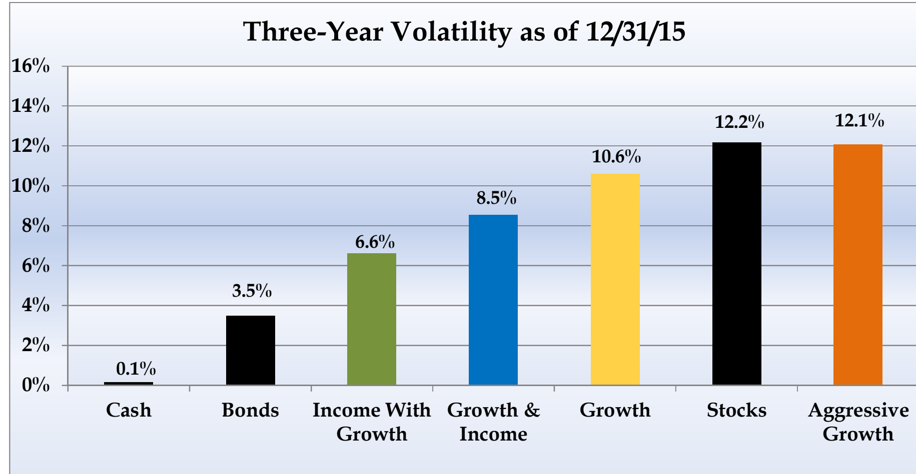
ASSET ALLOCATION QUARTERLY
First Quarter 2016

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.

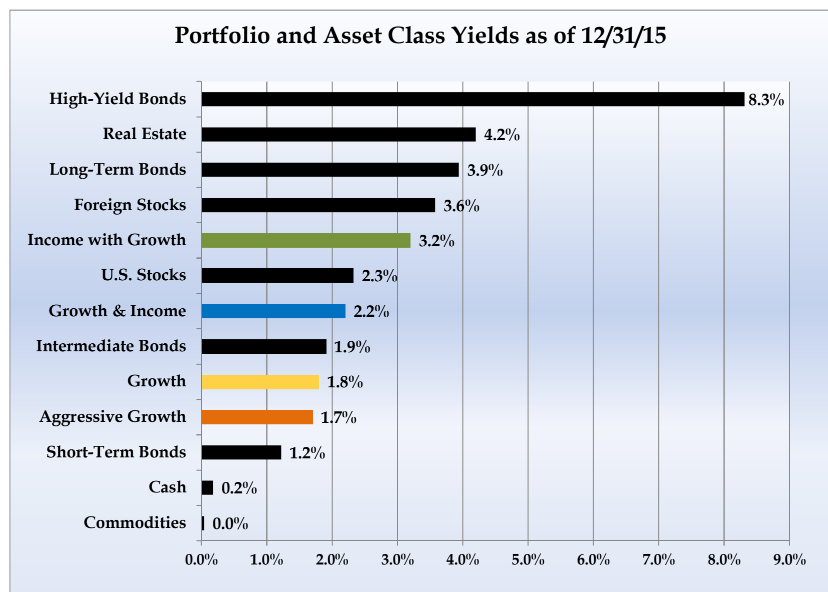


Source: Bloomberg, CIM. Cash is the ML 0-3 Month T-Bill Index; Bonds are the ML Domestic Master Index; Stocks are the S&P 500 Index. See disclosures on page 6* for important details.

