2021 AICA Business Development Company (BDC) Fall Forum Day 1 Panel #1; “BDC Products for Investors”

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Mike Taggart, CFA, Founder and CEO of Taggart Fund Intelligence moderates the opening panel of day 1 of the 2021 AICA Business Development Company (BDC) Fall Forum; “BDC Products for Investors”. Read the transcript below to hear the discussion among Mr. Taggart and panelists David Miyazaki from Confluence Investment Management, John Cole Scott from Closed-End Fund Advisors, and James Hickey from Spearhead Capital Advisors.


Mike Taggart


David Miyazaki


John Cole Scott


James Hickey

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Mike Taggart: Hello everyone, we’ll wait, John will be on here in a second. So while he’s joining I want to welcome you again to AICA’s Fall Forum. I’m Mike Taggart and I’ll be moderating your first panel, “BDC Products for Investors”. Now while I’ve been analyzing closed-end funds, traditional closed-end funds since 2010 at Morningstar, Nuveen, and now Taggart Fund Intelligence, I only know enough about BDCs to be dangerous.

But fortunately for you on our panel are three experts and investors. So alphabetically we have Dave Miyazaki, the senior vice president and portfolio manager at Confluence Investment management. Next we have Jimmy Hickey, managing director of alternative strategies at Spearhead Capital Advisors. And finally, John Cole Scott who we just saw. He wears many hats, and the hat he’s wearing on our panel is that of chief investment officer at Closed-End Fund Advisors. If you’re interested you can find out more about us on the forum’s homepage. And if you want to ask questions, obviously on the right you can ask your Q&A.

So John, I want to start with you, so luckily you had a couple minutes to rest your voice there. You kind of grew up with closed-end funds and then you followed this allure of BDCs along the way. What do you as an investor like about the BDC structure?

John Cole Scott: What I really liked about it, as I dug into it, I think it was still when I got into it about 50 names. There's been quite a few mergers and some that are no longer around. But lots of new ones, I'd say much better breeds. But what really got me interested in the BDC structure is that the manager analysis seemed to be far more crucial than simply ranking muni bond funds by either earnings coverage or leverage, a simple data screen.

And so what I really enjoyed about it was that ability to balance the traditional approach of Closed-End Fund Advisors, of manager analysis with some of the data we've been able to collect over time. To then think about how we can compare funds over time and seek better entry and exit points. I think all of us will agree here on this panel that one thing I had to learn, sometimes painfully early in the BDCs time for me in 2014, was that just looking for deep discounts was not the answer.

Mike Taggart: Okay. So Jimmy, can you hear me? Jimmy's having technical difficulties. Dave, I'm going to just hop over to you. You've been a BDC investor for just over two decades, so could you share with us how the industry has evolved, especially more in recent years maybe?

David Miyazaki: Sure. It really has experienced a lot of growth. I think that if we think back over the last 20 years, at the turn of the century you could count the number on one hand and still have maybe a finger or two left. So we've really seen a lot of growth. In part I think that what has changed is that in the early years BDCs were formed not so much for the investor but more so for the manager. That this was a permanent vehicle structure that created some visibility for managers. And was really something that because it is a permanent structure, not a fund that would close, it would be very lucrative for them. Especially [inaudible] early years.

What we've really seen since the financial crisis is that, I guess you could call it BDC version 2.0 came out. And in this version we had some managers with a little more pedigree came into the industry, the fee structures were really beginning to become much more aligned with shareholders as opposed to just for the benefit of the manager, which was very common initially. And really I would say in the last five years of the industry's growth you could almost call that group part of BDC version 3.0. Where the fees continued to come down, there's more protections that are put in place for shareholders, like performance watermarks for incentive fees, base management fees are coming down. You're seeing a lot more overt commitment by management teams to not issue equity below net asset value and dilute shareholders.

[inaudible] is highly transparent. I think it's something that tends to be underappreciated in that if you look at other financial companies from the insurance industry to the banking industry, you can't really at any quarter have a whole lot of visibility into all the details of what they're doing. And I think that BDCs set themselves apart from other financial sector companies because the transparency is so high. Personally I think that's a good thing, a little sunshine helps keep some bad things from even showing up in portfolios.

