John Cole Scott On Four Funds To Consider In The Fourth Quarter

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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 and Chuck look ahead to the fourth quarter on today's podcast. John discusses two equity and two fixed-income funds that hit his trifecta – an analytical mix of discount, dividend, and net asset value – and that he says look particularly promising for year-end portfolio moves.

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 getting his outlook on the rest of the year and we're talking about hitting the trifecta, this is 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. Joining me today, John Cole Scott, he's president at Closed-End Fund Advisors in Richmond, Virginia, which is online at CEFAdvisors.com. We're about to dig into funds using the firm's research, and you can do that for yourself at CEFData.com. John is also chairman of the Active Investment Company Alliance, you can learn about the alliance and more about closed-end funds, interval funds, and business-development companies generally by going to AICAlliance.org. John Cole Scott, welcome back to The NAVigator.

JOHN COLE SCOTT: Always enjoy being here, Chuck.

CHUCK JAFFE: So we are on the cusp of the fourth quarter, fourth quarter always an interesting time because we get a lot of action in trading around closed-end funds and tax-loss selling and all these other sorts of things, which also means people are going to want to be buying. So as we enter the fourth quarter with a rate cut, I want to start with your analysis of what you see happening, and then when I said we're going to hit the trifecta, it's because you have something called "Trifecta Analysis", that's going to help us understand what funds we might want to be looking at this quarter, but start with the outlook, please.

JOHN COLE SCOTT: Yeah, so the backdrop, we at CEF Advisors, we pretty much run diversified portfolios, almost always over 30%, often 35-40% are credit and equity funds, and we really use about 40 total funds in the portfolio, but that trifecta analysis really is balancing three things that are never perfect but we try our best at for each fund, for each client; it's that discount analysis, that dividend analysis, and that NAV analysis, which is really the guts and the active management of the permanent capital. And really, we go back and think about sometimes we find people will go on a filter or a sort, and they'll weed out funds, for example, on a discount data point, that's part of the analysis, and they want a wider than average, they just pick the average and only wider. We want to remind people, you can also get to what is an average by anchoring, for example, if the average is 8%, you can take a 6% and a 14% discount as companions and blend to a 10% discount, still be wider than average. I think that's really useful for an investor to consider going forward. But yeah, we thought we'd look at equity funds and bond funds, two of each, the backdrop is pretty simple, equity funds are up about 20% year to date, almost the end of the third quarter, and 5% of that is discount narrowing, and taxable bond funds are up about 16% year to date and about 7% of that is discount narrowing.

CHUCK JAFFE: Historically, when we get to a change in the rate cycle, and we get to the end of the year and we've seen a lot of activity, and as you point out 5% discount narrowing year to date for equity funds, 7% discount narrowing, well, that is a lot of action, that also talks about how wide discounts are. What traditionally happens to discounts as we get into a rate change environment?

JOHN COLE SCOTT: So honestly, a rate change environment, and it always depends on the magnitude and the pace of interest rate change, it's not just up and down, but in the current most people's analysis of getting to 1% lower from two weeks ago to end of the year, probably 75 basis points, maybe a full point next year, feeling like a slow change. The leverage math becomes much better, the bonds in these portfolios, most of the closed-end funds you may know are bond funds, have higher prices going forward, and there's a lot of just structural benefits. But generally speaking in up years, the widest discount for tax-loss selling season will be towards the end of December, nine times out of 10 for positive years versus negative years.

CHUCK JAFFE: You mentioned funds, and before we dig in, one item here, which is as you are looking at these funds, are these funds straight up, "Hey, I love these funds, I want to head in this direction"? Are these the funds that you're going, "I'm going to look at a portfolio and go, do I have some tax losses I want to realize? Do I want to be moving into this space?" Is there a difference to you about this is a straight up buy whatever conditions are or this is something you rotate into?

JOHN COLE SCOTT: Great question. So these funds we'll talk about shortly do cover the individual trifecta NAV analysis, but the step one of most firms, not just ours, is the asset allocation, and so we were looking for funds that were attractive across those three metrics, but also that their guts are things we're more comfortable owning today. Because we get new money almost every quarter from new clients, rolling over new assets, and we're often putting new money to work pretty much every market week, and these are funds that I think are attractive both at the guts of the sector and the entry point of the discount, and dividend policies that are pretty durable in our opinion.

CHUCK JAFFE: So with that said, let's dig into the funds themselves. And again, these are funds that you are looking at and saying these hit the trifecta for you.

