When The Industry Tries To Narrow Discounts, 'That's Good For All Of Us'

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Chuck Jaffe, in this episode of The NAVigator podcast interviewed Rob Shaker, Portfolio Manager at Shaker Financial Services. Read the Q&A below as Rob says that economic conditions, the debt-ceiling debate, troubled banks, higher interest rates, and persistent inflation have created a situation where the market isn't climbing the proverbial wall of worry, but rather a 'Wall of Meh.' However, he adds that there is opportunity in the unimpressive current conditions, noting that long-term investors in closed-end funds can use lagging investor sentiment to capture discounts as early as the second half of this year, when he expects a 'generalized recovery' from today's worrisome issues.

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

CHUCK JAFFE: Rob Shaker, portfolio manager at Shaker Financial Services, a discount-driven investor is here and we're talking about how investors are reacting to the changes fund companies are making to enhance yields and discourage activism, 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, which is a unique industry organization representing the entire closed-end fund business, 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 our journey includes Rob Shaker, portfolio

manager at Shaker Financial Services, he's been with us on The NAVigator multiple times and he is a discount-focused investor, he's always looking for the right discounts. You can learn more about what he does at ShakerFinancial.com. And to learn more about the workings of closed-end funds, interval funds, and business-development companies generally, visit AICAlliance.org, the website for the Active Investment Company Alliance. Rob Shaker, welcome back to The NAVigator.

ROB SHAKER: Thanks for having me.

CHUCK JAFFE: In recent weeks on The NAVigator we have talked with a number of different investors, but most importantly folks from BlackRock and Nuveen, about the way they are changing how certain funds are enhancing yields and discouraging activism. But you are on the other side of this, you are an investor, and as I said, you're very focused on discounts, so let's talk first about what you see happening, and then second, how you feel as an investor about what the fund companies are doing as they change the closed-end fund landscape.

ROB SHAKER: As you point out, at Shaker Financial, we as part of our fundamental trading strategy, which we coined discount capture, we are always looking at discounts. And I think a good starting point is to say that you can view individual funds discount as sort of sitting at this equilibrium level, there's a certain amount of buying pressures, there's a certain amount of selling pressures, and then it sort of works out to an equilibrium level and a general discount. And so any time something is happening, be it in the markets in general or with the way that funds are starting to do certain trends, we're always looking to see when that equilibrium might break for a period, because when that breaks there's an opportunity for us. As with most types of finance and economics, people like to sometimes look at things at a broader macro level or on a more individualized micro level, so I think we can take this theory first over to the macro level. Coming into the year we typically have some movements in discounts overall, what we call general movements or general narrowing, based upon the January Effect, and we had that this year, but then we had a very interesting time in which once again the equilibrium was broken. Markets got jittery in mid-April, there was a collection of things, there was some oil issues, we had rates popping, and we had excessive selling pressure. It's something I think we've talked to other times that we've had conversations about how that generates forced liquidations, we get a breaking of the equilibrium to the sell side, that creates a generic widening. And so in mid-April we had

widening maybe about 2% on bond funds, and then once everything stabilizes again the jitters stop, markets recover as they do over time, and that comes back. And so we've had on the general macro level of discounts, a trip upwards with that one little V in mid-April.

CHUCK JAFFE: As you look at what the fund companies are doing, does it change how you evaluate funds? And would it be different for you as a portfolio manager than it might be for one of our listeners if they're an individual investor? In other words, enhanced yield sounds great, but if I'm just getting back my own money, how great is it really? We want to make sure people aren't being bamboozled by the numbers, is that what you think fund companies are trying to do?

ROB SHAKER: I think you draw a perfect statement there in terms of putting forward how this works, right? With these enhanced dividends and distributions, you're having money come in a different way. I can say it this way, at Shaker Financial we are agnostic to where the money comes in through, we are only concerned with total return. So for example, if you had a fund that made $10, we don't care at Shaker Financial if that's all in price appreciation, or if it's six dollars in price appreciation and 4% in dividend, to us that's the same. It's $10, it's $10. However, there is a large number of CEF investors who we believe are more of the buy-and-hold style investors, who utilize this specific dividend distribution stream as their source of withdrawals, because of this they're much more attuned to the stated levels of distribution, as they will use these to craft a portfolio with a proper level of cash hit in account throughout the year. So to simplify, if a fund now increases that amount of dividends or distributions, that allows for a broader class of investors who may be trying to craft a higher income stream for themselves to be able to utilize that fund. What does that do? In general, that breaks the equilibrium, especially during the period of the announcement when it comes out, it breaks that equilibrium because now you have a little bit more buying pressure. A little bit more buying pressure, what does that do? It leads to a little bit of narrowing.

