Specialty Finance BDC

Alternative Investment Strategies

Confluence INVESTMENT MANAGEMENT

Fourth 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

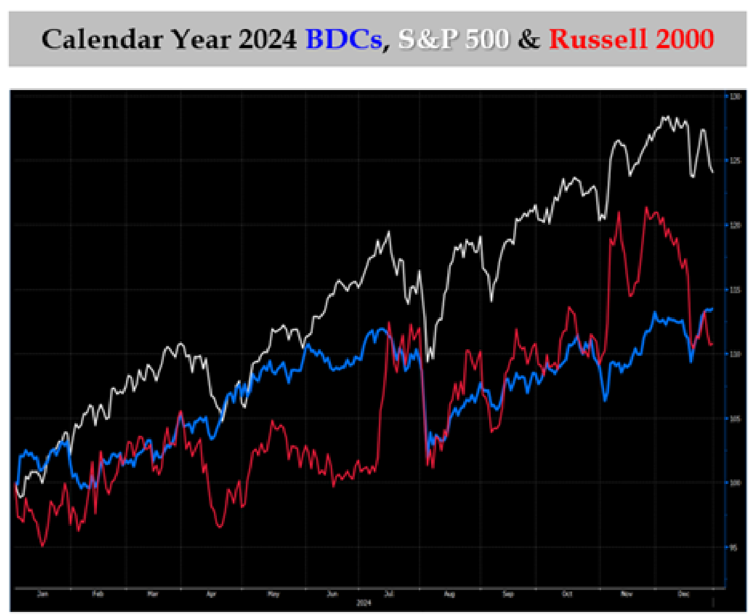
The Confluence Specialty Finance BDC strategy had a total return of 3.5% (gross of fees) in the fourth quarter of 2024, which was below the benchmark return of 4.7%. Year-to-date, the strategy gained 13.2% (gross of fees), slightly below the benchmark return of 13.7%. Over multi-year periods, the strategy's returns have generally been near or in line with the benchmark. [*The strategy's net-of-fees returns for the same periods were +2.7% QTD and +9.8% YTD. See disclosures on last page for fee description; actual investment advisory fees may vary.*]

In the fourth quarter, the S&P 500 delivered positive returns for the quarter, capping a strong year for large cap stocks. Technology and a few other sectors posted positive returns, although most sectors were negative, extending a multi-quarter trend where a relatively small number of stocks performed much better than the broader market. Financials, for both large and small caps, were one of the sectors that had a good quarter. In fact, for the first time in quite a while, the Financials sector delivered the highest yearly return in the S&P 500.

Total Return	Q4 2024	Year 2024
S&P 500	2.4%	25.0%
S&P 500 Financials	7.1%	30.5%
Russell 2000	0.3%	11.5%
S&P Small Cap Financials	3.9%	19.0%
MVIS U.S. BDC Index	4.7%	13.7%

(Sources: Bloomberg, Confluence; as of 12/31/2024)

As small cap financials, BDCs also had a good quarter and a good year. Importantly, BDCs were able to deliver solid returns with lower volatility than other financials and even the S&P 500, which includes many very liquid, mega-cap companies. On the chart, we show the calendar year returns of BDCs (blue line), the S&P 500 (white), and the Russell 2000 (red). Dividends, which were the primary source of total return during the year, played a central role in creating the lower relative volatility of BDCs during the year.



(Source: Bloomberg)

Operating fundamentals in the fourth quarter were steady, setting the stage for generally stable NAV trends and income levels in line with dividends. Still, the fourth quarter also involved a slight erosion of certain credit metrics. As an example, interest coverage ratios, which measure a borrower's income relative to its interest expense burden, remained at low levels for many borrowers. This credit metric began to decline after the Fed started raising short-term interest rates in 2022. The trend continued into the fourth quarter, so a measure of relief – and even some optimism – has formed now that the Fed is lowering short-term rates. Fortunately, severe credit problems have been episodic thus far and we aren't seeing widespread issues emerging for BDCs.

See GIPS Report on pages 3-4

Market & Strategy Commentary continued...

Because our BDC portfolio utilizes differing position sizes, the top contributors and detractors to return tend to come from the larger positions. For the fourth quarter, Main Street, Blackstone, Sixth Street, Hercules, and Golub Capital all delivered good operating results, which translated into positive portfolio contributions. These BDCs command some of the highest valuations in the industry, reflecting the long-term value delivered by their managers.

