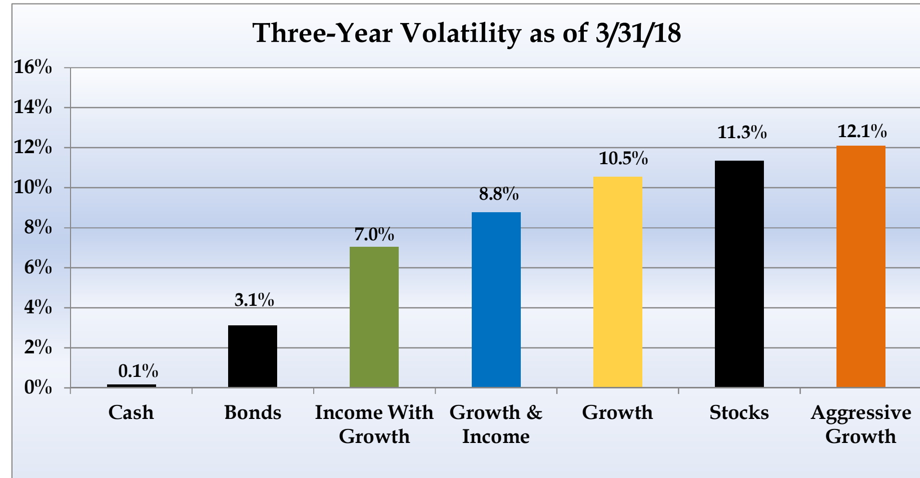
ASSET ALLOCATION QUARTERLY
Second Quarter 2018

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.



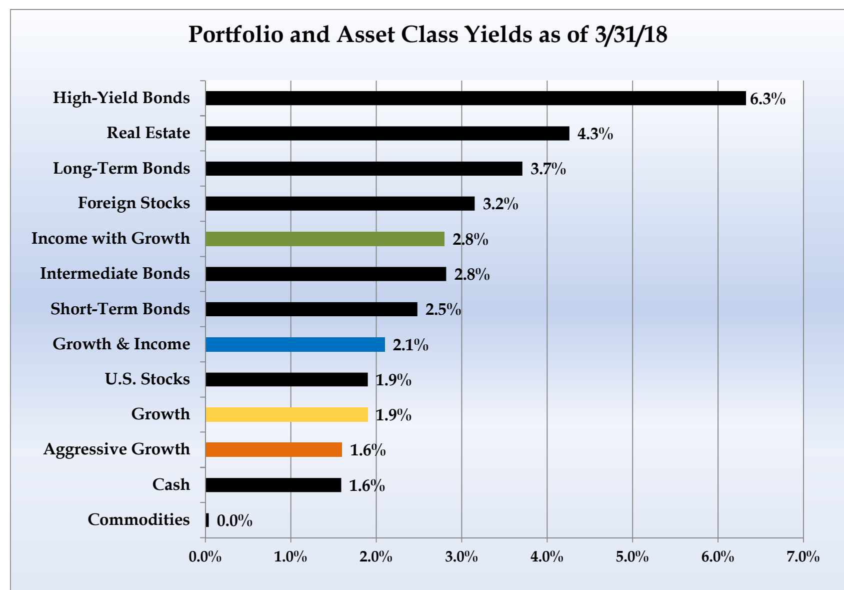
Source: Bloomberg, CIM. Cash is the ML 0-3 Month T-Bill Index; Bonds are the ML Domestic Master Index; Stocks are the S&P 500 Index. *This information is presented as supplemental information to the disclosures required by GIPS® standards. See disclosures on page 6 for important details.

