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Hennion & Walsh's Mahn Says Rate Cuts Will Push Investors Towards BDCs

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Chuck Jaffe, in this episode of The NAVigator podcast interviews Kevin Mahn, President and Chief Investment Officer at Hennion & Walsh Asset Management which runs the SmartTrust Unit Investment Trusts. Kevin says that he expects the Federal Reserve to cut rates over the next two years, which will drive investors to turn for income alternatives "since they can't find the 5 percent in the short-term CDs anymore." That will drive investors toward business-development companies and leveraged municipal closed-end funds, the latter benefitting from a reduced cost of leverage in a declining rate environment as rates drive down. Mahn talks about using unit investment trusts, and specifically covers his firm's UITs that invest in BDCs and closed-end funds in current conditions, and talks about how the UIT structure can be a benefit for investors now.

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

CHUCK JAFFE: Kevin Mahn, president and chief investment officer at Hennion & Walsh Asset Management is here, we're taking unit investment trusts and why they're working in these market conditions, 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 the full spectrum of the 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 for the first time in five plus years of doing The NAVigator, we're going in the direction of unit investment trusts with Kevin Mahn, president and chief investment officer at Hennion & Walsh Asset Management. You can learn more about the firm at HennionAndWalsh.com, and more about their SmartTrust unit investment trust offerings by going to SmartTrustUIT.com. Unit investment trusts, close cousin of closed-end funds, and if you want to learn more about closed-end funds and interval funds and business-development companies visit AICAlliance.org, that's the website for the Active Investment Company Alliance. Kevin Mahn, welcome to The NAVigator.

KEVIN MAHN: Why thank you, Chuck. It's great to be on.

CHUCK JAFFE: Great to chat with you, and today we're talking unit investment trusts, help us understand the structure a little bit. Because your offerings, as I said, unit investment trusts, close cousin, if you will, of closed-end funds, but also you've got unit investment trusts that are all about closed-end funds. So help people understand the structure and the defining characteristics of a UIT.

KEVIN MAHN: Certainly. So a unit investment trust, or a UIT for short, is another type of 1940 Act product, similar to an exchange-traded or mutual fund with the core difference being that a unit investment trust has a defined life. Each series of this strategy has a defined maturity date which is generally either 15 months or 24 months long. Second core difference is that unit investment trusts are passive, their portfolio components are static. In other words, when the portfolio manager selects the portfolio components on the deposit date, they stay consistent throughout the life of the trust barring any significant situations that may occur that would force you to remove a given security from a portfolio, although you can't replace it. So the core differences being again, they have a defined life, it's a static portfolio, but it also has some other unique characteristics such as the ability to blend together many different types of security types within the UIT structure, whether they be common stocks, AVRs, closed-end funds, BDCs, REITs, exchange-traded funds, all of those different security types can be wrapped up into a UIT to help it meet its investment objective.

CHUCK JAFFE: You've got everything from dividend-driven strategies to sector-driven strategies to ESG and here's the modern innovators UIT and things along those lines, and of course you have closed-end fund UITs.

KEVIN MAHN: Yes.

CHUCK JAFFE: So with that, an investor in closed-end funds understands, okay, I'm getting discounts, I'm doing whatever, but what is the benefit to a closed-end fund investor of holding closed-end funds in a UIT? Because you've got the Closed-End Fund Advisors run by John Cole Scott, the chairman of the Active Investment Company Alliance and a frequent guest here on The NAVigator, you've got the Closed-End Fund Advisors Select BDC Trust, for example. What is the benefit of owning closed-end funds that way as opposed to buying a couple of closed-end funds?

