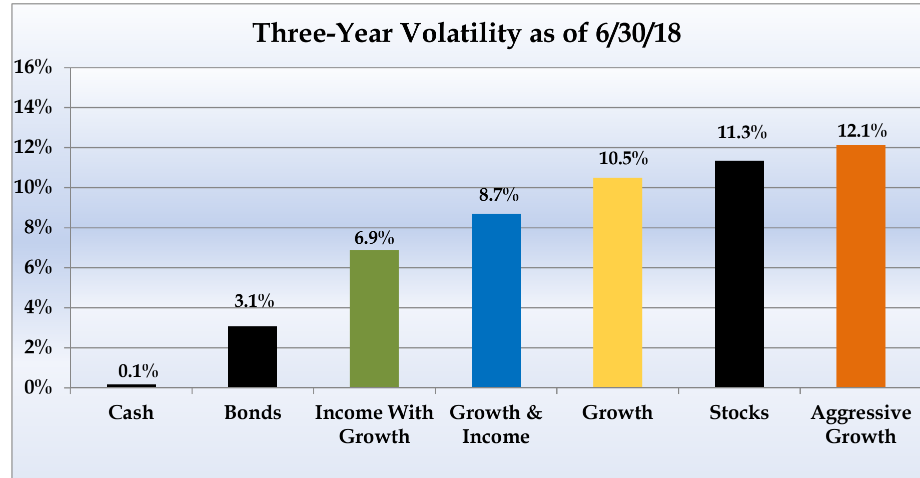
ASSET ALLOCATION QUARTERLY
Third Quarter 2018

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.



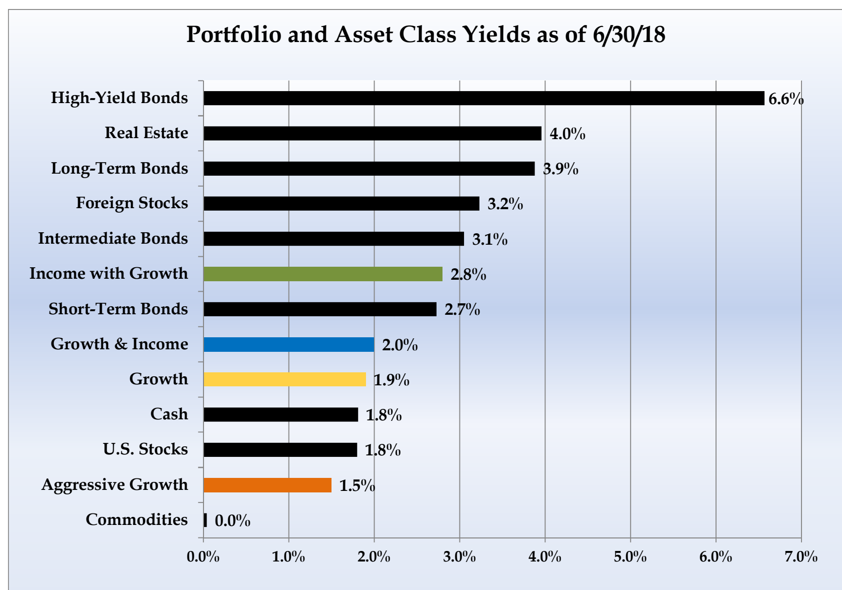
Source: Bloomberg, CIM. Cash is the ML 0-3 Month T-Bill Index; Bonds are the ML Domestic Master Index; Stocks are the S&P 500 Index. *This information is presented as supplemental information to the disclosures required by GIPS® standards. See disclosures on page 6 for important details.

