John Cole Scott provides opening remarks for the first Day of the 2021 AICA Business Development Company (BDC) Fall Forum Event along with a preliminary educational session on BDCs.

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John Cole Scott, Founder and Executive Chairman of the Active Investment Company Alliance opens the first day of the 2021 AICA Business Development Company (BDC) Fall Forum event with opening remarks and with a preliminary discussion on business development companies. Read the transcript below to hear what Mr. Scott had to say to kick off day one of this event.

John Cole Scott

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John Cole Scott: Good afternoon, John Cole Scott, executive chairman and founder of AICA. Thank you for logging in. Want to welcome you to the event. We are again thankful, we had a couple of hiccups with the platform at the one o'clock hour, glad we weren't starting till 1:15. If you had problems, that was the system not your machine.

I want to remind you that AICA is a nonprofit trade association for closed-end funds, BDCs, interval funds. This is our second event covering BDCs this year, it's our seventh event in totality and we are very pleased. I ran some numbers before we started, we've had 115 unique companies, organizations as part of our content. That includes 123 podcasts with our podcast host Chuck Jaffe, who's one of our moderators tomorrow. It also includes the 40 panels we've produced across these seven events, six virtually. This is our fifth on the Remo.co platform.

Really couldn't do it without all the members that we have. We're happy to have 15 members for AICA, and cannot do this work without the membership, that is the sustaining financial model for AICA. We do have the mission for content to be free, especially virtual. If we go in-person again, we will probably have to cover the cost of food and beverage, whatnot. But in that capacity we cannot do it without those members.

We also can't do it without wonderful speakers. And so everyone that speaks, or is on our podcast or is involved in our content as a presenter, is invited to speak. It is not a pay-to-play model. We have members that speak as well as non-members that speak. And so I just want to let you aware and we're going to get started with the "ABCs of Closed-End Funds".

If you don't know what a BDC is or business-development company, they are the funding source for small US-based companies. They tend to work with non-traded, though could be very small market cap companies, generally private, usually smaller than most people are familiar with unless they happen to be in your town or region. They've been around for over 20 years, so they aren't a new structure but they definitely have gained a lot of prominence in recent years as banks got out as much of that funding commitment to small businesses.

They are very similar to closed-end funds, we bucket them as a sector or grouping of closed-end funds in our CEF dataset. There are some nuanced differences. If you're familiar with them we'll try to highlight those throughout the event today and tomorrow. This is a two-day event, please come tomorrow for three more sessions. They are all under the 1940 Act, which means they're a registered investment corporation, so they're regulated by the SEC and FINRA. They have a relatively stable share count versus an open-fund structure which is akin to a mutual fund or an exchange traded fund. They have an active management that is building a portfolio of investments for investors and advisors to use.

And again, the ones we focus on usually are the listed ones, those that trade on the NASDAQ or the New York Stock Exchange. So they do offer investors daily liquidity at market prices independent from the fund sponsors themselves. It's actually exactly the same as traditional closed-end fund. As a RIC they're a passthrough entity, so they're really good and a good vehicle for yield. But you will hear on some of the panels at this event that yield isn't the only answer, total returns are sometimes the answer, and you need to have a stable or growing NAV generally to have a good long-term BDC investment.

They have similar leverage to traditional funds, though it can go higher, and there are some SBIC facilities, they're not considered regulatory leverage. Again, their debt to equity ratios if you're familiar with that. But we do in our system on CEF Data do include all gross leverage and how we report leverage, just like we include the preferred stock dividends and the expense ratio for traditional funds. That's something we've done decisively at CEF Data. Because these are typically like hedge fund structures but they offer liquidity, they typically have a little bit higher of a fee structure and there's usually a carry. But many of the BDCs have lookbacks, and hurdles, and other provisions to make their expense ratio fairer for investors.

