# David Stein from Money For the Rest of Us Podcast Discusses Closed-End Funds and Commodities

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**Dave**

0:00

All right, folks, welcome to Investing for Beginners Podcast. Today we have a special guest; we welcome David Stein. He's the host of the terrific podcast money for the rest of us and the author of the book of the same name. He's here to educate us more about money, how it works, how to invest, and how to live without worrying about money, which is a great topic to know about. So David is here to talk to us about closed-end funds, as well as other fun stuff about investing in the stock market. So David, thank you very much for joining us today. We really appreciate you taking the time out of your day to come to talk to us.

And we're very excited to learn more about you and all the great stuff you can share with us. It's great to be here. Thanks for having me. You're welcome. So I guess, as I mentioned in a little intro there, let's talk about closing funds. I guess for those investors out there that are not familiar with that term. Can you kind of help educate us a little bit about what those are?

**David**

0:54

Sure, sure. So a closed-end fund was the original mutual fund. It's a commingled investment vehicle where you have shareholders; you have a professional money management team that is selecting the underlying stocks that could be bonded and could be equity REITs. But what's unique about closed-end funds that differ from an open-end mutual fund or an ETF is an open-end mutual fund, for example, is what we're most familiar with in a 401k plan. It trades at the end of the day. So the fund sponsor figures out who wants to buy shares, who's who wants to sell shares, they net out, they figure out the price of all the underlying assets.

And then you exit or enter that fund. The market price equals the net asset value, which is the total assets divided by the share prices. Closed-end funds work; differently; they trade on an exchange, just like an ETF does. But there isn't a mechanism to make sure that the value of the assets, the net asset value per share, equals the market price. And so there are some advantages to that. Because then the fund sponsor has this set pool of capital, they can invest in maybe some more illiquid securities; they can use leverage. But the challenge or the opportunity for us as individual investors is that we can buy these funds at discounts to their net asset value. So you could buy a bond fund that sells at a 15% discount on the net asset value. They're a smaller market. So what I like about them is they're not a market that hedge funds can play in; you don't see a bunch of institutional investors buying them because they just can't get the liquidity. So most owners of closed-end funds are individual investors, which means one of the things that I'm always asking about, and in my book, I talk about this, is to ask who's on the other side of the trade.

Because investing is it's a competitive game. And we want to know, who's selling us a particular investment? Just like when we buy a house? Who's selling us the house? Or who's selling us a car? What do they know that we don't, and with most investments, typically, if hedge funds or bots or institutions are involved, they know more than us; it's individual investors, but with closed-end funds, it's other individual investors, and they tend to panic in a market environment like today. And so they sell these funds, they're not sure necessarily what they're owning. And so then you see these discounts widen. And then that becomes more of an opportunity for us.

**Andrew**

3:33

That's really cool. So I guess, you know, mutual fund space, ETF space, I think of the big names like Peter Lynch and his mutual fund from the 90s that had crazy returns. Today. It's like Cathy wood and the Ark fund. Are those close on funds? Are those open then funds? Whether the difference or similarities between those more popular funds and the ones you're talking about?

**David**

3:59

The Peter Lynch fund, the fidelity those are open in mutual funds; Ark is an exchange-traded fund. And I should probably extend my analogy to exchange-traded funds. So they exchange-traded funds, or like closed-in funds is, in that they trade on an exchange.

And you can see the price disconnect from the underlying net asset value. Or with ETFs, you have what is known as authorized participants, basically institutional investors that are always looking at the price of the ETF compared to the net value, which gets published every 15 minutes when the markets open. And then they can buy and sell the underlying securities or what's known as a reference basket, as well as the underlying shares that can short them, and so all that arbitrage allows ETFs basically to stay in line, the price to stay in line with the net asset value. And so, Cathy Woods Ark innovation ETF, I think it's ARKK that's an ETF now with its distinct because it's an actively managed ETF, whereas most ETFs are passively managed.

They're seeking to track a specific benchmark. But Ark is heavily active, very technology focused, certainly down 60% year to date, but its price will stay close to its net asset value, whereas a closed-end fund won't, and I mean, some of the big sponsors are closed in our Blackrock Nuveen. I mean, there are a number of big-time sponsors, and one of the other differentiators with closed-end funds is they tend to be leveraged. So they're borrowing money to leverage up the underlying assets to magnify the return. So they tend to often be more income oriented. So you'll see distribution yields of 678 percent. And that's where they can be attractive as we can pick up a yield at 6% to 7%. In an asset class that you know, it's selling at a discount to its underlying value of 15%.

