John Cole Scott On Well-Managed Portfolios

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In this interview with Jane King, John Cole Scott, President and CIO of CEF Advisors, explains how a well-managed portfolio should contain a mix of high-yielding closed-end funds (CEFs) and business-development companies (BDCs) to help generate income for clients. Scott says those funds have been yielding between 7% and 14%, outperforming stocks and bonds. That can be helpful for retirees looking to avoid return risk, Scott says. Scott also speaks to the tax-planning benefits of CEFs and BDCs, many of which often enjoy "pass-through" tax treatment, and municipal bond fund CEFs are federally tax-free, he adds. Scott also explains how these funds can offer diversification benefits and operate as a potential hedge against inflation. With an eye to monitoring market conditions, Scott says his firm actively manages portfolios containing CEFs and BDCs and makes changes as appropriate.

Learn more about John Cole Scott https://cefadvisors.com/CEFATeam.html, CEF Advisors https://cefadvisors.com, and the Hybrid (High) Income www.cefadvisors.com/hybridincome

JANE KING: John Cole Scott is president and CIO of Closed-End Fund Advisors, a second-generation 25-year industry veteran specializing in closed-end funds, BDCs, and interval funds. As an investment manager, database provider, and founder of the Active Investment Company Alliance, he offers a unique and multi-faceted perspectives. John, great to have you here. I know you suggest that a well-managed portfolio has a mix of closed-end funds, BDCs, it's an excellent way for people to have income with their investments, so can you explain a little bit further about that?

JOHN COLE SCOTT: Absolutely. So high yielding closed-end funds and BDCs currently yield between about 7-14%, far exceeding the traditional exposure to dividend stocks and traditional bonds, and we find that a lot of retirees can really rely on these cashflows to avoid the sequence of return risk. It's risky when you decide when you retire and what could happen next, because instead of selling down your assets during those traumatic periods, you're basically using the cash in the portfolio to pay your retirement, not being a forced seller at any given time.

JANE KING: Yeah, so explain a little bit the diversification and the management of the closed-end funds and the BDCs. Explain what a BDC is.

JOHN COLE SCOTT: Well, a BDC is a business-development company, it's a closed-ended management company under the 40 Act, really a hybrid, has earnings season, venture lending, great dividend component to a retirement portfolio. But we say basically in today's choppy markets, these funds are professionally managed, they're not passive ETFs, and so you really get access to that through the problems and the opportunities in the market, and we really find that an active portfolio usually can outperform a passive. And really owning, at our firm, 8-12% of our universe of funds in a portfolio that's traditionally 30 to 50 total positions is a really powerful way to use our CEF Data business to really screen for funds and report on funds actively.

JANE KING: Yeah.

JOHN COLE SCOTT: We also really like to use our trifecta analysis at CEF Advisors, that's basically balancing discount risk or analysis with dividend risk or analysis, and then of course we have to analyze the manager and the sector.

JANE KING: Yeah. Now what sectors are available in closed-end funds and BDCs? If somebody wants to focus on that and have a goal of high cash flows?

JOHN COLE SCOTT: Yeah, so there's a lot of sectors that really are great for this inflationary environment we've been in. You've got of course regular covered call fund with option premium, you've got senior loans, you've got private credit through BDCs, you got REIT exposure, real assets, infrastructure, dividend stocks, and of course all the regular bonds and fixed income areas of the market, and really it gives you that chance to be able to diversify a portfolio than just getting all of your income from one source.

JANE KING: Yeah. What about the tax advantage to these? Is there anything more than an equity portfolio?

JOHN COLE SCOTT: Absolutely. So at a basic level, these are pass-through tax advantaged entities and then a lot of the investments are not just ordinary dividends, of course a piece of what can happen. You've got return of capital, often durable in our analysis, you've got qualified dividends, you've got long-term capital gains, of course if you use muni bonds, those are federally tax free. And again remember, most of these funds are levered, and so they're typically able to give higher yield without only having to buy the highest yielding securities at the holding level for the portfolio.

