BDC institutional investor panelists discuss BDCs during AICA Summer Summit.

Thursday, August 13, 2020

Troy Ward from Ares Management, David Miyazaki from Confluence Investment Management, Michael Petro of the Putnam Small Cap Value Fund, and John Cole Scott of Closed-End Fund Advisors were panelists at the AICA Summer Summit held on August 13. The moderator of the panel was Nicholas Marshi, Editor of the *BDC Reporter*. Read the transcript from the discussion below to hear the insight from the panelists.


Nicholas Marshi


Troy Ward


David Miyazaki


Michael Petro


John Cole Scott

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Nicholas Marshi: Welcome everybody to the Active Investment Company's Alliance's Summer Summit, and if you're looking for the BDC track, you're in the right place. I'm Nicholas Marshi, editor of the *BDC Reporter* and your moderator for what promises to be an exciting panel looking at BDC and investing from an institutional investor's perspective. We're fortunate to have four wonderful speakers, each with different backgrounds and with plenty to say.

First, there's Troy Ward, who's a managing director at Ares Management, where he focuses on investing capital in high-yielding public equities with a particular focus on BDCs, but also commercial mortgage REITs and midstream managing. Prior to joining Ares Management in 2016, Troy was a sales side analyst with KBW covering the BDC sector. Troy's experience with

BDCs began all the way back in 2000 it the equities research department of A.G. Edwards, when there were less BDCs than fingers on one hand. I should point out upfront that although Troy works for Ares Management, he is no way involved in what happens at Ares Capital, the biggest BDC of all, and will not be able to offer us any juicy insight or insights.

Also on the panel is David Miyazaki, who is a portfolio manager at Confluence Investment Management. He manages speciality finance portfolios with an emphasis on business-development companies. This work includes co-managing the First Trust Speciality Finance and Financial Opportunities Fund, who's ticker is FGE, which many of you may know. David is also a member of the firm's asset allocation investment committee. In addition, he works with the firm's balance portfolios, with a particular focus on fixed-income, so he can speak to both BDC common stocks and bonds.

Batting third is Michael Petro, who is a portfolio manager of the Putnam Small Cap Value Fund, where he invests in BDCs as part of a diversified portfolio. He has been regularly investing in the sector since 2007, which in BDC years is a very long time and now includes two recessions.

Finally, I don't see him, and by no means least, we have as a panelist this time, John Cole Scott of Closed-End Fund Advisors who almost needs no introduction. Still, I'll let you know that in 2008, John founded the Closed-End Fund Universe, a data service covering all U.S. listed closed-end funds and BDCs, and he's been busy ever since.

Now we just have under an hour, which will give us time to hear from all these luminaries, but also give us enough time to answer questions you might have in the final 20 minutes. Please text us your questions on Zoom and we'll try to get them all asked and answered. So let's get started.

In a few minutes we'll discuss the latest developments in the BDC sector as earnings season is almost over. But right now I'm going to start with the simplest of questions, but also one who's answer is critically important to anyone investing in this sector. What makes for a good BDC investment? Let's start with Troy.

Troy Ward: Thank you, and thank people for joining, and thank you for having me on this panel for sure. Like you said, that's pretty straight down the fairway. What makes a good BDC investment for us? We think about investing in the BDC space, first and foremost we believe you have to look at the manager. Nicolas, like you said, I've been involved in this space for a long time, 20 years, and I can almost always point to disastrous situation coming back to either bad alignment or just a poor underwriting manager. And another member on this panel, David Miyazaki gave me some advice probably 10 years ago now, and you said one of the things that you almost never get paid for is owning that bad manager. Thinking that you're getting the valuation good enough to make up for a truly bad manager.

So I would say, what makes a good one? First and foremost, you own the manager. So understand who you own, understand why they're building a portfolio the way they are. And you have to have comfort in that. Beyond that, we love to see transparency and obviously the BDC model by itself provides a lot of transparency for investors, I think that's one of the huge overlooked things in this space. But then secondarily is the additional transparency and the way the manager can slice and dice how they're doing business, and as an investor, as a shareholder, how it can give you insights into what they're doing. I'll stop there. Just the high point for us is definitely the manager, and let maybe Mike go ahead and give his commentary on that.

Nicholas Marshi: Yes, Mike. You're up.

Mike Petro: Yeah. So first of all, I agree with everything that Troy said. I myself have fallen victim to that, trying to catch the falling knife, and it is really, really hard to do that. I think I've paid for that bitter experience that I've gained. So I definitely agree with everything Troy said, but also look at things maybe a little differently just because I'm a diversified portfolio manager. I don't have to own these things, they're not my benchmark, at least not yet. Stayed tuned on that. I don't have to own them and I am trying to beat a benchmark, and so I'm thinking can this outperform?

