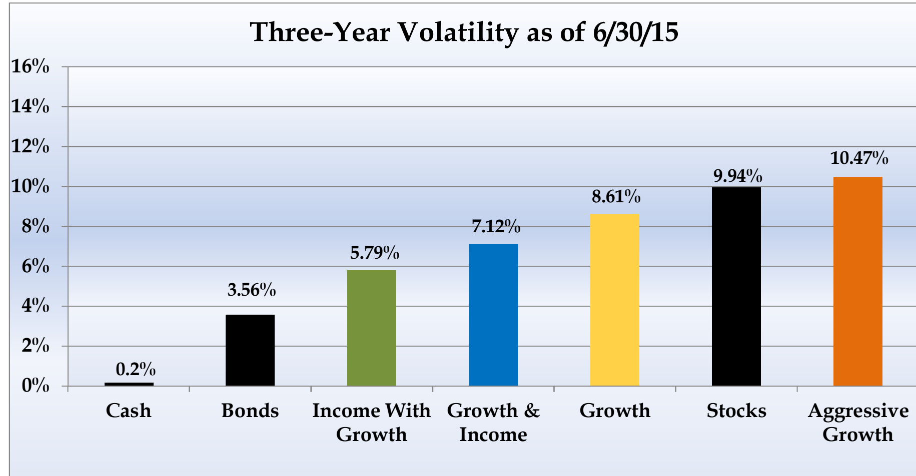
ASSET ALLOCATION QUARTERLY

Third Quarter 2015

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.



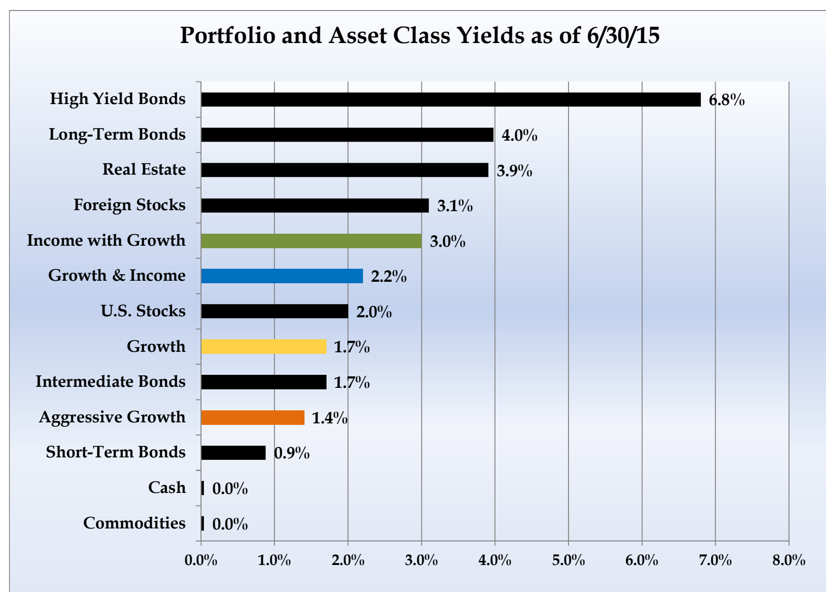
Source: Bloomberg, CIM. Cash is the ML 0-3 Month T-Bill Index; Bonds are the ML Domestic Master Index; Stocks are the S&P 500 Index. See disclosures on page 6* for important details.

