



John Cole Scott: BDC Worries Are Creating Headlines, Opportunities

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Chuck Jaffe, in this episode of The NAVigator podcast interviews John Cole Scott, President of CEF Advisors. The stock market has been beating up business-development companies, with the sell-off largely being blamed on the artificial intelligence boom and the high number of loans that BDCs make to software firms. Behind the theory that software companies will struggle to pay debts as artificial intelligence renders their products less useful and attractive, there are real loans, and John digs into the math that is impacting the lenders and BDCs in general. Scott, who also serves as Chairman of the Active Investment Company Alliance, discusses two BDCs and shows how the headlines could be creating values that make the industry more attractive, not less, for investors who understand and measure the risk.

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CHUCK JAFFE: Business-development companies are selling off, and it looks like the problem is fallout from the artificial intelligence boom, here to discuss it, John Cole Scott, president of CEF Advisors, this is The NAVigator. Welcome to The NAVigator, where we discuss all-weather active investing and how to plot a successful financial course with the help of closed-end funds. The NAVigator is brought to you by the Active Investment Company Alliance, a unique industry organization representing the entire closed-end fund industry, from users and investors to fund sponsors and creators. If you want excellence beyond indexing, The NAVigator's pointing in the right direction. Today however, we're talking about navigating through the rough seas of current troubles among business-development companies, and John Cole Scott, president of CEF Advisors, where they produce great data covering closed-end funds and BDCs, well, he's here to help. You can dig into the firm and its data for yourself at CEFData.com, and John is 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: Great to be here, Chuck.

CHUCK JAFFE: We are talking about tough times, and specifically business-development companies in private credit markets, which we discuss a lot here on The NAVigator. I mean, we've had some top BDC officials here just in the last few weeks, but also in the last few weeks the stock market has watched the software sector meltdown, and the blame for this has gone to the idea that artificial intelligence is going to eat software, that software companies will struggle to pay their debts as a result, and some people are saying this could create the kind of black hole for private company debt financing that we last saw during the subprime mortgage meltdown in 2008. So with that potential crisis as what some people are painting as the backdrop here, let's jump into it, start with what you see happening and why you think it's happening.

JOHN COLE SCOTT: So we've been watching this closely since even last fall, and probably even summer at some level. I mean, I really wanted to dig into this AI risk for the portfolio holdings of BDCs, and we thought it'd be useful to dig into two actual BDCs. One that won't surprise the listeners, Blue Owl Technology Finance, OTF, it's been regularly covered in the press, and another long-term BDC, maybe under the radar but still is overweight software, Saratoga,

SAR. We look at the macro [inaudible 0:02:56] UBS, double-digit defaults, aggressive AI scenarios, and the Citrini research that's been quoted a thousand places just week that I read at the airport last Sunday, and really looking at that '28 global crisis as a world where AI works so well that it's terrible and horrible in our current imagination for white collar incomes, leveraged software, credit is really feeling the backdraft of this, and the economy just kind of blows up. My thought is simple, let's look at what's actually going on in the data knowing that we're almost through earnings season, let's look at this new risk scoring methodology I created last Wednesday here at my desktop, and let's dig into these two funds and figure out how they're going. And so looking at Blue Owl, there's some merger headlines with the issues. Boaz Weinstein's been talking about this fund, but the *BDC Reporter*, Nick Marshi, who you know, has a free article that can go find on his website talking about where we thought that *Bloomberg* and Blue Owl both got that conversation wrong, part of my analysis is there, you should definitely listen to it. I'm not going to relitigate everything, but I really want to focus on what's inside these portfolios so we can really understand what's been happening.

CHUCK JAFFE: Let's keep going and let everybody know that Blue Owl, there are a few different Blue Owl entities here, and so part of the problem is we don't want to tarnish the entire BDC space based on a few things.

JOHN COLE SCOTT: Yes, the issue is with the private side of their business, versus they have two public BDCs, and OTF is the newest, it direct listed last summer, and that's where they're overweight software in the portfolio, as you do mention. And so the thing that they're talking about this one risk with the Citrini research is that the world collapses, that pressure really breaks out these portfolios, and there's defaults at levels really beyond what we saw in the Financial Crisis for BDCs, and so that is a left tail risk. The person that wrote the article later in the week said, "We put this out there because no one was talking about it. We don't think it's going to happen, but we say it can't not happen, and you should plan for it the way you should all market events." And so where we see BDCs today, Chuck, the data in CEFData, ROEs are still strong, non-accruals are still strong, average discounts are really, really wide, OTF is sitting at a 33% discount but down 21% year to date, but Saratoga, and this is why I wanted to pair them, is actually up two and mid-change year to date through February 26th.

