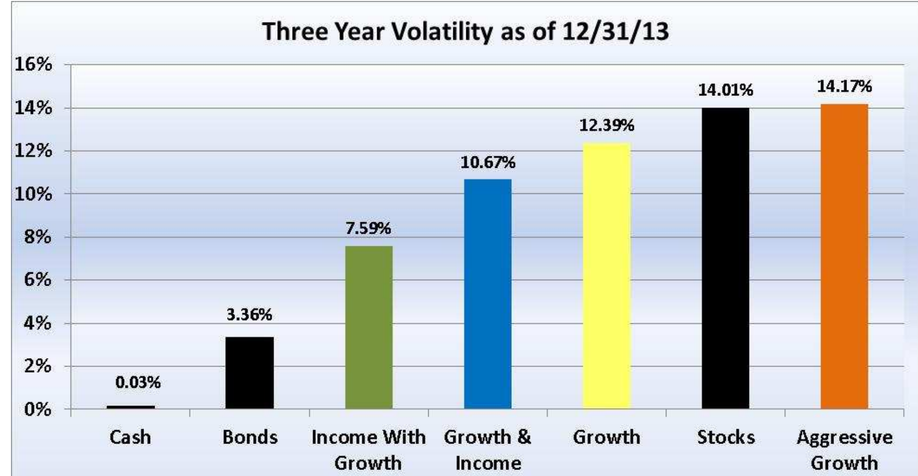
ASSET ALLOCATION QUARTERLY
First Quarter 2014

Asset allocation is a portfolio management process where various asset classes (stocks, bonds, commodities, etc.) are combined in one portfolio. Diversification helps to avoid having 'all eggs in one basket.' Risk and return are considered for the entire portfolio, as opposed to evaluating individual securities or investments.

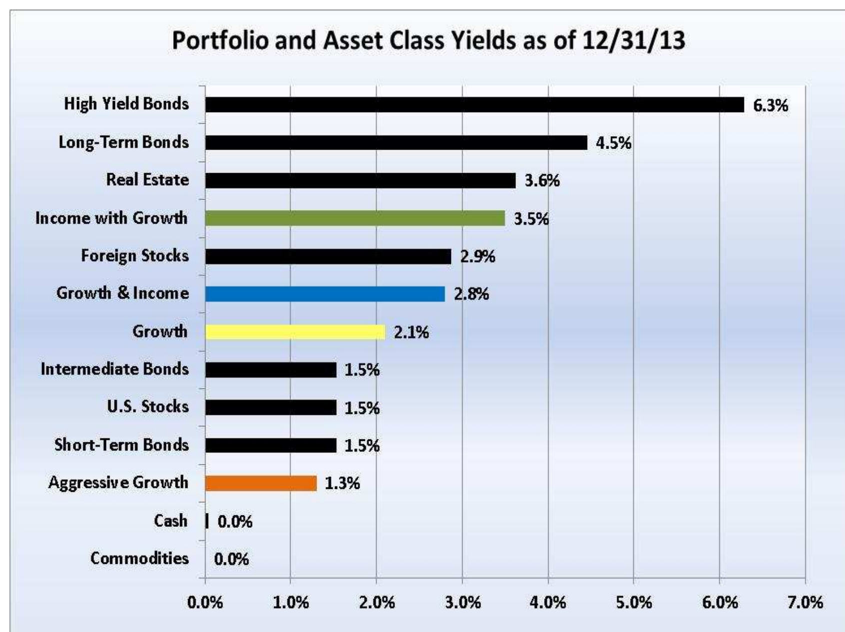


Source: Bloomberg, CIM. Cash is the ML 0-3 Month T-Bill Index; Bonds are the ML Domestic Master Index; Stocks are the S&P 500 Index.. See disclosures on page 6* for important details.

