

## Alternative Investments • Specialty Finance BDC

This portfolio is focused on a niche of the financial sector known as business development companies, or BDCs. BDCs lend to and invest in the private debt and equity markets. The majority, if not all, of holdings in this portfolio are in BDCs, typically involving 30-40 positions with a moderate level of turnover. The BDC portfolio is suitable for clients seeking alternative investment exposure to the private markets, one that involves high levels of income from an equity portfolio with above-average volatility. Most of the portfolio income will be in the form of non-qualified dividends.

### Portfolio Commentary

The strength of the equity markets in 2012 carried forward into the beginning of 2013 with the S&P 500 posting a first quarter total return of 10.6%. BDCs also fared well, with the benchmark Wells Fargo BDC Index setting a 7.4% total return. This quarter's lower performance may have been in part a function of BDC returns settling in toward the broader market, which the industry has outperformed for several quarters.

For the quarter, the Specialty Finance BDC portfolio composite return was 6.8% (gross of fees). (For detailed performance data and disclosures see: [www.confluenceinvestment.com/alt\\_investment\\_strategies#prod\\_164](http://www.confluenceinvestment.com/alt_investment_strategies#prod_164)). Much of the performance below the benchmark is a result of a substantially lower exposure to American Capital, a BDC weighted around 10% in the benchmark. The portfolio is primarily focused on dividend-paying BDCs and American Capital does not pay a dividend. The tradeoff is a higher dividend yield in the portfolio. At quarter end, the BDC portfolio was invested in 31 BDCs and the weighted average dividend yield was 8.4%. Over two thirds of the portfolio holdings have had stable or growing dividends in recent quarters.

Fundamentally, BDCs continue to perform well. Default levels remained relatively low and many BDCs were able to take advantage of favorable market conditions by raising debt or equity capital. Quarterly earnings reports revealed a mixed bag with regard to origination volume. Some BDCs took a

rather aggressive posture and originated unusually high volumes of new loans; others struck a more cautious tone, and stepped back from the declining yields in their lending markets. It remains to be seen which strategy proves to be more prudent. But we do know that the vintage of loans originated in the second half of 2012 will prove to have a significant impact on the performance of many BDCs, just because of its sheer size.

The top holdings in the portfolio remained in place during the quarter, even as their relative weights shifted a bit. Golub Capital, Medley Capital, PennantPark Investment, New Mountain Finance and THL Credit round out our top five positions. We favor these companies because we believe their managers have track records of good underwriting and proper balance sheet management. We believe their reasonable valuations, dividend strength and current yield help form a solid foundation for the portfolio.

Although the industry remains principally populated by small cap companies, its higher volatility often presents attractive opportunities for risk-tolerant investors. The number and size of companies in the industry continue to grow and positive trends related to balance sheet strength and managerial fees remain intact. We also expect stable and improving regulatory trends to continue, fostering a constructive environment for BDCs to grow. Therefore, our outlook for the BDC industry remains positive.

Top 10 Portfolio Holdings (as of 3/31/13)

Company	Market Capitalization (\$ millions)	Portfolio Weight
Golub Capital	467.0	8.5%
Medley Capital	454.3	7.4%
New Mountain Finance	443.8	7.1%
THL Credit	302.9	6.5%
PennantPark Investment	750.0	5.9%
Hercules Technology Growth Capital	734.1	4.7%
Ares Capital	4,500.6	4.6%
Solar Senior Capital	221.0	4.5%
PennantPark Floating Rate Capital	137.5	3.9%
TCP Capital	342.8	3.8%

BDC Dividend Statistics at 12/31/12

Year	Holdings	Avg. Yield	Dividend Change from Prior Year			
			# of companies with			
			Increase	Flat	Decrease	Initiated
2012	31	8.8%	15	7	5	4

Confluence Investment Management LLC

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