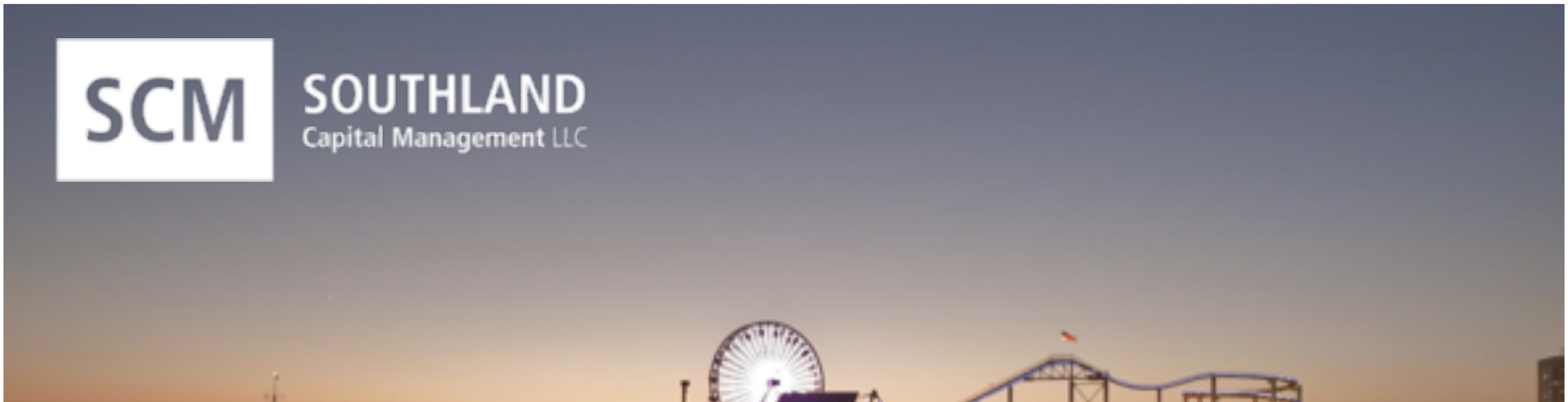


| Month | BDC Fund II* | HFRI EHI | S&P 500 TR | Dow Jones |
|---|---|---|---|---|
| FYE - 2009 | 4.37% | 2.92% | 6.04% | 7.37% |
| FYE - 2010 | 73.04% | 10.45% | 15.06% | 11.02% |
| FYE - 2011 | -46.38% | -8.38% | 2.11% | 5.53% |
| FYE - 2012 | 28.21% | 7.41% | 16.00% | 7.26% |
| FYE - 2013 | 13.20% | 14.33% | 32.39% | 26.50% |
| January - 2014 | 2.30% | -0.99% | -3.46% | -5.30% |
| February - 2014 | 4.21% | 2.85% | 4.57% | 3.97% |
| March - 2014 | -2.63% | -0.24% | 0.84% | 0.83% |
| April - 2014 | -4.10% | -0.84% | 0.74% | 0.75% |
| May - 2014 | 0.33% | 1.23% | 2.35% | 0.82% |
| June - 2014 | 8.28% | 1.73% | 2.07% | 0.65% |
| July - 2014 | -5.88% | -0.79% | -1.38% | -1.58% |
| August - 2014 | 3.14% | 1.64% | 4.00% | 3.23% |
| September - 2014 | -6.46% | -1.82% | -1.40% | -0.32% |
| October - 2014 | 0.91% | 0.37% | 2.44% | 2.04% |
| **Year to Date** | **-2.71%** | **2.32%** | **10.99%** | **4.91%** |
| **Inception to Date*** | **33.74%** | **30.81%** | **112.37%** | **79.06%** |
| **1/1/12 - Date**** | **33.06%** | **25.59%** | **70.45%** | **42.34%** |

* 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.)


## OCTOBER 2014 RESULTS

After a negative month in September, the fund experienced a volatile October as did all the markets. Down for the first half of the month, the BDC sector turned around on October 16th and rallied to close the month slightly up. The Fund was up +0.91% while the Hedge Fund Index (HFRI) was up +0.37%. The S&P TR closed up 2.44% while the Dow Jones was up 2.04%.

Inception To Date, after 61 months, BDC II is up +34%. We are ahead of the HFRI, which is up +31% during this period, but behind the two stock market indices, which have been the biggest beneficiaries of the post Great Recession financial boom. The Dow Jones is up +79% and the S&P 500 up +112% in the 5 years involved.

