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Bonus Episode: Gapstow's Chris Acito on Alternative Credit and the Search for ROE

"ROE, ROE, ROE": Gapstow's Chris Acito on Telling Bargains From Value Traps in BDCs and Credit Funds



Chris Acito
Chief Executive Officer
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Chuck Jaffe, in this bonus episode of The NAVigator podcast from his Money Life show, interviewed Chris Acito, Chief Executive Officer at Gapstow Capital Partners. Acito says return on equity is the first thing he checks when looking at discounted BDCs and credit closed-end funds. In his view, a fund earning 9% to 10% ROE should trade near NAV. That is why he doesn't shy away from the handful of BDCs trading at premiums, which have earned mid-teens returns. "Don't ignore the ones with a premium," he says. He then applies that rule to listener picks, including Blue Owl, SLR, Oaktree and the Eagle Point funds.

TOPICS DISCUSSED

- Why return on equity, the total return on a fund's loan portfolio, is Acito's first test for telling a real bargain from a value trap
- Acito's rule that credit funds earning 9% to 10% ROE should trade near NAV, and why the six BDCs above par, at an average 30% premium, have earned mid-teens ROE
- Why alternative credit means high-single to low-double-digit returns, which rules out munis, and how illiquidity and origination premiums give BDC loans extra yield
- How rising rates hurt fixed-rate holdings but can help floating-rate portfolios, and how weak ROE can force dividend cuts that start a "vicious circle"
- Lightning round: buys on Blue Owl Capital Corp. (OBDC) and SLR Investment Corp. (SLRC), whose discounts look too deep for their ROE, and "not so fast" on Oaktree Specialty Lending (OCSL)
- Why Eagle Point Credit (ECC) is a hard pass despite a 40%-plus yield and a price near 50% of NAV, while sister fund Eagle Point Income (EIC) is a qualified buy for the watch list

The discussion is educational in nature and intended to help investors and advisors better understand the tools, trade-offs, and data points involved in evaluating income-focused strategies.

EXPLORE THE DATA REFERENCED IN THIS INTERVIEW:

- Free CEF & BDC profile pages: cefdata.com
- 40+ CEF & BDC indexes: cefdata.com/index
- Listen to the full episode: AICAlliance.org

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THE CONVERSATION

CHUCK JAFFE

Hey, it's Chuck Jaffe, host of The Navigator podcast from the Active Investment Company Alliance. Every weekday, I also host an hour-long financial interview program called Money Life, and our show on November the 19th included Chris Acito, Chief Executive Officer at Gapstow Capital Partners. He was there for a feature called the Money Life Market Call, and since the focus of the conversation was closed-end funds and business development companies, we wanted to make sure you had a chance to listen in. So here it is as a bonus episode of The Navigator. Enjoy.

Chris Acito, Chief Executive Officer at Gapstow Capital Partners, is here. We're talking credit markets, closed-end funds, and business development companies now on the Money Life Market Call.

Welcome to the Market Call, the part of the show where we talk with experienced money managers about how they do their job, what they look for that determines their buys and sells, what they see happening broadly on the market, and how they put it all together. And making his debut today on the show, Chris Acito, Chief Executive Officer at Gapstow Capital Partners, online at Gapstow, G-A-P-S-T-O-W, Gapstow.com. He is a credit-centric manager, meaning we're looking at credit markets. He does it with closed-end funds, but not all closed-end funds. There are parts of the credit market that are not really his focus, and he does it with business development companies. And we're going to discuss all of that now. Chris Acito, great to have you here on Money Life.

CHRIS ACITO

Chuck, it is great to be here. Thanks for having me.

CHUCK JAFFE

We always start with methodology. You've got an approach that drills you into certain parts of the credit market, kind of keeps you away from the others, but also the things that you are looking for. You're pretty specific in what you want to see. So help us understand how it works.

CHRIS ACITO

Happy to, Chuck. I think you introduced Gapstow very well. Just to say it again, we are a credit-centric fund investor, and that's an important part to talking about the methodology for our audience. We're investing in funds, not individual stocks. And to me, it's an interesting question. You always like to think of money managers. You want to evaluate their process and their people, and all of the things are very important. But I think for the audience today, I want to tell you there's one metric that I really hone in on as sort of a good first step for whether or not a fund is something we want to be taking a look at from a valuation standpoint. And as you know, this is an interesting time to be talking about this, because people are familiar with the fact that BDCs and closed-end funds are trading at discounts, some very, very significant. How do you make sure that you're not in a value trap? How do you make sure that you're not just drawn to a very high yield? So my first and foremost metric to look at is return on equity, and I can dive into that, Chuck, if you want.

