Confluence INVESTMENT MANAGEMENT

Fourth Quarter
2011

ASSET ALLOCATION QUARTERLY

A Report from Confluence Investment Management

- The U.S. economy is slowing to the point where a recession is more likely. Even if a recession is avoided, growth will likely remain well below long-term averages.
- Slow or negative economic growth in European countries is likely to affect global economic growth and increases foreign currency risk.
- We believe low or negative developed country growth will harm many emerging market countries, many of which are highly dependent upon exports.
- We believe corporate bonds, including both investment grade and speculative grade, are attractive.
- We favor domestic equities, particularly large caps with sector exposure emphasizing defensive, less cyclical industries.
- Our style guidance remains in favor of growth over value, based upon the sector exposure within the styles.

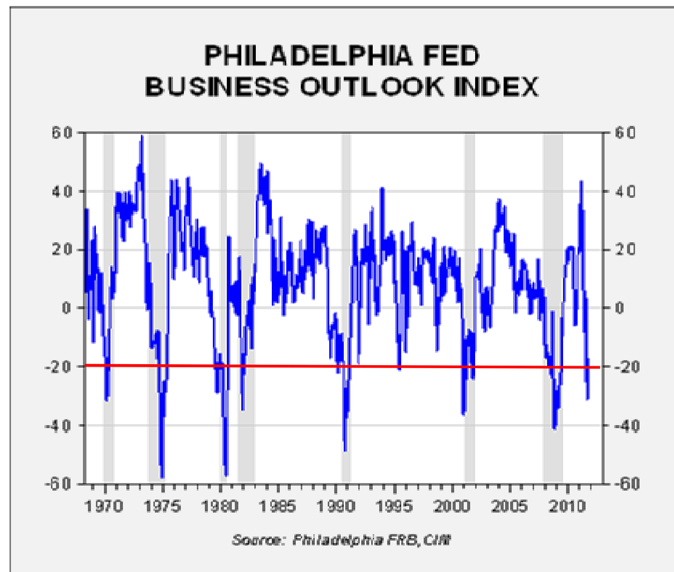
CONFLUENCE ASSET ALLOCATION – FOURTH QUARTER 2011 COMMENTS

In our previous report, we wrote that the U.S. economy was likely to enter a multi-year period of lower baseline growth. In recent decades, our economy has enjoyed higher growth levels, in part derived from rising levels of debt held by consumers, who have accounted for about two-thirds of the economy. With consumers no longer increasing debt, contributions from other factors are necessary just to restore previous levels of growth.

Over the past couple of years, these other factors have included stimulus programs from the federal government, which have had only limited and temporary benefits. Looking forward, the political environment in Washington is unlikely to direct higher levels of spending or incremental fiscal stimuli. In fact, we may see lower levels of spending, which could dampen near-term growth. Another important issue is the situation in Europe, where government spending is declining and uncertainty is very high. We believe many countries are likely to fall into recession. Given the size of the European Union economy (about the size of the U.S.), a slowdown there would affect economic growth around the world, including in the U.S.

Given these challenges, we believe the likelihood of a recession in the U.S. has now increased. And even if the U.S. is able to avoid a recession, the growth level may be so low that it will still "feel" like one. Compounding the challenges is the fact that the Fed has few monetary arrows left in its quiver, having already lowered short-term interest rates close to zero. Unfortunately, there are no easy policy decisions that can help immediately.

We monitor several economic variables, but we share one that has proven to be a relatively good predictor of recessions, the Philadelphia Fed Business Outlook Index. When falling below a -20 reading (red line), this indicator has only once incorrectly predicted a recession (1995) and has been accurate in five other instances (gray areas on the chart indicate a recession). It recently moved into a recessionary reading.



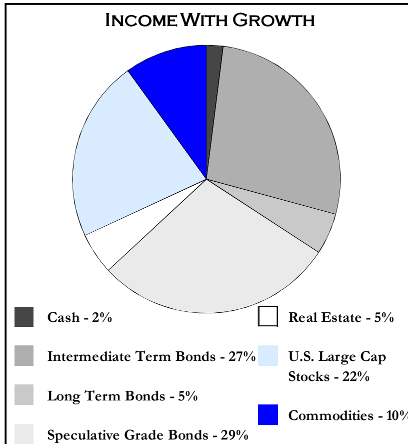
Even in a low or negative growth environment, there are attractive opportunities for investors. One asset class we continue to favor is speculative grade bonds, which we have recommended since the depths of the 2008 financial crisis. Although this asset class has a considerable amount of credit risk, we expect default rates to remain manageable, even in a recession. Credit underwriting standards in the recent cycle were generally maintained and the recent increase in yields forms an attractive return/risk profile. For these reasons, we are increasing the allocations to speculative grade bonds, even where growth is a primary objective. In some situations, speculative grade bonds may be a good alternative or complement to traditional equity allocations.

