Specialty Finance BDC

Alternative Investment Strategies

Confluence INVESTMENT MANAGEMENT

First Quarter 2025

The Specialty Finance BDC strategy 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 the portfolio holdings are in BDCs, typically involving 20-30 positions with a moderate level of turnover. This strategy is appropriate 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.

Market & Strategy Commentary

The Confluence Specialty Finance BDC strategy had a total return of 1.4% (gross of fees) in the first quarter of 2025, which was a bit higher than the benchmark return of 1.2%. Over multi-year periods, the strategy's returns have generally been near or in line with the benchmark. [*The strategy's net-of-fees return for the same period was 0.7% QTD. See disclosures on last page for fee description; actual investment advisory fees may vary.*]

After a good fourth quarter and strong year in 2024, stocks began the year on the right foot, moving upward nicely through the middle of February. However, sentiment began to change mid-quarter and the S&P 500 Index finished in negative territory by the end of March. Smaller cap stocks generally fared worse than larger ones, while financials delivered higher returns across capitalization sizes.

Total Return	Q1 2025
S&P 500	(4.3%)
S&P 500 Financials	3.5%
Russell 2000	(9.5%)
S&P Small Cap Financials	(4.1%)
MVIS US BDC Index	1.2%

(Sources: Bloomberg, Confluence)

Relative to other equities, BDCs followed a milder, more constructive path in the first quarter, particularly when compared to smaller companies. Dividends, which have always been a central part of portfolio returns, once again created a good opportunity to reinvest cash flow or fulfill distribution needs. During the quarter, we allowed dividends to accumulate a bit more than usual and were able to reinvest the cash later in the quarter as valuations came down. This maneuver contributed to relative returns in the first quarter.

The largest contributors to returns in the first quarter included BDCs with larger position sizes, which is usually the case. Sixth Street, Ares, Barings, Golub, and Capital Southwest reported steady results, to which the market assigned higher valuations as the operating fundamentals indicated ongoing dividend strength. The lowest contributors included Main Street, Hercules, Portman Ridge, Palmer Square, and Crescent. Although operating fundamentals for these BDCs remained in good order, their valuations declined a bit in the quarter. Note that Blue Owl III was acquired by its sister BDC, Blue Owl Capital, and the combined return from these two positions was close to break-even during the quarter.

Outlook

Of course, the bigger story is what happened after quarter end as the United States began imposing tariffs on its global trading partners, with particular attention directed toward China. The severity and abrupt implementation caused widespread uncertainty for the economy, and markets traded sharply lower across a wide range of asset classes. Although the final tariff levels are yet to be determined, companies directly involved with global trade will bear the initial consequences. However, the scope and scale of the changes in trade will in time wind through the entire country, affecting consumers and smaller businesses, including those with no direct trade exposure.

BDCs lend to private companies across a wide range of sizes and industries. Many of their borrowers may be challenged by tariffs, which may increase the price of some items, while also causing scarcity in others. Companies will need to find ways to absorb these costs or pass them along to customers. These maneuvers could become more difficult, or simply not possible, if the economy slows or tips into recession. In this environment, BDC managers — and BDC investors — may face rising credit problems.

See GIPS Report on pages 3-4

Outlook continued...

Compounding the challenges of the macro environment is the possibility of lower short-term rates. Most BDC loans have floating rates, so when the Fed eases, it can create downward pressure on BDC income. To address this issue, many BDC managers have established "base dividends," along with "supplemental distributions." The concept is to provide a measure of certainty around the base dividend as BDC managers express confidence in delivering adequate income to cover dividend distributions. At the same time, they recognize the potential downside pressure of declining rates through the supplemental distributions, which have more variability. Broadly speaking, we feel this policy can be helpful as it telegraphs a relatively certain level of income, while simultaneously recognizing the variability of income and how this may translate into variable dividends. A few of the BDCs in our portfolio utilized this kind of guidance on first quarter earnings calls.

The silver lining of the storm clouds in early 2025 for BDCs exists in their stable operating fundamentals. Many BDCs entered 2025 at the low end of their own leverage targets, indicating they had substantial "dry powder" to deploy. Having capital to lend when markets are dislocated allows BDC managers to play defense more easily, while also affording them opportunities to play offense. Furthermore, BDC credit quality has been fairly steady, notwithstanding a few isolated cracks that began to form after the Fed raised rates in the last cycle. With their houses in good order, many BDCs are well-positioned to weather the uncertainty facing the country, and we expect many to emerge from the cycle in better shape than they were going in.

With high current yields and strong balance sheets, BDCs are well-positioned to continue delivering income and returns derived from the alternative investment class of private credit. Although BDC stocks can become volatile during times of broad market dislocation, their valuations are well below historical averages, a condition that generally helps to lower risk. We continue to believe BDCs can play a constructive role for risk-tolerant equity investors who are seeking above-average yields.