And so same rough asset class, similar overweight in software, but different outcomes, and that's what I wanted to dig into today.

CHUCK JAFFE: You've got the shovel, keep digging.

JOHN COLE SCOTT: There we go. So we first looked at, what's interesting, people kept saying there's more software in BDCs than noted, and we go, "We've heard that, let's dig in." We actually found the average exposure now is about 25% by going through every BDC portfolio company in our holdings file and doing some deep AI and human-vetted oversight of the research, almost 1,200 software companies out of the 5,300 unique companies in our universe, and we broke them out into an AI-risk score between 1 and 10 and quarter increments. The questions that we worked on is, can AI directly replicate what this company's products produce? How strong are the moats around the companies? The data costs, the switching costs, regulatory costs, is it in healthcare and finance where there's more requirements for work? And how levered is it, and are there distress signals yet in these portfolio levels? We dug into it, we really said the stuff with issue is going to be expense tools, learning platforms, recruiting, and some customer support, SaaS, and then there's other ones that were more resilient that were on the regulated side, infrastructure and payment rails, that seem a little bit sturdier in the market. And so software in these portfolios, above weight than the S&P 500, but the actual average AI score wasn't really as surprising as we were worried about, and we blend this together [inaudible 0:06:44] for software, and we do it weighted at the portfolio to look for where these risks could be.

CHUCK JAFFE: Well, I know, because we had Chris Oberbeck from Saratoga on the show recently, but also because I've been reading a lot on the BDC issues, that it's not like we're seeing massive non-accruals on their loans, we're within historic norms.

JOHN COLE SCOTT: Yes.

CHUCK JAFFE: So we've got at least the perception of trouble, but as you dig in, if you don't find real troubles here, what you find instead are opportunities, don't you?

JOHN COLE SCOTT: I agree, and so looking at the earnings transcript from OTF, which is out now gratefully, \$14 billion portfolio, 200 companies, 70% of that book is software, that's why I wanted to focus here, but looking at these names, non-accruals are basically zero, ROE is still 9-10%, which is a great way to look at the long-term performance, and even short-term, of these managers, and really there's some good quality ownership of portfolio companies,

in our research, and mostly senior secured loans. Loan to values are low 30s, your audience may not realize but that's relatively safe considering what it could be, and so 65% of the equity would have to generally vanish before the loans were hit in a serious way, and that sounds aggressive versus the discount widening and what we think even could happen should we get the Citrini outcome. And some companies will benefit from AI, so it's not all negative, right? And so we just look at this and we just see a risk score for OTF right around 6.8-6.9, and the whole portfolio, if we weight, it is at 4.1-4.2, and that may not make a lot of sense for people, but the average BDC software score is a 5.8-5.9 and the whole portfolio a 3.4-3.6, but again, the average portfolio is more than half the exposure to software.

CHUCK JAFFE: Bringing this around to Saratoga, because like I said, we talked with Chris Oberbeck from Saratoga recently, and he was talking about how he acknowledges the broad concerns, but how he also worries that the industry will be painted with a broad brush.

JOHN COLE SCOTT: I would say looking at their portfolio, they're in a different place today, they have only one small non-accrual under 30 basis points of the portfolio at fair value, their net asset value has been creeping up, the portfolio has really been just average cost roughly, just really good quality performance. Their ROE is running similar to OTF at 9-10%, and with recent quarters they even saw some low teens in their ROEs. Structurally 80%, mid-80% are first-lien loans, so more first lien, less overall software, it's only about 44% in software, and so it's not AI-risk free, but we look at their risk score, really it's such a similar level, 6.6-6.7 for the software and 5.8-5.9 for the portfolio, so in the same mix, but I think their portfolio is more mixed with first lien, they're not getting as much focus on the software. I don't see *Bloomberg* talking about Saratoga's software portfolio, and they're both trucking along at similar levels, and so I do think that it's a good example of you can have this and be up year to date, the headwinds are not the retail, I'll say, panic currently in the market.

CHUCK JAFFE: We know the average investor doesn't understand BDCs all that well, but this is going to make it a lot tougher for some of those folks to be able to say, "I'll go with a non-traded BDC, I'll take some of that risk." Do you believe that it'll hit public BDCs more than the non-traded?

