



John Cole Scott: Expect ‘Upside Surprises’ For BDCs During Earnings Season

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Chuck Jaffe, in this episode of The NAVigator podcast interviewed John Cole Scott, chief investment officer at Closed-End Fund Advisors and the chairman of the Active Investment Company Alliance. Read the Q & A below as John says that business-development companies – which are built to handle a four-year business cycle – are looking at positive surprises as second-quarter earnings season arrives. From July 26 to August 10 – when the bulk of BDCs will report earnings – Scott says that BDC discounts are currently about 13 percent wider than median discounts have been over the last two decades, and that there has been very little uptick in



problem loans, which sets up a potential rally. Scott notes that BDCs have outperformed closed-end funds during the rough first half of 2022, and identifies several BDCs poised to deliver good yields, mostly at a significant discount now.

John Cole Scott

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CHUCK JAFFE: It’s earnings season for business-development companies and John Cole Scott of Closed-End Fund Advisors is here to talk about it, this is The NAVigator. Welcome to The NAVigator, where we talk about all-weather active investing and plotting a course to financial success with the help of closed-end funds. The NAVigator is brought to you by the Active Investment Company Alliance, a unique industry organization that represents all facets of the closed-end fund industry. From users and investors to fund sponsors and

creators, if you're looking for excellence beyond indexing, The NAVigator will point you in the right direction. Joining me again today, John Cole Scott, chief investment officer at Closed-End Fund Advisors in Richmond, Virginia, which is online at CEFAdvisors.com. We're about to dig into BDCs using some of the firm's research, which you can do yourself by going to CEFData.com. And John is also chairman of the Active Investment Company Alliance, which you can learn about at AICAlliance.org. John Cole Scott, welcome back to The NAVigator.

JOHN COLE SCOTT: I always enjoy being here, Chuck.

CHUCK JAFFE: John, we are at an interesting crossroads for business-development companies, because discounts are big but earnings season is going to be telling. Now at Closed-End Fund Advisors you're helping people build portfolios that are heavy on BDCs, interval funds, closed-end funds. So I'm curious, as you're looking at this earnings seasons, with BDCs coming in already at big discounts, etcetera, are you looking at this as the buying opportunity is ahead of the earnings releases, or is the buying opportunity what comes afterwards if they wind up being even further discounted?

JOHN COLE SCOTT: So we are currently expecting some upside surprises for many of the BDCs we focus on. There's around 50 listed BDCs, really 30 liquid, good targets for research, and then we often put between five and 10 in a portfolio. But earnings season, like I said, right around the corner, starts July 26th with the largest, the grandfather of BDCs, ARCC, and mostly winds down around August 10th with BXSL, the Blackstone recent add to the sector, and in those 12 days we'll really learn so much of what's going on. But remember, these are portfolios that are designed to handle a four plus year cycle. When they write the loans they don't know the future, and they're mostly variable loans and mostly secured loans, which are never perfect investments but generally better footing than other things through time.

CHUCK JAFFE: What you said was that we're about to learn more. So help lay this out for people who are not looking at BDCs the way you are. What do we know now? What are we looking for as we go through earnings season?

JOHN COLE SCOTT: So right now we really looked at discounts since roughly '04, and there are enough BDCs to have a really good discount, they are currently 13% wider than their median level for those almost 20 years. And the only times they really were wider were the periods where you might remember, the Great Recession and the Covid recession. We're roughly where we were in the energy pullback, and if we were to think once that did snap,

the upside was over 25% for BDCs, and so that is a way of looking forward. But what we'll be looking for is how many of the loans are non-accrual, that number is a non-payment for loans. It's been very low and we expect that to maintain. I expect a slight uptick but still very low historical levels. And then also the fair market value of the loans at cost. Again, that's a small down-written process for most BDCs right now and not too much movement. Where you see problems is if we actually are having a recession, which we both know you eventually do, you'll see much bigger write-downs of fair market value and loans be put on non-accrual.

CHUCK JAFFE: So knowing that that recession is coming, right now how do you play this sector? Because it kind of sounds like you're expecting, hey, we're going to get through this, have a significant rally, but then we're going to have that second shoe drop on those valuations.

JOHN COLE SCOTT: It is. Quickly, even though I said BDCs are wide, they're actually outperforming their closed-end fund brothers. We have the convertible bond closed-end fund sector off 28% and high-yield off 20%, senior loans off 14% and change. BDCs are only down 9.5% year to date total return, and just for perspective, the largest sector, munis are off 18%. But if I want to actually give listeners some answers where I'd be very comfortable putting money today even with the unknown future of earnings seasons, there's really three I'd like to talk about. One is Golub, GBDC, we're at a 12% and 8.9% yield, and a really high-quality manager known for doing excellent work in the middle market area. Another one is Oaktree, OCSL, it's an 8% discount, a 9.9% yield, and again a takeover of a previous BDC by Oaktree, a very good manager in this space with a lot of, we think, upside for future recovery. And there's a nice premium BDC, TSLX, it's a 10% premium, which is very low for this fund, and an 8.8% yield which is low for the sector because I told you they're kind of wide historically.

