



CEF Advisors' Scott: Upcoming Rate, Inflation Headlines Won't Rattle BDCs

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Chuck Jaffe, in this episode of The NAVigator podcast interviewed John Cole Scott, president of Closed-End Fund Advisors. Read the Q&A below as John says that, despite a rough outing for business-development companies this week, BDCs have had a strong quarter from a total return perspective, and that prospects remain strong as BDCs have been raising their distributions but the dividend-coverage percentages have remained roughly steady; a sign that they're not only positioned well now but that they are ready to deal with rising interest rates and inflation. Scott,



who is also chairman of the Active Investment Company Alliance, compares two BDCs – one trading at a premium, the other at a discount – and discusses how there is room for both in a portfolio despite the different way they are viewed by the market.

John Cole Scott

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CHUCK JAFFE: John Cole Scott of Closed-End Fund Advisors is here, and we're checking in on business-development companies during earnings season, welcome to The NAVigator. This is The NAVigator, where we talk about all-weather active investing and plotting a course to financial success with the help of closed-end funds. The NAVigator is 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. Back to chat with me again today, it's John Cole Scott, president at Closed-End Fund Advisors in Richmond, Virginia, which is online at CEFAdvisors.com, and we're about to dig into the firm's research which you can do yourself at CEFData.com. John is also chairman of the Active Investment Company Alliance, which you can learn more about and get information generally on investing in closed-end funds, interval funds, and business-development companies by going to AICAlliance.org. John Cole Scott, welcome back to The NAVigator.

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

CHUCK JAFFE: So as we record this, we're like a day or two short of earnings season for BDCs being over. We don't expect any real surprises but there are a few things we've learned in this earnings season about BDCs, haven't we?

JOHN COLE SCOTT: We have, and we kind of look at our index, we have the most [inaudible] liquidity in the debt-based BDC market in our index every 90 days. Over 90% have given us their data and are in our research system. The fair market value marks, which is the boards looking at every position and how they mark it up or down over time, because these are private investments remember, are similar to 90 days ago, about -3.1% off of cost. We talk about that being them planning for future challenges in the market. Which interesting, the net asset value return, not total return but return is down about 5.5%, and to me that's really a combination of two factors. It's the pullback and the marks of the portfolio, and also spread widening really pushing things down a little bit. Not a huge move, but I would say if you think that these are aggressively marked or moving frothy, that's currently not the condition. What I really love, we've had tons of dividend increases but the reported funds still are showing about an average 120% dividend coverage. And then we like to talk about truly what is in these 31 funds in that index; 3,400 loans from 2,100 companies, and remember, these are all basically private, small, American businesses. The current yield for the index is around 11%, on the higher end of normal. And we always talk about what do we think about going forward with rates? We think that they're set up well with their variable loans and fixed leverage, and that they've already started to plan for problems in the market should there be a recession.

CHUCK JAFFE: You've talked about the NAV, the net asset value being down, but on a total-return basis BDCs are up about 4%, right?

JOHN COLE SCOTT: Yeah, they're up about 4% year to date, that includes the pullback though, yes, they are doing well. Dividend yields are high, that definitely helps you as an investor see the cash flow come in accordingly when you own a diversified BDC portfolio.

CHUCK JAFFE: And let's remind the audience, today as we're recording this is after the market has closed on March the 9th, so don't necessarily expect BDCs to be down on the day that you're listening to this. But for investors, you're looking at BDCs hoping to get the right kind of return, but you can also get a product like your unit investment trust of BDCs.

JOHN COLE SCOTT: Yeah, so for the last eight and half years we've worked with a partner SmartTrust UIT, their website is that name dot com, and we have a basket of BDCs I select every four months, it's usually for advisor use and series 27 literally launched today. And we talk about how do we build this portfolio; it's passively held for 24 months, we usually will use four to eight BDCs in a diversified client's portfolio that we customize and can adjust. This is not an actively managed portfolio, it's just passively held, it's been 12 to 14 funds for essentially since the beginning, and we really focus on the smallest weighting being 5%, the largest 10%, that caps our risk but makes sure every BDC has a vote in the portfolio's outcome. We do look what the analysts cover, the wirehouses, some of the private analysts, and what I do say, we always try to pull together for the advisors or the investors that find this product, is a low nonaccrual, historically and currently, about half of the index currently at 0.8. And the dividend growth, we love dividend coverage and we love dividend growth stories, the UIT product, the underlying holdings are up 17 and change percent on a one-year basis, which is higher than 11 and change for the index. But at the same time there are five double-digit discounts and two double-digit premiums, and I thought it'd be useful if we chatted about two of the holdings as comparison about how very different funds can make a portfolio that acts very differently.