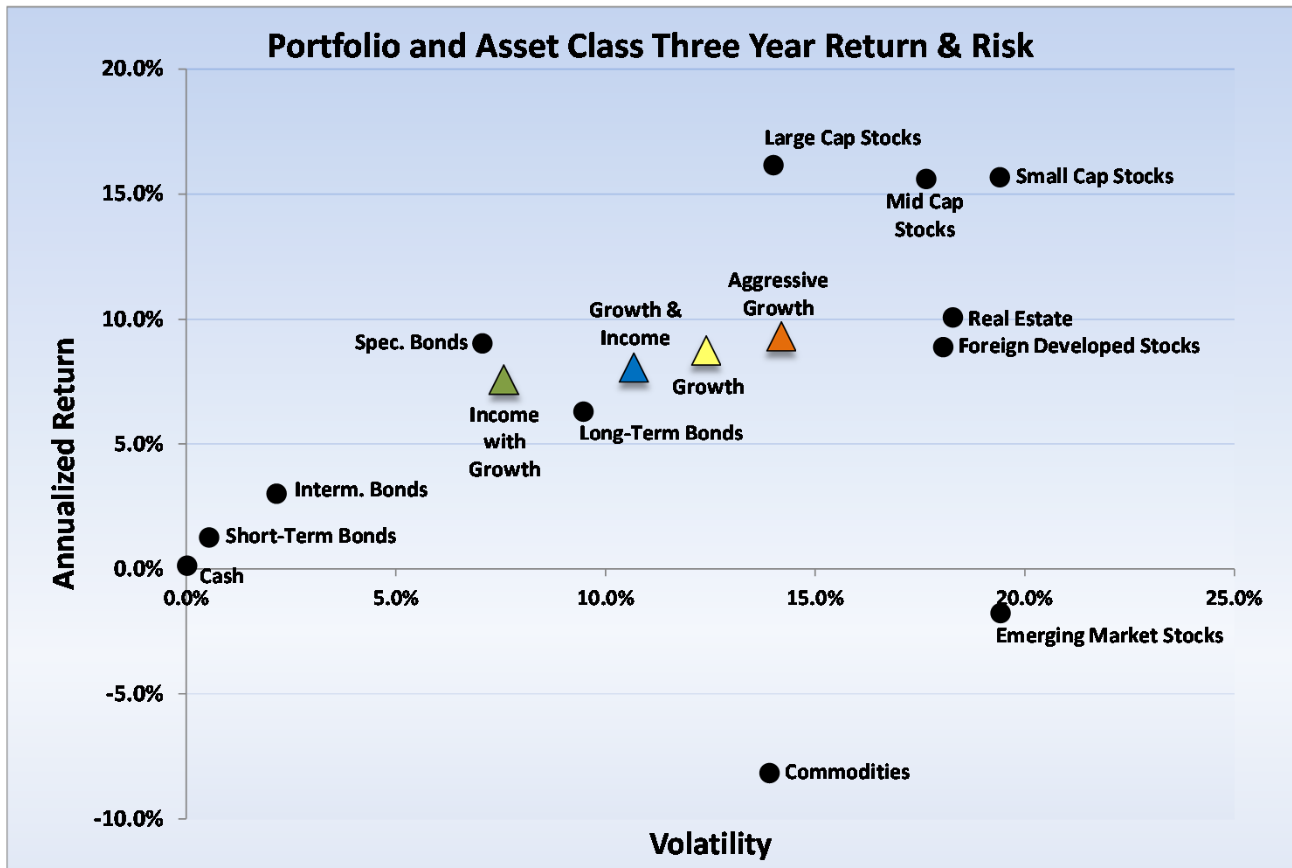
The Confluence asset allocation process is centered upon risk management. Our portfolios offer a broad spectrum of risk profiles, ranging from a fairly conservative posture in Income with Growth (green) to a more risk tolerant profile in Aggressive Growth (orange). The primary asset classes of cash, bonds and stocks are illustrated in the black bars for reference.

We recognize that risk levels and return potential rise and fall over market and economic cycles. Therefore, we apply a dynamic process, one that evaluates the economy, interest rates, regulation, valuations and other investment variables in a forward-looking context. Although we seek return opportunities, we do so with a consideration for the amount of risk taken to pursue these returns.

For many investors, income is an important objective and we make it a priority in our income-oriented portfolios. However, we balance the income objective relative to our outlook for various asset classes. Often times, higher yields may not translate into attractive return/risk tradeoffs. This chart shows the recent gross yields of our portfolios, relative to several asset classes.



Source: Bloomberg, CIM.. Portfolio yields are before fees. See disclosures on page 6* for asset class composition and other important details.



Source: Bloomberg, CIM, using monthly data and gross returns. See disclosures on page 6* for asset class benchmark details.

PORTFOLIO AND ASSET CLASS COMMENTARY

U.S. stock returns in recent years have been unusually high, while at the same time, volatility has been unusually low. The unusually high stock market returns reflect a recovery in valuations, as the last recession created deep discounts for many equities. The recovery in valuations also took place in other asset classes, generally favoring domestic ones, which we believe benefitted from an environment with greater economic growth and stability relative to foreign countries.

