# BDCs and Your Portfolio

A traditional investment portfolio contains a combination of stocks, bonds, cash or cash equivalents, and the mutual funds or exchange traded funds (ETFs) that invest in those asset classes.

While some mix of traditional asset classes is likely to yield satisfactory investment returns for the average investor, you may also look for non-traditional opportunities, commonly known as alternative investments, to create a more comprehensive portfolio and address your specific investment needs. For example, you might consider an investment in business development companies (BDCs) to diversify your investment portfolio and potential sources of income.

Of course, you'll want to be sure you understand the risks as well as the potential advantages of investing in BDCs. You should also research the up-front fees that apply and the possibility of additional fees during the holding period. Then, with your financial advisor, you can investigate whether a BDC can help you achieve your objectives.

## What's A BDC?

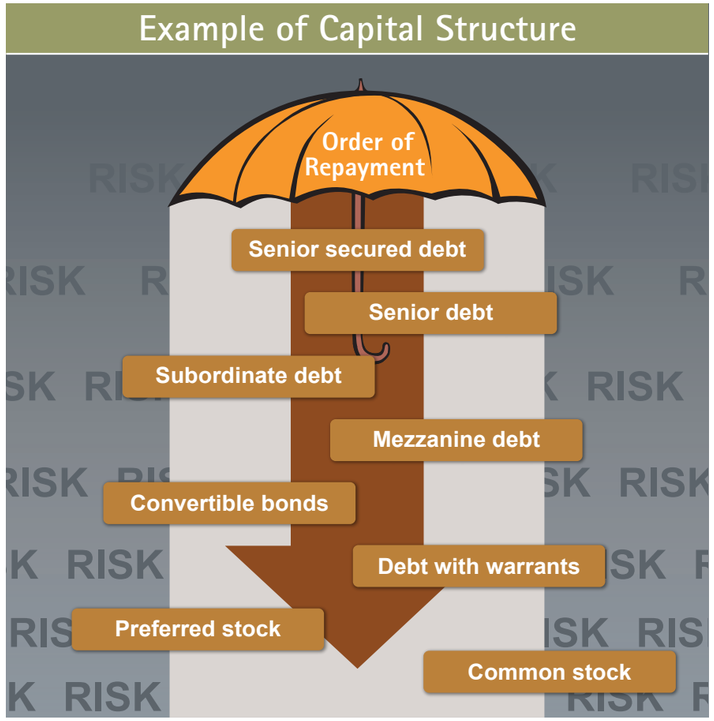
A BDC is a type of closed-end investment company that may be traded in a public market or non-traded. A BDC invests in private or thinly traded small or medium sized US companies with limited access to capital. Using a pool of money it raises from investors, a BDC purchases the debt or equity of its portfolio businesses. The BDC's management team is responsible for choosing investments, providing managerial assistance to portfolio companies, and making the enterprise profitable. Among other things, BDC managers seek to provide a steady stream of revenue that can be passed on as distributions to investors. However, there is no guarantee this objective will be met.

# Capital Structure

In fulfilling their objective of providing capital to small and medium-sized US businesses, BDCs can invest in a number of different types of securities, along a spectrum of investments that includes debt and equity. This spectrum is known as a business's capital structure.

Typically, a BDC will invest primarily in one area of the capital structure, and so be identified as a debt BDC or an equity BDC. Understanding the types of securities a BDC is purchasing will help you and your advisor more accurately assess the risk profile of the investment and the yield it has the potential to provide.

In the capital structure hierarchy, loans are intended to return principal and interest to investors but do not participate in the growth of the company. Senior secured debt with solid collateral is considered the least risky investment and typically pays interest at a lower rate than shorter-term unsecured loans. The common stock of small companies, on the other hand, may increase substantially in value if the company grows but typically does not provide current income and may be at greater risk in an economic downturn.




# The Lifecycle of a BDC


## Stage 1: The Start-Up

As it starts up, a BDC continues to raise funds to make investments for its portfolio. In evaluating the BDC as a potential investment, it is critical to consider the track record of the firm that is offering it. While past performance can never ensure success, it does provide valuable insight into the portfolios that the management team has built for earlier BDCs and the way it operated those entities.

## Stage 2: Portfolio Management

In this stage, the BDC winds down its money-raising efforts and focuses on building and managing the investment portfolio. For the majority of BDCs that are investing in small company debt securities, this stage will demonstrate the ability of the management team to generate income for investors in the BDC. Investors should be prepared for the Start-Up and Portfolio Management stages to last up to 7 to 10 years.

## Stage 3: Exit Event

BDC managers seek to monetize the portfolio to realize a capital gain for investors, although there's always the risk of a loss. To liquidate the portfolio, management may elect to sell the BDC portfolio as a single block or as multiple blocks. Alternately, it may choose to convert the BDC to publicly traded status through an Initial Public Offering (IPO). If the firm completes an IPO, investors may receive shares in the new publicly traded BDC or their share of the proceeds in cash. However, there is no assurance that the BDC will be able to liquidate, or that investors will recover the amount they invested.


While investing in a BDC may provide the potential for attractive returns, you take certain risks, just as you do when you make any investment. For example, changes in interest rates that may occur while investors hold BDC shares may reduce the anticipated rate of return or affect the market value of the BDC's investment portfolio.

Another risk may occur during the early stages of a BDC. Until the investment phase is complete, investment income may not be adequate to cover distributions. As a result, the BDC may choose to reduce the distributions it has promised or borrow to pay the distributions. The BDC may also pay distributions from offering proceeds, which would reduce the amount available for making additional investments and could reduce the BDC's overall return. Further, the amount of the distribution a BDC pays may decrease at any time. There is no guarantee of any return on investment and investors may lose all or a portion of their principal. In addition, it is possible that a BDC management team could have a limited operating history and/or conflicts of interest.

A BDC may also borrow funds to make investments. As a result, the BDC would be exposed to the leverage risks. Leverage increases volatility by magnifying the potential for gain or loss

Non-traded BDCs are not bought and sold on an exchange and must be liquidated in a planned exit event. However, there is no guarantee a liquidation event can be completed as planned, or, if it is, that investors will receive either the full amount of their investment or the current offering price. Thus, investors should be prepared to seek liquidity from other portfolio holdings.

Investors should consult with their tax advisors regarding the tax implications involved with a BDC investment.

## Are Business Development Companies (BDCs) Right for You?

The Small Business Administration estimates that small businesses employ half of the private sector workforce. Because these businesses play such an important role in our economy, financing their operations is of utmost importance. That's why business development companies (BDCs) were created in 1980.

A BDC provides financing, whether through loans or ownership, to small and medium sized businesses. It raises capital from retail investors who buy shares in the BDC. Before BDCs, there was very limited opportunity for small companies to raise needed capital and for investors to participate in this segment of the market. Most small businesses are privately held, and private equity firms that invest in them are generally not open to retail investors.

If investing in small businesses seems attractive to you, talk to your financial advisor about how BDCs may fit into your investment portfolio. However, BDCs are not suitable for all investors.

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# Guide to Understanding Business Development Companies


*An investment in knowledge pays the best interest.*

— Benjamin Franklin