Sizemore: “The Fed’s Actions Have Changed, But The Discounts Remain”

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Chuck Jaffe, in this episode of The NAVigator podcast interviewed **Charles Lewis Sizemore**, chief investment officer at Sizemore Capital Management. Read the Q&A below as Charles says that while short-term rates are as high as they are likely to be, the "massive discount" created in closed-end funds while rates were on the rise have not dissipated. That means closed-end funds remain a compelling value now, and Sizemore said he is finding particularly strong values in REIT-oriented funds and term funds. However, he noted that he's not a big fan of most equity-based funds now because with the market looking frothy "you probably don't want to be adding leveraged exposure to the stock market."

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

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CHUCK JAFFE: Charles Lewis Sizemore, chief investment officer at Sizemore Capital Management is here, we're discussing his outlook for closed-end funds now on 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 representing 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 pointing in the direction of Charles Lewis Sizemore, who is chief investment officer at Sizemore Capital, and he has written about closed-end funds and other investments for *Kiplinger's* and other publications for a long time. You can learn more about him and his firm at SizemoreCapital.com. And if you want to learn more about closed-end funds, interval funds, and business-development companies generally, you want to check out AICAlliance.org, the website for the Active Investment Company Alliance. Charles Lewis Sizemore, thanks for joining me on The NAVigator.

CHARLES LEWIS SIZEMORE: Hey, thanks for having me.

CHUCK JAFFE: I have, as the host of The NAVigator, been watching your stuff for years, and I will say there is a repetitive theme. Which is when discounts get big enough, you're telling the general public, "Hey, closed-end funds, if you didn't know about 'em, you should buy 'em now because they're on sale."

CHARLES LEWIS SIZEMORE: Who doesn't want to buy a dollar's worth of assets for 90 cents, 80 cents or even less? To me it's a no-brainer.

CHUCK JAFFE: That's true, and if we were talking for a really elementary audience we'd say, "Hey, people don't want to buy closed-end funds because they assume they're going to be complicated," but let's start with that discounted side. Because the discounts have been big and they should be attractive, and yet we haven't seen much narrowing of the discount as the market has done well. So give us first your take on where the closed-end space is now, and how attractive the current buying opportunities are for you as you're talking to investors?

CHARLES LEWIS SIZEMORE: Yeah, sure. Before I even answer that, let's back up a little. What drives closed-end fund discounts? They tend to get wider during times of market distress or when there's distress in the income markets, and that's really I would say the biggest driver lately has been, "Hey, the Fed jacked up rates at the fastest speed in history, starting in 2022 going through 2023." That was unprecedented and that sort of spooks the income markets. Why does that affect closed-end funds in particular? Because oftentimes they tend to be leveraged, they tend to borrow using oftentimes short-term trading instruments and then they invest in longer term securities. Well, when those short-term trading costs spike up, it tends to put people off, it tends to scare them. And beyond that, historically it has led to some closed-end funds having to cut their distributions, having to make changes, et cetera. All of that is pretty standard stuff. So where are we today? Well, the Fed's done raising rates. Jerome Powell, the Fed chairman has come out and said, "Look, I don't know when we're cutting rates, it may be a while, but I think we're done raising them." That's very likely to be done. There's always a little bit of noise that the Fed may have one last rate hike. Sure, fine, but if they surprise us all by raising rates by an extra 25 basis points or something, that's not really going to change the narrative here, and that's that the damage is done. Short-term rates are about as high as we should expect them to go for the foreseeable future, but that discount to NAV that got really wide over the last two years due to the aggressive rate hikes by the Fed and other factors, that hasn't really closed yet. So we have a lot of opportunities in that space where this massive discount that was created by the Fed's actions, the Fed's actions have changed but the discount remains.

CHUCK JAFFE: In terms of how you want to be able to play that, does that make it that to you the best bargains in closed-ends are the fixed-income bargains? And is there a specific space in fixed income that stands out to you?

CHARLES LEWIS SIZEMORE: Yes, and no. So even the closed-end funds that are not specifically fixed-income closed-end funds often behave like fixed income because there's a yield component. Even if you're buying a closed-end fund that does nothing but buy real estate investment trusts or buys oil and gas pipelines, or buys high-dividend paying stocks, utility stocks, whatever, they still sort of get lumped in with other income products because their yield is a big part of that. So I do like fixed income, I like it quite a bit, but that's not the only space I like there. I actually like a lot of the equity closed-end funds, and in particular some of the specialty ones, and I would say my favorite these days right now is actually real estate investment trusts. Real estate investment trusts got utterly hammered, just destroyed over the last two years, because they were essentially priced as bond substitutes, and when prices of bonds fell due to interest rate spikes, everything that was priced similar to a bond also got slaughtered. So what does that mean for closed-end funds? So the underlying assets that REIT closed-end funds hold has already gotten decimated, right? But then apart from that you have the discount in addition, so you're getting a discount on already cheap assets, which that doesn't come around that often. So what that means as an investor is you stand to gain actually three times; first if you buy the shares today and you do nothing you just collect the income from it indefinitely, great. As the value of the underlying securities recover, and I believe REITs have probably bottomed out, if not, they're very close to bottoming out, you also benefit from an improving net asset value. And then the final piece of that puzzle, when the discount to net asset value shrinks, it's sort of turbo charging your capital gains there, so you're getting paid three ways.