JOHN COLE SCOTT: Yes, and they're fund that we all currently own at least one or two in client portfolio models. The first fund is NFJ, it's the Virtus Dividend Interest & Premium Strategy Fund. At its core it's a US equity dividend stock fund, but it layers in a tactical convertible bond sleeve, and again, a very useful thing for equity funds, it layers in an option overlay which generally drops the volatility and increases the cash on hand to pay out its distributions to shareholders. Right now it averages about a 9.5% distributions paid quarterly, if you back out the discount it's 8.3% on a leverage adjusted NAV basis, relatively attractive historically speaking. And we care a lot about taxes for income clients at CEF Advisors, so if you're in the 22% marginal rate, it's a 7.6% after-tax yield based on the one-year lookback. There's no leverage, the expense ratio's actually very attractive at 96 basis points, and because of the option strategy, it's about 10% less volatile than the S&P 500 with a 0.91% beta. And then of course the last piece is discounts, it's almost a 13% discount, 5.8% wider than the peer group average, and in line with its 90-day average, which means it hasn't gotten ahead of itself recently with this market push forward.

CHUCK JAFFE: That's NFJ. Next one?

JOHN COLE SCOTT: We go to BlackRock, they have the BlackRock Enhanced International Dividend Trust, BGY, and it's a non-US large cap dividend stock fund that also throws in an option overlay strategy. Its yield's a little lower at a 7.1% forward looking distribution yield, but paid monthly, backing out the discount it's a 6.6% leverage adjusted NAV yield, which to me is very comfortable for managers to hit in the current market environment, and that same after tax analysis, it's about 6.6% at the 22% marginal rate. Again, no leverage, very common for covered call funds, expense ratio's still very reasonable at 1.1%. You get a lower volatility of the NAV here with a 0.73% beta versus SPY the last two years on a weekly basis. And again, a very attractive discount, a -12.7%, 3.5% wider than the peer group average, and 80 basis points wider than its own 90-day average.

CHUCK JAFFE: You told us two equity funds. I know the other two are on the fixed-income side.

JOHN COLE SCOTT: They are, and they're very different. The first one, we may have never covered on The NAVigator before is the Morgan Stanley Emerging Markets Domestic Debt Fund, EDD, and so this is predominantly sovereign bonds from not the US and not the developed markets. The top five holdings are in Egypt, Indonesia, South Africa, Peru, which you know is special to my heart, my wife's Peruvian, and Colombia, and those five positions are 50% of the allocation, truly getting exposure to emerging market debt. It's a 10.6% distribution yield paid quarterly, it's an 8.5% leverage adjusted NAV yield, honestly that's a little higher but we really like the active management and we really like the details you'll hear next. The after-tax yield blends to about a 7.6% at a 22% rate, only 12.6% leverage, and I would expect in the next six months, leverage to tick higher as the rates are more attractive for the portfolio. And as a credit fund duration, 7.6, expense ratio's reasonable for a niche-y fund, 1.41, and a 9.4% discount to net asset value, which is 7 points wider than the peer group average and only 34 basis points ahead of its own discount, still very attractive in the current market.

CHUCK JAFFE: Yes, and fully committed to being in the smaller of the emerging markets, which, yeah, you have personal reasons to love, but you gotta love the performance as well. And then the last pick this week?

JOHN COLE SCOTT: Such a different bond fund than the previous one, it's the Western Asset Inflation Linked Opportunities & Income Fund, WIW. Looking in the portfolio, holdings today, 77% exposure to TIPS or US government bond exposure, though another 150 other things in the portfolio. It's sporting about an 8.3% distribution rate, that's also paid monthly. What we really like is that the leverage adjusted NAV yield is down to 5.5%, very durable for the portfolio holdings to be earned by the manager at that level but set by the board, and going to the same after-tax rate for people in a taxable environment, the 22% marginal rate, which is for $200,000 income, so a real high income in most terms, 6.5%. It's 29.8% levered, the duration's a little higher than the previous fund at eight, great expense ratio, 78 basis points, and it's a 13.6% discount, 4.5% wider than the peer group average, and only 16 basis points higher than its own 90-day average, so very attractive discount-wise and useful in the current market.

CHUCK JAFFE: Four really interesting, very different funds, and interested to see how that'll play out. John, great stuff as always. We will talk again, because as we through the fourth quarter we get your look back and your look ahead for the next year. I'm looking forward to that already, thanks again for joining me on The NAVigator.

JOHN COLE SCOTT: Great to be here, Chuck.

CHUCK JAFFE: The NAVigator is a joint production of the Active Investment Company Alliance and Money Life with Chuck Jaffe. And yeah, that's me, and I'd love it if you'd check out my hour-long weekday podcast by going to MoneyLifeShow.com or by searching wherever you find your favorite podcasts. To learn more about closed-end funds, interval funds, and business-development companies go to AICAlliance.org, that's the website for the Active

Investment Company Alliance. They're on Facebook and LinkedIn @AICAlliance. And if you have questions about closed-end funds, send 'em to TheNAVigator@AICAlliance.org. Thanks to my guest John Cole Scott, the president of Closed-End Fund Advisors in Richmond, Virginia and the chairman of the Active Investment Company Alliance. His firm's online at CEFAdvisors.com and you can dig into their data for yourself by going to CEFData.com, and John's on X @JohnColeScott. The NAVigator podcast is available for you every Friday, make sure you don't miss an episode by following along on your favorite podcast app. We'll be back next week with more closed-end fund talk, and until then, happy investing.

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