Specialty Finance BDC

Alternative Investment Strategies

Confluence INVESTMENT MANAGEMENT

Third Quarter 2024

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 portfolio had a total return of -1.3% (gross of fees) in the third quarter of 2024, which was below the benchmark return of -1.1%. Year-to-date, the portfolio total return was 9.4% (gross of fees), which was also above the benchmark return of 8.7%. Over multi-year periods, the strategy's returns have generally been near or in-line with the benchmark. [*The strategy's net-of-fees returns for the same periods were –2.0% QTD and 6.9% YTD. See disclosures on last page for fee description; actual investment advisory fees may vary.*]

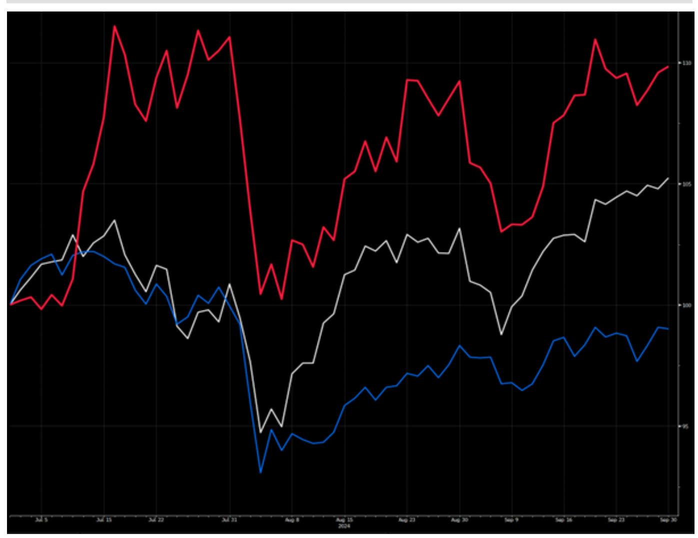
In the third quarter, the S&P 500 added another strong quarter of returns to an already strong year. However, there was a noteworthy difference in the nature of how the returns were delivered. Technology, which had dominated and led the S&P 500 in the first two quarters, was flat in the third quarter. Instead, the sectors with the highest returns included Real Estate, Communication Services, Utilities, Industrials, and Financials, which are sectors more typically associated with value stocks.

Total Return	Q3 2024	YTD 2024
S&P 500	5.9%	22.1%
S&P 500 Financials	10.7%	21.9%
Russell 2000	9.3%	11.2%
S&P Small Cap Financials	15.9%	14.5%
MVIS U.S. BDC Index	(1.1%)	8.7%

(Sources: Bloomberg, Confluence) **as of 9/30/2024*

This composition of return strength wasn't limited to only the S&P 500. Small cap stocks, including smaller Financials, outperformed large cap tech stocks in the third quarter. Although BDCs are Financials and most are small caps, returns for the industry were generally flat. Accordingly, the return pattern for BDCs remained quite different than other small caps, while also maintaining a lower level of volatility. On the graph, we compare the third quarter normalized total returns of BDCs (blue line), the S&P 500 (white), and the Russell 2000 (red). While BDC returns in the third quarter were comparatively mild, the multi-quarter trend reflects a differentiated and attractive return/risk profile.

Q3 2024 BDCs, S&P 500 & Russell 2000



(Source: Bloomberg)

In the third quarter, BDCs collectively delivered a relatively flat level of returns, taking a break from several quarters of strong returns. Accordingly, through the end of the quarter, the year-to-date return remains in a constructive high single-digit range.

Operating fundamentals reported in the third quarter were generally stable, reflecting steady income and substantial available capital at most BDCs. Origination volume remained on the lighter side of the range from recent years, even though the underwriting that has taken place has had attractive pricing and terms. Importantly, credit trends remained in good order, but we have observed a slight uptick in credit challenges and mild markdowns in loan values.

See GIPS Report on pages 3-4

Market & Strategy Commentary continued...

