NYSE, Nasdaq, and Arbor Land Advisors panelists speak during AICA Boot Camp and Round Table.

Wednesday, November 6, 2019

Andy Hall from NASDAQ, Jamie Patturelli from the New York Stock Exchange, and Jerry Raio from Arbor Lane Advisors were panelists at the AICA Boot Camp and Round Table held on November 6th in New York City. The moderator of the panel was Amy Charles, managing director of closed-end fund and ETF research for Raymond James. Read the transcript from the discussion below to hear the insight from the panelists.

Amy Charles

Andy Hall

Jerry Raio

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Note: AICA had to remove Jamie Patturelli from the video for compliance purposes. We apologize for the lost content.

Amy Charles: Welcome, it's always hard to be the first panel of a first conference, so we'll try not to put anybody asleep. But if we do that's because you don't have enough coffee. I'm Amy Charles, I'm the managing director of closed-end fund and ETF research for Raymond James. I have been in closed-ends doing this since you've been an a Capella, so for twenty-four years. So I've kind of seen the good, the bad, the ugly of closed-end funds the whole time at Raymond James, so I'm blessed to have a great firm to represent. And I'm going to let each one of our panelists, I'll start with you, to do a through and kind of give you their bios.

Andy Hall: My name is Andy Hall, I work on the New Listings team at NASDAQ. I've been with NASDAQ since 2004. I've been on the new Listings Team since 2007. I work with companies primarily that are seasoned, companies that are on a competing market NYSE, NYSE American, or the TSX, or the ASX, or companies quoted on the over-the-counter. And encourage them to list on NASDAQ. Also have interacted with the IPOs as well. So have seen quite a bit through that time period, and the trends that are related to it. Thanks.

Jerry Raio: Good morning, my name is Jerry Raio. I am the Founder and President of Arbor Lane Advisors, which I started about a year ago after a career on Wall Street in capital markets of about twenty-five plus years. My firm is focused on helping financial service firms navigate product development, product strategy, and marketing and distribution in the 40-Act space, predominantly in the closed-end funds space. And previous to this, I ran closed-end funds for Wells Fargo for thirteen years, so seen the ebbs and flows in the closed-end fund market. I'm also a board member of the River North Asset Management closed-end fund board. So thanks for having us today.

Amy Charles: Since you're new to the new listings at NASDAQ, what new listings have you seen in the BDC and the closed-end fund marketplace? And are you seeing any trends? Historical? Those type of things.

Andy Hall: Recently there haven't been too many BDCs listing. we've had about one a year, and then a handful of closed-end funds. It was more robust obviously from 2002 to 2013 with the lower interest rates. You had interest rates at the Fed fund's rate at 6% in 2000, and then that quickly in 2001, they dropped it all the way down to 1.75%, where we are today. And then from that point in time, we really started to see closed-end funds list. And in 2001 there were thirteen, so that was during that rachet down recessionary period. And then in 2002, there were thirty-six. 2003, thirty-eight, 2004, thirty-two, and twenty-four, and on downwards. So you really had that increase because of the lower rates. And as my panelists will indicate, because they're able to lever up. So as interest rates increase, I guess you see less come into market. Now at 1.75%, it's kind of hitting that line were we see a little bit more come to market. So I guess from the closed-end funds standpoint, that might help the new listings. From the BDC standpoint, we've only had one for '19, one for '18, one for '17, one for '16, one for '15. So as you look at that versus the IPO market, we've been on a very long bull market now with a lot of IPOs coming to market. You've had the VIX very, very low, so it's really kind of a Goldie Locks period in terms of new issues from the corporate common stock standpoint. Even just in 2019 year-to-date, NASDAQ's had 158 IPOs. NYSE, 47. Total proceeds raised for NASDAQ is a little bit over 29 billion. For the NYSE, 24 billion. So you're seeing that happen from an IPO standpoint. So you'd hope that that would kind of help the BDCs as well, but we're still just tracking at about one a year. And before 2014, there were a little bit more than that come into market. So that's what we've seen from a trends standpoint.

Amy Charles: And Jerry, we'll go to you. What attributes do underwriters look for in closed-end fund strategies? You mentioned the new structure, but what do you see? What do they need?

