Examining BDCs And Muni Funds, And Deciding Between The Two

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Chuck Jaffe, in this episode of The NAVigator podcast interviewed John Cole Scott, president of Closed-End Fund Advisors, chairman of the Active Investment Company Alliance. Read the Q&A below as Chuck and John look at two asset classes that investors are turning to now for yields. While business development companies and municipal bond closed-end funds have low correlation, investors are looking at both asset types in order to raise yield levels in this market.

Scott digs into his firm's data to examine where the two asset classes stand and offers a few picks in each sector that he thinks are poised to handle the changing rate picture well for at least the rest of the year.

John Cole Scott

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

CHUCK JAFFE: We're comparing the investment prospects of business-development companies and muni bond closed-end funds with John Cole Scott of Closed-End Fund Advisors, 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's going to point you in the right direction. Joining me today, John

Cole Scott, president at Closed-End Fund Advisors in Richmond, Virginia, which is online at CEFAdvisors.com, but we're about to dig into funds using the firm's research, and you can do that yourself by going to CEFData.com. John is also the chairman of the Active Investment Company Alliance, and you can use their website, AICAlliance.org, to learn all about the basics, closed-end funds, business-development companies, interval funds and more. John Cole Scott, great to have you back on The NAVigator.

JOHN COLE SCOTT: Always good to be here, Chuck.

CHUCK JAFFE: I'm really excited for this one because we are talking about two asset classes that, under normal circumstances I don't think I heard about them that often, but of late because of where rates are and what's been going on, and Fed not cutting and all the rest of it, I'm getting a bunch of questions about, "Where are you on muni bond funds?" and "What's going on with BDCs as alternatives for generating income right now?" So let's dig in. They're very different asset classes but they're both something that you might look for for yield, and do you want one, the other or both? Do you favor, one, the other or both in this environment?

JOHN COLE SCOTT: Yeah, absolutely. Historically correlations between muni bond funds and BDCs on a quarterly basis are like 16%, it's the lowest correlation in our universe. If you think about them, they're both levered fund vehicles, but the BDCs are mostly full of variable rate loans and munis are mostly full of long duration bonds, and so they tend to move very differently both in economic cycles and with interest rates.

CHUCK JAFFE: They move differently, but as I watch, they do kind of respond to interest rates as you would expect them to interest rates, similarly, it's maybe the volatility for one versus the rest might surprise you, et cetera. So help us understand what we're looking at in this environment and what you expect each asset class to do. If we watch just a little bit of Fed action, what's your expectation?

JOHN COLE SCOTT: So right now the BDC universe of 47 funds is yielding around 11%, we're about halfway through the earnings quarter which will be done roughly in the next 10 days in our CEFData system, dividend coverage is still 127% for the universe. Non-accruals which are the non-payment of loans is ticking around 1.43%, we think possibly by the earnings season they'll be on the other side of 1.5%. There's been a little bit more trickling in of some bankruptcies across the space, but we've been on this show a long time talking about BDCs and how the managers have been marking down some of these loans, they're actually reducing the net asset value for an expected loss, that's an unrealized loss on the balance sheet of around 3-4%, not uncommon through a non-benign market environment. And so I do feel that they're positioned for what we think could happen with bumps and bruises, and leverage-wise, BDCs because they can go higher than regular bond funds, are at 52%, which is still nowhere near the leverage you see in mortgage REITs on the banks' balance sheet.

CHUCK JAFFE: What's the take on the muni bond space and what we should expect from it?

JOHN COLE SCOTT: So the muni bond sector, it's about a 5% yield for the universe, about 108 funds that we track, currently running a 10% discount, versus BDCs are back above premium, which is normal for them. The duration's average is 12, but of course there's a wide mix of durations across that average, and those funds have de-levered a little bit and not added new leverage as prices have come up a bit, so the leverage is around 31%. And again, because of the different fundamentals under the hood of each fund structure, in the last three years, muni bond funds, their distributions are down about 18% as a universe and BDCs are about 20%. However in the current earnings quarter there's been only two small increases for BDCs, we've actually seen some more solid increases recently in muni funds as much of their leverage starts to become more profitable towards their average cost of investment in the universe.

