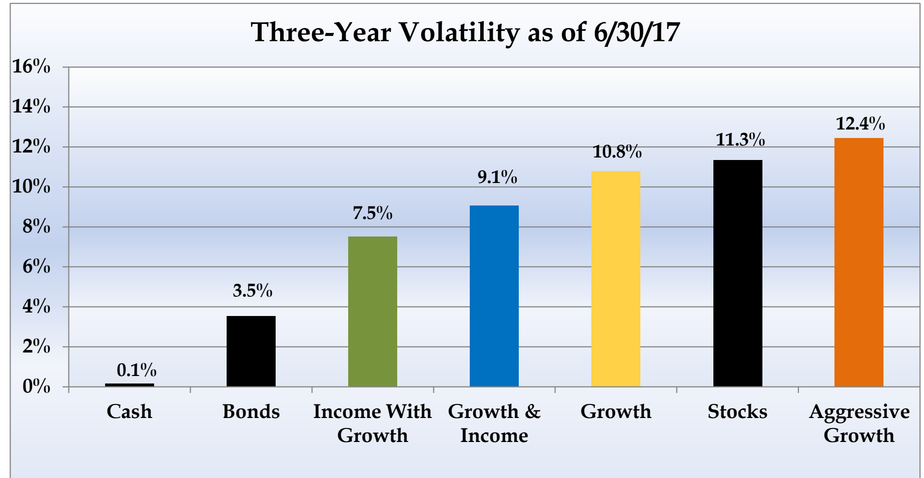
Confluence INVESTMENT MANAGEMENT

ASSET ALLOCATION QUARTERLY
Third Quarter 2017

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.



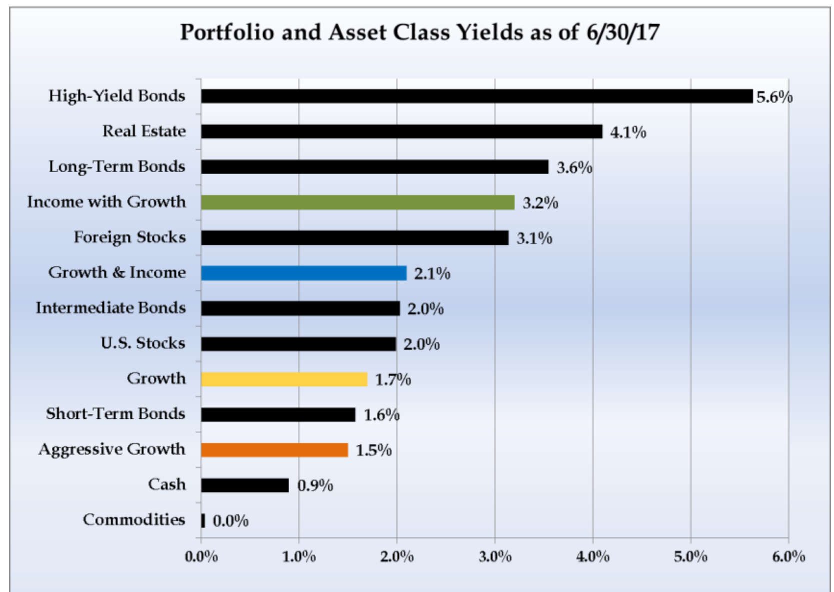
Source: Bloomberg, CIM. Cash is the ML 0-3 Month T-Bill Index; Bonds are the ML Domestic Master Index; Stocks are the S&P 500 Index. *See disclosures on page 6 for important details.