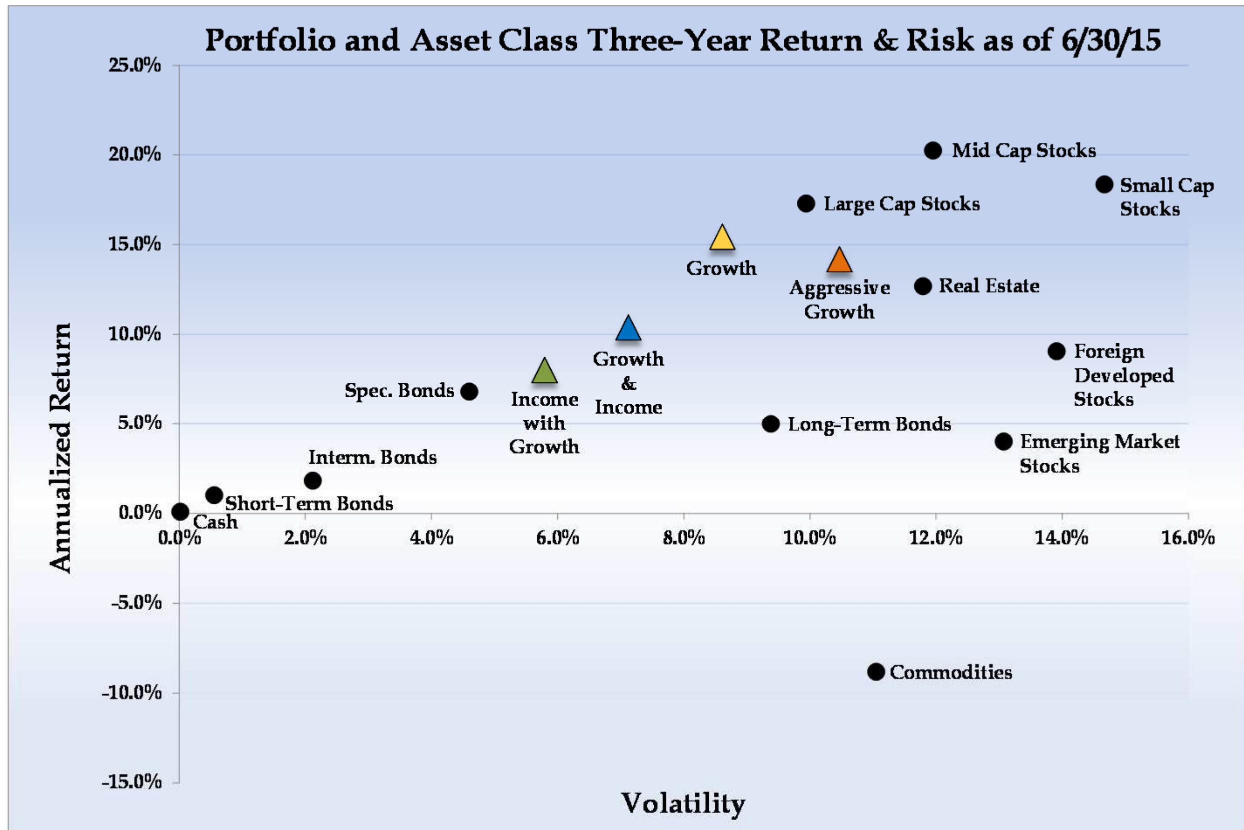
The Confluence asset allocation process is centered upon risk management. Our portfolios offer a broad spectrum of risk profiles, ranging from a fairly conservative posture in Income with Growth (green) to a more risk tolerant profile in Aggressive Growth (orange). The primary asset classes of cash, 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. However it's worth mentioning that this is merely a snapshot of a single three-year period. If we were able to animate the movement of the data points, one recent trend we would see is a general decline in returns, particularly for the equity-oriented asset classes. This trend is pretty consistent with mean reversion, which basically states that when returns have been higher than average, they are likely to be lower than average going forward. Equity returns since the 2008 financial crisis have been unusually high, so the fact that returns are moving down is consistent with mean reversion.

Also noteworthy are the lower returns delivered by income-oriented asset classes, including longer maturity bonds, speculative bonds and real estate. Domestically, interest rates have been rising due to concerns of tighter Fed policy, while rates overseas have become more volatile because of geopolitical events in places like Greece and China. Our recent allocations for income investors have had exposure to these asset classes and, as a result, these allocations often detracted from returns in the first half of 2015.

Rising volatility and lower returns aren't exactly pleasant, but investors should understand that the past several years of high returns and low risk were part of healing in the financial markets after the extreme downdrafts of the financial crisis. In part, this environment was fostered by the Fed and its extraordinarily easy monetary policy. As this policy is gradually withdrawn, financial markets may return to patterns more consistent with their long-term averages.

As we move through this cycle, we believe it is also important to consider valuations, which can help position the portfolio to benefit from mean reversion. It's a dynamic process, one that involves as much art as science. For example, it's noteworthy on this chart how low commodity returns have been. A purely formulaic approach could indicate that commodity returns should rise in the future. However, our work reveals that commodity return patterns often lack mean reversion, or the cycles may be much longer than those of other asset classes. We incorporate this kind of information into our process and, for now, remain out of commodities.

