A Smart Alternative to Junk Bonds

High-yield bonds aren't the only way to get decent income these days. The stocks of "business-development companies" can offer better yields and lower risks.

By
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April 20, 2013

For high investment yields that are worth the extra risk, look beyond junk bonds. Investors have piled into them, causing prices to rise and yields to fall to record lows. The BofA Merrill Lynch High Yield Master II index recently yielded just 5.7%.

Here's a better choice: a smaller, lesser-known investment class called business-development companies. Investors should stick with the safest ones, but even those yield about 8%. Go with Hercules Technology Growth Capital (ticker: HTGC), Golub Capital BDC (GBDC), New Mountain Finance (NMFC), and Ares Capital (ARCC).

Business-development companies, or BDCs, make loans to small and midsize businesses and pass the interest on to shareholders as income. They trade like stocks, much like their pass-through investment siblings, real-estate investment trusts and master limited partnerships.

Even the safest of BDC stocks are offering yields of 8%. By contrast, junk bonds are generally yielding less than 6%. Stuart Goldenberg for Barron's

BDC loans and junk bonds both carry elevated risk of default, which portfolio managers seek to keep in check with diversification and careful choosing. There are important differences between the two assets, however. Many BDC loans are "senior secured" debt, meaning that in the event of bankruptcy, they must be paid before junk bonds. Also, many BDC loans carry floating interest rates. That puts them at lower risk of price declines if rates broadly rise.

In addition, BDCs have relatively little competition. Their customers are generally too small to tap the bond market, and commercial banks are finding such lending less attractive in the wake of new capital requirements.

The dearth of rivals means that BDCs can charge rates commensurate with their risks. Most charge fees to issue loans, similar to points on a mortgage. Once the loans become securities, demand for them rises among investors that can hold such loans but can't originate them. "We're able to originate loans by putting up 98 cents on the dollar, and then sell them at 101 cents," says Leonard Tannenbaum, chief executive of Fifth Street Finance (FSC), a BDC. "Sometimes we sell them right away."

Little wonder that BDCs have been attracting more attention of late. Wells Fargo created a BDC index in January 2011. Soon after, UBS issued exchange-traded notes that track the index. This past February, Van Eck launched the group's first exchange-traded fund, Market Vectors BDC Income (BIZD). Rising recognition could eventually narrow the yield gap between BDCs and junk-bond funds. "I see an opportunity for valuation arbitrage," says Jonathan Bock, an analyst at Wells Fargo. "You pick up more than three extra percentage points versus junk-bond yields, and you get better protection."

Before buying into BDCs, however, investors should consider some of the potential pitfalls. Allied Capital and American Capital (ACAS) suffered high-profile blowups during the financial crisis of 2007-09. In hindsight, both companies had lent too aggressively while adding large amounts of stock exposure to their portfolios. BDCs use leverage, with a legal limit of 1:1, which amplifies the effects of excessive risk-taking. Since then, outside scrutiny of BDC loan books has risen, making today's valuations more reliable, says Bock.

Leverage can be a good thing, considering that many BDCs now can borrow at just over 6% (or 3.5%, if they use government-subsidized funds for small businesses) and lend at 10%. And many are prudent lenders; the group has managed to keep loan-loss rates at about 0.7% a year of capital deployed, below the rate of commercial banks.

BDCs must pay out the bulk of their income as dividends. Look for outfits that can cover at least three-quarters of their dividend payments with loan interest alone, before adding things like underwriting fees and gains, which can shrink in a downturn. Investor fees are important, too. Many BDCs charge like hedge funds, collecting 2% of assets plus 20% of winnings each year. Good ones have provisions that reduce management fees in the event of portfolio losses. Bad ones don't.

WELLS FARGO HAS divided the BDC universe into four tiers based on risk. Over the past two years, its top-ranked BDCs have gained a total of 36%, versus 24% for all BDCs in its coverage. Good bets from this lowest-risk group include Hercules Technology Growth, which specializes in tech companies and often negotiates for stock warrants as part of its deals. That gives it upside potential with less downside risk and mimics a tactic used by Warren Buffett in recent years. Golub Capital BDC is only three years old but is run by a firm with nearly two decades of lending experience. It has a shareholder-friendly fee structure and is particularly picky about risk. New Mountain Finance specializes in lending to companies whose earnings tend to hold up well during downturns in the economy.

Ares Capital is the largest BDC and a veteran of the financial crisis. Its shares plunged with those of Allied and American then, but with a crucial difference: Ares continued paying healthy dividends. The stock price has recovered, and while the ride for long-term holders has been anything but comfortable, it has been plenty profitable. The shares returned a total of 203% between their October 2004 debut and the end of last year. That compares with 50% for the Standard & Poor's 500 index.

Best Bets on BDCs

These stocks aren't the group's highest yielders, but they carry below-average risk.

Company/Ticker	Recent Price	Market Value (mil)	Dividend Yield	Dividend Coverage From Stable Cash Flow*
Ares Capital/ARCC	$16.93	$4210	9.0%	75%
Golub Capital/GBDC	16.02	540	8.0	77
Hercules Tech Growth/HTGC	11.92	631	8.4	86
New Mountain Fin/NMFC	13.82	432	9.8	97

*Measured by Wells Fargo. Ignores the contribution of fees, gains, and other income sources. At least 75% is ideal.

Source: Thomson Reuters

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