



## Despite Scary Headlines, Low-A.I.-Risk BDCs Are Worth A New Look

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Chuck Jaffe, in this episode of The NAVigator podcast interviews John Cole Scott, President of CEF Advisors. With the market kicking business-development companies in the teeth, John digs into his firm's data, looking at "artificial-intelligence risk scoring" to find BDCs that have been hurt by headlines without holding tainted portfolios. BDCs relied heavily on software companies due to the tech sector's blend of strong fundamentals, innovation and

ability to resist economic fluctuations, but have suffered as investors fear for the future of software in the face of challenges from artificial-intelligence companies. Scott, who also serves as chairman of the Active Investment Company Alliance, went looking for BDC's with "low AI risk, clean credit, and sensible leverage and costs," and came away from the analysis convinced that investors should lean into the troubles. Specifically, he mentions funds from Nuveen and Kayne Anderson as worth watching now.

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**CHUCK JAFFE:** Is there a way to reduce AI risk and pursue solid yields in business-development companies? That's what we're discussing with John Cole Scott, president of CEF Advisors, this is The NAVigator. Welcome to The NAVigator, where we discuss all-weather active investing and plotting a course to financial success using closed-end funds. The NAVigator is brought to you by the Active Investment Company Alliance, a unique industry organization representing the entire closed-end fund industry from users and investors to fund sponsors and creators. If you're searching for excellence beyond indexing, The NAVigator will point you in the right direction. And today it's pointing us in the direction of the area that has been the trouble spot, the thing that has been making headlines, and that is business-development companies, private credit, specifically it has been private credit and issues tied to AI. We're having that discussion with John Cole Scott, he's president of CEF Advisors, where they produce great data covering closed-end funds, business-development companies, and interval funds. John's going to be discussing that data, but you can dig into it for yourself by going to [CEFDData.com](https://www.cefdata.com). John's also chairman of the Active Investment Company Alliance, which is online at [AICAlliance.org](https://www.aicalliance.org). John Cole Scott, it's great to have you back on The NAVigator.

**JOHN COLE SCOTT:** Always good to be here with you, Chuck.

**CHUCK JAFFE:** Yeah, but wouldn't it be better if we didn't have some bad news headlines impacting the industry, specifically when it comes to BDCs and those that are tied to artificial intelligence? Or is it good to be talking then, because these things that are making headlines and scaring some people are making opportunities for others?

**JOHN COLE SCOTT:** I would say it's making opportunities for others if you dig a little deeper and do your homework like other parts of the capital markets. Just today I was reviewing with my data manager, this new AI risk score, which we talked about previously on the podcast, we have actually implemented it into data production and dug in really deeply to find out which BDCs actually don't give you that type of perspective. We talked about two of them, really focusing on those that also make our BDC Select list, so we're still using our trifecta analysis of liking the pricing, liking the other factors than just this AI-risk score.

**CHUCK JAFFE:** Before we dig in on those numbers, we're talking about AI risk and business-development companies, let's give a basic primer of why business-development companies, we understand software companies, software companies are facing AI risk and the market is punishing them because the idea is AI might put them out of business, and while I'm not sure it's going to go that far, there certainly is an impact. But it's not that AI is doing something that impacts a business-development company from a business perspective, it's about the loans and the credits, so explain the base of the problem and how you solved for it with your AI risk scores.

**JOHN COLE SCOTT:** So basically we looked at the portfolio company holdings of the entire listed fund universe, as we discussed last time, so we broadened it to be wider than just software because there's a lot of edges where software is hard to define. We did a more deep view of just which companies have a higher AI-risk component, and then rated these companies individually from a low of 1 to a high of 10 in increments, to then show a weighted score of each BDC, and then looked at the overall weight of these companies in the fund for a net score of basically how much this is driving some of the answers. For perspective, in the universe the average is about 20-25% in our review, but there are BDCs higher at 45-65%, even some close to 70%, and the ones that we're looking at here are under 10% exposed.

