Confluence
INVESTMENT MANAGEMENT

Second Quarter
2012

ASSET ALLOCATION QUARTERLY

A Report from Confluence Investment Management

- The U.S. economy continues to improve and ongoing expansion is now more likely than a recession.
- Numerous domestic and foreign challenges form a generally higher-risk investing climate. A focus on lower valuation asset classes can help address risk.
- We favor domestic stocks and continue to avoid foreign developed country stocks. This quarter we include a limited exposure to emerging markets in risk-tolerant portfolios.
- Domestic large cap stocks remain our preferred equity asset class. We overweight financials, healthcare and energy, and underweight consumer staples and technology.
- We shorten average maturities in bond portfolios this quarter. We recommend corporate bonds, including speculative grade bonds, where income is an objective.
- Our style guidance remains evenly balanced between growth and value.

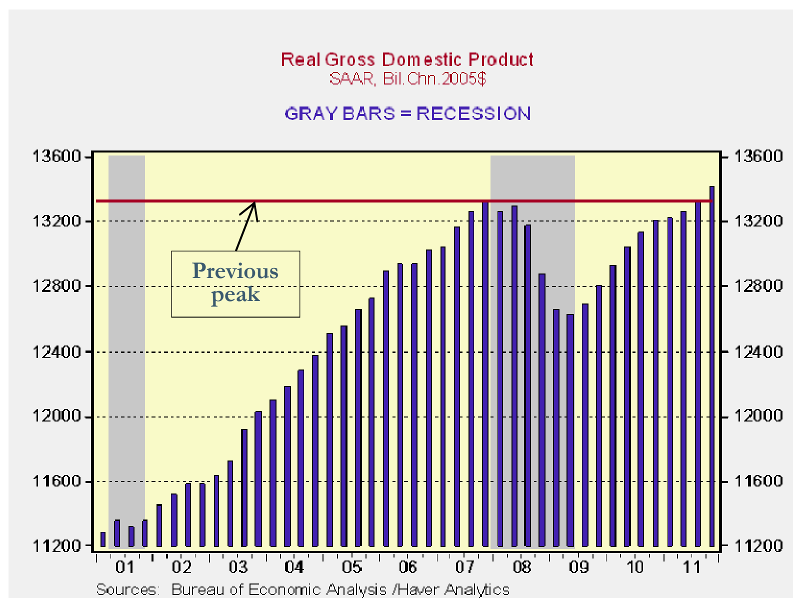
CONFLUENCE ASSET ALLOCATION – SECOND QUARTER 2012 COMMENTS

Last quarter we noted our cautious stance regarding the U.S. economy. The weak recovery was on a positive trend, but we had concerns that it might not have the strength to withstand problems from Europe or a looming reduction in fiscal stimulus. But during the first quarter, the economy continued to improve, drawing meaningful contributions from a better labor market and a more stable housing market. Meanwhile in Europe, enormous monetary policy expansion seemingly kicked the sovereign debt problem far enough down the road to allow a measure of relief in financial markets. Given these developments, we now believe the U.S. economy is likely to avoid dipping back into recession.

If this turns out to be the case, domestic stocks are positioned to deliver attractive returns. Corporate profits, already at record levels, are likely to rise further, buoyed by strong balance sheets flush with cash. The high level of profitability indicates that domestic stocks remain attractively priced, even after the strong first quarter run.

Still, we're not inclined to sound the "all clear" signal. (Not that we ever would!) There remain a long list of challenges and sources of risk that could derail the positive economic trends or upend markets. Foreign issues include the eventual return of European debt problems, a possible European recession, slowing Chinese growth and war in the Middle East. Domestically, we face a large federal deficit, a dysfunctional political environment, uncertain regulatory policies, near-term consequences of lower federal spending and the hazards of ultra-low interest rate policy.

The severity of any of these events, if they were to occur, will probably depend upon how much time our economy has had to strengthen. U.S. GDP just crossed over its pre-recession peak, moving out of the recovery phase and into expansion. More time in the expansion phase implies a better capability to handle unpleasant events, particularly foreign ones. But because it's still early, many of these events have the potential to create significant disruptions in the financial markets. So while we believe several asset classes offer attractive returns, we also believe risk levels are generally elevated. In short, we anticipate a higher return/higher risk investment climate.



We often stress our view that one of the best ways to address risk is to focus on investments with low valuations. For growth investors, our favored asset class remains domestic large caps; for income investors, we recommend a significant exposure to corporate bonds. We believe both asset classes have attractive valuation profiles and are well-represented across all portfolios.