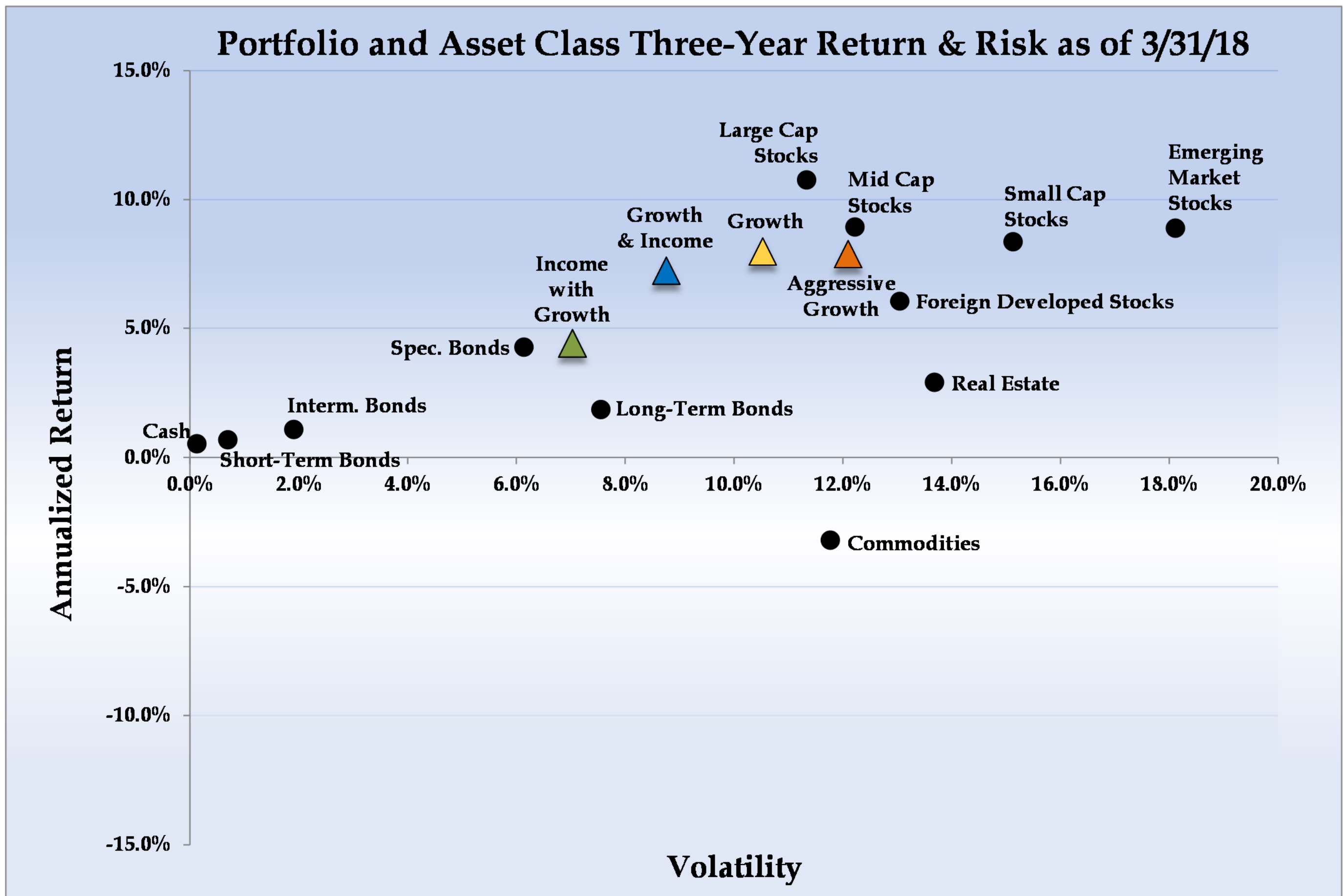
The Confluence asset allocation process is centered upon risk management. Our portfolios offer a broad spectrum of risk profiles, ranging from a fairly conservative posture in Income with Growth (green) to a more risk tolerant profile in Aggressive Growth (orange). The primary asset classes of cash, 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. *This information is presented as supplemental information to the disclosures required by GIPS® standards. See disclosures on page 6 for asset class composition and other important details.





