VettaFi’s Islam On The Highs And Lows Of Applying Rules To CEF Investing

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Chuck Jaffe, in this episode of The NAVigator podcast interviewed Roxanna Islam, Head of Sector and Industry Research at VettaFi. Read the Q&A below as Roxanna and Chuck discuss the benefits and flaws of applying rules-based investing to closed-end funds. Roxanna notes that changes in the industry have forced changes on a rules-guided index of closed-end funds created by VettaFi, and how that is impacting the holdings and asset allocation of the fund-of-funds that some investors are using instead of building their own portfolio of individual closed-end strategies.

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 the benefits and flaws of rules-based investing in closed-end funds with Roxanna Islam, head of sector and industry research at VettaFi, 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 we’re looking at the directions, instructions, and rules that people follow when they try to set up systems for themselves, we’re talking rules-based investing with Roxanna Islam, head of sector and industry research at VettaFi, which is online at VettaFi.com. And if you're looking for more information on closed-end funds, interval funds, and business-development companies in general, visit AICAlliance.org, the website for the Active Investment Company Alliance. Roxanna Islam, great to have you back on The NAVigator.

ROXANNA ISLAM: Yeah, it's really great to be back, Chuck.

CHUCK JAFFE: I love this topic because for starters closed-end funds for the longest time, investors are seeking them out now, but it was always a thing that advisors knew about that investors maybe didn't. And we've seen a lot of changes to closed-end funds and it kind of makes it that you want to have some more rules, you want to have an understanding, not just of what closed-end funds do but of what you want to be investing and how you want to be investing. Any kind of system that you set up that's going to have rules is also going to have unintended or maybe even intended consequences, so help us understand a little bit of the background and what you're seeing and what people should be looking at.

ROXANNA ISLAM: It's a funny issue for closed-end funds, like you mentioned when talking to investors a lot of them sort of see closed-end funds as these old-school niche investments, but they're really just wrappers, the same way an ETF is a wrapper for example. The investment inside can vary widely depending on what individual closed-end fund you're looking at, so there's actually a lot of different opportunities in closed-end funds that investors may not be aware of, and some of that is where the general market is trending right now. That's a lot of these higher risk asset classes, something like early-stage AI companies, something like tech, something that's really buzz-worthy. Closed-end funds don't just have to hold fixed-income or preferreds, they can hold a variety of different instruments inside.

CHUCK JAFFE: They can a variety of different instruments, does it force you to look at them differently? I mean, obviously if somebody owns equities versus fixed income, it's a different kind of evaluation. But as we've seen the evolution, and we've seen a lot of new funds and a lot of funds that are going in directions like equities that weren't necessarily what closed-end funds were always doing, does that change how you evaluate them at VettaFi?

ROXANNA ISLAM: Yeah, yeah, it does. So at VettaFi we provide a few closed-end fund indexes actually which underlie some ETFs of closed-end funds. One of those main ones is PCEF, and that's the Invesco Closed-End Fund Income Composite ETF, this one's pretty interesting because some closed-end fund investors use it as a core income holding and then they tactically select some individual closed-end funds, so you can sort of think of it like the S&P 500 of closed-end funds, but I think there's a lot to learn just by looking at its holdings. It's pretty different from its peers because it acts more as a benchmark for the taxable closed-end fund universe. So it's interesting, it doesn't just focus on those distributions, it instead tries to weigh premiums and discounts, which naturally tends to follow those higher distributions. It also has some of those rules based exceptions that we talked about like liquidity and eliminating higher expense funds, so that's a lot of the heavy lifting that you would so as an investor or advisor when you're trying to narrow down your options. So when you're looking at something like this, it's interesting because you've seen it sort of evolve over the years, and you know it does tend to do that because this is something that it's rules-based but it's sort of opportunistic, so you do see it change over the years. But between 2023 and 2024, there's been some significant changes, and we mentioned a little bit about it, there's equities, there's bonds, since I've known this ETF over the past few years, it's mostly been focused on fixed income. You had maybe about 60 to 70% of fixed income and then maybe about 20 to 30% equity, that's changed over the past year, so now it's about almost 50-50, there's about 45% weight in each of those asset classes. That in itself, it's a little interesting. So if you dig a little deeper and you look at the actual number of equity versus fixed-income funds, you know, it's a little bit surprising because equity funds actually only increased from 27 to 32 funds in this time period and fixed income decreased from 85 to 74, so that basically means that equity funds are receiving the higher weight due to either their net assets or wider discounts, because this fund does weigh by discounts. And broadly, equities have been trading at wider discounts than taxable fixed income has, so it seems like that's been the main reason for that change, but then you also look at some of these newer funds that have come out in the past five years or so, so you see a lot of these newer BlackRock funds are now in its top holding, so that's funds like BIGZ, BMEZ, BSTZ. So these funds, they do focus on those areas that I touched on earlier that are a little bit more exciting to investors like technology, healthcare, growth. It's funny, because this is where we're seeing market interest going, but funds like this have sort of flown under the radar and they aren't really receiving the same attention that an ETF of the same type would for example.