JOHN COLE SCOTT: I mean, in a certain way you can't get locked into these funds, but the discounts can be volatile, there was extreme volatility in '08-'09, though there were only really five BDCs back then, now there's 16 that are over a billion dollars of assets, and there's

50 that really can warrant looking at. The non-traded side have some use cases in the market, we've yet to use them because we're willing to trade for our clients at CEF Advisors, we are willing to rotate, take winners off the table, take losers off the table, lean into the things that we think are being overdone. And I know we talk about it a lot, but the RSI factor, [inaudible 0:10:58] about it maybe a year or so ago, great way to look at the extreme volatility happening. Remember, these are stocks and they're funds, we talk about this all the time, and a lot of people get the funded-ness wrong because they're more bank analysts for mortgage REITs, and a lot of people get the closed-end fund part wrong because they're not the best quality multi-sector bond fund because they're going to act differently, they have an earnings season, and you really have differentiation in what they can do and how the management will make decisions going forward. Hopefully, we think these people are all using AI in their process of underwriting loans, and they're going to start doing more internal work to figure this out. And just for trajectory, it would take a while for problems to really show, I recognize that, and I do think that these loans are slowly going to roll off the books and then there'll be very few old loans probably by '27-'28, and the problems opined could actually happen, they're going to be mostly loans underwritten since ChatGPT was on many peoples workstations.

CHUCK JAFFE: Does any of this change the prospects, the investment potential on BDCs? In other words, because we know that software risk is a real risk with a lot of the firms, if it becomes known that firms are facing that as a risk, does it change the pricing and what they can generate when they're out in the market trying to do things and they're working with other potential borrowers?

JOHN COLE SCOTT: If the universe was at a 5-6% premium on average, just below long-term numbers for the larger BDCs, then I would say the market hasn't priced anything into it, but we're sitting at mid to high teens average and OTF is a 30%+ discount. In my opinion, in a regular market, if this AI risk wasn't there, it would be trading at a 5-10% premium, the way Ares Capital has in those similar markets because it's a similar size, quality manager, good data on the regular stuff. I think it's overpriced in, it's our largest individual position for separate accounts at CEF Advisors, it [was at 0:12:49] year end, we even bought some more since the last time *Bloomberg* quoted us on this topic. We are very good at looking for the painful-est part of the market, but remember, our over allocation is 2.5% of a portfolio for

BDCs and five-ish for closed-end funds, so we will own four to six to eight, depends on the allocation of the clients, because we recognize one BDC is never the answer, in my opinion at least, and this is a piece of an allocation and a part of a portfolio. And just like everything, I believe John Templeton said, "You buy when there's blood in the streets," and I would argue at these price-to-book levels, you can have a lot of problems and still have good returns going forward, even with peak rates behind us and future issues with the economy.

CHUCK JAFFE: I get that some investors might be throwing out the baby with the bathwater here, do you wind up just saying, "I'll look at my BDCs, the ones I own, see how much software exposure they have, and if the software risk is above a certain level, I'm out"?

JOHN COLE SCOTT: So it would depend on their price-to-book at one level, this AI-risk score is going to be in our data file for data clients by April, we're going to write an article about it, out in the next week or so, we'll go into way more details than this conversation. But I would say it's a sector, it's a structure, if you're looking for high income, getting 10%+ yield without over leverage, and not CCC credit ratings for high-yield bonds, it's to me the where you can get that where the market is not excited here and you really need to lean into that because it's a powerful way. I mean, you underweight BDCs when the RSI is over 60-ish, even our firm that loves BDCs, and you overweight them when it's below 40-ish, and then when it gets below 20-ish you go, "Is this crazy? Are we missing something? Is the world broken?" And then usually under 20 lasts less than a week, and that's going back 14 years of data for the index, not any individual position.

CHUCK JAFFE: Ultimately, you expect the turnaround, you don't expect this to be that much of an ongoing problem because you wouldn't be buying into it if you thought it would be.

JOHN COLE SCOTT: We bake in problems in our portfolio analysis, Chuck, because problems always happen, especially ones you never imagined.

CHUCK JAFFE: We imagine that we'll be discussing this again with you soon, John. We appreciate the take on it today, thanks so much for joining me on The NAVigator.

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

CHUCK JAFFE: The NAVigator is a joint production of the Active Investment Company Alliance and Money Life with Chuck Jaffe, and yes, I'm Chuck Jaffe, and you can learn more about me and my show by going to MoneyLifeShow.com. Now to learn more about business-development companies and closed-end funds, go to AICAlliance.org, the website for the

Active Investment Company Alliance. Thanks to my guest John Cole Scott, president of CEF Advisors in Richmond, Virginia, the chairman of the Active Investment Company Alliance. You can learn about his firm and dig into its research and data for yourself at CEFDATA.COM, and John's on X @JohnColeScott. The NAVigator podcast is available every Friday, make sure you don't miss an episode by following or subscribing on your favorite podcast app. We'll be back next week with more closed-end fund talk, until then, happy investing, everybody.

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