Source: Bloomberg, CIM, using monthly data and gross returns. *This information is presented as supplemental information to the disclosures required by GIPS® standards. 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 various asset classes and our portfolios have performed over the three-year period ending March 31, 2018. As indicated by the points on the chart, fixed income asset classes exhibited lower volatility in the single digits while equity asset classes registered volatility in excess of 10%, albeit with generally higher returns. The sole outlier to this pattern was REITs, which exhibited return characteristics of bond proxies, yet with higher volatility.

The strategies positioned for lesser volatility through their allocations to fixed income asset classes also experienced lower returns over the past three years. Using the volatility metric of standard deviation as a measure of risk, the cadence from the more conservative Income with Growth strategy through Aggressive Growth proceeded in a stepwise progression. Although the Aggressive Growth strategy delivered a return that was 0.1% less than that recorded by the Growth strategy, the volatility it produced along the continuum was in keeping with expectations.

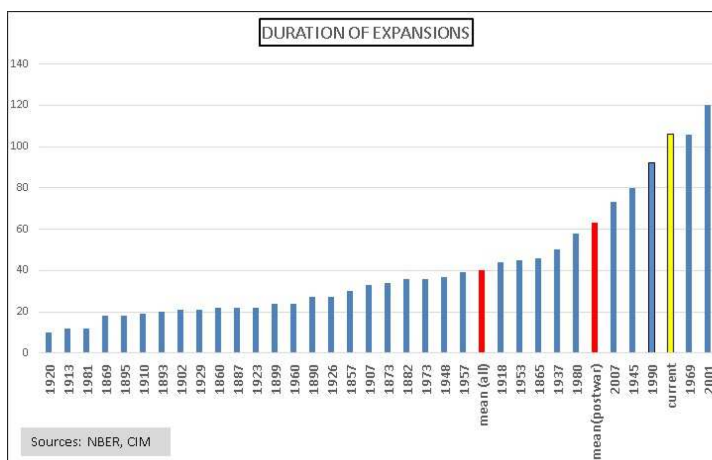
Over the past three years, elevated levels of investor risk appetite have prevailed, which have been manifested in excess returns and associated volatility for higher risk asset classes. For the Confluence strategies that incorporate income as an objective, allocations to equities remain high by historical standards. While this positioning has elevated their relative volatilities, the exposures have assisted in capturing higher returns than the investment grade bond asset classes. The absence of non-U.S. equities in our portfolios during the U.S. dollar rally from mid-2013 through the end of 2016 proved beneficial and their addition to the strategies at this point last year was also additive to returns as the U.S. dollar has weakened over this period.

Our cyclical forecast includes a continuation of the favorable environment for risk assets. However, we regularly reassess and review data that can affect our macroeconomic outlook and associated expected returns and volatility for each asset class constituent. We are cognizant that sentiment may shift, efforts by the Fed may lead to a policy mistake or geopolitical risks may become elevated. As a result, we regularly review the risk exposures for all the strategies given our perception of the environment over our three-year forecast period. Although we currently hold an optimistic view toward risk assets, any changes that might occur to this favorable economic outlook would cause us to adopt a more risk-averse posture for the strategies.

