Month	BDC Fund II*	HFRI EHI	S&P 500 TR	Dow Jones
December - 2014	-9.96%	0.04%	-0.25%	-0.03%
FYE - 2014	-12.52%	2.26%	13.69%	7.52%
FYE - 2013	13.20%	14.33%	32.39%	26.50%
FYE - 2012	28.21%	7.41%	16.00%	7.26%
FYE - 2011	-46.38%	-8.38%	2.11%	5.53%
FYE - 2010	73.04%	10.45%	15.06%	11.02%
FYE - 2009	4.37%	2.92%	6.04%	7.37%
Inception to Date*	23.01%	30.75%	117.53%	83.51%
1/1/12 - Date**	20.77%	25.52%	74.60%	45.88%

* 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.

**Represents investor with initial contribution of 1/1/12. (After revised investment strategy.)

DECEMBER 2014 Results

2014 ended the year with the worst month for all categories of non-investment grade debt (with one notable exception we'll discuss shortly) since the Euro-crisis of 2011. Price volatility was at a 2-year high. The S&P Leveraged Loan Index, which tracks the prices of the biggest leveraged loans, incurred their worst monthly loss since August 2011, according to their trade association. That resulted in two quarterly losses in a row for the Loan index. The last time that happened "was way back in the second half of 2008, the height of the financial crisis". For the year, the Loan index incurred it's third lowest recorded return in the past 19 years. Only 2008 and 2011 were worse.

The BDC Common Stock sector had an equally awful month. Using **Southland Capital Management's** proprietary index of 43 Business Development Companies equally weighted, the sector was down -5.3% in December, the worst month in the year. We have to look back to

November 2011 for a worse single month drop in prices (-5.7%).

It's no great comfort but the damage could have been even worse. In the first two weeks of the month, debt investments were even further in the red. In fact, the price drop in **High Yield Bonds** was more than twice as great as the final tally at month's end. The **BDC Sector** was down -8.5% in those first two weeks-probably the worst drop in it's history in that short a period. Thankfully, after a frantic period of "sell, sell, sell", there was a rally in the second half of the December across all leveraged debt classes, with the BDC Sector rallying the most.

DISMAL YEAR IN REVIEW

Cold comfort as 2014 overall turned out to be a very poor year for all the sectors in our investment universe. We've already mentioned the terrible returns in **Floating Rate Loans,** which was matched in the **High Yield Bond** sector (with energy bonds down 10% in 2014). The **Private Equity Asset Managers** were down -9.5%. **BDC Common Stocks** were down -16% according to the publicly traded UBS Exchange Traded Note with the ticker BDCS, and -12.0% using the SCM index. The latter was at the lowest level reached since November 2011.

We cannot stress enough how indiscriminate was the pullback in BDC prices in 2014. Of 43 stocks tracked, 40 were down in price on the year. Half the companies' stock prices dropped 20% or more from their 52-week highs. That's "Bear Market" territory. There was almost no correlation between companies underlying financial performance and their stock price. Ironically, only a handful of companies, 3 out of 43 by our count, saw their book values drop materially in 2014 due to above average bad debts. Even companies that met all expectations were hit

Month	BDC Fund II	HFRI EHI	S&P 500TR	Dow Jones
Jan 2012 to Date	20.77%	25.52%	74.60%	45.88%

hard. Take for example BDC leader **Ares Capital** (ticker: ARCC), whose Net Asset Value and Net Earnings increased during the year and whose distribution level was unchanged. Nonetheless, ARCC's share price at one point dropped 21% off it's 52 week high.

2014 was not pre-ordained to be such a disaster. In fact, there were times during the year that the prospects for one sector or another looked decidedly rosy. As late as June 2014, **High Yield Bonds** were trading at a premium to par, notwithstanding ever lower bond spreads. The main High Yield Bond Exchange Traded Fund with the ticker **HYG** was at a two year high. The Floating Rate Loan sector peaked earlier in the year, but through November both forms of publicly traded leveraged debt were in the black on Total Return terms (price change and distributions). The BDC Sector traded at an all-time high in February and was just 1% off at another peak in July. Even at the end of November, the Total Return Loss was in the middle single digits.

A BRIEF BREAK FROM ALL THE DOOM & GLOOM

Only one sector in which the Fund invests had a decent year in 2014: **BDC Debt**. As we've done for three years now, we invested in a wide range of BDC publicly traded "baby bonds", which sit high up on the capital structure. Taken as a whole, the BDC Debt sector was up 2.5% on the year in price terms, and paid out 7.0%+ in distributions.

