Confluence INVESTMENT MANAGEMENT

SECOND QUARTER
2022

All Cap Value • Value Equity Strategies

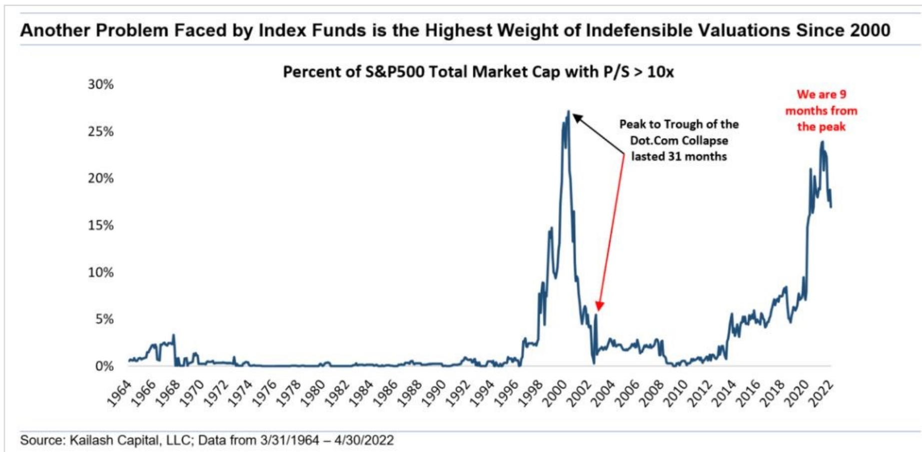
All Cap Value is focused on companies that range in market capitalization to create a diversified portfolio of businesses with capital appreciation potential. These companies are selected using a bottom-up, fundamental research process that seeks to identify individual businesses that possess substantial competitive advantages and are trading at discounts to our estimate of intrinsic value. The portfolio typically comprises 30-35 holdings and is expected to result in low to moderate turnover. The strategy is appropriate for clients whose primary objective is capital appreciation and whose secondary objective is dividend income.

Market Commentary

"Many shall be restored that now are fallen, and many shall fall that now are in honor."

- Horace, "Ars Poetica." The epigraph to Ben Graham's book *Security Analysis*.

