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%
January - 2012	14.08%	4.48%	8.01%	3.40%	7.07%
February - 2012	7.47%	4.32%	5.44%	2.53%	2.39%
March - 2012	-1.80%	3.29%	4.20%	2.01%	2.56%
April - 2012	0.29%	-0.63%	-1.46%	0.01%	-1.54%
May - 2012	-6.51%	-6.01%	-7.19%	-6.21%	-6.62%
June - 2012	3.90%	4.12%	3.81%	3.93%	4.99%
July - 2012	3.60%	1.39%	0.15%	1.00%	-1.38%
August - 2012	5.72%	2.25%	4.34%	0.63%	3.33%
September - 2012	2.79%	2.58%	1.61%	2.65%	3.28%
October - 2012	0.50%	-1.85%	-4.46%	-2.54%	-2.17%
November - 2012	-6.39%	0.58%	1.11%	-0.54%	0.53%
December - 2012	3.22%	0.91%	0.31%	0.60%	3.56%
Year to Date	28.21%	16.00%	15.91%	7.25%	16.34%
Inception to Date	24.16%	44.54%	42.27%	34.91%	46.89%

* 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.

DECEMBER 2012 RESULTS

The Fund bounced back from its November loss, gaining 3.2% for the month of December. We beat three of the four general stock market indices we compare ourselves against. On the month, the Russell 2000 (with dividends reinvested) was the best performer: up 3.56 %. Turning to the year-to-date, the Fund ended the year up 28.2%. Here we are well ahead of all the stock market indices. The number two and the number three performers were the Russell 2000 and the S&P 500, up 16.3% and 16.0% respectively. The laggard of the group is the Dow Jones up 7.3%.

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We had a much better year than most of our "hedge fund" brethren. According to a Goldman study 88% of funds trailed the S&P 500 in 2012. Our 28% return placed the Fund amongst the very top performers around the globe. Bloomberg Market Magazine listed the top 100 hedge fund managers in the world for 2012, who averaged a 20.2% return, versus 1.3% for the entire universe of funds. If we'd been managing over $1bn, our results would have made us the 4th top performing "hedge fund" in the world. Now to raise a billion dollars so we can get our numbers in Bloomberg…

Three years and three months after the launch of BDC Fund II, the so-called Inception To Date return is 24.16%. Because of our poor performance in 2011, the Fund still trails the major indices over the period. We are closest to the Dow Jones, up 34.91%, and furthest from the Russell 2000 at 46.89%.

As we'll discuss in the Outlook section below, we are optimistic about the Fund's prospects for 2013, and aim to meet or beat 2012's results, and out-perform the stock market indices and our hedge fund peers.

RISK MANAGEMENT RECAP

As we discussed in the Performance section above, the Fund had a very good year in 2012. **Skeptics might assume the above average returns were achieved by taking on above average risks, but that's not the case.** Like many of our hedge fund peers, the Fund played defense through much of 2012. In fact, during the year we expanded and improved our risk management program. We thought it might be useful to delineate the procedures the Fund utilizes to mitigate risk. We believe the Fund's risk management policies provide "belt and suspenders" protection, while still allowing us to take advantage of market opportunities, and should serve us well regardless of what 2013 will bring.

1. INVESTMENT MIX

The Fund deliberately reduced volatility in 2012 by the choice of assets in the portfolio. As we've mentioned ad nauseam in prior Newsletters, the Manager has broadened the Fund's portfolio mix, since December 2011, to include a higher proportion of BDC Notes, as well as Floating Rate loans and High Yield Bonds in publicly traded Exchange Traded Funds ("ETF") and Closed-End Funds ("CEF"). Many of these leveraged debt investments have historically been far less volatile than BDC common stocks, and less correlated with the movement of the S&P. Whereas the BDC sector's correlation with the S&P is 0.9x that of the S&P, High Yield Bonds are at 07x, Floating Rate Loans 0.5x and BDC Notes even less.