Jerry Raio: So I think in my years again, underwriting a lot of these funds, one of the things we'd look at is obviously the secondary market. To see what asset classes are either trading at a premium, or potentially trending well? In other words, they may still be trading at a discount, but the trend has been that we're seeing a tightening in the discount. And then whatever the strategy that the manager's bringing, how is that differentiated relative to what's in the market today? And what does it do for the investor that we're not seeing today? So that's two of the things that we look at. Obviously, and I think one of the changes that we've seen in the market, other than just the structure, and we could talk about that. Is the fact that the market and the participants from an underwriting standpoint, have become more amenable to looking at level distributions at the onset, versus just straight income. So before where when someone would come in, we'd say, "Okay. Well, how much is actually being generated in income off this strategy?" Which applies to fixed income funds, but doesn't work that well in equity funds. Now we're looking at, "Okay, what is a total return for the strategy? How long have you been managing it, and what's been the return that you've generated?" And then setting a distribution that's reasonable, relative to that total return. So that we're providing to investors, particularly on equity strategies, we're giving you some monthly distributions, but we're also giving you equity appreciation in it. And I think that's a big change in the market, because it opens up the universe of different strategies that we can bring to the market that are unique and differentiated. We used option strategies way back when, I think that's an area, and BlackRock just did one earlier in the year, but I think it opens the universe for new strategies. So again, for an asset manager, I think we have to look at, "Okay, what are we bringing to the market that's unique and different that meets a need for investors that's not being met today?" And it may be little tweaks in the strategy relative to what's out there today, that gives a little bit of a different risk/return profile. But I think that's really important to bring in a new fund and getting people interested in a new fund. And obviously it has to sync with what people's research is saying. And it's not today, when you're looking at a fund, you've got to look out. I told most asset managers, you've got to look out six to twelve months. Because by the time you get a strategy to the market, the market's probably changed. So you've got to have a projection, "Okay, we're going to be bringing this out. Where's the market? What do we think interest rates are going to be? What do we think the equity market's going to be? Where's the economy going to be six months from now when we're looking to bring this strategy out? And what will fit well in that environment at that time?" So I think that's some of the attributes that you'd look for.

Amy Charles: Yeah, as I look at all closed-end fund ideas for Raymond James, and those have been some of the same things I look for as well. Where are the discounts? And we'll talk about that later with the structure. But that new structure I think, is a game changer for new issues. And like Jamie said, hopefully it'll open the window pretty wide so we have some really good products launch. Andy, to that note, what is the NASDAQ doing to welcome more BDCs and closed-end fund offerings listed with you guys rather than NYSE?

Andy Hall: Sure. Yeah, from closed-end funds standpoint, the majority obviously are listed on the NYSE. I think they were just in the business longer than we are. But from an exchange standpoint, we make it welcoming from a fee standpoint for closed-end funds to list. The initial listing fee is only five thousand dollars. The minimum for a common stock corporate issuer is about a hundred and fifty thousand, so that's quite a bit of a discount there. And then once BDC and closed-end fund is listed on NASDAQ, the annual fees are about half. For example, if you had thirty million shares outstanding, the annual fee is thirty thousand versus fifty-five thousand for a common stock. And then for the closed-end fund families, or if you have more than one, we cap out at a hundred thousand. So even if you have say twenty, thirty closed-end funds or a grouping of BDCs, the most you're going to pay is a hundred thousand. And then for BDCs as a new issue, we help with investor relations services. So we provide a free set of services for two years with the listing. So you're getting a better annual fee schedule than the common stock, and then the two years of services include full stock surveillance, perception studies, global targeting, press releases, EDGAR filings, webcasting of your conference calls if you do that, log-ins to a tool called IR Insight for institutional targeting and tracking, and looking at trading in a CRM tool. So we're trying to have a lower fee schedule, and then also for those BDCs, help you with your cost as being a public company from the IR service standpoint.