We also include investment grade bonds in all portfolios. A slow or negative growth environment may increase volatility across all asset classes and one way to address this trend is to increase the proportional exposure to lower volatility asset classes, including bonds. Corporate and Agency mortgage-backed allocations provide attractive yields, while Treasury allocations help to address a variety of regulatory and geopolitical risks. Still, we note that bond returns are likely to remain fairly low and the utility from bond investments is likely to come more in the form of risk protection, rather than from returns.

This quarter we exit all foreign equity allocations, for both developed countries and emerging markets. The aforementioned slowdown in the EU presents significant challenges for many European companies. Meanwhile, Japan's export-dependent recovery is being challenged by its strong currency. With regard to emerging markets, we don't subscribe to the "decoupling" theory, where emerging markets are able to sustain high levels of growth, regardless of what happens in developed countries. We believe emerging markets are *highly* dependent upon developed countries for their exports. And slower growth in the U.S., Europe and Japan may dramatically impact economic and political systems in emerging markets. Removing foreign allocations also eliminates direct exposure to foreign currencies, which may prove to be additional sources of risk.

Our domestic equity allocation emphasizes large cap stocks, which have historically had lower levels of volatility relative to other equities. In addition, we believe valuations are attractive and have already discounted the likelihood of a slow growth economy. Within the large cap allocation, we utilize a defensive posture, overweighting sectors with less economic sensitivity, including utilities, consumer staples, healthcare and energy. We are underweight materials, consumer discretionary and industrials. We also remain underweight financials, which may be adversely affected by European sovereign debt issues. In our style guidance we continue to favor growth over value. The growth bias helps form a sector exposure which we believe better positions the portfolios in a slower growth environment.

We maintain substantial allocations to commodities, although we are shifting the focus. We remove the overweighted exposure to oil, as we believe lower global economic growth may lead to further price declines. We instead emphasize grains, which we believe should experience continuing demand with limited excess supply. The gold allocation helps address a widespread and ongoing desire among major central banks to depreciate local currencies.

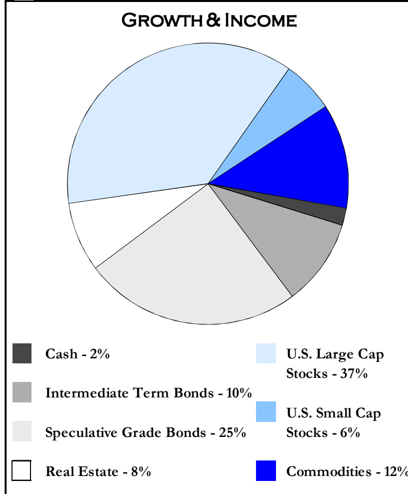


INCOME WITH GROWTH

In this portfolio, we favor corporate bonds, which we believe offer attractive relative yields and a stable default profile. We have this viewpoint for investment grade bonds and speculative grade bonds, which have much higher credit risk. To help balance credit risk, we also include smaller proportions of Agency mortgage-backed securities and Treasuries.

To pursue growth objectives, we include large cap stocks, which tend to have lower volatility relative to other equity asset classes. Large cap valuations are attractive and fundamentals of companies in this asset class appear strong. This quarter we exit foreign developed country stocks due to risks related to slower growth and currencies.

Commodities are included to increase diversification. We emphasize grains, due to ongoing demand growth, and gold, which helps address issues related to global currency devaluations. A real estate allocation helps pursue both income and growth objectives.

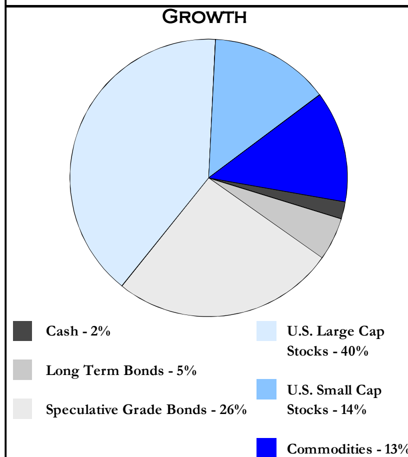


GROWTH & INCOME

This quarter we make a shift out of foreign equities and into speculative grade bonds. Although speculative grade bonds have substantial credit risk, their yields are attractive. We also believe defaults should remain at manageable levels, in part because leverage did not become excessive in the recent cycle. To help address higher credit risk, we continue to include Agency mortgage-backed securities and Treasuries in the bond allocation. We exit foreign equities because of risks related to the European financial system, slowing international growth and currencies.