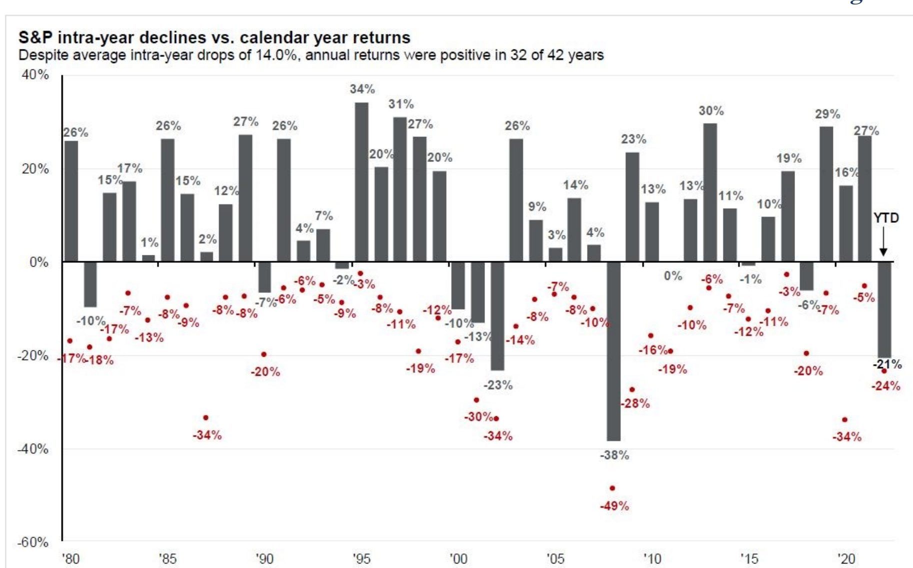
Figure 1



The first half of 2022 witnessed a sharp market pullback, with the S&P 500 Index down 20%. It was also the first consecutive quarterly decline in the S&P 500 since the Great Financial Crisis (GFC) of 2008-2009 and marks a sharp shift in sentiment following exceptional returns that averaged 16% from 2009-2021 following the GFC. Even more remarkable, the most recent five-year period from 2017 to 2021 averaged 19%—over twice the average annual return of 9% for the S&P 500 dating back to 1871 (data from *Kailash Concepts*). Of course, this period was afforded low inflation, which abetted accommodative monetary and fiscal policies that, in turn, favored financial assets. While the recent stimulus prevented a severe recession in 2020, the sheer size relative to the economy fostered pockets of excessive exuberance as many investors shifted their focus to what was *possible* as opposed to what was *probable*. This first chart from *Kailash Concepts* (*Figure 1*) highlights the extreme valuations that developed in a larger percentage of the markets and are now unwinding. Investors are beginning to restore and re-emphasize the fundamentals of valuations.

Figure 2

The recent pullback may be uncomfortable, but it is not uncommon, and provides a healthy cleansing of the prior excesses. It is during these market corrections that selling is generally broad-based, pulling down both the good and the bad. After all, when the bank calls, you sell what you can, not what you want. As time progresses, fundamentals and valuations begin to matter, and the wheat is separated from the chaff. This next chart from J.P. Morgan Asset Management (*Figure 2*) provides a good perspective of the annual intra-year declines dating back to 1980. Given the various pockets of excess, the current pullback is part of a healthy process and provides opportunities for long-term investors.

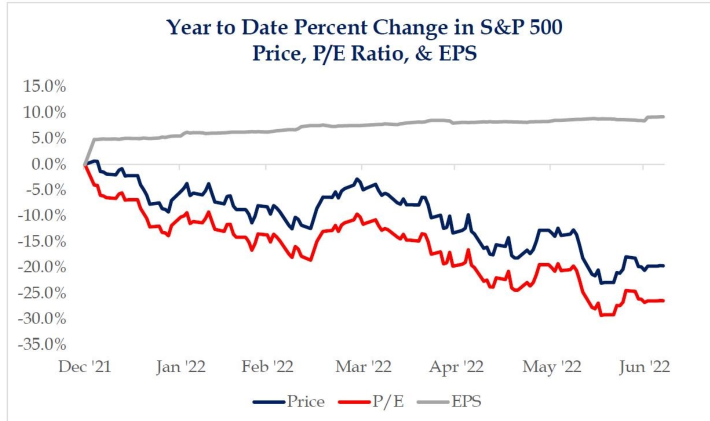


(Chart source: J.P. Morgan Asset Management; Guide to the Markets - U.S., Data as of June 30, 2022)

Market Commentary continued...

The main culprit behind the pullback is inflation! More specifically, its persistence is prodding expectations of higher levels of inflation which would ultimately reduce the present value of future cash-flow streams as well as create added uncertainty for businesses and consumers. This should naturally result in lower equity valuations, *ceteris paribus* (all other things being equal), which is occurring with the pullback. As this chart from Strategas reflects (*Figure 3*), the pullback was driven by a contraction in multiples and not a decrease in earnings as earnings per share rose in the mid-single-digits.