The Fund's performance from January 2012, since changing investment strategy and risk management policies, is more reflective of what we believe BDC II can achieve over the long term. In the 34 months since the change in direction, the Fund is up 33.06%, after all fees and expenses. The Fund is ahead of the "hedge fund" index, which is up 25.59%. We fell behind the Dow Jones, which is up 42.34%. However, the Fund trails the S&P 500 (as does most every other index in every asset class): up 70.45%.

| Month | BDC Fund II | HFRI | S&P 500 | Dow Jones |
|---|---|---|---|---|
| Jan 2012 to Date | 33.06% | 25.59% | 70.45% | 42.34% |

## INDUSTRY SECTOR PERFORMANCE

There's no way to sugar coat this: the Fund's target investment sectors are having a very mediocre year almost across the board. We charted out the performance of the five sectors we track for the first ten months of 2014 (spread out over 150+ different publicly traded investments), and the trend is clear: down.

High Yield Bonds, notwithstanding two big steps down in June-July and September-October of nearly 5% each, is the "best of the worst". By our numbers, junk bonds are down -0.3% in price terms, and probably achieving a 5% Total Return through October.

Poor old Floating Rate Loans-despite being an investor favorite last year-are down -2.0% in price terms. When the low distributions are figured in, Total Return is about 1.5%. That's what you'd make in a long term CD.

In 2013, publicly traded Private Equity Asset Managers were the big winner in price appreciation terms. This year, the index we use is down -8.3% in price terms, and Total Return is negative, even after generous distributions are factored in by PE groups harvesting long standing investments.

Last and least, the BDC Common stock sector-now packed with nearly 50 different players-was down -10.7% through October, and was at -16.4% at the lowest point in mid-October. Notwithstanding aggregate distributions increasing slightly in 2014 over 2013, the Total Return is -4.5% down.

(We've taken some comfort that BDC Notes - a sector which did not exist 3 years ago and in which the Fund is a pioneer investor - are up on the year. Two-thirds of the BDC Notes are trading higher at the end of October and the aggregate yield for the shorter terms issues that we invest in is nearly 7.0%.)


Nor is the problem just the absolute drop in asset values but the bouts of high volatility. On June 25, 2014, High Yield Bonds reached their second to highest level since the Great Recession, only to drop like a stone for the next several weeks before bottoming out on August 1, -3.5% down to a price level not seen in over a year. Then, the sector rallied only to drop again in 6 weeks by -4.5%. Within just over 3 months High Yield Bonds recorded their highest high and lowest low of 2014.

However, that roller coaster ride for investors was nothing compared to what happened in what we have aptly named our High Volatility sectors: Asset Managers and Business Development Company stocks. In regards to the former: one of our Asset Manager investments Apollo Group (APO) managed to drop -42% from high to low during 2014, including a -15% drop from July 24 to October 14th, after the stock was already down -33% on the year.

Likewise in the BDC common stock sector, which remains our principal focus. Earlier in the year, the BDC Sector dropped -10.3% between February 24 and May 14th, an 11 week period. We recovered therefrom, but much greater volatility came to pass from July 1st (when aggregate prices were only 0.5% off the year end 2013 level. Between July 1st and October 15th, the BDC Sector dropped -16.0% in 16 weeks. That's an average of -1% a week. However, in the last 6 weeks of the downturn, the pace was -2% a week. In the first 2 weeks of October when investors were throwing out the baby with the bathwater, the weekly decline was at a -3.75% pace. Or put another way, in a week BDC prices dropped more than High Yield did in 9 weeks between June 25 and August 1, as discussed above.

Those are volatility numbers for the BDC Sector as a whole. Individual stock movements were often higher. For example, Hercules Technology (HTGC) saw it's stock price drop -20.5% in ten weeks, of which half occurred in the final two weeks (a weekly drop of -5%). Yet HTGC's earnings were stable to growing through the year, the dividend increased and the portfolio growing. There are numerous other examples in this vein, but the point has hopefully been made: Investing can be difficult at times.

What may be lost in reading this post mortem, with the knowledge that the market began to rally on October 16 and through the rest of the month, is that SCM and all other investors in the markets could not know what was going to happen on October 15. We suspected prices were reaching a nadir at that point. The BDC Sector was trading at a level not seen since June 2012, and below pre-Euro crisis 2011 levels. However, we had "suspected" the turning point had been reached on several earlier occasions. After all, the July-October drawdown turned out to be twice as great as the biggest drop in 2013, and a third bigger than the worst time in 2012, while the underlying market and economic conditions appeared far less challenging than in those earlier periods.

Because we are a leveraged fund AND we are committed to capital preservation, we cannot remain steadfastly Long during these drawdowns, whatever our market view. We have to de-leverage and sell off a good portion of our portfolio to ensure that, just in case, we are not sitting with over-valued assets if the drawdown we are experiencing turns out to be the beginning of a much larger, and longer term, drop in prices. The de-leveraging of the portfolio is a form of insurance against the sort of catastrophes that hit investors in 2008-2009 and 2011. Like everybody else, we dislike paying for insurance ("money out the window") but recognize it's necessity.

