Month	BDC Fund II*	S&P 500 TR	NASDAQ Comp	Dow Jones	Russell 2000 (DRI)
FYE - 2009	4.37%	5.49%	6.91%	7.37%	3.49%
FYE - 2010	73.04%	15.07%	16.91%	11.02%	26.85%
FYE - 2011	-46.38%	2.11%	-1.80%	5.53%	-4.18%
FYE - 2012	28.21%	16.00%	15.19%	7.25%	16.34%
January - 2013	6.60%	5.18%	4.06%	5.77%	5.96%
Year to Date	6.60%	5.18%	4.06%	5.77%	5.96%
Inception to Date	32.35%	52.03%	48.05%	42.70%	55.65%

* Fund's inception was October 1, 2009. Performance shown is net of all fees & expenses including management & performance fees. Past performance is not necessarily indicative of future performance. This material does not constitute an offer to sell (nor the solicitation of an offer to buy) interests in BDC Fund II, LP (the "Fund"). Offering is made by Private Placement Memorandum from a Principal only. The indices included above are presented only to provide a general indication of U.S. Stock market performance for the periods indicated and not as a standard of comparison because they are unmanaged, broadly based indices.

JANUARY 2013 RESULTS

We had a very encouraging beginning to 2013, after a very good 2012. The Fund was up 6.60% in January, managing to outperform all the other indices. The small cap Russell 2000 (with Dividends Reinvested) was closest with a 5.96% gain, and the S&P 500 was at 5.18%. The smallest gain on the month came in the NASDAQ (Apple holding down the index?) up 4.05%.

Since the concerns about the Greek election back in May 2012, all the indices and the Fund have been up 7 months out of the last 8. (The indices were down in October and the Fund was down in November). We've outperformed the S&P 500 75% of the time during that 8-month span.

Inception To Date, the Fund's results are catching up with the indices, as we put our under-performance in 2011 further behind us. The Fund's return over it's 40 month history is 32.35%. We are closest to the Dow Jones, up 42.70% over that same period. The current leader is the Russell 2000, up an impressive 55.65%.

The Fund's results continued to outstrip those of our "hedge fund" brethren, even as the industry has become more bullish in recent months, and average performance has increased. The Lyxor Hedge Fund Index was up 1.6% in January, with 12 of 14 different strategies up in the period. We believe the Fund's gains in January 2013, and for all of 2012, makes us one of the highest performing of the 8,000 active "hedge funds" in the world.

RISK MANAGEMENT REDUX

There is a danger in a bull market to loosen up on risk management to take advantage of rising asset values, or just by being distracted by market conditions. With that in mind, we sought to remain disciplined in January, and continue to implement several of the risk management initiatives detailed in our last Newsletter.

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We took advantage of buoyant prices across all market sectors to “trim” down higher volatility investment positions to the targeted 25% (or below) of daily trading volume (Item 4 in the Risk Management Recap last month). We sold excess shares in 10 different investments, realizing both capital gains and ensuring greater flexibility during volatile markets.

We also sold down positions in three BDCs, where we held debt investments that exceeded 10% of the Fund’s equity. Previously we had maintained a limit of 10% of assets, so the changed policy is requiring further trimming. Again, we were able to sell our investments for a Realized Gain, and re-invest the proceeds into comparable risk and return opportunities elsewhere on our Buy List.

INTEREST RATE RISK MANAGEMENT

We didn’t discuss the subject last month, but we’ve been managing the Fund’s exposure to **Interest Rate Risk**, which means the prospect that interest rates will increase at some point in the future (or the market will anticipate such an outcome), and long dated bond investments will decrease in value. We have only moderate exposure to this much-discussed risk. Half of our investments are in BDC common stocks and Floating Rate Loan investments whose underlying loan portfolios are based on LIBOR, and who will benefit from higher rates, if and when they occur.

Of the remaining fixed rate assets in the portfolio, we’ve deliberately limited our exposure to investments with a maturity of 10 years or more. We track these investments on our proprietary database. We have 6 different investments in this category: all of them either BDCs or Finance Companies, which amount to 7.5% of total assets, and just under 20% of our equity. To offset our risk, we have a major position in an inverse high yield bond ETF, whose price goes up when long term bond prices move down, and represents another way we “hedge” ourselves. As a result, our “unhedged” exposure to long dated debt amounts to just under 6% of the Fund’s equity.

Which is a long way round to say that we “trimmed” a number of long dated investments in January to continue to reduce our net exposure to a future Armageddon of higher interest rates. Our ultimate goal is to bring net exposure down to zero. However, even if rates jumped tomorrow, the increase in the value of our BDC common stocks and Floating Rate Loan investments would be far greater than any reduction in the value of our long dated debt investments, all of which are rated BB or BBB.

WHERE DO WE GO FROM HERE?