The kind of BDC I'm in depends on where we are in the cycle, the credit cycle, the economic cycle, valuation, etcetera. Notwithstanding about what I said about having my head handed to me on the bad ones, I am willing sometimes to buy less than the best BDC just because I think that that's the right time to buy it and to make money. You don't have to be married to these, you don't have to own them for five years. I think that's a perfectly fine strategy, to pick the BDCs and you own them forever. With ROEs in the high single digits on the really good BDCs, that's actually a good strategy. But I think you can trade around them and be in different BDCs at different times.

So with that in mind, what do you do? I think it should be clear that BDCs are going to follow their NAVs. And after all that makes sense, because after all, that's their stock and trade. Their equity is what they use to generate income so they have to preserve that, that's really important. Now we're in a recession, credit's obviously under pressure, NAVs getting marked down. Of course we don't know how much of that is ultimately going to be realized as actually destroyed equity, but on the other hand you're going to see some destruction that's not reflected in the marks yet.

So if you look at the change in NAV quarter for quarter, we're getting a window into the credit performance of the BDC, although maybe it's a cloudy window. So Q1 we had these marks down a lot like 13%, those were technical marks because of the change in spreads. And then in Q2 we got a whole lot of that back. Now not enough to make up for the losses pre-COVID, but we got some of that back. And so you had this big mark down and then mark back up, but then overlaid on top of that, superimposed if you will are the fundamentals. So you've got some cases where BDCs didn't see a markup in Q2, or very small. If you back up, there's kind of special cases around big special dividends, etcetera. That's maybe like a clue, a clue that there is worse credit maybe that flat-ish NAV would indicate. Afterall, their credit is deteriorating so fast that it overwhelms the great technical markup we had in Q2. So that's one clue.

And then obviously I think we're in the quality trade right now. You want the strong first lien exposures, you want to look into 10 Qs and see where everybody is. If they've got aerospace and oil, obviously not a great place. Hospitality, not a great place. But then you've got to put common sense on this. There's some so-called defensive sectors turned out maybe not so defensive, like dental offices, people go to the dentist even in bad times. Well, not if they can't get there because they don't want to get sick, so you want to watch that.

So quality is king but I don't think that's going to be the case all the time. There's going to be a time when you want to do the exact opposite. You want those second lien names, you want those names that have a lot of [inaudible], you want the ones that had a rough time. They're getting marked down dramatically now and for good reason, but there is going to be a time when you want to own those names.

And then there's a third leg of that trade. So it's quality now, less quality later, and then I would say we'll call it junk without naming names. Those BDCs that are going to end up getting a lot of equity the hard way. They're going to have equity because their loans default and they're going to have to phone in the companies. Eventually when we get through this recession, that tide will float even their boats, and I think you'll get some nice returns. This is in that category of trying to catch the falling knife' so I don't think you want to do that right now.

So that's kind of the evolution of the trade and then you just have to think about the timing of it. So yes, quality right now, but you also have to appreciate that BDCs are not a really well covered corner of the Wall Street universe. And what that means is the implication is then that people are not going to look too far ahead. Right now, the equity markets in general are right near all-time highs. And so you'd argue that the market is looking through this recession and through this pandemic to better times. I don't think that people are going to look at BDCs the same way. They're not going to be looking that far ahead.

And then also, you just have to keep in mind that as this fundamental credit continues to deteriorate, it takes awhile to unravel. So like you have something marked at 90, then it's 70, then it's 50, then it's 20, and gee, next thing you know, you own the equity. So it's not like a BDC can take a big charge and write it all off in one quarter or two, these things tend to take longer than you think. So all that ups to the quality trade for now, at least through the end of the year I think, and into Q1. And then stay tuned, maybe at that time you can get into these second lien guys, the guys a little more [inaudible], a little riskier to catch the reflation trade. And then 18 months, two years from now you can get the junk with a lot of equity.

That's the way I'm looking at it. And Troy's taken the broad picture, which I think is great. I'm looking at it in a little bit more of a tactical way and that's kind of the way I see the trade evolving.

Nicholas Marshi: Okay, so I'm going to sum up so far to put David on the spot so he has to think of something new that hasn't already been covered. A good BDC, you look for good management, transparency. It's useful to look at the NAV change over time as to give you some hints as to what QED quality's doing. At the moment, mainly quality names, but also timing, knowing when. You buy some at some time and some at other times depending on where the cycle and where the BDCs themselves are. So with that, David, what would you add to that or what would you like to repeat that's already been said?

