then the last thing you did last year, and what you do every year, is you take a look at a couple of fund that you think are going to be working well for investors. And I will give out the ticker symbols as we do it, and I think I have this right. As I look at it, if I had to judge, it would be TSLX <ding>, EFT <ding>, MEGI <buzzer sound>, MFM <ding>, and NMAI <ding>. And I suppose I could have maybe gone three and two instead of four and one, but ultimately you were pretty spot on.

JOHN COLE SCOTT: Yes. I mean, we had dividend growth for the allocation, not every fund but the basket over the index, and we had average performance. Again, five funds is not a portfolio, but 20% for the year versus 15% for the index. So not the future, not a guarantee, but at least we liked our overweights and where we stuck our client's money.

CHUCK JAFFE: Yeah. And again, diversifying, if you do diversification it's not going to surprise you that if you have put five funds into a portfolio, you'd kind of be surprised if all five were moving in sync, that might be a sign that you hadn't really done your homework. So all told, by my count, and I would have maybe given you credit for the one you called a tie, but you had more right than you had wrong. Either way it was five, four, and one. If you count the tie, six, four the other way. And again, early means that maybe one or two of these things, they'll be right down the line. John, great stuff as always. I look forward to starting 2024 with you, and finding out what you think's going to happen next, next week.

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. Yep, that's me, and you can learn all about my hour-long weekday podcast by going to MoneyLifeShow.com or by searching for it wherever you find your favorite podcasts. To learn more about closed-end funds, business-development companies, and interval funds 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. The firm is online at CEFAdvisors.com and their data is at CEFData.com, and John is on Twitter @JohnColeScott. He will also be here next week giving his forecast for the year ahead, and you don't want to miss that. And if you don't want to miss anything, remember The NAVigator podcast is new every Friday, follow along on your favorite podcast app. We'll be back next week, have a great New Year's celebration in the meantime, and as always, happy investing everybody. *Recorded on December 28, 2023*

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