

ASSET ALLOCATION QUARTERLY

A Report from Confluence Investment Management

- The U.S. may be entering a period of lower baseline economic growth; in this environment, stimulative policies are likely to have only temporary benefits.
- We don't expect a double-dip recession, and believe inflation and interest rates will remain low. Corporate profits are likely to grow much faster than the overall economy, creating a constructive environment for equity investors.
- Returns for bond investors are likely to remain low. Corporate bonds can be helpful in providing incremental yield.
- There are numerous event risks related to regulatory and geopolitical developments. One way to address these is to include longer maturity Treasuries.
- Commodities can also help address event risk. We introduce an overweight in gold this quarter to address risks related to various currencies.
- Our style bias remains oriented toward growth over value.

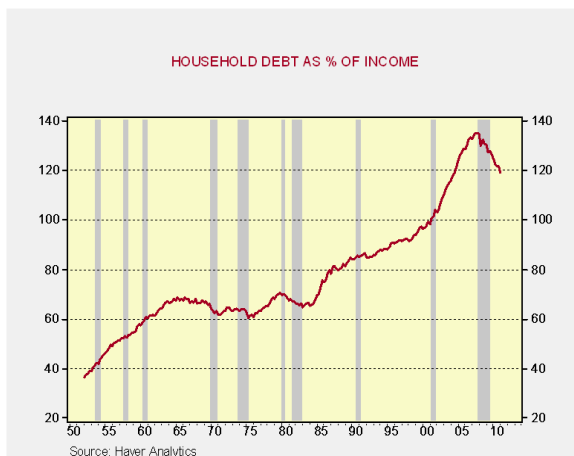
CONFLUENCE ASSET ALLOCATION – THIRD QUARTER 2011 COMMENTS

As we began 2011, there was a fair amount of optimism related to the economic recovery. GDP growth was beginning to accelerate, consumer activity was picking up, housing markets showed signs of stabilization and job creation was actually taking place. Unfortunately, many of these positive trends failed to carry forward with consistency as we moved through the first half of 2011. GDP growth stalled, hampered in part by government curtailments, including those from state and local municipalities; consumer confidence wavered in the midst of rising gasoline prices and growing conflicts in various Arab nations; housing data indicated ongoing weakness; and job growth tempered to the point where much of the progress in lowering the unemployment rate was lost.

We observe that several of the federal government's initiatives, although often clunky, have spurred economic activity in varying degrees. But low interest rates, deficit spending, homebuyer and car buyer tax credits, and various policies from the Federal Reserve, have in retrospect, provided only fleeting benefits. None thus far have been able to "prime the pump" and foster sustainable economic growth.

Could different policies or better execution have yielded better results? Most likely. But we are beginning to believe that the U.S. may be entering an extended period where its baseline growth rate in real GDP may be much lower than it has been in modern history. For the past few decades, the consumer has increasingly represented a larger and larger proportion of U.S. economic activity, reaching a point today where over 70% of GDP is related to consumer spending. And along the way, the consumer steadily increased debt levels, facilitating the construction of a vast number of residential and commercial properties.

In the aftermath of the 2008 financial crisis, a primary trend among consumers has been to lower debt (voluntarily and involuntarily), which has hurt the recovery and left a substantial excess of developed real estate. Until consumers stop deleveraging and housing is properly absorbed, baseline real GDP growth may average closer to 2%, well below the longer term trend of 3%. As the chart on the right shows, we are still in the early stages of this deleveraging; we believe a reading below 100% is probably the maximum level of debt to disposable income that can bring sustainable consumption. If this lower growth rate is the new reality, policy efforts to stimulate the economy will only result in temporary growth surges, regardless of how well they are planned or executed. Furthermore, low baseline growth suggests the unemployment rate is unlikely to decline. It also means the economy is less resilient and more prone to recessions from unexpected shocks.



Against the backdrop of this rather dour outlook, there is some good news. First, we expect lower baseline growth, but not another recession. Second, inflation should not be a problem. Granted, fuel and food costs may periodically spike, but widespread price increases are unlikely, given the substantial amount of excess global production capacity. Third, interest rates are likely to remain low and the U.S. dollar should stabilize, possibly even strengthening versus the euro and yen. We have issues here in the U.S., but Europe and Japan have much bigger problems and currency rates are an exercise in relativity. Finally, corporate profits are likely to grow. Wages and inflation should not put pressure on margins, allowing for ongoing productivity gains.