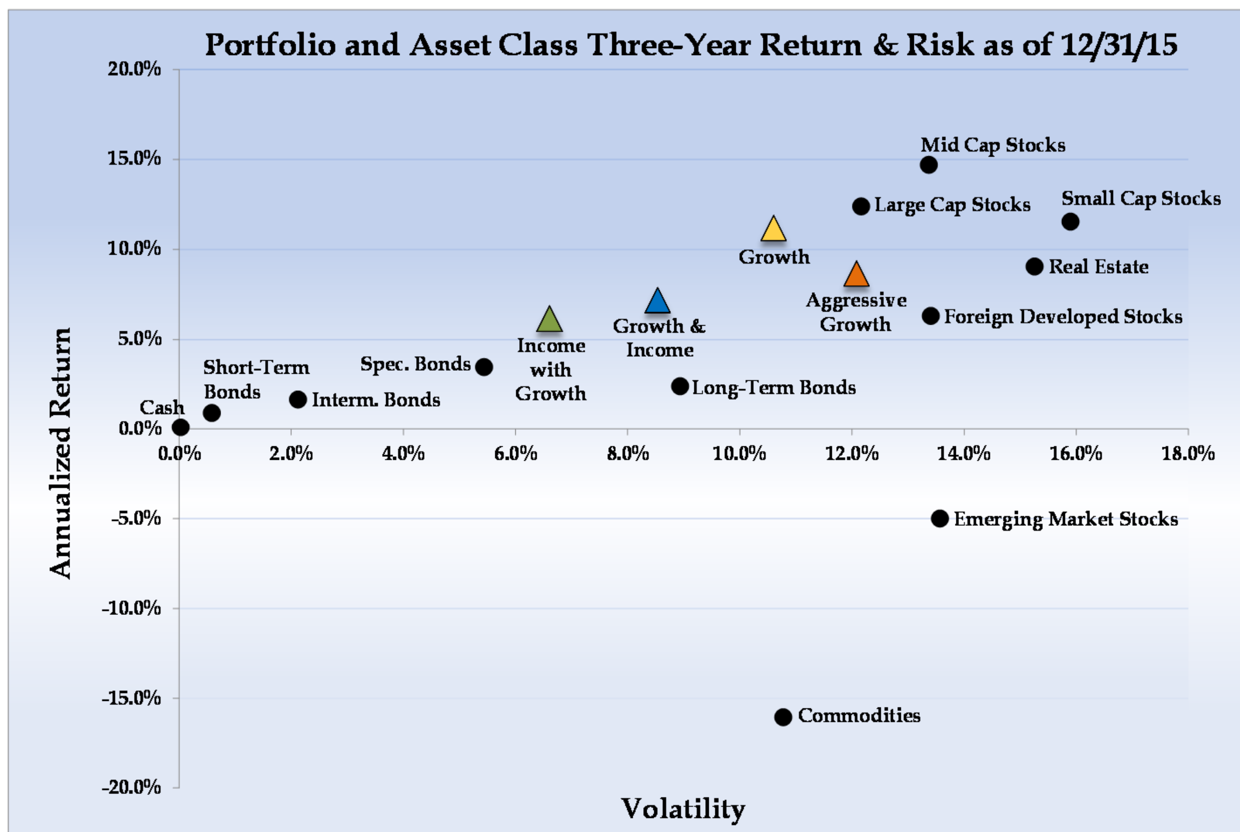
The Confluence asset allocation process is centered upon risk management. Our portfolios offer a broad spectrum of risk profiles, ranging from a fairly conservative posture in Income with Growth (green) to a more risk tolerant profile in Aggressive Growth (orange). The primary asset classes of cash,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

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

This chart illustrates the return and volatility for a variety of asset classes, as well as the composite performance for our asset allocation portfolios. It reveals how different kinds of asset classes and portfolios have performed over a three-year period.

Because this chart is a snapshot of a single three-year period, we can't see how much the circles and triangles have moved across time. However, we can see how higher volatility is indicative of a wider range of return outcomes. For example, commodities and large cap stocks often have a similar level of volatility, yet we can clearly see a big difference in returns over the past three years. Of course, when volatility is low, the range of outcomes is much narrower.

For our portfolios, which are illustrated by the colored triangles, the range of return outcomes is also a function of their volatility. Our more conservative, income-oriented portfolios have a volatility profile similar to their nearby asset classes. However, their composition has often been much different. We've typically included some exposure to higher volatility asset classes, including real estate and large caps, but because the proportional exposure was limited and diversified, the overall risk profile of the portfolios remained steady. As we move to the more risk-tolerant, growth-oriented portfolios, the proportional exposure to volatile asset classes has been higher. As a result, there has been more variability in their returns, a condition we expect to continue going forward.

Although we don't ever get all of our forecasts correct, the portfolios have benefited from our decisions to limit the exposure to foreign developed stocks, emerging market stocks and commodities. We've also been able to cyclically adjust allocations to real estate, speculative grade bonds and long maturity bonds in beneficial ways. On the other hand, we could have had more exposure to large caps, which have generally delivered good risk-adjusted returns. Therefore, while we will miss some opportunities, our process offers a consistent approach, one that incorporates risk management and positions the portfolios to pursue income as well as growth return objectives.