**CHUCK JAFFE:** Before this AI risk surfaced, obviously it wasn't really a factor that anybody was looking at. Nobody was saying, "Oh, I like this BDC because it's an AI-adjacent play," were they?

**JOHN COLE SCOTT:** No, actually the reason software grew to be such a large part of the sector is because, up until recently, really the edges started [inaudible 0:04:35] in the underwriting in late '24, but these software companies had very low non-accruals and very scalable, and really the prime market for private capital lending, which BDCs are about 10% of that market. And so it was almost a caveat for alpha to say, "We're overweight software, come and buy our BDC," whether it's a publicly traded one like we talked about in this example, or even the non-traded private BDCs. It's only recently that the market, since last fall, started to consider some of the risk of software exposure and what could be seen in the market as these vintages of various years come to refinancing and other impact events that'll be showing the true results as the market unfolds, what [inaudible 0:05:23]. And to be clear, we think it's

overdone, but we thought it'd be great to say, "If you think I'm wrong and AI is a real risk, let's find some BDCs you can choose that also are well covered in other perspectives."

**CHUCK JAFFE:** That also points something out, which is when you say you think it's overdone, effectively the market has punished every BDC as if it was loaded with software loans and having this problem?

**JOHN COLE SCOTT:** It is. Also peak earnings is behind us, so dividend cuts are going to be a normal thing to grapple with in the market as we get through the coming quarters. We're also looking at the fact, that Bloomberg TV was even covering BDCs while I was prepping for the panel at the end of this month on the non-traded side of the market, there's been 18 articles in the last seven weeks alone, deep articles just talking about private credit risk. And so it is now very salient, it's hitting beyond the normal scope of investors like us that follow this sector, it's broadly impacting lots of investors and lots of advisors with these questions. But you're right, the average BDC is trading about 25% off of its usual level by most broad metrics.

**CHUCK JAFFE:** So you're solving for, what can you get that's going to give you a good yield, that's not going to be impacted by the AI/software issues, you've got the data that's looking at AI risk, what are the BDCs we're talking about?

**JOHN COLE SCOTT:** So the BDCs we're talking about, first is going to be NCDL, the Nuveen Churchill, we calculate about 6.25% exposure, the management has said 4%, but again, I told you that our methodology is potentially broader than what a fund sponsor may just happen to use, and the weighted risk of those companies is 5.8, and if weight that at the entire portfolio it is less than 0.5. This is very, very low conceptually. There's another one, KBDC, the Kayne Anderson fund, it's actually only showing 1.6 AI exposure with a slightly higher risk of 5.99, but that weights down to basically 10 basis points. These are two of the larger platforms with very little exposure to AI-related portfolio companies, and they're still, again, well priced in my opinion.

**CHUCK JAFFE:** When you consider what's going on, do you treat BDCs the way you treat closed-end funds and go, "Ooh, the one I owned, even if it wasn't significantly AI risky, it's been beaten up, so tax-loss selling whenever I can take it?"

**JOHN COLE SCOTT:** Yes, we do, though we encourage people that these simple absolute discounts, or premiums sometimes, though not as often now, isn't the only thing to consider.

There is a lot of quality issues in BDCs that make them more stock-like, and you can have times where you could sell a 30% discount and buy a 10% discount and it's the right swap to probably make more money later. That's generally different than plain vanilla closed-end fund swapping between senior loan funds or muni bond funds.

**CHUCK JAFFE:** That's playing the funds that somebody has in their portfolio off against the two that you talked about. I will make an assumption here that all BDCs, even as they come through AI risk, are not created equal, and that you might have a preference or one of the other. So again, we're talking NCDL versus KBDC, how do we decide which one? Since you've talked about both of them, and in the limited time we've had, they both sound like they could be possible plays for investors right now.

