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How BDCs can help in changing equity markets

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Returns for small-cap value stocks have been nothing short of breathtaking over the past year. These stocks have reaped stellar gains, boosting returns for our small-cap value portfolio. Recently, this was due to an environment of declining unemployment, Covid-19 vaccine developments, and expectations for the reopening of the U.S. economy.

However, it is now important to consider how an investment portfolio might weather a retracement — or temporary reversal — of this trend. In the case of an equity market downturn or increasing market volatility, a stream of current income can provide a base level of return and add some ballast to portfolio performance. We believe one way to achieve this is through an emerging asset class known as business development companies (BDCs).

An emerging asset class for equity investors

Organized under the Investment Company Act of 1940, BDCs invest in the debt, and occasionally the equity, of U.S. middle-market businesses. In other words, BDCs provide financing capital to small- and midsize private companies.

- BDCs typically originate and hold a portfolio of loans, most often in the senior secured position of the capital structure.
- Net interest income, after management fees and expenses, is passed on to BDC equity investors via regular dividends.
- BDC holdings are generally diversified across industries.
- BDCs may take on leverage, but it is limited and is well below that of bank leverage.
- Similar to the REIT model, BDCs avoid tax at the corporate level as long as they distribute the bulk of their income to investors.
- BDCs can profit, and potentially increase their dividends, when short-term interest rates eventually rise because they typically hold floating-rate assets.

Like many REITs, BDCs are often managed by external firms. BDC managers include some of the best known and most experienced hands in debt capital management. While relatively small right now, the public BDC market is growing and includes many liquid names such as Ares Capital (ARCC), Owl Rock Capital (ORCC), and Hercules Capital (HTGC). It currently has a market capitalization of about $50 billion, which we expect to grow in the next year via both IPOs and equity follow-on offerings.

Attractive yield potential, but security selection is critical

Most BDCs strive to deliver returns on equity in the 8% to 10% range, which today generates commensurate dividend yields. They are able to achieve this through a combination of high-yielding loan assets, favorable corporate tax status, modest leverage, and strong underwriting.

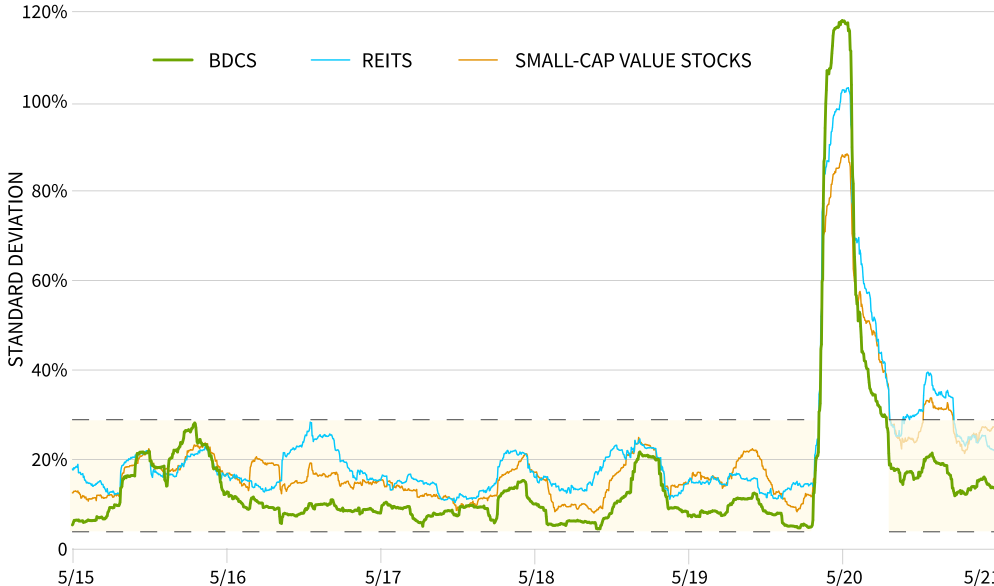
BDC managers differ in their approaches to credit and interest-rate risk, portfolio construction, fee structures, and raising additional capital. Credit quality is the biggest swing factor in individual BDC performance over time, with the best managers historically achieving long-term annualized returns that are several percentage points higher than the median BDC. A few BDCs have been hampered by less-robust underwriting, resulting in weak credit selection. In these instances, total return — dividend yield plus capital appreciation — is softer. As a result, stock selection is critical when investing in BDCs, as is properly evaluating a BDC's liability structure, dividend policy, fee structure, and underwriting philosophy.