Contribution[1]

(QTD as of 3/31/2025)

The portfolio's top contributors and detractors for Q1 2025 are shown in this table:

Security	Avg Weight (%)	Contribution (%)
Top 5		
Sixth Street Specialty Lending Inc.	6.64	0.48
Ares Capital Corp.	3.97	0.21
Barings BDC Inc.	7.40	0.21
Golub Capital BDC Inc.	7.75	0.20
Capital Southwest Corp.	3.85	0.19
Bottom 5		
Main Street Capital Corp.	6.61	(0.10)
Hercules Capital Inc.	6.14	(0.11)
Portman Ridge Finance Corp.	1.62	(0.16)
Palmer Square Capital BDC Inc.	1.78	(0.16)
Crescent Capital BDC Inc.	3.26	(0.27)

(Contribution data shown from a sample account, based on individual stock performance and portfolio weighting)

Performance Composite Returns[2] (For Periods Ending March 31, 2025)

	Since Inception**	10-Year*	5-Year*	3-Year*	1-Year	YTD	QTD
Specialty Finance BDC *Pure Gross-of-Fees[3]*	9.5%	8.4%	23.4%	8.1%	8.2%	1.4%	1.4%
Max Net-of-Fees[4]	6.2%	5.1%	19.8%	4.8%	5.0%	0.7%	0.7%
MVIS US BDC Index (MVBIZDTG)	9.4%	8.2%	23.9%	8.9%	9.0%	1.2%	1.2%

Calendar Year	Pure Gross-of-Fees[3]	Max Net-of-Fees[4]	Benchmark (MVBIZDTG)	Difference (Gross-Benchmark)	# of Portfolios	Composite Assets (000s)	Total Strategy Assets (000s)***	Total Firm Assets (000s)	Composite 3yr Std Dev	Benchmark 3yr Std Dev	Composite Dispersion
2011**	1.1%	0.9%	(0.7%)	1.8%	1	$104	$6,645	$937,487	N/A	N/A	N/A
2012	27.9%	24.1%	34.5%	(6.6%)	1	$133	$34,748	$1,272,265	N/A	N/A	N/A
2013	15.8%	12.4%	16.3%	(0.5%)	2	$1,459	$42,929	$1,955,915	N/A	N/A	N/A
2014	(4.4%)	(7.2%)	(7.8%)	3.4%	18	$3,644	$51,015	$2,589,024	9.7%	11.4%	0.0%
2015	(3.3%)	(6.2%)	(4.1%)	0.8%	25	$4,621	$51,912	$3,175,419	12.0%	12.7%	0.3%
2016	22.1%	18.4%	24.4%	(2.4%)	21	$3,857	$64,970	$4,413,659	13.1%	13.7%	0.8%
2017	0.9%	(2.1%)	0.1%	0.8%	19	$2,905	$55,878	$5,944,479	12.4%	13.6%	0.3%
2018	(1.7%)	(4.6%)	(6.6%)	4.8%	24	$3,702	$54,037	$5,486,737	11.1%	12.9%	0.2%
2019	25.0%	21.3%	27.3%	(2.3%)	35	$7,179	$57,964	$7,044,708	10.9%	13.1%	0.5%
2020	(6.8%)	(9.6%)	(11.2%)	4.4%	33	$6,782	$27,280	$6,889,798	31.6%	30.8%	1.0%
2021	32.0%	28.1%	36.4%	(4.5%)	38	$9,856	$20,805	$7,761,687	31.4%	30.5%	0.7%
2022	(10.2%)	(12.9%)	(8.6%)	(1.7%)	42	$9,231	$18,086	$6,931,635	33.2%	32.7%	0.3%
2023	25.8%	22.1%	27.3%	(1.5%)	42	$10,797	$13,104	$7,200,019	16.1%	17.6%	0.5%
2024	13.2%	9.8%	13.7%	(0.6%)	45	$11,907	$16,214	$7,280,773	14.9%	16.5%	0.3%

**Average annualized returns* ***Inception is 12/1/2011* *See performance disclosures on last page.*

Portfolio Benchmark

MVIS US Business Development Companies Index (MVBIZDTG) – A total return index that measures the performance of the largest and most liquid companies which are classified as BDCs in the U.S. The index is reviewed on a quarterly basis, is modified float market cap-weighted, and the maximum component weight is 20%. *(Source: Bloomberg)*

Confluence Specialty Finance BDC Committee

Mark Keller, CFA

David Miyazaki, CFA

For more information contact a member of our sales team: (314) 530-6729 or sales@confluenceim.com

See Territory Map on the Confluence website for sales coverage.

Disclosures

Market & Strategy Commentary—Individual holding performance and contribution methodology can be obtained by contacting Confluence. Material is published solely for informational purposes and is not an offer to buy or sell or a solicitation of an offer to buy or sell any security or investment product. Opinions and estimates are as of a certain date and subject to change without notice. Past performance is no guarantee of future results.