For the fourth quarter, the lower performers included Oaktree, Portman Ridge, New Mountain, the Goldman Sachs BDC, and Capital Southwest. These BDCs also delivered steady results, although they generally traded at valuations near or below their NAV, with the exception of Capital Southwest. Although the return contributions from these names were negative for the quarter, their dividend payments were additive to overall income production.

Trading during the fourth quarter included the sale of long-term holding, Blackrock TCP. This BDC has experienced several management changes in recent years and performance has generally declined. Further management changes were announced last year, and we determined it was time to move on to other names. In that light, a small position was initiated in Runway Growth Finance, a BDC focused on venture lending. This BDC has recently experienced a few credit challenges, and the stock faced certain technical factors that pushed its valuation well below the level of most peers. Although we expect this BDC will continue to face challenges, we believe the lower valuation creates an attractive return/risk profile for a limited position.

Outlook

Although BDC returns in recent quarters have generally been quite good, the performance has generally not been built upon rising valuations. Instead, most of the total return has been delivered through dividends, which is an overall profile we expect most of the time. This means that despite the industry's good performance, investors won't necessarily have to face the headwinds caused by high valuations. Instead, there is an opportunity to pursue high single-digit dividend yields at valuations generally in line with the industry's long-term history.

Lower interest rates do present a macroeconomic challenge for BDCs, which may surprise some investors given that most dividend-paying stocks tend to benefit from lower rates. However, BDC loan portfolios are predominantly floating rate and income can be pressured lower as rates decline. In addition, one of the factors that often encourages Fed easing is slowing or negative economic growth, which can also create rising credit defaults. Accordingly, when the Fed lowers interest rates, it can signal challenges for BDCs.

With the Fed now well into the easing part of its cycle, it's wise to monitor BDC operating fundamentals to see if low rates are pressuring income lower and/or if credit problems are rising. Thus far, we have not observed widespread problems. Furthermore, BDC managers are generally well-positioned to handle challenges from the current environment. Industry liquidity is relatively high, while leverage is often at the low end of BDC managers' preferred range. In addition, lower short-term rates have begun to unlock many parts of the private debt and equity markets, which should help elevate loan origination volume. So, on the whole, we believe the risks and opportunities for the BDC industry are pretty well balanced.

With the four-year election cycle behind us and the Fed now easing, we remain optimistic that BDCs can continue to deliver a high level of income to investors. This income is principally derived from the private debt markets, creating a unique profile that can add to diversification, while positioning investors to participate in a growing industry.

Contribution[1]

(QTD as of 12/31/2024)

The top contributors and detractors for the portfolio in Q4 2024 are shown in this table:

Security	Avg Weight (%)	Contribution (%)
Top 5		
Main Street Capital Corp.	6.18	1.12
Blackstone Secured Lending Fund	6.00	0.75
Sixth Street Specialty Lending Inc.	6.49	0.40
Hercules Capital Inc.	6.19	0.29
Golub Capital BDC Inc.	8.03	0.29
Bottom 5		
Oaktree Specialty Lending Corp.	3.90	(0.12)
Portman Ridge Finance Corp.	1.75	(0.16)
New Mountain Finance Corp.	5.96	(0.18)
Goldman Sachs BDC Inc.	4.50	(0.42)
Capital Southwest Corp.	3.98	(0.49)

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

Performance Composite Returns[2] (For Periods Ending December 31, 2024)

	Since Inception**	10-Year*	5-Year*	3-Year*	1-Year	YTD	QTD
Specialty Finance BDC *Pure Gross-of-Fees[3]*	9.5%	8.7%	9.5%	8.5%	13.2%	13.2%	3.5%
Max Net-of-Fees[4]	6.3%	5.5%	6.2%	5.3%	9.8%	9.8%	2.7%
MVIS US BDC Index (MVBIZDTG)	9.5%	8.6%	9.9%	9.8%	13.7%	13.7%	4.7%

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%
2024	13.2%	9.8%	13.7%	(0.6%)	45	$11,907	$16,214	$7,280,773	14.9%	16.5%	0.3%

*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.