SECOND QUARTER 2018 ASSET ALLOCATION OUTLOOK

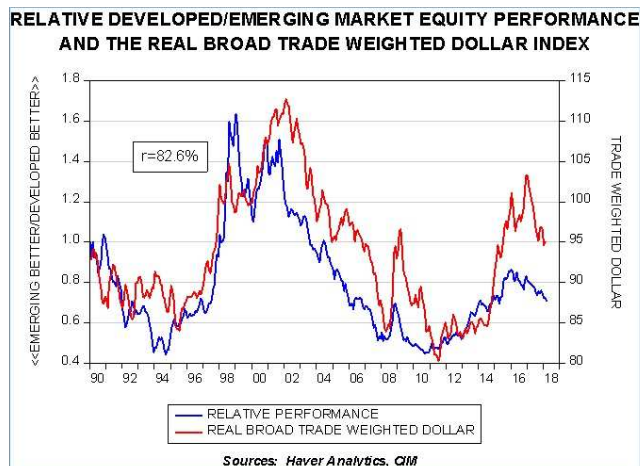
- **Near-term expectations for earnings growth resulting from the Tax Cuts and Jobs Act of 2017 remain heightened.**
- **Continued Fed policy tightening, through measured increases in the fed funds rate and reductions in the size of the Fed's balance sheet, is not expected to weigh on the economy over the next two years.**
- **Our outlook for a softer U.S. dollar is underscored by recently released CBO estimates of the projected budget deficit.**
- **Equity exposures remain elevated across all strategies relative to our historic allocations.**
- **Our sector and industry outlook favors a growth style bias among U.S. equities at 60%.**
- **We initiate a position in precious metals to add diversification given the potential for global political instability and appreciation against a soft U.S. dollar.**

ECONOMIC VIEWPOINTS



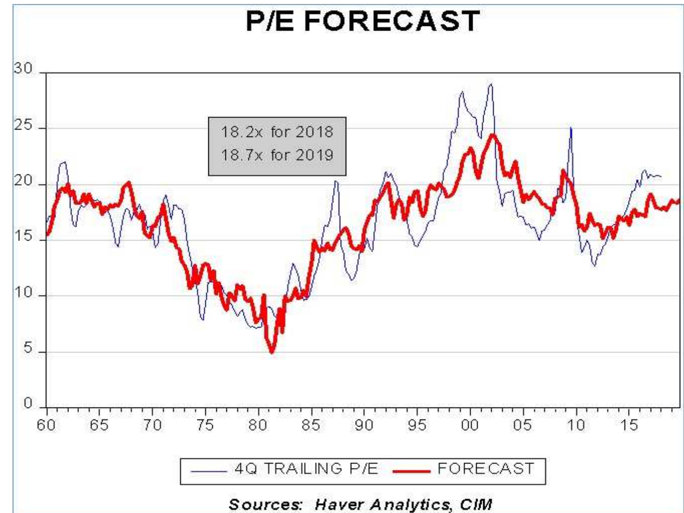
Measures of the U.S. economy continue to point to a continuation of the expansion, which is poised to tie for the second longest expansion on record and a year away from becoming the longest expansion dating back to 1854. Though the U.S. NFIB Business Optimism Index readings have moderated somewhat over recent months, the index remains elevated by historic standards. Similarly, consumer confidence has declined recently, as measured by the Conference Board's Consumer Confidence Index and the University of Michigan's Index of Consumer Sentiment, yet remains at high levels. The recent declines notwithstanding, the Federal Reserve's efforts to reduce its balance sheet and raise the fed funds rate multiple times this year and next appear to continue unabated. While our view is for continued economic growth until nearing the end of our three-year forecast cycle, we remain wary of the potential for a misstep by the Fed that would lead to excessive tightening and increase the odds of a recession. Such wariness is balanced by the prospect for an uptick in GDP from its mild post-recession figures. The combination of the fiscal stimulus in the latest budget accord and the corporate and individual benefits unleashed by the Tax Cuts and Jobs Act of 2017 set the stage for potentially rapid growth over the next two years. With a higher level of GDP growth, we would expect the Fed to be more hawkish in its tightening over the next two years, which would thereby impede the nascent inflationary pressures that caused investor angst in early February.

The domestic economic environment we forecast for our three-year cyclical outlook is supportive of range-bound intermediate and long-term rates and equity valuations. Specifically, inflation expectations of 2.1%-2.2%, inferred by the breakeven rate of TIPS versus maturity-equivalent Treasuries, underscore our thesis of the current fair valuation for equities and bonds.