I think the fee evolution has been positive, the alignment with shareholders is positive. We still have a ways to go for the industry. We're seeing a lot of the BDCs become larger, the liquidity's better, the institutional ownership is growing. A better commitment to good capital [inaudible] are also really part of the more recent evolution. A lot of good things happening but it has taken, as you mentioned, many, many years for us to get here.

Mike Taggart: Jimmy, can you hear me now?

James Hickey: Yes, I can.

Mike Taggart: Excellent.

James Hickey: I am so sorry, there's something with these Air Pods where if I turn off the mic it just shuts off all audio. Thank you, Katherine for suggesting that. That seemed to do the trick. You guys can hear me, right?

Mike Taggart: Yeah, we can hear you. So to come back to you, I've asked John what got him as an investor, what does he like about the BDC structure? Same with Dave. How about yourself? You've touched on BDCs in various ways throughout your career, can you offer us some big picture perspective on what you see are the structural benefits of BDCs?

James Hickey: Sure. I would just sort of take a step back. It's worth looking at this from my role when I was chief investment officer of Avantax. Avantax is an $80 billion RIA platform for advisors, we've got 3,500 advisors on it. One of the core things we do is we build models, investment models that our advisors use, and these are mutual funds and ETFs. And they're allocated for the retail client, our average client size was about $300,000 to $400,000.

The traditional model everyone does is equity and fixed income. That's what we learned in business school and what we were all taught. And that was great back in 1990 when the 10-year US treasury paid 8.5%. The problem is since 2010, 10-year US treasuries have paid terribly. They've hovered around 1-3% for the last decade plus. And so what I'm faced with as a challenge is our clients want a mixture of growth and income. Well, how do I solve for income when the traditional securities don't work? It doesn't mean peoples' income needs go away just because the 10-year treasury is paying 1.5%.

And so I started looking around, and one of the neat things we've really had in the last 20 years, an explosion of what I call return of asset. And this fits right down the fairway of products that combine equity-like features, your BDC is technically an equity investment if you buy it, and has fixed income in terms of it's a passthrough very high income. And so you look at BDCs, you look at MLPs, you look at REITs, convertibles falls in the same category and preferreds falls in the same category. So holistically these new asset classes are really fascinating for the next generation of retail investors. So I think it's very, very interesting.

Now to dive deeper into BDCs, I always really, really like BDCs. I'm not a fan of MLPs and REITs because you're really doing a sector bet and you have to be bullish on real estate, you have to be bullish on energy. If you want to diversify, those don't really solve your problem because you're taking an industry sector bet. Whereas if you look at BDCs as John talked about, you're really going across platforms, so you're betting on an income stream. And so that really was powerful. And so I look at today you're going to get 8-9% on average, there are some that are paying up to 11%. That's really interesting when I'm looking at other products out there to put in my portfolio. So that's one part of it.

The other part of it is that I have a mandate to invest in funds. We're not in the business for advisors picking individual BDCs. Part of it's, to be honest, if we pick an individual BDC, $100 million may flow in. We'll distort a lot of BDCs if we put that much money in, and so you have to pick a fund. Well, currently there's three products out there, but when I started the dominant one was BIZD, which is a market weighted ETF. It does its job and it does its job admirably, but it doesn't work for investment firms like ours when one of our mandates is diversification. Because BIZD is market weighted, literally 30% of the ETF is allocated to securities and 50% to five securities. So it doesn't work for us because I still that idiosyncratic risk that I've just got to get rid of.

And so we looked around and we ended up partnering with Virtus. Virtus has really pioneered this alternative income play, and what we worked with them was how do we build a BDC ETF that actually checked my compliance boxes? And so working with Virtus they built for us an ETF, Virtus Private Credits. Unlike 25 in BIZD, it's 60. So it's a nice diversification, no more than 5% for any given security. So again, I'm not taking big idiosyncratic risk. We pick BDCs for income so it's market weighted to yield. So again, checks the box.

The one thing they did, which I like but I caution, is they added closed-end funds that are not BDCs to it. So they added closed-end funds that invested in senior loans and CLOs. So that's how they got to 60 from 40. So that's the one tweak they did, they added about 20 non-BDCs. That's how we got in, that's how we created it. I think a good point is if you're looking at products, there's three out there. There's FGB with David [inaudible], there's the BIZD, and the Virtus Private Credit. And so for retail investors, those are your three products. They each have their strengths and weaknesses but that's the universe you look at.

