John Cole Scott on BDCs, How They Stack Up To Closed-End Funds And More

Friday, February 28, 2025

Chuck Jaffe, in this episode of The NAVigator podcast interviews John Cole Scott, Chief Investment Officer at Closed-End Fund Advisors, the Chairman of the Active Investment Company Alliance. John returns to The NAVigator in an ongoing project to answer audience questions, this week diving into the world of business-development companies. He sorts out the differences between BDCs and closed-end funds, explaining why some investors, himself included, analyze BDCs like a closed-end fund rather than a stock, but then digs into his firm's data to show what to look for to find "safe" business-development companies, and how bad things could get if a BDC encounters trouble.

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

CHUCK JAFFE: You've got questions about business-development companies, and we've got answers from John Cole Scott from Closed-End Fund Advisors, welcome to a BDC Q&A on 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, which is a unique industry organization representing 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 returning to the show today, John Cole Scott, president of Closed-End Fund Advisors in Richmond, Virginia, online at

CEFAdvisors.com, and their data which is available to you is at CEFData.com. John is also the chairman of the Active Investment Company Alliance, and if you want to learn more about closed-end funds, interval funds, and yes, business-development companies, go to AICAlliance.org. We have put together a couple of NAVigator segments that are going to be focused around questions, and if you've got questions, we'd love to hear from you, TheNAVigator@AICAlliance.org is where you should send them. John Cole Scott, it's great to chat with you again.

JOHN COLE SCOTT: Great to be here, Chuck.

CHUCK JAFFE: We are going to dig in today and keep this one entirely about business-development companies, because they are a part of the closed-end fund industry even though they're not really part of the closed-end fund industry in terms of they aren't actual closed-end funds. So we're going to start there, because we've got a question that asks, "Why do we include BDCs with closed-end funds, aren't they stocks? Shouldn't they be analyzed as stocks rather than as closed-end funds?"

JOHN COLE SCOTT: So closed-end funds are closed-ended management companies in a regulatory structure of the US markets, as are business-development companies and interval funds and tender-offer funds, that's why we cover them, they're all closed-ended. What that means is they're basically a stable share count structure, and so BDCs, you are correct, when we talk about them, they're a fund with an active manager of holdings, but they have an earnings season and they have more upside/downside in volatility during roughly the couple of weeks every quarter where they get their announcements. Traditional closed-end funds, even the interesting ones, don't have an earnings season. So your listener is both right and wrong because they're the hybrid structure, but they are that closed-ended management and we find that they are useful to analyze the manager, the wrapper, and the guts, which as you know from the years we've known each other, the way we analyze funds at CEF Advisors.

CHUCK JAFFE: Okay, but I have to ask a question, and this one comes from me, not from any of our audience members, that's a follow-up to that answer. Which is for you, when you look at other people's evaluations, you can look at something like Morningstar, where they don't do a great job of evaluating closed-end funds but they do their stock evaluations, and if they've got a stock rating on a BDC, well, it's looking at a BDC as a stock. When you evaluate their ratings, do you feel that when somebody is looking at a BDC as a stock, their research is maybe missing something or it's not quite on par, as opposed to what you might find if you're simply considering as another closed-end fund?

JOHN COLE SCOTT: Historically, as I think most listeners may know, Morningstar cut their teeth focused on analyzing traditional open-end funds, they've leveraged into closed-end funds, they bought Fundamental Data back in 2008, we formed our data business after they migrated to their systems in London. I would say I've never even noticed what Morningstar does with BDCs because they have nobody on their staff, in my opinion, that knows what they are. I talk to BDC analysts at the major wire houses, I talk to independent BDC research, I talk to other institutional investors of BDCs, and those are the people that we can talk about our style of BDC investing. You have to remember, BDCs aren't banks, they're specialty finance and they do lend, but they are baskets of portfolios of transparent loans updated every 90 days. They can't have a run on the bank per se, because they're a fixed capital structure, hence the closed-endedness of the fund. So I would say *Seeking Alpha* authors often get a lot of BDC and closed-end fund stuff, in my opinion, relatively terrible, which is great for the market. I'm not going to be always right, but I see some analysis there, because we follow *Seeking Alpha* deeply because a lot of retail investors use it in their work, and we see a lot of interesting perspectives on BDCs there; not thinking about internal management versus external, fee structure, high-water hurdle marks, lookbacks, credit quality and historical resources of the manager platform, the workout teams that step in to take over a loan and maybe make it equity and then somehow still make money. So maybe it's a really long answer, but I'd just say I've never really heard anyone in my world use Morningstar for BDC analysis.

CHUCK JAFFE: Well, I wasn't talking about Morningstar necessarily as much as just how you find the analysis for anyone who looks at them more like a stock than a closed-end fund.