What is return on equity? Coming back to funds, the funds that we look at, and BDCs included within that, are portfolios of loans. That's what they own. And so you would think that the portfolios would more or less be valued at what their net asset value is. But as we know in the listed fund world, sometimes those funds can trade away from net asset value, at a premium or discount. But if you focus on how well that actual portfolio of loans is performing, that is what ROE is. That's what return on equity is. Did the portfolio of loans maintain its value? Add some interest to that, the dividend to it, and that's what the return on equity is. It's different than what the share price return is, and different than what a dividend rate is. It's the total return associated with owning that portfolio.

To summarize slightly differently, I've given this manager $1. Are they doing a good job with it from a cash-on-cash return to the underlying portfolio? And maybe that share price goes through volatility swings, maybe premium, maybe discount. That's somewhat out of a manager's control. Are they doing a good job with investing the capital within that fund structure?

CHUCK JAFFE

When you look at current markets, you're credit-centric. We have seen interest rates rise, but for a long time now, whenever rates have gone up and people have said, "Well, you know, rates go up, we're going to see more defaults and things along those lines," we haven't had waves of defaults. But for you as an investor, do rising rates change the game significantly?

CHRIS ACITO

Rising rates will change the game over time, particularly on valuation. If you're holding fixed income-oriented underlying investments, rising rates will pinch the valuation of those holdings. Sometimes, though, some of these funds are holding floating-rate obligations that will actually increase in value with a rising-rate environment, or at least directionally so, and certainly pick up from the dividend yield standpoint. So, depending on the underlying collateral, rates will really have [inaudible] environment.

And I think you've transitioned to a really interesting point, Chuck, which is, you know, what's a good return for that ROE I was talking to you about? And I'll give you my metric, if you're so interested. I think these funds should be earning a 9% to 10% return on equity. Listed funds, they apply some leverage, they take risk with their underlying collateral. That strategy should be able to, over time, produce 8%, 9%, 10% return on equity. And if they are not doing that, then I think there is some concern with, is the manager doing a good job with the portfolio? And potentially they can do a little bit higher.

And I think if you want to assess where we are in the marketplace, everyone is asking right now: BDCs are trading at 80% of book value. Should I jump in? That seems like a terrific opportunity. Question is, how do I know it's not a value trap? Think about ROE, and I'm going to beat this drum throughout this podcast, Chuck. ROE, ROE, ROE.

To give you an example, you know, if something is trading at a 9% to 10% ROE, I think it should trade more or less at NAV. These are obviously directional rules, but a good starting point. If you are looking at a BDC or closed-end fund that's generating a 5% return on equity, I don't think it should be a surprise to people that that probably needs to trade at a discount. That's not an irrational discount. That's saying, I will pay less than $1 for this net asset value in order for my return on my own invested capital to creep back up to that 9%, 10%.

Similarly, there are some BDCs right now who trade at a premium. Why would a premium make sense? Why would I pay more than net asset value? Well, those are BDCs and closed-end funds that generate a return on equity that's measured kind of in the mid-teens. Let's be really specific. There are 38, more or less, listed BDCs right now. The six BDCs that trade above par, and they on average are trading at a 30% premium to book, have a five-year return on equity measured in the mid-teens. Well, Chris's back of the envelope says a NAV-oriented price should be 9% to 10%. No surprise that a fund that is trading at a premium has a much higher ROE. The other end of the spectrum, though, the 10 or so BDCs that trade at 60% of book value or less have a five-year ROE of 6% on average, so well below Chris's back of the envelope for what a good position should be. I know we're going to talk some specific names later on, but I'm going to use this directional rule on an ongoing basis to establish whether or not there is a value trap. So we can get into it.

CHUCK JAFFE

> One of the other things is, you're looking for that ROE. There are parts of the fixed income and credit markets that you really don't get into, like you're not into muni bonds and things along those lines, which I know because we've talked in the past, not for the show, but for the Active Investment Company Alliance roundtables that we've appeared at together. Is that a market call or is that an investment asset class? In other words, is this an asset class that you don't want to be in, even though you're looking for credit, or is it a call on, "I'd be there, but this is not the time to be there"?

CHRIS ACITO

> Yeah, it's an asset class, almost an asset class definition, Chuck, which is, for alternative credit investing, which is Gapstow's specialization, we need to look for return profiles that are in the high single digits, if not low double digits, for credit instruments. That is what we focus on. Definitionally, because that's what credit investors demand as having a role of credit in a portfolio. That is to say, they need that return profile to make it relevant. That's very different than munis or traditional fixed income, which have a very different return profile. They play a different role within the portfolio. They diversify from equity, as credit does, but they do it in a way that produces a lower return profile. It's one of the reasons people are so interested in credit over the last decade or so, which is, how do we introduce into our portfolios equity-diversifying asset classes that don't have a low return profile?