JANE KING: And inflation, of course you've been dealing with that, now going into year three or four, do the closed-end funds and BDCs offer some kind of hedge against that or mitigate that risk?

JOHN COLE SCOTT: So some funds and sectors do, some don't, and so we do lean into that based on our opinion for the economic outlook, for interest rates, for a possible or probable recession, which is always our best guess, Jane. And we really find that ahead of that with the discounts of closed-end funds, you're able to look to sell narrow discounts and buy wide, and that's a little bit of a tailwind which helps take any of the hiccups of a headwind that we don't expect.

JANE KING: Yeah. What kind of experience has your firm delivered? How are you positioned for long-term success for clients?

JOHN COLE SCOTT: It's a great question. I've been at the firm, you said 25 years, my longest income client gave me his portfolio in 2009, he basically has invested around $980,000, over the time period we've paid him basically over $80,000 a year. We basically, on a performance measure, have been roughly 3% over a passive basket of closed-end funds and BDCs, that's our 15-sector index, and we've really felt like that's a great way to give him what's worked out to roughly over 8% annual cash on what he invested. The portfolio, we paid him over a million dollars, the portfolio is worth over a million dollars as of this recording.

JANE KING: Wow.

JOHN COLE SCOTT: We've had very good success, though the future is never guaranteed and we cannot predict that all investments will do well.

JANE KING: For sure, but I'm just thinking, what a nice way to retire, knowing that you're going to be having that cash coming in and you've still got a nest egg there. What measures do you take to ensure that this approach works well, say over a 15-year time period?

JOHN COLE SCOTT: Yeah, so there's the last 15 years, but there's always the next 15 years, right, Jane? And so what we've done for our viewers is we've shortcut CEFAdvisors.com/HybridIncome, that's our most popular model, and you can really look at the current allocation, it's yielding almost 12%, roughly 20% over that 15-sector index. Right now we'd argue that a payout yield after fees is about 9% if you want a stable payout, versus 7.5% if you want your increases with CPI inflation over time, that's a really powerful way to build this portfolio. And so this portfolio is 35 closed-end funds and BDCs across 15 sectors, the smallest allocation is to BDCs at 1.5%, the largest is to closed-end funds at 4%. It's got 35% equity exposure with a usual historical swing of 35-65% equity exposure at this model portfolio, and really only 17% of this equity is in the S&P 500, and we just calculated it for this recording, Jane, only 2% in the Mag Seven, so do not expect this to act like those stocks that are really driving the headlines today. Digging in deeper, the portfolio is just over 30% weighted leverage. Thinking about expenses, the average gross non-leverage expense ratio is just over 1.2%, so again, really meaningful, really easy for an active portfolio, very useful. And then discounts, always important in our world, about almost an 8% discount, almost 10% wider than that 15-sector index, and 7% wider than a peer group average. Yet people always wonder, are closed-end fund discounts wide because the funds are bad? We look at the average net asset value performance of the past year, and our basket in this portfolio is trending right in line with their peer group, so it's not just worst investments with a cheap discount.

JANE KING: Yeah, and so what does this mean in terms of money for somebody? Like I mentioned, retirement, what can they expect from something like this?

JOHN COLE SCOTT: Imagine you put $2.5 million into this portfolio style, we'd say you could take about $18,700 monthly if you take that fixed rate, or $15,700 if you want the inflation increases over time, both very possible, and then we look at a marginal tax rate of 20%, really 87% tax efficient, under $39,000 expected in annual taxes, really giving you a high dividend portfolio. But remember, this is not a passive portfolio, we do change it actively over time based on market conditions.

JANE KING: Yeah. Well, thank you so much for explaining this, John. It sounds like a nice place to have some cash and you can rest a little easier.

JOHN COLE SCOTT: We do our best at the firm, and thank you for the time.

JANE KING: Thank you.

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