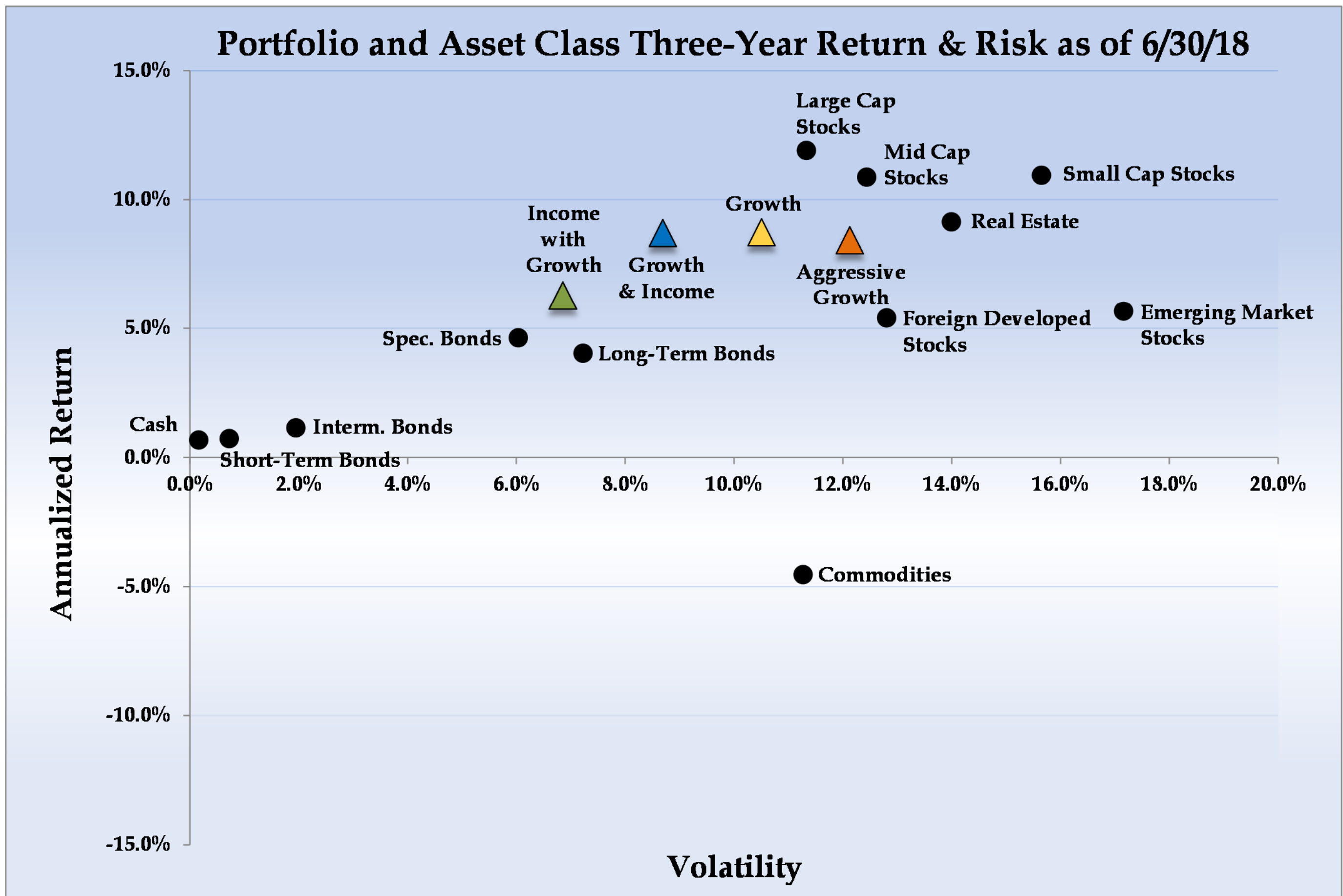
The Confluence asset allocation process is centered upon risk management. Our portfolios offer a broad spectrum of risk profiles, ranging from a fairly conservative posture in Income with Growth (green) to a more risk tolerant profile in Aggressive Growth (orange). The primary asset classes of cash, 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

The chart above depicts the returns and risk, as measured by the volatility of returns, for twelve primary asset classes as well as the composite performance for our asset allocation portfolios over the three-year period ending June 30, 2018. During periods of positive market returns, as have been witnessed over the examination time frame, expectations are that returns of risk assets such as equities will exceed those of bonds, with associated higher volatility. The experience has certainly conformed to expectations, with a wide divergence of returns and volatilities for equities and a more narrow level of return variance for bonds, all of which have experienced volatility levels in the single digits.

The colored triangles in the chart represent the Confluence portfolios. As expected, Income with Growth experienced lower volatility, yet with a lower return due to its average allocation of two-thirds to bonds. The other three strategies followed cadence in terms of volatility. However, the Growth & Income return equaled that of the Growth strategy, while Aggressive Growth delivered a marginally lower return.

