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John Cole Scott on the ABCs of BDCs

John Cole Scott, AICA Chairman and President and CIO of CEF Advisors, kicked off 2025 with a round of interviews on business development companies (BDCs): uniquely structured funds that invest in startups, small companies, and financially distressed firms. BDCs are closed-ended management companies registered in compliance with the 40 Act and are professionally managed to help businesses succeed.

Over the course of three interviews, Scott explained how BDCs work, how they fit into the larger universe of closed-end funds (CEFs), and how they have performed in recent years relative to stocks and bonds.

Portfolio Performers

In an interview with Jane King on Wall Street, Scott discusses how BDCs — like interval funds and other types of alternative investments — can help diversify actively managed portfolios and potentially generate long-term income for investors.

According to Scott, high-yielding CEFs and BDCs have been yielding between 7% and 14%, outperforming income from most stocks and bonds. Those results could be attractive to retirees looking to avoid sequence-of-return risk, Scott noted. BDCs also focus on a variety of sectors such as variable-rate senior loans in private credit, which helps investors gain income from more than one company and sector, making them "(potentially) great for this recessionary or inflationary environment," Scott said.

Scott also explains how BDCs enjoy "pass-through" tax treatment and can potentially generate higher yields due to their being modesty levered.

With an eye to monitoring market conditions, Scott says his firm actively manages portfolios containing CEFs and BDCs and makes changes as appropriate. One model that is popular since 2009 is the Hybrid Income Model, which has a majority allocation to debt-focused BDCs, majority exposure in U.S. bonds (52.33%) and U.S. equity (26.1%), and 35 holdings.*

*As of March 5, 2025; CEF Advisors

Unique Risk Profiles

BDCs are unique to the CEF universe and thus often prompt questions about how they should be analyzed for potential investment risk. BDCs and CEFs both have an active manager of holdings, but BDCs have an earnings season while CEFs don't, Scott told Chuck Jaffe on AICA's NAVigator Podcast. Thus, BDCs may often experience a degree of seasonal volatility, relative to their quarterly disclosures, that other CEFs don't, Scott said.

Rather than analyze publicly traded BDCs as a stock, he said it's best to analyze them as a CEF, or use his firm's signature approach: analyze the manager and wrapper, and the discount and dividend confidence — CEF Advisors' trifecta analysis.

In this interview, Scott also spoke to a potential downside in investing in BDCs: namely the risk of a sector or individual company going through problems, which can hurt the dividend. This is why it's especially important to analyze the manager and their track record, he said.

"NAV is important [for BDCs], but accounting is complicated," Scott noted in an interview with Nasdaq's Jill Malandrino. "You can hide things in NAV," therefore it's crucial to factor in a fund's return on equity when trying to determine if it's performing well or not, he added.

To learn more, access the three interviews with John Cole Scott from February 2025:

- Interview with Jane King (AICA)
- Interview with Chuck Jaffe (NAVigator Podcast)
- Interview with Jill Malandrino (Nasdaq Trade Talks)