Meet the Manager:
Pathstone's Closed End Fund Strategies

Pathstone is pleased to kick off a new interview series with some of the passionate and committed asset managers who head our recommended investment strategies. By offering a look behind the curtain of key strategies our team has implemented for client portfolios, we aim to share the depth and breadth of expertise and collaboration that goes into our investment process.

Our inaugural conversation features Alex Paulsen, the founder of Kilihune Research LLC. Alex has served as Portfolio Manager to the Pathstone Closed-End Fund (CEF) strategies for more than nine years. We have had the pleasure of working with Alex through major market events that have had significant impact on our use of CEF strategies. Alex was interviewed by Joseph Koch, CFA, Senior Analyst within the Investment Research team.

***

Joseph Koch, Pathstone: *Welcome Alex, I appreciate you taking the time today. As you know, 2022 has seen unprecedented market action, from the size and speed of the Fed tightening to the highest inflation seen in 40 years. Pathstone has positioned portfolios to protect defensively from the drop in asset values as well as to capture market opportunities as they've presented themselves. Closed-end fund (CEF) allocations have played an important role in our strategy. Before we dive into more detail on this role, why don't we start with your background and experience with closed-end funds?*

Alex Paulsen, Kilihune: Thanks, Joe. I was first introduced to closed-end funds in June 2008 as a quantitative researcher [at Parametric]. My task was simple: identify how fundamental factors were associated with future CEF returns. After graduate school and a few years at BlackRock, I returned to Eaton Vance/Parametric in 2012. That summer, I took over all the investment management and business development responsibilities for two closed-end fund strategies and continued until February 2021. I modeled every trade, monitored real-time execution, evolved our strategy, and published client-friendly research.

> A **closed-end fund (CEF)** is an investment structure whose shares trade on the open market. A CEF is capitalized through an initial public offering (IPO), and the proceeds are used to construct a portfolio. Unlike a mutual fund, investors do not add to or withdraw capital from the fund (i.e., it is "closed" to new capital); rather, the shares of the fund itself are traded. This creates a dynamic where the share price of the fund may be higher or lower than the market value of the fund's underlying assets (commonly referred to as a premium or discount).

Over the years, I engineered four new CEF strategies, including two custom strategies for Pathstone in 2013 and in 2015. In 2013, the "taper tantrum," where fixed income funds just got obliterated, led to the inception of what we now know as CorePlus. In 2015, there was a similar dislocation in commodities that also hit the credit markets, leading to the inception of the Multi-Asset Income strategy. In both instances, I worked closely with Pathstone's investment team focusing on a dislocation and capturing something interesting as a result.

JK: *For new investors out there, could you please explain the benefits of closed-end funds?*

AP: Sure, this is a great question. It helps to think about other, more common investment structures like a mutual fund or an ETF [exchange-traded fund]. Unlike these open-ended structures, CEFs launch through an IPO process with a fixed number of shares. This has two main investment implications. First, it can create a market imbalance based on demand for the fund vehicle itself, which can cause the fund to trade at a "premium" or a "discount" to the fair market value of the underlying securities in the fund. These divergences create trading opportunities for investors. Second, you get a stable pool of investment capital within the fund -- investors can't pull money out or add money and dilute a potentially interesting portfolio at any given time, which allows for investing more broadly across the liquidity spectrum.

CEFs may employ leverage or derivatives to efficiently scale up a less risky portfolio to a desired return or yield target. Another benefit of having fixed or stable investment capital within a CEF is the ability to defer capital gain realization and reduce transaction costs. These benefits are rare in open-end mutual funds.

JK: *Many CEFs trade at discounts to their net asset values for long periods of time. Why do discounts persist if markets are efficient? Shouldn't these go away? Why is this important to investors?*

AP: This goes back to those fixed share counts of CEFs and ownership profiles. In a mutual fund, the fund sponsor can meet investor demand with the creation or retirement of shares, which keeps funds trading at their net asset value. In the CEF space, there is no opportunity for fund sponsors to immediately meet changes in demand.

Also, the CEF market has a total capitalization just north of $200 billion. So, we're talking about an entire market that's the size of Costco's market capitalization, which is small for most large investors. It's not that there aren't any institutional investors in CEFs, there just aren't enough.

A mutual fund can only hold so much of another '40 Act fund. This and other regulations create conflicts for traditional asset managers that sponsor closed-end funds to be active investors in the space. When I've looked in the past at the ownership composition of the closed-end fund market, only 10% was institutionally owned. Absent sufficient institution activity, CEF market prices can materially diverge from fair value, creating opportunities for a systematic strategy.

