First Quarter
2012

ASSET ALLOCATION QUARTERLY

A Report from Confluence Investment Management

- The S&P 500 ended 2011 almost exactly where it began the year, delivering limited returns despite a lot of volatility. Although large cap stocks generally didn't appreciate in price, the underlying businesses grew, meaning that valuations declined.
- Lower valuations help to lower investment risk. Although there is no shortage of things to worry about, low valuations in certain asset classes are creating a variety of opportunities.
- The European debt crisis remains unresolved and is likely to drive Europe into a recession that would negatively affect the global economy. The slow-growth economy of the U.S. could also tip back into recession.
- We continue to avoid equity allocations to both foreign developed and emerging market countries. Domestically, we favor large cap stocks.
- We believe corporate bonds, including investment grade and speculative grade bonds, offer an attractive return/risk opportunity.
- Our style guidance shifts from 80/20 growth/value to an even weight of 50/50.

CONFLUENCE ASSET ALLOCATION – FIRST QUARTER 2012 COMMENTS

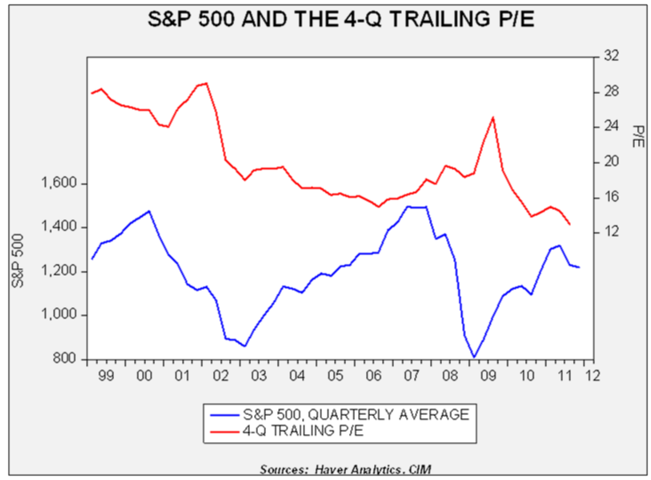
Although the stock market is often likened to a roller coaster, seldom is the metaphor quite as precise as it was in 2011. The S&P 500, a widely followed stock index, rose 8.4% by the end April, fell to -12.6% by early October, and climbed out of the hole to finish at its exact starting point of 1,258 (with dividends, the return was 2.1%).

For stock investors, the ride is altogether too familiar. Since January 1999, when the S&P 500 first reached this level, it has crossed back and forth 79 times, and the annualized total return of the index has been only about 2%, which was derived almost entirely from dividends. It's reasonable to question whether it's even worth it to endure all the ups and downs, if only to capture modest gains.

We believe the answer is "yes." Although many stock prices have remained relatively flat, many of the underlying businesses have grown substantially. The most visible illustration of this trend is reflected in earnings. In 2011, we estimate the S&P 500 earnings increased by about 17%. When stocks rise less than earnings, valuations (like the P/E ratio) decline. And when something becomes worth more, but you don't have to pay more, there's often an opportunity.

Now, we've pointed out for quite some time that large cap stock valuations are relatively low. This doesn't necessarily indicate higher future returns, but lower valuations do usually translate into lower risk. And if we look back through 2011, there was no shortage of concerning events: widespread political unrest in Arab countries; the Japanese tsunami; the downgrade of U.S. Treasuries; and the European debt crisis, just to name a few. Against the backdrop of uncertainty and negative events, the fact that stocks broke about even helps illustrate the fact that lower valuations helped limit risk.

Finding asset classes with lower valuations is particularly important as we look forward, because there remains a multiplicity of risks for investors. At or near the top of our list is the European debt crisis. There are no easy solutions and we expect the combination of lower governmental spending, high unemployment and the lack of credit to drive the EU into recession. A European recession would negatively affect the U.S. economy as well as Chinese and other emerging market economies.

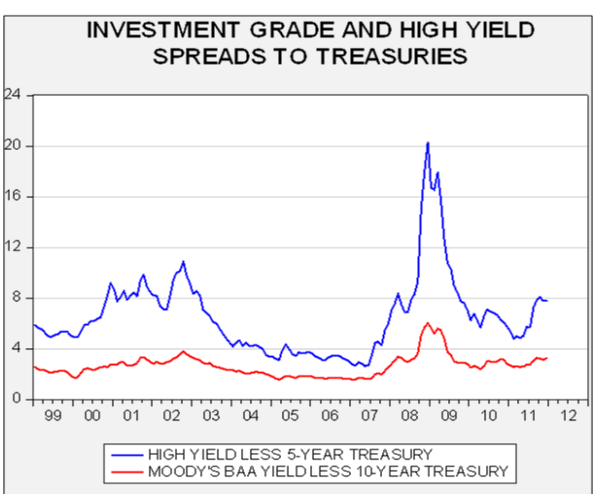


Could the U.S. slip back into recession? We continue to think there's a better than even chance it happens in 2012, given the situation in Europe, the limited number of stimulative fiscal and monetary policies available and the fact that the U.S. is still in a low growth state. But if it were to happen, we don't expect the financial markets to experience the same acute pattern we had in 2008. Because leverage and valuations are so much lower today, we believe the downside risk is much less and certain asset classes could actually perform relatively well.