FIRST QUARTER 2016 ASSET ALLOCATION OUTLOOK

- **Low global growth rates and tighter Fed policy are combining to lower financial market return potential, while increasing overall volatility.**
- **We believe U.S. growth will remain low and the Fed will raise rates gradually. At this point we do not foresee a recession.**
- **The low growth rate in the U.S. will likely be higher than that of many foreign countries. We expect China's lower growth rate to have an adverse effect on many other countries.**
- **We remain diversified across capitalization sizes. Our allocation remains entirely domestic, except for a limited foreign developed allocation for aggressive investors.**
- **We expect inflation and interest rates to remain low. We continue to emphasize intermediate and longer maturity bonds.**
- **Our growth/value style bias remains at 60/40, based upon our sector and industry outlook.**

ECONOMIC VIEWPOINTS

After an up and down year in both the stock and bond markets, 2015 ended roughly flat. The S&P 500 Index posted a total return of 1.4%, while the ML Domestic Bond Index came in at 0.6%. Throughout the year, we saw bouts of higher volatility as the markets wrestled with ongoing slow growth, tighter Fed policy and rising geopolitical risks. Unfortunately, as we've noted in the past, we could be entering a period of lower returns and higher risk. This doesn't necessarily create an adverse investing climate, but it does underscore the importance for investors to appropriately position themselves according to risk tolerance and to properly calibrate reasonable return expectations.

What is behind this change in the return/risk landscape? Several factors are at play, but valuations are certainly front and center. Recall that during the last recession, valuations for many asset classes became extraordinarily low. As they recovered, the positive contributions to asset class returns were very significant. Then, valuations (and investor returns) were given additional boosts as the Fed engaged in a multi-year stimulative monetary policy known as Quantitative Easing. Easy monetary policy also lowered volatility across most asset classes.

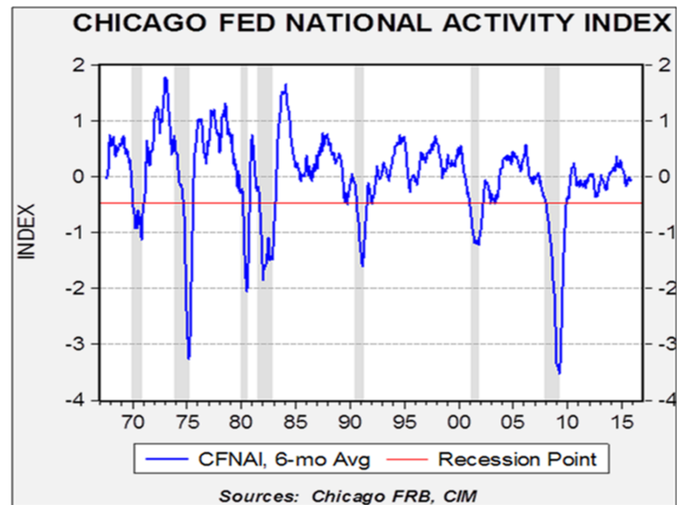
However, as we look forward, similar valuation escalations appear unlikely. In part, it's because we simply aren't starting from an unusually low point. It's also important to note that the Fed is no longer increasing monetary stimulus…it is in fact now doing just the opposite by raising short-term rates. We believe tighter monetary policy is likely to not only limit valuation growth, but also to increase market volatility.

Against this backdrop, much of our viewpoint is shaped by how successful (or unsuccessful) the Fed is in managing tighter monetary policy. We'll put it front and center that we feel it's very odd, and perhaps hazardous, to be raising rates right now. Economic growth remains well below long-term averages and inflation is also very low. There just isn't an obvious need to tap the brakes on the economy.

Fortunately, the U.S. economy remains stable, even if its growth is low. We monitor a wide range of factors including manufacturing activity, sentiment, consumer trends and borrowing, to name a few. For example, the chart on the next page shows the Chicago Fed National Activity Index where readings above zero indicate the economy is growing faster than its long-term trend. The index is a pretty reliable indicator of recessionary periods, which are shaded in grey. We note that recessions tend to emerge when the trend moves below the red line (for more details, please see our 2016 Outlook report). Currently, we are above the recessionary level, but the economy is growing at a pace below trend. Because many other indicators confirm this trend, we don't foresee a recession at this point.

We believe the primary risks to the economy are a Fed policy error (raising rates too far or too fast) and pockets of weak foreign growth that could ultimately slow the U.S. economy. Both factors appear to have played a role in financial market volatility in early 2016. As the Fed contemplates further rate hikes, we believe it will be important for policymakers to move slowly, perhaps even pausing for a while if economic conditions deteriorate.

STOCK MARKET OUTLOOK



Recessions tend to foster some of the greatest risks for equity investors, which is why we monitor economic conditions so closely. At this point, we don't foresee a recession. Slow but stable growth in the U.S. economy should create a reasonably good operating environment for many corporations.

Still, there will likely be areas where growth is absent or even negative due to industry conditions. We have ongoing concerns over fundamentals in the energy and materials sectors, which we underweight. Cyclical concerns in financials, healthcare and telecom cause us to be underweight these sectors as well. On the other hand, we are overweight technology, consumer discretionary, consumer staples and utilities, which we believe can provide a combination of specific industry growth and counter-cyclical resilience. Our style bias remains at 60/40 growth/value, based upon our viewpoints for sector exposures.

We remain entirely out of foreign stocks, except for a relatively small allocation for aggressive investors. Although foreign valuations are low, we still favor domestic equities. We believe many foreign developed countries face ongoing weak economic growth, if not recessions. Meanwhile, China continues to adjust to a significantly lower growth rate, which is creating financial market turmoil and is adversely affecting other emerging economies. For these reasons, we remain allocated primarily to domestic equities, with diversified allocations across a variety of capitalization sizes.

BOND MARKET OUTLOOK

Although their returns were generally flat in 2015, bonds played a very helpful role in portfolios. Not only did they provide meaningful stability, bonds also contributed significant diversification. Oftentimes, bond prices rose when equities experienced some of their biggest downdrafts. In this way, bonds delivered a very important aspect of risk control.

Our bond allocations remain focused on intermediate and longer maturities. With the Fed raising short-term rates, many investors have questioned this posture, concerned that tighter Fed policy could potentially cause long-term rates to rise. Our view has been that tighter Fed policy would put the most upward pressure on shorter maturities, which has been the case thus far. In a low growth, low inflation environment, we believe longer maturities can provide attractive opportunities, even as the Fed tightens. For example, if the Fed overtightens and the economy stalls, longer maturity bonds should perform well. On the other hand, if the Fed retreats from tighter policy, the market may consider this to be very accommodating to longer maturities. For these reasons, we maintain our focus on intermediate and longer maturity bonds, including both corporate and Treasury sectors. Speculative grade bonds can be useful where income is a priority, but we have been lowering this allocation for a while and exit the asset class entirely this quarter. Defaults may begin to rise, particularly among energy issuers.

OTHER MARKETS

We continue to hold real estate allocations in most portfolios. Real estate fundamentals remain strong, benefiting from low interest rates, high occupancy and strong demand from foreign investors. However, like many other asset classes, real estate valuations have risen in recent years. For this reason, we have been lowering allocations and now utilize a more limited exposure. Still, we believe real estate can benefit portfolios, particularly where income is an objective. We also believe real estate can help to address rising levels of volatility in equity asset classes.

In recent quarters, we have witnessed significant price declines in many commodities, including those related to energy, industrial and precious metals, and grains. Much of the decline reflects lower demand from slower global economic growth, particularly in China. However, prices also reflect excess supply capacity as well. We believe that some prices may be reaching equilibrium levels and may have the potential to recover. However, at this point we believe the cycle continues to have more downside and we remain out of commodities in all of the portfolios.

First Quarter 2016	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	19%	(5%)	-	-	-	-	-	-
Long Term Bonds	35%	11%	27%	-	7%	-	5%	5%
Speculative Grade Bonds	-	(4%)	-	-	-	-	-	-
Real Estate	10%	(2%)	4%	-	5%	-	-	(5%)
U.S. Large Cap Stocks	7%	-	20%	-	40%	-	15%	-
U.S. Mid Cap Stocks	12%	-	27%	-	26%	-	15%	-
U.S. Small Cap Stocks	15%	-	20%	-	20%	-	58%	-
Foreign Developed Country Stocks	-	-	-	-	-	-	5%	-
Emerging Market Stocks	-	-	-	-	-	-	-	-
Commodities	-	-	-	-	-	-	-	-
Total	*100%*		*100%*		*100%*		*100%*	

INCOME WITH GROWTH

The foundation of the Income with Growth portfolio remains allocated to high quality bonds with intermediate and long-term maturities. These allocations have provided both income and stability at a time when volatility in the financial markets has risen. Because we expect economic growth and inflation to remain low, we believe this posture is appropriate, even as the Fed has begun raising short-term rates. We believe Fed policy will increase yields primarily among shorter maturity bonds. Furthermore, if the Fed were to tighten too much, economic growth may slow and longer term yields could decline. Accordingly, this quarter we lengthen the average maturity of the bond allocation to help address this risk and exit the speculative bond allocation due to cyclical conditions.

The equity allocations remain entirely domestic. We believe the U.S. economy has better growth prospects than many foreign countries, which should foster a better equity environment. The portfolio remains diversified across capitalization sizes. Real estate provides diversification and contributes to portfolio income.

GROWTH & INCOME

The Growth & Income bond allocation remains entirely in long-term bonds. This allocation has benefited the portfolio, often performing well when equity allocations were adversely affected by rising volatility. We maintain this allocation as we continue to believe growth and inflation will remain low, even as financial market volatility may remain elevated. Although the Fed is raising rates, we believe most of the increase in bond yields is likely to take place among shorter maturity bonds.

The equity allocation is diversified across large, mid and small cap stocks. Even in a relatively low growth economy, we believe the environment should allow many businesses to operate profitably and grow earnings. We also believe economic conditions are poised to favor domestic equities over foreign ones as many foreign countries are likely to face low or recessionary growth conditions. For these reasons we remain entirely out of foreign equities in this portfolio.

GROWTH

Growth investors have faced an equity environment characterized by rising volatility and declining returns. We believe these conditions are a function of low and declining rates of economic growth around the world, along with tighter monetary policy directed by the Fed. Although we expect these conditions to largely remain in place, we still believe there are good opportunities for growth investors, predominantly in domestic equities.

Large cap stocks tend to have lower volatility relative to other equity asset classes. In addition, larger companies often have significant resources that enable them to work through periods of economic uncertainty. For these reasons, large cap stocks remain the primary allocation. However, small and mid cap stocks bring a dimension of higher growth potential, albeit with higher volatility. The allocations to long-term bonds and real estate help to address rising market volatility. We remain entirely out of foreign equities in this portfolio, where we believe growth may be lower relative to the U.S.

AGGRESSIVE GROWTH

Since the last recession, economic growth in the U.S. has generally been below its long-term average. With the Fed now raising short-term interest rates, we don't expect growth to improve much, if at all. Accordingly, we believe aggressive growth investors may be able to participate in higher growth through exposure to small cap stocks. Smaller companies are often able to work in smaller niches of the economy and successful ones can deliver higher growth. It is for this reason that the majority of the Aggressive Growth portfolio allocation is in small caps.

Still, we recognize small caps also have higher volatility and diversification is appropriate even for aggressive investors. For these reasons, we also include large and mid caps. This quarter, we also introduce an allocation to long-term bonds. This allocation not only helps address portfolio risk, but it also may contribute to total return in a low growth, low inflation environment. Generally, we favor domestic equities over foreign ones. However, we recognize that some foreign equities have reached low valuations. For aggressive investors, we believe a relatively small allocation to foreign developed country stocks is appropriate, positioning the portfolio to participate in a potential improvement.

Performance & Disclosures

As of 12/31/15

Strategy	Quarter	YTD	1 - Year	3 - Year	5- Year	ITD
Aggressive Growth - Gross of Fees	4.5%	-2.2%	-2.2%	9.9%	7.0%	5.83%
Aggressive Growth - Net of Fees	3.7%	-5.1%	-5.1%	6.6%	3.8%	2.69%
Benchmark - S&P 500	7.0%	1.4%	1.4%	15.1%	12.6%	9.02%
Growth - Gross of Fees	4.7%	-0.4%	-0.4%	10.3%	8.0%	5.92%
Growth - Net of Fees	3.9%	-3.3%	-3.3%	7.1%	4.8%	2.78%
Benchmark - S&P 500	7.0%	1.4%	1.4%	15.1%	12.6%	8.91%
Growth and Income Taxable - Gross of Fees	3.1%	-0.9%	-0.9%	7.9%	7.3%	6.09%
Growth and Income Taxable - Net of Fees	2.3%	-3.8%	-3.8%	4.7%	4.1%	2.94%
Benchmark - 70% S&P 500 and 30% ML Bond Index	4.8%	1.3%	1.3%	11.0%	9.9%	7.85%
Income Taxable with Growth - Gross of Fees	1.8%	-0.8%	-0.8%	6.6%	6.9%	10.40%
Income Taxable with Growth - Net of Fees	1.1%	-3.7%	-3.7%	3.4%	3.8%	7.12%
Benchmark - 40% S&P 500 and 60% ML Bond Index	2.5%	1.1%	1.1%	6.9%	7.1%	8.77%

ITD: Inception-to-Date. Inception: Income with Growth (12/1/08), Growth & Income (9/1/08), Growth (9/1/08), Aggressive Growth (8/1/08).

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, which are subject to market risk, including the possible loss of principal. 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. ETFs trade like a stock, and there will be brokerage commissions associated with buying and selling exchange traded funds unless trading occurs in a fee-based account. Investors should consider an ETF's investment objective, risks, charges, and expenses carefully before investing.

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 12/31/15. 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 or high yield 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). Yield chart data as of December 2015. 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.