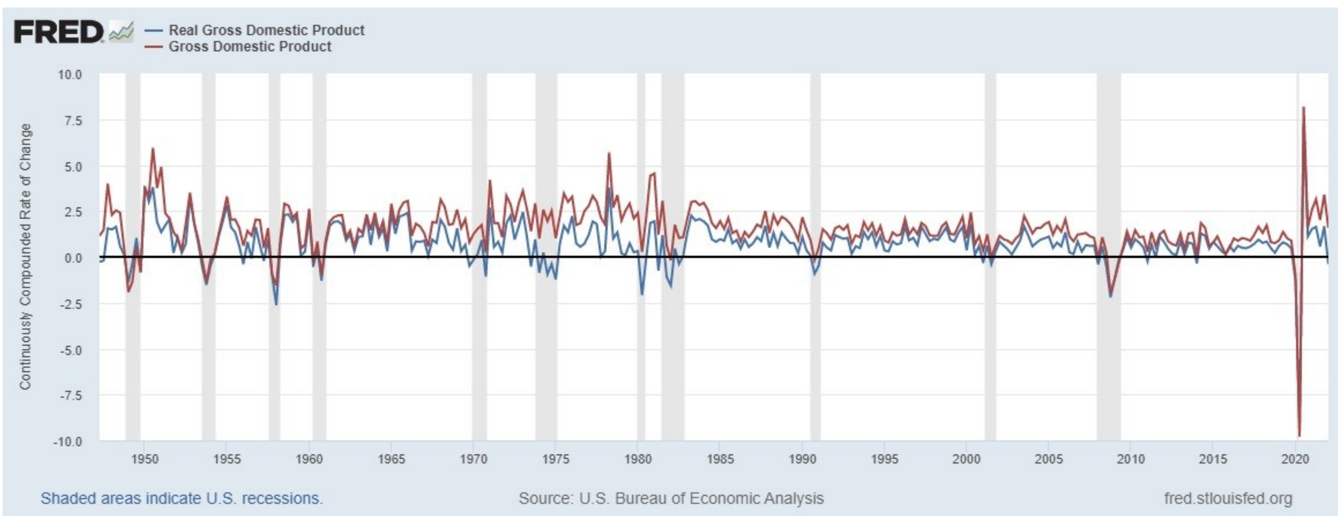
Figure 3



(Source: Strategas; 7/8/2022)

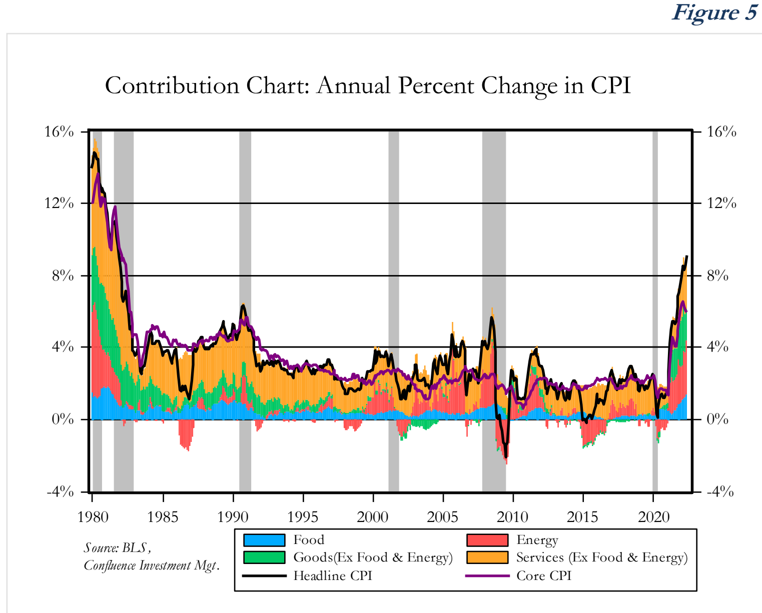
It is worth noting that in an environment of high inflation, a shallow recession can result in nominal GDP growth as mid-to-high single-digit inflation could mask a real GDP decline. This scenario occurred a few times between 1969 and 1982, which was also the last time we had high levels of inflation. [See *Figure 4* below, where Nominal GDP, red line, is above zero, and Real GDP, blue line, is below zero.] During the first quarter of 2022, real gross domestic product (GDP) did decrease at an annual rate of 1.6%, while revenue and earnings grew in nominal terms.