For these reasons, we remain focused on asset classes with attractive valuations. For growth-oriented investors, domestic large caps receive the largest allocation. A smaller proportion of small caps is included to improve growth potential, but we avoid mid caps due to their higher relative valuations. Foreign equities, both in developed and emerging market countries, remain out of portfolios because of our concerns regarding European challenges and slowing global growth.

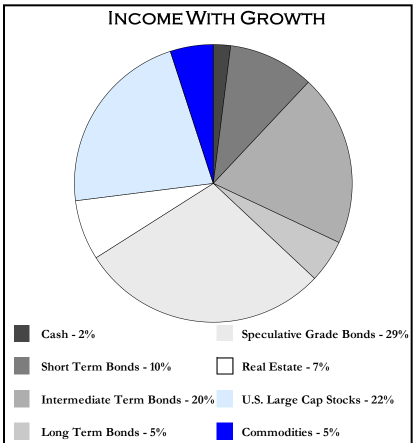
We also shift our small cap equity style guidance, which for many quarters has favored growth over value, from 80/20 to a 50/50 even balance. This style shift is based upon our expectation that the environment for industries within the value component, particularly financials, is improving. Unfortunately, larger financials are likely to face a difficult regulatory environment, so we remain underweight this sector in our large cap allocation, along with economically sensitive sectors including consumer discretionary, industrials and materials. We favor energy, which may help address certain geopolitical risks, along with the defensive sectors of healthcare, consumer staples and utilities.

For income-oriented investors, we also emphasize asset classes with lower valuations, including corporate bonds with short to intermediate maturities. Corporate bond yields are relatively high when compared to Treasury bonds with similar maturities. In bond parlance, this is called the "spread," and we believe spreads are attractive for both investment grade and speculative grade bonds. In fact, speculative grade bond spreads are wide enough to create attractive opportunities for growth investors, too.



Although we generally avoid longer maturity bonds, we include an allocation to longer-dated Treasuries in all portfolios. These bonds are among the few investments that have performed differently than most other assets during a crisis, providing beneficial diversification when it's most needed. Our return expectation for this allocation isn't particularly attractive, but the position is helpful in managing overall portfolio risk.

This quarter we increase allocations to real estate where income is an objective. We believe the real estate markets should continue to stabilize and yields are attractive. Our commodity allocations are lower this quarter based upon our expectation that lower global economic growth may temper demand.

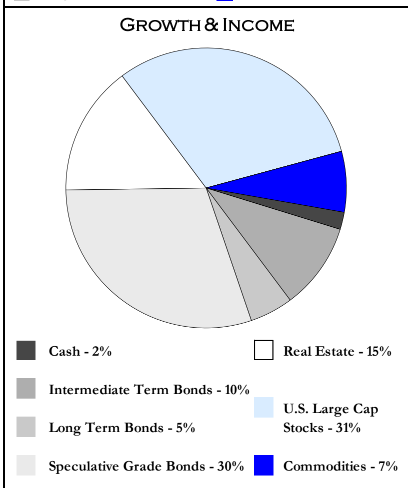


INCOME WITH GROWTH

This quarter we shift a portion of the portfolio to shorten the average maturity of the overall investment grade bond allocation. Yields continue to decline and we make this adjustment to help protect against risks caused by potentially rising rates. The majority of the investment grade allocation includes corporate bonds and Agency MBS, which we believe have attractive yields. We also maintain a longer-dated Treasury position to help address risks from the European debt crisis and potentially lower U.S. and global economic growth.

Speculative grade bonds continue to have attractive yields and we expect a favorable default profile, even if U.S. economic growth were to slow. We increase the real estate allocation due to stabilizing market fundamentals and attractive yields.

We utilize large caps to pursue growth objectives due to their attractive valuations. We reduce the commodity exposure, based upon our expectation of lower global economic growth.