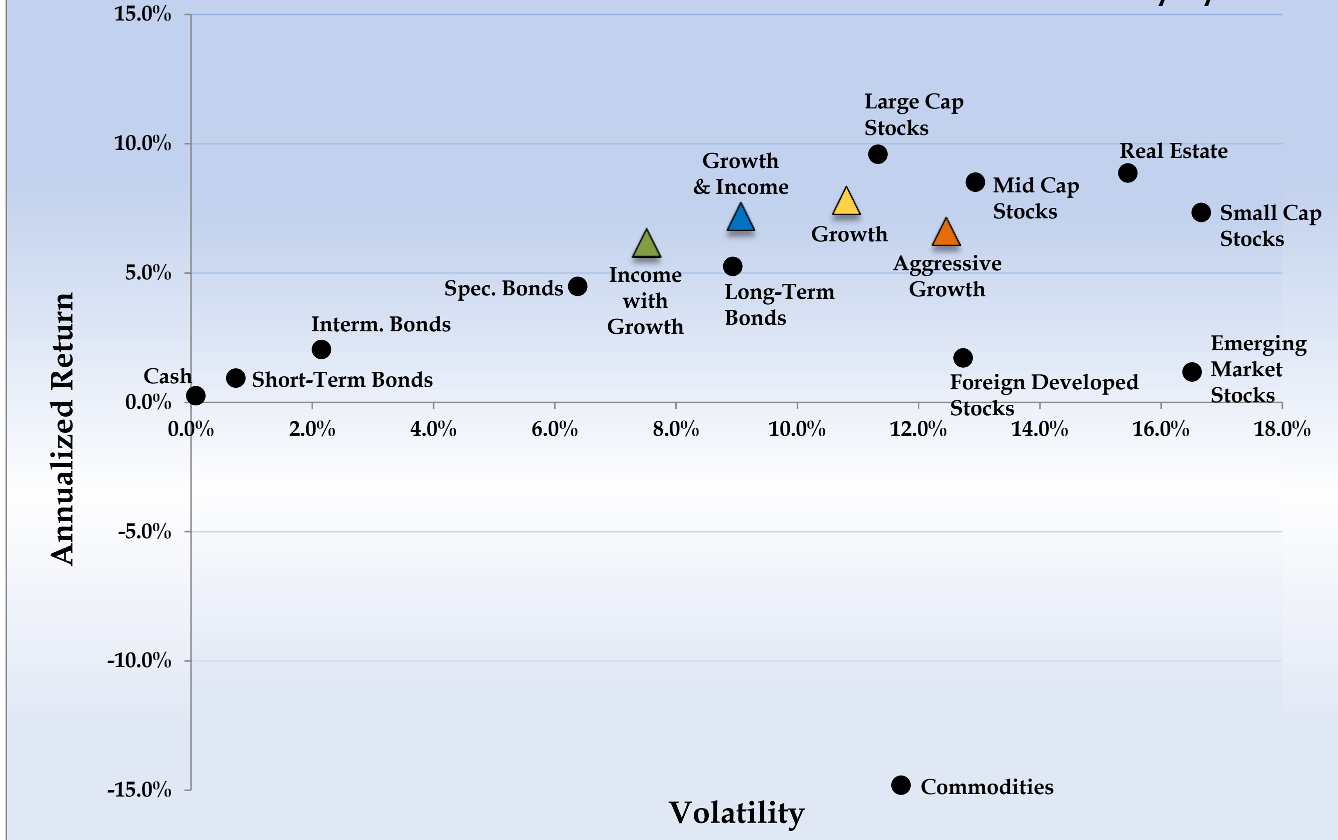
The Confluence asset allocation process is centered upon risk management. Our portfolios offer a broad spectrum of risk profiles, ranging from a fairly conservative posture in Income with Growth (green) to a more risk tolerant profile in Aggressive Growth (orange). The primary asset classes of cash, 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 our portfolios have performed over the rolling three-year period ending June 30, 2017.

As one would expect, the strategies positioned for lesser volatility have also experienced lower returns during the advancing markets we have enjoyed over the past three years. Our outlook for risk, as measured by volatility, has aided our expectations for return, which has worked in nearly a stepwise progression from the Income with Growth portfolio through the Growth portfolio. The sole outlier has been Aggressive Growth, where our concentration in small cap stocks and lesser weighting in real estate have been eclipsed by excess returns recorded by large cap and mid-cap stocks. Nevertheless, we expect the historic excess returns for smaller capitalization stocks to prevail over time. Beyond this outlier, the portfolios have followed the expected cadence for each unit on the risk/return spectrum.

