John Cole Scott On New Trends Reshaping Closed-End Funds

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Chuck Jaffe, in this episode of The NAVigator podcast interviewed John Cole Scott, President of Closed-End Fund Advisors and Chairman of the Active Investment Company Alliance. Read the Q&A below as John talks about the good and bad in recent industry developments. For example, Scott discusses how fund sponsors are taking steps to keep a lid on discounts, potentially reducing a fund's attractiveness to activist investors. He also highlights the trend towards managed payouts and how investors should size up distributions that might be connected more to marketing materials than to what a fund can actually deliver.

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

CHUCK JAFFE: We're talking about whether changes in the way funds manage both discounts and distributions are good or bad developments for traditional closed-end fund investors with John Cole Scott from Closed-End Fund Advisors, welcome to The NAVigator. This is The NAVigator, where 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 it's pointing us towards John Cole Scott, he's president at Closed-End Fund Advisors in Richmond, Virginia, which is online at CEFAdvisors.com, and if you want to dig

into their data and their research, you can do that yourself at CEFData.com. John's also the chairman of the Active Investment Company Alliance, which you can learn about at AICAlliance.org. John Cole Scott, it is great to have you back on The NAVigator.

JOHN COLE SCOTT: I always enjoy being here, Chuck.

CHUCK JAFFE: I'm really happy that we've got you here because I want to build on some things that we've talked about on The NAVigator. It's our chance to get your take and follow-up with you, which we don't do often at The NAVigator, we talk to guests but we don't always necessarily link things together. So specifically near the end of March we talked with Axel Merk of the ASA Gold and Precious Metals Fund, and he was discussing the impact that Saba Capital Management is having on the fund and on shareholders as it came into the fund as an activist investor. Now Saba is trying to narrow a double-digit discount, and Axel made it clear that he believes shareholders who bought the fund for exposure to gold miners, well, they might get paid if Saba succeeds but they would lose out on the fund they wanted to invest in. Then just last week on The NAVigator we had Stephen Minar from BlackRock, and he was discussing how, yup, discounts drive money flows into closed-end funds, but also attract activist investors, and those activist investors, their actions might be harmful to long-term individual investors. BlackRock was addressing this in ways that other fund companies have. In BlackRock's case, they're launching a series of new funds that can reduce discounts, thereby making funds less likely to attract activists, and they're also managing payouts which increases consistency in distributions. So here you are, you've built your entire business around closed-end funds, and for most people closed-end funds, the secret has been, buy the biggest discount and look at the distribution, make sure it's real, and go for big distributions at big discounts. But this kind of changes that, or does it? So are these developments good for you as you're looking to build portfolios or do they change the way you evaluate funds? Maybe they're still good for you, but you're looking at different things?

JOHN COLE SCOTT: There's no perfect fund, and we always have used our data, our research, our instincts to build the portfolios for our clients, kind of massaging the data to build a nearly perfect allocation, and it really reminds me that you love the discount if you haven't bought yet, you hate the discount if you weren't part of it. And that's the same for any other investment if things pull back dramatically, but what we really find is that the discount, and even a sturdy long-term discount doesn't really concern us because we study it and so we're

not expecting all of them to go away. We realize that there's always tailwinds in closed-end fund investing, there's a dividend increase, usually we love the ones that are built on earnings coverage or other positive outcomes. And we love discount narrowing, because when discounts narrow it's like you're canoeing down river versus canoeing up river, which is way more fun, everyone makes more money without extra market risk. The one thing I really think is useful is that what's the point of a closed-end fund? What is that stable capital base? Is it there to get exposure to less liquid and private, things that can't live in the open-end fund wrapper because of that seven day 15% rule? Is it something where prudent leverage, which works mostly for shareholder benefit, not always, we've learned that in the last two years, but that leveraging of the fund for income investors gives you that extra positive tailwind? And when you marry discounts and levered tailwinds assets, it can be more income than economic risk which is positive. Now you know our firm loves a trifecta analysis, dividend analysis, discount analysis, manager or sector analysis, when you pay ridiculous yields, it does lead to less discounts because investors are drawn to yields. That's been proven for decades in closed-end funds. The challenge that concerns me, as I said about the advisors I talk to that sometimes feel every dividend is real and not a distribution, if you want to be a nerd about it, and that it's basically a policy set by the board based on their feelings or whims. And I worry about the investors that may see a 20% yield on an equity fund and go, "That's amazing, I can retire at 55 and live 40 years on this," but I do love that a high yield is basically a really low-cost-- I mean, if you like the 10% and 20% tenders going on now, 98 cents on the dollar, well, these 20% yields and 15% yields are at 100 cents on the dollar and they come monthly, not once a year or once every five years. So the key is the education that you can't always spend every dollar in your closed-end fund allocation, you should reinvest a piece back with logic and prudence, but it is good for investors if the funds should be in the structure and offer value as we see for many of the funds on the market.