THIRD QUARTER 2015 ASSET ALLOCATION OUTLOOK

- **Significant disruptions or financial stress from Greece's debt problems appear to have been avoided, in the near term. However, structural problems that led to the Greek crisis have yet to be properly addressed and we expect the issue to emerge again in the future. It will be important to monitor how Greek creditors and other peripheral countries respond.**
- **China's equity market volatility has thus far been mostly contained within the country. However, China's economic growth has already been slowing and if the recent volatility inhibits growth, then the impact could spread to other countries.**
- **The Federal Reserve remains on a higher interest rate path, but determining how high and how soon is a complicated endeavor. We expect the Fed to move gradually and don't believe this path will cause a recession. However, it will be important to closely monitor the Fed and how its actions affect the economy.**
- **Our equity allocations remain focused on domestic stocks, which we believe have a superior return/risk profile relative to foreign equities for most investors. However, for aggressive investors, we introduce a limited foreign developed country allocation.**
- **Real estate fundamentals appear solid and we expect foreign investors will continue to increase their allocations to real estate in the U.S. We believe real estate can play a constructive role, particularly where income is an objective.**
- **Our style guidance remains in favor of growth over value (70/30).**

ECONOMIC VIEWPOINTS

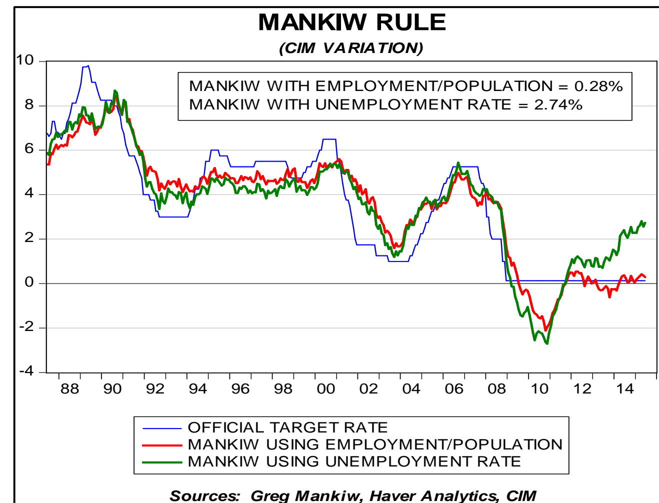
It's summer, the time of year when Europe seems most likely to fester with a government debt problem. And so it's not surprising to find Greece on center stage, playing a familiar role. We've seen this show before…too much debt, a weak economy and the need for more time and money. The endings tend to be the same. The hardest issues are not fully addressed, while debt and solvency problems are kicked down the road. The upside is that Greek problems seem unlikely to create a widespread financial crisis, but we note that the challenges are chronic and unresolved. We expect sequels to this play and will watch closely to see how Greece and other weak peripheral European states respond.

Another drama unfolding in a different theater is the enormous volatility in the Chinese equity market. Following a meteoric rise, fueled in large part by margin-laden speculation, Chinese stocks have gyrated wildly, oftentimes collapsing in spectacular form. It appears much of the movement, both up and down, has been caused inadvertently by governmental policy. Command and control capitalism is oxymoronic, yet the Chinese government is attempting to displace Adam Smith's invisible hand with the Communist Party's iron fist. It's an odd situation, one that reveals the undeveloped nature of China's financial system. Fortunately, most of the volatility and downdrafts have been contained in China. But China has the world's second largest economy, and its growth rate has been slowing. Therefore, we'll continue to monitor how and if China's equity challenges affect global economic growth and geopolitical risk.

Even as Greece and China are making headlines, we believe the more important story continues to be with the Fed. U.S. economic data have been strong enough for the Fed to plan on raising short-term rates. But it's a difficult maneuver, one complicated by external factors—like Greece and China—but also by the unusual nature of U.S. economic expansion. Inflation, wage growth and labor participation remain abnormally low given where we are in the economic cycle. If the Fed moves too quickly or goes too far, it risks creating a recession, a condition that historically has been one of the greatest risks to equities. On the other hand, if the Fed remains too easy with policy, it could set the stage for financial market "melt-ups" in which valuations spiral upward. These melt-ups may be enjoyable on the way up, but usually end with high volatility, outsized losses and numerous bankruptcies.

The chart on the next page illustrates a model from the economist Greg Mankiw. Using unemployment and inflation, his model does a good job of indicating where Fed policy may go. With the decline in the unemployment rate, it indicates the Fed's neutral policy rate could be close to three percent.

However, we have adjusted the model to account for the low labor participation rate and this modification indicates no need for the Fed to raise rates. Our work indicates the Fed is likely to choose a path in between, gradually raising rates in a manner that is unlikely to cause a recession. Still, we note that it will be very important to monitor the Fed's actions and how the economy is affected.