Mike Taggart: The universe of ETFs that invest in BDCs.

James Hickey: Yeah.

John Cole Scott: I was a little flustered when you started. I'm forgetting to mention that we have a UIT of BDCs.

James Hickey: Oh, I'm so sorry, John. I am so sorry!

John Cole Scott: It's okay, man. That's why we're all here. We all learn something new every event.

James Hickey: I totally overlooked. I'm so, so sorry. Yes. And John does a great job, jut for the record.

John Cole Scott: But it's different because the UIT wrapper, and I actively select it every four months for SmartTrust, and so I just last week we launched Series 23. And over the course of 23 trusts, I really also tried to make rules of at least 5% so that I'm convicted, no more than 10%. Because a UIT investment is an actively selected, passively held. So if you hold it for all 24 months you're only answer is to hold it or to sell the entire basket of portfolio. And so what we've really done is trying to add the things I've learned from analysts and investors like David and others in the ecosystem, is how to offer a product that I can tweak, set for a 24-month trajectory. But the difference is it doesn't have any rules like with an ETF, I think yours rebalances semi-annually, Jim. So there's some change over time, but of course David's work can be active like we do for our separate accounts.

The goal of this panel and why I wanted to have it is there's different ways to do it. And they're all different with advantages and disadvantages, and it all depends on what you're trying to get out of the portfolio.

Mike Taggart: Great, so let's get into that a little bit about the different ways. David, you were touching earlier on better. What does better mean for you? I'm sure with your experience you know when you see it. But for somebody like me who only knows how to spell BDC, what would I do? How would I know better?

David Miyazaki: Well, first of all I usually need to get out a pad of paper and doublecheck myself before I spell BDC. Even that takes a while to learn how to wield properly. But the thing about better is it's a qualitative assessment. You can look at balance sheet numbers, and nonaccrual rates, and fee schedules, and those are all very quantitative. But one of the things about financial companies is that the most important assets go home every night. And so you're dealing with people, and you're dealing with behavior, and you're dealing with incentives, and so there is this lens of qualitative analysis that we think is pretty important when you're looking at BDCs. And that's kind of how we get into, are they becoming better?

And it's not obvious a lot of times. I've told people many times that I've lost a lot of fingers holding the wrong BDCs. I'll tell you, there's a lot of management teams out there, they're very knowledgeable, the executives can be very charming, and they're not good at what they do. Either because they're trying to do the wrong thing or they're just not good at what they do. But when you meet them it's very hard to know because they're good at communicating, they're good at personal interactions.

But when I say better, I think one of the things that this industry when it was first formed was, as I said earlier, it was kind of created because it was an opportunity for managers to have another sleeve of asset management, one that was publicly traded and permanent. So the paradigm was really that, hey, this is an opportunity really to have a lot of fees in something that is continuous. And that's really not a very healthy paradigm. I think that if you think about the institutional world, professional pension managers, and foundations, and institutions, they're looking for managers who are willing to put their interests before those of the manager. And so that's really what we began to see in industry version 2.0 and 3.0.

Unfortunately like most things in the capital markets we don't really evolve on a straight line. It's sometimes two steps up and one step back. One of the largest BDCs that's in the industry recently consolidated two of its publicly traded siblings into one, and removed the performance lookback for the incentive fee. And that was the first time really in years that somebody's actually pulled it out. In fact I can't even remember another BDC that's done that. And unfortunately when that kind of thing happens it opens the door for other BDCs to point at that and say, "Hey, maybe this isn't that important." And we had a BDC that came public here in recent weeks and decided not to put that in there. And this is something that's a really important aspect of making the shareholder the center of importance so that the shareholders' interests are well in front of those of the manager.

Mike Taggart: That's one of the better things that you're looking for, correct? So you're looking for a BDC where management doesn't just say, we've all heard it, "Oh, we put shareholder interests first." But you're looking for actions where they actually do put shareholder interests first so that everybody can benefit. The shareholders and the executives can both benefit from the performance of the BDC.