**Andrew**

6:00

Is it as simple as finding those closed-end funds that are trading at a discount and buying them and selling them? When are they fully valued? What kind of a strategy Have you found tends to work? Well, when talking about these kinds of investments?

**David**

6:17

Well, what type we're trying to find is a closed-end fund whose discount is greater than average. And so if you go to a website, like C, F Connect, you can screen-free, you can screen based on the biggest discount, and they calculate what's known as a z score. And it's basically a statistical measure. And Morningstar reports the same thing. Basically, just how big is that discount relative to its average? And so when I'm investing in closed-end funds, I'm typically looking for a z score of negative three or less, in other words, so it's negative four, negative one, you probably don't get more than negative four.

But generally, it's more negative than negative three. And that typically shows that the discount is greater than average. So that's an opportunity. And then the other thing to consider is this just recognize is their dividend sustainable. So if they're, they have a six or seven 8% yield. Now that dividend has to be funded somewhere, either out of an income or at a gain. And so it's just, you know, just like if you're going to analyze a company to invest in a stock, and there is some due diligence required on closed-end funds, just to understand whether that income is sustainable, or that dividend sustainable.

**Dave**

7:32

Yeah, that makes sense. So I guess, to help educate people, and I get myself to with closed-end funds, do you have the same kinds of choices of baskets that you could choose from? Or is it a smaller asset class, and there are fewer choices than you would have with ETF? So if you're looking to invest in, you know, just technology versus commodities versus maybe real estate? Do you have different closed-end funds that focus on those kinds of areas? Are they more a broad range of like, you know, the NASDAQ and the s&p and the Dow kind of idea?

**David**

8:07

Now, they're all different types of asset classes, bet 60%, or more fixed income, just because that focused on the distribution yield, but there's equity. I mean, there's value, there's growth, there's technology, there are their debt funds, there's even, and one of the holdings that I own is the bearings. Corporate investors fund the tickers MCI; they basically do private market lending. So they're lenders to private companies. And you know, that's an example of a fund that is available within close in funds in that this is private debt. And so it's not necessarily valued every day. It's not illiquid. But this is a way that individual investors can get access to private investment. And that isn't necessarily available, but within a public market category, when we don't want it any more than we can sell it. So it's sort of access to illiquid investments in a more liquid way,

**Andrew**

8:59

Kind of along those lines as a venture. Do they have venture capital and private equity as well?

**David**

9:05

I'm sure there are the ones that are in sort of private equity type companies because they do exist; they tend to have much wider discounts because it's so difficult to value those companies with something like private debt; this particular question from the bearings, corporate investors, they strike their net asset value quarterly. So they're able to lease value the debt quarterly, and that's the other thing with these closed-end funds, if they're holding private assets, you want to dig into the financial or the annual report, the semi-annual report the perspectives just to understand what is their valuation policy, like, how are they valuing the assets in order to come up with the net asset value?

**Andrew**

9:45

Okay, yeah, I could see how that can be really helpful. I was telling somebody to go research an ETF. I know there are websites like etf.com where people can go, and there's almost like a database of, I don't know if it's every ETF, but this seems like any of the ETFs that you would think of seems to be on that website. Is there anything? I know you mentioned the website earlier, but is there anything like that for closing funds? Is it just a matter of I'm going to Google this fund and kind of have to do my own independent research based on what they're disclosing? What's the research process behind that?

**David**

10:19

So Cefconnect.com is the main one that I use that provides some profiles that allow you to screen Morningstar covers closed-end funds. So you, I mean, they you can get the returns and some basic information. No, typically after, if I look at Morningstar, see connect, then go to the sponsor's website and get the fact sheet or look at the underlying documents. And in that sort of process, we do have on our website of free investment guide on how to research closed-end funds and explain more about them, which could potentially be a helpful resource to listeners. Cool, what's the website where I took money for the rest of us.com/closed End funds? So closed hyphen, n hyphen funds, and I'll send you the link; you can put it in the show notes. So that's kind of a guide we wrote a couple of years ago. That's, that's helpful.