The past three years have been characterized by elevated levels of investor risk appetite, which have 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 has increased portfolio volatilities, the equity exposures have captured higher returns than bonds have produced. The larger exposure to non-U.S. equities in the Confluence Growth and Aggressive Growth strategies, while beneficial last year, have proven to be an encumbrance thus far in 2018, leading to three-year annualized returns that equal the more conservatively postured Growth & Income strategy.

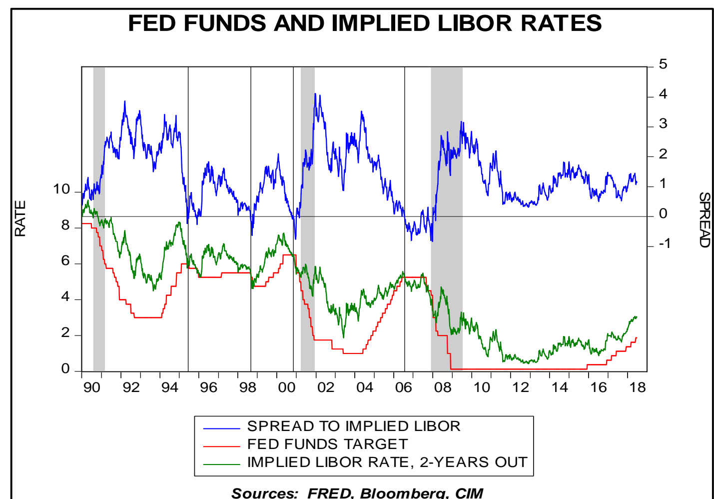
Although our cyclical forecast is for a continuation of the positive economic environment that should reward risk assets, we regularly reassess and review data that can affect our macroeconomic outlook. Accordingly, if we find a shift in market sentiment, an increase in the potential for a policy mistake by the Fed, a higher probability for a recessionary environment, a pronounced disruption to global trade and/or magnified geopolitical risk, we will naturally adopt a more risk-averse posture for all of our strategies.

THIRD QUARTER 2018 ASSET ALLOCATION OUTLOOK

- **We expect that Fed policy will continue tightening through year-end, with as many as two additional increases in the fed funds rate in tandem with a measured reduction in the size of the Fed's balance sheet, but the prospect for a recession is not included in our cyclical forecast.**
- **Our expectations are for continued GDP growth throughout the balance of this year and into 2019. Accordingly, equity exposures remain elevated across all strategies relative to our historic allocations, with a 60% growth style bias among U.S. equities.**
- **The outlook for the U.S. dollar is path dependent upon the durability of both trade conflicts and Fed posture into and through next year.**
- **We retain a modest allocation to gold given the combination of the potential for global political instability and its current price well below our estimate of fair value.**

ECONOMIC VIEWPOINTS

Continued tightening by the Federal Reserve, with its two increases in the fed funds rate thus far this year, combined with the gradual reduction in its balance sheet and the gravitational pull of negative yields in much of the developed world have led to a flattening of the U.S. Treasury yield curve. 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. Though an inverted yield curve is widely viewed as being indicative of an impending recession, a flattening curve is not necessarily a precursor to an inversion. What we have found to be an even more important metric to measuring Fed policy than either the spread between fed funds and the 10-year or the 2/10 segment of the curve is the spread of fed funds to the implied LIBOR rate advanced two years. As the accompanying chart indicates, implied LIBOR has increased since mid-2016 and remains comfortably in excess of fed funds. When this measure falls into negative territory, it is a signal from the financial markets that the Fed has overtightened policy. If or when this occurs, it will cause us to reassess the probability of a near-term recession. Until that point in time, we are consoled by the high levels of several sentiment indices, including the U.S. NFIB Business Optimism Index, the Conference Board's Consumer Confidence Index and the University of Michigan's Index of Consumer Sentiment. In addition, low unemployment and strong GDP figures compel us to retain equity exposures at their historically high levels for the portfolios until such time that potential risk outweighs expected return. Finally, inflation expectations remain around the 2% level, which creates a stable backdrop for both bonds and equities. While we are cognizant that the mid-term elections in the U.S. may engender fiscal changes that could challenge the economic environment, we find it premature to factor any effects into our forecast.