Much of the increase in prices came in the longer dated bonds-some as long as 30 years-but we remain focused on the short to medium term maturities so our benefit was not quite as great. Nonetheless, just about every issue in this sector performed well through the year, helped both by the strong credit position and the surprising drop in long term interest rates which are always a benefit to existing bonds.

WHY THE HUGE PULLBACK IN A BULL MARKET ?

With the benefit of a few weeks hindsight, the principal culprit for this seismic change in confidence in the credit markets appears to be oil. Or, more specifically, the huge drop in the global oil price. In the second half of the year, the price of oil has dropped by 50%, continuously reaching levels that analysts and pundits only days or hours before said were "unthinkable." In recent years, the oil and gas industry has raised substantial amounts of debt capital in the form of bonds and loans, alongside huge amounts of equity capital from Private Equity and the public stock markets. That has helped fund the famous "shale revolution" and the unexpected swing in American oil production from a net deficit in oil production to a net gain.

However, the drop in the oil price-which you've all heard about, has suddenly caused the markets to worry about the creditworthiness of the hundreds of billions of dollars in energy-related debt. The credit markets, which for years have carried loans and bonds at par or above, have written down energy credits by 10% or more in anticipation of credit losses down the road. On November 27th, OPEC met and decided not to support the oil price by cutting production. Brent oil dropped to $75 from $78. By month's end, the price dropped to $55.

EVERY SECTOR HAS ENERGY EXPOSURE

The proportion of energy credits in each of the major debt sectors that we invest in varies. High Yield Bonds have the greatest proportion of energy loans as a percentage of total debt outstanding at 16%, and Floating Rate Loans the least at 4.5%. According to investment bank KBW, the BDC Sector's exposure is 7.0% of portfolio assets, which is equal to about 11% of equity capitalization.

Of course, how each sector might be affected by a lower oil price is very hard to estimate for a number of reasons. Every borrower has made different arrangements about hedging, or not, their oil production; each has different break-even rates; each has a varying amount of liquidity available. Lenders have different covenants and remedies. Furthermore, nobody knows what the long-term market price of oil will be. Despite all the fuss being made in the financial press with every minute-by-minute change in the spot price of oil, it is almost irrelevant what the price is today from a credit standpoint. What matters is what the price will be over a sustained period in 2015-2017.

In December, those uncertainties, which are unfathomable even if you can parse the specifics of every borrower and every loan agreement/bond indenture in turn, caused the markets to sell anything with exposure to the oil price indiscriminately. That's what markets do in the face of unquantifiable risks, and we have been swept up in the market "correction".

WHAT WE DID

Most of our focus has been on the BDC Common stock sector. We stopped investing in Floating Rate Closed End Funds in the spring and in Exchange Traded Funds in September. What had previously been low yielding but

stable investments were trending downwards, while still paying inadequate yields, so we bailed from all our exposure. Likewise, we largely exited the High Yield sector, both Closed End Funds and Exchange Traded Funds, between April and November. (We continued to add to our BDC Debt positions which were essentially unaffected).

We certainly didn't see the huge drop in the oil price coming. However, we were following hawkishly the direction of the BDC Sector. In our Spreadsheet we tracked daily prices and volume for the sector, checked how many stocks were going up and how many down, how many were trading above their 50 and 200 Day Moving Average, etc. This helped us greatly in October. In the first two weeks of the month, the BDC sector, and all the major indices were down in a big way. The BDC Sector was down 7.4% (and 16.1% since the July 1 high). We sold off a substantial portion of our assets to mitigate Unrealized Losses, and then "jumped" back in on October 16 and 17th as all markets rallied. The BDC Sector ended up only -1% down on the month, and we were able to break-even.

However, by the end of November, our data suggested that the rally in the BDC Sector was petering out. (We recognize now that a worry about the oil price was the culprit). Starting on November 28th, we began selling off a portion of our more liquid BDC common stock positions to protect gains made from mid-October. On December 1st, the BDC sector dropped -2.2% in one day. We had set ourselves a trigger price when we would sell off which was reached on that day so we sold out of virtually all our liquid BDC common stock positions. We reduced our total assets by over 32%, and our higher risk BDC Common Stock (and a few Private Equity Asset Managers) by more than 50%.