Andy Hall: You know, it all sounds great. There's this DMM who is the buyer and seller of last resort, right? So they're there. You the closed-end fund or the corporate issuer, you're not paying them. The exchange is not paying them. There's no good Samaritans in the markets. They're profit motivated individuals, why would they step up and put their necks out to benefit the issuer? They're there to make money. DMM's are market makers just like anybody else, and how they make money is through volatility and wide spreads. That's how they make money. And if you look at Virtu, which is one of the ones that's public, there earnings are bad when volatility is low. And when volatility is high, that's how they make money. And then they don't even have a banking business to sell, so they could show off and say, "We've done great for you. Can you throw us a bone on your next deal?" And then the obligations that they require, it's so wide that you're not a player at all if you're not meeting those minimums. And NASDAQ and the NYSE, we both rebate if you're at the National Best Bid and Offer. So that that rebate incentivizes someone to be at the National Best Bid and Offer, and our rebate system is a little bit better. But why you have DMM's? The last public sale for a DMM was thirty million dollars when IMC bought it from Goldman in 2014. And Goldman bought it from Speer, Leeds Kellogg for seven billion in 2000. Why is the firm worth thirty million? I think it's cool. I mean, if I was IMC or Virtu or Citadel or GTS, thirty million bucks to say I'm one of the four remaining DMM specialists on the floor? That's cool. You may have never heard of me before, but look at me, my branding on the back of *The Post*. Also in a price/time priority, I get to jump the line, so if there's five thousand shares coming in and my price is at $25.25, and someone is ahead of me, I can jump the line and take half of that order. So that's a benefit to me at times as well. But this is today's world with technology, and it's competitive. And one person's not there to help you when they're not being incentivized.

Amy Charles: You good? You've got something else to say?

Amy Charles: All right. One more and then we're moving on.

Andy Hall: Well, we have the incentivization of the National Best Bid and Offer, a little bit better rebates.

Jerry Raio: So let me ask the audience a question. How many people know about the new structure in an IPO? How it's structured today versus how it historically has been structured? Okay, so in my mind this was really a game-changer. Again, having run closed-end funds for thirteen years at Wells, and before that City and Morgan, I really saw an evolution in the market. We tried to address two big concerns that investors always had in buying-in the IPO. One is that closed-end funds perpetually trade at discounts, right? So what we did is we introduced terms, so that you knew that at the end of a specific period, you would get whatever the net asset value is. So if you believed in the manager, you believed in the strategy, the asset class. At the end you could stomach the volatility, you still could trade around the NAV, but you knew you would get the NAV at the end of that term. And that helped things for a while. But the bigger issue is why buy in the IPO? Because they consistently trade down. And quite frankly we saw that over a number of years, is that every IPO that we did after the stabilization period, traded down. Because you started at twenty dollar market price, and a NAV of $19.06 once you took out the gross spread and the marketing expense. And that was the big problem. So the new structure is that the manager, the advisor pays that upfront spread. So in other words, now instead of you starting at a NAV of $19.06 getting invested in that strategy and that asset class, you start at twenty dollars. So your client pays twenty dollars, and the NAV is twenty dollars. In my mind, that's a game-changer. It puts us on par with every other vehicle, mutual funds. Now it's not to say it can't trade at a discount, however know that if you hold it for twelve years, that you will get back your NAV at the end of the twelve years. The new term that's been introduced now is what I would say is a contingent conversion. What happens is at the end of year eleven, they do a one hundred percent tender offer. So everyone can tender their shares and get the net asset value of the fund. If after that tender offer, a hundred million dollars, or two hundred, whatever they set as that level, is remaining in the fund, the fund becomes a perpetual closed-end fund. Which is very, very valuable to the asset manager. So the cost for the asset manager has gone up considerably to do an IPO, and they're taking a lot of risk. If these assets go down, the management fee they get goes down, it's a longer break-even period. But if odds are that at the end of the term, you think you're going to perform well and a lot of people are going to stay in the fund, it converts to a perpetual fund. That can become extremely valuable to the manager. So I believe now with this change in the market, again, it puts us on par. I was out on the road marketing one of the River North funds, and in my mind is that if you believe in the manager, if you believe in the strategy, and you believe in the asset class, you have optionality here. So you're going to start at twenty bucks just like you would on a mutual fund, over the period of twelve years, it's going to ebb and flow. It could trade at a premium, it could trade at a discount, but you have optionality to sell it and take whatever that price is. If you don't like where it's trading, you hold it for the twelve years and you're going to get whatever your NAV is if you tender it. So to me, if you look at it from a portfolio manager's standpoint, any portfolio manager you talk to will say, "The closed-end fund is by far the best investment vehicle to manage bar none." Because you have permanent capital. You can stay to your investment thesis. You don't have to worry about inflows and outflows of capital. You don't have to worry about cash. You can invest in more illiquid securities, which offer a lot of times, very attractive attributes, especially in the market today. You can utilize modest amounts of leverage in it, which today again, interest rates going down can be extremely valuable to do. So if you look at returns, and I think BlackRock had this up on their website years ago. If you looked at returns over a market cycle, because you're going to benefit in times of lowering interest rates from leverage, and you're going to get hurt when you have rising interest rates. But if you look over time in most asset classes, the closed-end fund returns on a NAV perspective have actually outperformed mutual funds. And that's because it's a better investment vehicle to manage money than other vehicles. So I think now with the new structure, it really opens the door. And we expect to be a pretty robust calendar. I can tell you, talking to the various underwriters, there's a lineup all the way out until April of next year already. Because a lot of managers now are seeing this as an opportunity, and we need to be innovative in this space. There's a lot of really interesting alternative strategies that can be brought to market, and I think with this new structure, many more people are willing to take a look at it. And I think again, this could be very important. They used to say, this is the retirement income solution. Closed-end funds, that's what we do. On an equity fund, we convert some of your total return, and we distribute that. Some as monthly distributions, and some as capital appreciation. So it's an under-utilized vehicle, and now you can get a known quantity at a known price in the IPO if you're looking to take big size. And it could be ideal for your clients that are looking for retirement income.