KEVIN MAHN: It's a great question, and I'll start by saying at SmartTrust we have 28 different UIT strategies, some are growth-oriented, some of them are income-oriented, and some are growth and income-oriented. One of those strategies as you correctly pointed out is our CEFA Select BDC Trust, where we use John Cole Scott from Closed-End Fund Advisors to select the business-development companies for the portfolio. Now for an individual investor, why would they want to seek to use a UIT leveraging John Cole Scott's experience to access this unique area of the market? Well, first and foremost, many investors don't even understand or know what a business-development company is to start, and I'll tell those investors that BDCs are publicly traded closed-end funds that help to provide capital to small and midsize businesses who can't avail themselves to traditional lines of capital that could come from banks as an example. Many of these BDCs do trade publicly on an exchange but they're very small, so BDCs can lend their assets in their portfolios to private or public companies with lower trading volumes that have a market value of less than $250 million. So how is an investor going to find those opportunities and screen out those that may prove problematic down the road based upon the nature and composition of their loan portfolio? Why not leverage an expert in the field like John Cole Scott and invest in a UIT that does that selection process for you, is completely transparent so you know exactly what holdings you have, and allows you to have some degree of discipline over the two years that the trust is in place so you don't have the temptation to try and time the market by buying or selling certain BDCs on a daily basis?

CHUCK JAFFE: But of course you're going to be out in 15 months, 24 months, depends on the term of the UIT in terms of what the actual rules will be. Is there a benefit to having that reinvestment side of things or don't you add reinvestment risk into the picture?

KEVIN MAHN: So here's a great point and another feature to the UIT structure. So in this particular strategy, the CEFA Select BDC Trust, it's a two-year UIT, every two years that strategy will mature and the portfolio manager will build a new portfolio based upon those BDCs that he feels has the best characteristics for the next two years. The investor on the other hand has the optionality to either roll their proceeds from the prior series into the next series or take those proceeds and move it into a different area of the market completely with one of our other UIT strategies, or of course take the money and put it somewhere else in the market completely. So it does give them the opportunity to roll into the next series, remembering that this is a static portfolio and over those two years there may be certain securities that you don't want to invest in for the next two years, and that gives the portfolio manager an opportunity to reset the portfolio. So I generally like to think of these portfolios, Chuck, as 10-year investments with five resets over the course of those 10 years, recognizing that it's a two-year UIT. I think that's a better way to look at the overall portfolio structure than just trying to pick and choose at different points in times, where do I want to be for 15 months or 24 months? Look at it over a longer period of time.

CHUCK JAFFE: Well, and again you noted that UITs, the holdings are static, barring something that forces a portfolio event, and if it does have a portfolio event, that can't be reinvested, so making it that you can rejigger the portfolio and get a fresh start makes a lot of sense.

KEVIN MAHN: Yes.

CHUCK JAFFE: I'll point out that as I look through the fact card, available again at the SmartTrust UIT website on the CEFA Select BDC Trust, John Cole Scott as I said has been on The NAVigator plenty of times, and when he's talking about BDCs he sometimes is talking about the not-traded ones, and this is all publicly traded BDCs. So I'm curious, because that's a mandate presumably, why that mandate in BDCs right now?

KEVIN MAHN: That's a mandate that we worked on at SmartTrust with Closed-End Fund Advisors for this particular strategy, and it's because SmartTrust has an overarching view of the importance of liquidity. Look, I've been doing this now for well over three decades, Chuck, and I feel that liquidity is paramount, and when does liquidity matter most? Generally during periods of crisis, and it's during those periods of crisis where you see downturns in the markets and investors looking to access their capital to get out of the market or to reposition. If you're in an illiquid investment or a non-publicly traded investment, you have less liquidity in those types of scenarios. So I would much prefer to build a portfolio of publicly traded BDCs that alleviate that risk but also allow you to access this very intriguing area of the market that provides a high level of income potential.

CHUCK JAFFE: In terms of strategies now, you talked about how SmartTrust UIT platform has a couple dozen different offerings, but they're all designed to take advantage of different things, but we have a market and many of your offerings pretty sensitive to what's going on when it comes to interest rates. We've got an interesting interest rate environment--

KEVIN MAHN: We certainly do

CHUCK JAFFE: In that we've been seeing rate cuts. Yeah, but we haven't necessarily been seeing rates go down, right?