Figure 4



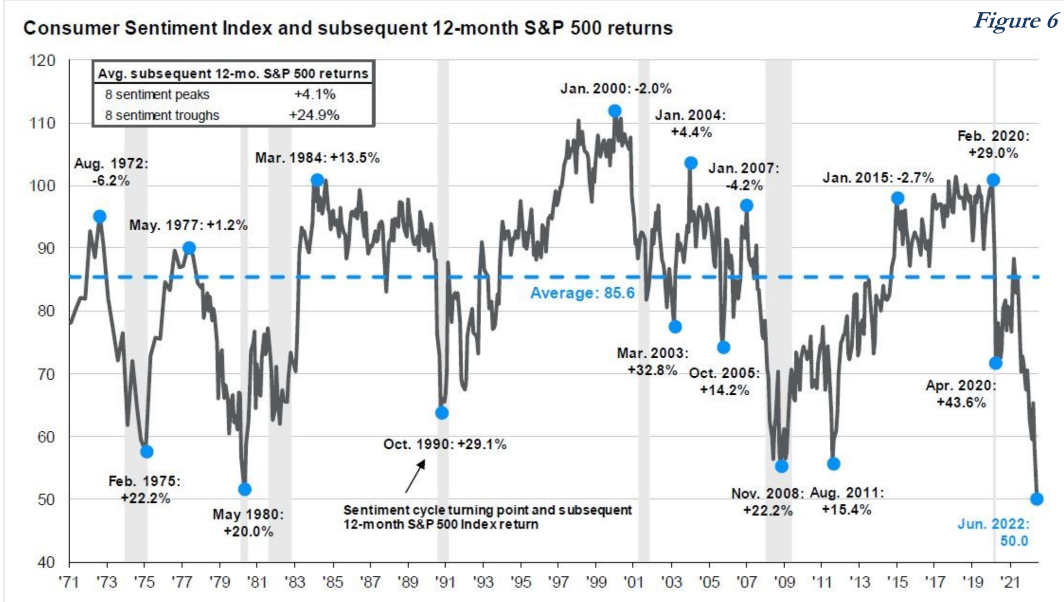
Interestingly, inflation has not been center stage since the 1970s and early 1980s. This chart of the Consumer Price Index from Confluence's macro team (*Figure 5*), shows the history of inflation and its key contributors dating back to 1980. The chart reveals that inflation was relatively benign leading up to the most recent couple of years, which is why the Federal Reserve believed inflation would be transitory. In fact, the Goods component (shown in green) is an atypically large contributor to current inflation as demand for Goods has been elevated by fiscal stimulus, while consumer spending was redirected away from services due to pandemic restrictions. Energy (red) has also contributed to the recent inflationary pressures as geopolitical issues have been impacted by the supply of oil following the Russian invasion of Ukraine and the ensuing sanctions. It is important to note that Energy is excluded from Core CPI as it is often impacted by short-term geopolitical issues that cause extreme volatility, both good and bad; therefore, monetary policy response would offer little to no utility. Going forward, the focus will be on changes that may impact the structure of inflation, such as de-globalization/regionalism and de-regulation/regulation surrounding technology. The Confluence macro team discusses these topics regularly in their various reports, so be sure to follow their publications (*Daily Comment, Bi-Weekly Geopolitical Report, Weekly Energy Update,* etc.) on the **Research & News** section of our website.

Figure 5

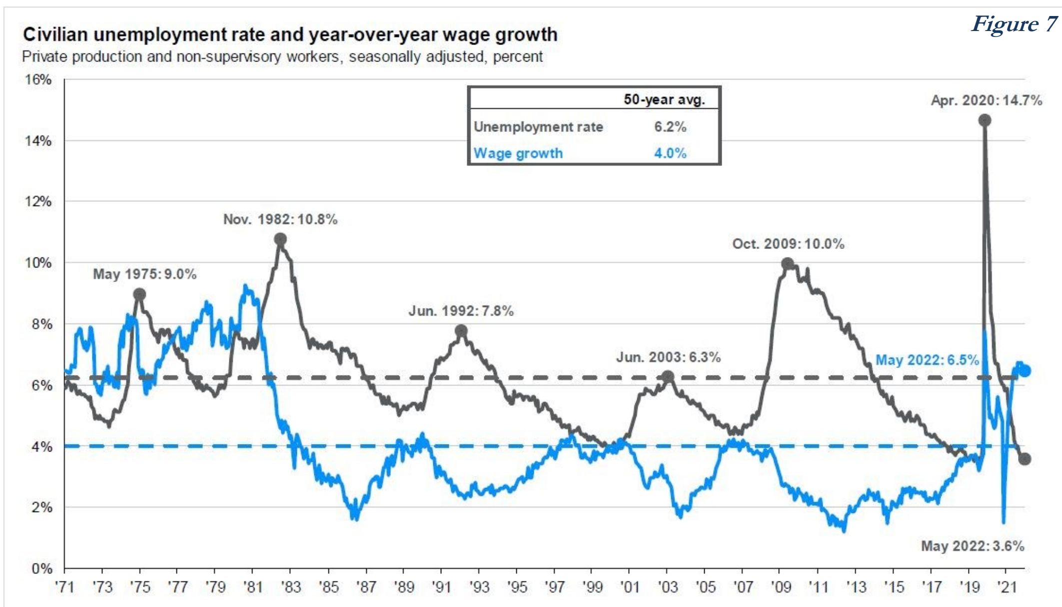


Market Commentary continued…

Inflation is also weighing on consumer confidence as reflected in the University of Michigan's Consumer Sentiment Index, which is currently at a multi-decade low. Consumer sentiment is influenced by unexpected rises in inflation since it acts as a stealth tax and disproportionately impacts lower income earners who spend more of their income on basic goods and services. This chart *(Figure 6)* overlays the subsequent 12-month equity returns at peaks and troughs in the survey. The data reveals a contrarian bias, i.e., trough confidence produces better returns over the ensuing 12-months than peaks.