Understanding the unusually low volatility is more complex. We believe much of it is a result of the Fed's monetary policy, which over this timeframe has pumped trillions of dollars into the bond market. Our view is this flow has pushed capital into many asset classes, creating an unusually strong upward bias in valuations, while diminishing the frequency and magnitude of price declines. The multi-year effect created unusually low levels of volatility across the marketplace.

Against this backdrop, it is natural to ponder what might happen when the Fed rolls back its liquidity injections. For starters, we expect the Fed to maintain its stimulative policy, even as it slows the flow of capital into the bond market. Therefore, we don't expect a big downdraft in valuations. However, we expect return levels to moderate and volatility to rise as the natural flow of capital in markets becomes more prominent and the Fed's pricing distortions begin to fade.

The diversified posture of our portfolios has positioned them in the middle portion of the return and risk spectrums. Certain asset classes (commodities and emerging markets) added to diversification, while detracting from returns. At the same time, U.S. equities, speculative grade bonds and real estate contributed to returns. Limiting the exposure to long-term bonds and foreign developed stocks was also constructive in managing return and risk.

FIRST QUARTER 2014 ASSET ALLOCATION OUTLOOK

- **A significant portion of high returns from equities came from rising valuations. We expect more moderate returns for most asset classes going forward.**
- **The U.S. economy is likely to remain in a low and stable growth mode.**
- **With weak employment conditions and low inflation, we don't expect the Fed to abruptly change its monetary policy. We don't expect a rapid escalation in interest rates.**
- **Higher long-term rates have improved the return/risk profile of longer maturity bonds, while rising valuations have made speculative grade bonds less attractive.**
- **We expect reasonable returns from U.S. stocks, including large, mid and small caps. This quarter we initiate a limited allocation to foreign developed countries.**
- **Real estate fundamentals and valuations are constructive to pursue both income and growth objectives. We remain out of commodities and emerging markets**

ECONOMIC VIEWPOINTS

We expect the economy to continue along its path of slow, but stable growth. The economy is being helped by an improving housing market, lower levels of consumer debt, low interest rates and high levels of corporate profitability. On the other hand, a less than robust labor market, fiscal tightening and ongoing consumer deleveraging continue to hold back economic growth. Furthermore, changing policy by the Federal Reserve involves a withdrawal of some of the stimulus it has been providing through the bond market. This last point probably has a more direct impact on the financial markets, but may also create an added drag on economic growth as interest rates move higher. So altogether, the good and the bad seem likely to come together in such a way that we probably remain on the same path.

Although we expect U.S. economic growth to remain below its long-term trend, we also believe the domestic economy will grow faster than many foreign ones, including those of Japan and Western Europe. So, as is often the case, the U.S. is likely to set the pace of global economic growth. For both foreign developed and emerging market countries, this scenario also indicates growth rates below long-term trends.

One upside to lower domestic and global economic growth is inflation for the U.S. will probably remain low, as excess capacity in manufacturing and services limit price escalations. Low inflation is not a certainty for all countries, particularly in emerging markets where capital flows and currency volatility distort pricing. But for the U.S., low inflation can provide a measure of predictability, which in turn fosters stability.

STOCK MARKET VIEWPOINTS

For the second consecutive year, the equity markets delivered returns well above historical averages, even as economic progress was below long-term averages. The S&P 500 total return for 2013 was 32.4%, a remarkable level, particularly against the backdrop of the 16.0% return delivered in 2012. In contrast, GDP growth was tepid, employment conditions improved modestly and income levels were stagnant. The disparity between the two has surprised many, and it's important for investors to understand the variance.

Source: Bloomberg

The economy and equity markets have a loose affiliation with one another. Equity markets tend to be forward looking, as investors continuously attempt to gauge how businesses will perform in the future and what those businesses will be worth. On the other hand, many commonly followed economic yardsticks (like GDP growth and unemployment) reflect what has already happened. This mismatch is often exacerbated because investors frequently become overly optimistic or pessimistic. But the economy does affect how businesses perform, so there is a linkage…it's just often erratic.