David Miyazaki: I think both Troy and Mike bring up some great points. I would say that to Troy's point, when you look at any financial company, the most important assets go home every night, and so management is clearly going to be of paramount importance. The problem is when you're looking at management and you listen to what they have to say, they're very skilled at describing their portfolio and they will come across as being very sincere, and legitimate, and having the resources and experiences to manage through all parts of the credit cycle.

As you look at the track records of the different management teams in the industry, you see a pretty wide spectrum of outcomes. And so clearly there's some managers out there that are not as talented as they are able to convince people. So I think you need to be careful of that, focusing on high-quality managers and understanding the portfolios. Fortunately in the BDC industry, there's a lot of information because the structure of how BDCs report their results and their balance sheets is very revealing. The transparency is higher than what you get in most financial companies. You can really sort through and see what loans they have, what industry exposures exist. And so in that regard, you get a pretty good view of their portfolios.

And so really I think what our approach is, is to try and focus on the managers that don't just sound good and look good but actually have demonstrated real results across time, and then look inside their portfolios. I think what Mike's talking about in sort of leaning in and out of different kinds of asset exposures, is certainly something that can add a lot of value for BDC investing. That said, at least for our perspective, what we try to still keep a focus on is still stay with the high-quality managers.

There can be very high-quality managers that have some second lien that maybe they have some more equity, maybe they've recently taken over the management contract of a BDC. They may have higher defaults and more non-accruals but they're still a good team. That could present an opportunity, to Mike's point, at the right time in the cycle. But kind of to what Troy was talking about, regardless of whether someone's cleaning something up or where they have their exposures on the capital stack, I think it's really important to always stick with the good managers. Because if you traffic around with some of the scoundrels, it's very hard to know what exactly you're getting into and what exactly their intentions are.

So I think it's a little bit of both. To Troy's point, stick with the good managers. To Mike's point, take advantage of the transparency and understand what kind of exposures you have at different points in the cycle.

Nicholas Marshi: That's great. I thought that John was going to be on with us. John, are you there? John Cole? No.

So before we move onto what's happening now in the market, it's a very interesting time in the market. I'm just going to sum up what we learnt here today for anybody who dropped in late. you want good management in this business, everybody agrees on that. Transparency's important, and as David is saying, take advantage of the transparency that the BDCs offer but it isn't in every single sector, and dig into those portfolios to know what you're buying. You don't always know what you're buying, and in the BDC case, you can know more than in other places. Look at NAV change over time as that tells you something about credit and how they're performing on credit. And it always seems to come back to, buy the quality names, but you can also buy the weaker names at the right time. Some people might agree, some people might disagree, and that's what makes a market.

So thank you for that first part, now let's turn to current events. Second quarter BDC earning season is just coming to and end, it's been a doozy as Mike was mentioning. First everything went down, then everything went up pretty much across the board, with some exceptions. I don't think anybody believes, either on this panel or who's listening, that it's over by any means. But it's the end of the beginning as Churchill would say.

So I'd like to go around again and ask each of our panelists they think what was the most interesting development that came out. There have been so many different things from prospects to long-term preferred, to many, many unsecured debt offerings, the rights offerings. Of course the acquisition of MVC by Barings. So there's so much to talk about. So each of you, starting with Troy, what was the most interesting thing that you found this earnings season?

Troy Ward: Before we get down, I do want this to be a four part question because Nicholas, I'd love to hear your thoughts on that as well as somebody who is into the weeds as much as anybody in this space. But I'll expand and go just outside of second quarter, and I think definitely for us the most surprising thing about this three, four month period was Golub Capital. Golub Capital having to do the rights offering-- having is maybe not the right word, choosing to do it to protect their balance sheet.

And that's not a knock on the Golub team, I think everybody, all the investors anyway that I'm familiar with here on the institutional side, it came as a surprise and it came as just like we're investing in all kinds of names, things come out of left field that you don't realize until after the fact. And for people listening in, the Golub transaction, they did a rights offering to bring additional equity capital onto the balance sheet because in a nutshell in my opinion, I'm not sure David would exactly say it this way, but the structure of their liabilities is securitization. Which looks great on paper and it is great. We love the securitization model because it's assets and liabilities do a great job of matching, it's a good low-cost form of funding this balance sheet.

The problem that we found as we entered the COVID environment was the inflexibility of that structure and the fact that there was no unsecured assets on the balance sheet that he could pledge so that he could kind of protect to securitizations as maybe some of his buckets started hitting their triggers. So in a nutshell that is the most surprising things to us as we enter this whole COVID environment.

Nicholas Marshi: Good. Mike?

