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

"Interest rates are to asset prices what gravity is to the apple. When there are low interest rates, there is a very low gravitational pull on asset prices."

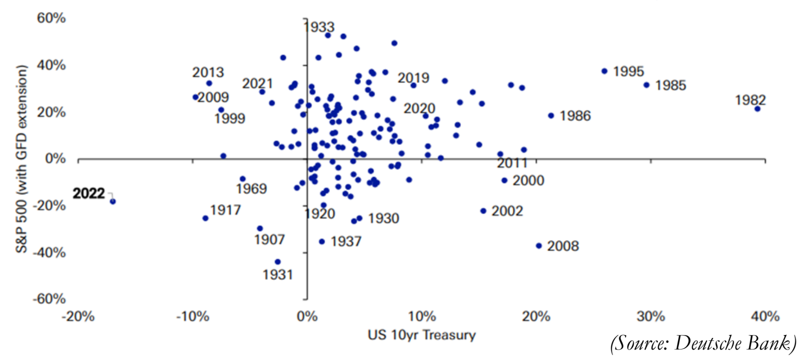
- Warren Buffett

2022 was a difficult year for financial assets as stocks and bonds experienced sharp declines, while commodities rallied. The primary culprit was the persistent rise in inflation that forced the Federal Reserve to shift monetary policy quickly and aggressively to a more restrictive stance. This shift occurred after an elongated period of accommodative policy following the Great Financial Crisis of 2008 that markedly benefited financial assets. The upward adjustment to inflation and inflation expectations as well as tightening Fed policy elevated the risk of a slowdown or recession, which explains the poor performance of financial assets this past year.

Putting the year into perspective, 2022 was the first year since 1872 that the S&P 500 and the 10-year Treasury lost more than 10% on a total return basis for a full calendar year, posting losses of 18.1% and 17.0%, respectively. This chart from Deutsche Bank (*Figure 1*) is a scatterplot of calendar year performance since 1872, demonstrating how 2022 was truly an outlier.

Figure 1

Annual Total Return Performance of the S&P 500 & 10-Year Treasury Since 1872

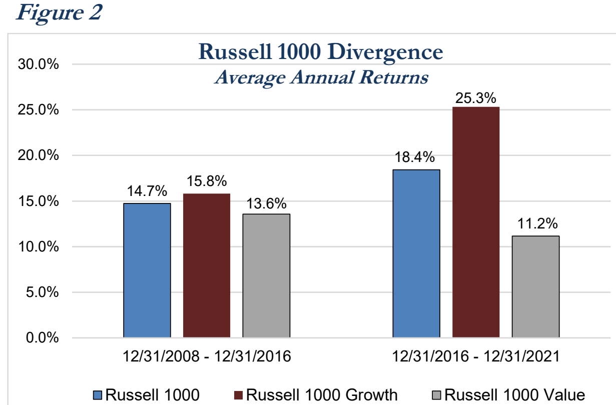


(Source: Deutsche Bank)

Delving deeper, the catalyst behind the headwinds was the sharp and sustained rise in inflation that prompted a dramatic shift in Fed policy. Inflation had been subdued over much of the past four decades as globalization, deregulation, and innovation led to a disinflationary environment which allowed for accommodative monetary policy. That all changed in 2022 as the FOMC increased the fed funds rate by a robust 4.25% over the course of the year and switched from quantitative easing to tapering via liquidating assets to reduce its balance sheet. Underlying these policy changes was a shift in the nature of inflationary pressures. These pressures were initially perceived as "transitory" (resulting from the economy reopening post-COVID and supply constraints) but now appear to stem from structural concerns emanating from geopolitical issues challenging globalization and a shift toward a more fractured, multipolar world.

The protracted length of time and magnitude of the accommodative monetary policies dating back to 2008 provided a strong tailwind that primarily benefited financial assets, specifically domestic equity markets, and fostered speculation which created pockets of excess exuberance. This preceding period should be viewed in context with the losses incurred in 2022. More specifically, from the end of 2008 through 2016, the returns in the domestic markets were broad-based and well above the historical average, which is approximately 10%, with the Russell 1000, Russell 1000 Growth, and Russell 1000 Value indexes generating average annual returns of 14.7%, 15.8%, and 13.6%, respectively. However, a frenzy began to emerge from the end of 2016 through 2021, with the Russell 1000 Index posting an average annual return of 18.4% and a wide divergence developing between growth and value. During this period, the Russell 1000 Growth Index dramatically outperformed the Russell 1000 Value Index at 25.3% versus 11.2%, respectively.