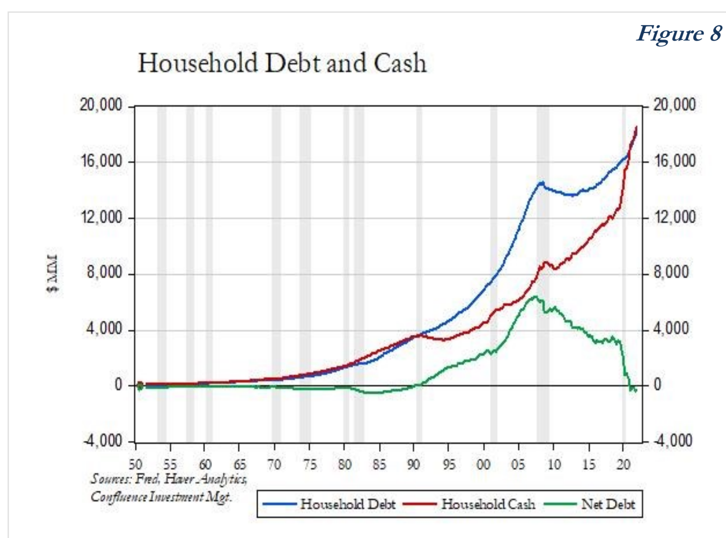


Although the probability of a recession has increased due to inflation remaining stubbornly high, which requires more restrictive monetary policy, it is important to remember that these actions are the result of strong demand which is pushing against constrained supply chains. Unemployment remains near historic lows and wage growth is strong (see *Figure 7*)—there are two job openings for every job seeker—and households are in the best shape in decades (see *Figure 8*). None of the postwar expansions died of natural causes but rather the result of monetary policy intended to stem incipient inflation. However, due to the underlying strength of demand and tight labor markets, the result is likely a shallow recession.



(Figures 6 and 7 chart source: J.P. Morgan Asset Management; Guide to the Markets - U.S., Data as of June 30, 2022)

The past few years have been yet another reminder of the difficulties in forecasting the future and the impact that emotions have on investor sentiment as they shifted from panic in the spring of 2020 to euphoria following the stimulus and reopening of the economy. Investor sentiment was very strong leading into 2022, supported by cash on the sidelines that entered the market and led to areas of excess that are now being purged. We view it as a healthy process, albeit frustrating in the near-term as selling has been indiscriminate. At Confluence, the leadership team has been at the helm since our process began in 1994 and navigated prior cycles with the same consistent application of our investment philosophy. This investment approach implicitly acknowledges the difficulties in forecasting and instead focuses on understanding businesses and what they are worth, with an emphasis on owning companies with substantial competitive advantages that are trading at a discount to intrinsic value. For long-term investors, it is important to maintain a proper perspective of the recent volatility. Rest assured that Confluence remains committed to our disciplined investment process that has served our clients well through uncertain times.



Strategy Commentary

The Confluence All Cap Value strategy was down 12.8% (gross of fees) in the second quarter of 2022, outperforming the S&P 500 Index which was down 16.1% for the quarter and in line with the Russell 3000 Value Index which was down 12.4%. On a year-to-date basis, All Cap Value posted a loss of 19.1% (gross of fees) compared to the S&P 500, which fell 20.0%, and the Russell 3000 Value, down 13.2%. [*Net-of-fees returns for the same periods were -13.5% QTD and -20.3% YTD. See disclosures on last page for fee description; actual investment advisory fees may vary.*]

During the second quarter, a bear market (defined as a 20% decline from the market high) set in as the stock market began to take higher interest rates more seriously. With strong consumer balance sheets and insatiable demand, the Fed has pledged to raise interest rates enough to soften demand and bring down inflation, prompting concerns that this will result in a recession. As for the stock market, it appears the speculative fever has broken with valuations moving back toward long-term averages and speculations declining; one example was Bitcoin which fell 73% from its high last November.

