Confluence Investment Management

Second Quarter

2023

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.

Market Commentary

After a tumultuous first quarter, the equity markets steadied in the second quarter of the year. The S&P 500 Index led the way, propelled narrowly by a relatively small number of companies in the Technology sector. Outside of that group, performance was generally more muted. Large caps in the Financials sector performed quite well, while small cap financials delivered negative returns as regional banks and REITs continued to face challenges. Although most BDCs are small cap financials, the industry continued to deliver positive returns in the second quarter.

In the aftermath of the Silicon Valley Bank failure, we were very interested to hear the perspective of BDC managers. As lenders to small and mid-sized companies, BDCs simultaneously compete and collaborate with banks. Their borrowers may lean heavily on bank credit or utilize very little. Oftentimes, BDC managers sit on the same side of the table as banks, while at other times they negotiate against them. Accordingly, BDC managers hold a unique perch from which to share observations.

Total Return	Q2 2023	YTD*
S&P 500	8.7%	16.9%
S&P 500 Financials	5.3%	-0.5%
Russell 2000	5.2%	8.1%
S&P Small Cap Financials	-3.4%	-14.6%
MVIS U.S. BDC Index	6.8%	11.9%

**as of 6/30/2023*

(Source: Bloomberg, Confluence)

Earnings calls from the second quarter were filled with manager commentary on the short-lived banking crisis. The federal government's response not only prevented wider problems in the financial markets, but they also limited interruptions for small and mid-sized businesses. Overall, BDC borrowers had very little, if any, direct exposure to failing banks and the few that did were able to adjust quickly and continue to operate their businesses in a normal fashion. Even for the BDCs who focus specifically on venture capital, which was at the epicenter of Silicon Valley Bank's business, few problems were reported. In fact, most venture-oriented BDC managers were optimistic that their lending opportunities would improve in the aftermath.

Still, this isn't to say that the solid performance in the second quarter was without concerns. The banking crisis didn't materially alter the credit landscape for BDCs, but we continue to watch how higher short-term rates are affecting credit quality. Most BDC loans are floating rate, and tighter Fed policy has boosted BDC interest income and driven dividend distributions higher. However, BDC credit metrics reveal a bit of rising stress among borrowers, perhaps most visible when considering the overall interest coverage ratios across the industry. On a recent earnings call, one very experienced BDC manager noted that defaults weren't caused by higher interest rates but instead were caused by other many other factors and circumstances. That may be true; however, if a borrower is experiencing operational challenges, a higher interest burden certainly isn't going to help. So, from a loan quality perspective, we think it's helpful that the Fed is nearing the end of its tightening cycle. Nevertheless, the full impact of higher rates is still in front of us and it will be important to keep a close eye on middle market credit trends.

Strategy Commentary

The Confluence Specialty Finance BDC strategy had a total return of 6.2% in the second quarter of 2023 and was up 10.2% year-to-date (both gross of fees). [*The strategy's net-of-fees returns for the same periods were 5.4% QTD and 8.6% YTD. See disclosures on last page for fee description; actual investment advisory fees may vary.*]

The strategy slightly lagged the benchmark, with the MVIS U.S. BDC index returning 6.8% and 11.9%, respectively, over the same time periods. Across multi-year time frames, gross portfolio returns are mostly in-line with the benchmark.

During the second quarter, Hercules (HTGC), Blackstone (BXSL), Capital Southwest (CSWC), Blue Owl (OBDC) (previously named Owl Rock), and BlackRock TCP (TCPC) were the largest contributors to total return. Hercules delivered very strong operating fundamentals, surprising investors with good results given that this BDC is focused specifically on venture lending. Meanwhile, the other four BDCs mentioned benefitted from steady results and improving valuations after experiencing declines in the first quarter.

Positions with the lowest contributions to performance during the quarter included Trinity (TRIN) and TriplePoint (TPVG), which are also focused on venture lending. These BDCs, along with Portman Ridge (PTMN), made roughly no contribution to returns, while OFS Capital (OFS) and SLR Investment (SLRC) delivered slightly negative returns. Although operating results for these BDCs were generally steady, their valuation improvements lagged the broader industry. *[See contribution table on next page.]*

Trading and turnover in the portfolio were relatively light in the second quarter. We were able to take advantage of price fluctuations and reinvest some cash distributions into existing positions to true-up allocations. OFS was trimmed, which was part of a broader tilt in the portfolio's focus away from smaller BDCs, which tend to lend to smaller borrowers, and more toward larger BDCs. Larger BDCs lend in the upper middle market, where larger borrowers often have a wider array of resources available if business conditions deteriorate. This ongoing shift is part of our strategy to proactively address possible risks associated with a slower growth economy.

Outlook

One less obvious, but very positive, development for BDC investors from the first half of 2023 was an apparent step forward in the industry's maturation. During previous market panics, like what unfolded in the fourth quarter of 2008 and the first quarter of 2020, BDC stock prices became highly volatile and declined far below book value. However, in the first quarter of this year, when depositors created a run on certain banks and investors, in turn, experienced a run on many bank stocks, BDC stocks held up in much better form. They certainly experienced volatility and downward pressure, yet the declines were shallower, liquidity was higher, and the recovery was much faster when compared to previous episodes. We are optimistic that the evolving BDC industry continues to make progress in forming a more durable shareholder base, one that better understands the distinctions of these companies relative to other lenders in the broader Financials sector. The destination may include an overall industry profile with less volatility and more liquidity for BDC investors seeking a high level of current income derived from alternative investments in the private debt market.

Contribution[1]

(QTD as of 6/30/2023)

The top contributors and detractors for the portfolio in Q2 2023 are shown in this table:

Security	Avg Weight (%)	Contribution (%)
Top 5		
Hercules Capital Inc.	5.39	0.95
Blackstone Secured Lending Fund	6.49	0.81
Capital Southwest Corp.	4.01	0.56
Blue Owl Capital Corporation	5.23	0.50
BlackRock TCP Capital Corp.	5.12	0.46
Bottom 5		
Trinity Capital Inc.	0.96	0.08
Portman Ridge Finance Corp.	1.85	0.00
TriplePoint Venture Growth BDC Corp.	1.99	0.00
OFS Capital Corp.	2.06	(0.06)
SLR Investment Corp.	6.09	(0.11)

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

Performance Composite Returns[2] (For Periods Ending June 30, 2023)

	Since Inception**	10-Year*	5-Year*	3-Year*	1-Year	YTD	QTD
Specialty Finance BDC *Pure Gross-of-Fees*[3]	8.4%	6.3%	7.8%	18.6%	11.2%	10.2%	6.2%
Max Net-of-Fees[4]	5.2%	3.2%	4.6%	15.1%	7.9%	8.6%	5.4%
MVIS U.S. BDC Index (MVBIZDTG)	8.3%	6.0%	7.6%	19.7%	14.4%	11.9%	6.8%

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%

*Average annualized returns

**Inception is 12/1/2011

See performance disclosures on last page.

Portfolio Benchmark

MVIS U.S. 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)*

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

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Disclosures

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Indices: The MVIS U.S. 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, 2021. 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.

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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.

[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. **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.