The past three years have been heavily influenced by accommodative monetary policies and an attendant increase in investor risk appetites. Consequently, equities, particularly those that have been fueled by significant investor flows to passive investment vehicles, have been amply rewarded over the period. The influence of positive investor flows was most pronounced in large and mid-cap equities, while those for small cap stocks were more muted, according to asset flow data published by Morningstar. Non-U.S. equities were stymied by a combination of slow growth rates abroad and historically high valuations for the U.S. dollar. For U.S.-based investors, the increase in the value of the dollar has dampened the returns recorded in the local currency.

Within bonds, risk and returns were consistent with the positive slope of the yield curve. Short and intermediate maturities delivered coupon returns with low volatility, while long-term bonds exhibited elevated volatility and benefited from higher coupons as well as price appreciation. Speculative grade bonds provided returns in excess of intermediate maturity Treasury equivalents, though with higher volatility due to repricing of the energy complex during this period.

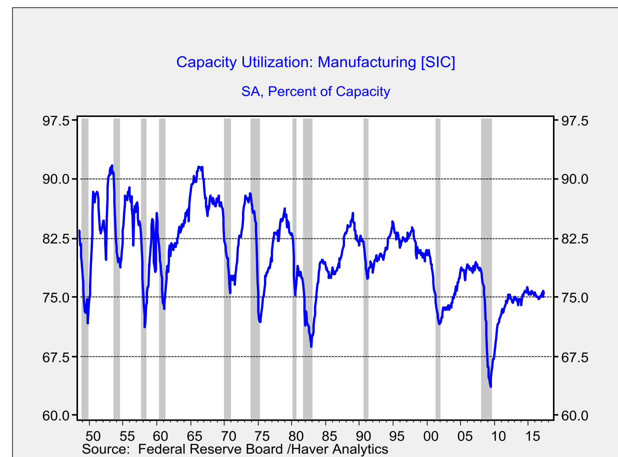
Overall, the portfolios and the individual asset classes conformed to volatility and return expectations. However, the favorable economic landscape over the past several years is not likely to be repeated with the same refrain. Accordingly, we remain on guard for signals of weakness and regularly reassess our macroeconomic outlook and expected returns and volatility for each asset class. As a result, the cadence for returns over the ensuing years may look different from recent experience, but the volatility for each of the portfolios is expected to conform to what we have historically witnessed.

THIRD QUARTER 2017 ASSET ALLOCATION OUTLOOK

- **Economic data remain supportive and the inflation outlook is currently benign.**
- **Though the economic expansion is elongated, we do not anticipate a near-term recession.**
- **Fed policy is expected to tighten in terms of rising short-term rates and the reduction in the size of the Fed's balance sheet.**
- **We expect the Fed to commence the reduction of its $4.5 trillion balance sheet with a $10 billion monthly run-off by the end of this year.**
- **Expectations for a softer U.S. dollar combined with attractive valuations overseas have encouraged us to include non-U.S developed and emerging market equity exposure, the former with a tilt toward Europe.**
- **Overall allocations to bonds are intact, though with a heavier presence in intermediate-term bonds. Speculative grade bonds remain supportive for income objectives.**
- **Our growth/value even weight of 50/50 remains unchanged from last quarter.**