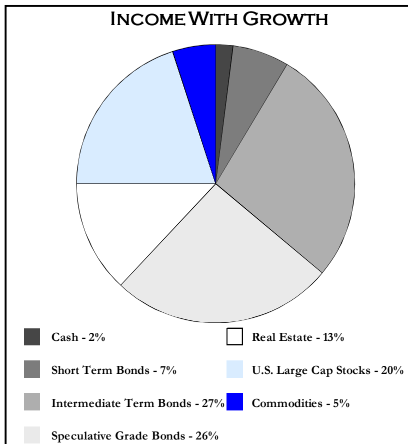
Investors with growth objectives should note that we again exclude foreign developed country stocks from the portfolios. Among developed countries, we believe the U.S. has one of the more favorable environments for growth and therefore direct developed country equity allocations domestically. However, many emerging market countries have higher relative growth potential. Accordingly, we recommend a limited allocation to emerging markets for risk-tolerant investors. We do have some concerns regarding lower growth and credit markets in China and recommend a tilt in favor of Brazil where possible.

Our sector view favors healthcare and financials, which we expect to benefit from improving regulatory clarity. We also continue to overweight energy for its cyclicality and geopolitical risk utility. We underweight the exposure to defensive industries, including those in the consumer staples sector, due to valuations and our preference to tilt into cyclical industries. We temper technology allocations due to the sector's somewhat outsized and growing prominence among domestic equities.

On the bond side, we shorten overall maturities in recognition of the strengthening economy. We believe longer term bonds have unattractive yields relative to their interest rate risk, and therefore focus more on short and intermediate maturities. We continue to favor corporate bonds, including speculative grade bonds, while limiting the exposure to Treasuries.

We expect commercial real estate to continue improving and increase some real estate allocations this quarter. Real estate has some cyclical properties that position the asset class to benefit from a stronger economy, particularly if interest rates remain low. Allocations to commodities remain intact, with an emphasis on exposure to gold. Gold can help address risks associated with certain geopolitical issues and low-interest rate policies in place around the globe.

Our style view remains evenly weighted (50/50) between growth and value.

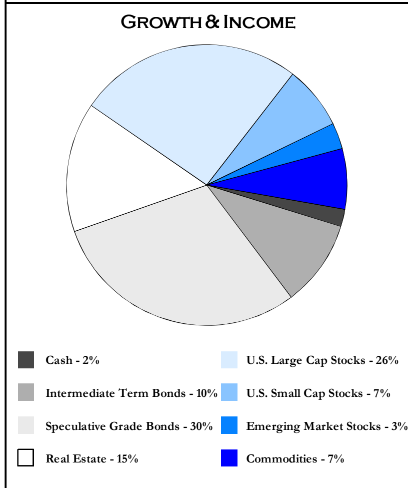


INCOME WITH GROWTH

We continue the trend of shortening the average maturity of the investment grade bond allocation in this portfolio. As the economy strengthens, we prefer to limit the exposure to interest rate risk by focusing on short and intermediate maturities. We maintain the emphasis on corporate bonds (including utility sector bonds) due to attractive yields, but also include exposures to Agency MBS and Treasuries. The corporate exposure includes both investment grade and speculative grade bonds.

This quarter we increase the allocation to real estate. We expect fundamentals of this asset class to continue improving and believe the yield profile is helpful in pursuing income objectives.

We utilize large cap stocks to pursue growth objectives due to their attractive valuations. Commodities add to diversification and may help address certain global geopolitical risks.



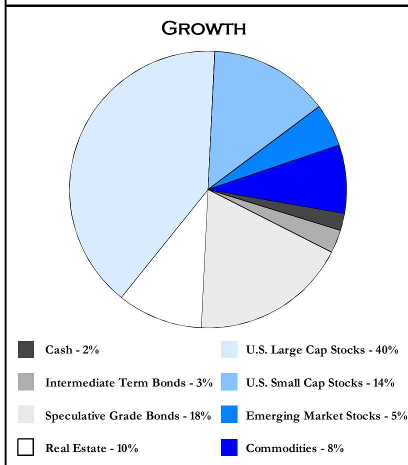
GROWTH & INCOME

With the economy strengthening and the European debt crisis abating, we eliminate exposure to longer Treasury bonds. We maintain the focus on short and intermediate maturities, with an emphasis on corporate and utility sector bonds. Our favorable view toward corporate bonds also includes speculative grade bonds, which should benefit from a stronger economy. We include smaller proportions of MBS and Treasury exposures to round out the bond allocation.