From a global perspective, the recent saber-rattling on trade and tariffs has the potential to be highly disruptive to global economic growth. While we harbor optimism that cooler heads will prevail on matters of trade, the rise in populism keeps our hopes for unfettered global trade in check. Although trade accords, such as NAFTA and TPP, offer the potential for improvement, we are less than sanguine that they will be resolved amicably, at least absent a high degree of histrionics. Among non-U.S. economies, Europe is three years into its economic expansion. Though facing political headwinds, most recently illustrated by the Italian and Hungarian elections, the European economic climate is improving. In addition, our analysis of purchasing power parity of the U.S. dollar versus other major currencies indicates continued overvaluation despite recent softness, which should prove to be a tailwind for returns of non-U.S. equities for U.S.-based investors. As the accompanying chart illustrates, the environment for emerging market equities is particularly attractive.

STOCK MARKET OUTLOOK



Our views on U.S. equities are favorable. We expect inflation to remain contained, accompanied by low levels of unemployment. We also expect an increase in earnings spawned by last year's corporate tax reduction, and an increase in share repurchases and M&A activity stemming from the repatriation of overseas assets. Our positive forecast for equities reflects our expectations for P/Es, as depicted on the accompanying chart, which encourages elevated exposures across all strategies relative to our historic allocations.

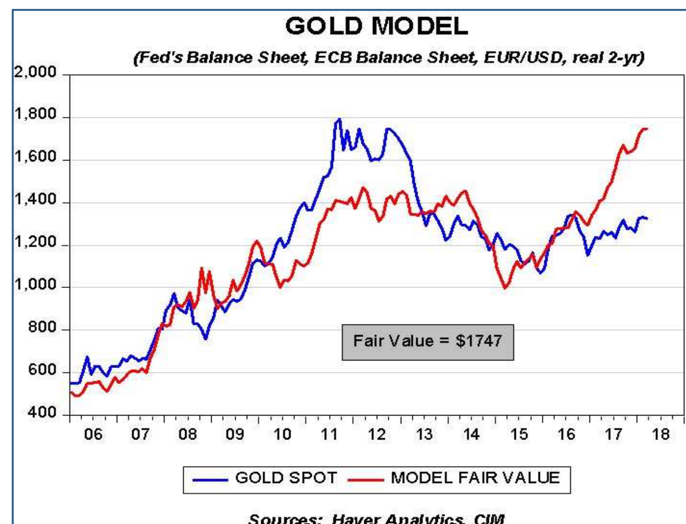
At this stage of the economic expansion, we retain a 60% tilt toward growth and 40% to value. In U.S. large caps, we overweight energy, financials and materials, while establishing an equal weight in technology and consumer discretionary in anticipation of their reconstitution as part of the new communications services sector in September. Mid-cap and small cap equities have an identical tilt to growth and are both overweight in the more growth-oriented strategies. Outside of the U.S., we retain our historic maximum exposure owing to our expectations of a continued soft U.S. dollar.

BOND MARKET OUTLOOK

As we noted last quarter, the rise in Treasury yields since the passage of the tax legislation has many commentators suggesting a bear market in bonds has developed. The jump in rates in early February added further fuel to their argument. While we understand and appreciate their premise, our view is that such a bear market will be secular and, accordingly, will require years to unfold. As evidence, we review the figures from the secular low in 1945 and the two decades that ensued prior to rates becoming a problem for financial markets. Absent inflationary pressures, we uphold our forecast for a gradual rise in rates that will be borne mostly by the front-end of the curve as the Fed maintains its tightening measures, inclusive of the reduction in its balance sheet. Accordingly, we expect the curve to continue to flatten, with the intermediate and long-term maturities being range-bound over our forecast period and a terminal fed funds rate of 2.50%-2.75%.