CHUCK JAFFE: Since we're talking about rules-based funds and how rules-based investing can change, et cetera, do we have a situation where you would all think that advisors or individuals who buy these funds maybe think they're getting one thing but five years from now if they're holding it long term will be looking at something else? Can you get to where you're going, "Is this still the same fund I thought I was getting?" Because again, they're following rules, at least on the surface, that's what you want them to do.

ROXANNA ISLAM: The main thing driving this rules-based investing I think is diversification. I think that's always king when it comes to ETFs, closed-end funds, or any other type of fund structure. It's important because there's not really a clear-cut solution, it doesn't always work that way. So for example, if you look at the number of managers, we just mentioned BlackRock and Nuveen, if you look at this fund of funds, Nuveen, if you look at their taxable funds they have about 17 funds out there, and there's only 10 of those in PCEF, so you can arguably say, "Well, this doesn't really represent the market, you're not really getting what you think you're getting." But like I said, you do have to remember that this is always constantly evolving, it's rules-based so it is looking for those more opportunistic weightings out there, and so you might also miss out on some funds that are trading at premiums. For example, I'll also bring up PDI, that used to be a top holding in this fund, and that has been trading at a premium for a while, so arguably you can say, "Well, you know, was it the right time to sell or could you have held onto it for a little bit more of that distribution?" It's really hard to say, there's always exceptions and there's always going to be issues when you're looking at rules based methodologies. Even just looking at the S&P 500, people sort of look at that as the perfect fund, it represents the equity markets, everything's good there. That in itself has had some issues lately just with overconcentration, not just with the mega-cap tech stocks, but now NVIDIA, so there's always going to be some issues, there's never going to be perfect diversification, perfect rules-based investing. But I think you're going to have to weigh those pros and cons, and you're going to have to weigh those against active management, you're going to have to weigh those against individual security selection and see what works best for you.

CHUCK JAFFE: And that is an important thing here because what we're talking about like with PCEF, you're basically looking at buying a closed-end fund of funds, and on the one hand it's rules-based, and on the other hand, if those rules aren't your rules or if you want more control or you want to be able to do tax-loss selling and some other things, you might want to own the individual securities under that circumstance, right?

ROXANNA ISLAM: Right. Yeah, there's no right or wrong answer when it comes to investing.

CHUCK JAFFE: Roxanna, the right answer is always to get more information, we appreciate the information you've given us today. Thanks so much for coming back to The NAVigator, look forward to talking with you again down the line.

ROXANNA ISLAM: Thanks Chuck, I look forward to it too.

CHUCK JAFFE: The NAVigator is a joint production of the Active Investment Company Alliance and Money Life with Chuck Jaffe. Yeah, that is me, and I'd love it if you'd check out my show on your favorite podcast app or by going to MoneyLifeShow.com. To learn more about interval funds, closed-end funds, and business-development companies check out AICAlliance.org, that's the website for the Active Investment Company Alliance, which is on Facebook and LinkedIn @AICAlliance. Thanks to my guest, Roxanna Islam, she's the head of sector and industry research at VettaFi, and they've got a full suite of tools there for you at VettaFi.com, and they're on Twitter or X @Vetta_Fi. The NAVigator podcast is new every Friday, we'd love it if you'd make sure that you're not going to miss an episode by following along or subscribing on your favorite podcast app. And we'd love to have you leave a review and tell your friends about us because, well, that stuff really helps. We'll be back next week, and until then, happy investing everybody.

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