Mike Petro: I think that's hard to top. That was going to be my answer too. The shock that Golub, which is considered to be one of the better managers had to do that or chose to do that, under duress let's say. So laying aside Golub I guess, I think I would have to go with just the diversity of opinion that's out there from management teams with respect to the attractiveness to the market now.

I've seen managers say, "Well, we're not doing anything." And this is not always because they're at the top of their leverage, some of them have their fire power. But they're saying, "Well, no. We don't want to do anything, we don't know what's going to happen." And then other people are saying, "We are open for business, and we are seeing attractive credits, and we are funding them in real-time now." That's kind of interesting to me.

To a certain extent I guess BDCs always say, "Well gosh, we're that lender that's going to be there for you." "We work closely with the sponsors and the management teams of those companies." "We're there to act quickly when the big guys wont." And so here we are in this moment when companies need capital and some companies are stepping up and others aren't. I don't know, maybe the right answer will be, "Gosh, I'm glad I didn't underwrite anything in Q2 or Q3." I don't know, I think there probably are some good opportunities out there. But I guess I was surprised to see the number of BDCs that really don't seem to be open for business.

Nicholas Marshi: David?

David Miyazaki: Right. So I think that I could answer this on a good news, bad news, two different lines. First I would say that the good news is that when we look back to the last crisis in 2008, I think one of the most remarkable and underappreciated characteristics of BDCs is just how durable they are. In 2008, BDCs are really the only industry in the financial sector that didn't get any direct assistance from the government. And at the same time, it's the only industry group that didn't have a single bankruptcy and didn't have a single payment default.

Now there was a lot of damage that took place, but you did not have a system problem that required bailouts from the government. I think that played a role in why the industry's been able to grow faster generally than the rest of the financial sector. And what played out, what we saw in the first quarter, particularly in March, was that although there was significant credit risk that was appearing throughout the middle markets and the rest of the credit markets, that the BDCs again proved to be incredibly resilient.

There were certainly holes that we didn't expect. I think that if you look at a large BDC that was principally senior secured, not terribly high in leverage, led by an experienced management team, you would not have expected Golub to be the one who had the problem. And so to Troy's point, that was surprising but I think what it also shows is that the rest of the industry was generally pretty well prepared for it. We did have a rights offering from Bain, and we have seen some debt issuance in preferreds that have come out that have been sort of expensive from a cost of capital perspective. But generally speaking, the industry really demonstrated how resilient it is.

On the downside what I would say is that March in particular showed us just how far the industry still has to go in broadening out it's shareholder base. The volatility that we saw in March in many ways was worse than what we saw at any point in 2008. The declines in prices, the volume that spiked, the complete lack of liquidity created a situation where the valuations for the stocks in the BDC industry were so distanced from their operating fundamentals. And so that really shows that the industry still has a very long ways to go in bringing in a broader more stable shareholder base.

The panic that we saw that was ripping through the retail shareholder base really created a self-fulfilling sort of vortex, that downward prices begat more downward prices. It took a long decline in prices over a short number of days to really bottom out and I think that's very destructive. If we're looking at an industry that's trying to provide income, most income investors tend to have a lower risk tolerance. And so having the price volatility that unfolded in March is really unfortunate and I think that's a consequence of many different factors, some including the regulatory framework that we're in. But I did find it to be surprising just how far and how fast prices could fall despite the resilience of the BDC model.

Nicholas Marshi: Thanks David, and that brings my little contribution. Thank you Troy, which I'm putting to you guys. Here's my point. It seems to me the COVID crisis has accelerated a process that was already underway before. Is that there are a number of - well, let's be kind - zombie BDCs that are developing that are not really returning a decent return to investors. They continue to make management fees for the managers who themselves are probably wondering, "What do we do with this thing?" And many of the losses that occurred recently have only heightened it.

On our list, we see at least a quarter of the industry, there's a sort of question mark as to whether or not they can continue as independent companies. As we've seen, MVC Capital about to be bought by Barings, and we see Garrison buying Portman Ridge, and there are other things probably going to happen.

So very quickly, we have about 10 minutes til we get to questions. What do you guys see as the future of the size of the industry and its direction? Is it going to be all large cap areas, capital-like companies. Are we still going to have diversity? Are we going to have as many players in let's say, three years, than we have today?

