Confluence INVESTMENT MANAGEMENT

THIRD 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 & Strategy Commentary

The Confluence Specialty Finance BDC strategy had a total return of 9.1% (gross of fees) in the third quarter of 2023, which was higher than the benchmark return of 7.6%. On a year-to-date basis, the Specialty Finance BDC strategy total return was 20.3%, in line with the benchmark at 20.4%. Over multi-year periods, strategy returns have generally been slightly above the benchmark. [*The strategy's net-of-fees returns for the same periods were 8.3% QTD and 17.6% YTD. See disclosures on last page for fee description; actual investment advisory fees may vary.*]

It was another good quarter for BDCs, building on what has been a very good year. Rising interest rates can cause many problems for companies, but BDCs have benefited in this cycle, at least thus far. BDC portfolios are predominantly comprised of floating rate loans, while at the same time most BDCs have a large proportion of fixed-rate borrowing. So, when interest rates began to rise last year, BDC net interest margins and profitability also rose. That positive trend has continued into 2023, helping to set the stage for the solid year-to-date returns. It's also reflected in portfolio dividend trends:

Regular dividends for the Specialty Finance BDC portfolio at quarter-end:

Q3 2023 increases	11
Q3 2023 reductions	0
Q3 2023 special dividends	11

Portfolio weighted average dividend growth*:

Q3 2023 dividend growth	3.2%
YTD dividend growth	6.8%

** Applies portfolio model position weights as of 9/30/23 to regular dividends and excludes special dividends*

The strong performance of BDCs stands in contrast to most other areas of the equity markets. Looking more broadly, we see the S&P 500 delivered a negative return in the third quarter, although the year-to-date return remained quite elevated. Still, the high level of this year-to-date return is a function of a relatively small number of companies in the index. Across a wide array of equities, returns have generally been flat to negative in 2023, including many companies in the Financials sector. This trend is particularly the case for smaller financial companies.

Total Return	Q3 2023	YTD*
S&P 500	(3.3%)	13.1%
S&P 500 Financials	(1.1%)	(1.7%)
Russell 2000	(5.1%)	2.5%
S&P Small Cap Financials	2.4%	(12.5%)
MVIS U.S. BDC Index	7.6%	20.4%

(Source: Bloomberg, Confluence) *as of 9/30/2023

Market & Strategy Commentary continued...

Given that BDCs are financial companies that are generally small caps, it's reasonable to question why their performance has been so different. We believe a few factors are involved. First, BDC fundamentals have been strong. Their loan portfolios have had low levels of credit problems, a characteristic much different than the profile of other lenders, including many banks, which have been harmed by real estate and mortgage loan performance. Strong credit quality has allowed rising interest rates to drive income and dividends higher. Another factor has been the valuations of BDCs, which were a little on the low side coming into 2023. It seems many investors had concerns that BDCs would face rising credit problems as rates rose. Yet, as the year has progressed (even through the depths of the Silicon Valley Bank crisis), loan quality has remained intact, paving the way for higher BDC valuations. Finally, due to the banking crisis and its related problems, BDCs have been able to gain market share as non-bank lenders to small and mid-sized companies. Of course, none of these conditions mean that BDCs won't face their own challenges going forward. For our part, we continue to closely monitor how BDC loan portfolios hold up in the higher interest rate environment and through an upcoming economic environment that appears to have low, or even negative, growth.

At the portfolio level, the biggest contributors to portfolio returns in the third quarter came from the larger positions. Barings, Hercules, Golub, Sixth Street, and Capital Southwest all delivered double-digit returns, which involved substantial income as well as capital appreciation. Each of these companies delivered solid results, enabling them to either increase their regular quarterly dividend or pay a special dividend during the quarter (Hercules, Golub, and Capital Southwest did both). Not surprisingly, the positions making the least contributions to portfolio performance were smaller positions. Still, three of the five smallest return contributors delivered positive returns in the third quarter, with only Triplepoint on the negative side and Portman Ridge roughly neutral.

Outlook

Looking forward, our outlook remains cautiously optimistic for BDCs. Although BDC returns have surpassed most other equities, valuations remain reasonable, even as they have moved higher during the year. Furthermore, in the private debt markets, conditions generally remain tilted in favor of lenders, who continue to wield more control over pricing and terms relative to many borrowers. But as we have long noted, credit factors remain the central issue for BDCs. The trend has been surprisingly constructive, given the combination of high inflation, supply chain interruptions, and rising interest rates. BDC loan portfolios have been resilient thus far, but we will continue to monitor credit quality as the Fed moves to lower inflation by slowing economic growth. Our strategy for this environment has been to gradually adjust the portfolio weights more toward larger BDCs. Their borrowers tend to be larger companies which often have more resources to navigate periods of slow or negative economic growth.

Contribution[1]

(QTD as of 9/30/2023)

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

Security	Avg Weight (%)	Contribution (%)
Top 5		
Barings BDC Inc.	6.29	0.97
Hercules Capital Inc.	6.15	0.85
Golub Capital BDC Inc.	7.43	0.82
Sixth Street Specialty Lending Inc.	6.71	0.81
Capital Southwest Corp.	4.25	0.78
Bottom 5		
FS KKR Capital Corp.	1.74	0.12
Trinity Capital Inc.	1.00	0.09
Owl Rock Capital Corp.	0.28	0.02
Portman Ridge Finance Corp.	1.67	(0.00)
TriplePoint Venture Growth BDC Corp.	1.81	(0.15)

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

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

	Since Inception**	10-Year*	5-Year*	3-Year*	1-Year	YTD	QTD
Specialty Finance BDC *Pure Gross-of-Fees[3]*	9.0%	6.9%	8.5%	20.1%	31.2%	20.3%	9.1%
Max Net-of-Fees[4]	5.8%	3.7%	5.3%	16.5%	27.3%	17.6%	8.3%
MVIS U.S. BDC Index (MVBIZDTG)	8.8%	6.3%	8.2%	20.8%	33.5%	20.4%	7.6%

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, 2022. 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.