David Miyazaki: That's exactly it, Mike. They're all going to say, "We look out for the shareholders," but we want to actually see the actions that backup those words. Fortunately if you look at the other large IPO that we've had here recently, they were very overt in putting a watermark in. They were very overt in lowering the base management fee too. About the lowest level that we've seen in the industry. And very, very committed to making sure that the shareholders interest have a prominent priority. And that's why I think it was really the most successful IPO that I can remember over the course of my history in the industry.

So there are good things that are happening. But there are times when, again we're dealing with people and people have their own opinions and have their own behaviors, and sometimes we step backwards and sometimes we move forward. But I think we are seeing steps taken that begin to put shareholders first and foremost. We've had a couple secondary offerings here just in the last week, and in both of those situations the BDCs aren't quite at net asset value, and the managers stepped in to fill the gap to make sure that they weren't issuing equity below net asset value. That's a positive thing because they're sticking to their commitment to not diluting shareholders with equity offerings below NAV. So it's those kinds of things that help make the industry better, and we think that's how you should position your portfolios.

John Cole Scott: I might add it does change over time. Because as I got to meet BDCs in person and reviewing analysts work, and deciding how to use them tactically for my SMAs and passively for the UIT, you kind of have ones that you like and you lean into and you overweight a little bit. And then you see behavior or an opportunity they could have been better, they could have risen above the requirements of what the SEC and FINRA require. And just be good stewards of the capital, which is a separate concept of writing loans and getting paid back. I always kind of joke that's step one to be a BDC.

But there are nonlisted BDCs that can be very popular as well, and this isn't the only way to access this investment. It's the easiest for retail investors because it's a listed, you can buy it with $1,000 in your stock account. But it's not the only way. But you can't forget, as was reminded, you have equity shareholders. And so you need, as Dave has been talking about, not forget the governance and what happens to them if you don't do a good job with secondaries. Or you do a dilutive rights offering and you're raising capital for the sake of capital raising not because you actually have a great opportunity set.

And there's a lot of opinion brushed in there but I think that's the interesting thing, is that you have to learn. There's some BDC managers I'm still a little hesitant about because they made bad decisions three years ago. Eventually they can heal that relationship. Life isn't black and white, we have to pick a competitive landscape of BDCs and what's the most attractive at the right size for our investors. And so I think that's a layer I would throw in there, it's very complimentary to what David was saying. It's not static, it does tend to evolve and you have to keep an eye on what they're doing regularly, as I know he does.

David Miyazaki: I think, John, you're right. One of the most expensive burdens of this industry is opportunity cost, and what a lot of managers could have done if they had made the right decisions for shareholders.

Mike Taggart: I think that's true whether you're in the BDC or straight up equity manager or fixed income manager, right? But it's something I think that a lot of managers don't do or don't have the time to do, is to step back and say, "What was the opportunity cost by making that investment?" and learning. So John, are there any other kinds of things on your checklist when you're performing BDC due diligence, besides you've already done the work, you have your universe already established and you're looking at valuations and the management teams?

John Cole Scott: It is. Because we pretty much from Series 1 to Series 23, we've really told the story for the advisors that use our product. Our goal is quality management, we want to see dividend coverage as best we're able to at the time we're setting the portfolio. We want to find managers that are generally better at getting paid back on their loans, so lower nonaccruals as well as better fair market value versus cost. Because we basically take the 14 BDCs and show weighted data on our system on CEF Data every day to help provide answers to an investor or advisor before they invest, as well as during the entire 24 months.

So if you've been in BDCs for five years, you've had some ups and downs and maybe some loop-the-loops like a rollercoaster. And it has been helpful to have basically been able to maintain that story, because this is a passively held version of the investment and so we have to be careful in what we're doing. But as long as we try to make the data align as in we have dividend coverage, lower nonaccrual, more variable loans, more fixed leverage. Yes, it's not the perfect output because I'm also picking managers and weighting them based on my current thoughts and opinions on direction of market prices. Both relative to each other and then what I think could happen in the market.

So those are the major things. Again, there's a lot of data to look at. We have 270 data points covering BDCs right now on CEF Data, it's a big spreadsheet as you know Mike. Not any one datapoint is ever the most important, but I think the concert of data and the experience for trends in data, and then adding the opinion of where you think things will go. So whether you care more about fixed versus variable leverage, variable versus fixed loans, how much equity do you want in the portfolio versus just pure debt?