Figure 2



(Sources: Bloomberg, Confluence)

Market Commentary continued...

If readers will recall, the Zero Interest Rate Policy (ZIRP) and Quantitative Easing (QE) policies began in late 2008 and lasted until December 2015 when the first rate increase of 25 bps transpired. The next rate increase did not occur until December 2016, with the Fed signaling additional increases throughout 2017. It was at this point that concerns arose of an economic slowdown or recession, prompting investors to lean toward businesses with higher-growth profiles, which were perceived to be more capable of weathering a slowdown. The rate hikes promptly ended in December 2018 as liquidity concerns surfaced, and the Fed was forced to cut rates from 2.25% to 1.5% in 2019. Of course, this was followed by the events of 2020 which infused mass liquidity (monetary and fiscal) and shifted investor attention to the few businesses that were benefiting from the lockdowns—the same growth-oriented tech names which then rallied through 2021. The Fed's aggressive actions in 2022, raising rates seven times to 4.25%-4.50% by year-end, deflated much of the excess exuberance of the mega-cap tech names as well as other speculative areas, such as the Wall Street Bets/Reddit names, electric vehicles, SPACs, and crypto. This first chart from Kailash Capital (*Figure 3*) reflects the concentration in the largest 30 names by comparing their market caps to GDP over the past 30+ years. The next chart from Kailash (*Figure 4*) demonstrates the speculation that formed in unprofitable businesses in the smaller cap arena.

Figure 3

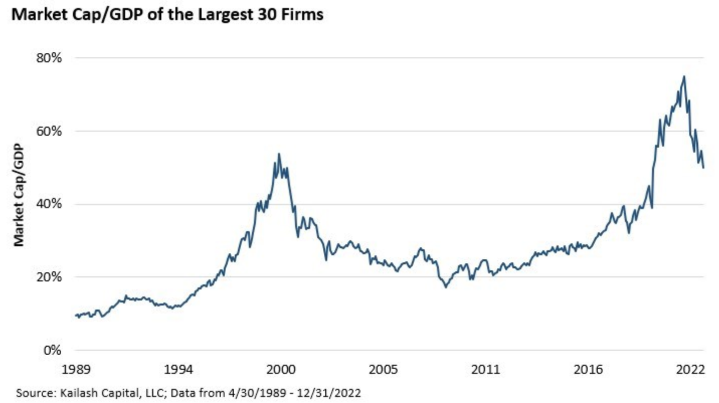


Figure 4

(Source: Kailash Capital)

The curtailment of accommodative monetary policies in 2022 marked the end of the tailwinds for long-duration assets (stocks and bonds), hence, the sharp losses in fixed income and equities, particularly in businesses with cash flow expected in the outer years, i.e., "growth" stocks. The markets also faced geopolitical challenges during the past year as Russia invaded Ukraine, which disrupted commodity markets and drove commodity and materials prices higher. These events led to a market rotation from mega-cap growth toward cyclical value as evidenced by the Russell 1000 Growth posting a loss of 29.1% relative to the Russell 1000 Value's loss of 7.6%. Delving into the sectors, Energy (+65.7%) and Utilities (+1.6%) were the only two sectors to post positive results, while Consumer Discretionary (-37.0%) and Communication Services (-39.9%) were the laggards. The varying sector weightings in the indexes explain the relative performance as the table below from J.P. Morgan Asset Management exhibits (*Figure 5*).

Figure 5 **Returns and Valuations by Sector**

	Energy	Materials	Financials	Industrials	Cons. Disc.	Tech.	Comm. Services*	Real Estate	Health Care	Cons. Staples	Utilities	S&P 500 Index
S&P weight	**5.2%**	**2.7%**	**11.7%**	**8.7%**	**9.8%**	**25.7%**	**7.3%**	**2.7%**	**15.8%**	**7.2%**	**3.2%**	**100.0%**
Russell Growth weight	1.7%	1.5%	3.3%	8.1%	14.2%	43.2%	6.8%	1.6%	13.5%	6.1%	0.1%	100.0%
Russell Value weight	8.4%	4.3%	20.1%	10.5%	6.0%	8.3%	7.3%	4.5%	17.4%	7.4%	5.8%	100.0%
Russell 2000 weight	6.8%	4.3%	17.2%	15.6%	10.4%	12.7%	2.6%	6.4%	16.9%	3.6%	3.5%	100.0%
4Q22	22.8	15.0	13.6	19.2	-10.2	4.7	-1.4	3.8	12.8	12.7	8.6	7.6
2022	65.7	-12.3	-10.5	-5.5	-37.0	-28.2	-39.9	-26.1	-2.0	-0.6	1.6	-18.1