CHUCK JAFFE: When you're talking about these managed payout funds, it's great on the marketing side, and that works well for somebody trying to put that fund out there, but investors have seen in other flavors of funds, like absolute return funds investors were offered chances of, you know, hey, a 1%, 3%, 5%, 7% absolute return, everybody said, "Oh, well, 7% obviously, let's go for the most risk," things along those lines. Do you worry that the managed payout funds where they're going, "Hey, we're going to wind up saying that this is

our payout ratio," and as you pointed out, it might not be real, you might be eating your own seed corn? Do you wind up in a situation where at some point they're setting investors up for trouble, like if the market doesn't support that yield and we wind up finding out that that yield's not real, this is where the hammer hits?

JOHN COLE SCOTT: So I had a great conversation with a friend at Guggenheim talking about GOF, and as we talked about how they run that fund with a very sturdy dividend, though very high and a very longevity of a high premium and asset value, he reminded me of some of the mechanics that seemed to be working from my perspective. When they're well above NAV, so many people say that closed-end funds have a fixed share count, I probably said that the first time we talked, I now use the phrase stable. If you're well above NAV, you can have an at-the-market offering where you're getting shares growing a small number a day, a couple million dollars for a large fund, and the share count grows, and that's a small tailwind because you're raising capital well above NAV. We also looked at a fund like that, and while they never time anything perfectly, they lowered the leverage as things got frothier, being patient for when they think things turn to some trouble, they can re-lever the portfolio, and in theory while the yield is unsustainable topically you can time that in wonderful ways. And so that's a very hard thread, needle to put together, but it's not just high yield, no indifference, but there is some ways to be positive in the structure and to be tactical in that fund approach. And so as I look at that, we love closed-end funds, we wish more people bought them, there's always new ones coming out. The benefit of ETFs being so successful, now actively successful with management, and interval fund growth that really if you want to bring a closed-end fund to market, it has to be the right idea, the wrapper well utilized, and really be meaningful investors, because it's not the only fund structure that can be traded during the day with active management or have leveraged and illiquid guts. So it's that really good differentiation of the right product for the right investor at the right time that I think can keep the sector growing.

CHUCK JAFFE: If we see folks like Axel Merk fighting against activists, or we see BlackRock building funds that are less attractive to potential activists, or we see other fund companies, because you and I read plenty about what's happening in the closed-end fund space and there are plenty of funds out there that have taken steps to reduce discounts and the rest, at least theoretically that's good. But you don't want to get to a spot where this makes a fund

immortal, because there's a balance to be struck. You want good funds to exist, you want management to care about running them well, but if management can make it that, "Hey, whatever happens we're going to be around and we're not going to face a challenge while we're around," then management can get sloppy and that's not good for shareholders either, right? So how do we strike a balance in this space, and is there a development or something else that you're watching?

JOHN COLE SCOTT: There's a couple bright lines I have as someone that's pro structure but pro investor. The common stock shareholder, if you have a common stock shareholder then you have people that you must have governance to and they actually own the fund. You and I can't launch a closed-end fund, we're not a fund sponsor, we don't have those resources. We can own any closed-end fund we choose to, and so it's always balancing a good NAV. I was working with a financial reporter this week trying to educate them on this structure because they're new. I'm like, "The NAV is really important, and the NAV is how you analize the manager's success after cost," so if the fee's a little bit higher but they're a better manager, that's fine with me. But you can never forget that if you have a common stock share class for a listed closed-end fund or even a listed BDC, you must care about those people, support them, be reasonable to make things easier. And while activism can be tough on the fund sponsors, I do believe from my review of other markets and historical trends, my dad did this for 50 years, I've done it for almost half that. If we had less activisms I think we would have some terribly wide discounts of the nineties in muni funds where no one even cared about them because the NASDAQ as booming back then. So it's a healthy balance, build a good NAV, manage the common stock expectations, and while it's true tenders don't fix a fund, but with the threat of tenders or triggers to do other positive things, or really the high dividend's really better than a tender because it doesn't require a board vote, all this paperwork. It's just, "We're going to raise it, and if it's too high and we trade well, we can always raise money later through a secondary, a rights offering, an ATM program." So it's hard to say it's split in the middle, but if it was a terrible fund that shouldn't exist, the country funds of the nineties are almost gone because when the euro came around and when ETFs could do that work again, what's the hassle? Why would you do a closed-end fund in a country now? There's no reason to have an Israel fund today, but there was in the nineties. And then we go look at interval funds, people get frustrated with them because you can't

trade them every day, but you can't get a terrible discount either. You can't have both. You can't have daily liquidity in a common stock shares class and no risk of discounts. It's like having a risk-free 20% government bond when interest rates are 3%, it just doesn't exist.

CHUCK JAFFE: It'll be interesting to watch how it plays out, how the developments keep rolling, and John, of course we'll chat with you about that and more as we get together again down the line on The NAVigator. Thanks so much for joining me today.

JOHN COLE SCOTT: My pleasure, sir.

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