Amy Charles: Great. And I'll point out too, I noticed that we did, Raymond James actually participated in BlackRock fund. BSTZ is the first one that we had participated in in three and a half years. And not only did we do more than we normally do with an IPO, I had a bigger audience if you will. So that new structure, I agree, game-changer is the way to use it. Advisors who said they would never buy a new closed-end fund, if they actually listened to me and looked at the structure, they open themselves up. And so we saw just a broader distribution. And I think that we're seeing that. And I think it helps the funds trade too, when you see a broader distribution where it's not just a lead underwriter doing seventy percent of the deal. When it's a broader distribution, it also helps the funds trade much better in the after-market. Jamie, I'm going to move to you real quick. Jerry mentioned that there's a pretty deep bench coming, the line-up is there. Are you seeing any specific trends? Are you seeing anything coming to market that's different? Or like in 2000, it was the year of the muni - '99 or 2000. And then it was the year of the REIT, and then it was the year of the preferred. And then it was just option, premium, option, premium, option, premium. Are we seeing those types of trends? Or are we seeing a bunch of different types of products?

Amy Charles: Yeah. For a while there, we were seeing a lot more interval funds before the new structure, and now it's kind of switched gears. With that, we're getting the hook here soon, so we're going to open it up for questions. Anybody have questions for the panel? Go ahead.

Audience: So for Jerry, what is your expectation for the percentage of people who will tender for someone who's contingent invertible deals. Just based on what we've seen so far, some of the ones that are termed, what are your thoughts?

Jerry Raio: We really haven't had any of these that have termed out. We've had some of the target terms that have termed out. I don't know what the exact numbers are in terms of tenders, but it's going to be far less than the number to get to where this will convert. So BlackRock did, it was a 1.4 billion dollar raise. Actually 1.6, and they printed 1.4. It's a two-hundred million dollar conversion. So if they have less than two-hundred million, it liquidates. Odds are pretty high that unless we have a calamity in the equity markets, that that's going to convert to a perpetual fund. So I would expect that a lot of these funds are going to become perpetual funds. And that's extremely valuable, and that's one of the calculations that the manager has to go through, is that it's expensive. I can tell you River North, it was probably about 5%. To bring a new fund, it cost you 5%. So if you're giving them a one percent management fee, it's a five year breakeven. So you're taking a lot of risk, you're not breaking even for five years, and then if it liquidates in year twelve, you had it for seven years. But the real value proposition is, odds are that these are going to convert to perpetual funds. And I guess that's also incumbent upon the manager to do a good job, if they're doing a good job managing the net asset value of the fund. Again they can't control what the market price is, that ebbs and flows based on emotion in the market. But if you're doing a good job, then odds are that people are going to be happy with it, and that's going to continue to be a perpetual fund. So to answer your question, I'm not sure exactly what that's going to be, but my expectation is that a lot of these funds are going to go and become perpetual funds.

Audience: My question is also for Jerry. These new funds, hasn't it been a mixed bag in terms of the discounts and premiums that they have been experiencing? And that these structures are more beneficial for the asset managers than the actual investors? That perhaps maybe it's fees that should be addressed, not really the underwriting?