Real estate remains in the portfolio as a complement to the income from the bond allocations. Real estate fundamentals should benefit from a stronger economy and ongoing low interest rates.

To pursue growth objectives, we favor both domestic large and small cap stocks. We believe the financial and healthcare sectors may benefit from better regulatory clarity and emphasize these exposures, along with energy, which provides cyclical exposure and can help address geopolitical risks.

Commodities diversify the portfolio. The exposure to gold helps address geopolitical risks as well as the widespread low interest rate policies enacted around the globe.



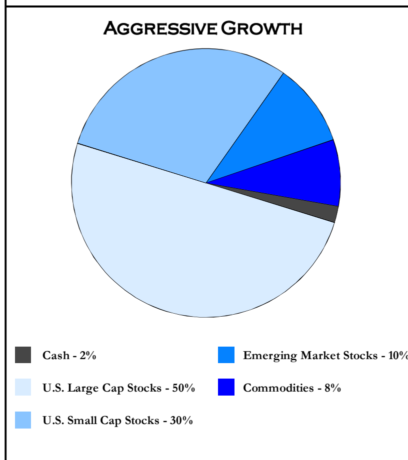
GROWTH

With the economy strengthening, we reduce the fixed income allocation, eliminating the exposure to long maturity Treasuries and paring back the speculative grade bond allocation. We continue to view speculative grade bonds favorably, but we believe other asset classes are gaining in relative return potential.

One notable shift this quarter includes an allocation to real estate. The combination of a strengthening economy and low interest rates help form a positive environment for this asset class and we believe it can play a constructive role in a growth portfolio.

We continue to avoid foreign developed country stocks and instead focus on domestic large and small cap stocks. We emphasize the financial, healthcare and energy sectors, which we expect to benefit from improving regulatory conditions and a stronger economy. Emerging market equities round out the equity allocation and we introduce a focus on Brazil, which we find attractive relative to many other developing countries.

The commodity allocation adds to portfolio diversification and gold helps address a variety of geopolitical and monetary policy risks.



AGGRESSIVE GROWTH

In 2011, this portfolio utilized Treasury bonds to address risks from Europe and a slow-growth recovery in the United States. With recent progress on both fronts, we eliminate the allocation this quarter. We had also utilized a substantial allocation to speculative grade bonds, which provided attractive total returns early in the recovery. We believe other asset classes have gained in relative return appeal with the economy shifting into expansion.

Domestic large cap stocks remain our favored equity asset class. We emphasize the financial, healthcare and energy sectors, which we believe are positioned to benefit from better regulatory clarity and a stronger economy. U.S. small cap stocks are also attractive, offering higher growth potential, albeit with higher risk.

We believe emerging market stocks have attractive valuations and have the potential to grow at relatively high rates. We have some concerns regarding policy challenges in China and shift the exposure to emphasize Brazil, which we believe has an attractive growth profile. Commodities add a differentiated exposure to emerging markets and can also help address a variety of geopolitical and monetary policy risks.

Confluence Asset Allocation Models
Second 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	7%	(3%)	-	-	-	-	-	-
Intermediate Term Bonds	27%	7%	10%	-	3%	3%	-	-
Long Term Bonds	-	(5%)	-	(5%)	-	(5%)	-	(5%)
Speculative Grade Bonds	26%	(3%)	30%	-	18%	(13%)	-	(30%)
Real Estate	13%	6%	15%	-	10%	10%	-	-
U.S. Large Cap Stocks	20%	(2%)	26%	(5%)	40%	-	50%	15%
U.S. Mid Cap Stocks	-	-	-	-	-	-	-	-
U.S. Small Cap Stocks	-	-	7%	7%	14%	-	30%	10%
Foreign Developed Country Stocks	-	-	-	-	-	-	-	-
Emerging Market Stocks	-	-	3%	3%	5%	5%	10%	10%
Commodities	5%	-	7%	-	8%	-	8%	-
Total	*100%*		*100%*		*100%*		*100%*	

The Confluence Team

Mark Keller   Brian Hansen   Bill O'Grady   David Miyazaki

Patty Dahl   Kaisa Stucke   Dan Winter   Joe Hanzlik   Tore Stole

Chris Stein   Dustin Hausladen   Tom Dugan   John Wobbe

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.

This material is published solely for informational purposes and is not an offer to buy or sell or a solicitation of an offer to buy or sell any security or investment product. Opinions and estimates are as of a certain date and subject to change without notice. Investments or investment services mentioned may not be suitable to an investor and the investor should seek advice from a financial consultant, if applicable.