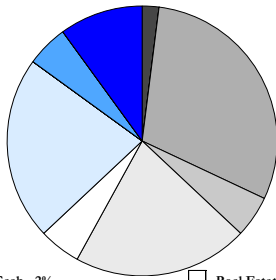
This environment creates a mixed bag for investors. For bond investors, an easy Fed, low inflation and low growth confirm our existing belief that there is no bond bubble and interest rates are unlikely to spike. Still, the low interest rate environment also indicates bond returns should remain low. We continue to recommend the use of corporate credits to improve bond allocation yields, including the limited use of speculative grade bonds, particularly where income is a primary objective. At the same time, we don't believe yields of longer maturity bonds offer a compelling return.

For equity investors, our outlook is more constructive, particularly for domestic stocks. Despite the low-growth economic environment, corporations should be able to lift profits to record levels. Margins should remain intact, helped by lower labor costs, and unlike consumers and the government, many corporations have relatively low levels of debt with manageable interest burdens. Strong fundamentals and reasonable valuations form an opportunity for higher returns for stock investors. Although we believe equity returns should be relatively good, we also expect elevated levels of volatility. There are today a myriad of high-impact events that could unfold and create large waves in the financial markets...these events range from unrest in Arab countries to debt problems in Europe, or punitive regulatory/legislative decisions from Washington. In most of these situations, the political bodies responsible for solutions have proven to be remarkably consistent in failing to deliver them. Therefore, the likelihood and severity of "event risk" is high, and we recommend equity investors incorporate longer maturity Treasuries as a way to address some of this risk.

Commodities can also play a role in addressing event risk, particularly developments that may cause energy supply interruptions. (For this reason, we remain overweighted to oil.) There is a duality to this asset class in that it can also participate in global economic growth, particularly from the emerging market countries. And this quarter, we introduce a recommendation to overweight gold, which can help address certain risks caused by central banks interested in devaluing their currencies.

Our style bias remains in favor of growth over value, based upon the sectors and industries within each style. For large caps, we favor the energy and healthcare sectors, which we believe can perform well in a slower growth economy. We underweight financials and telecom, sectors which face challenging regulatory and capital expenditure cycles. Our country weights among foreign developed countries remain oriented toward Japan, Canada and Australia and away from Western Europe, where we expect limited economic growth.

INCOME WITH GROWTH

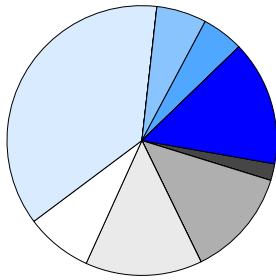


INCOME WITH GROWTH

In this portfolio the focus remains on intermediate maturity bonds. Although we favor corporate bonds, we also recommend Agency MBS and Treasuries in the allocation. We recommend only a limited exposure to longer maturity bonds, as low yields and higher price volatility make this asset class less attractive. This quarter we reduce the allocation to speculative grade bonds. This asset class has served investors well for several quarters. Yields have declined and we believe it is prudent to trim back some of the exposure; however, the remaining allocation is still substantial.

We continue to believe an allocation to large cap stocks is helpful in pursuing the portfolio's growth objectives. We expect earnings to rise, even in a tepid-growth economy. The relatively low valuation of large caps helps form a lower risk profile compared to other equities. Foreign developed country stocks and real estate help diversify the portfolio and add a measure of income to the portfolio. Commodities also add to diversification, while helping to address event risk.

GROWTH & INCOME



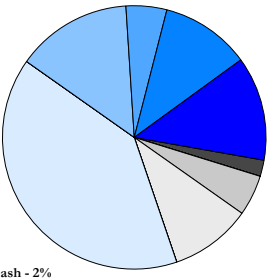
GROWTH & INCOME

We continue to focus the bond allocation on intermediate maturities, including corporate investment and speculative grade bonds. We also recommend a modest increase in real estate to help pursue income objectives.

