



John Cole Scott On BDCs Vs. Private Credit Funds, AI Impacting Money Management, And More

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Chuck Jaffe, in this episode of The NAVigator podcast interviewed John Cole Scott, President of Closed-End Fund Advisors and Chairman of the Active Investment Company Alliance. Read the Q&A below as John shares takeaways from a recent industry conference focused on business-development companies (BDCs). He talks about how BDCs compare to private credit funds, how the market is changing, and how some money managers are using artificial intelligence to get better information on market trends that could help them pick better investments or improve timing on the trades they make.

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CHUCK JAFFE: I'm talking about the state of the private credit market and investing in private credit with John Cole Scott of Closed-End Fund Advisors, welcome to The NAVigator. This is 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 representing 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. And today we are headed in the direction of private credit, because joining me is John Cole Scott, he's president at Closed-End Fund Advisors in Richmond, Virginia, and you can go online to CEFAdvisors.com to learn about the firm or you can dig into their research

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and their data at CEFData.com. John is also the chairman of the Active Investment Company Alliance, which you can learn about at AICAlliance.org. Now John was just at the Dechert Private Capital Conference, a huge gathering of folks in the BDC business, and so we're talking private credit today. John Cole Scott, it's great to have you back on The NAVigator.

JOHN COLE SCOTT: Always happy to be here, Chuck.

CHUCK JAFFE: Let's dig into what you were learning from the conference. I won't say doing at the conference, what you were doing at the conference was going to a bunch of different sessions on the state of the private capital market. But as you build portfolios for investors, private credit has become an increasingly vibrant part of investors' portfolios, even folks that not that long ago wouldn't have been investing there because they really didn't know about it or think about it. So give us first a state of the private credit market and the BDC market.

JOHN COLE SCOTT: Yeah, so the BDC market is about \$350 billion in assets, about two thirds of those funds are non-traded or private and one third are those traditional longer legacy listed BDCs, but that's on the backdrop about, again the industry's conference, they had numbers between \$1.5 trillion and \$2 trillion in private credit exposure, and if you really think about what's missing outside the BDC, it's the stuff that's in the private funds. And so while some people dislike BDCs because there's only a quarterly NAV and they can be volatile during periods of euphoria or fear, there's way more transparency in the BDC space and these private funds, which again are meant for sovereign wealth funds, endowments, and accredited or qualified investors, so not a retail product, but there's a lot more transparency there. And they really talked about how you really have to anchor private credit, whether it's the BDC version or others, against the broadly syndicated loan market, which is like the funds we cover in the closed-end fund space that go buy these corporate loans, and that market, it's a different one. It's usually considered more liquid, but a lot of the commentary was sometimes there's less document and not as good of work on the challenges in that market. You have to remember that all of this is really a reaction to banks, because you really can think of a BDC as a non-bank bank, and the banks had some issues both in the Great Recession and in 2020 and last year in the regional banking crisis, and the good thing is that BDCs really handled that well. What was interesting is that they're worried that this market's growing, and why has it grown so much since we first started the podcast or 10 years ago

when I first launched the BDC exposure in my data business? It really comes down to private equity.

CHUCK JAFFE: That's an interesting comment because we're talking private credit, not private equity, but the story behind all of the growth in private credit is that we're seeing it because of private equity. Explain that link there.

JOHN COLE SCOTT: Happy to. So you probably heard on the podcast we also talked about some of the private equity stuff, why are there more exposure there? Roughly half the number of public companies as 20 years ago, and really if you think about it, the private equity ecosystem has grown and allowed the ability for much larger and larger US companies to delay or never go public. And when you have a growing private equity ecosystem, I think the phrase I heard at the conference was the private credit market drafts the private equity market, they're related but not the same area. And so this speculation at the credit market could in the next 10 years grow from, let's call it the highest answer, \$2 trillion to possibly \$40 trillion, which would equate if the numbers stay the same, and I'm sure they won't, but five to \$8 trillion in BDC exposure, which is way bigger than the \$350 billion we have now. I think the major factor is that there are expanded areas of private credit that are just getting traction today.

CHUCK JAFFE: One of the interesting comments that came out of the Dechert conference was that in this market where we've seen higher rates for longer, and we have expected but haven't seen a lot higher levels of defaults, we haven't seen junk bonds becoming junkier and the rest, there was some talk that if we saw that, if we had a little bit of stress on credit markets, that that would be good for the industry and good for BDCs. How is that possible? I mean, I can't imagine anybody's rooting for credit stress, are they?

