The Outlook For BDCs Is Strong Heading Into 2022

Tuesday, November 2, 2021

Chuck Jaffe, in this episode of The NAVigator podcast interviewed John Cole Scott, chief investment officer at Closed-End Fund Advisors and founding chairman of the Active Investment Company Alliance. Read the Q & A below as John gives his take on where business-development companies stand midway into earnings season and with the New Year just around the corner. He highlights four individual BDCs, talks about portfolio construction, and highlights an upcoming BDC event that the Alliance will host later in November.

John Cole Scott

The podcast can be found on AICA's website by clicking here: https://aicalliance.org/alliance-content/pod-cast/

CHUCK JAFFE: John Cole Scott, founder of the Active Investment Company Alliance, chief investment officer at Closed-End Fund Advisors is here and we're talking about business-development companies and earnings season now on The NAVigator. Welcome to The NAVigator, where we talk about all-weather investing, plotting a course to financial success with the help of closed-end funds. The NAVigator's brought to you by the Active Investment Company Alliance, a unique industry organization that represents 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's going to point you in the right direction. And today it's pointing us in the direction of John Cole Scott, who is chief investment officer at

Closed-End Fund Advisors which you can learn about at CEFadvisors.com, or if you want to work their data for yourself, CEFdata.com. He is also the executive chairman of the Active Investment Company Alliance, and you can learn all about it and everything it does in the closed-end fund world at AICAlliance.org. John Cole Scott, great to have you back on The NAVigator.

JOHN COLE SCOTT: It's always good to be here, Chuck.

CHUCK JAFFE: John joins us right now on the Gainbridge hotline. Annuities don't have to be complex, the Gainbridge platform lets you make a commitment of time for money by choosing an investment period that works for you and locking in a guaranteed fixed rate. Simple. Learn more at Gainbridge.life. John, it is earnings season for BDCs, business-development companies. And you and I, well, we've talked recently about closed-end funds, business-development companies, of course kind of a sister investment. But earnings season, a really interesting time, so give us a little bit of the rundown on what you're seeing right now.

JOHN COLE SCOTT: BDCs are having another pretty solid earnings season. We're probably maybe 35% of the way through it and we're seeing similar kind of expansion in successful loans to portfolio holding companies, as well as pretty consistent dividend coverage and some small NAV write-ups getting well past the lows after the Covid pullback. It's probably important to talk about BDCs are in our world, and for our clients and our BDC UIT, we don't just sift for highest yield and deepest discount, but we do try to find the best entry point for the quality of the manager, the governance that the fund has, how fair they are at their expense ratio, which is far more complex than a regular taxable bond fund, to make those allocations. And so I thought it would be nice, a lot of people know about Ares, ARCC, kind of the big, largest BDC, it's been around since pre-2008. But I want to talk about four other BDCs, they're different and maybe you've heard of some of them. The first one is Oaktree Specialty Lending. What we like about it is it's trading right around net asset value, a very small premium. It's yielding at high sevens and it' really been a turnaround story in replacing the yield from the previous manager, and just a nice, solid portfolio where you're able to get good management of Oaktree. A lot of people have heard of Oaktree, maybe they didn't realize they had a BDC. Another one is Owl Rock. Owl Rock's newer but the players at the firm are really well known. There's a small discount, again yielding eight and mid-change.

And you're getting a lot of just nice portfolio exposure, these are mostly variable loans, there's very low non-accruals which are loans that aren't paying right now, and a great place to be in your portfolio. Another fund to consider is the Carlyle BDC, and that one's actually at a 12.5% discount. It did lower its yield during Covid and it's still down 13% from the previous yield, but it's trading at that wider discount and still has that similar portfolio and fee structure that we like for investors. You're getting a little bit higher yield from that, it's about a nine and low change, but that's because it's a little more beat up. The last one, it came out, gosh, maybe five years ago, it's the Goldman BDC. A lot of people thought that it wouldn't trade well, that Goldman wouldn't do a great job with this tiny little retail product. But I'll tell you, Chuck, they've done a great job. It's premium is about 18% and it's not considered expensive from most analysts, and the yield's still in the low nines. And what we really like when you add all these four different managers, we always talk about we build teams of portfolios and what's your favorite BDC? Well, it's hard, they're all different. What I like about this portfolio, if you were to as an example put all four in equal weight in a portfolio, you're getting a blended eight and high change yield. You have 800 loans from 900 companies, four managers, and a blended one premium, that's not expensive. Our index for comparison, the average premium is a 17% premium right now, so we feel it's an attractive sleeve to consider. We don't know everyone's situation, but if you want to be in more variable loans with fixed leverage, things that should do well in a rising rate environment, this is the type of opportunity we think is worth chatting about.

CHUCK JAFFE: So we're talking about ticker symbol, OCSL, ORCC, CGBD for Carlyle, and for Goldman, GSDB. You've got a difference here between discounts and premiums, obviously a little bit on what they do, and you talked about Ares in well in passing, which is ticker ARCC for those following along at home. Obviously just as I can build a portfolio of closed-end funds and cover pretty much the entire investing universe, with BDCs it's maybe not as much of the investing universe, but how many do I need to have to be fully diversified? There would be some people who maybe aren't that familiar with how to invest in BDCs who would say, "Well, wouldn't I get the one either with the biggest discount or the biggest yield? Do that one and ride that? Why do I need the others?"