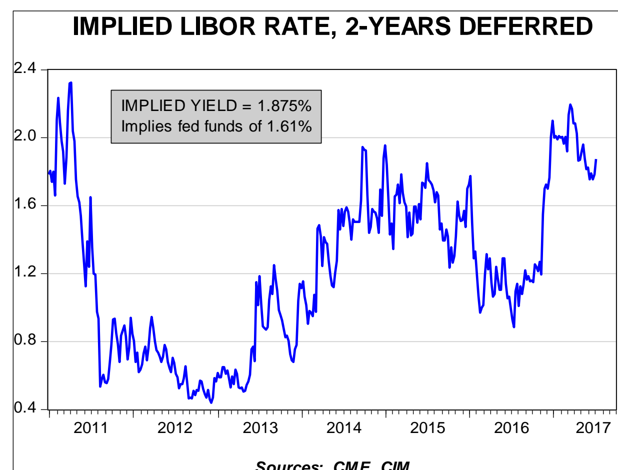
ECONOMIC VIEWPOINTS

The themes present at the start of the year continue unabated, with inflation and unemployment at low levels and both consumer and business sentiment remaining elevated. Although the U.S. is now 97 months into an expansion, closing in on the second longest on record, there are pockets of softness. For example, consumption is slower than historical experience as measured by PCE, investment is muted and capacity utilization is running at 75%, as evidenced in the accompanying chart. In addition, government spending, inclusive of the contributions of states and municipalities, is very low as a percentage of real (inflation-adjusted) GDP. These measures all factor into our belief that a recession is not on the near-term horizon and the economy holds solid potential for continued expansion despite its current length.



Although members of the FOMC are signaling further monetary tightening through an increase in the fed funds rate as well as a reduction in the reinvestment of balance sheet proceeds, markets anticipate that the Fed won't be as hawkish as the current trajectory implies. For example, the Fed's much-publicized dot plots indicate a fed funds rate of 2.25% by this time next year, while the markets, as measured by LIBOR, provide an implied rate of 1.61%, as exhibited in the below chart.

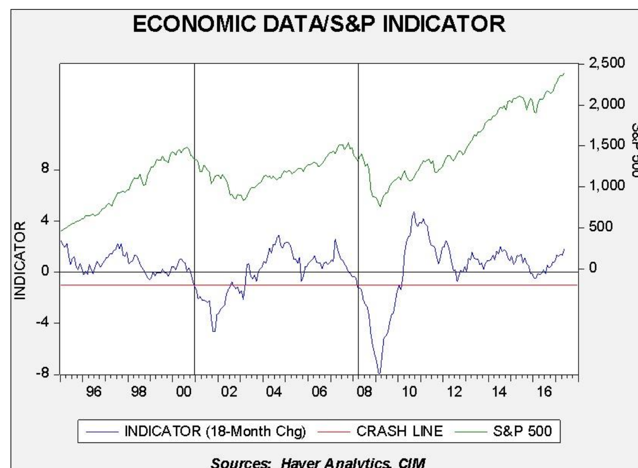
The Fed appears mollified by the improvement in unemployment figures and the lack of deflationary pressure, providing the latitude to move rates higher and commence some withdrawal of stimulus by reducing the reinvestment of proceeds from its $4.5 trillion balance sheet. However, uncertainties abound regarding not only the path of balance sheet reduction and its concomitant effect on the U.S. banking system and the availability of credit, but also the complexion of the Fed's Board of Governors with its three vacancies and the prospect of a new Fed Chair. As mentioned in our last quarter's report, it remains unclear as to whether the Trump administration will be appointing members who are hawkish or populist. While the issues surrounding the complexion of the Fed and its amount of monetary accommodation remain unresolved, the pace of tightening thus far has been appropriate and there are no indications that they have raised the prospect of thrusting the economy into a recession.



Our view is that the issues that create headlines, such as current Congressional activity surrounding healthcare and the potential modifications to the tax code, are more distracting than influential at this juncture. Until, or unless, legislation is advanced or the Fed missteps, we retain the perspective that equity markets carry fair value on the traditional metric of Price/Earnings with a benign level of inflation. In addition, the intermediate and long portions of the bond market provide positive inflation-adjusted returns. The greater near-term investment significance for U.S.-based investors include expectations that nascent U.S. dollar weakness relative to foreign currencies will continue, particularly versus the euro and the basket of emerging market currencies. The Trump administration's encouragement of a weaker dollar is a marked departure from the policies of prior administrations and consistent with our belief that U.S. economic hegemony is waning.