JOHN COLE SCOTT: They're not, but a credit manager, one of the BDC managers said credit managers wake up every day grumpy, always expecting the worse outcome because their best case scenario is to get paid back in full. No one ever says, "Thanks for the loan, here's extra money for giving us the loan." And really credit stress could be considered, we've had such benign markets, without the Covid blip and maybe the banking crisis mini blip, for the last 15 years it's really hard to prove who wrote the deals right, who can actually work out the big, hard problems? And you really want a credit manager to structure the deal well and to be prepared to work on it actively should it go wrong, because some deals always can go

wrong, and it's going to get worse if and when we have a real recession, the concept it's been too easy for too long. And again this really goes on the backs of the growth of private credit is really coming into areas of direct lending and asset-backed securities and leasing and supply chain financing, all these other areas which will grow private credit, and we believe, and the managers mentioned, will trickle down into some investments inside of the BDC funds themselves.

CHUCK JAFFE: Private credit I think still to most individual investors seems like a small deal, right? You think about the public markets and you're thinking that's huge, but it's become a big deal in terms of its market power. So help give us some perspective on that, and then is there a worry with the growth in private credit and the rest that there could be a blowup? Because the rest of the financial services industry, I mean, look, we lived through the Great Financial Crisis of 2008, which was problems with the banking industry. Private credit is kind of unregulated, so are we worried or should we be worried that there might be a blowup at some point in BDCs or private credit markets?

JOHN COLE SCOTT: So at the end of the day, remember, BDCs have leverage but way less than banks themselves and mortgage REITs and other traditional levered vehicles, the BDCs themselves that we mentioned are relatively transparent. There is some concern that regulators are noticing that there's way more dollars in the sector, and especially the non-registered funds, the non-BDCs, the non-closed-end funds, the non-interval funds that do work in this space don't have that reporting of scheduled investments and transparency that can allow people to understand what's going to happen, and so that could be a concern. Can the private fund, sovereign wealth funds and others, be possible issue for the next pullback? I would say that there's still hundred million dollar checks or even billion dollar checks able to be done, and one way that's possible is that the BDCs, many of them have exemptive relief. So if you've got a BDC platform, they could have two private funds, a public fund, even a sovereign wealth unregulated fund, they can slice a billion dollar check into four or five pieces, and suddenly it's a digestible, reasonably sized portfolio exposure for that fund. And that's been relatively new, that you can really have both these smaller BDCs doing the lower middle market work, think the average American type of company that's not well-known. And it was reminded that the middle markets, not the big companies, is the third largest economy in the world after China, the only thing bigger than the middle market is the total

US GDP and then China. It's a big area and it still expects to grow because there's just so much growth in the private stuff, because it seems to be easier to get deals done that are good for the companies and the investors are comfortable too.

CHUCK JAFFE: Lastly, whenever you go to a conference there's a lot of other things that get thrown out there and they're always taking a look at things in the industry, and there was a session that was looking at how AI is going to impact private credit and general lenders. I don't necessarily know that I would expect to see the connection there, so what is it?

JOHN COLE SCOTT: Well, it's interesting, most the managers said they already have major investments, whether it's a Morgan Stanley or an Ares or a KKR, some of those larger players, in AI data science and pulling deals. I mean, Fidelity was mentioning that they can take their data scientists and pull all of the deal records from all of the deals they did, they didn't do, and really get information about the health of the economy, and then later really assess quickly what's going on. One of the BDCs mentioned they can have a ChatGPT-like bot for their team that can just query all of the sub docs for thousands and thousands and thousands of loans that they have, and in the public data that's available for other funds, and can really quickly understand trends and really prove what's going on. Now one of the lawyers says he doesn't believe that AI will kill the lawyers job, but he did say this probably applies to a BDC manager too, you can lose your job to a lawyer that uses AI better than you. So I think the key going forward is the industry's going to have to grapple with whether a firm like mine, a smaller firm, or these giant firms like Blackstone and others, you must embrace AI because it's going to be a huge part of the whole ecosystem of loans and investment theses going forward.

CHUCK JAFFE: Really interesting stuff, John. Glad you had a good trip to the conference, thanks for reporting back to us. We'll talk to you again soon.

JOHN COLE SCOTT: Thank you, Chuck.

CHUCK JAFFE: The NAVigator is a joint production of the Active Investment Company Alliance and Money Life with Chuck Jaffe. And yes, I am Chuck Jaffe, I'd love it if you'd learn more about my work and my show by going to MoneyLifeShow.com or by searching for it wherever you find your favorite podcasts. To learn more about business-development companies, closed-end funds, and interval funds go to AICAlliance.org, that's the website for the Active Investment Company Alliance, on LinkedIn @AICAlliance. Thanks to my guest, John Cole

Scott, the president of Closed-End Fund Advisors in Richmond, Virginia and the chairman of the Active Investment Company Alliance. You can learn about his firm online at CEFAdvisors.com and dig into their research at CEFData.com, and John is on X or Twitter @JohnColeScott. The NAVigator podcast is available every Friday, make sure you don't miss an episode by following along or subscribing on your favorite podcast app. We'll be back next week, and until then, happy investing everybody.

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