Because the strategy utilizes differing position sizes, the top contributors and detractors from return tend to come from the larger positions. For the third quarter, contributions from the top five were close to the break-even level, reflecting the low volatility of their stock prices over the summer and the role of dividend contributions to total return.

The five lowest contributors share a narrative similar to the top five contributors, with the exceptions of Oaktree Specialty Lending and Blackrock TCP. Both BDCs reported credit problems, which weighed on income and NAV during the quarter. We trimmed the Blackrock TCP position during the quarter, avoiding some of the downdraft but not all of it. Proceeds were deployed into new positions: Morgan Stanley Direct Lending and the Kayne Anderson BDC. These two BDCs entered the public arena earlier in the year with high-quality loan portfolios. Their valuations drifted lower in the quarter, creating what we believed to be attractive entry points.

Outlook

BDC origination volume has been on the low side for several quarters, yet most BDC managers expect M&A volume to rise in the middle markets as private equity sponsors move to take advantage of declining rates. We hear from many managers that as the Fed drove SOFR into the mid-single-digits, sponsors often held back on transactions, uncertain of how far the Fed might go. If M&A volume were to rise and BDC origination volume followed suit, we believe the higher activity levels would benefit BDCs as capital turnover would help to drive more fee income, prepayment activity, gain realizations, and new growth opportunities. Furthermore, we believe the private debt markets are likely to continue to take share from public debt markets and bank lending, given the high level of capital flowing into these markets and the flexible value proposition that private lenders are able to deliver to borrowers.

Given that dividends usually compose the majority of BDC total returns, we're pleased that dividend conditions for the industry remain constructive. Many BDCs have separated their dividend payments into the categories of "core" and "supplemental," or "special" distributions, with the latter two labeled with a high level of variability. These dividend policies have helped BDC managers communicate the variable nature of their income, while still providing stability with regard to the core dividend. Declining short-term rates may cause some supplemental and special dividend distributions to decline relative to recent years, but it appears that investor expectations have been properly managed. At the same time, we believe most BDCs should be able to maintain their core dividends even as the Fed eases and lending spreads narrow.

BDC valuations are generally in line with historical averages. We believe current levels reflect a general recognition of good results delivered as the Fed tightened, countered by a measure of uncertainty as the Fed eases. To us, this environment sets a level playing field, where high-quality, experienced BDC managers should be able to deliver good results, while their investors don't shoulder the hazards of unusually high valuations. As is always the case, our work will be to identify those good managers and invest in the BDCs they lead.

Contribution[1]

(QTD as of 9/30/2024)

The top contributors and detractors for the portfolio in Q3 2024 are shown in this table:

Security	Avg Weight (%)	Contribution (%)
Top 5		
Barings BDC Inc.	7.91	0.26
Ares Capital Corp.	3.97	0.11
Bain Capital Specialty Finance Inc.	1.97	0.09
Main Street Capital Corp.	5.89	0.08
Palmer Square Capital BDC Inc.	2.01	0.07
Bottom 5		
Blackstone Secured Lending Fund	5.89	(0.10)
Hercules Capital Inc.	6.35	(0.11)
Goldman Sachs BDC Inc.	5.05	(0.29)
Oaktree Specialty Lending Corp.	4.18	(0.46)
BlackRock TCP Capital Corp.	3.04	(0.70)

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

Performance Composite Returns[2] (For Periods Ending September 30, 2024)

	Since Inception**	10-Year*	5-Year*	3-Year*	1-Year	YTD	QTD
Specialty Finance BDC *Pure Gross-of-Fees[3]*	9.4%	8.0%	9.5%	9.0%	14.4%	9.4%	(1.3%)
Max Net-of-Fees[4]	6.2%	4.8%	6.2%	5.7%	11.0%	6.9%	(2.0%)
MVIS US BDC Index (MVBIZDTG)	9.3%	7.7%	9.7%	9.9%	14.9%	8.7%	(1.1%)

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%

*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)*

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See Territory Map on the Confluence website for sales coverage.

Disclosures

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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.

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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 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.