STOCK MARKET OUTLOOK

The economic landscape has proven favorable for U.S. equities and we find that the current economic environment remains healthy. However, signals of policy tightening from the Fed advise a degree of caution and bear continued scrutiny. In addition, recent readings of small business optimism exhibit softness compared to earlier in the year. Nevertheless, factors that are typical of elevated downside risk are noticeably absent, as shown on the accompanying chart. This graph depicts the monthly average for the S&P 500 Index versus our conflation of initial jobless claims, the Conference Board's Consumer Confidence data and the CRB commodity index using adjusted standardized data.[1] Though this shows that the U.S. economy is well advanced in the economic cycle, near-term concerns are not evident. Valuations have certainly advanced over the past year, but we believe that they can be persistent and are not untenable at this stage. Large cap, mid-cap and small cap equities have all enjoyed solid returns and traditional valuation metrics of Price/Earnings, Price/Book, and Price/Cash Flow have advanced accordingly. In contrast, non-U.S. equities, while enjoying positive returns this year, are generally priced below U.S. counterparts on traditional valuation metrics. Furthermore, given our views of a softer U.S. dollar environment, we are shifting some U.S. exposure to foreign equities. Much of this shift is being pulled from U.S. mid-cap exposure as pricing is more elevated and therefore expected returns are more muted. Among foreign domiciles, we tilt toward Europe in developed countries and also introduce exposure to emerging markets for more growth-oriented strategies.



[1] For a full description of the standardization of data, please refer to our Asset Allocation Weekly, 6/30/17.

Among U.S. large cap sectors, we favor healthcare and industrials and continue to underweight telecom and consumer staples. We reduce our previous overweight of financials and utilities to even-weight. REITs continue to be positioned in two strategies for their diversification benefits and potential for modest appreciation. Our growth/value style bias remains evenly balanced at 50/50, reflecting our views toward sectors and industries.

BOND MARKET OUTLOOK

The Treasury yield curve has flattened over the course of this year, reflecting tighter monetary conditions at the Fed. Though the duration of the bond exposure in the more income-oriented strategies remains consistent with our prior exposures, it is now attained through a greater allocation to the intermediate segment as opposed to the former bar-belled overweights to short- and long-term bonds.

The exposure to long-term bonds has proven beneficial, but the current outlook has encouraged a more cautious positioning for the months ahead, especially as the Fed begins to engage in some normalization of its balance sheet. We maintain our favor to investment grade corporate bonds over Treasuries and mortgage-backed securities as the spreads continue to be attractive and supported. We also retain exposure to speculative grade bonds given our outlook for contained default and recovery rates.

OTHER MARKETS

Despite a more favorable outlook for commodities, we have concluded that introducing exposure at this time may be premature. In an environment of faster economic growth and/or a surge in inflation expectations, commodities would prove helpful to a diversified portfolio. However, we harbor no expectations of either environment over the near term. Accordingly, there remain no allocations to commodities in the strategies.

Third Quarter 2017

	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%	5%	-	-	-	-
Intermediate Term Bonds	21%	21%	10%	-	5%	-	-	-
Long Term Bonds	10%	(20%)	5%	-	-	-	-	-
Speculative Grade Bonds	12%	-	5%	-	-	-	-	-
Real Estate	20%	-	-	(5%)	5%	-	-	(5%)
U.S. Large Cap Stocks	22%	(4%)	30%	(13%)	40%	-	-	-
U.S. Mid Cap Stocks	-	(7%)	15%	(10%)	20%	(10%)	25%	(10%)
U.S. Small Cap Stocks	-	-	18%	13%	8%	(10%)	48%	(10%)
Foreign Developed Country Stocks	10%	10%	5%	5%	10%	10%	10%	10%
Emerging Market Stocks	-	-	5%	5%	10%	10%	15%	15%
Commodities	-	-	-	-	-	-	-	-
Total	*100%*		*100%*		*100%*		*100%*	

INCOME WITH GROWTH

In the Income with Growth strategy, we trim the healthy exposure to long-term bonds in favor of intermediate-term bonds. Though more muted, we retain an allocation to longer maturity bonds due not only to their higher yields, but also the diversification benefits for conservative investors as these bonds typically rally in price during equity market declines. We retain the exposure to speculative grade bonds, which have higher yields, albeit with greater credit risk. We expect the default environment to continue to be benign, maintaining a favorable risk/reward backdrop for higher yields.

The equity allocation shifts this quarter from purely domestic to include a non-U.S. developed market exposure with a decided tilt toward Europe. Favorable valuations and expectations for a softer U.S. dollar encourage our positioning. Within the U.S., we retain much of the former allocation to large cap equities but eliminate the allocation to mid-caps. Our allocation to real estate is unchanged due to expectations of strong income generation from continued low financing costs.