Mike Taggart: Right, okay, great. So Jimmy, coming back to you. Are there any red flags for you when you're considering a BDC or even after you're invested in one?

James Hickey: Sure. So first off--

Mike Taggart: No Mike, there aren't any!

James Hickey: Let me applaud David on something he said about manager interviews. I think they're a monumental waste of time. I've done so many manager interviews in my role over time. The reality is anyone who gets to become portfolio manager or run a fund with a couple hundred million to a couple billion is always going to present well. So you don't really get any insight from doing that. So I'm a big believer you go right to the data. It's kind of like if you want to figure out who's a good baseball player, go look at their batting average. The numbers are right there that tell you.

For what it's worth, although it's circular logic, at one time I regressed BDC returns based upon a couple variables. And the most predictive was return on equity for future performance. But that is if you think about it somewhat circular because a good return on equity would mean that you grow. So giving that as a little bit of background. First and foremost, ask the question, why are we investing in BDCs? We're not doing a deep asset play. I'm not trying to find and unlock this forgotten asset that has tons of future potential. So my first advice is steer clear of any BDC that's not paying a dividend or not paying a good dividend, it's just not worth it. So that eliminates things like SBDC and Medley, Phenix Finance. It's not that they may not be really interesting plays, but that's if you're going to do a distressed play. I'm saying go to BDCs for income. So filter number one is that.

The next thing I think about is leverage. I am not negative on leverage, let me be clear. That's part of how we get the return. What I just want to understand is disaggregate how much of their return is a leverage play versus how much of their return is really good investing? And in a pair with that is, do they have dry powder? When things like March 2020 happen, it's good to have capacity because, one, you never know if you need to repay back some of your loans, and two, that's actually the best time to be investing. So you never want funds that are fully invested, because that means there's not much wiggle room and the risk of that black swan event is very, very high.

And the third thing I look at is price to book. The bottom line is BDCs are just a collection of loans, with a vehicle that passes them through and charges a fee before you get it paid. And so I like funds that are lower than price to book. Now you don't always get it but those are better and more attractive. Because the way I view it is I have two ways I can make returns. I can obviously keep collecting the yield, but there is this hope that if they're below NAV maybe they can rebound to NAV and so I get a second payout. So those are kind of the big things. And then obviously go Google the companies, check to see if there are any lawsuits outstanding. It's a very good indicator, if you see companies enmeshed in lawsuits run away, your life is too short.

Mike Taggart: Words to live by there, Jimmy.

John Cole Scott: I was just going to say I might add a different opinion brush. I found, and Dave and I have talked about this in the last event, we often think from some of the deep discount is a future opinion on NAV, and the NAV reverts to market price in many occasions. You're right, in my BDC trust the average premium right now is a 3.5%, 10 points below the sector because I have some spots that I think that the market's wrong eventually. And I'm hopefully right.

But yeah, I find when you're allowed to be well over par you can do accretive offerings of equity when it makes sense. And it's because you typically have a better fee structure, you'll be more successful in doing what you're doing. I don't know, I'm sure we'll get to that some more but I just wanted to add that as a piece for BDCs.

Mike Taggart: I want to remind the audience about submitting questions, so if you have any questions please feel free to use the buttons, I think they're on the bottom of your screen. Ask your questions.

Jimmy, you just mentioned leverage. In my experience, even though I don't know much about BDCs, but when I've heard people talk about them or let's say ordinary investors, leverage and transparency are two issues that some people use to dismiss BDCs from their investable universe. They think, "Oh, the leverage is too high," and there's a sense that transparency is not good. But I've heard here on the panel already that they are transparent. And so just kind of wanted to hear, you three successfully invest in BDCs despite those issues, so what are your views? And maybe Dave, if you could start us off on how you think about leverage and transparency, and why you think that they're not impediments to investors.