(Source: J.P. Morgan Asset Management; Guide to the Markets®, U.S. 1Q 2023, as of December 31, 2022)

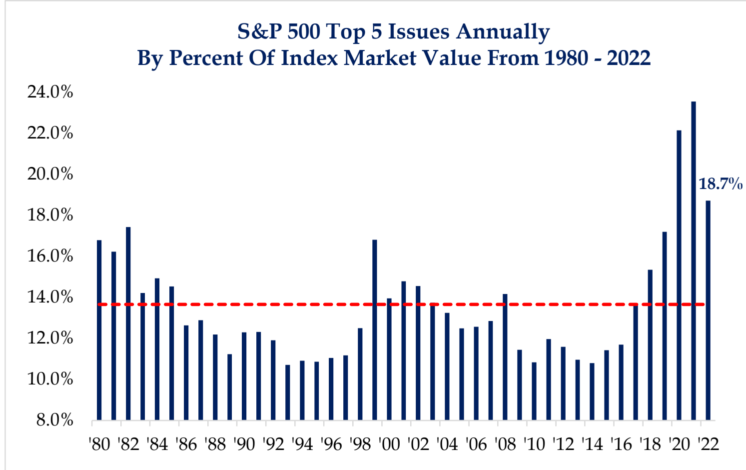
As we move into 2023, there is an elevated probability of a recession sometime this year (see our *Current Perspectives* report, "The 2023 Outlook: A Recession Year") as the Fed remains in tightening mode as policymakers seek to contain inflation and maintain credibility. No one knows the exact level of rates needed to tame inflation or inflation expectations, despite the constant fodder amongst economists, but equity markets have historically been a leading indicator for the economy. The sharp drop in equity markets in 2022 may have already marked the coming recession. More importantly, with monetary policy normalizing, the value of fundamental analysis and investing with a margin of safety will likely regain focus, which should benefit good active management. Meanwhile, the pullback is presenting more attractive valuations for high-quality companies. Of course, we will continue to stay focused on our investment philosophy, which has always been centered on business and valuation analysis.

Strategy Commentary

Confluence All Cap Value gained 8.7% in the fourth quarter of 2022 and ended the year down 16.2% (both gross of fees), outperforming the S&P 500 Index, which was up 7.5% in Q4 and declined 18.1% for the full year. [*Net-of-fees returns for the same periods were 7.9% QTD and -18.7% YTD. See disclosures on last page for fee description; actual investment advisory fees may vary.*]

It appears that the irrational exuberance of 2020 finally deflated in 2022. Like most speculative frenzies throughout history, this one was fueled gradually by the Fed's zero interest rate policy (ZIRP) for over a decade, which supported highly valued, high-growth technology companies (e.g., FAANG+). We have often discussed how the speculative party really got going in 2017 and led to a blowout in 2020, propelled by trillions of dollars in pandemic stimulus (see *Figures 3-4* in the previous section). As the work from Strategas reflects in this chart (*Figure 6*), the top five names in the S&P 500 increased their weighting from low double-digits (11% in the early days of ZIRP in 2010) to over 22% in 2021 and retreated to 18.7% in 2022.

Figure 6



(Source: Strategas; 12/31/2022)

While inflation and dramatic rate increases from the Fed brought this party to an end in 2022, the good news is that Confluence's value equity portfolios watched the craziness from the sidelines. As a result, in 2022, Confluence All Cap Value outperformed the S&P 500 for the year. Although a negative return for the year is never desired, All Cap Value avoided the speculation and permanent losses discussed above, so the high-quality, growing businesses in the portfolio should more quickly rebound and continue to compound for the long term. Put another way, our quality value investment philosophy aims to own stocks that bounce like tennis balls coming out of a down market, not like tomatoes that go splat at the bottom.

