CEF Advisors' Scott on Discounts, Wildfires, Benchmarks and more

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Chuck Jaffe, in this episode of The NAVigator podcast interviews John Cole Scott, chief investment officer at Closed-End Fund Advisors, the chairman of the Active Investment Company Alliance. John Cole Scott brings his data and portfolio-management methods back to The NAVigator to answer questions from listeners, covering concerns for California municipal bond funds in the wake of recent wildfires, how a steepening yield curve will impact discount levels, why investors shouldn't worry if closed-end funds don't appear to be keeping up with the stock market, and how historical levels of returns for closed-end funds compare to traditional mutual funds and other alternatives.

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

CHUCK JAFFE: You've got questions, we've got answers from John Cole Scott from Closed-End Fund Advisors, welcome to a closed-end fund Q&A 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. If you're looking for excellence beyond indexing, The NAVigator will point you in the right direction. Joining me again today, John Cole Scott, president at Closed-End Fund Advisors in Richmond, Virginia, which is online at CEFAdvisors.com, and the firm also makes its data and closed-end fund

research available for you as well, you can dig into it for yourself at CEFData.com. Beyond his own firm, John is chairman of the Active Investment Company Alliance, and if you want to learn more about closed-end funds and also what's happening throughout the closed-end fund industry, check it out at AICAlliance.org. John Cole Scott, let's get busy.

JOHN COLE SCOTT: Always great to be here, Chuck.

CHUCK JAFFE: We're digging into some questions that have come in for The NAVigator, and before we start, I should remind everyone that, hey, if you've got questions, submit them to TheNAVigator@AICAlliance.org. John, we've got these questions, some are direct from our audience, some are kind of aggregated where a couple of people came in on the same kind of subject, and we're going to do a few Q&A sessions. But today, well, we're going to start with something that is the most current of events that has closed-end fund investors wondering. So we're heading out to California because we got a question from a listener who said, "Should I be concerned for California muni bonds because of the recent wildfires? Are we seeing a widening of discounts, et cetera, and is there a price to be paid that's going to show up in California muni bond closed-end funds?"

JOHN COLE SCOTT: Yeah, great, happy to dive into that. So at a high level we always believe that there's some risk management for a portfolio, like should you be 100% in California muni bond funds? Probably not even as a California resident in the worst tax structure. So here we like a couple of things, one is the fixed capital structure of closed-end funds where the managers are never forced to sell if there is fear in a sector, we also like the active management and the deep bench of analysts across the closed-end fund managers that focus on the California market both in the national funds and the state-specific funds. And it reminds me a little bit about the previous experience with the Puerto Rico exposure and the Detroit exposure, that there's going to be better outcomes and worse, and if you're in a passive basket versus an active, it could be a worse outcome. Going into discounts, they're in the 12-13% recently for the California group, that is wider than the average national, even the average state fund, and so it feels like that risk has been overpriced in the market, and so we offered to investors, we've bought California funds recently for people in New York state because we thought the discount is attractive, it's a nice satellite component to the portfolio. So at the highest level, we think you'll be well suited if you stay diversified, you up that exposure if you're in the state, or even if you're not, and you look for movements in discounts

and updates over time. And remember, don't bet the farm, bet above weight versus market weight or underweight.

CHUCK JAFFE: Well, now we'll move from the wildfires to a very different kind of story, which is as we've seen the yield curve disinvert, we've also seen the yield curve get a little more steep. So the question, what should happen to closed-end fund discounts as the yield curve steepens, and how likely is it that as a result my closed-end fund will ever close its discount?

JOHN COLE SCOTT: The steepening yield curve is a tailwind for the structure, it's where leverage is additive, versus a couple of years ago we were talking about it being a headwind to investors, and managing the distribution in notional terms, to keep it higher but also the challenges with having this gross notional leverage, and so a benign environment is a yield curve that is steep for closed-end funds that tend to borrow short, invest long. The general leverage-adjusted duration for many of these funds is over 10%, easy to find 11% to 14% currently in the market, and if you're thinking about the discount narrowing, we've always thought about, it's not just the amount of change, it's the rate of change. So as things happen slowly, more like a dripping of the ocean versus gushing of the ocean, will be less waves formed in the ocean. And so we'd say that discounts, while muni funds and taxable bond funds are trading differently right now, both have periods of time they tend to trade at or around net asset value, and we feel that it's the dividend story of being sustained by more leverage will be positive. However, these are all different funds in different sectors, there could be market events, whether it's global, political, you name it, and so that goes back to being thoughtful about what's available. Discounts should narrow in the wider funds now, and it will be a great use of the structure to have the yield curve stay where it is, steepening over time.

CHUCK JAFFE: A question that we hear in various forms I think fairly often, why have closed-end funds underperformed the Standard & Poor's 500 for the past five years?

