John Cole Scott On How Funds Perform After Tenders, Closings, And Dividend Changes

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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 explains how closed-end funds have responded historically to corporate actions like tender offers, liquidations, transitions to open-end funds, rights offerings, and big changes in dividend policy. He notes that understanding how those events play out gives investors a guideline on what to look for and how to act if they see those same actions in the funds they own.

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

CHUCK JAFFE: John Cole Scott of Closed-End Fund Advisors is here, we're digging into what his data says about corporate actions in closed-end funds now on 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 representing all facets of the closed-end fund industry from users and investors to fund sponsors and creators, and if you're looking for excellence beyond indexing, The NAVigator will point you in the right direction. Returning to The NAVigator today, John Cole Scott, president of Closed-End Fund Advisors in Richmond, Virginia, which is online at CEFAdvisors.com, and we're about to dig into the firm's data, which you can do for yourself at CEFData.com. John is also chairman of the Active Investment Company Alliance, and you can learn about that online at AICAlliance.org. John Cole Scott, great to chat with you again.

JOHN COLE SCOTT: Great to be here, Chuck.

CHUCK JAFFE: We're talking about corporate actions, and I'm really glad we're doing it now because there are more of these actions than ever, and among the investors touched by them, well, me. I recently received a tender offer on a BlackRock fund that I've owned for a long time, so let's start by talking about what has been happening with tender offers.

JOHN COLE SCOTT: Yeah, so as you know, CEF Data is 12.5 years old, and since its inception we've tracked pretty much everything we can think of, and that includes the 178 unique tenders in those 12.5 years, the total is about $10.3 billion in funds offered for tendering, average is about $60 million each time. Historically the average amount offered is about 18% of the shares, most commonly it's been 10 and 25%, that's the historical average. But the cool thing is, because most investors, and even most financial advisors we talk with don't actually tender their shares, I hear you barely were able to for yours. The average acceptance is 46%, that's a 2.5% extra shares just for remembering to do something that comes into your email or mailbox. The average tender is about 98% of NAV, and in the past 12 months it's been 98.5% of NAV. And if you look at discounts, because that's really the closed-end fundedness that we always talk about on this podcast most times, 90 days before the announcement, those 178 had an average 11% discount. One day prior to the announcement it was a 10% discount, which tells me very little leakage for the idea to be happening in the market. One day after, a 9% discount, so a little movement. But one day prior to expiration, it closes again to just a 7.9% on average. That's a 3% discount tailwind if you overweight funds that might or could do tenders, and if you oversubscribe it's about a 4.1% tendering alpha. So just by stacking the deck in your favor for tenders, there's a 7% discount tailwind. You'll never get them all, but it's a great opportunity to put some good funds, extra performance in your portfolio.

CHUCK JAFFE: Yes, and in my case I tendered my shares, but the offer from BlackRock which put tender offers out on a number of its funds was oversubscribed, so only about 20% of the shares I tendered actually were sold in this deal.

JOHN COLE SCOTT: But they offered five?

CHUCK JAFFE: They did. They said they would repurchase up to 5% of all outstanding shares, and they oversubscribed it, so I still own the fund, but I turned a quick little profit on the shares I sold, and the hope would be for me that they're going to do more of these. But is there a reason why advisors or investors would not take a tender offer? I mean, I know in my case I almost missed it simply because I hadn't looked at my portfolio to see messages about it. I saw it and I acted quickly, but is there a reason why someone who hears about a tender offer might sit out an opportunity like this?

JOHN COLE SCOTT: So a lot of advisors use closed-end funds five to 10%, maybe 15% if you're lucky, in their portfolios, it's just one of the many things they do. It does take some work to focus and say yes to almost all tenders all the time, which we do at CEF Advisors for our clients, and it's one of those little things where even investors with seven plus million dollars in the portfolio, I look at their funds going, "Did you tender the shares?" They go, "Oh no, well, we like the fund so why deal with the change? I like it, it's going to be up eventually." I'm like, "Yes, but there's structural tailwind here." It's probably because it's really not of course in open-end funds, it's not in ETFs, maybe if you're an operating company investor you might be used to tenders, but there it's much more aggressive activism and it's usually a much different outcome than these slivers of tailwind alpha.

CHUCK JAFFE: You mentioned open-ending, that's the next kind of corporate action we need to talk about in closed-end funds, because there have been liquidations and also increasingly some open-endings.

JOHN COLE SCOTT: Yeah, so the same 12.5 year time period, we launched CEF Data back on 12/31/11, exactly 117 open-endings or liquidations, basically an ETF, open-ended fund, or a liquidation event. Ninety days prior though this 12.5 year history, it's an average 8.5% discount. One day prior is a 5.6% discount, which tells you there is either anticipation of potentially leakage in the market. One day after it narrows again to a 2% discount, and then seven days after we get to about the lightest discount historically, about 1.5%. What that means is just by loading your deck again, and we don't like funds to go away, but if you overload your deck in discounted funds you're more likely to end up with tenders and liquidations because of activism or just frustration from the fund sponsor, that's another 7% alpha opportunity and 40% is before the announcement. It goes back to another reason why us and many other focused firms lean into discounts. You're not going to get an open-ending or a liquidation or a tender, in my experience, when you're trading two points off of NAV or a three premium, because there's no math that would make that plausible.

CHUCK JAFFE: As with tender offers for you, if there's a notice about liquidation or open-ending, do you stick with the fund to the bitter end to catch it or do you sometimes say, "They just announced it, I'm going to take the immediate pop that's likely but I'm not going to ride it out all the way"?