JK: *How does our collaboration in managing Pathstone's CEF strategies address these challenges?*

AP: You should think about CEFs as two opportunities combined. There's an opportunity for the "buy and hold" CEF investor to earn return through distributions associated with the income collected and the asset appreciation within each fund. The income production and asset growth are enhanced by the additional net benefits of the stable investment capital. So that's one strategic opportunity.

The second opportunity stems from being a liquidity provider in the market, or, in other words, from buying into fear and selling into fads. For Pathstone's strategies, this means buying CEFs at a discount when negative sentiment drives down prices and selling CEFs as discounts narrow or premiums emerge when optimism grows. This opportunity is strengthened when investors can also tactically shift their asset allocation. I enjoy working closely with Pathstone's investment team to identify tactical asset allocation shifts to take advantage of changing investor preferences across sectors.

JK: *This year you worked with Pathstone to raise cash and ETFs to offset volatility and to mitigate downside risk in our CEF strategies. Why is that level of active risk management important, and what kind of volatility should an investor in this strategy be prepared for?*

AP: Let's think about the risk of a CEF strategy. By linking the underlying assets to familiar risk levels, you can start to separate out the risk due to owning bonds and stocks. Owning those securities through CEFs creates a separate kind of risk — that market prices do not equal underlying value.

The key question is: how big is that second layer of volatility above the underlying investments? Over the last five years, about a quarter of the total risk in our strategies is due to CEF premium and discount volatility.

Last September [2021], Pathstone's research indicated that market risk was not fully reflected in asset prices, including underlying assets in CEFs. On the CEF side, narrowing discounts made deeply attractive CEFs difficult to find.

That alignment of the Pathstone's macro view and the CEF perspective led to a quick deployment of two risk mitigation strategies. First, we swapped these richly priced CEFs into ETFs to preserve the structural allocation. We knew many clients wanted long-term muni and credit exposure from this allocation. For Multi-Asset Income, they also wanted equity or inflation-sensitive exposures as well. In both strategies, we kept the desired focus, but reduced the discount-widening risk. The second risk mitigation strategy deployed was raising and maintaining a large cash cushion, particularly in CorePlus, so we had dry powder to deploy when the next dislocation emerged.

JK: *What has it been like for you personally to manage a fund through such turbulent times? Give us some insight into how things have changed over the last few months.*

AP: Compared to my past experience, surprisingly little has changed in terms of the day-to-day processes. In just the last decade we have seen the taper tantrum, the commodity and credit meltdown, a global pandemic, an inflation surge, two tightening cycles, and multiple geopolitical risks. Although none of these shocks were identical, each episode built up a period of acute uncertainty and exceptionally discounted CEFs. Eventually markets normalized and moved on.

At a high level, we have strategic allocations set in close consultation with Pathstone's investment team. These efforts inform strategies to deliver useful credit and equity risk alternatives. Within each strategy there's a holistic focus on diversification across and within asset class, across and within fund complexes, and across individual funds. With these building blocks, we have a consistent, systematic approach to trading through each dislocation, aiming to capture value along the way.

But very little changes. It's sort of a testament to the strategy. It feeds and lives and succeeds during a crisis. The good news is that we had a crisis [laughs], and the better news is what happens when markets normalize. So, we're in a pretty good place.

JK: *Alex, thank you very much.*

***

If you would like to learn more about Pathstone's Closed-End Fund strategies, please contact your Pathstone advisor. Available to Pathstone clients only.

PATHSTONE

Disclosures

This presentation and its content are for informational and educational purposes only and should not be used as the basis for any investment decision. The information contained herein is based on publicly available sources believed to be reliable but is not a representation, expressed or implied, as to its accuracy, completeness or correctness. No information available through this communication is intended or should be construed as any advice, recommendation or endorsement from us as to any legal, tax, investment or other matters, nor shall be considered a solicitation or offer to buy or sell any security, future, option or other financial instrument or to offer or provide any investment advice or service to any person in any jurisdiction. Nothing contained in this communication constitutes investment advice or offers any opinion with respect to the suitability of any security, and this communication has no regard to the specific investment objectives, financial situation and particular needs of any specific recipient. Past performance is no guarantee of future results. Additional information and disclosure on Pathstone is available via our Form ADV, Part 2A, which is available upon request or at www.adviserinfo.sec.gov.Any tax advice contained herein, including attachments, is not intended or written to be used, and cannot be used, by a taxpayer for the purpose of (i) avoiding tax penalties that may be imposed on the taxpayer or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein.