Confluence
INVESTMENT MANAGEMENT

FOURTH QUARTER
2023

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

A late-year rally in 2023 produced the bulk of the outsized returns for equity markets following a very tumultuous 2022. The year began with continued concerns regarding both inflation and how the Federal Reserve's aggressive tightening actions would impact the economy. The impact was not clear amongst investors, however, as divergent paths became apparent in the fixed income and equity markets. A sharply inverted yield curve implied fixed income investors were concerned about a recession, while the equity markets had a more optimistic view of the economy following a strong Q4 in 2022 and expectations of earnings growth in 2023. Given these crosscurrents, and coupled with the Fed's continued rate increases in 2023, equity returns were unable to gain traction for most of the year, fluctuating between positive and negative. It was not until late October when the Fed gave a clear signal that rate hikes had likely peaked with rate cuts more probable in 2024, which provided the spark that led to strong rallies in financial assets. From the lows in late October, the 10-year Treasury rallied from a yield of approximately 5% to under 4% and equities were up in the mid-teens, with the S&P 500 up 16%, the S&P 500 Equal Weight up 18%, and the Russell 2000 up 24% during this period. Those returns during the quarter led to a solid year, with the S&P 500 up 26%, the S&P 500 Equal Weight up 14%, and the Russell 2000 up 17% for 2023.

The strong returns of 2023 helped to recoup much of the losses from 2022, leaving many of the large cap indexes essentially flat for the past couple of years, with the S&P 500 up 3% and the S&P 500 Equal Weight up 1%, whereas the small cap Russell 2000 is down 7% since the end of 2021. So, why the contrast between 2022 and 2023 when the economy avoided a recession? While 2022 may have sidestepped an official recession, there were factors at play that typically lead to or indicate recessions, such as: real incomes declined which eroded confidence following the sharp inflationary spike driven by stimulus demand; manufacturing and transport experienced normalization in 2022 following strong demand for goods over services in the prior year; housing and commercial real estate stalled due to the spike in rates; and mega-cap tech saw a sharp pullback as we witnessed a collapse in speculative IPOs, SPACs, meme stocks, and early stage and/or unprofitable businesses. Despite these headwinds, the economy continued to grow and employment remained strong, with unemployment staying below 4%. Many of these headwinds have now subsided or have shifted to tailwinds, allowing the Fed to pause on hikes and begin to contemplate cuts in 2024, which provided support for financial assets.

While equity returns were strong, the breadth was narrow. This is evidenced by the return difference between the equally weighted and market cap-weighted S&P 500 indexes at 14% versus 26%, respectively. Moreover, the S&P 500 ended the year at $41.7 trillion market cap, up $8.2 trillion, and $5.0 trillion of that growth came from the mega-cap tech businesses, primarily the Magnificent 7 (M7), which posted a cumulative 73% return. Hence, approximately two-thirds of the index's return came from just seven names, while the remaining 493 businesses contributed the remaining $3.2 trillion in market cap growth.

The dominance of the M7 is also reflected when looking at the sector contributions as Communication Services (GOOG, META), Technology (AAPL, MSFT, NVDA), and Consumer Discretionary (AMZN, TSLA) trounced all the other sectors (see table, *Figure 1*). It also shows that two of the defensive sectors, Consumer Staples and Utilities, were flat to negative. Energy was the only other sector to post a loss following a stellar 2022, when it returned over 60%.

Figure 1 **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	3.9%	2.4%	13.0%	8.8%	10.9%	28.9%	8.6%	2.5%	12.6%	6.2%	2.3%	100.0%
Russell Growth weight	0.5%	0.7%	6.4%	5.9%	15.8%	43.5%	11.4%	0.9%	10.6%	4.1%	0.1%	100.0%
Russell Value weight	7.8%	4.9%	21.8%	13.9%	5.2%	9.5%	4.7%	5.0%	14.6%	7.9%	4.8%	100.0%
Russell 2000 weight	6.9%	4.5%	17.1%	17.0%	11.0%	13.6%	2.3%	6.2%	15.4%	3.4%	2.7%	100.0%
4Q23	-6.9	9.7	14.0	13.1	12.4	17.2	11.0	18.8	6.4	5.5	8.6	11.7
2023	-1.3	12.5	12.1	18.1	42.4	57.8	55.8	12.3	2.1	0.5	-7.1	26.3

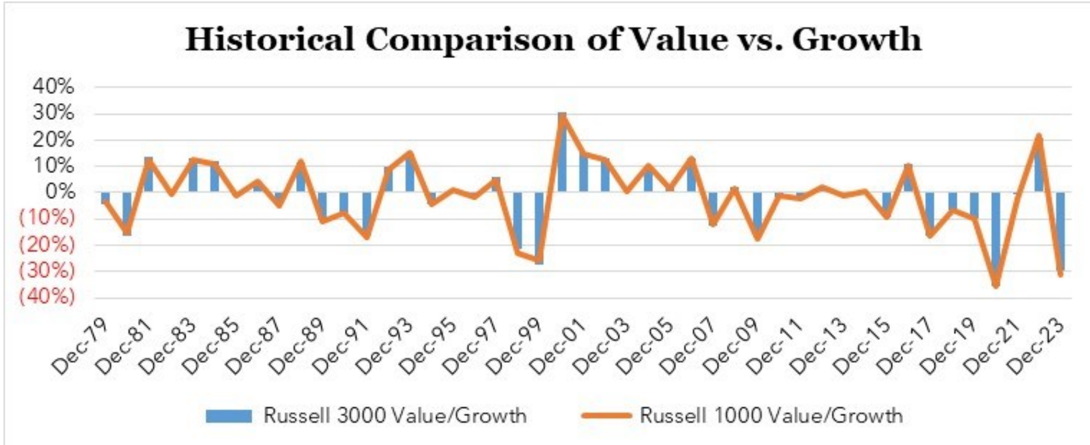
See GIPS Report on pages 5-6.

(Source: J.P. Morgan Asset Management; Guide to the Markets®, U.S. 1Q 2024, as of December 31, 2023)

Market Commentary continued...

It is worth noting that the M7 were the driving force behind the outperformance of large caps over small caps as well as the Growth style trouncing Value by one of the widest historical margins (see *Figure 2*).

Figure 2



(Sources: Confluence, FactSet)

It is also worth highlighting the impact of the M7 on the dividend segment of the market as the M7 pay little to no dividends, except MSFT and AAPL. There was a clear benefit to the non-paying and lower dividend-yielding businesses as reflected in the following chart showing the S&P 500 returns ranked by yield quartile from Ned Davis Research (*Figure 3*), where higher-yielding quartiles are dramatically lagging the low-paying or non-paying quartiles. Their impact can also be seen when we look at dividend growers versus non-payers (see table, *Figure 4*) as companies that grow their dividends have lagged the non-paying dividend stocks.

Figure 3

S&P 500 Stock Constituents* Ranked by Quartiles (Dividend Yield)

*Actual Historical Constituents. *Returns through 12/31/2023*

Highest yielding in Quartile 1 and lowest in Quartile 4; Non-dividend-payers are in Quartile 0

Figure 4

Returns of S&P 500 Stocks by Dividend Policy

Portfolio Performance Statistics
Analysis Dates: 12/31/2022 to 12/31/2023

Portfolio	Gain/Annum %	Growth of $100
Dividend Growers & Initiators	8.1%	$108.09
All Dividend-Paying Stocks	8.6%	$108.64
Dividend Payers w/No Change in Dividends	14.2%	$114.22
Dividend Cutters & Eliminators	(1.9%)	$98.10
Non-Dividend Paying Stocks	21.6%	$121.58

Returns based on monthly equal-weighted geometric average of total returns of S&P 500 component stocks, with components reconstituted monthly.

(Sources, Figures 3 and 4: Ned Davis Research)

Is It Different This Time?

The M7 have driven the broad indexes for the better part of the past seven years, so what causes a rotation? We have addressed this issue in a special *Value Equity Insights* report that offers some perspective on the bifurcation that has occurred in the current market along with historical context in order to help investors navigate the investment landscape more safely.

Outlook

As the Fed pauses and contemplates a shift toward more accommodative policy, the equity markets have rallied on the anticipation that this will result in a soft landing and continued earnings growth. The late-year rally was much broader in breadth than earlier moves and elicits the prospect that the market could broaden further should the economy continue to expand. Of course, 2024 brings with it many uncertainties from elections here and abroad to many simmering geopolitical hotspots, such as the conflicts in Ukraine and the Middle East and China's overtures toward Taiwan, all of which may incite events that impact the financial markets. Meanwhile, the domestic economy has been able to weather the recent spike in inflation and the ensuing monetary tightening without the typical rise in unemployment and ultimate recession, which may or may not continue in 2024. History has shown that uncertainties always abound, which is why it is important to remain steadfast in your investment discipline — something the team at Confluence has been doing for three decades. We remain committed to our philosophy of focusing on fundamentals and valuations as our emphasis is on identifying competitively advantaged businesses trading at attractive valuations.

Strategy Commentary

As discussed last quarter, in September the market started believing the Fed's "higher for longer" message, but that didn't last long as the 10-year U.S. Treasury yield topped 5% on October 23, the stock market bottomed on October 27, and then it was off to the races on expectations of significant rate cuts in 2024. As a result, on October 27, the S&P 500 Equal Weight Index was down 4.0% year-to-date and the S&P 500 Index was up 8.6%, but after the November/December rally the indexes ended up 13.9% and 26.3% for the full year, respectively. The unusually large difference between the two indexes was entirely from the outsized weighting in the S&P 500 of the M7 growth stocks (Apple, Microsoft, Amazon, Google, Meta, Tesla, and NVIDIA), whose aggregate market cap increased 73% in 2023.

As we wrote about a year ago, with value stocks outperforming in 2022 and the M7 down almost 40%, it looked like the five years of ZIRP/pandemic-induced speculation had finally come to an end. However, in 2023, the M7 came roaring back on excitement about AI followed by rate-cut hopes late in the year. This bifurcation is further reflected in the Growth versus Value imbalance, with the Russell 3000 Growth Index up 41.2% in 2023, while the Russell 3000 Value Index was up only 11.6%. By comparison, the Confluence All Cap Value strategy was up 18.8% in 2023 (gross of fees). [*The strategy's net-of-fees return for the same period was 15.3% YTD. See disclosures on last page for fee description; actual investment advisory fees may vary.*]

In 2023, All Cap Value trailed the S&P 500 almost entirely due to the sectors driven by the M7 growth stocks. With a strong gross return for the year, the portfolio outperformed across the non-M7 sectors, hence the outperformance relative to the S&P 500 Equal Weight Index and the Russell 3000 Value.

The top contributors to performance in 2023 were tech-related: Google/Alphabet (GOOG/GOOGL), Microsoft (MSFT), Broadridge (BR), Oracle (ORCL), and NXP Semiconductors (NXPI). The weakest performers held at year-end were consumer-focused companies: Diageo (DEO), alcohol; Keurig Dr. Pepper (KDP), consumer beverages; and Thermo Fisher Scientific (TMO), healthcare research tools. While these are great businesses, they have lagged in 2023 as their valuations contracted with rising interest rates and concerns about consumer spending. [*See contribution table on page 5.*]

During the fourth quarter, we sold RE/MAX (RMAX) and Hexagon (HXGBY) and bought Vontier Corp. (VNT) and Hershey (HSY). RE/MAX, a franchisor that caters to highly productive independent real estate agents, has been pressured as rising interest rates have impacted mortgage affordability and the company's cost of debt, but the real change came in October when courts ruled in favor of upending the industry's commission structure. This commission structure has been in place for decades and seemed unlikely to change given heavy lobbying by the National Association of Realtors. This landmark ruling brings much uncertainty to the business model over the next decade, so we decided to exit the position at a loss. As for Hexagon, a maker of industrial measurement equipment, the company has struggled to grow earnings since 2017 and has been slow to expand recurring revenue, so we decided to sell at a small gain over our four-year holding period in order to purchase Vontier.

Vontier was spun off from Fortive in late 2020 and is the legacy industrial technologies segment consisting of assets that supply a wide range of solutions spanning from advanced environmental sensors; fueling equipment; field payment hardware; point-of sale, workflow, and monitoring software; vehicle tracking and fleet management; and vehicle mechanic and technician equipment. VNT markets its products and services to retail and commercial fueling operators, convenience store and in-bay car wash operators, tunnel car wash businesses, commercial vehicle repair businesses, municipal governments, public safety entities, and fleet owners/operators on a global basis. A large percentage of the revenue is repair/maintenance, replacement, subscription, or franchise fees. While the end markets may not be the most glamorous, they are good asset-light businesses generating solid free cash flow, high margins, and ROC, and they possess solid market share in their respective industries. For example, Gilbarco Veeder-Root is the leader in fuel dispensers, while Matco Tools is a solid #2 behind Snap-on. Furthermore, the spin-off from Fortive left Vontier reasonably capitalized.

Vontier's introduction as an independent public company was not ideal due to the pandemic lockdowns and subsequent reopening, which wreaked havoc on supply and demand. VNT also had to contend with the card networks requiring EMV readers on gas dispensers by the end of 2022, which pulled forward demand that had to be fulfilled. The timing also created a difficult comparison for calendar-year 2023. Despite these events, VNT executed well operationally and earned high marks on capital allocation. Management divested a couple of units and completed a handful of acquisitions which positions them to drive organic revenue post-EMV. Management has also pared back debt and repurchased shares at attractive levels. Shares currently trade at 10.5x P/E with a high-single-digit free cash flow yield, which provides an attractive entry for a business with a solid market position in its end markets. VNT appears to be an above-average business that can utilize the free cash flow to enhance shareholder value via acquisitions, share repurchases, debt reduction, and/or dividends. At current levels, we feel the shares present an attractive risk/reward opportunity.

Strategy Commentary continued...

In December, Hershey was added to the portfolio. Hershey is one of the largest confectionary companies in the world, amassing a portfolio of top brands and embedded cultural relevance over its 125+ year history. Through its confectionary operations, the company produces and sells its eponymous Hershey candy bars, Reese's candies, Twizzlers, York Peppermint Patties, and Kit Kat bars. The company derives 82% of its sales from North American Confectionary sales, while 10% comes from North American Salty Snacks, and the remainder is from International sales.

Hershey exhibits multiple sources of competitive advantages, including a formidable portfolio of leading brands and a significant distribution network, which reaches nearly every type of retail outlet in the country. Strong consumer preference for the company's brands, led by taste and embedded cultural significance, have supported Hershey's pricing power and volume growth over time. The company maintains industry-leading operating margins and generates significant free cash flow.

Hershey's strong financial performance has been complemented by a consistent focus on judicious capital allocation. The company has paid an uninterrupted dividend since 1930 and has raised its dividend in 29 of the past 30 years. Management has also deployed capital toward share repurchases, reducing the average share count by 11% since 2011. Additionally, Hershey has been deploying capital to grow its Salty Snacks portfolio, acquiring brands such as Dot's Pretzels, Skinny Pop, and Pirate's Booty Popcorn. The company's vast distribution network has allowed it to rapidly grow and scale these brands.

Over the past year, a few short-term concerns in the market have had an outsized impact on Hershey's stock, bringing the valuation multiple to lows rarely seen in the past 20 years. Most of these factors are centered around general macroeconomic concerns and consumer spending pressure. Hershey's significant brand loyalty, distribution capacity, and ability to adapt to changing consumer preferences have allowed the company to weather similar environments in the past. The company has many levers it can pull to adjust pack size and pricing levels to manage these headwinds and maintain or grow its competitive position. The market's focus on short-term headwinds has created an opportunity to own Hershey at an attractive discount relative to the long-term value of the business. Over time, we expect Hershey to continue generating industry-leading profitability and returns on capital, which should ultimately lead to value creation for shareholders.

Outlook

As is human nature, investors have talked themselves into the best outcome for 2024 — a "soft landing" — wherein inflation subsides, the economy grows, and the Fed cuts interest rates significantly, even absent a recession or something breaking in the financial system. This is possible (and would be great!), but it would also be unusual, if not unprecedented.

Despite the romp by the M7 growth stocks in 2023, we continue to believe that quality businesses with sustainable competitive advantages owned at attractive valuations will continue to outperform over the long run. While we do not attempt to time the market, there are several factors that indicate Growth's dominance over Value is at an extreme, reminiscent of the 1970s Nifty Fifty or the late 1990s Blue Chip/Tech Bubble (for more about this, see our recent *Value Equity Insights* report, "Is It Different This Time?"). Over the long term, we expect this imbalance to even out as it has historically. In the meantime, we will continue to stay focused on owning great companies with capable management teams purchased at a discount to intrinsic value.

Contribution[1]

(YTD as of 12/31/2023)

The top contributors and detractors for the portfolio in 2023 are shown in this table:

Security	Avg Weight (%)	Contribution (%)
Top 5		
Alphabet Inc.	3.91	1.88
Microsoft Corp.	3.72	1.87
Broadridge Financial Solutions Inc.	3.12	1.53
Oracle Corp.	3.27	1.34
NXP Semiconductors N.V.	2.91	1.23
Bottom 5		
Thermo Fisher Scientific Inc.	3.48	(0.16)
Keurig Dr. Pepper Inc.	3.02	(0.18)
Hexagon A.B.	*Sold*	(0.28)
Diageo plc	2.49	(0.44)
RE/MAX Holdings Inc.	*Sold*	(0.71)

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

Performance Composite Returns[2] (For Periods Ending December 31, 2023)

	Since Inception**	15-Year*	10-Year*	5-Year*	3-Year*	1-Year	YTD	QTD
All Cap Value *Pure Gross-of-Fees[3]*	9.7%	13.3%	10.9%	14.3%	7.1%	18.8%	18.8%	10.9%
Max Net-of-Fees[4]	6.5%	9.9%	7.6%	10.9%	3.9%	15.3%	15.3%	10.1%
S&P 500	9.6%	14.0%	12.0%	15.7%	10.0%	26.3%	26.3%	11.7%
Russell 3000 Value	7.5%	11.0%	8.3%	10.8%	8.8%	11.6%	11.6%	9.8%

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%
2023	18.8%	15.3%	26.3%	11.6%	(7.5%)	1,046	$385,449	$7,200,019	16.9%	17.3%	16.7%	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)*

Confluence Value Equities Investment Committee

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Disclosures

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Indexes: The S&P 500 and Russell 3000 Value 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 (net), based on each holding's contribution to the sample account for the period stated.

[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, 2022. 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.**

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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.