JOHN COLE SCOTT: There's a lot to unpack there, but I'll say so we have that BDC UIT, we're hitting series 23 next week, it typically has 12 to 15 names. The caveat is it's a buy and hold portfolio for 24 months. And so when I build that I'm building more safety net for advisors to offer their clients, an allocation that I've selected, but the only way to get out is to sell the entire thing. When we do our separate account work for our individual clients at the firm, they often have four to six BDCs, and we typically do smaller allocations because they're more volatile, on the downside they fall harder. This year they're up a lot because they're recovering from that bigger fall, so we typically use them at 1% allocations to 2.5%. We often have sleeve allocations for a diversified closed-end fund portfolio of like 4-9%, depends on the model they're in. So I do think it's important that the BDCs, when they trade well above net asset value, so let's talk about the biggest premium here, the Goldman. When they are writing increasing use shares above NAV, it makes the net asset value grow even more than if just the investments do well. When investors trust a BDC to trade above the average for the sector, there's some in the 50, 60, 70 premiums right now, it's because the fee structure is fair, they've proven to do good work, and the performance can be higher when you trade that well because you're able to offer shares accretive to net asset value in a way you can't if you traded only at a discount.

CHUCK JAFFE: You mentioned the unit investment trust, but that's not all that you're doing in your multiple roles when it comes to BDCs. So explain what's going on with AICA and some of the work you're doing there that our audience members can get involved in.

JOHN COLE SCOTT: So coming up in just a couple of weeks on November 16th and 17th, we're having a two-day investor forum. It looks like we're going to be able to have two full panels of BDCs presenting. We have a BDC analyst roundtable. We're having a service provider session where it includes someone from Fitch, and somebody from NASDAQ, and somebody from the SEC. And then even a products of BDCs where we're talking about our UIT work, but also Confluence which runs separate accounts in the closed-end fund of BDCs, as well as a passive index that's mostly BDCs. With different access points to the market, we're really excited to bring the breadth of perspective from numerous players. We have Ares presenting, and Owl Rock, and Saratoga, and others still firming up all the agendas. Just go to the AICAlliance.org/events, and you can register for it today. And of course if you're willing to wait a little while after, there'll be replay content as always. And we're just doing that to give people more knowledge than we can do simply in this short little interview on the podcast.

CHUCK JAFFE: We're going to extend this interview by one more question, which is of course we're talking about what looks good among BDCs. But here we are as we head into the last little bit of the year, we're getting through earnings season but the outlook on these BDCs, is there any reason to believe that they'll do anything different? We're not expecting necessarily a massive change in market conditions, but as we get through the holidays when other parts of the market are worried about Santa Claus rallies, and January effects, and things along those lines, do BDCs ride along with those things or do BDCs tend to just plow through it no matter what the conditions are?

JOHN COLE SCOTT: So right now for the four funds I talked about, we're really kind of seeing in the next three to nine months, appreciation of the price of the BDC of 5-9% is our models and our estimates. We see dividend growth opportunities. One thing we love of that four ticker allocation, it's over half the leverage is fixed and 92% of the loans are variable. So it's very set well for an inflationary, potentially rate rising environment. That being said, if rates start going up, these things might widen their discounts because people react that way to BDCs. But what I care about is the growth of dividends and the quality of the loans we're getting, and the fact that there's a lot of loans in there and you're not getting those in other places, it's a great place to be. So if we get bumps and bruises in the capital markets, BDCs tend to go down a little faster. It's a great time to rotate into higher quality names that sometimes fall farther. And if it doesn't happen, like we've been waiting for more downside volatility for a lot longer than I would have thought this year, and so we don't know the future but BDCs definitely can handle that. And they're doing that with a lot of success and good BDC gaining more investor confidence. Discounts are actually wider than in June, because net asset values have grown so fast prices are still actually up on a relative basis. But we're not at the narrowest discount though for BDCs, but we're still relatively narrow historically.

CHUCK JAFFE: John, always interesting, I learn something every time we talk. Let's do this again soon.

JOHN COLE SCOTT: I look forward to it, Chuck.

CHUCK JAFFE: The NAVigator is a joint production of the Active Investment Company Alliance and Money Life with Chuck Jaffe. Yep that's me, and you can learn more about my work and my show at MoneyLifeShow.com. And I'd like to apologize for this episode of The NAVigator being out in November instead of at the end of October, but you can't do a joint production when there's no power and my studio and show were affected for several days. To learn more about business-development companies, as well as closed-end funds, go to AICAlliance.org, the website for the Active Investment Company Alliance. They're on Facebook and LinkedIn @AICAlliance. And of course, they've got the online webinar that John Cole Scott was talking about, and you can more information on the website. Thanks also to John, the chief investment officer at Closed-End Fund Advisors in Richmond, Virginia, the founder and executive chairman of the AICA. His firm is online at CEFadvisors.com and CEFdata.com, and he's on Twitter @JohnColeScott. Barring more storms, The NAVigator podcast is available every Friday, and we hope you'll subscribe on your favorite podcast app and join us again next week for more closed-end fund fun. Until then, happy investing everybody.

Recorded on November 1st, 2021

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