Our expectations for a gradual rise in rates reinforce our use of a bond ladder in strategies that have income as an investment element. Bond ladders hold the dual attraction of offering a degree of defense against rising rates through capturing the roll yield while also allowing maturing issues to be deployed at the longer rungs of the ladder, benefitting from the yield advantage farther out on the curve. The laddered nucleus will modestly reduce the overall duration from one quarter to the next until a new rung on the ladder becomes available later in the year. Relative to spread sectors, we maintain exposure to investment grade corporates in the ladder and a concentration in the intermediate segment of the yield curve through the use of an ETF containing mortgage-backed securities. Speculative grade bonds hold less allure as spreads have tightened and have double-digit exposure to the debt of telecommunications companies. As a result, we substantially reduce exposure to speculative grade bonds.

OTHER MARKETS



We retain our allocation to real estate in the more income-oriented strategies given attractive and improving dividend yields, while reducing the REIT allocation in risk-tolerant portfolios. As a function of yield relative to potential risk, we view REITs more favorably than speculative bonds.

We introduce an allocation to gold this quarter within commodities, where we have been void for the past year. Recognizing that gold can serve as a safe haven during periods of heightened geopolitical and currency risks, we are incorporating a modest allocation as a means to temper these potential risks. Moreover, our analysis of the fair value price of gold indicates it is currently attractively priced, as depicted on the accompanying chart.

Second Quarter 2018	Income With Growth		Growth & Income		Growth		Aggressive Growth	
	Current	Change	Current	Change	Current	Change	Current	Change
Cash	2%	-	2%	-	2%	-	2%	-
Short Term Bonds	3%	-	5%	-	-	-	-	-
Intermediate Term Bonds	22%	-	10%	-	-	-	-	-
Long Term Bonds	11%	(4%)	5%	-	-	-	-	-
Speculative Grade Bonds	4%	(3%)	-	(5%)	-	-	-	-
Real Estate	10%	-	-	-	-	(5%)	-	-
U.S. Large Cap Equity	31%	4%	30%	-	40%	-	-	-
U.S. Mid Cap Equity	-	-	10%	(5%)	10%	(5%)	23%	(2%)
U.S. Small Cap Equity	-	-	15%	2%	13%	5%	35%	-
Foreign Developed Country Equity	14%	-	10%	-	15%	-	10%	(3%)
Emerging Market Equity	-	-	10%	5%	15%	-	25%	-
Commodities	3%	3%	3%	3%	5%	5%	5%	5%
Total	*100%*		*100%*		*100%*		*100%*	

INCOME WITH GROWTH

The allocation changes are modest and include reductions to long-term bonds and speculative grade bonds in favor of a marginal increase in large cap equity exposure and the introduction of a nominal exposure to gold, which adds diversification. Regarding equities, exclusively large cap for this strategy, we maintain a 60% tilt toward growth in the U.S. exposures based on our expectations of continued momentum stemming from the economic expansion.

The exposure to non-U.S. developed markets remains unchanged, though elevated, given these issues not only retain favorable valuations relative to U.S. counterparts but also due to our expectations for a continued soft U.S. dollar.

GROWTH & INCOME

Allocations shift slightly among the major asset classes due to the elimination of the small speculative grade bond exposure. Allocations to equities are at historically high levels for the strategy and reflect our positive outlook. Within the equity sub-asset classes, we trim U.S. mid-cap equities in favor of an increased exposure to small cap equities, double the prior small weight to emerging market equities and introduce a minor exposure to gold. We retain a 60% tilt toward growth in U.S. equities given our expectations of continued economic expansion. Beyond eliminating speculative grade bonds, there were no changes to the bond exposures, where we retain a bond ladder with a heavier weight to the intermediate segment. In the longer maturity areas, most of the allocation is in Treasuries due to the fact that spread compression among corporates has reduced their attractiveness from a return/risk standpoint.

We maintain the foreign developed allocation and increase emerging market equities due to favorable fundamentals combined with our expectations for a softer U.S. dollar and attendant benefits for U.S.-based investors.