CHUCK JAFFE: Is there a particular real estate fund? And after you've answered that, let's move to what else do you like right now?

CHARLES LEWIS SIZEMORE: One that I've followed for years, I still like it quite a bit, is the Nuveen Real Estate Income Fund, ticker symbol JRS. Now let me very clear, we're not giving out specific investment advice here, these are just general observations. This is a very diversified REIT portfolio, you're essentially buying the biggest and best REITs you would buy in a typical REIT ETF or mutual fund, except you're doing it at a discount, it trades at about a 12% discount to NAV right now, sports a very attractive yield. So if you already like real estate investment trusts, if you're already attracted to the sector, why not buy it at a discount?

CHUCK JAFFE: And then in terms of what other spaces you particularly like right now?

CHARLES LEWIS SIZEMORE: I wouldn't necessarily call this an asset, like a subclass, but it's more of a descriptor than anything else, I really like term funds, and let me dig into why that is. So the issue with a closed-end fund is, hey, you can identify a huge discount to net asset value, but there's no guarantee that it's ever going to be closed. A cheap closed-end fund can just be cheap forever, right? There's no guarantee that that discount's going to close. Now obviously over time they oscillate, they widen, they narrow, but on your particular time horizon, there's no guarantee it's going to close. Well, with a term fund you do have that guarantee because these mature, similar to a bond, they have a date at which they stop trading and they liquidate at net asset value. So in a hypothetical case here, let's say you have a closed-end fund that is a term fund that is scheduled to mature next year, it hits its term next year at NAV, and today it's trading for whatever, a 10% discount to NAV. You are going to get NAV when the thing matures, that's how it works. Now NAV can change between now and then, sure, it can be higher or it can be lower, but that discount will shrink to zero because they literally sell the assets off and send you the cash. So that's a sort of subset of the closed-end fund universe I particularly like. You have a lot of fixed income in that space, and then you do also have some equities and some specialty closed-end funds. One that I like, one that I've traded off and on for years, the ticker symbol is TEAF, it's a very interesting orphan fund, I call it, because they own a combination of traditional energy assets, oil and gas properties, but then they also own a lot of renewable energy. And so it becomes a total orphan because none of the renewable energy crowd wants to buy it because it has traditional oil and gas, but none of the traditional oil and gas crowd wants to buy it because it has alternatives in it, so there's no sort of natural clientele, and so it trades at a phenomenally deep discount. Right now it's trading at about a 20% discount to NAV, it's also scheduled to hit its term in 2031. So if you're willing to hold this thing for, call it six years, you are going to get, that discount is going to close, it's going to pay off at net asset value, and along the way you're getting a monster yield. So again, not a specific recommendation by any stretch of the imagination there, do your own homework, but those are the kind of opportunities I love.

CHUCK JAFFE: Are there parts in the closed-end space that you're like, "No, just can't do it"? Anything obviously that might be at premiums might be on your no list, but generally speaking as you look at the space, are there parts of it that you just can't get behind at all?

CHARLES LEWIS SIZEMORE: I would never, well, never say never, right? But I would not expect to ever pay a premium for a closed-end fund. To me, for these to be interesting, they have to have the right set of circumstances line up. One, I have to be attracted to the underlying assets, there needs to be an opportunity there, I need to feel good about the direction the underlying portfolio's going to go. Two, I need to feel confident that the income stream is sustainable. And then three, that icing on the cake, I really like to see a good deeper than usual discount. So yeah, immediately if a closed-end fund is trading at a premium, not saying there's not some scenario I haven't imagined where that might make sense, but let me tell you, I haven't imagined that scenario, so that I would stay away from. As a general rule, I would probably also stay away from the broader equity closed-end funds, and not because I dislike them as a long-term asset class, it's more a function of closed-end funds are often leveraged bets. So if you think that the stock market's looking a little frothy right now, and it makes sense to be selective in what you buy, you probably don't want to be adding leveraged exposure to the stock market. So I would tend to focus my attention more on the fixed-income space, and more on specialty sectors like REITs and like the energy closed-end fund I mentioned.

CHUCK JAFFE: Charles, thanks so much for joining me on The NAVigator to talk about it.

CHARLES LEWIS SIZEMORE: Yep, you bet. Anytime.

CHUCK JAFFE: The NAVigator is a joint production of the Active Investment Company Alliance and Money Life with Chuck Jaffe. And yeah, I am Chuck Jaffe, and I'd love it if you'd check out my hour-long weekday podcast on your favorite podcast app or by going to MoneyLifeShow.com. And if you want to learn more about interval funds, closed-end funds, and business-development companies please go to AICAlliance.org, it's the website for the Active Investment Company Alliance. They're on Facebook and LinkedIn @AICAlliance. Thanks to my guest, Charles Lewis Sizemore, he's chief investment officer at Sizemore Capital Management, and a long-time writer for *Kiplinger's* and other financial publications. Learn more about him and his firm at SizemoreCapital.com. The NAVigator podcast is new every Friday, make sure you don't miss an episode by subscribing or following along on your favorite podcast app. And if you like this podcast, please leave a review and tell your friends, because that stuff really does help. We'll be back next week, and until then, happy investing everybody.

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