**Dave**

11:10

So a question that kind of springs to my mind is, what kind of investment vehicle would be best to invest with these funds? Like, oh, versus a traditional or Roth or a brokerage account? Where would be the best place to put those, or doesn't matter?

**David**

11:27

Well, because they have higher distributions, you know, sometimes in a tax-deferred vehicle, an IRA or Roth IRA can be helpful. But the reality is, one's wealth growth is they can't put all their assets in. In tax-deferred vehicles, I have exposure to closed-in funds, both my taxable accounts as well as my tax-deferred accounts.

**Andrew**

11:49

Okay. Yeah, I think that's helpful to kind of think of; it's like, if there's a focus on distributions, kind of treat it like you would any investment that generates higher income. Right. So that's definitely a fascinating option. And something I know doesn't get a lot of press in the investing world. And so we appreciate you breaking down that kind of an investment option for people. I know you had; this is gonna like completely shift gears here.

But I know you had an interesting podcast episode talking about commodities, and how just to give like a few background commodities, if you think of oil, call gold, any of the basic building blocks of the economy, really, the price of those have been doing very poorly in the last couple of decades. And so I know, there's been a lot of talks out there about how maybe, you know, the economy is moved past commodities. And, you know, it's all a technology-type company economy now; what are your thoughts on commodities, and give us like a breakdown of what you covered in that episode, and kind of what you've been observing in the world lately around commodities?

**David**

13:02

Sure. So we have been in a commodities bear market, really, from 2011. So coming out of the great recession, we had a peak in 2008, and then commodities sold off, and then they really peaked again in 2011. And then, really, from 2011, through May 2020, we'd really, I think you'd call it the bottom because if you recall, in May 2020, the price of oil went negative; there was a lot of press regarding that. And it wasn't oiled itself; it was oil futures.

And we'll get to that because it's important to recognize that as investors, we cannot go buy a barrel of oil. And so we, as individuals, and even institutions, unless you're buying a ship of oil, you're investing in commodity futures, which is very different than investing directly in a commodity. If you go out and buy gold, you can buy a gold coin. But for most commodities, we can't access that. And so when we think about commodities, we've had a boom in commodities over the past several years. And much of that is certainly the Russian invasion of Ukraine. I have been part of that because a big part of the supply now has sanctions, and that's caused some issues. But another issue within commodities is when we went into this bear market, oil companies just didn't invest as much. Their shareholders demanded they pay higher dividends and be more disciplined in their investment in oil. And as a result, we had really come under-investing in oil for about a six to seven-year period. And then as we came out of the pandemic, and as there were supply constraints, and we had this under-investing in a lot of different commodities that shot the price of commodities up, and so then the big question is, are we in a new bull market for commodities or is this just a temporary thing? And it's an incredibly difficult question to answer.

Because unlike 20 years ago, when you can look at these very long cycles, we now have this energy transition going on with the electrification of autos. And so, at some point, you'll get more and more EVs online that obviously don't use oil; they'll use other ways to generate electricity. So, you know, in an episode, we kind of went back and forth and looked at both sides, is there a new commodities boom, because of the underinvestment, or is this a temporary thing, and because of the energy transition, you'll see, and because China's economy is slowing, and they were a big consumer of commodities in the prior bull market, and their economy is transitioning, and so you have all these pieces going on.

At the same time, the hardest thing about commodities, when you think about commodity futures, when you buy an ETF, such as the Deutsche Bank, commodity tracking ETF, or some other commodity ETF, let's say just an oil, they're buying commodity futures, and a commodity futures a promise to take delivery of a specific commodity. In the future, the prices of those futures are based on the consensus of what investors believe the price of that commodity will be 30 days from now or 60 days from now. And so with commodity futures, the only way to make money, if you're investing in ETF that's investing in commodity futures, or you're doing it directly, is the commodity price has to do better than what everybody already expects; it has to beat the consensus priced into those contracts. And that's why where you can see somebody investing in oil. And as they roll over that contract, it loses money every month because the future price was too optimistic. And then it's called what's known as negative role yield essay on our website about how that works.

But basically, you can have this investment in a commodity and lose money unless we get a period like we just had the past two years where the commodity prices spiked way more than anybody thought. And that's why commodities are up 35% year to date. So it isn't just that they went up; they went up more than what everybody expected, which is priced in the futures contracts.