STOCK MARKET OUTLOOK

Although stock returns in the first half of the year were quite limited, this condition is not necessarily a negative situation. Over the past several years, rising valuations have provided an additive lift to equities and were a significant part of the above-average returns delivered by the market. As a result, stocks have moved out of the "cheap" valuation range and crossed into the "moderately expensive" category. This doesn't necessarily mean a bubble has formed, but it does indicate returns are likely to be lower going forward. The upside is that the recent sideways direction of equities can allow for earnings and other fundamentals to catch up with prices. It also indicates that equity investors are exhibiting a measure of risk aversion, and aren't necessarily willing to pay any price for stocks. So while the near-term performance may be somewhat disappointing relative to the past few years, it helps set the stage for healthier equity markets in the long run. This may be just what the Fed is seeking as it sets out to raise interest rates.

In this environment, we believe it is important to consider both valuation as well as growth potential. Our work indicates that although foreign equities have generally underperformed those in the U.S., their valuations aren't quite low enough to adequately compensate most investors for the lower growth we anticipate. So, at this point, we remain out of both developed country and emerging market equities, except for aggressive growth investors.

The domestic equity allocations remain diversified across the spectrum of capitalization sizes to include large, mid and small caps. Our bias remains toward mid and small caps, because their growth potential appears to be higher. However, these equity asset classes also tend to have higher volatility relative to large caps, so we also include large caps. Our sector guidance within large caps favors technology and consumer discretionary sectors, while we are underweight utilities, telecom and energy. Our style guidance remains overweight growth versus value (70/30). We continue to believe growth-oriented industries may perform relatively well as we move into the time frame when the Fed begins to raise interest rates.

BOND MARKET OUTLOOK

For both intermediate and longer term bonds, yields have become more volatile in recent months as investors digested the news coming out of Greece and China. At the same time, bond investors have a close eye on the Fed, watching for guidance with regard to when and how much the Fed will tighten. The various cross-currents generally pressured interest rates higher in the first half of the year, but our outlook for the overall bond market remains in place. U.S. growth should remain below average, but is likely to be higher than most developed countries. For these reasons, we don't expect rates to move significantly higher and foreign interest in U.S. bonds should remain relatively strong. Therefore, our bond allocations continue to involve intermediate and longer maturity bonds.

OTHER MARKETS

Real estate recently faced some headwinds as interest rates around the world moved upward, yet fundamentals remain strong and we believe foreign interest for U.S. real estate is likely to remain relatively high. Still, we believe real estate at this point in the cycle appears most appropriate where income is a primary objective. Therefore, we reduce the real estate allocation this quarter in growth-oriented portfolios.

Returns in the commodity asset class remain low and we don't expect a turnaround anytime soon. Global supply remains high and has yet to fully adjust to lower demand, especially from China, but also from many developed countries. At this point, we remain completely out of the asset class.

Third Quarter 2015	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	25%	(2%)	2%	-	-	-	-	-
Long Term Bonds	25%	7%	20%	-	7%	2%	-	-
Speculative Grade Bonds	2%	(4%)	5%	-	-	-	-	-
Real Estate	12%	(6%)	8%	-	5%	(5%)	5%	(5%)
U.S. Large Cap Stocks	7%	-	20%	-	40%	(5%)	15%	-
U.S. Mid Cap Stocks	12%	5%	33%	-	26%	3%	15%	-
U.S. Small Cap Stocks	15%	-	10%	-	20%	5%	58%	-
Foreign Developed Country Stocks	-	-	-	-	-	-	5%	5%
Emerging Market Stocks	-	-	-	-	-	-	-	-
Commodities	-	-	-	-	-	-	-	-
Total	*100%*		*100%*		*100%*		*100%*	

INCOME WITH GROWTH

Concerns regarding Greece and China, along with uncertainty with regard to Fed policy, have increased volatility in the bond market, particularly for longer maturity bonds. Although rates moved higher in the first half of 2015, we still believe intermediate and long maturity bonds can play a constructive role in bond allocations. We don't anticipate U.S. or global economic growth to accelerate significantly, nor do we believe inflation is likely to increase. In this environment, we believe the Fed's tightening should be gradual and don't expect significant escalations in interest rates. We continue to believe corporate bond yields are attractive, while default levels should remain low.

