Confluence INVESTMENT MANAGEMENT

Specialty Finance BDC

December 31, 2022

Objective

Invests in business development companies (BDCs) within the financial sector. Primary objective is to pursue BDC income with capital appreciation as a secondary objective.

Investment Philosophy

The Specialty Finance BDC strategy invests in specialized companies in the financial sector known as business development companies, or BDCs. BDCs lend and invest in the private debt and equity markets, working with small to mid-sized companies. Their structure avoids income taxation at the corporate level as long as income and gains are distributed to shareholders. This structure, which has some similarity relative to that of Real Estate Investment Trusts (REITs), creates a stock profile that typically has substantial dividend payments and relatively high current yields.

Although BDCs share a common organizational structure, they are varied in their focus and strategy. Some may focus on particular industries, while others apply a more generalized approach. BDCs may choose to invest predominantly in senior loans, or they may seek exposure to junior loans or even equity. Depending upon their size, BDCs may work with issuers that are larger with more liquid debt securities, or ones that are smaller with less liquid securities. The different approaches play a role in forming a variety of return/risk tradeoffs.

Investment professionals at Confluence have analyzed and invested in BDCs since 2001 and the portfolio management process evaluates BDCs individually and within the context of a complete portfolio. Over time, we believe this approach should position investors to participate in potential dividend growth and capital appreciation.

Overview

- Most, or oftentimes all, of the portfolio holdings will be in BDCs
- Emphasis is on BDCs led by high-quality managers with strong performance track records
- In most environments, dividend income may provide most of the total return (in the form of non-qualified dividends)
- Appropriate for investors seeking an alternative investment exposure with a high level of income derived from an equity portfolio with above-average volatility

Portfolio Holdings[1]

Characteristics	
Dividend Yield	11.0%
Number of Positions	20-30
Annual Turnover *(5-Year Rolling as of 12/31/22)*	8%

5 Largest Holdings	Weight
Golub Capital BDC Inc.	7.1%
Sixth Street Specialty Lending Inc.	7.0%
Barings BDC Inc.	6.9%
BlackRock TCP Capital Corp.	6.4%
Main Street Capital Corp.	6.1%

Market Cap	
Weighted Avg. Market Cap ($MM)	1,958.6
Largest Market Cap ($MM)	9,387.5
Median Market Cap ($MM)	887.0
Smallest Market Cap ($MM)	127.5

Large Cap (>$10B)	0%
Mid Cap ($3B-$10B)	17%
Small Cap (<$3B)	78%

Investment Process

Security Selection

Our disciplined investment process emphasizes exposure to BDCs with the following attributes:

High-Quality Management

- Led by managers with successful track records of making loans in the private middle market
- Appropriate fee levels, accretive capital management policies and managerial incentives are properly aligned with shareholders

Valuation

- Determining BDC valuations includes price/NAV, dividend yield and various yield spread metrics
- Assess valuations relative to operating fundamentals and overall risk profiles
- Attractive valuations relative to company and industry historical trends

Portfolio Construction

Investment team evaluates BDCs individually and within the context of a complete portfolio:

- BDCs of varying size and lending focus are combined to position portfolios to pursue income and gains from a broad range of credit exposure
- Position sizes are not necessarily uniform; consideration is given to an individual BDC’s liquidity, leverage, operating fundamentals and valuation
- Although turnaround opportunities are often part of the strategy, the portfolio’s foundation is grounded in BDCs led by high-quality management teams with strong performance track records

Sell Discipline

To help preserve capital, portfolio positions are continually reviewed.

A company's stock may be sold if:

- Changes in operating fundamentals or management alter company profile
- Rising valuations diminish the return/risk profile of the stock
- Superior alternatives emerge or portfolio posture requires adjustment

Background on the BDC Industry[2]

Business Development Companies (BDCs) were formed under congressional amendments to the 1940 Investment Company Act, which were made in 1980. The formation of BDCs was intended to help facilitate the flow of capital into companies whose small size precluded access to the broader public markets. Accordingly, public BDCs are companies that lend to and invest in the private debt and equity markets. Their structure is somewhat similar to that of Real Estate Investment Trusts (REITs) in that they generally do not pay income taxes at the corporate level, so long as their taxable income is distributed to shareholders.