For the first half of 2022, the Confluence All Cap Value strategy has performed roughly in line with the broad markets, as measured by the S&P 500, as investors moved toward quality companies with attractive valuations, strong cash flow, low leverage, and dividends, and they began to move away from expensive high-growth stocks and speculation. In particular, the strategy's outperformers year-to-date were several property and casualty insurance holdings in the Financials sector, including W.R. Berkley (WRB), Progressive (PGR), and Markel (MKL). Other top contributors included discount retailer Dollar Tree (DLTR) and Energy sector company Kinder Morgan (KMI). The weakest contributors thus far in 2022 have tended to be great companies with valuation multiples that have contracted to very attractive levels: Lowe's Companies (LOW), NXP Semiconductors N.V. (NXPI), Brookfield Asset Management (BAM), Alphabet (GOOG), and Starbucks (SBUX). *[See contribution data on the next page.]*

In early April, CarMax was added to the portfolio. CarMax is the nation's largest buyer and seller of used cars, with a market cap of around $15 billion. Through a network of 230 retail locations, it offers prospective car buyers a deep selection of vehicles coupled with transparent pricing and a low-pressure sales environment. The company has historically competed against traditional dealers as its superior scale and data confer a host of competitive advantages. Its no-haggle pricing offers a better buying experience and self-selects a consumer that values convenience over pinching pennies. CarMax has recently developed omni-channel capabilities, allowing consumers to buy in-person or online.

CarMax has a history of earning consistent unit profitability regardless of prevailing used car prices. It is focused on gross profit per car rather than margin percentages. For example, since 2010, the average price of a used car has ranged from $17,000 to $20,000. Over this period, the company has achieved a relatively steady gross profit per car of around $2,000 to $2,200. Despite the average price of a used car spiking nearly 30% over the last year, CarMax continues to earn the same $2,200 in gross profit per car. This stands in contrast to some high-profile, new entrants such as Carvana and Vroom, which despite much fanfare have struggled to achieve self-sustaining profitability. CarMax has a track record of prudent management, possesses attractive returns on capital, and consistently buys back stock with excess free cash flow. The company's consistent playbook is responsible for significant value creation over multiple decades. With <5% market share, we believe there is plenty of runway for CarMax to compound value over the long term as used car prices and availability normalize.

Outlook

High prices for gas, cars, and houses have begun to weigh on consumer sentiment as it has dropped to an all-time low dating back to 1952. In the second half of 2022, inflation will likely decline from 40-year highs, but the economy will be more widely impacted by rising interest rates. As a result, the next stage of the bear market could come from weak earnings per share on top of the valuation multiple contraction that occurred in the first half. If this occurs, it could provide opportunities to buy great companies at very attractive valuations.

In All Cap Value, we continue to focus on owning quality businesses with capable management teams and competitive advantages that facilitate pricing power. Fortunately, the stock market favored these types of investments in the second quarter and will likely continue to do so as markets unwind years of speculation. Most stocks decline in a bear market, but these losses should be temporary for the high-quality, growing, reasonably valued companies that we look to own. As for the highly valued speculations we look to avoid, bear market declines will likely result in a permanent loss of capital for their investors. Of course, we remain focused on our core strength, which is analyzing and valuing businesses.

Contribution[1]

(YTD as of 6/30/2022)

The top contributors and detractors for the portfolio thus far in 2022 are shown in this table:

Security	Avg Weight (%)	Contribution (%)
Top 5		
W. R. Berkley Corp.	3.64	0.65
Dollar Tree Inc.	3.51	0.49
Progressive Corp.	3.34	0.36
Markel Corp.	2.87	0.10
Kinder Morgan Inc.	1.97	0.09
Bottom 5		
Starbucks Corp.	2.45	(0.97)
Alphabet Inc. (Class C)	4.10	(1.02)
Brookfield Asset Management Inc.	3.76	(1.02)
NXP Semiconductors N.V.	2.80	(1.06)
Lowe's Cos. Inc.	4.55	(1.56)