CHUCK JAFFE: So how should somebody respond to that? Because I would think, and in fact I had this happen, I was hearing after our discussions with the fund executives from different listeners, and one of them I know reinvests all of his distributions. He's got a higher yield but he's getting back some of his own money, he doesn't really care because it's just being reinvested. The other is trying to live off the income stream, so the income stream is higher

but he feels like he's eating his seed corn. Should they be looking at this differently than you do because what they're doing with the money is different?

ROB SHAKER: If you're a buy-and-hold investor and you're reinvesting it, then it's part of your total return and it really shouldn't matter to you what the dividend yield is because it's just getting put back in, right? In the same way that we use our dividends as they come in to reinvest as part of the natural turnover process of our discount capture. Where it becomes a little bit interesting is what happens when you have that dislocation and the discount narrows? For us, as a non-buy-and-hold, what we're looking for is that attractive selling price so that we can sell out of a given fund and reinvest it into one that might be undervalued so that we can continue to do the discount capture [inaudible 0:07:17]. So for us, if that reaction to the change in the distribution or dividend yield is excessive and pushes it to a narrower discount than will be maintained over time, then we can sell at that point. You have a narrowing of the discount, you can sell it at that point, reinvest in something else, let things sort of filter back through, people start looking back at different other alternatives for the fund, and if that narrow comes back down, then you can get back in. An example of this might be the movements in some of the BlackRock funds in which they have moved narrower closer in time to when the announcements were made, but sort of settled back a little bit as we progressed.

CHUCK JAFFE: Let's look at the other things that these fund companies are doing for you, because they are looking at, how do we make it that our funds are less attractive to activist investors? Some of this is about narrowing the discounts, other is about backroom sort of operational stuff. Does any of that discourage you as someone who is looking at acquiring large stakes in funds?

ROB SHAKER: No, in fact it's actually a positive. In general, we've always felt, and I believe this is good for the entire CEF industry, activists serve a great purpose. They serve a purpose of creating a floor for how far discounts can fall, they should be sitting there trying to help the overall investor because they're keeping discounts narrower. From where we sit, I don't care, and I don't think an investor should care whether or not it's the activist who is helping my discount or the fund themselves helping the discount. Either way, I'm winning. And so any time the industry as a whole thinks that way, starts thinking like, "Hey, we all want our discounts to narrow a little bit," that's good for all of us.

CHUCK JAFFE: So ultimately for you, these are things you want to be watching, observing, but you don't want to be fearing them?

ROB SHAKER: Right. I don't think there's any reason to fear them, I think you should support any time a fund is trying to create something that they believe is enhancing shareholder value, that's something we would like them to be thinking about. At the same time, I think it's important to realize exactly what is the benefit? And as you sort of pointed out earlier on, the benefit may just be a redistribution of the gains through a different means. If the total return is the same, and depending on how you're investing, that could be a big thing for you because you really wanted that dividend, but if you're more like us and it's agnostic towards the dividend versus price appreciation, it's really not changing fundamentally your total return expectations over the near to mid-term, other than the potential narrowing of the discount.

CHUCK JAFFE: Rob, really interesting. Thanks so much for joining me to talk about it, I look forward to chatting with you again on The NAVigator down the line.

ROB SHAKER: Thank you, and happy birthday, friend.

CHUCK JAFFE: The NAVigator is a joint production of the Active Investment Company Alliance and Money Life with Chuck Jaffe. And I am Chuck Jaffe, and yes, it was my birthday this week, and you can check out my show, maybe as a gift to me or something, at your favorite podcast app or at MoneyLifeShow.com. To learn more about interval funds, closed-end funds, and business-development companies 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, Rob Shaker, portfolio manager at Shaker Financial Services, learn more about him and his discount capture investment style at ShakerFinancial.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 we'd love it if you'd leave us a review and tell your friends about us, because that stuff really helps. We'll be back next week with more closed-end fund talk, and until then, happy investing everybody.

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