As a part of the 1940 Act regulations, BDCs have additional requirements mandated in their capital structure. One of the most important ones is related to the amount of debt a BDC may carry. In most instances, BDCs are limited to 2:1 debt/equity, meaning BDCs operate with substantially less leverage relative to other financial industries, where debt proportions are often several multiples of equity. Regulations also determine the kinds of eligible investments and require certain levels of diversification.

Most BDC portfolios are oriented toward private debt. Interest is collected on these portfolios, operating expenses and management fees are deducted, and the residual net interest income is then distributed to shareholders. This structure means that most BDCs have substantial dividends, generally much higher than other equities (most BDC dividends are not qualified dividends), and income from these stocks typically represents a substantial portion of the total return of the security.

During periods of financial market duress, such as in 2008 or during the early stages of the COVID-19 shutdown, BDC stock prices have become volatile as investors worry about company operating fundamentals. Yet the BDC structure has proven to be resilient in these kinds of environments. Although the companies seldom receive direct governmental assistance, many BDCs often have adequate balance sheet strength to stand on their own and not just survive, but actually grow and prosper. Granted, some BDCs have been harmed during market downturns, but the industry has never had a bankruptcy—a distinction that sets it apart from the rest of the financial sector.

The BDC industry is relatively young and is still growing, with the number and average size of BDCs significantly increasing in recent years. This growth profile, paired with income sourced from the private debt markets, creates a unique investment opportunity for equity investors seeking a high level of current income.

Performance

Composite Returns[3] (For Periods Ending December 31, 2022)

	Since Inception**	10-Year*	5-Year*	3-Year*	1-Year	YTD	QTD
Specialty Finance BDC *Pure Gross-of-Fees[4]*	7.9%	6.0%	6.3%	3.4%	(10.2%)	(10.2%)	9.1%
Max Net-of-Fees[5]	4.7%	2.8%	3.1%	0.3%	(12.9%)	(12.9%)	8.3%
MVIS U.S. BDC Index (MVBIZDTG)	7.6%	5.4%	5.7%	3.5%	(8.6%)	(8.6%)	10.9%

Calendar Year	Pure Gross-of-Fees[4]	Max Net-of-Fees[5]	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.

Confluence Specialty Finance BDC Committee

Mark Keller, CFA

David Miyazaki, CFA

For more information contact a member of our sales team:

Ron Pond, CFA | *Northwest*
Director of Sales
(314) 526-0759
rpond@confluenceim.com

Jason Gantt | *East*
Sr. Regional Sales Director
(314) 526-0364
jgantt@confluenceim.com

Jim Taylor | *Mid-South*
Regional Sales Director
(314) 526-0469
jtaylor@confluenceim.com

Denis O'Grady | *East & Mid-South*
Regional Sales Associate (Internal)
(314) 743-5294
dogrady@confluenceim.com

Wayne Knowles | *ID, MT, WY*
Advisory Director
(314) 526-0914
wknowles@confluenceim.com

Steve Mikez | *Southwest*
Sr. Regional Sales Director
(314) 526-0776
smikez@confluenceim.com

Michael Kelnosky | *North-Central*
Regional Sales Director
(314) 526-0622
mkelnosky@confluenceim.com

Matt Winter | *Southwest & North-Central*
Regional Sales Associate (Internal)
(314) 526-0522
mwinter@confluenceim.com

Disclosures

[1] **Portfolio Holdings—**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. 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 strategy may differ, sometimes significantly, from these listings. Contact Confluence for a complete list of holdings. Portfolio yield: composite-level weighted average yield, calculated based on annualized current dividends; source: FactSet. Annual turnover 5-year rolling calculated from sample accounts for periods ending 12/31/2022.

[2] **Background on the BDC Industry—**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.

[3] **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.

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 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.

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

[5] 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. 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.