**Andrew**

17:24

Almost like whoever is selling these features are the only ones who are making money off, this doesn't seem to help the companies; it doesn't seem to help commodity traders. I mean, just to be like, completely oversimplify something that it seems like whoever is selling these contracts is making a killing,

**David**

17:39

We could sell a contract, I mean, commodity markets, a zero-sum game, if you are going long a commodity, there's not like a Vanguard selling it to you. It's somebody on the other side of the trade that believes that commodity will fall in price, or they're just, they want to take the opposite, and just take the short the commodity every month, and then they'll capture that negative role yield, and that ends up being a positive return. And so yeah, it and then I mean, you have oil producers that are hedging, there are uses for commodities to hedge your production cost or something like that.

But much of it, I agree with you, Andrew; it's speculative. But it's people speculating on both sides of the trade, which is why commodities are an incredibly difficult way to invest. Because it's a zero-sum game, you have to be smarter than the consensus to think things are going to do it. And if your view is we're in a commodities bull market, in the consensus is wrong, we're going to continue to the prices are going to go up even more than people expect, then you go along, but you mentioned, you know, earlier gas prices and gas prices have fallen some, so commodities are off 15% In the last month, so if an investor decided I'm gonna go long commodities invest in DVC. They're down 15% already, and it's only been a month, so they can be very volatile.

**Andrew**

19:03

So, you know, obviously, we could get into all of the angles of, you know, whether what's going to happen in the future with commodities, but just let's just like side step that and let's just assume that somebody believes that we do have a commodity supercycle ahead, that whatever is happening now is something that seems like it would persist. It sounds like you're not going to recommend buying and holding these contracts. Where would you think an investor should start to look if they want to position their portfolio for some sort of commodities bull market, the way

**David**

19:40

That I had invested in the past that we did when I was an institutional investor? It is the Deutsche Bank commodity tracking ETF, so dBc is the ETF; what's unique about the ETF it tries that it doesn't necessarily just buy the front month contract. So the one with the one that's 30 days out, it can vary which contract It buys in order to try to minimize this drag or this negative role yield. I don't own commodity futures right now. And I wish I had bought them back in May 2020.

But we're in the midst of the pandemic. And again, so I'm looking at these futures curves. And I could see all right, the front month contract is negative, but the word assume I don't know, I think it's like $20 a barrel for oil for the next month. So then you say, Okay, we'll go up 20 bucks in a month like I don't know. And that's the challenge with commodities that I don't typically like to invest in a way that I have to do better than what the consensus already thinks. And with a zero-sum game, that's exactly what you're doing. And that's what commodities are speculation, something as discussion on the show, as well as the book, you know, what's the difference between investment, the speculation and the gamble? The speculation is commodities where there's disagreement and what the price should be; see if people short the commodity and people go long, somebody's going to win, not everybody with an investment. It has a positive expected return has cashflow. It has something some income.

And so your returns are expected to be positive. And then a gamble is something that has a negative expected return. And so, as an investor, I prefer investments versus speculations; although I'll have some, I have some gold, have some bitcoin, etc. But most of the workhorse of our portfolio should be investments with positive expected returns.

**Andrew**

21:30

So what kind of allocation? What are you talking about? When do you mention the Dulwich commodity basket? Just ballpark kind of how is it invested?

**David**

21:38

Or how like a typical investment? Yeah, I mean, generally, speculations should be kept less than 10% of your portfolio; I have seen this problem speculations, people just get so excited, and they're so confident they're going to be right, without really understanding it, I have a family friend that basically lost their farm, betting on commodities. And it was so frustrating because he showed me this fund; it was a private fund investing in commodities; he was very excited about it.

And I noticed they closed that one fund, and then they started a new one. So there was like a break in their track record pointed out to him, and as I did more research because they lost all the money. So here's the private commodity fund that had to shut down and then started a new one. And the guy still invested and lost his shirt and lost their farm. And so keep it less than 10% of your allocation. Like in the case, you know, I only have about three to 4% of my net worth in gold, gold coins, I mean, their hedges, their protection, but their zero-sum games, they'll only go up if people are willing to pay more. There's no cash flow associated with it.