2. MAXIMUM SINGLE POSITION: 10% OF EQUITY

We tightened our internal policy of limiting any single investment position from 10% of total assets to 10% of total equity. **Unlike many hedge funds, which seek to make "big bets" on a few concentrated positions, we are aiming at maximizing investment diversification.** This policy protects us against being unduly affected by unusual price moves or price deterioration in an individual investment. With a universe of nearly 100 investments that meet our Buy List criteria, we have plenty of investment choice. Moreover, remember that the BDC, ETF and CEF investments we make are all portfolios of multiple leveraged loans themselves, ranging from 20 to 500 or more, which only adds to the diversification of credit risk. At any one time, the Fund has indirect exposure through it's investments in over 2,000 borrowers of every size, region of the country and industry imaginable. **We believe that the Fund has anywhere between five times and ten times greater borrower diversification than any other publicly traded leveraged debt investment.**

3. LIMITATION ON HIGHER VOLATILITY INVESTMENTS

We dialed down the Fund's exposure to the more volatile investments on our Buy List. Using data generated from historic price performance, we classified each of our prospective investments into three categories: A, B and C. "A" investments are investments with the least credit risk, and which have a history of very low volatility. These would include medium term BDC Notes, often rated investment grade, certain High Yield Bond ETFs which invest in shorter term and higher quality bonds, etc. "B" rated investments have slightly higher volatility, but still substantially less than the stock market at large, and include such investments as longer term High Yield Bond ETF, certain Floating Rate CEFs, etc. Finally, "C " rated investments are those with volatility/risk close to or higher than the S&P, which includes all the BDC common stocks, and certain High Yield Bond and Floating Rate Loan CEFs. (The CEFs are more volatile because they are permitted to use a modest amount of leverage, equal to 50% of their shareholder's equity).

The Fund is currently limiting its exposure to the most volatile (albeit the higher yielding, higher return) C investments to 1.0x our equity. The remainder of our investments are in the A & B category. We believe this approach substantially reduces the Fund's volatility during times of market turmoil. We implemented this policy in mid-November 2012.

4. MATCH INVESTMENT POSITIONS WITH MARKET LIQUIDITY.

We tightened our limits on individual investment positions based upon their average daily trading volume. The Fund has managed investment liquidity from the outset in 2009, but we decided to raise the bar further in recent weeks. At the moment, we max out exposure to any individual C investment to 25% of their daily dollar trading volume, and 50% where B investments are concerned. This allows the Fund to be confident of being able to exit any particular investment on very short

notice in the case of a market pullback. The Manager wants to have the ability to move out on a moment's notice of investments most susceptible to very rapid, material price changes.

(By the way, we have not set up a Liquidity requirement for our A rated investments because, by definition, their volatility is very low. Where a C rated investment might move 5% up or down, an A rated investment would move only 0.5% - 1.0%. Nonetheless, we do track the liquidity of our A rated investments, and limit our exposure to the less liquid investments to a maximum 10% of total Fund assets).

5. **CAP ON HIGHER RISK LOANS IN INVESTMENT ASSETS**

We instituted a limit to our exposure to investments with higher credit risk assets. For an investment to be included on our Buy List, the Manager requires that no more than 20% of the underlying loans in their portfolio be of "higher risk." Where High Yield Bond and Floating Rate Loan investments are concerned, we do not invest in any vehicle that has more than 20% of loans in portfolio with a rating by Moody's or S&P of CCC or below. CCC loans are deemed "highly speculative" and historically have defaulted at far higher rates than higher rated "below investment grade" credits, and have far lower recovery rates in bankruptcy. This screen has kept many potential ETF and CEF investments off our Buy List, and ensures the Fund is invested in the higher quality range of high yield bonds and loans, albeit at the expense of the higher yields that are derived from the "highly speculative" loans.

BDCs do not have public ratings so in that instance the Manager reviews every company's public filings where portfolio loans are listed and valued for fair market value purposes over cost. We rate any BDC's portfolio loan that has been written down by more than 25% off cost as being equivalent to a CCC rating. The Fund will not invest in any BDC with more than 20% of investment assets in this "highly speculative" category.

Moreover, the Manager monitors higher risk assets by adding up all the Fund's exposure to "highly speculative" assets. Currently, we limit outstandings to these higher risk loans to 20% of the Fund's equity.

