2025 Outlook: John Cole Scott On The Year Ahead For Closed-End Funds

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Chuck Jaffe, in this episode of The NAVigator podcast interviews John Cole Scott, President of Closed-End Fund Advisors. John doesn't have a crystal ball, but he does have a mountain of data, and he digs through it to look at the stories he anticipates to be central to the closed-end fund landscape in the new year. Beyond looking at the big stories, John identifies five investments poised for breakout performances in the next 12 months.

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

CHUCK JAFFE: We're looking at the 2025 outlook for closed-end funds and giving you some funds to consider in the new year with John Cole Scott of Closed-End Fund Advisors, 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, a unique industry organization representing all facets of the closed-end fund industry from users and investors to creators and fund sponsors. If you're looking for excellence beyond indexing, The NAVigator's going to point you in the right direction. And joining me today to point us into 2025, it's John Cole Scott, he's president at Closed-End Fund Advisors in Richmond, Virginia, which is online at CEFAdvisors.com. This week and next we're going to be digging into the firm's research, which you can do for yourself at CEFData.com, but we're doing it in a unique way because most year-end retrospectives start with the year that was, but we're holding that off until next week when 2024 is actually complete and John can talk in terms of final statistics. That means that it's forecast time from John for the year ahead, and John is well positioned to make forecasts because beyond the data, well, he's the chairman of the Active Investment Company Alliance, which you can learn about at AICAlliance.org. John Cole Scott, happy holidays, welcome back to The NAVigator.

JOHN COLE SCOTT: It's always great covering funds with you, Chuck.

CHUCK JAFFE: Let's dig into your look ahead for the new year, because 2024 was an interesting year, we're going to hold off on a lot of the specifics until next year but it sets us up for interesting times, and as everybody knows when you live in interesting times it is at least as much of a curse as it is a blessing.

JOHN COLE SCOTT: It is. We always at the start are thinking for next year for positioning our client portfolios and the work we do for consulting clients with where we think things are likely to end up, and so we feel from our research that there's no significant risk of a recession, we do feel like inflation, as many people seem to agree, might be stickier, we wouldn't be surprised a year from now to have a 3-3.5% handle on the current inflation trends, and the current 10-year is about 4.6% and change, and we feel that the yield curve will get a little bit of steepness by the end of '25 in our modeling for a 5.25-5.5% 10-year going forward. If you think about the landscape, one of the biggest stories the last couple of years have been the non-listed closed-end fund and BDC universe, I'll cover that briefly. Really offering for many people a retail access, $2,500 to $5,000 overweight to non-private credit, private equity, venture capital, and those funds, we're not looking at interval funds, about 109 funds, we're modeling towards about 120 and assets growing from $105 billion to $120. Tender-offer funds usually more likely to be venture equity and private capital, sometimes accredited qualification required, but 120 funds going to 130, and the $82 billion modeling towards about $95 billion for investors next year. And then the non-exchange BDCs, so these are the private non–traded is 103 as of today, and we're modeling about a net seven new ones and the assets going from about $244 billion up to $280, that's sector really has performed well with some high-quality managers coming to market and plenty of new filings coming to date.

CHUCK JAFFE: That helps us get the best set up in terms of what we expect to happen from an industry standpoint and a growth standpoint, but what about a performance standpoint?

JOHN COLE SCOTT: We've been so far to date right in the last three years, our fourth year doing this, we do believe a diversified closed-end fund portfolio, as you measure with our 15-sector equal weight index will again beat the S&P 500 equal-weight index, and we do believe that'll be driven more this year than previous years by fixed-income net asset value performance, and we think some of the active management around the non-core large cap growth and maybe some extra upside in the globally focused funds or the value-focused funds. When we think about discounts, that's a big part for closed-end funds, so the current index, we think it's going to actually widen in the year but we think that's still going to be a positive experience. So right now we're looking for 2-4% widening just based on the bumpiness of the future, and we think it'll be closer to the 25-year average of around a 3-4% discount for the index versus the 50 basis point premium average for the index as of today at the end of 2024.