Mike Petro: I can start off with that one. Yeah, so I think that you're going to see a bifurcation. And I think this happens in probably most industries, where you're going to see the large players get bigger. And I know the big guys like Ares have been beating this drum for a long time and saying how important the economies of scale are and the ability to write the big check, and I think there's something to that. So I think you are going to see this consolidation, but at the same time I don't want to lose sight of what I think is going to be a fact that you're going to have smaller BDCs and there is a place for them. And part of it's structural because they can use that SBIC money, those licenses, which are very cheap, long-term, committed capital. They have a low cost to capital and they're playing in a space where frankly the big guys would have to underwrite 150 or 300 names to move their needle.

So there is going to be a place for the little guys, I think it's that middle where you get killed. I think it's the middle where you're too big to really be playing the SBIC angle, and you're too small to be getting the scale and you can't write that big check. So I think there's that middle that'll be in peril, but the ends will do well.

Troy Ward: I agree with that 100%, and I think if you look historically at some of the BDCs that I think David kindly called them 'scoundrels', they wanted to be something they weren't.

Whether it was dial it back to a Fifth Street, that's now gone, thank the heavens. And even a Medley, what they tried to do. And I would even throw Triangle in that group, which was a great BDC for a long time, but they decided they wanted to be one of the big boys and they started raising a ton of equity and they kind of got outside of their comfort zone, outside of their own sandbox. They didn't know it until it was too late, and I think Medley, Fifth Street, and Triangle all fit that bill.

And so I would maybe disagree with Mike in one respect, is there could be a middle ground BDC, as long as they know who they are and who they're not. I think quite honestly any size can be successful if you have the right team focused on the right areas. It is harder to be a middling BDC because you'll have the Golubs, and the Ares, and the Josh Easterly's of the world come down and pick out the best assets that you would love to have had, and you'll have some of the small good guys pick up and get the best assets. So you're kind of in a tough spot and I definitely agree with Mike on that.

But I do think, and I'm a huge fan of some of the smaller BDCs that are okay with being small. I really believe that there's good opportunity in those smaller names. Just like Mike said, Ares ARCC is not going to do a $20 million underwriting anymore, it doesn't move the needle. And quite honestly, any manager will tell you, whether it's David Golub or Josh Easterly, they'll say it takes almost as much work to do it because this underwriting process doesn't change that much. So you do all this level of work and then you only get a little bit of an investment. So the big guys aren't going to do it.

I do think you're going to see some of the zombies, as you said Nicholas, go away, and we've started to see some of that. It's really hard for M&A in the space for a lot of reasons, especially because of the external management in most of them that make it difficult. And the second part is, if you're a manager of a BDC, do you really want to be taking on the underwriting of somebody else who's already failed? So those portfolios are probably under a lot of stress. They've already been worked, so you probably have adverse selection. It just makes it really hard. So those zombies, unfortunately some of them will be out there for a long time. I'd love to see them get rolled up even more, but my guess is we're going to live with a handful of them forever.

David Miyazaki: Yeah, you know I would say that one of the common themes that when you talk to management teams comes about, is how bigger is better. I used to joke when I would talk to management teams, what is the ideal size of a BDC? Is it $400 million in assets, $500 million, a billion, two billion, whatever it is. And the answer was almost always about 20 or 30% bigger, whatever size they happened to be. This is a derivative of the fact that they collect more fees if the assets are larger.

And so there's always this bias towards becoming bigger, and if you ask the bigger managers they'll say, "Well, we lend to the upper middle market." These are bigger companies with better resources, more sophistication, better equity sponsors, and so this is a safer profile. And then if you ask the guys in the lower middle market they're like, "Well, we operate where there's no price pressure. When corporate bonds spreads tighten up we can underwrite terms that are more favorable. And we don't have to have the competition that exists int he upper middle market with a broadly syndicated loan market. So we're a lot better off because we can be very selective." And so what happen is whatever manager you ask, "What's the best size and what is the best place to lend?" they'll always tell you wherever they happen to be is the best place.

I've heard time and time and time again from managers about how scale is important and size and resources, and these oftentimes in my opinion are justifications as to why you get bigger. But if you look at the larger BDCs, yes, Ares has performed very well, Golub has performed very well, and you have Sixth Street that has come in and is doing very well. However, we all know, and I've lost some fingers on the bigger guys, that the performance for many of the bigger BDCs, and I could name them if you'd really like to know, but I think we all kind of know who the big names are in here, bigger has not been better. It has absolutely not been better.

The biggest determinate really is the quality of the manager, the alignment with the shareholders, and to Troy's point, they know who they are, they know what they do, and that's really of paramount importance. I think that one of the more successful managers, and this surprised me in the 2015-2016 timeframe, was Mainstreet. This is a BDC not based in New York, in the flyover area known as Houston, that is irrelevant and in the middle of the energy patch. You would think this is a BDC that would be loaded to the gills in energy. That wasn't the case.