With this in mind, the strong equity returns of the last two years were borne mostly on the optimism of investors and their view of what the future value of businesses are worth today. Corporate earnings, cashflow and balance sheet strength did grow…but just not at a rate anywhere near their stock price growth! Therefore, business valuations have risen, a trend we can see on the previous price/earnings graph.

Anticipating valuations is one of the greatest challenges investors face. It is very difficult to know how investors in the future will value something. But we are able to distill an important point: for equity returns to remain unusually high, business conditions must improve dramatically…or valuations must escalate.

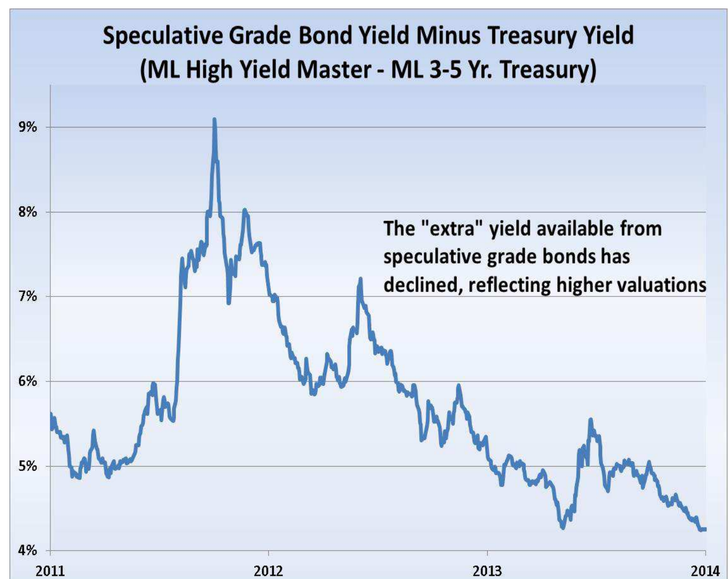
Where could valuations trend in this environment? On the one hand, a low-growth environment might indicate a low valuation environment. On the other, stable growth could form a viewpoint that valuations could remain intact or even move higher, especially given the Fed's accommodative monetary policy. Ultra low interest rates have pushed significant amounts of capital into a variety of destinations, and the aforementioned valuation escalation has not been limited to equities.

Our view is that although valuations are high, they are not unreasonable. Part of the escalation in recent years reflects a recovery from unusually low levels caused by the last recession. Accordingly, we expect more moderate returns across asset classes. U.S. stocks can deliver reasonable returns and we prefer large and mid caps, with a smaller exposure to small caps for risk tolerant investors. We are evenly balanced between growth and value, favoring the technology, energy, industrial and consumer discretionary sectors.

This quarter we initiate a limited allocation to foreign developed country stocks. It has been a long while since we've had such an allocation, but we believe U.S. economic growth should benefit many foreign multinational companies. We recommend a diversified allocation, one that emphasizes Western Europe.

BOND MARKET OUTLOOK

For bond investors, changing Fed policy created a volatile and oftentimes unpleasant 2013. And although the bond market remains somewhat distorted by monetary policy, we believe longer term bonds have an improved return/risk profile. We also don't expect a rapid escalation in long-term rates. Rates may rise, but we expect a gradual path as employment conditions and inflation remain weak. At the same time, we observe that speculative grade bonds are no longer "cheap." Therefore, we pared back our long standing speculative grade bond allocation to make room for some longer maturities, exchanging a measure of credit risk for interest rate risk. Note that although we are beginning to include longer maturity bonds, short and intermediate maturities remain the primary focus.



Source: Bloomberg

OTHER MARKETS

Real estate is an asset class where valuation escalations were limited as interest rates rose in the latter half of 2013. Yet fundamentals related to occupancy, rental rates and capital costs are constructive, making this asset class appropriate where yield is an objective. Reasonable valuations also create an opportunity for growth-oriented investors.

Commodities and emerging markets remain out of the portfolios. Demand, particularly from China, remains below production capacity for many commodities. And while emerging market valuations are relatively low, we believe many countries face challenges related to economic growth, political instability and currency uncertainty, making the return/risk tradeoff relatively unattractive.