CHUCK JAFFE: Obviously we're just getting to 2025, what do you think about the start of the year? Are we going to have a January effect in closed-end funds?

JOHN COLE SCOTT: Historically almost every year you have it. We do believe that with the way the market is set up, that it's going to be basically for the broad based universe, muted plus or minus 50 basis points, so effectively no effect, but have seen two areas that are in some ways very disconnected but also very interesting. Munis have had a bit of a pullback from a market price perspective from high points this year, we do expect them to have some tax-loss selling pressure and a moderate bounce in January. And what's interesting, the BDC sector is very nonhomogeneous, we're looking at both a year-to-date and a six-month price return for the sector, and about a third of the industry, the liquid funds are down over 5% on a price base, so we think there's a good chance there'll be a slight pop in BDCs the first month of the year, because again there's opportunities for selling into the year-end and then a recovery in January.

CHUCK JAFFE: One of the things that closed-end fund investors are most concerned with are their distributions, what's going to happen to distribution levels in 2025?

JOHN COLE SCOTT: So as you know, we cover these deeply in our research and our history at the firm from a fundamental basis, but we do feel the overall trend in 2025 will be stable, but that really comes from two factors. We think that the credit funds with some cushion will basically be keeping that cushion for problems, either credit losses or bumpiness, and we also realize that most funds concerned about the risk of activism are going to be very careful to do cuts where you may have seen three to five years ago in a market like we expect in '25, but we're likely to have relatively higher yields. As long as you're still moderate discounts, those are democratized tenders and not terrible for investors, and so we do think that the average leverage adjusted NAV yield for our index, which currently is about 8.5%, and the current forward looking yield for the index is about 10.2%, we expect a year from now to be about 25 basis points off that 10% indicated yield and that the leverage adjusted NAV yield comes down to eight and lower change than the eight and mid-change.

CHUCK JAFFE: What is the outlook for activism in the new year?

JOHN COLE SCOTT: As you know, as you moderated our panel in November at the conference, it was a pretty active year, we do feel that '25 will be a more muted year for a couple of reasons. Right now there's no recent IPOs, there's more focus on secondary market support, there's this pending uncertainty about the New York Stock Exchange annual meeting proposal which can affect these funds long term but more affect them all immediately, and then Saba is getting more active in the London market and discounts are relatively narrow, so just it feels like there's not as many fat pitches for activism to be easy to pitch to the underlying investors in those strategies to make successful and above average performance after fees in 2025. There's three closed-end funds managed by activists, two are run by Saba, the Saba funds, BRW, Saba or SABA, are about eight and change discounts, they have very different year-to-date total returns on the manager basis, BRW's 14, SABA's 23%, and different benchmarking, the peer group for the taxable bond fund is about a 1% discount and about a 10% net asset value performance this year. And then Bulldog has an older fund, SPE, more of a fund of closed-end funds, it's an 11% discount, had a really good performance this year at 29%, and the closest non-activist peer is FLF from Cohen & Steers, it's actually at a 4% premium and a lower performance, so very positive this year, about 23% total return on a NAV basis. It's always interesting to see these activism funds in the market, how they're performing, generally wider discounts but not terrible performance for investors.

CHUCK JAFFE: Well, now let's move from a lot of the nuts and bolts stuff to the stuff that people want to know a little bit more in terms of what are you looking for for the new year? And let's start with just a general take, are there specific moves, before we get into which sectors or areas that you want, that might make sense for an investor to consider this year?