And I asked them, "How did you guys know not to be in there?" And they're like, "It's just not what we do." And it's really important for a manger to know what they do and what they're good at, as opposed to just trying to go all over the place up and down the capital stack, across different industries, getting bigger and bigger all the time. You've got to know who you are and you've got to be good at what you're doing. And so to me, that's the really differentiating point between the BDCs.

I can remember back in the day when Triangle and Mainstreet were very small, pre the 2008 crisis. And asking some BDC managers in New York City, "What do you think of these little BDCs out here, Triangle and Mainstreet? Are they just going to blink out and become irrelevant?" And they took what I would consider a pretty standard sort of view of the world from New York, and that is, "These guys are small and irrelevant but they can hang on forever, but they really just don't matter. But they can hang on forever because they'll just keep collecting their fees and underwriting loans." Well, that perspective turned out to be wrong because both of those BDCs made it through the 2008 financial crisis better than most of the New York managers did.

Ultimately as Troy pointed out, Triangle ran into different kinds of problems. But really, I think what you can take away from that is you can survive for a long time as a zombie. This industry doesn't roll up particularly well, and really the closure around situations like what we've seen here with MVC or you can go to any number of the other consolidations that have taken place. From the large side of American Capital or Allied Capital down to smaller ones like MCG. The big important ingredient for rollups of the zombies is the zombies have to no longer want to be a zombie. Because if the manager doesn't want to give it up, it's not going to happen.

Nicholas Marshi: Thanks, that's all very true and very interesting David. We've come to the end of the regular session and now we're moving into the Q&A. I do have a very interesting question here which sort of builds on what we've been talking about because it's a looking forward question. And so again, I'll put it out to all of you. I'm just going to read it here so I don't sort of misstate it.

It would be interesting to hear the opinions of the panelists about the shape of the recovery from COVID, square root sign, W, wide view, etcetera. No V apparently anymore. Many people are talking about the outlook for say, the third quarter, and this strikes me as perhaps not the right framework. So I'm curious about how these sages thing about this. Who would like to start?

Mike Petro: I can start with that. I guess that's the most general of all. I've thought about this for a long time because it impacts all the stocks I have, in capital goods, in base materials, tech, and consumer, and everything. I think my vision is coming to pass, although it didn't really pan out that way for the stocks. But economically I subscribe to the view that we're going to have, I guess what you would call the mirror image of the square root. And by that, a sharp drop down, so from your perspective, like this. Then you come up pretty steeply but not all the way, and then you kind of flatten out from there.

I think that's a natural result of states opening at different times and reclosing as the virus reignites in places. Look at the South, they weren't hit that bad initially, they reopened and then, "Oh gosh, the caseloads are increasing," they're closing back down again. And meanwhile New England and New York have been doing pretty well. So you've got a superposition of spikes in activity and then declines, and that adds up to kind of a flat. So I'm not really surprised where the economy is now, I think we have more of this to come.

The stock market at large , you would think, "Okay, unemployment's 10%," it's improved to 10%. So you would think, "Well gosh, the stock market should be down given that." But no, it's not, it's up. Again, they're relying on all the Fed and government stimulus and they're looking through this. But the BDCs are much more related to the real economy than your average stock. Because they're lending to real world companies, middle market companies that may have smaller product lines, less wherewithal financially, and are going to be economically more sensitive than your big multinationals with $300 million market caps.

So I think it actually is the right question to ask for the BDCs, what is the economy going to look like, even though that turned out not to be the right question for the broad stock market. But that's my two cents, is I think that a mirror image of the square root actually is the right answer.

Nicholas Marshi: Troy?

Troy Ward: I was actually trying to pull up a first quarter stat for you real quick. Okay, so we just got done with second quarter earnings as everybody knows. One of the things, first of all I'll say right up front I have no idea what this is all going to look like and I don't think anybody does. But one of the things I like about being able to invest in the BDCs, or choose not to invest in the BDCs, as Mike said earlier, we don't have to own these. Is the marked to market really does give you a temperature of the individual portfolios.

So in the first quarter we saw the BDC portfolios come down about 14.5%. In the second quarter, the 38 that we follow, I think they're up 3.6%. And what I think is interesting is when managers talk about what percentage of the decline in the portfolio, this is just marked to market and this is actually credit. I think given where the debt markets are, where the spreads are, things like that, I think we would have expected a bigger increase this quarter. And so for me as I step back and think about, "Okay, what's the manager really telling me by not telling me through the marked to market function?" And that is that the portfolios are slightly worse than they probably would have admitted at the first quarter.