First Quarter 2014	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	35%	-	12%	(5%)	8%	-	-	-
Long Term Bonds	12%	5%	10%	10%	-	-	-	-
Speculative Grade Bonds	10%	(5%)	10%	(5%)	-	-	-	-
Real Estate	19%	-	18%	-	20%	-	-	-
U.S. Large Cap Stocks	19%	(3%)	20%	(11%)	45%	(5%)	31%	-
U.S. Mid Cap Stocks	-	-	25%	8%	20%	-	47%	5%
U.S. Small Cap Stocks	-	-	-	-	-	-	15%	(5%)
Foreign Developed Country Stocks	3%	3%	3%	3%	5%	5%	5%	5%
Emerging Market Stocks	-	-	-	-	-	-	-	(5%)
Commodities	-	-	-	-	-	-	-	-
Total	*100%*		*100%*		*100%*		*100%*	

INCOME WITH GROWTH

The Fed has announced a program to gradually pare back the number of bonds it purchases in the marketplace, an initiative known as "tapering." Following the announcement, bond prices declined, with larger declines taking place among intermediate and long-maturity bonds. We believe that bond prices have approached a more natural equilibrium and don't expect big price downdrafts or spiraling interest rates. Therefore, this quarter we continue a gradual lengthening of the average maturity of the bond allocation. Most of the portfolio remains centered on intermediate bonds, but the longer maturities can begin to play a slightly bigger role.

Although our outlook for speculative grade bonds remains positive, the valuation of this asset class has increased in recent quarters. Accordingly, we continue to reduce the exposure, which helps accommodate the increase in longer maturity bonds.

Real estate fundamentals are solid and valuations are reasonable, allowing this asset class to play a constructive role in pursuing income objectives. Large cap stocks and a much smaller allocation to foreign developed stocks position the portfolio for growth.

GROWTH & INCOME

This quarter, we pare back a portion of the allocations to intermediate bonds and speculative grade bonds to initiate an allocation in longer maturity bonds. Effectively, we are reducing some of the bond allocation's credit risk and exchanging it for some interest rate risk. Higher valuations in speculative grade bonds have reduced the extra yield they provide, while rising interest rates have improved the return/risk profile of longer maturity bonds.

We also trim back the allocation to large cap stocks. Although we believe large caps remain attractive, we recommend a reduction to accommodate an increase in mid caps, which we believe offer an attractive balance of growth and valuation. We also initiate a foreign developed stock allocation based upon our expectation that U.S. growth should benefit many foreign multinational companies.

The real estate allocation continues to provide opportunities for both income and growth objectives. We believe fundamentals are strong and expect them to improve.

GROWTH

The growth portfolio remains centered on large cap stocks. Although large cap valuations have risen, we believe they are reasonable. We expect U.S. companies to continue operating well, even if the slow growth environment persists. We also include mid cap stocks, which bring an aspect of higher growth potential into the portfolio without creating excessive volatility.

We initiate an allocation to foreign developed stocks based upon our belief that many foreign multinational companies are positioned to benefit from U.S. economic growth. We also complement the growth portfolio equity exposure with a real estate allocation. Real estate fundamentals are solid and we believe they can improve, creating an opportunity for growth-oriented investors.

The allocation to intermediate bonds provides diversification and can help address the possibility of rising market volatility.

AGGRESSIVE GROWTH

The aggressive growth portfolio includes allocations to large, mid and small cap stocks. Although equity valuations have risen over the course of the past several quarters, we believe they are still reasonable and continue to create attractive capital appreciation opportunities. Last quarter, mid caps became the largest allocation and we continue to add to the position this quarter. We believe mid caps form a good balance between growth potential, volatility and valuation.

We have not allocated to foreign developed country stocks in this portfolio since 2011. However, we believe U.S. economic growth should create opportunities for many foreign multinational companies to grow. We avoid emerging market stocks, where economic, geopolitical and currency uncertainties create a less attractive return/risk profile.

Performance & Disclosures

As of 12/31/13

Strategy	Quarter	YTD	1 - Year	3 - Year	5- Year
Aggressive Growth - Gross of Fees	8.5%	23.7%	23.7%	9.3%	14.9%
Aggressive Growth - Net of Fees[1]	7.7%	20.0%	20.0%	6.1%	11.5%
Benchmark - S&P 500	10.5%	32.4%	32.4%	16.2%	17.9%
Growth - Gross of Fees	6.6%	17.7%	17.7%	8.7%	13.7%
Growth - Net of Fees[1]	5.8%	14.2%	14.2%	5.5%	10.4%
Benchmark - S&P 500	10.5%	32.4%	32.4%	16.2%	17.9%
Growth and Income Taxable - Gross of Fees	4.9%	11.7%	11.7%	8.0%	12.5%
Growth and Income Taxable - Net of Fees[1]	4.1%	8.4%	8.4%	4.8%	9.2%
Benchmark - 70% S&P 500 and 30% ML Bond Index	7.2%	21.0%	21.0%	12.3%	14.0%
Income Taxable with Growth - Gross of Fees	2.9%	7.8%	7.8%	7.6%	11.4%
Income Taxable with Growth - Net of Fees[1]	2.1%	4.6%	4.6%	4.4%	8.1%
Benchmark - 40% S&P 500 and 60% ML Bond Index	4.0%	10.5%	10.5%	8.5%	9.9%