**Dave**

22:49

So how do the commodity prices affect investments that we could make? So, for example, I noticed the other day that the price of copper has dropped, you know, as oil did in 2020. And with him has kind of gone the other way. And so when you think about kind of the Evie coming revolution with cars, it's hard to look at some of those companies and try to figure out whether you think a company like Albemarle is going to be a winner in the long run versus a company that's mining copper. And both are important to electric vehicles. But it's kind of hard to figure that out. That's what I struggle with.

**David**

23:27

Well, it is, which is why I purchase individual stocks because I spent 15 years researching hedge funds managers, and long only stock managers came away disillusioned in the sense that the smartest investors in the world, most of the time, they're wrong or they might be right about something. But then something complete surprise happens. And so, you know, my approach to investing is how do I invest in a way that I don't have to know what's going to happen. And but even though everybody else still thinks they know what's going to happen, and that's what gives you opportunities, like within closed-end funds, or I'm gonna be at the end today, we have to make an investment.

And so I mean, there are areas of the market that can become more attractive, they get cheaper, but I've always been an asset allocator focused on baskets of securities, versus individual securities, you know, sort of once a Tuesday unless, you know, it's something credibly simple like an AI series I savings bonds or something like that.

**Andrew**

24:31

Can you give us just a taste of how you make those allocation decisions? Like, what is it over, let's say a five-year period that makes you say, I'm gonna allocate more here, or I'm gonna allocate more there. Can you give us an example?

**David**

24:44

Yeah, so this is what we did to show investors. It's what I do on my websites; when to do my personal investing is come up with expected returns for different asset types. So in the building blocks of that is what it's called. So yield can be dividend yield. It's a bond yield. If it's preferred stock, its dividend yield, I want to look at what that cash flow is. We want to come up with an estimate of how fast would that cash flow growth over time. Now, if it's a stock US stock market, for example, we can look at the dividend yield. It's one and a half percent right now; if we assume that earnings grow over 6%, that's the second element of it. And then the third thing that drives returns is what are investors willing to pay for that cash flow stream today versus five years from now?

And so that we're looking at price-to-earnings ratios for different markets. And so that's the approach I use for all different asset classes and then look at and decide, okay, this area is more attractive. We want to add more there. But I'm also cognizant of the risk, and the risk that we use in our approach is maximum drawdown. So as institutional investors, we focused on volatility, but the reality is that volatility is not something that is intuitive to investors. And we don't care about upside volatility. Yeah, if it goes up more than everybody expects, that's great. So I focus more on maximum drawdown, how much could we lose stocks historically have lost worst case scenario is 60%.

So I want to scale my allocation to stocks, assuming they could lose 60%. And in that, that 60% loss is bad. If you're a young investor without much money, fine, you just write it through. But if you're nearing retirement, then it can impact your lifestyle. And so the idea is to scale your investments based on not only the downside risk but the impact of that risk on your lifestyle. And then I'm just diversified on dozens of different types of investments and asset classes, both public and private.

But I'm generally more of a risk-averse, conservative type investor because I am older than many. So I'm not a young pup anymore. So the reality is that I don't need to take the risk because I'm financially independent. So in that case, like, I'm gonna be a more conservative investor, but it's still going to be diversified and, and still take advantage of opportunities as they arise.

**Andrew**

27:15

Yeah, I do like that really big-picture approach and appreciate you sharing your wisdom with us. Okay, the last thing is, before I wrap up anything else you guys want to discuss before we wrap it up. I thought that was a good place to end unless you guys had something you wanted to add to that. That's good. A lot of good stuff there, David, and we really appreciate your time. In your joining us, you have a great podcast called Monday for the rest of us. Just even scrolling through the episode list, you can see a wide variety of topics.

And I think that has an attractiveness all on its own just based on that. So you have your podcast; where else can people go to find out more about you and what you're doing online?

**David**

27:58

The main website money for the rest of us.com. So I'm there occasionally to dip into Twitter @jdstein, but most of our free investment guides, such as enclosed in funds. So when I mentioned negative role yield or investing in commodities, you can find that money for the rest of us.com in the menu item is guides.

**Dave**

28:19

Cool, awesome. Well, again, David, we really really do appreciate you taking the time to come join us today and help educate us on all the great topics that we discussed today. So without any further ado, I'm gonna go and sign us off; you guys go out there and invest with a margin of safety, emphasis on the safety. Have a great week, and I'll talk to you all next week.

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