JOHN COLE SCOTT: Well, they trade price to book, which book is like NAV, basically it is NAV, it's just called book there. Their leverage is regulatory leverage, we also look at regulatory and notional total leverage, but there's leverage that's not regulatory. And then there's a PE ratio that they tend to trade at, there's also a price-to-book implied by the quality of the manager and the internal versus external management structure, which you just can't get by saying it's a bank or a stock.

CHUCK JAFFE: Given that we're looking at research, it brings us to the next question, which is simply, how do you find less risky BDCs?

JOHN COLE SCOTT: Great question. I'll tell you how we deal with it for our clients. You've heard me say a thousand times, closed-end funds tend to be a two-ish percent minimum allocation, 4.5-5% is conviction, 6% is like fat pitch home run in my world for a portfolio that's often 30 to 40 names for our clients, that's my normal. One way we deal with the risk of BDCs, because they are more upside-downside volatile in many environments, is we half-size that, so we're roughly a 1-3% in a portfolio level. There are 50 or so listed BDCs, there's about 36 with reasonable liquidity, and there's usually about 10-15 that we think are relatively good managers and we're looking for the best price to the entry of that manger. We're also thinking about there's some managers doing more pure senior loan exposure, the workhorse BDC allocation, there's some doing more venture and niche-ier stuff, there's some that do more equity and other than pure first-lien loans, and so there's a lot less homogeneity as we talk about in BDCs across the landscape of the 35 or so liquid funds, and so it's easy to build a portfolio of four to eight funds tactically, maybe eight to 12 less tactically, that is diversified as long as you're remembering if you put 2% of BDC in a portfolio, great fund, the market gives you a downside, you can add another percent, 50% more shares than you owned, that's a large weighting but that's not like you're going to make your portfolio exposure 10% of the portfolio because you already own eight and you want to buy more with what happened next.

CHUCK JAFFE: And that brings us to our last question today, which is what's the absolute downside of a business-development company in a market downturn? Since they're quasi-closed-end funds or what have you, what's the worst that could happen?

JOHN COLE SCOTT: There's two sides. I'll say first let's talk about a basket of loans, generally first lien, that's typically 90% of the universe, the leverage is generally fixed, the leverage and loans are typically well matched in the market, and there's typically hundreds of loans in a portfolio and usually there's nothing over two or three percent exposed in many that's an individual loan to an individual company. So the risk of a sector or individual company going bankrupt will hurt the dividend, will hurt the NAV, just like it would in a way like a regular bond fund. The governance and the fairness and the way that a BDC treats its investors is equally important in our work, so we look at the way they've marked their loans historically, are they conservative or aggressive? And do they put extra money or overweights in joint ventures or CLO, which aren't always bad but have more complexity and downside? And so that's one way to think about it, but let's go back to '08 and Covid were two extreme downside experiences for BDC investors, couple differences in '08-'09, there were only a handful of BDCs of any size, and so the options to be diversified were very limited. BDCs grew tremendously in the following 12 years, by 2020, for our clients, when BDCs fell, I want to say 40-50, 60%, depends on the fund, we could buy Main Street Capital, which was trading at 80% premium pre-Covid, at a 20% discount, the first time I'd ever bought it for my clients and expected it to return. The risk, like any disconnected market price to NAV structure, so a closed-end fund or BDC, is an elastic carnage downside event, you freak out, you panic, and you sell, and you don't get the bounce. Bounces aren't guaranteed, but that's also why we recommend having-- some of our peer firms, their 13 filings, they're larger than us, they own one or two, maybe three BDCs, and they're large percentages of the assets in our experience, I'm not that smart to be that exposure to one manager. There are managers I love, but they're too expensive, I'm waiting, I'm waiting for the right time to buy it, and there are managers that are cheap that I think aren't cheap enough because they're not the best managers.

CHUCK JAFFE: Interesting. I'm sure this is going to engender more questions, but for now we've done the questions we've got on BDCs, but we have more questions and maybe we'll get some more too. Again, if you've got questions, TheNAVigator@AICAlliance.org is where you should send them. John, we'll talk to you again soon.

JOHN COLE SCOTT: Can't wait.

CHUCK JAFFE: The NAVigator is a joint production of the Active Investment Company Alliance and Money Life with Chuck Jaffe, and yeah, I am Chuck Jaffe, you can learn more about me and my show by going to MoneyLifeShow.com. But if you want to learn more about closed-end funds, interval funds, and of course, business-development companies, go to AICAlliance.org, it's the website for the Active Investment Company Alliance; and if you have questions about closed-end funds, anything involving the industry, send them to TheNAVigator@AICAlliance.org. Thanks to my guest John Cole Scott, he's president of Closed-End Fund Advisors in Richmond, Virginia, and the chairman of the Active Investment Company Alliance, his firm is online at CEFAdvisors.com and their research is available at CEFData.com, and John's on X @JohnColeScott. The NAVigator podcast is available every

Friday, make sure you don't miss any of our new episodes by following or subscribing on your favorite podcast app. We'll be back next week with more closed-end fund talk, until then, happy investing, everybody.

Recorded on February 28th, 2025

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