**JOHN COLE SCOTT:** And to be clear, we owned both two months ago, and we own more of both today, it's not like we're choosing, we just want to give people different flavors. I'll cover the high-level differences. NCDL is at a 25% discount, yielding almost 11%, and basically the reason that's driven that is they cut the dividend about 20% last month, or I guess late February. If you think about the data of these funds beyond the manager analysis, their expense ratios are around the same, their leverage costs are around the same, they're really very similar in a lot of ways. I would say NCDL has a little bit more loans from '22, which could be where there's less AI components, though that's really not impacting these portfolios, and a very small number of loans from '23. We've seen general credit underwriting improve recently than the older vintages, and then also it'll take longer for newer vintages to have to be re-done, and so there's more time for the companies to work through problems. Beyond that, it's going through the fact that KBDC hasn't cut the dividend yet, so it's a 14% discount versus the 25%. If you look at the portfolio and we model an estimate, we think it probably is due for a 5-10% dividend cut, even though management said last quarter they don't see it this year, and they do know their portfolios more than I do. The leverage level is a little lower, 49% at KBDC, and it's 54% at NCDL, which another slight benefit is if there's a BDC to pick up extra loans, the one with less leverage has more dry power to deploy. And so basically, if you only cover about lowest software, KBDC, if you buy a BDC after dividend cut, NCLD. The rest of the data, there's some general nuances, but they're very, very similar, and again, we could see also owning both because they're not true competitors in the market in a deep way.

**CHUCK JAFFE:** And definitely, if you're hearing about these for the first time and you're going to consider them, wait for that dividend cut, because of course it'll get beaten down after that happens. If you think it's on sale now, it should really be on sale after?

**JOHN COLE SCOTT:** Kind of, but NCDL was trading at 15% of its one-year discount range, KBDC, 30%, these are still attractive. RSI is around 50, not crazy but not frothy. And like I said, we are expecting a dividend cut simply because we expect dividend cuts, and so it's a chance that KBDC a year from now could have rode out the storm without dividend cuts and I could have been wrong, and it may have been a better investment. It's more than just that analysis, Chuck, you've really got to look into the portfolio, get a sense of what you're comfortable with and whether you're leaning towards a portfolio with less leverage, more leverage, already had a cut, might have a cut. Cuts are never guaranteed, it's just we see the mechanics of them likely to happen in the market because of where leverage cost is and where the portfolio yields are coming in.

**CHUCK JAFFE:** But again, if I'm looking for clean, low AI risk, then I'm talking about Kayne Anderson BDC, that's KBDC. What I heard you say, if it's new money, then maybe I'm going to NDCL, Nuveen Churchill Direct Lending.

**JOHN COLE SCOTT:** Yes.

**CHUCK JAFFE:** Great stuff, John. Always is when we get a chance to chat with you, thanks so much for coming back to The Navigator.

**JOHN COLE SCOTT:** Always good to be here.

**CHUCK JAFFE:** The NAVigator is a joint production of the Active Investment Company Alliance and Money Life with Chuck Jaffe, and I'm Chuck Jaffe and you can learn more about me and my show by going to [MoneyLifeShow.com](http://MoneyLifeShow.com) or you can just find the show at any of your favorite podcast apps. Now to learn more about business-development companies, interval funds, and closed-end funds, go to [AICAlliance.org](http://AICAlliance.org), that's the website for the Active Investment Company Alliance. Thanks to my guest, John Cole Scott, he's president of CEF Advisors in Richmond, Virginia, and he's the chairman of the Active Investment Company Alliance. You can learn about the firm and you can dig into its research and check out those AI-risk numbers for yourself by going to [CEFData.com](http://CEFData.com), and John's on X, he's @JohnColeScott. The NAVigator podcast is available for you every Friday, make sure you don't miss an episode

by following along or subscribing to us on your favorite podcast app. We'll be back next week with more closed-end fund fun. Until then, happy investing, everybody.

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