A legitimate question existing and prospective investors might be asking themselves is whether the Fund can continue to achieve the superior returns that we highlight at the top of the Newsletter every month. The question becomes increasingly worth discussing with every passing month of positive returns. As we discussed at the outset, we’ve had seven out of eight months of up markets, both in the Leveraged Debt sectors we invest in, and in the stock market in general. As we write this, the stock market has been reaching, and occasionally breaking records. Nor are we unaware that the multi-month downturn in BDC stock prices that occurred in the summer and fall of 2011, which saw average prices drop 28%, was preceded by a two-year run-up in stock prices. As major investors in the Fund ourselves, with the bulk of our personal liquid net worth, and that of family members invested herein, we are always asking: where do we go from here ?

The short answer is that we’re bullish about the Fund’s prospects for as far as the eye can see, and believe we have the opportunity to match or exceed last year’s stellar returns. Ironically, though, our optimism does not rely on the assumption of much higher prices for Leveraged Debt assets. In fact, we currently have very modest expectations for most of the sectors that we are invested in.

SECTOR UPSIDE

The **High Yield Bond** sector, which jumped out to a fast start in January (up 1.7% on our Buy List), we expect to be flat for the rest of the year. Likewise, we project that **Floating Rate Loans** will increase less than 2% for the next 12 months. We are a little more optimistic for **BDC Notes**, because this very new corner of the fixed income market in which we were one of the first investors, is becoming better known and attracting new investors drawn by the above average yields compared to other investment grade offerings. [For example, we were an early investor in Gladstone Investment’s BBB rated 7.125% Preferred Stock issue, which has increased in value by 10% since we initiated the investment]. Assuming a stable, low rate environment, we project a 5% further increase in our BDC Note portfolio (already up 4% over cost).

In terms of capital appreciation opportunities, we are most sanguine about select BDC common stocks, although the sector as a whole is reaching fair value. Our proprietary database tracks month end closing prices for 34 different BDC common stocks, dating back to February 2011 (when the BDC sector was at it’s previous post-Recession height). In aggregate, the BDC companies’ stock prices are trading at just under 95% of our

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Realizable Value estimate, and towards the top of historical multiples of recurring earnings. However, our aggregate Realizable Value estimates for the BDC investments that we own projects out an 8.5% pro-forma increase in value yet to be received. Moreover, if we get multiple expansion in the future (which we've not figured into our estimates), BDC common stock prices could yet expand by double-digit percentages. We'll be happy to discuss the details of our outlook with anyone interested in getting into the weeds.

CAPITAL APPRECIATION AND INCOME

Very roughly, we are hoping for a further 4% appreciation in the value of the Fund's assets, which translates into a potential 12% increase in the value of our equity. **However, the bulk of the Fund's return should come (assuming a low rate, slowly growing economy) from dividend and interest income**. Despite lower yields, due to the actions of the Fed and the Fund's mix of higher and lower risk Leveraged Debt assets that we've explained before, we're still targeting current income equal to 20% or more over the next 12 months.

The positive tradeoff from less price appreciation is a more stable environment for both lenders and borrowers. As a result, we expect that we'll see a less volatile environment for Leveraged Debt prices than we saw in 2012 (which was already lower than 2011), and the Fund will be able to "clip coupons" most of the time in the year ahead. In fact, and we know we're jinxing ourselves with this statement, we foresee for the next 3 years a stable environment for Leveraged Debt investments. This would be similar to the situation in the last expansion when Leveraged Debt prices (including BDC loan assets) were valued at a very stable 100% of par for years (2003-late 2007). If we're right, the Fund should be able to book superior returns even in the absence of any material increase in asset prices besides the ones already outlined.

EXPECTING THE UNEXPECTED

Of course, life and the market never play out as we expect. The Manager is ready to change course if the macro conditions change, and/or price volatility increases. The steps we've taken to keep the Fund's investments either highly liquid (80%) or highly rated (20%) provides us with considerable protection. We can turn on a dime if we need to, and take advantage of volatility should conditions change. Moreover, the Fund is highly diversified, both by sector and by individual investment, which should afford us additional protection. Currently the Fund is invested in 74 different instruments across all four major Leveraged Debt sectors. By comparison, at this time two years ago, the Fund was in 16 investments, and two sectors (BDC common stocks and High Yield Bonds). Moreover, at the end of January 2011, all our investments were in high volatility investments, equal to 300% of the Fund's equity, whereas today higher risk-return investments account for 130% of the Fund's equity (even less when short positions are taken into account).

Notwithstanding all the preceding, capital preservation remains our overriding goal and we will act accordingly if and when the wind changes.

WELCOME NEW INVESTORS!

We want to close by welcoming this month's new investors in the Fund. (For your confidentiality we won't mention names, but you know who you are.) Please feel free to contact Nicholas or Bill at any time, with any questions or issues. We appreciate the opportunity to manage your investment and we look forward to a long and fruitful relationship.

NEWSLETTER

Keeping investors and prospective investors updated on the activities of Southland Capital Management and BDC Fund II

Office

100 Wilshire Blvd., Ste. 950
SantaMonica, CA 90401

Tel: 800.579.1651

Nicholas Marshi
Chief Investment Officer

Email:
nmarshi@southlandcapitalmanagement.com

Bill Hansen
Chief Marketing Officer

Email:
bhansen@southlandcapitalmanagement.com

Visit Us @

www.southlandcapitalmanagement.com

Accredited investors:

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