David Miyazaki: Yeah, I think that one of the things that some managers either don't understand or unfortunately take a while to understand is a basic cost of capital. And I say that because it then matters what it is that you're lending to. So I'll give you an example. Let's say that a BDC is trading right at its net asset value and that dividend yield is 8%. In that kind of framework you could argue that most of the investor's expectation is that the return is going to come from the dividend, that they're not trying to close a NAV gap, and so 8% could be a proxy. And you can argue this but let's say that it's a general proxy for the cost of equity. And then let's say that they're able to go out and issue some bonds, they're able to put a revolver in place, there's some fees, and their debt cost is 4%. We'll just kind of make up some numbers here.

Well, if they're levered at 1:1, equal amounts of debt and equity, then that means that their blended cost of capital is 6%. Well, if they have a loan book and the yield on that, let's say that they don't have a nonaccrual problem, is 7%. Well, then they're covering their cost of capital. I know that I don't have expenses in there but let's just say that their after-expense yield is around 7%. So they're covering what exists as their cost of capital. So incremental loans then are going to be additive to their income. [inaudible] that maybe they ran into problems with nonaccruals, maybe that they are hearing too much pushback from shareholders that they have too much credit risk in their portfolio, so they will rush into first lien shooter term large company loans.

Well, if this company decided to do that, and maybe they could only get 4.5-5% yields in their portfolio, well, the problem here is that their loans are going to look great, they're big companies, diversified, low nonaccruals, no nonaccruals maybe. But every day that you go forward they are eroding their net asset value and they're eroding their ability to pay the dividend. And so there really needs to be a really good understanding of, what is my cost of capital on a blended basis? What is my cost of capital on an incremental basis, the marginal cost of capital? And that's where debt becomes really, really important.

Of course there are ceilings per the 40 Act as to how much debt that you can have. We have oftentimes seen that because of the marked to market requirement on the asset side of BDC books, that leverage can rise even when they don't add incremental amounts of leverage to the right side of their balance sheet just because the values fell on the left side of the balance sheet. And that can create a precarious situation for BDCs because suddenly when they thought their 1.5 times debt to equity that they go up to 1.7 or 1.8, and pretty soon they're getting into the danger zone. And so these are all considerations that not all the BDCs apply the same amount of leverage, and not all the BDCs invest in the same kinds of assets. So what's important is not just to evaluate whether or not they're leveraged, but how does that leverage match up with the kind of assets that they're investing in?

Mike Taggart: Right. It's more complicated than just, oh, they're highly leveraged. Because they could be highly leveraged and out earning their cost of capital. They could be low leverage and underearning their cost of capital. So yeah, it doesn't matter.

James Hickey: Can I add?

Mike Taggart: Yeah Jimmy, and right before you do I want to throw something else at you. Because we got a question in and I think you were talking about transparency earlier. The question is, when evaluating a BDC, how much effort do you put into studying the underlying companies and loans that the BDC is invested in? So comment and then please answer that.

James Hickey: Sure, so the answer is some. For the most part they're privately held companies, so you're going to have limited information. What are the things you want to look for? You want to look for sector diversification. Sure, there's some that are all [inaudible], sector diversification. You want to look to make sure there's no concentration in any one or two companies. You want to see what is the current yield, what are the terms of the loan? And by the way, this is all available in the 10Ks and 10Qs. And one of the things to pay attention to there is are there outsized loans that are very lucrative that are coming due or going to be paid off? Because that may have impact in future. So those are the things you look at.

If you're investing in multiple BDCs you'll probably want to, and this is qualitative more than quantitative, overlay multiple BDC holdings. Because sometimes BDCs hold the same underlying companies, so you're not necessarily getting as much diversification as you think. They're not all entirely separate, particularly in today's world where people are clubbing on deals. The same three or four BDCs may own the same company. So those are big things I look at. I recommend things like Googling. There's some interesting things which I've thought of about trying to provide a service where you try to look and evaluate peoples' risk of bankruptcies. But the reality is they're privately held, you're just not going to get a lot of transparency. So big picture, concentration, diversification, and then are any coming due soon and what would be the impact for reinvestment risk?

John Cole Scott: I might add to that, I remember one year I pulled the BDC holdings of one of our trusts on the way to an advisor's office because questions were going to come up. I went through, I think I recognized three companies because I was in California at the time. And I'd say we pulled that data. One thing that I have found useful is, and this is just more for perspective, if you can find more than one manager owning similar. Either not the same loan or the same piece but you can modify your model a little bit, you can start to learn which managers are more aggressive with their marks and less aggressive. And that's a useful piece, not necessarily for the investment but for just building your models about how you might determine a manager's bias. Because that's the only other time you can really get a sense of what the loans could be marked at the in the market.