(Contribution data shown from a sample account, based on individual stock performance and portfolio weighting)

Performance Composite Returns[2] (For Periods Ending June 30, 2022)

	Since Inception**	15-Year*	10-Year*	5-Year*	3-Year*	1-Year	YTD	QTD
All Cap Value *Pure Gross-of-Fees[3]*	9.3%	9.2%	12.6%	10.1%	8.9%	(10.0%)	(19.1%)	(12.8%)
Net-of-Fees[4]	6.1%	6.0%	9.2%	6.9%	5.6%	(12.7%)	(20.3%)	(13.5%)
S&P 500	8.9%	8.5%	12.9%	11.3%	10.6%	(10.6%)	(20.0%)	(16.1%)
Russell 3000 Value	7.2%	6.1%	10.4%	7.0%	6.8%	(7.5%)	(13.2%)	(12.4%)

Calendar Year	Pure Gross-of-Fees[3]	Net-of-Fees[4]	S&P 500	R3000 Value	Difference (Gross-S&P500)	# of Portfolios	Composite Assets (000s)	Total Firm Assets (000s)	Composite 3yr Std Dev	S&P 500 3yr Std Dev	R3000V 3yr Std Dev	Composite Dispersion
2005	2.4%	(0.4%)	4.9%	6.9%	(2.5%)	242	$27,603		N/A	N/A	N/A	0.5%
2006	14.4%	11.3%	15.8%	22.3%	(1.4%)	224	$26,916		N/A	N/A	N/A	0.6%
2007	4.6%	1.8%	5.5%	(1.0%)	(0.9%)	220	$27,835		6.9%	7.7%	8.3%	0.7%
2008	(26.9%)	(28.9%)	(37.0%)	(36.2%)	10.1%	19	$1,778	$291,644	13.9%	15.1%	15.5%	N/A
2009	26.8%	23.0%	26.5%	19.8%	0.3%	33	$11,558	$533,832	18.6%	19.6%	21.3%	2.8%
2010	9.7%	6.4%	15.1%	16.3%	(5.4%)	41	$13,980	$751,909	21.0%	21.9%	23.5%	0.5%
2011	3.6%	0.5%	2.1%	(0.1%)	1.5%	40	$14,294	$937,487	18.4%	18.7%	21.0%	0.6%
2012	18.0%	14.5%	16.0%	17.6%	2.0%	40	$11,654	$1,272,265	14.6%	15.1%	15.8%	0.3%
2013	35.3%	31.3%	32.4%	32.7%	2.9%	73	$22,893	$1,955,915	11.2%	11.9%	12.9%	0.7%
2014	14.7%	11.3%	13.7%	12.7%	1.0%	119	$34,036	$2,589,024	8.8%	9.0%	9.4%	0.4%
2015	0.1%	(2.9%)	1.4%	(4.1%)	(1.3%)	207	$50,568	$3,175,419	10.0%	10.5%	10.7%	0.6%
2016	14.2%	10.8%	12.0%	18.4%	2.2%	345	$91,109	$4,413,659	9.7%	10.6%	11.0%	0.6%
2017	15.7%	12.3%	21.8%	13.2%	(6.1%)	649	$167,342	$5,944,479	8.7%	9.9%	10.3%	1.1%
2018	(5.2%)	(8.0%)	(4.4%)	(8.6%)	(0.8%)	689	$168,742	$5,486,737	10.1%	10.8%	11.1%	0.6%
2019	35.6%	31.6%	31.5%	26.2%	4.2%	818	$262,167	$7,044,708	11.7%	11.9%	12.0%	1.1%
2020	17.3%	13.8%	18.4%	2.9%	(1.1%)	953	$333,804	$6,889,798	18.5%	18.5%	20.0%	0.9%
2021	23.4%	19.7%	28.7%	25.3%	(5.3%)	1,084	$422,786	$7,761,687	17.5%	17.2%	19.3%	0.6%

**Average annualized returns*
***Inception is 1/1/2005*

See performance disclosures on last page.

Portfolio Benchmarks

S&P 500® Index – A capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

Russell 3000® Value Index – A capitalization-weighted index designed to measure performance of those Russell 3000® Index companies with lower price-to-book ratios and lower forecasted growth values. *(Source: Bloomberg)*

Disclosures

Market & Strategy Commentary—Information is presented as supplemental information to the disclosures required by GIPS® standards. Individual holding performance and contribution methodology as well as a list of every holding's contribution to the strategy can be obtained by contacting Confluence. 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. Past performance is no guarantee of future results.