In our case, good insurance coverage is much more than sending an annual cheque to Prudential for a life insurance policy. We need to both de-leverage when the markets are going down AND re-invest when markets go up. Selling is easy enough. Buying is hard. That's especially the case after


a series of "head fakes" from the BDC Sector market in this period. Within the July 1-October 15th "drawdown where the BDC Sector was down -16%, there was a period between July 17th and September 12th when BDC prices were actually on the rise. 75% of the drawdown (a 12% drop!) happened in just over 30 days, and even within that period prices were up a third of the time).

## WHY DON'T YOU JUST SIT ON THE SIDELINES AND WAIT?

We cannot just take our ball and go home at these times of market stress because of the universal investment truth that the bulk of gains in most market rallies are made in the first few hours or days after sentiment turns. The investor who waits to receive confirmation that the "turn" is for real will pay the price. This is illustrated in what happened to the BDC Sector rally in the second half of October.

We were in the London office working on October 16th. At the market open in New York, we were watching the screens. In the first few minutes the BDC stocks were down. However, there were a few signs of strength in certain bellwether stocks., so we put on hold any plans for further selling. (At that point we had sold two-thirds of our BDC common stocks). About an hour in, we noticed volumes growing across the space (and markets generally) and BDC stock prices were suddenly being jacked up by market makers. As the expression goes, it was time to "back up the truck' and buy with both hands. For the next 48 hours we went on a shopping spree across the BDC space, most of the time buying at lower prices than we had sold for. (We keep a list on our Proprietary Database of our sales for this purpose). Virtually all our BDC common stock purchases were made between October 16 and 17.

Between October 15th and 31st, the BDC sector was up a remarkable 6.9%. However, 75% of the gain was made in those first two days. If we had waited a week to drive our truck round (to the close on October 24th), the gain in the last week of the month would have been just 1.9%. Of course, we were not able to get a super-bargain price on every position we wanted to. Market makers immediately mark up prices when market conditions change. Plus, the less liquid stocks take time to buy and as MS Howells is buying for us prices rise.

We are telling you all this to underscore how an active manager like SCM provides protection both on the downside (by selling out a portion of the Fund's positions to reduce the risk of being caught with a top heavy and expensive portfolio) and on the upside (by pushing the button at the right time-several times in our case-to take advantage of a highly volatile market).

In a year where the Fund could be down by double digits between the sector price drops, the cost of borrowing, transaction costs and fees, we are essentially flat (up 2.0% if fees are excluded). Furthermore, what those numbers cannot show, is that we would have been essentially on the sidelines, with huge amounts of liquidity, if the market downswing had continued after October 15th. (That's the problem with insurance: it's benefits are only rarely experienced).

## WHAT GOES DOWN COULD GO UP

Here is the other comforting insight. Nothing goes down forever. We don't know when BDC prices will end their slide. (We are up slightly in November, but that could change at any time). We have been able to break-even in a BDC sector that is 11% down in price terms in 2014. Imagine what the Fund might be able to achieve should we have an 11% increase in our future. That's when the economics of BDC II will come into play. With 150% of our equity invested in High Volatility BDC or Asset Managers, and assuming a 10% dividend yield and an 11% capital gain in a one year period: the Fund's gross return would be 32%. That's leaving aside any gains


to be received from investing in BDC Notes and High Yield Bonds. If we assume just a 7.0% yield and no price appreciation, fully invested that's another 10.5% in annual gross return. In total, that's a 43% annual return if the wind was at our backs rather than the current difficult conditions.

We are not predicting the BDC sector will increase by 11%. (Still, such an increase off the October 31 price would still be 2% below the 52 week high, and below the level reached July 1st, 2014 - just a few months ago). We are pointing out that our active management of the Fund provides both insurance against a Great Crash (by ensuring we are largely in cash should the worst happens and with only minor collateral damage); mitigation of losses during periods of market downturn like the one we have been in all year and the opportunity for outsized gains when markets are in a bull phase. (We remind you that when the BDC Sector was up 29% a year in price terms in 2012-2013, the Fund was up 43%, and that's after all fees and expenses. Moreover, we overcame 5 major drawdowns in those 24 months of 5% or more, including a 13% drop in November 2012).

We believe we've proven by the performance this year, and in 2012-2013 that the Fund's model works, respectively, in up markets and down markets. Unfortunately, we fumbled the ball in 2011 during the 2011 Euro-crisis and did not achieve the capital preservation we aspire to. However, the results in the past few months, when volatility and price drops have reached levels close to the 2011 experience, give us comfort, and that we have the right formula to cope with very difficult markets.

We don't know when the markets will zig or zag. Nobody does. However, we are increasingly confident, after 5 years in the trenches and many hours a day devoted to the Fund, that we have the right formula for all market conditions, and that should allow us to generate superior returns over the long term. Now, we're going to go back to our screens and wait for that bull market…

## NEWSLETTER

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

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