But we have the whole holdings universe. I'll say it's helpful for reporting purposes, whether it's geographic or sector or overlap. But I'd say it's far more important. Just to follow up, I think the wrapper terms, and the expense ratio terms, the type of leverage, and the actual manager is far more important than whether he bought this company or that company because there's so many investments in a portfolio, it's not just one.

David Miyazaki: I think that's good. One of the points of transparency that John references is that you can look at three BDCs and they may all own the exact same piece of debt because they do syndicate out their loans sometimes when they originate them. And it's interesting to see why they can mark the same piece of paper at different levels. If the posture of the management team is more aggressive than you kind of see that they consistently do that, whereas other ones are going to be more conservative. So that's a useful check, it's qualitative but it is helpful in one way to evaluate things.

One of the things too that I've seen is that if you think about the larger BDCs, they will be focused more on what's called the upper middle market. Because if you're managing $10-15 billion dollars in assets, there's only so many 10 or 15 or $20 million loan sizes that you can make. You're looking to do 50,100, 200's. The loan sizes are much bigger, so you don't really operate so much in the lower middle market. Whereas the smaller BDCs, not only do they operate in the lower middle market where their borrowers may have $5-15 million in EBITDA, so they're smaller, the smaller BDCs also tend to have fewer holdings. So you may only have 30 or 40 or 50 names in the portfolio for the smaller guys, but the bigger ones can have 150-250 different credits in their portfolio.

So one of the things that we have found that can be helpful as a strategy, and John you mentioned that you take 5% positions because you want to have some real conviction behind those investment choices, for some of the smaller BDCs maybe you take a 1% position in five names. And that way if they all have 30 names in their portfolio, you've basically taken a 5% position in an exposure that has 150 names in it. So there's a few different ways that you can cut things up and mix and match them. It does take a little bit of work on understanding what's in the portfolios, but that's the great part of having some transparency in the industry.

John Cole Scott: When I said that, I meant in our BDC trust. Which is not, I hope, anyone's only portfolio. I mean, whatever works for you, I'm not the advisor. But in our client accounts we often use BDCs between 0.6-0.81. I think or two is an outside position in a separate account in our world. But we're all BDCs, all closed-end funds, interval funds, we don't do any other wrappers.

Mike Taggart: I think, John, I'm just going to say I'm taking some extra time with your permission since we started a little bit later. So we have about seven minutes left, we're going to go to 2:20 Eastern. Hopefully we can answer this, but interest rates are going to rise at some point, and this is a key focus for investors these days. And it kind of ties back to leverage, the cost of capital. That's kind of an interesting question. What happens to BDCs when rates go up? As investors, do you just go to cash? What historically has happened? I think maybe again we'll do a round robin thing and we'll start with Dave. Or we can start with Jimmy maybe. Let's start with Jimmy.

James Hickey: First off, I know it's a side comment but I'm much more concerned about inflation right now. Because to go to John Cole Scott's observation earlier, about 50% of the BDC investments are LIBOR or going to be the LIBOR new version, so there's some ability to adjust. But we're looking at 6% inflation, so if you're investing in a BDC at 8%, you're giving away 6%, if somebody's in a taxable account they're at 5%. So they're actually degrading 1% of returns right now. Now that's still better than your other options out there in fixed income, so I'm not saying it's bad, I still think it's actually a good play. But inflation's what I'm very, very worried about right now.

I think if the Fed raises rates, long term it's going to be good for the BDCs because so much of it's floating and so much of the notes are relatively short periods like three years. So you're going to work out most of that stuff and re-paper it higher. Now what may happen if the Fed raises rates though, is you have a reinvestment risk. Not in terms of not getting good returns, it's just a lot of companies may choose to be on the sidelines if borrowing becomes too expensive.

Mike Taggart: Okay, so Dave, sorry for the head fake there. What's your take? And what has experience shown in your opinion, what happens in rising rate environments?