CHUCK JAFFE

> Well, looking for the higher return profile, you know, historically high yield has been considered junk bonds, and yet they haven't been junky for a long time. And so there seems to be this sliding scale. While the public still thinks of them as junk bonds, now it might be private credit or something else like that that maybe should earn the label. So I'm curious, because you are looking at alternative credits and you're looking at things like BDCs. Are you basically what would now be considered sort of the junk investor, or is the credit quality still good enough that, no, there's something a little further out there that qualifies as junk now?

CHRIS ACITO

> Yeah, well, it is all junk. I like not to use that. It is below investment grade, all of these instruments. The BDCs are different in that the below-investment-grade loans that they own are typically private. That is to say, not broadly syndicated. They are narrowly distributed, sometimes even bilaterally negotiated with a client. As a result, these are less liquid instruments, and so in addition to getting paid the high-yield premium, which is available, there's also an illiquidity and an origination premium that come along with these loans as well. So they are like high yield, rated below triple-B, you know, so double-B, single-B, triple-C, but the less liquid nature of the BDC-oriented loans confers an additional yield pickup as well.

CHUCK JAFFE

> So while we're going to talk some specific names when we get to my audience's picks in the lightning round, what is a name or two that's kind of the poster child for you right now? Like, this is the space that I like to be in. This is the kind of fund or BDC that really is an exemplar of what we want to do.

CHRIS ACITO

> Yeah, well, I think we need to turn to those using my metric here. You know, who are those BDCs that are trading well above book value, who are generating those above-average returns on equity? You know, the six firms I referenced earlier include Main Street, Capital Southwest, Trinity Capital, Hercules, Sixth Street. You know, Ares is pretty close to a NAV or a premium as well. That's a heterogeneous group. It is interesting that between the smaller end of the market and the larger end of the private credit market, these firms have been able to generate those higher returns on equity relative to the peer group right now.

CHUCK JAFFE

> And a lot of people will hear this and go, "Wait, did he just say that the poster child for the methodology are the things that are trading at premiums?" Because almost every time we talk to a closed-end fund investor, it's all about the discount. This is distinctly not discount capture, but that is what you said, right? Like, the poster children are all the ones that are at premiums.

CHRIS ACITO

> Well, I think there's a good argument for why the higher-quality return on equity metrics, so no value judgment here, just, are you returning a higher rate of return, are the ones that are being rewarded with that premium. And again, we can now get into, is the premium too much or not enough? But in terms of not being a value trap, those are the ones. And good pickup, Chuck, that, you know, there are some in the middle that I think we're going to talk to in a few minutes that maybe are trading below where they should be. But don't ignore the ones with a premium.

CHUCK JAFFE

> And is that ultimately what winds up making you sell? Is that fundamentally it's just, if the ROE is not good enough, that's going to be the sell discipline?

CHRIS ACITO

> That is a very large component, and the ROE is important because not only is it going to be difficult to push the discount back to par, there are other components to it, which are, if you're not earning a big enough ROE, are you generating enough income in order to keep a dividend level stable? Do you begin to get into a bit of a vicious circle, which is having to cut dividends, which then doesn't attract more investors, which pushes share price down even a little bit more? You know, that's where ROE is important as well. Not just that you're doing good stewardship, but we also know this is a very

dividend-oriented investing universe, and so, you know, cutting dividends is another downside to not being able to continue to produce a good ROE.

CHUCK JAFFE

Well, now we're going to get your quick and dirty take on some BDCs and closed-end funds my audience is particularly interested in. Yes, it's Quick and Dirty. That's what we call our lightning round here in the Market Call, and we're doing it today with Chris Acito, Chief Executive Officer at Gapstow Capital Partners. Gapstow, G-A-P-S-T-O-W, Gapstow.com, if you want to learn more about Chris and the firm and what they do. You know how Quick and Dirty works, but if you want to get in on closed-end funds and BDCs, make sure you send your requests for those, too, to Chuck@MoneyLifeShow.com. Include the tickers and your hometown. We're going to start today with a request from Al in Orchard Park, New York. It's one of three BDCs we're going to discuss. He wants to know about OBDC. That's Blue Owl Capital Corp., OBDC.

CHRIS ACITO

NAV returns close to 10%, 9% to 10% historically. Yield 12%. Okay, Chris's metric should mean that should trade closer to par. In fact, Blue Owl, and these are all as of last week, is trading at a more than 20% discount to NAV. I find that interesting. What could potentially arrive at that conclusion? You know, Blue Owl has been associated with a greater degree of technology investment and software investment. That's not necessarily true of this BDC, but maybe there is an overall concern with the name in that regard. But you would think, at least on the Gapstow simple back of the envelope, it's interesting that they're trading at, you know, more of a discount than the ROE would lead one to believe.

CHUCK JAFFE

So, given that situation, that's a buy on OBDC, Blue Owl Capital Corp. Javier in Wilmington, North Carolina, wants to know about SLR Investment Corp. That's SLRC.