JOHN COLE SCOTT: Well, for those that attend my hour-long quarterly session probably have heard me talk about this for almost every session since 2012 when we started them. At a high level a closed-end fund portfolio is not the S&P 500, it's not even US stocks, it's a blend of US stocks, global stocks, US bonds, global bonds. We did go into our index that covers US equity funds and the 10-year return is basically in line with the equal-weight S&P 500 Index. You'll remember when we cover our thinking about closed-end funds, we tend to focus on

the equal-weight index because there are very few funds you can even shop from in the cabinet to add to your portfolio that are techy and mimic the S&P, probably 15 funds out of 450 funds in my universe that even could mimic the S&P 500. And we believe if your goal is durable, diversified distributions, many of our clients are taking 2% a quarter on a portfolio that's yielding 10%, the fee's 1%, they reinvest 1%, that's nothing like the S&P 500 from an experience perspective. I know you've talked about [inaudible 0:06:39] return risk recently and over time, and one of the things we love with closed-end fund portfolios is if you build a portfolio that's diversified, paying more yield than you need and you're reinvesting something, you're never forced to sell a share because you need to pay a bill, and you're always adding the share count slowly over time, helps reduce that risk in my opinion. We actually report to our clients the amount of their portfolio that's even in the S&P 500 is typically 10-20%, maybe 30% in the most equity-focused models, you should not be doing that, it's not the right measurement stick. I sit on a couple of endowment boards, you don't benchmark a diversified portfolio to SPY.

CHUCK JAFFE: It's an apples to oranges comparison. Remember that the S&P 500, dominated right now by the Magnificent 7, not the other 493, and a closed-end fund may not even be trying to look in that universe, so it's a hard comparison to make.

JOHN COLE SCOTT: And actually one thing, before the Great Recession, we had active clients who beat the S&P 500 for the 15 years prior in a globally diversified portfolio, just not since.

CHUCK JAFFE: Let's now make a different comparison, which is the historical net returns on closed-end funds compared to mutual funds and other alternatives. Because there's a basic question for investors when they start to educate themselves about closed-end funds, they love the discount aspect, they love being able to bargain shop, but they functionally want to know, are closed-end funds better?

JOHN COLE SCOTT: And so here there's never one answer, but the way we can think about it is a couple of things. If your goal is to get $100,000 of senior loan exposure, you could buy $100,000 of an ETF or open-ended fund, or you can by like $80,000 of a closed-end fund. So there is discounts and leverage, maybe even $70,000, depends on discounts and leverage, so you have to normalize what you're getting access to. We also, as we've discussed previously, we use gross non-leverage expense ratio, it's all the operating costs to administer the fund, not just the management fee, we deal with leverage separately in our analysis, leverage is

usually a beneficial tailwind and we don't feel it's appropriate. And when taxable bond funds or muni funds leverage at 30-40%, BDCs can be 40-50%, occasionally above that, you really are not doing apples to apples. So the goal would be, with a closed-end fund or a BDC, did you buy it at an attractive price or an unattractive price? The fees are relatively comparable or benign in our experience, it's all-weather did you buy a 10% premium or a tight discount? What month did you buy it? Your returns are the NAV return plus distribution, plus a discount narrowing or widening, and the biggest difference in all of those fund structures versus closed-end funds is you can have a disconnected market price to NAV. And so if you get a relatively wider discount, there's more tailwinds to outperformance, if you get a relatively narrow or premium, there's more headwinds to your performance, and that's for a basket of funds over time. But also as you know, closed-end funds have that stable structure to reduce selling in a panic, think the tech bubble, Great Recession, Covid, they love to buy the loans or the illiquid stocks from the open-end fund managers when the redemptions are at all-time highs, but you've got to be careful, you are going to have downside volatility in a market event with a closed-end fund, the risk is just don't sell when they underperform because they usually outperform next.

CHUCK JAFFE: John, great stuff. We're going to make some Q&As a little bit more, I won't say a staple, but an occasional thing that we do here on The NAVigator. So again, I want to encourage folks, if you've got questions please send them to TheNAVigator@AICAlliance.org, and we will see you again with more questions and more information that we want to get from you on the closed-end fund industry soon. Thanks for joining me on The NAVigator.

JOHN COLE SCOTT: Always 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 you can learn all about my hour-long weekday podcast by going to MoneyLifeShow.com or by searching for it wherever you find great podcasts. To learn more about closed-end funds and business-development companies generally go to AICAlliance.org, it's the website for the Active Investment Company Alliance, and if you have questions about closed-end funds or the industry, send 'em to TheNAVigator@AICAlliance.org. Thanks to my guest John Cole Scott, president of Closed-End Fund Advisors in Richmond, Virginia, the chairman of the Active Investment Company Alliance. They're online at CEFAdvisors.com, and the firm's data which you can dig

into for yourself is at CEFData.com. The NAVigator podcast is here for you every Friday, make sure you don't miss any of our episodes by following or subscribing on your favorite podcast app. We'll be back next week with more closed-end fund talk, until then, happy investing, everybody.

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