6. **STOP LOSS ON EVERY INVESTMENT POSITION**

Finally, we have instituted one more major risk management policy this year to protect against a market meltdown like the ones that occurred in 2008 and 2011. We believe that if the Fund is exposed to very extreme volatility in the future, our initial priority should be to limit losses, and go to cash. In this regard, we have established Stop Loss positions with our Prime Broker for every B and C, and many of the A investments we hold, all at varying discounts to market price. We call this our "reserve parachute". If all else fails, it's good to have a back up.

We doubt that the Fund will face such a market meltdown in 2013 (see Outlook). Moreover, even if there was another major market break-down we doubt that all the assets we own would be impaired, or that we would not be able to sell many investments at a price higher than the Stop Loss bottom. Nonetheless, it should be some comfort to both existing and prospective investors that the Manager has an exit plan under extreme circumstances. What's more, we are able to quantify what the maximum loss might be. Our spreadsheet calculates at all times on a live basis, what the maximum loss to the Fund would be if every investment dropped to their Stop Loss price. Currently, this pro-forma maximum loss is equal to 12% of the Fund's equity.

WAIT: THERE's MORE...

This is not a complete list of our risk management policies. We have additional credit risk policies, as well as interest rate risk mitigation strategies, which we'll discuss in future Newsletters

REAL TIME RISK MANAGEMENT

Besides implementing all the policies listed above, the Fund manages risk on a dynamic basis as market conditions dictate. Both Managers monitor the market throughout the working day. We utilize our proprietary spreadsheet to identify individual and sector trends. We track the monthly closing price of all the 94 investments on our Buy List back to February 2011 (which was the post Great Recession market high), as well as the 52 Week Low and High, and the All Time Highs against the latest market price. (We color code stock performance to see which investments are trading up and down over time). Furthermore, we analyze each investment in turn by reviewing public filings and generate a target price ("Realizable Value"). The Managers constantly review the current price of the investments versus the Realizable Value and the other data points. We can tell at any moment how any stock sector or the entire portfolio is trading versus cost, Realizable Value, 52 Week High etc. and what the proportion of assets is in every industry and volatility category. We also know what the dividend and yield is for every investment and when the distribution goes ex-dividend.

RISK MANAGEMENT ON THE FLY

Armed with all this data (and a lot more we don't have time to discuss) the Managers are in a position, on a moment's notice, to reduce risk exposure above and beyond the risk management policies already in place. If we become concerned about a potential pullback in a stock or a sector, the Managers will sell off positions or change the volatility mix in a very short period. Most notably in 2012, the Fund reduced total investment assets by 45% between March and May month-end due to concerns about the implications of Greek election on the global economy. By the end of May, our leverage ratio (investment assets to equity) was as low as 2.1x, and remained under our nominal target through the summer. For a shorter period, we rolled back leverage in the weeks before the fiscal cliff negotiations in November and December, and reduced our exposure to C rated investments by 50%.

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Generally we don't kid ourselves that we can market time sector pullbacks. There were several market corrections in 2012, when market prices dropped sharply in a short period. Although the largest month-to-month drop was "only" -2.1% (in May), intra-month movements were as high as -9.3% (November 2-November 14th). The Manager recognizes that the Fund will often be exposed to the initial impact of a change in market sentiment. We accept that most of the time the Fund's fair market value will initially drop (and at an above average level due to our leveraged nature) when stock market corrections occur. However, because of the Managers day-to-day focus on the portfolio, and our "safety first" policy of de-leveraging, and/or shifting into lower risk investments when market conditions turn negative, we are able to reduce our risk profile in a very short period. This serves to limit the impact of further market deterioration, should it occur. We liken this approach to an insurance policy, with a loss deductible.

CONCLUSION: REDUCE DOWNSIDE VOLATILITY & MAXIMIZE OPPORTUNITY

We believe the risk management steps we've taken through 2012 should ensure the Fund should be able to mitigate market volatility going forward, notwithstanding our leveraged nature, while still outperforming the general market. In 2011, the Fund outperformed the S&P only 4 months in 12. By contrast, in the past twelve months, we outperformed the S&P 9 months out of 12. Of the 3 months that we underperformed two were very close (less than 0.5% difference), with only November being the outlier. Moreover, the Fund's volatility dropped in 2012 by more than 50% from the levels of 2010 and 2011, and we expect this trend will continue in 2013.