They're better than they were in the first quarter, but in the first quarter they were giving us the verbiage that if the economy recovers, and if we don't have worst case, and if we see the debt markets recover to where quite honestly they're at, I think we would have seen a 5 to maybe 7% increase in book value when we saw 3.6%. So for us when we look at that, we're becoming more cautious, not just because the valuation, the BDCs have gone up with the market. Not as much as the market maybe, but with the market.

So we're becoming more cautious and we are still deploying some capital, but we're starting to go back up into more defensive names because we think if there is a third quarter pullback based on third quarter earnings where something else happens, we think those middling BDCs-- or I'll say they're not the highest quality and they're not the scoundrels but the middling BDCs I think maybe have the most to go down. So I don't know where it's going, but based on the clues that I'm getting from our portfolio analysis, I would say that we're tending to be more cautious with at the current valuations.

David Miyazaki: Yeah, and I would say that one really important thing to think about is that although it's very uncertain as to when all of the COVID shutdown, slow down ends, there's a really big difference in what happens in the economy and what happens in the stock market. The stock market will tend to lead, but I think it's our opinion that right now the biggest driver of what's happening in the stock market is Fed policy.

So we know that during the three waves of QE, that the Fed provided enormous liquidity into the marketplace and it really just didn't flow into main street America. It flowed into the financial system and it propelled valuations much higher, particularly for the stock market. And I think that's what's happening right now, that the recovery what we're seeing in the economy pales in comparison to what's happening in the financial system. To Mike's point, the Federal Reserve can sort of engineer where corporate bond spreads go, but they're not really able to engineer how main street operations go. You lower interest rates and you grow your balance sheet, that's not going to open the dental office, right?

So we have a situation, there's a big separation between what happens in the marketplace versus what happens at the operating level, and the BDCs are sort of stuck in between. On one side they should be carried forward with higher valuations and benefit from the marked to market because spreads have narrowed. On the other hand, if the businesses are still closed, they can't really move their marks up, and I think that was part of the reason we saw rather disappointing improvements or recoveries in net asset values with the second quarter marks.

As we look forward, I think that the million dollar question is how long does this last? It seems to me that if the economy begins to open more in the third quarter and the progress continues into the fourth quarter, most BDC balance sheets are able to withstand that, that they're not highly leveraged. In fact, in the second quarter, I think the industry generally deleveraged. They may have to provide some room on covenants and maybe pick some income and start getting cash. They may have to reorganize some of their debt holdings. But they ought to be able to make it through if we recover in the third and fourth quarter economically on main street.

If however we go into flu season, if we go into the cold winter where the infection rates rise and dental offices stay closed until next summer or late spring, there's going to be a lot of pain I think. And because we don't really know which way this is going to break, I think what you've seen in the second quarter, generally speaking, is that the BDC managers are being pretty cautious. That yes, there wasn't a whole lot of deal volume to participate in, but most balance sheets got smaller and there was a significant deleveraging that took place. And that tells me at least that these guys really are not pushing in their chips, they don't think the end is soon and they're trying to play the long game. I think that makes sense.

Nicholas Marshi: Yeah, I would agree. I have one more question here I'm going to ask but I'm just going to do a quick follow up. Let's sort of take a second from each of you, so think about what name would you recommend to anybody listening if you want to go defensive if you believe that things are going to get worse in the next six months. Which BDC would you recommend as being a good place to hide, if you wanted to hide in anything besides cash or something else?

Mike Petro: Well, I could start. I like Barings. I think that they still have a lot of BSL, which is higher grade larger companies, debt, so these companies would theoretically be able to stand the downturn better than your average middle market company would. They don't have a lot of leverage. At the same time, they're doing this MVC acquisition, I like the protective structure they've put in there with the credit support agreement. So I think that provides an opportunity for earnings and some NAV accretion over time, which would offset any trouble they might run into. So I think that they have levers to pull to kind of actually improve from here and cover any mistakes they might make.

Nicholas Marshi: Troy?

Troy Ward: You went first Mike, you took the softball. I think Barings is a great opportunity as well because their assets took that mark down, which I think is going to be more of a temporary markdown. A name that maybe a lot of folks aren't quite as familiar with is a name like Whitehorse. I think they've done a nice job, they're affiliated with HIG, they've done a nice job over the years, they're still at a below 80% to NAV. If you look through their portfolio, I think they added two new non-accruals in the quarter. But again their overall credit profile, we think is much stronger than the market currently is valuing them, and if you look at their liability structure, it's also very strong as well.