GROWTH

While the U.S. equity exposure is diversified across large, mid and small caps, the large cap allocation continues to serve as the core component and remains unchanged. Our overall posture for U.S. equities has a 60% tilt toward growth as we expect the economic expansion to continue. We reduce the allocation to mid-caps in favor of small caps, owing to more attractive fundamentals as well as the potential for appreciation in an environment where M&A activity is elevated. We eliminate the previous small allocation to REITs in order to introduce a gold allocation, which we believe is attractive relative to its fair value price and its potential to reduce overall portfolio risk.

We maintain the strategy's high exposure to non-U.S. equities with an equal split between developed and emerging markets. The prospect for continued improvement in the European economic climate affirms the foreign developed allocation, and attractive fundamental valuations for emerging market equities encourage this exposure. Our thesis for a softer U.S. dollar will further benefit this positioning for U.S.-based investors.

AGGRESSIVE GROWTH

We introduce a 5% allocation to gold, resulting in minor reductions to U.S. mid-cap and foreign developed equities. The gold exposure stems from its attractive price relative to our analysis of fair value as well as the hedge it affords for portfolio risk. U.S. equity exposures remain in mid-cap and small cap, both of which retain a 60% tilt toward growth due to our expectations of continued economic growth and the merit of growth-oriented equities at this stage of the economic cycle. The significant small cap allocation is due to attractive valuations and potential for increased M&A activity.

The exposure to non-U.S. equities is dominated by emerging markets. Their continued attractive relative fundamentals combined with our expectation of higher currency valuations relative to the dollar encouraged the continuation of this exposure. We maintain the allocation to emerging market small caps owing to their differentiated returns. The foreign developed exposure remains oriented toward Europe, where economic conditions continue to be supportive.

Performance & Disclosures

As of 3/31/18

Strategy	Quarter	YTD	1 - Year	3 - Year	5- Year	ITD
Income Taxable with Growth - Gross of Fees	-2.6%	-2.6%	4.9%	4.4%	6.6%	9.8%
Income Taxable with Growth - Net of Fees	-3.3%	-3.3%	1.8%	1.3%	3.4%	6.5%
Benchmark - 40% S&P 500 and 60% ML Bond Index	-1.1%	-1.1%	6.3%	5.1%	6.4%	8.3%
Growth and Income Taxable - Gross of Fees	-0.4%	-0.4%	10.5%	7.2%	9.0%	7.4%
Growth and Income Taxable - Net of Fees	-1.2%	-1.2%	7.3%	4.1%	5.8%	4.3%
Benchmark - 70% S&P 500 and 30% ML Bond Index	-0.9%	-0.9%	10.1%	7.9%	9.9%	8.5%
Growth - Gross of Fees	-0.5%	-0.5%	11.2%	8.0%	10.2%	7.4%
Growth - Net of Fees	-1.3%	-1.3%	7.9%	4.8%	7.0%	4.3%
Benchmark - S&P 500	-0.8%	-0.8%	14.0%	10.8%	13.3%	10.2%
Aggressive Growth - Gross of Fees	0.3%	0.3%	12.1%	7.9%	10.4%	7.5%
Aggressive Growth - Net of Fees	-0.5%	-0.5%	8.7%	4.7%	7.1%	4.3%
Benchmark - S&P 500	-0.8%	-0.8%	14.0%	10.8%	13.3%	10.2%

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 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. 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.

The asset allocations shown represent the individual ETFs used for the asset allocations in the model portfolios as of 4/17/2018 and do not represent the precise allocation of assets in an actual client account. Asset allocation in client accounts may vary based on individual client considerations and market fluctuations. The allocation of assets in the model portfolio may be changed from time to time due to market conditions and economic factors. The investments held by the portfolio are ETFs and are not guaranteed and do carry a risk of loss of principal. 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 but charge internal management fees; 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 3/31/18. 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 March 2018. Representations: U.S. stocks are the S&P 500; foreign stocks are the average of developed country & emerging markets.

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Confluence Investment Management LLC is an independent 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.