GROWTH & INCOME

We increase the bond allocation in the Growth & Income portfolio, stemming from the introduction this quarter of a modest allocation to short-term bonds and the retention of prior weightings to intermediate and long-term investment grade and speculative grade bonds. The mix among Treasuries, mortgage-backed securities and corporate bonds across the term structure produces a well-diversified combination of exposures.

Among equities, we introduce modest allocations to non-U.S. developed and emerging market stocks due to favorable fundamentals and expectations of a softer U.S. dollar. Though U.S. large cap and mid-cap allocations were trimmed and real estate exposure eliminated, we elevate the allocation to small cap equities. Our views on valuations in the small cap space are similar, albeit more modest, to what we have found in foreign equities. Additionally, the small cap exposure provides the appropriate risk/expected return profile to complement the non-U.S. allocations.

GROWTH

Though the environment for U.S. equities remains relatively positive, with stable economic growth and measured tightening by the Fed, our expectations for non-U.S. equities are enhanced by favorable fundamentals and the potential for a softer U.S. dollar. In the Growth strategy, the non-U.S. stock allocation is split between developed markets, where we have a tilt toward European stocks, and emerging markets. Though exposure to U.S. large caps is unchanged, the non-U.S. allocations were sourced from a portion of mid-cap and small cap equities. While these categories retain favorable risk/return profiles, our expectations for foreign equities are more pronounced.

We retain the small allocations to real estate and intermediate bonds as we believe they continue to provide associated diversification benefits to the portfolio.

AGGRESSIVE GROWTH

The posture of the Aggressive Growth portfolio shifts to global exposure with the introduction of sizable weights to non-U.S. developed and emerging market equities. The backdrop of attractive fundamentals and softening U.S. dollar encouraged our positioning. The developed foreign exposure has a tilt toward Europe, where economic growth is strengthening and the ECB has indicated that an increase in stimulus is no longer necessary. This portfolio continues to be void U.S. large caps. We trim the allocations to mid-caps and small caps this quarter, though the latter still accounts for nearly half of the portfolio's exposure given favorable risk metrics relative to our expected return for the category. Moreover, current ratios of P/E, P/B, and P/CF for small caps are attractive relative to historic measures.

We eliminate the small allocation to real estate owing to elevated expected returns for non-U.S. equities and include emerging markets and emerging market small caps that we find to be appropriate for an aggressive risk profile at this stage.

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Performance & Disclosures

As of 6/30/17

Strategy	Quarter	YTD	1 - Year	3 - Year	5- Year	ITD
Aggressive Growth - Gross of Fees	1.7%	3.7%	14.7%	6.6%	11.3%	7.0%
Aggressive Growth - Net of Fees	1.0%	2.1%	11.3%	3.5%	8.0%	3.8%
Benchmark - S&P 500	3.1%	9.3%	17.9%	9.6%	14.6%	9.9%
Growth - Gross of Fees	2.3%	6.1%	13.9%	7.8%	11.2%	7.1%
Growth - Net of Fees	1.6%	4.6%	10.6%	4.6%	7.9%	3.9%
Benchmark - S&P 500	3.1%	9.3%	17.9%	9.6%	14.6%	9.8%
Growth and Income Taxable - Gross of Fees	2.7%	6.9%	11.1%	7.2%	9.6%	7.2%
Growth and Income Taxable - Net of Fees	1.9%	5.3%	7.8%	4.0%	6.4%	4.0%
Benchmark - 70% S&P 500 and 30% ML Bond Index	2.6%	7.2%	12.1%	7.6%	10.9%	8.4%
Income Taxable with Growth - Gross of Fees	3.2%	6.0%	6.6%	6.2%	8.0%	10.5%
Income Taxable with Growth - Net of Fees	2.5%	4.4%	3.4%	3.0%	4.8%	7.2%
Benchmark - 40% S&P 500 and 60% ML Bond Index	2.1%	5.1%	6.6%	5.5%	7.2%	8.6%

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 6/30/17. 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 2017. 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.