We believe large cap stocks that emphasize a defensive, less cyclical orientation offer an attractive opportunity to pursue growth objectives. A slow growth economy presents a variety of challenges for equities, but large cap valuations are low, while fundamentals are generally strong. We believe many larger U.S. corporations have the resources to work through a variety of economic challenges. A smaller allocation to small cap stocks provides diversification and brings exposure to companies with higher growth potential.

The commodity allocation provides diversification and helps address geopolitical and global currency risks.

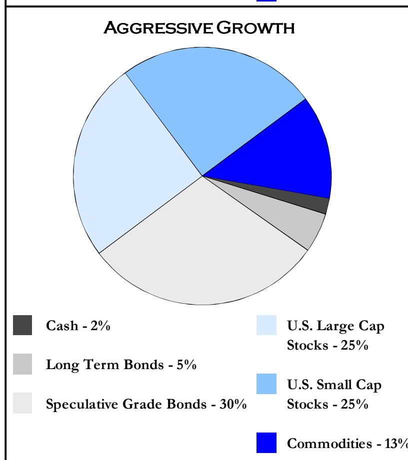


GROWTH

This quarter we eliminate exposure to both foreign developed country and emerging market stocks. We expect developed countries (e.g., U.S., Japan and Western European countries) to experience slow or negative economic growth. In this environment, we believe domestic equities are likely to perform relatively better. We also believe emerging market economies may be adversely affected as their export volume to developed countries declines.

We increase the allocation to speculative grade bonds. We believe higher yields and a manageable default cycle form an attractive return/risk profile, one that complements a defensive domestic equity allocation. Despite a weaker economy, we believe large cap stock valuations are attractive and large company fundamentals are generally strong. A small cap allocation creates exposure to companies with higher growth profiles.

Commodities are included to improve diversification and to help address a variety of geopolitical and global currency risks.



AGGRESSIVE GROWTH

We believe slower global growth may create a variety of challenges for emerging market countries, most of which are highly dependent upon exports to fuel their growth. Slower growth is likely to translate into higher volatility and greater political risks. For these reasons, we exit emerging market stocks this quarter. We also exit developed country stocks. We find this asset class less attractive due to slowing economic growth and currency risks.

We substantially increase the allocation to speculative grade bonds. Although this asset class has high credit risk, we find the yields attractive and expect the level of defaults to be manageable. It is an asset class that generally has less volatility than most equities and can complement the domestic equity orientation in this portfolio.

Despite our expectation of a slow or negative growth economy, we believe there are many attractive investment opportunities in large and small caps for aggressive growth investors. Valuations are low, while fundamentals are strong. Still, we favor a defensive, less cyclical posture and diversification that includes commodities, which can help address geopolitical and currency risks.

Confluence Asset Allocation Models
Fourth Quarter 2011

	Income With Growth		Growth & Income		Growth		Aggressive Growth	
	Current	Change	Current	Change	Current	Change	Current	Change
Cash	2%	-	2%	-	2%	-	2%	-
Short Term Bonds	-	-	-	-	-	-	-	-
Intermediate Term Bonds	27%	(3%)	10%	(3%)	-	-	-	-
Long Term Bonds	5%	-	-	-	5%	-	5%	-
Speculative Grade Bonds	29%	8%	25%	11%	26%	16%	30%	25%
Real Estate	5%	-	8%	-	-	-	-	-
U.S. Large Cap Stocks	22%	-	37%	-	40%	-	25%	5%
U.S. Mid Cap Stocks	-	-	-	-	-	-	-	-
U.S. Small Cap Stocks	-	-	6%	-	14%	-	25%	-
Foreign Developed Country Stocks	-	(5%)	-	(5%)	-	(5%)	-	(10%)
Emerging Market Stocks	-	-	-	-	-	(11%)	-	(20%)
Commodities	10%	-	12%	(3%)	13%	-	13%	-
Total	*100%*		*100%*		*100%*		*100%*	

The Confluence Team

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Confluence Investment Management LLC ("Confluence") is an independent, SEC Registered Investment Advisor located in St. Louis, Missouri. We provide professional portfolio management and advisory services to institutional and individual clients. Our investment philosophy is based upon independent, fundamental research that evaluates global markets and economies, and continues all the way down to specific companies. Our portfolio management philosophy begins by addressing risk, and follows through by positioning clients to achieve income and growth objectives.

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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