That turned out to be the "right thing to do" as prices dropped like stones. For example, American Capital (ACAS) was trading at $14.99 on November 28, but dropped -6.8% in price in the next 2 weeks. Similar stocks like Apollo Investment, Ares Capital and BlackRock Kelso dropped more than 10 %.

WHAT WE DID NOT DO

However, we sold only our most liquid BDC Common Stock positions. We did not sell the less liquid stocks we owned and/or those which had already dropped to historically very low levels in price (some of which we had invested in recent weeks at "bargain" prices). Our logic was that these stocks must be trading at or close to their bottoms. Moreover, given that most of them trade on lower volumes and wide bid-spread prices, getting out only to get back in would be a losing proposition. For example, we had a big position in Medley Capital (MCC). The stock was already 23% off it's 52 week high at the end of November at a price of $11.16 (our cost was $12.1- a 17% discount to the highest price and 3% below NAV and paying a yield on cost of 12.1%). In the short run that proved to be "the wrong thing to do".

Obviously, with the benefit of hindsight we would prefer to have sold MCC (by way of example) at $11.16 at the end of November. By the end of December MCC was at $9.24: a remarkable 17% drop in 1 month, or nearly half it's entire loss on the year in the last 4 weeks. In the case of MCC, and about a dozen other positions, we under-estimated how feverishly investors would dump these stocks in December. Much of the Fund's Unrealized Losses in December comes from this decision.

DEFENSE! DEFENSE!

Yet, in retrospect, we believe our investment approach was the right one. We are not short-term traders, and turning over the entire portfolio in turbulent markets is not feasible. In each case we reviewed each position after every price move and asked ourselves two questions. First, do we have reason to believe there was any permanent impairment to the Company's results that would justify selling at a very low price to reduce long-term losses? If not, the second question we ask ourselves is whether the Company's stock price will likely trade higher once the market trades more "normally". (In the case of the BDC Sector, as proven over many years, is in a band of 8-12x earnings). In the case of MCC, the stock is trading at 6.4x future earnings, Net Asset Value is unchanged on the year and we are comfortable with the management and business strategy of the Company. We have a Realizable Value of $13.3 for the stock, just 9x 2015 projected earnings. (Historically, the Company has traded north of 10x earnings). If the stock price moved back to it's book value, it would go to $12.43- a 34% increase. Even if the stock never increases in value from here, the return from the distributions would be 12% for the foreseeable future. In such situations we choose to stay long, collect the double-digit dividend involved and wait for a revaluation of the stock by the market in the future. The downside, as illustrated in December, is that we incur an Unrealized Loss while we wait for distributions to pile up and for the stock to trade at a more "normal" price. Only time can prove our investment thesis, but we will report back periodically on our progress, or otherwise. (Just one week in into January 2015, MCC is up 2.7%).

SELLING IS EASY: BUYING (BACK IN) IS HARD

Thanks to divesting ourselves of our more liquid positions in High Yield Bonds and BDC Common Stocks, the Fund had substantial liquidity in December. One of the reasons we sell out of perfectly good companies in more liquid positions is to buy them back at a later date for a lower price, higher yield and higher ultimate capital gains. However, timing the buy back in is never easy. In December we "got back in" to the market on two occasions. The first time was on December 8th, when we re-invested a portion of our liquidity, when we believed a rally was about to occur. (Remember that at that point the BDC Sector was down -14.1% on the year and down -4.2% on the month). That turned out to be too early, so we sold out shortly thereafter to limit losses. We bought back in again in mid-December, catching the rally that continued through the rest of the month.

While we mostly stayed away from the High Yield and Floating Rate Loan sector, we did buy into one Exchange Traded Fund (**HYLD**) early in December when the price reached an all-time low. However, HYLD went even further down, and we sold out a few days later. (We subsequently bought back into the investment, which pays a yield north of 11%. At the end of December, we were down by -0.5%, but up when the distribution was considered. In 2015, we are up another +1.5% in price terms. If HYLD returns to the July 1 2014 level, the potential price appreciation over December's close is 30%.

LOOKING FORWARD

We believe the credit markets will remain unsettled until there is greater clarity on the long-term direction of the oil price-and what damage might ensue, if any, to the thousands of private and public companies in different aspects of the business. We were probably too sanguine in December, despite the drastic write-downs in all the credit markets that we've discussed.