For the full year, All Cap Value's outperformance relative to the S&P 500 was driven by our holdings in the Financials and Consumer Discretionary sectors. In particular, Consumer Discretionary holdings Dollar Tree and TJX Companies were up single-digits for the year, while the index's largest holdings in the sector, Amazon and Tesla (with market caps of $1.7 trillion and $1.1 trillion to begin 2022!), were down 50% and 65%, respectively. Notably, our focus on property and casualty insurers provided robust returns in the Financials sector, with W. R. Berkley and Progressive as the strongest contributors in the portfolio. During the fourth quarter, outperformance was also led by a few names in the Information Technology sector that were down only single-digits versus the 28% overall sector decline in the market. This portfolio outperformance was partially offset by less exposure to the Energy and Health Care sectors, which were among the top-performing sectors in 2022. [*See contribution data on the next page.*]

Although our All Cap Value strategy performed well against the broad market, as measured by the S&P 500, it did lag the Russell 3000 Value Index, down 8.0%, in 2022. The primary detractor relative to the value index was the lack of exposure to the Energy sector. Regarding commodities, in general, our investment philosophy is focused on competitively advantaged companies which often steers us away from commodity-oriented and highly regulated industries as their competitive landscapes inherently hinder their ability to generate above-average returns on capital over long periods. This philosophy instead guides us toward entities operating in niche or oligopolistic markets where they have pricing power, which allows them to produce above-average returns on capital. Our process tends to result in a higher-quality portfolio of businesses; for instance, Confluence All Cap Value fared well when compared to factor ETFs focused on high quality, such as the iShares MSCI USA Quality Factor ETF (QUAL), which was down 20.5% for the year.

During the fourth quarter, we were able to opportunistically add to underweight positions as the market hit new lows in October. We are also making an addition to the portfolio that is still in process, which we can discuss in a future report. In this down market, there are several great businesses we are watching closely as they approach valuations that should provide a solid margin of safety.

Outlook

The speculative craze in 2020 has many similarities to the tech bubble of 2000, one being that it could take a few years to wash out the die-hard speculators, many of whom are relatively new to investing. From an economic perspective, two key differences from 2000 versus today are the currently high inflation and rising interest rates, but these will likely moderate in 2023, with or without a mild recession like the one the U.S. experienced in 2001.

As markets work off the excess speculation, long-term investors are again attracted to our type of investing—owning great companies with high returns on capital, strong free cash flow, and solid balance sheets that are selling at reasonable valuations. We have not waivered from our focus on these types of businesses. Furthermore, this market sell-off has provided opportunities to buy more of these high-quality businesses at attractive prices, which we believe should drive continued outperformance over the long term.

Contribution[1]
(YTD as of 12/31/2022)

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

Security	Avg Weight (%)	Contribution (%)
Top 5		
W. R. Berkley Corp.	3.60	0.93
Progressive Corp.	3.69	0.75
Dollar Tree Inc.	3.26	0.29
TJX Cos. Inc.	2.81	0.28
Kinder Morgan Inc.	2.03	0.28
Bottom 5		
Lowe's Cos. Inc.	4.56	(1.03)
Black Knight Inc.	3.50	(1.03)
Brookfield Asset Management Inc.	3.44	(1.13)
Morningstar Inc.	2.93	(1.22)
Alphabet Inc.	3.85	(1.69)

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

Performance Composite Returns[2] (For Periods Ending December 31, 2022)

	Since Inception**	15-Year*	10-Year*	5-Year*	3-Year*	1-Year	YTD	QTD
All Cap Value *Pure Gross-of-Fees[3]*	9.2%	9.6%	12.3%	9.3%	6.6%	(16.2%)	(16.2%)	8.7%
Max Net-of-Fees[4]	6.0%	6.4%	9.0%	6.1%	3.5%	(18.7%)	(18.7%)	7.9%
S&P 500	8.8%	8.8%	12.6%	9.4%	7.6%	(18.1%)	(18.1%)	7.5%
Russell 3000 Value	7.3%	7.0%	10.1%	6.5%	5.8%	(8.0%)	(8.0%)	12.2%

Calendar Year	Pure Gross-of-Fees[3]	Max 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%
2022	(16.2%)	(18.7%)	(18.1%)	(8.0%)	2.0%	1,065	$342,473	$6,931,635	20.5%	20.9%	21.5%	0.7%

*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)*

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Disclosures

Market & Strategy Commentary—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.

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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.

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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.