JOHN COLE SCOTT: As you know, we're a rather granular hands-on firm, we're active in our portfolio modeling and tax-loss selling, we're really good for taxable accounts, we look at the dividend classification of every position from the previous 12 months to estimate a tax [inaudible 0:09:06] for clients. You can do a light version of it yourself just by sector or looking at the 19(a) notices throughout the year, and definitely handling your taxable account differently than your tax deferred. It's hard to believe that we'll have another year where there'll be three or four opportunities to do tax-loss harvesting like we had the last three calendar years, but it does feel like every year that's not light and boring with no push and pull in the market, we think there's going to be push and pulls next year, we can't tell you what or when, but we're very active, and so we think investors with a higher tax bracket should definitely be rotating or selling the same manager or the same sector at a loss to then harvest that loss to offset the gain previously or bank losses for next year, a really important thing to do. And then there's terrible discounts that we've covered on this podcast before, but all else equal, when you can't do the analysis, just lean to the deeper discounts, because in most cases over time discounts beat premiums eight times out of 10 in our experience.

CHUCK JAFFE: Now let's go into what areas of the market you expect are going to be performing particularly well and you want to lean into this year, and maybe what you want to lean away from.

JOHN COLE SCOTT: So at a high level we do like to diversify our choices because we know we're not omnipotent and don't have a crystal ball, but we always keep looking for one on eBay around the holiday season, but we do lean into global equity for the diversification outside the US large cap growth, covered-call funds which offer equity exposure with generally less beta and some tax optimization. We do think that munis, which had a relatively good year considering the last year will have a better 2025, and we really like some of the funds inside the hybrid balance category, which are very different but they blend equity and fixed-income exposure, some with leverage, some without, in a really unique way, so we think are very useful for income investors. And we really are trying to reduce our exposure to convertible bonds, senior loans, which have done tremendously well but we feel are overpriced by the market, and generally US equity, and we're really thoughtful on BDCs because they're not really expensive or cheap and they're so nonhomogeneous, which we talk about all the time, and you really have to dig in a lot more than just discount and yield and the brand name and the manager to really understand the portfolio's composition and how they build their expense ratio and how their team considers risk in the mix of what's going on. And we really feel that BDCs, they did okay this year, they're still 11% lower than their premium highs back in June of '21, so we feel there's a good chance with the right mix of BDCs to be well positioned for '25, but it's not simply just buy the deepest discount or the highest yield or the fund you've always held.

CHUCK JAFFE: Now let's get down to the brass tacks that maybe everybody's been waiting for this entire time, let's talk about a fund or two that look great to you going forward.

JOHN COLE SCOTT: We always try to blend three things we talk about regularly on the podcast, manager NAV analysis with the sector component being them wanting to be in areas and overweight. Dividend analysis, which is a little bit different than two, three years ago, we want to make sure the discount's there if it's overpayment. But the discount analysis, which is not just the absolute discount, we do comparable, relative, and event-driven discount analysis, and we really are looking forward to these five funds we're going to talk about today are not an entire portfolio. This is not investment advice but there are some picks that we think really show what we do for clients and where we put our money for the benefit going forward, and so we'd love to cover. The first one will be an equity fund, we've actually covered it this fall, EOD, it's the Allspring Global Dividend Fund, it's still a 12 and change discount, the yield's 9.8%, but its blend of discount and leverage gives you a really easy return profile for that. As we discussed previously, it's got a nice mix of a little bit of debt exposure, very low exposure to the S&P 500, it has a great performance on a one-year basis, about 22% one-year NAV total return, and we think it's a great opportunity to get global dividend exposure at a very attractive discount, about four points wider than the three-year average.

CHUCK JAFFE: So again, EOD, the ticker symbol there, that is a fund that you have liked for some time. What else is spinning your fan for 2025?

JOHN COLE SCOTT: Well, we talked about it lightly, but Saba really is, we think well positioned, the activist fund that took over, SABA is the ticker symbol, the yield is 7.7%, and so it's really not aggressively high, it only takes about five and mid-change to fuel that, and it's a diversified tactical approach to different positions and we feel like they've actually had good performance. The one-year performance I mentioned earlier is about 23% one-year

NAV. It's hard to find a credit, a fixed-income focused discount in this universe, it's a newer version of a fund and it often you'll get credit for that in the market.