CHRIS ACITO

So SLR, SLRC, a little bit of a different BDC. Unlike Blue Owl, which focuses on senior loans to corporations or private equity companies, SLRC has a unique business model in which the bigger part of their portfolio is oriented towards asset-backed lending, for example, equipment finance. So a little off the beaten path for a typical BDC investor, if in fact they're focusing on the business model. Gapstow back of the envelope: NAV returns in the 7% to 8% range, so maybe a little bit below where we thought. Strong yield at 11%. Trading at a big discount, more than a 30% discount as of last week. So, you know, this would warrant a little bit of a discount on the NAV return, but a 30% to 35% discount for an interesting firm, maybe a little bit much. Maybe it's being hurt by the fact that people don't understand the business model as well as they should.

CHUCK JAFFE

So back of the envelope says yes, that would be a buy on SLR Investment Corp., SLRC. And Peter in Wesley Chapel, North Carolina, wants to know about Oaktree Specialty Lending. That's OCSL.

CHRIS ACITO

Good three choices. They're very, very different, at least in terms of situation. Oaktree is similar to Blue Owl in that they make primarily senior loans, but of the group, lowest NAV returns over the last few years, more in the 5% to 6% range, and they're trading at a 20% discount. That's interesting. That one seems to indicate that, you know, this is not an irrational discount for ROE-type measures relative to its peer group. If it's well below that 9% to 10% heuristic, perhaps a discount is appropriate here.

CHUCK JAFFE

Yeah. So the discount being appropriate means the back of the envelope is saying "not so fast" on OCSL, Oaktree Specialty Lending. We're going to finish with two closed-end funds. They are sister funds, so we'll lump them together. They also came from the same audience member, Dave in Jacksonville, Florida, who wants to know about Eagle Point Income, that's EIC, and then Eagle Point Credit, that's ECC.

CHRIS ACITO

Yeah, so both funds focus on CLO investing, collateralized loan obligations. CLOs are themselves funds that own broadly syndicated loans, for the most part. There are two ways to invest in a CLO: to either provide debt financing to the CLO, or own the lowest tranche in the securitization, which gives you the broadest and deepest and riskiest exposure to that underlying portfolio. EIC focuses on the debt. ECC focuses on the equity of CLOs.

Let's start with the equity. That's a really difficult situation. CLO equity over the last 12 to 30 months has had a very rough go of things. For the most part, CLOs have been underperforming, with yields coming in. Perhaps no surprise, then, that ECC has had an internal core return on its portfolio, ROE, that's actually slightly negative. And even though its yield is, hold on to your horses, over 40%, that might attract a few people. The price to NAV is around 50% right now. So again, what might seem very, very attractive right now: price to NAV of 50 cents on the book, a yield that's very, very high, and yields are measured relative to the current market price. So, you know, 42% at a book value of 50 is maybe not crazy, but it's an eye-catching number. But one needs to understand that right now, and it has been for the last five years or so, ECC has been a portfolio that has been shrinking in value over time. So a really interesting situation, based on the part of the market that it focuses on.

Eagle Point Income, I think we can go back to our usual metric. You should know it by now, Chuck. 15% yield, NAV return at 6.6%, which is a little bit below. I bet you're going to guess a discount of 20% makes sense in this case. And lo and behold, directionally, that's about right. Probably the CLO

mezzanine investing, the CLO debt, has been actually a pretty attractive space over the last few years, and as a result, mezzanine-oriented funds like EIC have done reasonably well. I might argue the NAV return is a little bit low relative to what your expectations for such a fund would be, as we've made throughout this discussion. So maybe a situation where a NAV discount is warranted.

CHUCK JAFFE

Yeah. So we finish: Eagle Point Credit, that's a hard pass on that one, on ticker symbol ECC. Eagle Point Income, EIC, well, maybe a qualified buy. Certainly one that's going to be on the watch list, not necessarily a good buy, just one that people can look at to see if it's going to pass their back-of-the-envelope test. And speaking of good buys, well, we've gotten to the point where we have to say [inaudible], Chris. But this has been great. I really appreciate you coming on the show. Hope we'll do this again down the line.

CHRIS ACITO

Chuck, thank you for having me. Enjoy the discussion.

That's Chris Acito. He's Chief Executive Officer at Gapstow Capital Partners. Gapstow.com to learn more about the firm. We'll be back to wrap up this show. But don't give up now, or you won't cross the finish line, and then you might just feel like a loser. This is Money Life.

Chris Acito is Chief Executive Officer at Gapstow Capital Partners. Learn more about the firm at Gapstow.com. Visit AICAlliance.org for more on BDCs, closed-end funds, and interval funds.

Click the link below to go to the home page of Active Investment Company Alliance to learn more: https://AICalliance.org/

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