THE UPSIDE

However the stage is set for a substantial rally at some unknown point in the future. The BDC sector is trading at 87% of book value, compared to a premium to book value before the oil issue arose. That suggests the market has written down the sector's oil exposure to zero. In virtually any scenario that's likely to have been an over-reaction. After all, some BDCs have little or no energy exposure whatsoever. Even BDCs who have made loans into the oil and gas space are usually in a first lien position, and are unlikely to have substantial losses even if borrowers default. We expect that with greater clarity we will see BDC stocks, which otherwise have very few credit problems, plenty of liquidity and cheap debt and equity capital, trade up.

WHY WE STILL GET UP IN THE MORNING

We are allocating the Fund's capital equally between lower risk-lower return BDC Notes and higher risk-higher return BDC Common Stocks. Let's look at prospects for the latter: as in 2012, when the BDC Sector rallied after the pullback occasioned by the Euro-crisis, we could see prices return to the pre-oil crisis level. All the other ingredients which supported credit prices through July 2014 remain in place: low interest rates as far as the eye can see; a growing U.S. economy; very low credit defaults (S&P just projected another low record year for defaults in 2015); a pull-back from leveraged lending by banks due to regulations and continued demand for leveraged debt financing for buy-outs, recapitalizations and refinancing.

When we review each company in turn, using analyst consensus earnings as well as our own calculations, and look at portfolio quality, yield trends, debt costs etc., we see earnings and distributions unchanged or higher in 2015 over 2014, even after adjusting for potential losses of 10%-20% on oil investments.

SHARPENING OUR UPSIDE PENCIL

If the BDC Sector was to return to prior highs, and the Fund was positioned to participate in the upswing, prices could rise at much as 20%. Given that we are allocating 1.5x our equity to purchasing BDC assets, the Fund's potential capital appreciation is 30%. Add to that up to 18% in dividend income over a 12-month period, and interest income from BDC Notes/ HY Bonds, adding another 12% and the Fund's potential gain in 2015 could be as much as 58%, after borrowing costs but before management fees.

CONCLUSION

We recognize 2014 was a difficult year for the Fund and it's investors. We have diversified our portfolio from "all BDC Common Stocks all the time" since 2011. That has proven the right thing to do as we would be down over 30% on the year (including all fees) if we had struck blindly to such an approach. Nonetheless, we are still a sector fund (i.e. non investment grade credit) as opposed to being a go-anywhere diversified fund ("some U.S. stocks, some emerging market stocks, add in some bonds and a sprinkling of gold, real estate and venture capital").

As a result, we are, up to a point, at the mercy of our investment universe. Just for fun we counted up how many of the investments we track (excluding BDC Notes) that were actually up in price on a full year basis across Private Equity Managers, BDC Common Stocks, High Yield Bonds and Floating Rate Loans (both Closed End Funds and Floating Rate Loan Funds). The number: 9 out of 99. That means 90% of the stocks we track were in the red over a 12 month period, and with much volatility along the way. Not getting wet by running between the raindrops is hard to achieve.

Moreover, if you look at the history of the BDC Sector at least over the years, which is where the bulk of our exposure lies both for good and ill, these big swings in price up and down are a feature of the landscape as investors try to get ahead of one another predicting the future of cash flows that are many years off and subject to a multitude of variables. Here is the annual swing in the price of Ares Capital's stock since the end of 2004:

2005	-15%		2010	+36%
2006	+20%		2011	-6%
2007	-30%		2012	+10%
2008	-64%		2013	+2%
2009	+261%		2014	-12%

Still, we have worked hard to mitigate the impact of difficult market conditions. Through most of the year we have kept leverage low, which has reduced interest expense and limited our exposure to the many downswings we faced. That has meant much buying and selling in an effort to minimize losses. (In BDC Common stocks alone we count 6 "drawdowns of 5% or more in 2014, the worst of which was 11.8% between September and October).

We have been, and remain, very liquid, with plenty of availability to take advantage of any sustained rally. All those investments sold off at a loss in 2014 are available to invest in 2015… Of course, with not only the BDC sector but also High Yield Bonds and Floating Rate Loans trading at levels not seen since spring 2012 (the last Greek crisis!) it's easy enough to feel beaten down, and that prices can only go in one direction-down! However, we point you to those annual swings above as a reminder that the only constant is change. With half of our portfolio invested in investment grade (BBB mostly) BDC Notes and the rest in a set of BDCs (and a couple of very diversified High Yield Bond ETFs), which both ourselves and the analyst community, expect to maintain or increase their distributions in 2015 regardless of what happens to the price of oil, we may be susceptible to more price swings but our fundamental positioning is sound. We are "keeping calm and carrying on".

NEWSLETTER

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

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