So it's a management team that we've known for a long time. It's a name that the valuation, I think is still compelling. And a name that I believe probably has-- again, we have to be looking at upside versus downside. As Dave said, if it breaks the wrong way, I think a name like Whitehorse that hasn't followed the group up high would have less downside. So it'd be a decent defensive pick while still retaining some of that upside if we break the right way.

Nicholas Marshi: Thanks. David?

David Miyazaki: Although not particularly original, I really have to agree with Mike. I do think that if you're going to have a defensive posture, the valuation of Barings, the recent acquisition, and the support of the external manager, Barings MassMutual is worth a lot. It's an underleveraged BDC, it has a fee structure that is very well aligned with shareholders. You want to find the managers that don't just talk a good game but they walk a good walk.

That said, I think that if you are a larger investor and liquidity matters to you, although Mr. Ward couldn't say it, I think that Ares ARCC is a pretty good one to be in. Because you do have a lot of liquidity, you have a lot of spillover income, you have a strong balance sheet on both sides, asset wise as well as how funding is set up, and a track record of making it through recessions and market disruptions. And so I think Ares is certainly one to consider.

And I'll throw a third one out there, and this one I think is one that has made it through very, very well so far. A little bit expensive in that it's a premium to NAV, and that would be Sixth Street. And Sixth Street is led by a team and Josh Easterly who has been one of the most opportunistic managers out there. And so long as the COVID crisis continues and there's a lot of disruption, taking advantage of those disruptions is really something that the Sixth Street team is doing. And so that's a little way to be able to get out there and play a little offense with a company that has done a great job of playing defense so far.

Nicholas Marshi: Well that's great, but we do have a question here which I'd like to read about the BDC bonds. Which we really don't talk enough about even though there's 43 public bonds now and I know a lot of individual investors are very interested in the subject. We have five minutes, so I'm afraid I'll have to limit to you each a minute quickly about this, but here's the question.

What do you think about the ratings on BDC debt? Do ratings reflect true default risk? Worth noting both the SEC and TSLX have triple B minus rated unsecured debt. David, I know that you're interested in bonds, do you have a thought?

Troy Ward: I'll seed my time to you, David. I don't need to talk on this one.

David Miyazaki: Well I think one of the big challenges with BDC debt is that most of those bonds are pretty illiquid. So if you're an individual investor, you might be able to step in and out of these things, but it's pretty hard for most institutional investors to get in there and build a meaningful position because they're just no liquid enough. That said, you are in a position on the BDC balance sheet above the equity. BDC managers nowadays pretty much across the board have permission to issue equity below NAV, and so they're going to be very interested in doing things that are going to protect their franchise.

So from my perspective, I do think that BDC debt, particularly if you have a situation where the manager is following good capital allocation polices, overearning its dividend, is not terribly leveraged, that there's some pretty good opportunities for smaller investors in BDC debt. I think that some of the lower ratings that you get from BDC debt is in part a hangover from the ratings agencies in that there's a lot of trepidation by the rating agencies toward the industry itself.

In fact, one of the major ones just got back into rating BDC debt, they had not been in the space at all. And so I think that there's a lot of skepticism towards the industry when it comes to bond ratings. A lot f the BDCs are smaller and there have been some real scoundrels in the arena that have created some questions around the voracity of the management teams. And so to the extent that you get a good BDC with a strong balance sheet, you might be able to take advantage of a rating that might be triple B minus or be double A three, and the credit risk profile is actually a little better than that.

Nicholas Marshi: Mike, you get the last word.

Mike Petro: As David pointed out earlier, none of the BDCs went under in 2008 and it doesn't look like any are going to go - fingers crossed - right now. So I think part of the ratings structure is an explicit statement by the ratings agency. They are not going to give BDCs, at least at this point, a rating higher than-- it's either triple B or triple B minus, I forget what it is. But they have a ceiling on those ratings and they don't care who you are and how good your capital is, they are not going to give a BDC a rating higher than that ceiling.

And so it's sort of like taking a test where everybody can get 100, it doesn't actually give you much discrimination power. So I feel like there are some very strong BDCs that really have minimal risk to the creditors and they're not going to be recognized by those credit agencies. And that's the position the credit agencies have, the industry's working to change it. But the agencies say, "Hey, these are small companies, they don't have a lot of trading history. The industry is very small still." So I think on the upside they are in some cases underestimating the company's stability and ability to pay their debts to the bond holders. The downside I can't really speak to.

Nicholas Marshi: That's a good note to end on with one minute to go. People shouldn't underestimate the BDC sector generally because they're still here after all these years and now two recessions, so that's a good sign for everybody in the space. So thank you all for your words and thank you all for listening, and for those who asked questions, appreciate it. I hope we'll all get back to you in some future conference, and I have no idea how else to close out.
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