Large cap stocks remain our favored asset class to pursue growth objectives. We expect corporate earnings to rise, even in a mild economic growth environment. And though the large cap allocation remains substantial, we pare it back this quarter to accommodate an increase in small cap stocks, which we believe have higher growth potential. We also eliminate the exposure to emerging market stocks. Their performance has been strong, but we expect risk levels may rise and currently prefer to avoid exposure in this portfolio.

Commodities are a lower volatility manner by which investors can participate in emerging market growth. This asset class also helps to address event risks.

GROWTH



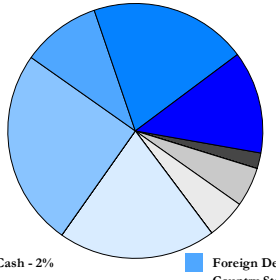
GROWTH

We believe large cap stock valuations are relatively low and expect corporate earnings to increase. The combination creates an attractive return/risk profile, appropriate for growth investors. Nevertheless, we trim the allocation this quarter to accommodate an increase in small cap stocks. Many smaller companies may be able to advantageously position themselves to grow faster than the overall economy.

We include speculative grade bonds, which we continue to find attractive, but are paring back the allocation to introduce exposure to longer maturity bonds, specifically Treasuries. Although this allocation is atypical, we believe it can be an effective way to help address a variety of potential event risks that may arise from regulatory or geopolitical developments.

We believe higher-growth emerging economies create a higher return profile for emerging market stocks. Commodities may also benefit from developing country growth, while simultaneously helping to address event risks.

AGGRESSIVE GROWTH



AGGRESSIVE GROWTH

This quarter, small cap stocks become the largest recommended allocation for aggressive growth investors. We believe many smaller companies are positioned to grow much faster than larger companies and the broader economy. And while, we continue to view large cap stocks favorably, we reduce the exposure this quarter.

We introduce long-term bonds this quarter, not so much for return potential, but to help manage potential event risks that can arise from regulatory or geopolitical developments.

We maintain a sizable foreign allocation, directing the developed side more toward Japan, Canada and Australia, while limiting the exposure to Western Europe. Most of the foreign allocation is in emerging markets, which have a higher growth profile. Commodities may also benefit from growth in developing nations and at the same time help address event risks.

Confluence Asset Allocation Models Third Quarter 2011

	<u>Income With Growth</u>		<u>Growth & Income</u>		<u>Growth</u>		<u>Aggressive Growth</u>	
	Current	Change	Current	Change	Current	Change	Current	Change
Cash	2%	-	2%	-	2%	-	2%	-
Short Term Bonds	-	-	-	-	-	-	-	-
Intermediate Term Bonds	30%	6%	13%	3%	-	-	-	-
Long Term Bonds	5%	-	-	-	5%	5%	5%	5%
Speculative Grade Bonds	21%	(9%)	14%	-	10%	(6%)	5%	-
Real Estate	5%	-	8%	3%	-	-	-	-
U.S. Large Cap Stocks	22%	3%	37%	(9%)	40%	(10%)	20%	(10%)
U.S. Mid Cap Stocks	-	-	-	-	-	-	-	-
U.S. Small Cap Stocks	-	-	6%	6%	14%	9%	25%	5%
Foreign Developed Country Stocks	5%	-	5%	-	5%	-	10%	-
Emerging Market Stocks	-	-	-	(3%)	11%	-	20%	-
Commodities	10%	-	15%	-	13%	2%	13%	-
<i>Total</i>	<i>100%</i>		<i>100%</i>		<i>100%</i>		<i>100%</i>	

The Confluence Team

Mark Keller		Brian Hansen		Bill O'Grady	
David Miyazaki	Dan Winter	Joe Hanzlik	Patty Dahl	Tore Stole	
Chris Stein	Dustin Hausladen		Tom Dugan	John Wobbe	
Kaisa Stucke		Lisa Pepper		Sean Long	

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The Confluence team is comprised of experienced investment professionals who are dedicated to a high level of service and communication to our clients. We develop innovative investment solutions for our clients, and our disciplined investment process has stood the test of time across a broad range of economic and market cycles.

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