Specialty Finance BDC • Alternative Investment Strategies

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.

Strategy Commentary

The Specialty Finance BDC strategy was up 31.0% (gross of fees) in the second quarter of 2020, higher than the Wells Fargo BDC Index benchmark return of 29.9%. Year-to-date through the end of the second quarter, the Confluence BDC strategy had a total return of -27.1% (gross of fees), which was also slightly higher than the benchmark level of -27.7%. (*Net-of-fees returns for the same periods are +30.0% and -28.2%. See disclosures on p.2 for fee description; actual investment advisory fees may vary.*)

The first quarter of 2020 (March, in particular) proved to be a very volatile time for BDCs. The impact of the COVID-19 shutdown was negative for all equities, but it was particularly acute for BDCs. Investors worried that BDCs would experience a large number of defaults in their loan portfolios, which could potentially lead to lower income and dividends. We also believe technical imbalances exacerbated the negative trend. Price declines fanned investor fears and led to even greater price declines. BDC stock valuations declined much faster and more deeply than BDC operating fundamentals, and as a result the downward vortex drove BDC valuations to levels not seen since the Great Recession in 2008-09.

As the second quarter began, BDC stock prices stabilized and investors learned details of operating fundamentals as earnings were reported in early May. The companies revealed that although the COVID-19 shutdown was causing stress in BDC loan portfolios, conditions were not nearly as dire as many had expected. The industry operates with a relatively moderate amount of leverage with diverse funding sources. This profile helped maintain balance sheet strength, particularly when combined with BDC loan portfolios predominantly senior in nature.

Regarding NAVs, BDCs are required to mark their portfolios to market at the end of each quarter. With bond and loan prices significantly down as of the end of March, the industry reported loan price declines generally in the 5-10% range, which translated into NAV declines usually in the mid-teens. Declining NAVs are always a cause for concern; yet we also have a measure of cautious optimism, given that most of the lower loan pricing was caused by market conditions as opposed to actual credit problems. If borrower operating fundamentals can begin to stabilize over the summer and fall, there is a pathway to significant NAV recovery for many BDCs.

BDC earnings were also largely intact, although most managers reported some early signs of credit stress. As a result, most BDCs in the portfolio were able to maintain their dividends. Of the 22 stocks held in the portfolio at the end of the second quarter, 15 were able to maintain dividends. This resulted in a decline of only about 6.2% of the quarterly dividend profile for the portfolio, a decline that was partially offset by three BDCs that recently paid special dividends.

Looking forward, we're watching to see how the second coronavirus wave affects government policy, social response and individual behavior. Our general view is that the economy is unlikely to be completely shut down the way it was in March, even as it may take a while for economic expansion to begin. If this turns out to be the path of recovery, we expect most BDCs to make it through in good shape.

The million-dollar question is how long will small to mid-sized borrowers have their businesses interrupted? If a business franchise is strong and durable, it should be able to fully recover from being closed or partially closed for a few months. On the other hand, prolonged closures that last into the winter and beyond into 2021 will almost inevitably create a tide of rising loan nonaccruals, defaults and bankruptcies, even among strong companies.

We believe BDCs led by high-quality managers, who have focused on strong borrowers and positioned themselves as senior lenders, have the capability to create shareholder value. BDC valuations remain historically low and dividend yields are currently quite high. We believe this combination creates a significant opportunity for BDC investors.

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5 Largest Holdings (as of 6/30/20)

Company	Market Capitalization	Portfolio Weight
	($ billions)	
Ares Capital Corporation	6.1	7.6%
Solar Capital Ltd.	0.7	7.2%
New Mountain Finance Corporation	1.6	6.7%
Sixth Street Specialty Lending, Inc.	1.1	6.7%
Goldman Sachs BDC, Inc.	0.9	6.6%

The listing of “5 Largest Holdings” is not a complete list of all stocks in the portfolio or which Confluence may be currently recommending. Application of the investment strategy as of a later date will likely result in changes to the listing. Individual client portfolios in the program may differ, sometimes significantly, from these listings. Contact Confluence for a complete list of holdings.

All investments carry a certain degree of risk, including possible loss of principal. It is important to review your investment objectives, risk tolerance and liquidity needs before choosing an investment style or manager. Equity securities are subject to market risk and may decline in value due to adverse company, industry or general economic conditions.

Performance Composite Returns For Periods Ending 6/30/20

	Pure Gross-of-Fees[1]	Net-of-Fees[2]	Benchmark (WFBDC)
Since Inception**	5.1%	1.9%	4.6%
5-Year*	0.8%	(2.2%)	0.2%
3-Year*	(5.3%)	(8.1%)	(6.2%)
1-Year	(21.6%)	(23.9%)	(22.4%)
YTD	(27.1%)	(28.2%)	(27.7%)
QTD	31.0%	30.0%	29.9%

Calendar Year	Pure Gross-of-Fees[1]	Net-of-Fees[2]	Benchmark (WFBDC)	Difference (Gross-WFBDC)	# 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%

**Average annualized returns*
***Inception is 12/1/2011*

Portfolio Benchmark
Wells Fargo BDC Index – A total return index that measures the performance of all Business Development Companies (BDCs) listed on the NYSE or NASDAQ that satisfy market capitalization and other eligibility requirements. *(Source: Bloomberg)*

Confluence claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards.
Confluence has been independently verified for the periods of 8/1/2008 through 12/31/2018. A copy of the verification report is available upon request. Verification assesses whether: 1. the firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis, and 2. the firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards. Verification does not ensure the accuracy of any specific composite presentation.
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 U.S. Dollar is the currency used to express performance. Returns are presented gross and net of all fees and include the reinvestment of all income.
[1] Pure gross returns are shown as supplemental information to the disclosures required by the GIPS ® standards.
[2] 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: 1.00% on the first $500,000; 0.90% on the next $500,000; and 0.75% 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. Additional information regarding policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request. The annual composite dispersion is an equal-weighted standard deviation calculated for accounts in the composite for the entire year. 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.
**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.

Individual holding performance and contribution methodology as well as a list of every holding's contribution to the strategy 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. Holdings identified do not represent all of the securities purchased, sold or recommended. Information is presented as supplemental information to the disclosures required by GIPS ® standards. Opinions and estimates are as of a certain date and subject to change without notice. Investment or investment services mentioned may not be suitable to an investor and the investor should seek advice from an investment professional, if applicable. Past performance is no guarantee of future results. Investing in securities involves the risk of loss of the amount invested that investors should be prepared to bear. There can be no assurance that any investment objective will be achieved or that any investment will be profitable or avoid incurring losses.* ***Indices:*** *The Wells Fargo 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.*