JOHN COLE SCOTT: So I'll speak to a recent one, the FEI and other funds managed by First Trust, most of them converted into one ETF, so the same manager, it's a manager that spoke at our conference back in '19, did a great job. And so we decided for most of the investors to just hold on for the liquidation because we were keeping the NAV, we would eventually lose the leverage and lose the potential discount downside, and for all but one client driven by the advisor and their tax situation, we sold everyone out of that liquidation and merged them into additional teens discounts of MLP funds to potentially do it again. And wouldn't you know it, about a month or so later, maybe two months, a Tortoise basket of funds also announced ETF conversations and we've been able to ride that forward for some investors again. We don't think it'll happen a third time this year, but you know what, we'll take our chances.

CHUCK JAFFE: Let's move from liquidations and open-endings to rights offerings.

JOHN COLE SCOTT: So rights offerings are something that we recognize happen, and we usually try to talk fund sponsors if they share the opportunity to reach out to us, to do less dilutive rights offerings, which is less painful to the current shareholders that own the stock, but 90 days before a rights offering, there's 127 in our database, an average 6.7% premium for those that issued rights. At the expiration of the rights, it's a -4.7% discount, then 90 days after it trades at just slightly above net asset value of the expiration. But what that does mean is if you buy and hold rights offerings, if you don't oversubscribe, if you don't trade around the risk, then you have an 11% average negative alpha, and if you were to rotate out, get back in and maybe be lucky as you tend to, you can maybe get even 5% reversion to mean back up. So this requires to be a little bit more trading thoughtful, focused, and organized to step into these opportunities.

CHUCK JAFFE: Yeah, unlike a tender offer, which is pretty much always good news, a rights offering could convince you that if you don't get out now, you're going to wind up taking at least a temporary haircut, and then have to wait and hope for the fund to come back.

JOHN COLE SCOTT: Again, another reason to try to avoid either fund sponsors that often do rights offerings, usually seasonally if you look at the calendar of their history, or generally speaking more likely at narrow discounts or premiums, if you tend to avoid those funds there is less rights risk in your portfolio.

CHUCK JAFFE: Now as much as it's possible to miss a tender offer or a rights offering or sit it out, the one thing every closed-end fund investor notices is a big change in dividends, and you've tracked a lot of those both working for and against shareholders.

JOHN COLE SCOTT: Yeah, so we looked at dividend changes, I used a 10% cutoff this time, in the last 12.5 years there's 1,075 dividend downsides over 10%, the average cut was just over 20%, and 90 days before that announcement the average fund in that group over the 12.5 years was a 3.8% discount. One day before, a 5.2% discount, which means either some sense of it or some leakage, both can happen. One day after, a 6.3% discount. Ninety days after, an 8.2% discount, so what that means is a negative four and mid-change negative alpha to experience a dividend cut. Again, another reason to be overweighted funds with more conservative policies based on the ecosystem, and just able to decide if you like the manager and the dividend was too high, get back in if there's a dividend cut. There's 415 funds, you don't have to own all of them, you can be selective and have a good diversified portfolio and reduce some of these risks as well.

CHUCK JAFFE: What about dividend increases?

JOHN COLE SCOTT: So there's been less of those, of the 10% increases, 799 at CEF Data, and the average increase is about 23%. Thirty days before there's a 10% discount, one day before the downspin, only a 9.8% discount, which suggests people weren't expecting it. Ninety days after, a 7.8% discount, so only a 2% alpha. This opportunity to talk about these alphas are helpful. The one good thing for your listeners and most advisors is these dividend increases, when they're too big, are democratized tenders at less cost closer to NAV. It's worse for my clients and other clients that focus, because we love to do the tenders and we get those extra shares, but everyone receives the additional payout on these overpaying funds right now when they increase their dividends. You've got to be thoughtful living off that money, but it is a powerful tailwind to help make the portfolio. Closed-end funds average 8% a year, over time, just like the US stock market depends on when you measure it over 30-40 years, you've got to use these tailwinds to be thoughtful and make a little bit more money without taking extra risk, in our experience.

CHUCK JAFFE: And that's really where your data helps folks. You get this stuff, you're not sure what to do, here's the skinny. Tender offers, the advice is to take them. Liquidations, get what you can out of them, whether you ride them all the way to the end or not. Rights offerings could be a sign that maybe you're going to be deluded or have some trouble. And big dividend changes, the direction they're moving determines how you respond. Is that a pretty good sum up? To determine what you do next, is that a pretty good sum up?

JOHN COLE SCOTT: That's pretty good. And as you might imagine, we have a giant spreadsheet we sell to institutional investors that organize this a thousand ways to Sunday so they can do their own pre/post and decision making around these things, as we do for our clients. It really helps us understand perspective broader than we ever have before with the ability to call and focus on the data that we collect.

CHUCK JAFFE: Well, thanks for helping us focus on the data so that it can help us with the way we manage our closed-end fund holdings. John, great stuff, we'll talk with you again soon.

JOHN COLE SCOTT: Great being here, and exactly why we do The NAVigator, to educate your listeners further.

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, you can learn more about my hour-long weekday podcast by going to MoneyLifeShow.com or by searching for it wherever you find your favorite podcasts. Now if closed-end funds, business-development companies, and interval funds could be your favorite investments, you might want to check out AICAlliance.org, it's the website for the Active Investment Company Alliance, which is on Facebook and LinkedIn @AICAlliance. Thanks to my guest John Cole Scott, president of Closed-End Fund Advisors in Richmond, Virginia, and the chairman of the Active Investment Company Alliance. His firm is online at CEFAdvisors.com, and you can dig into the data he was talking about and what he uses by going to CEFData.com to check it out for yourself. By the way, John is on X or Twitter @JohnColeScott. The NAVigator podcast is available every Friday, make sure you don't miss an episode by following along or subscribing on your favorite podcast app. We'll be back next week with more closed-end fund talk. Happy Labor Day, everybody, and happy investing.

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