Jerry Raio: So you're saying that the new funds have come out that have traded?

Audience: Yeah.

Jerry Raio: I think that the glide path for a lot of these new funds have actually been a lot better. Again, from the beginning. Again, you're buying whatever the asset class is, and eventually the fund is going to trade relative to that asset class. And again, I also caution people to look at the discount. You don't need to look at the absolute discount, you need to look at the path to that discount. So I can tell you the first River North fund that we did, traded at a discount. Why? Because the underlying net asset value went up so fast for a muni fund, because it was a combination of individual munis and muni closed-end funds, and the time we did it was October of last year and discounts were really wide. So the return on the underlying NAV of the fund was so good, it took a little while for the market to adjust. So the NAV moved up at a faster pace than the NAV on the fund, so we traded it at a discount. In my mind, that's a good discount. That's what you want to see, that the NAV is doing well and maybe the market's not catching up. But it's not to say that these funds can't trade at a discount, they can. And some of them, I think Tortoise trades at a discount today, maybe PIMCO, but you do know that at the end of twelve years, you're going to get what your NAV performance is. And the glide path to get it after the stabilization, you have a forty-five day stabilization period where the syndicate is bidding to hold it at the twenty dollars or around there. So before, because the NAV was all the way down at $19.06, right after the forty-five days, the stock would drop and it would go down and potentially go to five percent discount. So you had a ten percent round trip for the investor that bought in the IPO, and the NAV didn't change. Now you're starting at a higher NAV, commensurate with the market price. It could trade at a discount. But again, if you're designing products that the market wants, with the attributes that the market wants, the combination of risk and return, and yield, and potential growth potential, then I think these will trade well. So some of them are trading well in the secondary market, some of them. But the discounts overall have come in on the closed-end funds because interest rates have gone down. But I think you're going to see that again, there's a lot of particulars. But I think that the new structure, having the two guardrails of better upfront economics to the investor, and an end term where you get the NAV, is a much better vehicle for the investor today than it was five years ago.

Amy Charles: And just from my point of view, perpetual funds as of last night, average discount for all funds was 4.1%. Average discount on term funds was 0.92%. So it's par. So they trade better. So it is a much better experience for the client for sure. And like Jerry mentioned earlier, it's better for a portfolio manager. Or it seems to have better performance on a portfolio manager on a NAV to NAV basis, versus an open-end fund. And so when you're at par, that's a much better experience for the client. Question? Somebody else? Yeah.

Audience: Well, kind of along with what you're saying, and the NASDAQ guy. The problem with your saying too though, is you're trying to make those wide markets. Do you feel like you're getting prime time by the specialists? I mean, it's hard to do that because you can't ever get the shares because of executive deals, that's just part of this. He's just going to take them and he'll say, "I improved your price a penny," right?

Jerry Raio: Market-on-close orders. You've got to use those tools. That's a bigger problem than just closed-end funds. It's these thinly traded securities, which the SEC is trying to address right now. But these thinly traded securities is a bigger issue, right? Because you have no resource. We were just talking about this. Most firms don't even put any resources behind these small companies anymore, because there's no money to be made, so then they trade poorly. So how do you rectify that problem? You either got to increase spreads to make it more attractive for the market makers to make markets in it. So they put more resources, research, trading desk. Or you've got to increase volume and give incentives to increase volume. So I don't know how you cure that problem, but it's something the SEC right now, there's a comment letter on that's looking at it. Not closed-end funds, but broadly.

Andy Hall: I mean, for most of the close-end funds and BDCs, you're looking at companies that only have a few hundred million in market cap. And sometimes the volume is under a hundred thousand shares a day, under ten thousand shares a day. And the investor, which we indicated, it's mainly retail. Institutions make ten to thirty percent, your long-term fundamental investor is not going to be sleeping at night and getting up in the morning and saying, "Let me buy or sell the three hundred million market cap closed-end fund." That's why the spreads are wide. And then you do have the high-frequency traders and the algos, which people think, "Shame on them." But they're actually providing some liquidity if they've worked to trade, so maybe only 15% of the buy's and sell's. And some of these securities are actually fundamental investors. The rest is just short-term players that have no long-term investment or approach into the fund.

Recorded on November 6, 2019

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