CHUCK JAFFE: Let's also put in a plug for Closed-End Fund Advisors here, because you are involved in a unit investment trust of BDCs. Talk about that for a moment.

JOHN COLE SCOTT: We're in the 25th series of our BDC select UIT with our partner Smart Trust, it actually goes live on July 15th for advisors and investors, and it's really our 24-month curated best hold. You may remember I say for our SMA clients we do five to 10 positions as a normal allocation, obviously when we can't change our mind we diversify it a little bit because we can't make changes over those 24 months. And then as you know, we

also cover the whole sector through our quarterly research call coming up next week on July 20th.

CHUCK JAFFE: Let's also translate some jargon there. What John was saying in case you missed it was that for SMA clients, which is separately managed accounts, that is folks who are placing large amounts of money with the firm but again they have the flexibility so they'll be buying five or six positions and then they'll make movies. Whereas in the unit investment trust, which investors can get and don't have to be separately managed account clients, there are many more positions in there. And it's an important thing, John, because the other side of this is even as you mentioned three, as you mentioned GBDC, OCSL, and TSLX, investors who have portfolios and are looking at this have to figure out, hey, if I want to add one or two, how does it fit into a portfolio? For somebody who is not as dedicated to this space in the market as you are, one or two because they give a diversification, because they put them in a different asset class, because you're able to buy at a discount and all the rest of that, does that make sense? Or do you have to commit to a bigger position and more holdings in order to truly get good impact off of BDCs?

JOHN COLE SCOTT: So we generally put BDCs at like a four to 12%, maybe 15% allocation, which is high by most standards but it's our focus as we've talked about for years. But we make BDCs half sizes because they do have that little bit more volatile experience with the earnings season. So the lowest level for most closed-end funds for us is a 3% allocation, and the lowest level for BDCs is about a 1.5% allocation. And we'll go a little wider for tax purposes or other reasons, but I would say diversification is helpful there. We know people that focus more than that, but I would say it's just too complex to go into more than three names in a short interview like this, and those are three good names that I feel comfortable with for a longer horizon because of the quality of the platforms involved.

CHUCK JAFFE: One more thing that's important here. Because if somebody says, "Okay, I want to go look at those names," as you pointed out, big discounts on two of the three of them, one at a premium, but also big yields. And at a time when you're looking at inflation that came out with a nine handle, when you're looking at yields of almost nine or around nine, which you are in those three names, there are folks who would worry that, am I chasing yield? Am I doing this for other reasons? The answer is this yield feels good to you, separate from the emotional failure of, hey, I'm actually keeping pace with inflation, where does that

happen? This yield from a you're an investor standpoint and you like BDCs, this yield feels solid to you like it's there and you'd be happy about it regardless of the market conditions, regardless of inflation?

JOHN COLE SCOTT: It is because these are actually lower yielding BDCs. BDCs are so wide a 10% yield is not uncommon now, like there's 10-12% yields. And if you go to our index page for BDCs you can sift by yield and get a sense of the liquid BDCs and where their yields break up, so these are not high-yielding BDCs, they are just high yielding versus other debt funds available.

CHUCK JAFFE: Okay, that's going to require one more question, which is why? And we had this on my show *Money Life* with somebody who was just talking about being a dividend investor and where they are in terms of pursuing dividend yields, why would somebody not go use the information they can find at CEFData.com, plug in, look for the highest yielding BDCs, especially because they are yielding more than inflation and they're into double digits, and not just go, "Let me go high yield, highest possible yield all the time"? Why is there a high yield that is okay, but a higher or highest yield that is maybe more suspect?

JOHN COLE SCOTT: So if you don't have time to go through BDC education and financial statements, I always tell people the simplest way to find the better BDCs is to sift from premium to discount, lop off the bottom, sift from yield highest to lowest, lop off the top, fish in that 25% and those options. But the market's already giving you a better governance answer because they're requiring lower yield because they feel more comfortable in the governance, the quality, the shareholder relations. Sometimes a deep discount is a turnaround story, sometimes it's a bad fund. And sometimes a high yield is sustainable, sometimes it's a reach for the stars.

CHUCK JAFFE: John, great stuff as always, thanks so much for joining us. We'll talk to you again soon.

JOHN COLE SCOTT: All right, thanks so much, Chuck. Happy to be here.

CHUCK JAFFE: The NAVigator is a joint production of the Active Investment Company Alliance and Money Life with Chuck Jaffe. And yes, that's me, and you can learn more about my hour-long weekday podcast at MoneyLifeShow.com. To learn more about business-development companies, interval funds, and closed-end funds generally, go to AICAlliance.org, the website for the Active Investment Company Alliance. They're on

Facebook and LinkedIn @AICAlliance, and they're a lot more active on LinkedIn these days, so be sure to check 'em out. And if you have questions about closed-end funds send them to TheNAVigator@AICAlliance.org. Thanks to my guest John Cole Scott, chief investment officer at Closed-End Fund Advisors in Richmond, Virginia, the chairman of the Active Investment Company Alliance. His firm is online at CEFAdvisors.com and CEFData.com, and he's on Twitter @JohnColeScott. The NAVigator podcast is available every Friday, please subscribe on your favorite podcast app and join us again next week for more closed-end fun. Until then, happy investing everybody.

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