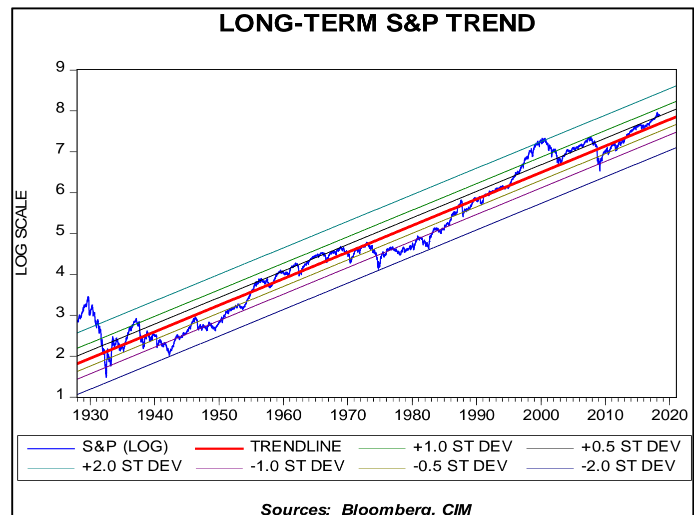


The global economic environment, while still positive, faces a number of challenges. The imposition of tariffs by the U.S. and, as a result, several of its trading partners, holds the potential to develop into a full-scale trade war with obvious downward implications for global growth. Although Europe is still in expansion, the ECB has maintained a dovish stance on rates and has indicated it might forestall a reduction in its balance sheet until mid-2019, citing a moderation in growth in the first half of the year and concerns emanating from increased protectionism. The Japanese economy has similarly exhibited recent signs of difficulty. After eight straight quarters of GDP growth beginning in 2016, the economy shrank in the first quarter. Although it was a modest decline of -0.2%, it echoes the moderation in Europe and encourages the extension of the BOJ's asset purchase program. Of even greater consequence to the global economic environment is China's response to U.S. protectionism. We believe China has the will and determination to engage in a full-scale trade war with the U.S. In addition, China may employ any economic weakness accruing from a reduction in its trade to contain its debt growth, which is prominent in Chairman Xi's economic construct.

Given the global dispersion of economic growth rates and central bank policies combined with the potential for protectionism to take hold, we find the value of the U.S. dollar versus other currencies to be on a knife's edge. Continued U.S. economic expansion and weakness abroad are normally a recipe for U.S. dollar strength relative to other currencies. However, though the interest rate differentials support a strong U.S. dollar and a global trade war would lead investors to seek safety in the greenback, leading to the potential for the U.S. dollar to reach historically high valuations, a more localized trade dispute solely with China would limit the overall economic impact.

In the event that the goal of the U.S. administration's trade rhetoric is simply to improve America's bargaining position, the U.S. dollar could be vulnerable to a pullback to its fair valuation. If the Trump administration openly opposes Fed policy tightening, then the dollar could be especially vulnerable.

