There's a Cheshire Cat In Your Portfolio

Saturday's With Jim

By Jim Pursley
President and CIO, Gaia Capital Management, Inc.
www.gaiacapital.com
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Dear Friends,

Closed-end funds (CEFs) are investing's Cheshire Cat, mischievously grinning at the confusion they spark among investors. Why should we own investments that often separate the price we pay for them and their underlying value? The CEF is the first type of pooled fund investment to appear in the early 20th Century. They function like stocks in that they raise money to operate at an initial offering, in this case to buy a portfolio of securities, close the doors to new subscriptions and trade on an exchange at whatever buyers and sellers agree as their value du jour. The market price often differs from the underlying value of the securities they hold (called Net Asset Value or NAV) because CEFs are mainly owned by apparently less than disciplined individual investors who often bid these funds well above or well below the market value of their securities portfolios.

Using our most volatile bond CEF as a model, the Guggenheim Strategic Opportunities Fund (GOF), here are some sometimes startling observations:

- **Year to November 5th, 2018 GOF gained 4% in NAV but is flat on its price**. At the beginning of the year, GOF's premium over NAV was higher than it was on November 5, causing the market price to stay stagnant while the NAV gained. This means that the fund's portfolio return is understated because the premium dropped more than the value of the securities in the portfolio. Meanwhile, we gain a 10% safer than stocks dividend yield on the NAV.

- **How can we get a 10% dividend yield when most bonds offer 2% to 5%?** CEFs pump up their dividend yields by borrowing money to purchase securities – the process is called applying leverage. Closed-end "unconstrained" funds are free to roam anywhere in the investment universe in search of yield. GOF's current portfolio, the high yield notwithstanding, is largely populated with bonds rated A or above. The managers don't want to reach for yield by buying lower quality but higher paying bonds right now. So GOF ventures into areas where institutions find bargains unavailable to individual investors. Herein lies the principal risk we face in owning GOF. We rely on the acumen of the manager to keep us safe. So far so good. Guggenheim's Global Chief Investment Officer, Scott Minerd, is the well-known and respected manager, helped by three associates.

- **Why do we own such mischievous funds?** We own CEFs for the opportunity they present when we buy them at lower than their normal premium/discount range. We will trade them for some accounts, hoping to buy at a high discount or a historically low premium and hold until their premium rises to well above the normal range. For most accounts, though, we hold these funds for their high yields and still lower than stock volatility. Our two other closed-end holdings are managed by PIMCO's Chief Investment Officer, Daniel Ivascyn, and his partner, Alfred Murata. One fund invests principally in mortgage-backed securities (symbol PCI) while the other resembles GOF in that it combs the world looking for credit opportunities (symbol PDI). We should mention one drawback to leveraged CEFs since they are owned mostly by individual investors who tend to panic. Unlike most bonds, our three closed-end holdings will likely drop like rocks in a bear market.

The nuts and bolts of investing are anything but exciting, but we think it worth our time and yours to explain our portfolios from time to time – especially the more arcane holdings we may have.

Thank you for investing with us.

Performance and fund manager data obtained from Morningstar, Inc.