David Miyazaki: Well, I would say generally speaking that the concern that investors have towards BDCs, and because they have such a high yield profile they oftentimes get lumped along with other equities that have interest rate sensitivity like the utilities sector or REITs or MLPs. The thing about the BDCs is that they are lenders, as Jim has pointed out, this is a book of loans. But if the loans in the middle market are underwritten properly, they tend to get paid off in three or four years. And so if you're looking at a book of loans through the four-year maturities, that means a third to a quarter of the portfolio's running off every year.

And so interest rates move higher, it does matter why the interest rates are moving higher, not just that they are to Jim's point. If interest rates are moving higher because the economy is stronger and that's creating inflation, that's probably going to create a pretty good environment for the BDCs because they're going to have fewer credit losses and they're going to be able to reinvest at higher yields. In that regard they can keep their real dividend yield attractive. Whereas if interest rates decline then that may indicate we're going into a recession. And of course if a third to a quarter of your portfolio is running off and rates have declined, you're probably going to have non-accruals rise. And you're borrowers, the ones that are healthy are going to pay you off sooner. So maybe it's not a third or a quarter of your portfolio, it's a third or a half of your portfolio pays off. And then you have to reinvest in lower yields, and that's a little bit of where we're at right now over the past couple of years here.

I would say one of the things that I think deserves a measure of caution right now as interest rates rise, as John pointed out, there are a lot of LIBOR floors that exist on the asset side of BDC loan portfolios. So this means that if short-term interest rates rise, the BDCs are going to face higher interest expense on their credit facilities from their banks, they have to pay higher rates. But their asset side is not going to move until we see LIBOR or whatever the reference is get over 1-1.5%. So that actually means that the initial move off of very low interest rates can compress margins for the BDCs and create a bit of a headwind. Personally, and I talk to BDC managers a lot, they all hear what I have to say, almost none of them listen to me.

Mike Taggart: Their loss.

James Hickey: That's my life.

David Miyazaki: It's all right, I raise teenagers so I'm kind of accustomed to it. But I wish that they didn't even have the floors in there. Because I'm sure that the offset to the floor was that they got [inaudible]. And if they just didn't put the floors in at all, okay, I understand that their asset yield would float down as rates fell. But if they've matched it with the credit facilities they should be kind of indifferent as to whether interest rates rise or fall. But what they've done with the floors is actually created a headwind for themselves as interest rates begin to rise. So [inaudible] do it, but again they don't listen to me.

Mike Taggart: Senior loan funds suffered from this as well in the last cycle. Where, "Hey, we have these floors in place," which was great when we are where we are now.

David Miyazaki: Right.

Mike Taggart: But as the Fed increased rates, like you said, there was asset compression, whatever, the assets didn't respond. And the discounts capped out significantly on the senior loans. So John, we have one minute left. Any thoughts here in terms of interest rates on your end?

John Cole Scott: The things that we do, and not that it's done by others, but we really like to see the adjusted core NII in most cases because we're more dividend focused investors. We don't want everyone to lose money, but a lot of our clients are, whether they're UIT clients or separate accounts, it's a dollar defined, focused portfolio, is a little bit of an earnings coverage over that. And especially at the portfolio level. One thing anyone that's invested in BDCs or closed-end funds has definitely learned is dividends are not promises, they're policies set by a board and they change based on quality of management, interest rates, economic cycles, and everything out there.

So what we do attempt to do is provide some of that cushion at the sleeve level for investors in the different ways we work with them. And at the end of the day, we have for years been pushing towards overweight variable investments, overweight fixed-income leverage. I will say that one thing we've nudged, typically between 92 on the high side for loans in the portfolio to maybe 83 on the low side. When we want to overweight a little more equity, or managers that have more equity exposure because we think we're going to need that to get the total return characteristics while still fulfilling the goal for dividend coverage for our investors. That's how we think of it, everyone's a little different. Hopefully that's useful.

Mike Taggart: Excellent. Well, we're out of time. So Dave, Jimmy, John, thanks for your insights. To the audience, thanks for listening and for your questions. We're going to get off the stage now and let the next panel.

John Cole Scott: A 10 minute break, so feel free. Next panel starts at 2:30.

Mike Taggart: All right, thank you.

David Miyazaki: Thank you.

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