Investment or investment services mentioned may not be suitable to an investor and the investor should seek advice from an investment professional, if applicable. It is important to review your investment objectives, risk tolerance, and liquidity needs before choosing an investment style or manager. All investments carry a certain degree of risk, including possible loss of principal, that investors should be prepared to bear. Equity securities are subject to market risk and may decline in value due to adverse company, industry, or general economic conditions. There can be no assurance that any investment objective will be achieved or that any investment will be profitable or avoid incurring losses.

Indices: The S&P 500 Index and Russell 3000 Value Index are shown as additional information. These indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only & do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance.

[1] **Contribution—**Table showing the top 5 contributors/detractors reflects the strategy's best and worst performers, based on each holding's contribution to the sample account for the period stated. Holdings identified do not represent all of the securities purchased, sold or recommended. Individual client portfolios in the strategy may differ, sometimes significantly, from these listings. Contact Confluence for a complete list of holdings.

[2] **Performance Composite Returns—Confluence Investment Management LLC claims compliance with the Global investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. Confluence Investment Management LLC has been independently verified for the periods August 1, 2008, through December 31, 2021. The verification report is available upon request. A firm that claims compliance with the GIPS standards must establish policies and procedures for complying with all the applicable requirements of the GIPS standards.**

Verification provides assurance on whether the firm's policies and procedures related to composite maintenance, as well as the calculation, presentation, and distribution of performance, have been designed in compliance with the GIPS standards and have been implemented on a firm-wide basis. Verification does not provide assurance on the accuracy of any specific performance report.

GIPS® is a registered trademark of CFA Institute. CFA Institute does not endorse or promote this organization, nor does it warrant the accuracy or quality of the content contained herein.

The All Cap Strategy was incepted on January 1, 2005, and the current All Cap Value Composite was created on August 1, 2008. Performance presented prior to August 1, 2008, occurred while the Portfolio Management Team was affiliated with a prior firm and the Portfolio Management Team members were the primary individuals responsible for selecting the securities to buy and sell. Confluence Investment Management LLC is an independent registered investment adviser. Results are based on fully discretionary accounts under management, including those accounts no longer with the firm. 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.

[3] Pure gross returns are shown as supplemental information to the disclosures required by the GIPS® standards.

[4] Net-of-fee performance was calculated using the highest applicable annual bundled fee of 3.00% applied quarterly (2.75% prior to 7/1/08). This fee includes brokerage commissions, portfolio management, consulting services and custodial services. The Confluence fee schedule for this composite is as follows: 0.60% on the first $500,000; 0.55% on the next $500,000; and 0.50% 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.

A complete list of composite descriptions is available upon request. Policies for valuing investments, calculating performance, and preparing GIPS Reports are available upon request. The annual composite dispersion is an equal-weighted standard deviation, using gross-of-fee returns, calculated for the accounts in the composite for the entire year. The three-year annualized standard deviation measures the variability of the composite gross returns over the preceding 36-month period. The All Cap Value Composite contains fully discretionary All Cap Value wrap accounts. All Cap Value is a value-based, bottom-up portfolio that utilizes stocks from all market capitalizations.

N/A-Composite Dispersion: Information is not statistically meaningful due to an insufficient number of portfolios in the composite for the entire year. N/A-3yr Std Dev: Composite does not have 3 years of monthly performance history.

Prior to August 1, 2008, the composite was named the All Cap Global Composite. Effective August 1, 2008, the composite definition was changed to no longer emphasize global ADRs but the underlying portfolio and strategy did not change.

About Confluence Investment Management LLC

Confluence Investment Management is an independent Registered Investment Advisor located in St. Louis, Missouri, that provides professional portfolio management and advisory services to institutional and individual clients. Confluence's investment philosophy is based upon independent, fundamental research that integrates evaluation of market cycles, macroeconomics and geopolitical analysis with the firm's value-driven, company-specific approach. The portfolio management philosophy begins by assessing risk and follows through by positioning clients to achieve their income and growth objectives.

Confluence Value Equities Investment Committee

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