CHUCK JAFFE: Saba is ticker SABA, the second of your funds for 2025. What's next?

JOHN COLE SCOTT: The Nuveen Muni Credit Opportunity Fund, it's NMCO, it's almost a 10% discount, which is about four points wider than its three-year average. The yield's a little bit aggressive at 7.8%, we've talked about it regularly for muni funds to defend activism, but we like the composition of the management of the portfolio, they're going after really tactical and opportunistic components of the market and just not a plain vanilla exposure to long dated duration munis, and so it's a great tax-free and maybe some tax-deferred income components, the duration is high but we're comfortable with that where we think interest rates will be. The duration's 15, but it's a great place to get a relatively wide discount with a very good active management and an above average yield that you should re-investment maybe 10% of, but definitely enjoy that tax-free, tax-deferred income. The last closed-end fund we'll cover is TBLD, it's the Thornburg Income Builder Fund, it's about 11 and change discounts, it's a 7.6% indicated yield, no leverage, and it basically is a nice diversified approach to the firm's exposure to both equities and bonds in a way that you can think about lower beta and good exposure. The beta's only half the beta of the S&P 500, we think it's a great place to have a discount tailwind and a diversified income stream to help you out.

CHUCK JAFFE: So again, NMCO then TBLD, and you said we're out of closed-end funds, but you also said that you're leaning into BDCs for the new year, so there's gotta be a BDC in here for us to talk about, right?

JOHN COLE SCOTT: There is. We're talking about the Goldman Sachs BDC, GSBD, it's a had a little bit tough of a year, but we love the idea of a quality manager that's bruised not broken. So it's sporting about a 5% discount, which is 10% wider than its three year average, it's currently about a $3.5 billion fund, it trades over $10 million a day. Thinking about the expense ratio, it's very reasonable, about 1.4 gross non-leverage expense ratio, its underlying holdings have an average yield of the investments it makes of 13.3%, it's showing 124% dividend coverage. Based on our models and our research we've digested at CEF Advisors, about 20% long-term target price from where it sits today at the end of the year, which is about 10% higher than the average BDC, which we're optimistic on. And it's ROE is a little lighter recently, which is important, but we feel that the market's overreacted to that, its nonaccruals are only slightly above the peer group average, and it's 96% first-lien loans and 56% fixed leverage, and right now we're a big fan of overweighting fixed leverage because we believe it's going to be cheaper long term for investors to be there. We think it's a great spot to be as our pick for '25 for a manager that can get through the bumps and bruises, but the market's given it a ding at the end of '24 to set it up for hopefully an above average '25.

CHUCK JAFFE: We certainly hope that an above average 2025 is in the cards. We will check in with you regularly, and we'll get a good measurement on 2024 when we talk with you next week. But John, Happy New Year, Happy Holidays, we will talk to you again when The NAVigator reconvenes in 2025.

JOHN COLE SCOTT: Look forward to it. Thanks so much, Chuck.

CHUCK JAFFE: The NAVigator is a joint production of the Active Investment Company Alliance and Money Life with Chuck Jaffe. And yep, that's me, and you can learn more about me and my show by going to MoneyLifeShow.com. You can find us on your favorite podcast app too. To learn more about closed-end funds, business-development companies, and interval funds go to AICAlliance.org, it's the website for the Active Investment Company Alliance. Thanks to my guest John Cole Scott, he's president of Closed-End Fund Advisors in Richmond, Virginia, and he's the chairman of the Active Investment Company Alliance. His firm is online at CEFAdvisors.com and you can dig into their research at CEFData.com, and John's on Twitter @JohnColeScott. The NAVigator podcast is available every Friday, and we'll be back with John again next Friday for the year in review, make sure you don't miss an episode by following along on your favorite podcast app. Have a great New Year's celebration, we'll see you next week, and until then, happy investing.

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