A potential counterweight to market volatility

The S&P BDC Index delivered a solid 5-year average annual return of 9.8% as of 4/30/21. Cushioned by BDCs' high current yield, the index has a 5-year realized beta of 0.93x versus the Russell 2000 Value Index. It has generally exhibited lower volatility in non-recessionary periods when compared to both the Russell 2000 Value Index and REITs. These characteristics, combined with their high cash dividends, make BDCs a good counterweight to market volatility in the current environment.

BDCs have been less volatile in non-recessionary periods

Volatility trends in BDCs, REITS, and small-cap value



Sources: S&P BDC Index; Russell 2000 Value Index; Russell 2000 Value Index diversified REITs subsector. Past performance is not a guarantee of future results. Indexes are unmanaged and do not incur expenses. You cannot invest directly in an index.

Rebounding economy should favor BDC performance

Because they are vehicles for accessing the private credit markets, BDC equities are not immune to recessions, as we saw most recently in 2020. This is because investors quickly price in expected losses to BDC book values from negative credit developments. However, with the recession firmly in the rear-view mirror, we expect the rapidly rebounding economy to continue to improve credit metrics and asset valuations broadly. This should support rising BDC book values and dividends, independent of short-term gyrations in the stock markets, and contribute to lower volatility of BDC equities compared to most other small-cap value stocks.

The past year has been a great one for small-cap value equity returns. However, high investor expectations can lead to periods of flat performance, declines, and volatility, even within a longer-term bull market. In this context, active portfolio management is essential. Portfolio construction strategies — such as investments in BDCs with attractive yields and volatility-dampening characteristics — should prove beneficial.

As of 4/30/21, BDCs represented 2.70% of Putnam Small Cap Value Fund assets, and the portfolio yield was 1.35%. As of 3/31/21, Ares Capital (ARCC), Owl Rock Capital (ORCC), and Hercules Capital (HTGC) were not held in Putnam Small Cap Value Fund.

The S&P BDC Index is designed to track leading business development companies that trade on major U.S. exchanges. The Russell 2000 Value Index is an unmanaged index of those companies in the small-cap Russell 2000 Index chosen for their value orientation. You cannot invest directly in an index.

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Diversification does not guarantee a profit or ensure against loss. It is possible to lose money in a diversified portfolio.

Consider these risks before investing: Investments in small and/or midsize companies increase the risk of greater price fluctuations. Value stocks may fail to rebound, and the market may not favor value-style investing.

The value of investments in the fund's portfolio may fall or fail to rise over extended periods of time for a variety of reasons, including general economic, political, or financial market conditions; investor sentiment and market perceptions; government actions; geopolitical events or changes; and factors related to a specific issuer, geography, industry, or sector. These and other factors may lead to increased volatility and reduced liquidity in the fund's portfolio holdings. These risks are generally greater for small and midsize companies. From time to time, the fund may invest a significant portion of its assets in companies in one or more related industries or sectors, which would make the fund more vulnerable to adverse developments affecting those industries or sectors.

Our investment techniques, analyses, and judgments may not produce the outcome we intend. The investments we select for the fund may not perform as well as other securities that we do not select for the fund. We, or the fund's other service providers, may experience disruptions or operating errors that could have a negative effect on the fund. You can lose money by investing in the fund.

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