Investment or investment services mentioned may not be suitable to an investor and the investor should seek advice from an investment professional, if applicable. It is important to review your investment objectives, risk tolerance, and liquidity needs before choosing an investment style or manager. All investments carry a certain degree of risk, including possible loss of principal, that investors should be prepared to bear. Equity securities are subject to market risk and may decline in value due to adverse company, industry, or general economic conditions. There can be no assurance that any investment objective will be achieved or that any investment will be profitable or avoid incurring losses.

Index: The MVIS US BDC Index is shown as additional information. This index is unmanaged. An investor cannot invest directly in an index. It is shown for illustrative purposes only & does not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance.

[1] **Contribution—**Table showing the top 5 contributors/detractors reflects the strategy's best and worst performers (net), based on each holding's contribution to the sample account for the period stated.

[2] **Performance Composite Returns—Confluence Investment Management LLC claims compliance with the Global investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. Confluence Investment Management LLC has been independently verified for the periods August 1, 2008, through December 31, 2023. The verification report is available upon request. A firm that claims compliance with the GIPS standards must establish policies and procedures for complying with all the applicable requirements of the GIPS standards.**

Verification provides assurance on whether the firm's policies and procedures related to composite maintenance, as well as the calculation, presentation, and distribution of performance, have been designed in compliance with the GIPS standards and have been implemented on a firm-wide basis. Verification does not provide assurance on the accuracy of any specific performance report.

GIPS® is a registered trademark of CFA Institute. CFA Institute does not endorse or promote this organization, nor does it warrant the accuracy or quality of the content contained herein.

The Specialty Finance BDC strategy was incepted on December 1, 2011, and the current Specialty Finance BDC Composite was created on February 1, 2013. Confluence Investment Management LLC is an independent registered investment adviser. Results are based on fully discretionary accounts under management, including those accounts no longer with the firm. Past performance is not indicative of future results. The US Dollar is the currency used to express performance. Returns are presented gross and net of all fees and include the reinvestment of all income.

[3] Pure gross returns are shown as supplemental information to the disclosures required by the GIPS® standards.

[4] Net-of-fee performance was calculated using the highest applicable annual bundled fee of 3.00% applied quarterly. This fee includes brokerage commissions, portfolio management, consulting services and custodial services. The Confluence fee schedule for this composite is as follows: 0.80% on the first $500,000; 0.70% on the next $500,000; and 0.60% over $1,000,000. There are no incentive fees. Clients pay an all-inclusive fee based on a percentage of assets under management. The collection of fees produces a compounding effect on the total rate of return net of fees. Subsequent to February 1, 2013, bundled fee accounts make up 100% of the composite. Actual investment advisory fees incurred by clients may vary. Wrap fee schedules are provided by independent wrap sponsors and are available upon request from the respective wrap sponsor.

Performance prior to February 1, 2013, is based on the Specialty Finance BDC–Direct Composite which was created on December 1, 2011. The Specialty Finance BDC–Direct Composite includes accounts that pursue the Specialty Finance BDC strategy, but do not have bundled fees. Gross returns from the Specialty Finance BDC–Direct Composite include transaction costs and net-of-fee performance was calculated using the highest applicable annual bundled fee of 3.00% applied quarterly.

A complete list of composite descriptions is available upon request. Policies for valuing investments, calculating performance, and preparing GIPS Reports are available upon request. The annual composite dispersion is an equal-weighted standard deviation, using gross-of-fee returns, calculated for the accounts in the composite for the entire year. The three-year annualized standard deviation measures the variability of the composite gross returns over the preceding 36-month period. The Specialty Finance BDC Composite contains fully discretionary Specialty Finance BDC wrap accounts. The Specialty Finance BDC portfolio invests primarily in Business Development Companies (BDCs) to earn current income with potential long-term capital appreciation.

The benchmark was changed prospectively starting 7/1/2021 as the prior benchmark, the Wells Fargo BDC Index (WFBDC), was discontinued in July 2021.

**Results shown for the year 2011 represent partial period performance from December 1, 2011, through December 31, 2011. ***Total Strategy Assets are shown as supplemental information. N/A-Composite Dispersion: Information is not statistically meaningful due to an insufficient number of portfolios in the composite for the entire year. N/A-3yr Std Dev: Composite does not have 3 years of monthly performance history.

A BDC's portfolio typically will include a substantial amount of securities purchased in private placements, and its portfolio may carry risks similar to those of a private equity or private debt fund. Securities that are not publicly registered may be difficult to value and may be difficult to sell at a price representative of their intrinsic value. To the extent a BDC focuses its investments in a specific sector, the BDC will be susceptible to adverse conditions and economic or regulatory occurrences affecting the specific sector or industry group, which tends to increase volatility and result in higher risk. BDCs may employ the use of leverage in their portfolios through borrowings or the issuance of preferred stock. While leverage often serves to increase the yield of a BDC, this leverage also subjects the BDC to increased risks, including the likelihood of increased volatility and the possibility that the BDC's common share income may fall if the interest rate on any borrowings rises.