Confluence Investment Management LLC is an independent registered investment adviser. Past performance is not indicative of future results. The U.S. Dollar is the currency used to express performance. Returns are presented gross and net of all fees and include the reinvestment of all income.

[1]Net of fee performance was calculated using the highest applicable annual bundled fee of 3.00% applied quarterly. This fee includes brokerage commissions, portfolio management, consulting services and custodial services. The Confluence fee schedule for this composite is as follows: 0.40% on the first $500,000; 0.35% on the next $500,000; and 0.30% over $1,000,000. There are no incentive fees. Clients pay an all-inclusive fee based on a percentage of assets under management. The collection of fees produces a compounding effect on the total rate of return net of fees. Bundled fee accounts make up 100% of the composite for all periods. Actual investment advisory fees incurred by clients may vary. Wrap fee schedules are provided by independent wrap sponsors and are available upon request from the respective wrap sponsor.

Each strategy is implemented using Exchange Traded Funds (ETFs) and the investment objective is the pursuit of nominal returns (yield and growth) in excess of inflation, subject to the limitations of the risk constraint for each strategy. The targeted risk constraint and appropriate investor risk tolerance for each strategy is as follows; Aggressive Growth (High), Growth (Average), Growth and Income Taxable (Moderate), and Income with Growth (Conservative). ML Bond Index consist of Merrill Lynch US Corporate, Government, and Mortgage Bond Index.

Confluence claims compliance with the Global Investment Performance Standards (GIPS®). A complete list of composite descriptions and/or a GIPS compliant presentation is available by contacting Marketing@confluenceim.com or calling 314-743-5090.

There are investment risks in investing in these strategies. Each asset class has specific risks associated with it and no specific asset class can prevent a loss of capital in market downturns. In a rising interest rate environment, the value of fixed income securities generally declines. Speculative grade bonds are subject to greater risk of loss of principal and interest, including default risk, than higher-rated securities. Investments in international and emerging market securities include exposure to risks such as currency fluctuations, foreign taxes and regulations, and the potential for illiquid markets and political instability. The real estate asset class is a portfolio containing Real Estate Investment Trust (REIT) securities.

Confluence utilizes fixed income ETFs for the bond asset classes to deliver the income and lower volatility traditionally available from a diversified bond portfolio. Fixed income ETFs are not bonds, but are pro-rata interests in publicly traded bond funds. Investors should be aware there are limitations in utilizing fixed income ETFs. There may be times when an ETF's performance may vary relative to its targeted benchmark. And while ETFs generally trade very close to their net asset values, during times of market disruption they can trade at discounts or premiums, directly affecting performance. Liquidity can vary depending upon market conditions.

Information provided in this report is for educational and illustrative purposes only and should not be construed as individualized investment advice or a recommendation. The investment or strategy discussed may not be suitable for all investors. Investors must make their own decisions based on their specific investment objectives and financial circumstances. Opinions expressed are current as of the date shown and are subject to change.

*Benchmark return and volatility calculations utilize monthly data through 12/31/13. Investors cannot invest directly in an index. Past performance does not guarantee future performance. Asset class and benchmark index representation: cash (ML T-Bill); short-term bonds (ML 0-3 Year C/G); intermediate bonds (ML 3-5 Year C/G); long-term bonds (ML 10+ C/G); speculative grade bonds (ML High Yield Master); real estate (FTSE NAREIT Equity); large cap (S&P 500); mid cap (S&P MidCap 400); small cap (Russell 2000); foreign developed country (MSCI EAFE); emerging markets (MSCI Emerging Market); commodities (Dow Jones UBS Commodity). The yield chart data are as of January, 2014. Representations: U.S. stocks are the S&P 500; foreign stocks are the average of developed country and emerging markets.

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Confluence Investment Management LLC 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.