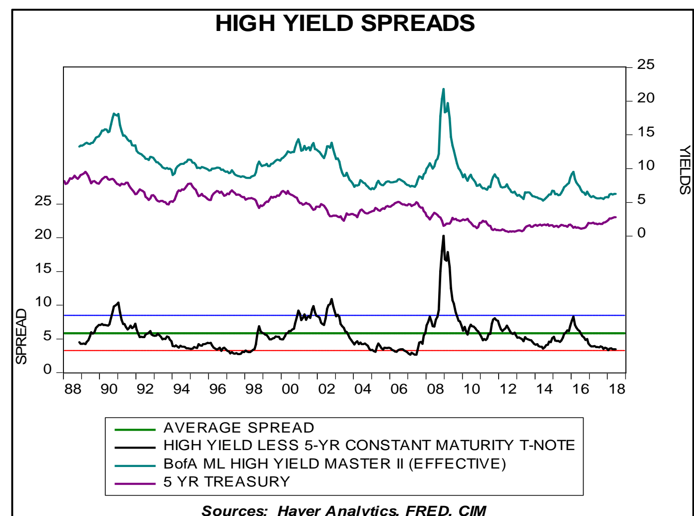
STOCK MARKET OUTLOOK



Despite trade tensions and the potential for a misstep by the Fed, our views remain favorable on U.S. equities. Our assessment is that inflation should remain contained, the low level of unemployment will persist and GDP growth will be maintained. As expected, the level of share repurchases, M&A activity and repatriation of overseas assets have been elevated since the passage of the tax act at the end of last year. Current readings show no indication of these trends abating in the near-term. Although equity prices, as measured by the S&P 500, are in excess of the long-term trend, as shown in the accompanying chart, expectations of higher corporate earnings and solid economic data combined with high levels of consumer and business confidence encourage us to retain our historically high equity allocations in each of the strategies. In addition, due to the current stage of the economic cycle, we maintain the 60% tilt toward growth equities, yet without an overt overweight to any particular growth-oriented sector due to potential effects on the Technology and Consumer Discretionary sectors from the upcoming introduction of the new Communications Services sector at the end of September. The overweight to the traditionally value-oriented sectors of Energy, Financials and Materials that have existed since the beginning of the year are supported by attractive valuations and are therefore retained.

Mid-cap and small cap exposures have an identical tilt to growth equities and are both overweight in our strategies that have growth as an objective. Outside the U.S., we retain most of the posture from last quarter. The factors discussed above regarding the U.S. dollar exchange rate will naturally create either a headwind or tailwind for returns on non-U.S. equities, but the attractive relative valuations advocate for their retention.

BOND MARKET OUTLOOK



The more hawkish composition of voting members of the Fed's Board of Governors as compared to last year produces the expectation of continued tightening and balance sheet unwinding. Combined with a stable inflationary outlook, this leads to a forecast of an extremely flat yield curve over our three-year cyclical outlook. Though this bodes well for the longer rungs on the ladder, as well as the long-term Treasuries employed in the income-oriented strategies, such a flattening will impact the intermediate rungs of the ladder. However, given our outlook for the full three-year cyclical period, any price pressure on the intermediate rungs will prove ephemeral as their roll toward maturity will find them comfortably recovering. While our view of the bond market is sanguine over the cyclical time frame, we harbor some level of trepidation in the speculative bond space. As the chart alludes, spreads are at post-recession tight levels. In addition, Moody's estimates that $952 billion of high-yield bonds will be maturing between 2019 and 2022, most of which will be seeking refinancing. Coupled with the tax legislation limitation of interest deductibility to 30% of EBITDA by corporations, this may pressure spreads to widen. Accordingly, exposure to speculative grade bonds remains at the low end of our historic levels in the strategies.

OTHER MARKETS

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

We also retain our allocation to gold, which was introduced last quarter. Owing to the fact that gold can serve as a safe haven during periods of heightened geopolitical and currency risks, and the knife's edge of the U.S. dollar's exchange value, we find the modest allocation to be helpful as a governor of risk. In addition, gold is currently trading well below its fair value price as suggested by our analysis.

Third 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	27%	5%	10%	-	-	-	-	-
Long Term Bonds	11%	-	5%	-	-	-	-	-
Speculative Grade Bonds	4%	-	-	-	-	-	-	-
Real Estate	10%	-	-	-	-	-	-	-
U.S. Large Cap Stocks	26%	(5%)	30%	-	40%	-	-	-
U.S. Mid Cap Stocks	-	-	10%	-	5%	(5%)	23%	-
U.S. Small Cap Stocks	-	-	15%	-	23%	10%	35%	-
Foreign Developed Country Stocks	14%	-	10%	-	10%	(5%)	10%	-
Emerging Market Stocks	-	-	10%	-	15%	-	25%	-
Commodities	3%	-	3%	-	5%	-	5%	-
Total	*100%*		*100%*		*100%*		*100%*	

INCOME WITH GROWTH

The single allocation change this quarter is a 5% increase in the intermediate bond weighting sourced from a portion of the U.S. large cap exposure. Due to the normal quarterly duration decay associated with the bond ladder, the modest increase to intermediate bonds allows the strategy to achieve a duration more in line with the index, yet still moderately shorter by roughly 0.50 years. The U.S. equity exposure remains all large cap, with a tilt of 60% to growth, and sector overweights to Energy, Financials and Materials. We retain the non-U.S. equity exposure entirely in developed countries, with an emphasis on Europe. The Income with Growth strategy maintains a modest 3% weighting to gold for its potential to reduce overall portfolio risk accruing from currency and geopolitical risks.

