John Cole Scott, President & CIO @ CEF Advisors on BDC 1Q 2023 Earnings Season & His BDC Outlook

Tuesday, June 13, 2023

John Cole Scott sat down with Jane King on June 13, 2023 for a NAVigator interview and discussed the most recent earnings season for BDCs (Business Development Companies) and how the firm selects and manages BDCs both for their Fund with partner SmartTrust and for custom client separate account allocations. Data as of 6/9/2023 on CEFdata.com.

John Cole Scott

BDC Fund - smarttrustuit.com/trust/stbdax/
BDC Index - cefdata.com/index/details/407/
NAVigator Weekly Pocast - AICalliance.org/NAVigatorPOD

The podcast can be found on AICA's website by clicking here:
https://dev.2022.aicalliance.org/alliance-content/video_interviews/

Note at 2:49 Mr. Scott did not clarify that the 2nd dividend growth figure was over a 3-year period, 22% for their fund vs. +16% for the index.

Jane King: Closed-End Fund Advisors is a registered investment advisory firm which manages client assets through global diversification with a value-oriented and active approach, and with me is the founder John Cole Scott, to talk about closed-end funds and also BDCs. So I'm very curious to hear about those, let's start with introduce yourself and the firm.

John Cole Scott: Yes, Closed-End Fund Advisors is primarily a customized income separate account manager for sophisticated investors, work through financial advisors and directly with those investors. We also have a 12-year-old data business, CEFData.com, that covers all closed-end funds, business-development companies, interval funds and tender-offer funds, and then we even have a fund for advisors in the BDC space.

Jane King: Okay, let's start with BDCs. What are those? Are they investment vehicles? Explain that.

John Cole Scott: So BDCs are a 1980 combination of operating companies and funds like a regular closed-end fund. They have the fixed-capital structure, which is a stable share count. They have the public listing for most of the funds where you and I can buy them like we can any ETF or stock. And there's an elastic disconnect between the net asset value, the value of the portfolio, and the market price that you pay. They regularly trade at premiums and discounts, and the guts are typically variable rate first-lien secured loans often matched with fixed-rate leverage.

Jane King: Who would these be appropriate for?

John Cole Scott: So these investments are really appropriate for retired investors, they have a lot of dividend yields in the market, and so basically right now in our index we created back in 2016, the average yield's about 11% for that 34-ticker symbol index. What's interesting, that's a lot of yield. Right now we're at about a 5% discount on average for price to net asset value. We go back two years when things were slightly different, Jane, inflation wasn't a problem, yet, the sector was at an 8.3% yield and a 12% premium. You might think dropping to a 12% premium to a 5% discount means you lost money, we've actually had a 10% total return in that mix.

Jane King: Yeah.

John Cole Scott: Rather interesting.

Jane King: Well, and even in a non-inflationary time it sounds like it still has a healthy return, the 8%.

John Cole Scott: It is, and because those dividends really require to be paid out to maintain their status as a BDC, what we really find is that they're well situated for what we've been through, so a lot of the dividends have grown. Our one-year dividend growth rate for our UIT product, which is the fund we built for advisors, is about a 14% dividend growth rate for one year versus 11% for the index, and it's 22% for our product versus 16% for the index, so the trends have been positive. We have a research process at the firm, how we build our portfolio allocations for our clients and for the BDC fund we operate, we try to bring out the best of both.

Jane King: Now how do you use these for clients and investors?

John Cole Scott: Yeah, so we really use them as part of their fixed-income allocation, and we use them as a companion to whether it's emerging market debt or muni bond funds or regular senior loan funds. What we really like about them is the fact that you're able to access these private venture loans with a liquid access point, and we're able to rotate and change our mind during different market cycles. So last year there was volatility for our taxable clients, we actually did tax-loss selling three or four times, building tax assets to help with future tax issues.

And we love being tactical with them because they're so non-homogenous, as we tell our clients and prospects. And the fact that you can look at them and say, "Some BDCs, a premium is expensive or a premium is cheap, and some BDCs at discount is expensive, or a discount is cheap." You've got to sift a little more than just a regular, screen highest yield, deepest discount, and we find that really comes through when looking at the quality of the portfolio, and the quality of the manager, and the fairness of the fee structure and other important fundamental data points in the sector.

Jane King: Okay, I was going to ask about that, the expenses, and then also leverage. How do you review a portfolio?

John Cole Scott: So there's two types of data, there's the wrapper data, that's the expense ratio, the leverage, basically who the fund sponsor is, then there's the guts, that's the actual make-up of loans. These are not operating companies, as I said, they act kind of like them, they typically have 100+ holdings inside of them, they're highly diversified. And even though we had problems in March of this year where BDCs pulled back 5% with the banks, but then rallied this quarter since, and really proved that permanent capital structure of a BDC was stable and was able to work through the problem and not have the risk of a market turmoil.

The index has a leverage about 54%, could technically go to 100% roughly if they wanted to, our product, a little lighter 47%. We look at our expense ratios as gross non-leverage expense ratio, right now our product has about 2.9% fee-weighted, which is a third less than the index. There's also the quality of the holdings. Are the investments that the manager's done paying income to the BDC, which then they pay to us as dividends for us and our clients, and right now the non-payment rate or non-accrual is about 0.9% versus 1.4% for the index.

And for the last fundamental data point I'll talk about for these funds, really important, every quarter the board sets a mark for every holding publicly for all to see, tremendous transparency. And the average fair market value versus cost for our product is about -2.9%, a reasonable pullback in the economy. However if you look through the entire universe of BDCs, the average fund's weighted down 6.8%. We don't know the future but we like to build a portfolio that has dividend coverage, 120% for our product, dividend growth hopeful, and have a sturdier NAV and a manager that we think can navigate tough waters. But for our fund, it's a 5% to 9% allocation, every BDC is a vote but no one is steering the ship, and that's really how we think about being overweighted, tactical, and to be focused in the sector.

Jane King: What is your outlook for BDCs?

John Cole Scott: So I never know the future, I left my crystal ball back on the airplane.

Jane King: None of us do.

John Cole Scott: But I'd like to think with the dividend coverage we're seeing, and even with recessionary forces in front of us, there is capacity for 5-10% dividend increases for probably the index. We like to think our allocation will be a little bit higher than that. We know that BDCs can be volatile, and that the best thing you can do whenever the volatility happens like it did in March, is you either hold because you bought it for a reason and your reason did not change, you can rotate, maybe a higher quality BDC plummeted farther than the one you're in, or you can always add.

A third of our clients with BDC allocations, we call them up in March and they put more money in the portfolio, we immediately bought more BDC exposure and they're up more today because we did that timely component. So being anti, basically a contrarian, as long as you're diversified and you never are a forced seller of a BDC or closed-end fund, we tell our clients you can do a great job.

Jane King: Yeah. Well, thank you, John, for explaining BDCs. It's fascinating for me to learn about them as well, so thank you so much.

John Cole Scott: Well, thank you as well.
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