CHUCK JAFFE: Let's talk about some of your favorites in each place and maybe do that cross comparison.

JOHN COLE SCOTT: We often like to say we always focus on discounts and yield, it's more than top line, we go under the hood in those data points, but we also remind people, we're also a NAV or a fundamental investor, and so we like to tell stories of funds that are different but could look the same to investors. So one fund that they may be familiar with, it's MIO, it's one of the CEF 2.0 funds that's had a terrible IPO experience. It yields about 4.5%, its discount's around 12%, but its duration is 7/7 because its leverage is under 11%, and so it's really a great way to think of a discounted closed-end fund where you want less duration and you want less leverage. And the tailwind is it's more susceptible to activism based on that terrible IPO experience, and so this potentially puts on the investors, it could press on it going forward. On the other side is VFL, it's an Abrdn closed-end fund, it's not a CEF 2.0, it's a takeover of Abrdn of a previous manager. It's a 15% discount, that same four and mid-change yield, but its leverage is 40.17% and its duration is 17. It literally is the highest duration in the universe, and MIO's one of the lowest, and I like to compare them because you can say, hey, discounted closed-end funds yielding 4.5%, but you're going to pick one over the other differently based on your opinion about interest rates in the next three to nine months.

CHUCK JAFFE: That's on the muni bond space, what about the BDC space?

JOHN COLE SCOTT: There's a lot of wonderful BDCs out there, but we like to focus on some uncovered gems or those that are not pristine and perfect, there's CION, it was a direct listing of a non-traded BDC, it's trading around a 30% discount with a 12 and change yield, really having a lot of wiggle room and problems to work out with lots of coverage in its payment to investors. The reason why it's sticking down there in our experience is it's not the highest brand name manager in the space, and also a lot of investors really wanted out of the non-listed structure and so they're still rotating through the shareholder base, and it usually has a while until the BDC will trade closer to its peer group. On the other side is a little bit older BDC but still newer to the space, Trinity Capital, TRIN, it trades around a 9% premium, but it's internal management, which is usually valuable by investors to 15-20% versus external management of BDCs, which means the costs are billed not as a percentage but as a direct cost. It's a much higher yielding portfolio, it yields about 14% because it goes after some higher yielding investments, and it's had a good run and it's really proven to use the BDC structure well. But these are definitely not Ares Capital, Blackstone, the middle of the road, solid, but they're interesting companion BDCs to look at higher yields with a focus or a deeper discount with a possible tailwind.

CHUCK JAFFE: That's really that decision that somebody's got to make. If you're looking in this space, you could go with both obviously and that's just diversifying further, but it's the discount versus the higher yield, which are you more comfortable playing into, right?

JOHN COLE SCOTT: Our portfolios as you know are 30 to 45 positions, we own BDCs as often as four to six, maybe seven. During carnage periods we always tell our clients and prospects who are going to become our clients, "You're not going to enjoy down markets, but we do our best work there because everything tends to fall at the same level and you can sift through for those fallen angels as some people call them to find the right spots." And looking at these BDCs, if you break down the leverage-adjusted NAV yield, which is in simple terms what the manager has to hit to meet the board of director's policy, Cion is a 5.4 and Trinity is a 10.4, so almost double and yet both are covering their dividend because they're doing very different things. And that's why you can't just call a BDC the same, it's as different as any other sector of unique opportunities.

CHUCK JAFFE: Always interesting when we get a chance to catch up, John. Thanks so much for joining me, we'll talk to you again soon.

JOHN COLE SCOTT: Always great being 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, you can learn all about my work, 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 check out AICAlliance.org, the website for the Active Investment Company Alliance, on Facebook and LinkedIn @AICAlliance. Thanks to my guest John Cole Scott, he's president of Closed-End Fund Advisors in Richmond, Virginia, he's also chairman of the Active Investment Company Alliance. His firm is online at CEFAdvisors.com and you can dig into all the data he was talking about here today by going to CEFData.com. John's on Twitter too, he's @JohnColeScott. The NAVigator podcast is available every Friday, make sure you don't miss anything by following along on your favorite podcast app. We'll be back next week, and until then, happy investing everybody.

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