This is pulled from our quarterly deck as most of the slides here are, I pulled a few BDC-centric. I want to let you know there's about 45 listed BDCs. There's actually some new ones that'll be in next quarter's deck, but give you a sense of where the whole group was trading, and the size, and the average yield. There are some non-debt focused BDCs and a few with suspended dividends. So if you look at the debt BDC, three down in the green, you get a little bit more of an accurate datapoint for the more loan focused, because there are four that currently aren't debt focused BDCs.

And again remember this is that slide that really talked about that the loans go out to small businesses, interest is paid generally speaking, and then the excess yield comes back to shareholders in the form of dividends. It's what makes them a very good strategy for retired investors. Especially those that are worried about duration exposure, because these are generally variable loans that can do well in inflation and rising rates.

So what type of loans? I mentioned that they're smaller. They're almost two thirds first lien secured loans, then the next biggest tranche is second lien loans. Only 5% of the loans in the portfolio are unsecured, and there's a really hairy group of equity other preferreds, warrants, a whole lot of things that can be as an average 19%. But we find that a lot of BDCs are typically 95% or more, even 98% or more loans, and then some are more around 80% because they have an equity component to their investment strategy either on the frontend or throughout the time and life of the BDC.

These loans aren't static. These portfolios actually, as you'll hear, can turn around and get repaid faster. Really almost make it hard to have a reason to raise more equity in the markets because you're getting prepaid and paid down faster in some periods of time like today, as some companies are stronger and they're able to lock in lower rates for similar or larger funding in many cases. Eighty-four percent of the loans are variable, 16% are fixed. That's been pretty stable for the six years or so we've covered the sector. LIBOR floors, though I guess eventually that name will change because LIBOR is basically dead, but we'll say floors. It's about half the loans and a 1.3% average level. That is of course different for every BDC. And like I try to mention, the average size of a loan is $10 million and two thirds are under $25 million.

And again, another reason people tend to like BDCs is they're not really long-dated credit investments, but they pretty much have an average maturity under four years. The longest we've seen the dataset is six, the shortest typically two. And there's no average BDC, but if you take the entire universe there's typically 239 loans for the average from 166 companies. So it's not uncommon to have well over 150-200 loans and over 100 companies in almost every BDC portfolio.

This is the blue line looking at the market price indicated yield for the peer group, so there's no other lens done. And then we take out the impact of discounts, premiums, and leverage for the green line. We use this a lot at our firm as we think about different asset classes. And the two things I'll point out is, number one, this concept, the blue line is what the board of directors distribution policy is currently. The green line is what the manager has to do economically at the investment holding level to fuel that policy set by the board.

And so the two things I'll note is that the average BDC is still trading north, almost 100 basis points north of a CCC loan. And I would say that most of these investments are far safer than most CCC loans. I'll so say that economically they actually on average have to do a little bit less than a senior loan fund, yet they're able to provide almost 200 basis points more of indicated yield. It's important to note that yield is never guaranteed, it can change over time. We have a couple of slides on that in our system that we use to monitor. But I want to make sure, that's just where the lay of the land is today and where I think it's the most appropriate comparison for new people in the sector.

We always talk about volatility as part of the, some people say risk, we always say just flavor of investment. I think that risk is actually having dividends falling or net asset value falling, actually losing principal in a way that it can't recover versus the ebbs and flows of markets. Just like many of the credit funds that we look at, the net asset value volatility is less than the market price. Net asset value is in the green, market price is in the blue. And BDCs definitely had a wilder five-year period than usual, but again we like to show that even preferred funds had higher market price volatility than senior loan funds because those investors got a little bit more panicky during the Covid pullback.

But the point here I would argue is that while it's good to know where volatility lives in NAV and market price, I would say that if you're building a portfolio that's diversified and BDCs can be a piece of your portfolio, that is going to be very powerful to be able to use them in conjunction with other sectors for your needs. And that volatility can basically give you potentially better exits and better entrants if you can think about conviction and think about taking the emotion out of investing.