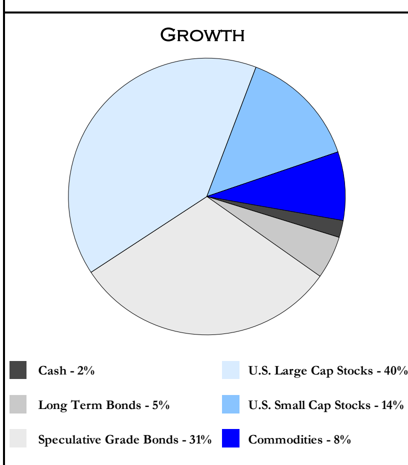


GROWTH & INCOME

The bond allocation in this portfolio remains focused on corporate bonds, with a majority of the allocation in speculative grade bonds. We favor this asset class because we believe the yields are attractive and expect default risk to remain fairly low. This quarter we add longer maturity Treasury bonds to the investment grade bond allocation. Although we generally prefer short and intermediate maturities, we believe longer Treasuries can help address a variety of risks in the financial markets as well as risks caused by slower global economic growth. We also increase the real estate allocation this quarter. We believe REIT fundamentals are stabilizing and their yields are helpful in pursuing income objectives.

We are reducing the overall equity allocation, which includes an exit from small caps. With our expectation for lower global economic growth, we believe equity risks may rise and prefer to maintain exposure to large caps.

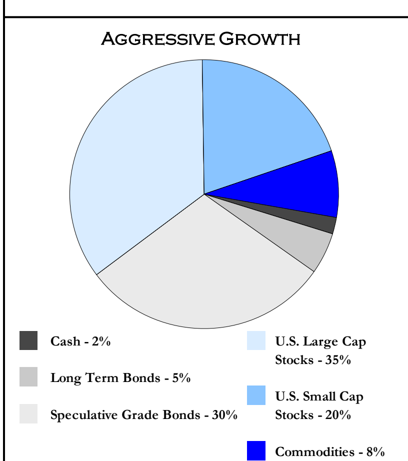
Commodities contribute to diversification and can help address certain geopolitical risks. However, this quarter we pare back the allocation based upon our expectation that global demand may slow.



GROWTH

Although speculative grade bonds are a somewhat unusual allocation for this growth portfolio, we continue to view this asset class favorably and increase the allocation this quarter. We believe yields are high enough to make the total return profile of this asset class competitive with many equity asset classes, even as the volatility is likely to be much lower. In addition, we expect the default trends among speculative grade bonds are likely to remain manageable, even in a slower growth economy. Longer maturity Treasuries remain in the portfolio to help address overall risk.

We maintain a domestic exposure in equities, avoiding both developed and emerging market foreign equities. We believe the return/risk opportunity in U.S. stocks is more attractive and prefer to limit exposure to risks in Europe, Japan and emerging markets, where debt problems, slower growth and currencies create higher risks. U.S. large caps have good fundamentals and attractive valuations, while small caps broaden the domestic allocation and contribute to growth potential. Commodities add to diversification and exposure to emerging markets, but we reduce the allocation this quarter as we expect global demand to decline.



AGGRESSIVE GROWTH

We believe attractive valuations in speculative grade bonds make the return profile of this asset class competitive relative to equity asset classes. The combination of high yields and a potentially low default profile form the framework of an attractive opportunity. We also maintain the allocation to longer maturity Treasuries to help address global financial market risks and issues that may arise from slower global economic growth.

We prefer large cap stocks over other equities because their lower valuations and strong fundamentals potentially provide attractive returns for aggressive investors. Small caps are also included to bring a measure of growth, while foreign equities remain out of the portfolio. We believe foreign developed countries, particularly Japan and many in Europe, face difficult economic conditions. And it is likely that lower developed country growth also lowers emerging market growth, while increasing risk.

The commodity allocation can help capture some emerging market growth potential, but we pare back the allocation due to the possibility of lower global demand.

Confluence Asset Allocation Models
First Quarter 2012

	Income With Growth		Growth & Income		Growth		Aggressive Growth	
	Current	Change	Current	Change	Current	Change	Current	Change
Cash	2%	-	2%	-	2%	-	2%	-
Short Term Bonds	10%	10%	-	-	-	-	-	-
Intermediate Term Bonds	20%	(7%)	10%	-	-	-	-	-
Long Term Bonds	5%	-	5%	5%	5%	-	5%	-
Speculative Grade Bonds	29%	-	30%	5%	31%	5%	30%	-
Real Estate	7%	2%	15%	7%	-	-	-	-
U.S. Large Cap Stocks	22%	-	31%	(6%)	40%	-	35%	10%
U.S. Mid Cap Stocks	-	-	-	-	-	-	-	-
U.S. Small Cap Stocks	-	-	-	(6%)	14%	-	20%	(5%)
Foreign Developed Country Stocks	-	-	-	-	-	-	-	-
Emerging Market Stocks	-	-	-	-	-	-	-	-
Commodities	5%	(5%)	7%	(5%)	8%	(5%)	8%	(5%)
Total	*100%*		*100%*		*100%*		*100%*	

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

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.

349 Marshall Avenue, Suite 302 | Saint Louis, MO 63119 | 314.743.5090
WWW.CONFLUENCEINVESTMENT.COM