GROWTH & INCOME

There were no changes to the allocations in the Growth & Income strategy from last quarter. Exposures to equities, both U.S. and non-U.S., remain at historically high levels and underscore our positive view toward valuations and economic conditions. Within the U.S., we retain a skew to growth equities and hold a sizable 15% exposure to small caps, with the expectation that M&A activity will remain elevated. Among large caps, the overweight to growth is partially offset by sector positioning in Energy, Financials and Materials. While there were no changes to the bond allocations, we eliminate the remaining position in long-term corporates in favor of long-term Treasuries as we find the risk/return trade-off to be more attractive.

As noted above, we maintain the exposure to non-U.S. equities at a historically high level with an equivalent split between developed and emerging markets. The developed exposure has an overweight to Europe. This strategy also retains its prior 3% allocation to gold, given its tendency to offer a hedge against geopolitical and currency risk.

GROWTH

We increase the allocation to U.S. small cap equities by 10% this quarter, sourced from U.S. large cap and developed market equities. The increase in small caps reflects not only our positive expectations for the economy, but also the prospect for continued elevated M&A activity. Across the capitalization spectrum for the U.S. is a tilt toward growth in recognition of where we stand in the economic cycle, though in large caps the tilt is moderated by incremental exposure to the traditional value sectors of Energy, Financials and Materials.

Equity exposure, inclusive of non-U.S., remains at a historically high level for the Growth strategy. With the shift of a portion of the developed market exposure to U.S. small cap equities, the emerging market allocation now exceeds that of developed. The emerging market exposure includes a portion dedicated to small cap emerging market equities and the developed market exposure has a concentration in Europe. We retain the 5% allocation to gold, which we believe is attractive relative to its fair value price and for its potential to reduce overall portfolio risk.

AGGRESSIVE GROWTH

There were no changes to the allocations or sub-asset class exposures in the Aggressive Growth strategy this quarter. The U.S. equity exposure is still exclusively mid-caps and small caps, with a tilt toward growth. This is reflective of our positive economic outlook and expectations for further earnings growth, along with the prospect that M&A activity will continue to increase. We retain the 5% allocation to gold introduced last quarter, stemming not only from its attractive price relative to our analysis of its fair value but also due to the hedge it can provide against geopolitical and currency risk.

The Aggressive Growth portfolio's allocation to non-U.S. equities has a majority of its exposure in emerging markets, where there is a sizable exposure to small caps due to their differentiated returns. The developed non-U.S. exposure retains a concentration in Europe, where relative valuations remain attractive.

Performance & Disclosures

As of 6/30/18

Strategy	Quarter	YTD	1 - Year	3 - Year	5- Year	ITD
Income Taxable with Growth - Gross of Fees	1.3%	-1.2%	3.0%	6.3%	7.1%	9.7%
Income Taxable with Growth - Net of Fees	0.6%	-2.7%	-0.1%	3.1%	3.9%	6.4%
Benchmark - 40% S&P 500 and 60% ML Bond Index	1.3%	0.1%	5.4%	5.8%	6.8%	8.3%
Growth and Income Taxable - Gross of Fees	1.3%	0.9%	9.1%	8.7%	9.7%	7.4%
Growth and Income Taxable - Net of Fees	0.6%	-0.6%	5.8%	5.5%	6.5%	4.2%
Benchmark - 70% S&P 500 and 30% ML Bond Index	2.3%	1.4%	9.8%	8.9%	10.1%	8.5%
Growth - Gross of Fees	0.6%	0.1%	9.4%	8.7%	10.7%	7.3%
Growth - Net of Fees	-0.1%	-1.4%	6.1%	5.5%	7.4%	4.1%
Benchmark - S&P 500	3.4%	2.6%	14.4%	11.9%	13.4%	10.3%
Aggressive Growth - Gross of Fees	0.9%	1.1%	11.1%	8.4%	10.7%	7.4%
Aggressive Growth - Net of Fees	0.1%	-0.4%	7.8%	5.2%	7.4%	4.2%
Benchmark - S&P 500	3.4%	2.6%	14.4%	11.9%	13.4%	10.3%

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 7/18/2018 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 6/30/18. 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 June 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.