This chart used to be more blues and less red, but we deal with the data that we're given. We'll have a 10-year dataset New Year's Eve, and so this'll be a little broader based backwards looking in the CEF Data. But essentially one of the arguments for BDCs is that they do, even on a quarterly basis or even a weekly basis, but again it moves quarterly, really relatively low correlation to other places.

This is taken from our index page, this one is actually not every BDC. It is debt-focused BDCs with over a million dollars of liquidity every quarter, so it reconstitutes and rebalances every 90 days but allows us to have more granular perspective and historical lookback on a purer benchmark. It's an equal weight benchmark as well. And so one thing I will note here is that while BDC prices are near their highs, they're still a little bit below their June premium highs. Because if you're noticed in the last six months, net asset values have gone up faster than market prices, which is impressive in many cases.

The average in the index, just a couple of data points here, is a 14% premium, an 8.2% yield. If you think about it, the leverage is 47.9%, that's all leverage included. And if you take out the costs of leverage, the average expense ratio like you would look at an ETF or open-end fund is

3.89%. I would argue that you may want to look at gross non-leverage expense ratio because there is so much leverage here and the portfolio assets are larger than a small levered investment.

Two other things I'll comment that I think are worth noting, is we take the adjusted core net investment income. Current average coverage for the index is 105%, and non-accruals, this is the lower right hand corner, are currently sitting at 1.13%. That's the percentage of loans that are currently in non-payment. And again, I'd say a high number is mid-single digits. We have often seen this in the last five years below levels even today. Below one is uncommon but can happen occasionally. And I think that's the keys that I really wanted to make sure you had a sense of.

This is just a pull of a total return chart. It reminds me to tell advisors and investors interested in BDCs that you can't just look at the stock price. Though of course what you paid for it and what you sell it for is also important, but you can't forget in a high dividend investments that dividends and the total return calculations are really, really important. Make sure you're doing that as you benchmark yourself over time.

This is a discount history, and it really will remind that while we never know what's going to happen next, that discounts are the anchoring point to net asset value. That we really are sitting at much more of an average level for BDCs today than they're really expensive. But again we were sitting here in March of 2020 or back in 2008 when there were far less BDCs, the discounts were actually wider. Though what's interesting is the market prices as we've studied them on a daily basis, this is not daily data, went from further down in March of 2020 than in 2008, which was to me impressive.

This is a pull from an earnings dashboard. It's too small and I couldn't think of an easier way to show it to you, so I just basically wanted to visually let you know these are the BDCs that have reported so far this earnings season and our data team has pulled the data into our system. There's a couple of day lag because there's a lot of stuff to go through every quarter for it, but it's the best I could show you today.

On the first column that's colored, this dividend was increased or decreased. Many more increases than decreases. The next column is a three-year percent dividend growth, and I put that in again, green is an increase, red's a decrease. There have been some zombie or broken or beat-up BDCs that have been converting with better managers and have a newer future and we don't know where they'll go, but we suspect it'll be a better place than they were. And some of those have some of the more negative data points, but we still have to use the data in our system even with a manager, investment advisor change of that nature. But the goal is that there's been tons of dividend increases even on a three-year basis, which is well prior to Covid.

The next two columns, the first one is anything that it's more than a 3% fair market value versus cost of investments, and there are a good number of some negatives. Only one big positive, and that's Gladstone, GAIN. What I'd say is if you look at the dividend data and the fair market value data, they tend to overlap. And so what's important is while some people may not focus on the marks of loans or net asset value performance, which is that last column, the green is up and the red is down. That's basically what I wanted to cover.

This is the last slide. I just want to say that almost done with earnings seasons, they're up in the last six months quite a bit. This deck will be in the follow-up and the focus of everything. Apologize for running over a little bit but it's been a bit of an interesting day. I just want to let you know that this is a good slide to look at later. We don't know if tax-loss selling season will happen, but this historically is what's happened for closed-end funds in the past, IPOs and disclosures.

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