CHUCK JAFFE: Yeah, let's do that. Because of course for a lot of people they look and go, "Discounts, I'll buy 'em. Premiums, I won't."

JOHN COLE SCOTT: We always talk about BDCs are a different animal, they're a part operating company, that's why they actually have an earnings season. We never talk about closed-end fund earnings season, we talk about fact cards being updated. TSLX is a well-known focused BDC in this space, it actually was my pick for this year on the December podcast we did. It is at around a 10%+ premium, its three-year average is a 21% premium, and it's been over

40% in the last three years. It's got 10% yield and it's covered very well, it's good at what it does. What I really do like, net asset value performance is not the most important thing for BDCs, return on equity is, but its three-year NAV is 44%.

CHUCK JAFFE: And that's again TSLX, which is Sixth Street Specialty Lending.

JOHN COLE SCOTT: Absolutely. It's been a BDC for many, many years, no changes in management and the core work. BBDC is a Barings BDC, it's actually a BDC turnaround story. It's still sitting at a 25% discount, it's three-year average is closer to 15%, and it barely touched a premium, in the last three years it's one day almost. It's sporting a 12% yield and its three-year NAV total return is only 18%, but what you don't know without knowing their story, it was a broken BDC taken over by a quality manager and it takes time to turn an aircraft carrier, these loans have three to four years of turnover. And so while we don't love its net asset value total return, we understand the market's given it its discount because it hasn't proven the healing yet.

CHUCK JAFFE: Whether you're looking at these or BDCs generally, I know that you are optimistic by nature but a little bit pessimistic in terms of where you see the market headed. So given where we are in the rate cycle and the inflation cycle and what you think is the potential for recession and bear market, how do you expect BDCs to perform the rest of the year or into whatever downturn we might see ahead?

JOHN COLE SCOTT: Because they're either considered private investments or small cap stocks, they're relatively illiquid by S&P 500 standards but not by other closed-end fund standards. A lot of liquidity for almost every investor we've talked to, they tend to move in bigger jumps than a regular fund, take the average closed-end fund, the average ETF. So you are going to be having to handle some volatility, that is one reason why some people like the UIT wrapper, because you don't see the individual volatility just the combined. But you need to be comfortable with downside volatilities for expected or unexpected reasons, good or bad news can drive these things up and down. But at the end of the day we'd like to think if you pick a good NAV and you're thoughtful on your entry point, and your goal is a dividend stream that's covered, it's a very healthy thing to do. Now however, we don't know when markets turn. When they turn, what we do when we're active, we sell almost every BDC, and when Covid hit, the top five, and equal weight them and wait to see what happens. Because the best BDCs fall almost as far, sometimes even further than the worst BDCs, and you need

to be willing to trade on those hard days because these are definitely not boring Lehman Agg exposure.

CHUCK JAFFE: That gives us the outlook. John, this has been great, thanks so much for joining me to talk about it.

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

CHUCK JAFFE: The NAVigator is a joint production of the Active Investment Company Alliance and Money Life with Chuck Jaffe. And yes, that's me, and you can learn all about my work, my show, and everything we do there at MoneyLifeShow.com or by finding us wherever you get your favorite podcasts. To learn more about closed-end funds and business-development companies go to AICAlliance.org, the website for the Active Investment Company Alliance, on Facebook and LinkedIn @AICAlliance. And if you have questions, send them to TheNAVigator@AICAlliance.org. Thanks to my guest, John Cole Scott, president of Closed-End Fund Advisors in Richmond, Virginia, chairman of the Active Investment Company Alliance. He's on Twitter @JohnColeScott, and the firm is at CEFAdvisors.com and CEFData.com. The NAVigator podcast is available every Friday, sign up so you don't miss one. We'll see you again next week, and until then, happy investing everybody.

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