The equity allocation emphasis in the Income with Growth portfolio remains on small and mid caps, which we believe have higher growth potential. Still, volatility is higher for these equity asset classes, so we temper the allocations with the large cap exposure. We remain out of foreign developed and emerging market equities, where the return/risk profile appears less attractive relative to domestic equities. Real estate has performed very well in recent years and we expect fundamentals to remain strong; however, we trim the exposure this quarter to accommodate an increase in the allocation to mid caps.

GROWTH & INCOME

This quarter we maintain our allocations in the Growth and Income portfolio. The bond allocation remains heavily skewed toward long-term bonds. Although this asset class faced the headwinds of rising interest rates in the first half of the year, we expect low global economic growth, limited inflation and moderation in Fed tightening to limit increases in long-term rates. The corporate bond exposure continues to include both investment grade and speculative grade bonds.

The equity allocation remains diversified across large, mid and small caps. We attempt to balance the higher growth potential of smaller companies with the lower volatility often exhibited by larger ones. We note that the equity allocation remains entirely domestic, based upon our belief that the return/risk profile of U.S. equities is more favorable for this portfolio. Real estate fundamentals are strong and we expect this trend to continue. In addition, we expect foreign investors are likely to continue allocating into U.S. real estate. For these reasons, we maintain the real estate exposure, which is helpful in pursuing both income and growth objectives.

GROWTH

One of the primary risks to equity investors is a recession which may cause volatility and negative returns. At this point, we believe the Fed is likely to follow a path of tighter monetary policy that does not create a recession. We consider this good news for growth investors, but at the same time recognize that earnings growth is likely to slow a bit. We also know that equity valuations are higher than they have been in recent years, which sets the stage for generally lower returns going forward. But all in all, we believe equities, across a broad range of capitalization sizes, continue to offer constructive return/risk profiles for growth investors.

Our focus in the Growth portfolio remains on domestic equities, which we generally believe to have better growth potential than foreign equities. Many developed countries continue to struggle and are often very dependent upon U.S. growth. Emerging market equities may have higher growth, but the volatility from declining growth and scattershot government policies from China lower the appeal of this asset class. We maintain a small allocation to long-term bonds, which may help offset increases in equity volatility.

AGGRESSIVE GROWTH

Because we believe tighter Fed policy is unlikely to cause a recession, we believe the environment for equity investing is generally positive, even if stock returns are unlikely to be as high as they have been in recent years. Our equity allocations remain focused on domestic stocks. We believe the U.S. economy is likely to set the pace for global growth and we expect it to be higher than most other developed countries. Still, this quarter we introduce a small foreign allocation…something we haven't had for several quarters. Although the Greek bailout caused significant volatility in European financial markets, we believe the temporary resolution opens the door for opportunities for risk-tolerant investors.

Within the U.S., the Aggressive Growth portfolio is highly focused on small caps. We believe higher growth potential may create higher return opportunities for aggressive investors. We continue to believe real estate should perform reasonably well, but pare back the exposure to accommodate the allocation to foreign equities.

Performance & Disclosures

As of 6/30/15

Strategy	Quarter	YTD	1 - Year	3 - Year	5- Year	ITD
Aggressive Growth - Gross of Fees	-0.6%	2.6%	5.7%	14.2%	12.8%	7.18%
Aggressive Growth - Net of Fees[1]	-1.4%	1.1%	2.5%	10.8%	9.4%	3.92%
Benchmark - S&P 500	0.3%	1.2%	7.4%	17.3%	17.3%	9.93%
Growth - Gross of Fees	-1.4%	1.7%	6.7%	13.0%	12.7%	6.69%
Growth - Net of Fees[1]	-2.1%	0.2%	3.5%	9.7%	9.4%	3.53%
Benchmark - S&P 500	0.3%	1.2%	7.4%	17.3%	17.3%	9.57%
Growth and Income Taxable - Gross of Fees	-2.7%	0.9%	4.7%	10.4%	11.1%	6.82%
Growth and Income Taxable - Net of Fees[1]	-3.4%	-0.6%	1.6%	7.1%	7.8%	3.66%
Benchmark - 70% S&P 500 and 30% ML Bond Index	-0.3%	0.9%	5.9%	12.6%	13.2%	8.38%
Income Taxable with Growth - Gross of Fees	-3.9%	-0.8%	2.7%	8.0%	9.3%	11.24%
Income Taxable with Growth - Net of Fees[1]	-4.6%	-2.3%	-0.4%	4.8%	6.1%	7.94%
Benchmark - 40% S&P 500 and 60% ML Bond Index	-0.9%	0.5%	4.3%	7.9%	9.0%	9.37%

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 6/30/15. 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 June 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.