OUTLOOK

We manage the asset mix, stock selection and leverage of the Fund based upon our Outlook for the direction of the economy, the state of the leveraged debt market and the stock market in general. So we need to tell you what we see in our crystal ball as the year begins. However, we are cognizant of the ever-changing conditions, and are prepared (as discussed in too much detail in the prior section) to change our minds as new facts emerge.

Here are the key metrics we track, and our Outlook at time of writing:

U.S. GDP GROWTH:

Range of 2.0% - 3.2%. (Source: Fed Reserves Esther George and James Bullard respectively). From a Leveraged Debt perspective, this is the Goldilocks' level: neither too hot nor too cold. Lower and we have to become concerned about slipping into recession, above and we worry about overheating, and the risk that short and long term interest rates will rise sooner and faster than currently anticipated. None of the Leveraged Debt markets we invest in has ever had a losing year during an economic expansion so the direction of the U.S. economy is a critical factor.

S&P OUTLOOK:

There are as many predictions for 2013 as there are pundits. However, a recent survey of all analysts estimates projected a near 4.0% growth in the stock index. We are not concerned about any specific number, but the general direction of the stock market as there is a degree of correlation between what happens with leveraged debt investments and stock investments generally, especially amongst the most volatile investments.

FED FUNDS RATE:

The rate has been pegged by the Fed between 0.00%-0.25% since December 2008! We expect that range to remain unchanged in 2013. Of course the Fed Funds rate is important as a driver of all rates. With the Fed committed to keeping rates low through the year, borrowers can expect to count on being able to borrow at record low rates.

INTEREST RATES:

With the Fed artificially keeping interest rates down, we expect both short and long term rates to remain remarkably low for the year. We expect that London Interbank Rates (LIBOR), on which most commercial borrowing is based, will range between 0.5% - 0. 75%. The ten-year Treasury yield should rise, given the GDP assumptions above, but is not expected to rise above 2.0 - 2.25%.

CREDIT DEFAULT RATES:

Credit losses across all segments have remained low, and are expected to stay there in 2013. Moody's just reported that the default rate in high yield dropped to 3.2% in December on a rolling 12-month basis from 3.6% in the third quarter. In 2013 Moody's projects defaults at a lower 3.0%, and Fitch is even more optimistic. Floating Rate Loan defaults are pegged at between 1% - 2% (versus 10% in the Great Recession), according to JP Morgan. Our own review of new BDC bad debts in 2012 revealed only a handful of new problem credits amongst the hundreds of new loans added in the past three years. We expect default rates to be the lowest of all the sectors: under 1.0% in 2013.

SECTOR GROWTH:

Broadly speaking, we expect modest price improvement in all the leveraged debt sectors in which we invest in 2013, but not at the same pace. We are the most optimistic about price appreciation for BDC common stocks (target: 5.0% - 7.0% increase). We expect the Floating Rate Loan and BDC Notes sectors to increase 1.0% - 1.5% in 2013, and High Yield Bonds 1.0%.

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FUND PERFORMANCE:

There are too many variables for the Manager to project with any sense of certainty the likely performance of the Fund in 2013. However, we undertake a pro-forma calculation on our spreadsheet of what the Fund's net gains would be if all the investments we own reached their Realizable Value, and we receive the current level of projected dividend income. We also calculate the pro-forma costs to the Fund in terms of margin interest, operating expenses and management fees (but not profit allocation as this varies depending on each investor's high water mark). **Anyway, the pro-forma calculation shows a potential 32% for 2013. Half the income would be derived from dividends and interest and half from asset appreciation.**

MONTH TO DATE PERFORMANCE:

The leveraged debt markets have begun the year on a positive note, with all sectors up. The Fund has been well positioned to take advantage. **At time of writing, we estimate the Fund (after all interest, expenses and fees) was up 5.8% through Monday January 14th.**

We wish you all a Happy, Healthy and Prosperous New Year!

NEWSLETTER

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

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