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Why BDCs Matter (Part Four)

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When business development companies were created by Congress in 1980, they were designed in response to concerns about liquidity.

Specifically, a provision in the 1940 Act limited the number of holders of investment company securities to 100 persons. That, of course, effectively eliminated public ownership. Private equity and venture capital firms argued this would put a major damper on financing for small to medium-sized companies.

Three decades later, the availability of public capital to BDCs has established them as viable alternative financing sources for the middle market. But, as importantly, the BDC now provides thousands of individual investors access to an otherwise illiquid asset class; namely, middle market loans.

But their ride has been a bumpy one over the past year.

The first pothole was the Russell index de-listing. In brief, an SEC rule required funds which own BDCs to report those fees as if they were their own. Despite the fact that the BDC fees aren't paid by the funds. Don't ask.

Rather than report higher fees, Russell (and before them, S&P) opted to remove BDCs from their funds. Russell alone accounted for about 10% of the outstanding BDC shares, so when the de-listing kicked in this past June, shares plummeted.

Those values soon recovered, but then came the market hiccup in October. Along with worries about global growth and Ebola, rate concerns accentuated the volatility. If the Fed continued its dovish ways, interest rates would remain low as far as the eye could see. Which made moot a prime virtue of floating rate assets.

In response, retail cash departed from loan mutual funds in droves and shares of BDCs slumped again. Since the end of October, as our *Chart of the Week* shows, BDCs have clawed their way back, but not to where they were earlier in the year.

As has been the case since the credit crisis, investors are increasingly selective based on manager performance. They are scrutinizing default experience, track record, portfolio diversification, origination capability, and of course, yield/expense ratios.

In summary, as our friend Jonathan Bock has highlighted, is the fund being run for the benefit of the manager, or the shareholder?

How investors allocate their BDC dollars will determine winners and losers. Those companies whose shares trade below book value are effectively shut out of future capital raisings – no capital, no growth, and no business.

Next week: We conclude our series by taking your questions on BDCs and hand them to the experts for answers. Send them to info@theleadpc.com.