KEVIN MAHN: No.

CHUCK JAFFE: Like yes, there's a rate cut, and yet mortgage rates are up and what have you, and the rate picture has been a little unusual if not downright weird. So how are the various UIT offerings, but especially the one that's going into BDCs which are very interest rate sensitive, how are they performing in these conditions?

KEVIN MAHN: They're actually performing quite well, and I'm going to compare and contrast two of our UIT strategies that are more focused on income. First of course the one that invests in publicly traded BDCs that are selected by Closed-End Fund Advisors, the second one is our Tax-Free Income Trust, which invests in a portfolio of leveraged municipal closed-end funds. Given the outlook of the Federal Reserve right now, and I'm relying upon the dot plot chart that they've released in their meeting in September, which will be updated in a couple weeks' time after their meeting in December, but according at least to that last dot plot chart, they're forecasting interest rates to be cut over the course of the next two plus years until they hit a neutral rate of around 2.9%. If in fact that's the case, Chuck, and interest rates do move lower, particularly on the short end of the curve, and gradually on the longer end of the curve, investors are going to turn and look for other income alternatives since they can't find the 5-5.25% in the short-term CDs anymore. BDCs are one such area that provides a high level of current income potential, and then I think about those leveraged municipal closed-end funds, guess what happens to that leverage as short-term interest rates decline? Well, the cost of the leverage goes down as well, and that cost savings translates into enhanced yield for the holders of those leveraged municipal closed-end funds, and they also pay a high level of current income potential that's even more advantageous for people in higher tax brackets. So it's those type of strategies, Chuck, that I believe that investors will turn to more and more over the next two years, if in fact the Fed holds true to their forecast and interest rates move lower over the next two years.

CHUCK JAFFE: And a quick follow-up on that, if we wind up seeing leverage costs come down, is that its own form of de-risking those investments to one extent? I mean, obviously if you've got less leverage and you're looking at the same portfolio, did we just take some risk off even in an environment that you might consider a risk-on environment for the investment?

KEVIN MAHN: Yeah, you've taken some risk off, you've taken some cost off, and you've enhanced the yield, that's a pretty powerful trifecta. And I would just remind everybody, so in the case of leveraged municipal closed-end funds, they had their worst year in the last 25 years in 2022, that shouldn't be surprising because the Fed was raising short-term interest rates dramatically over a short period of time. That hurts leveraged closed-end funds, particularly by adding more risk. But that is now behind us now, and as we're entering an environment where short-term interest rates are coming down, that de-risking is starting to take place, you're seeing investors return to these closed-end funds now and the discounts shrink. So it's not only just for income potential, but now we're seeing total return potential given that outlook over the next two years.

CHUCK JAFFE: Kevin, great stuff. I really appreciate you coming onto The NAVigator and talking about it. We'll talk to you again soon, I hope.

KEVIN MAHN: My pleasure, Chuck. Appreciate you having me on.

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 it would be great if you would check out my hour-long weekday show on your favorite podcast app or by visiting MoneyLifeShow.com. To learn more about interval funds, closed-end funds, business-development companies, and yes, UITs even, go to AICAlliance.org, that's the website for the Active Investment Company Alliance, on Facebook @AICAlliance. Thanks to my guest Kevin Mahn, the president and chief investment officer at Hennion & Walsh Asset Management, learn more about the firm at HennionAndWalsh.com, and more about their SmartTrust Unit Investment Trust offerings at SmartTrustUIT.com. Kevin is on X @KMahnHW, the firm is @HennionAndWalsh. The NAVigator podcast is new every Friday, subscribe or follow along on your favorite podcast app to make sure you don't miss an episode. We'll be back next week, and until then, happy investing, everybody.

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