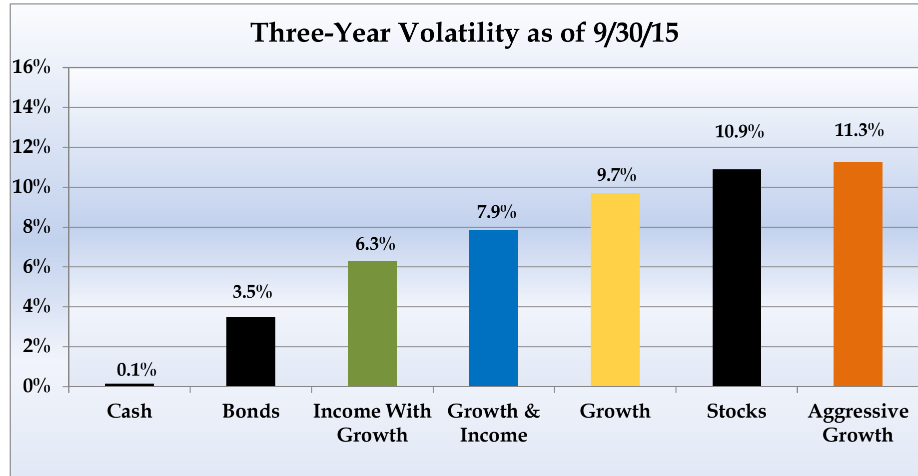
ASSET ALLOCATION QUARTERLY

Fourth 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.



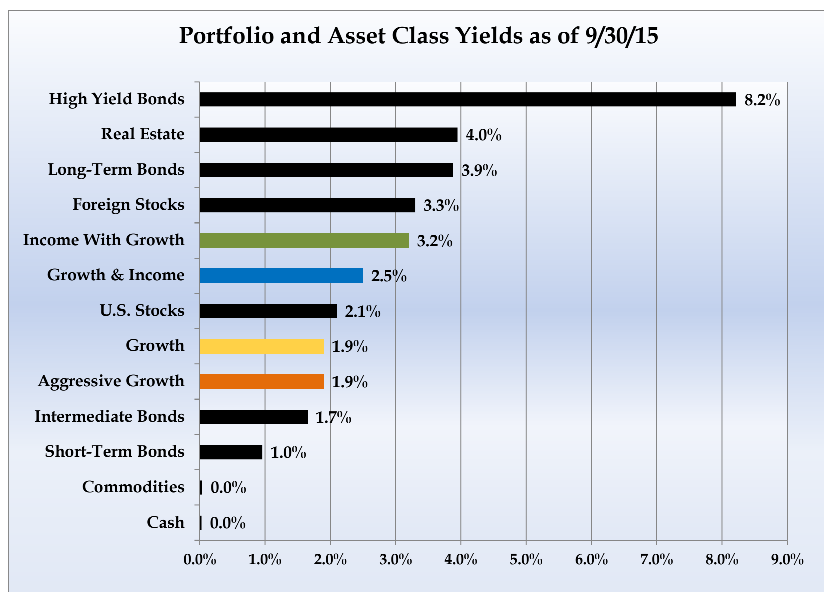
Source: Bloomberg, CIM. Cash is the ML 0-3 Month T-Bill Index; Bonds are the ML Domestic Master Index; Stocks are the S&P 500 Index. See disclosures on page 6* for important details.

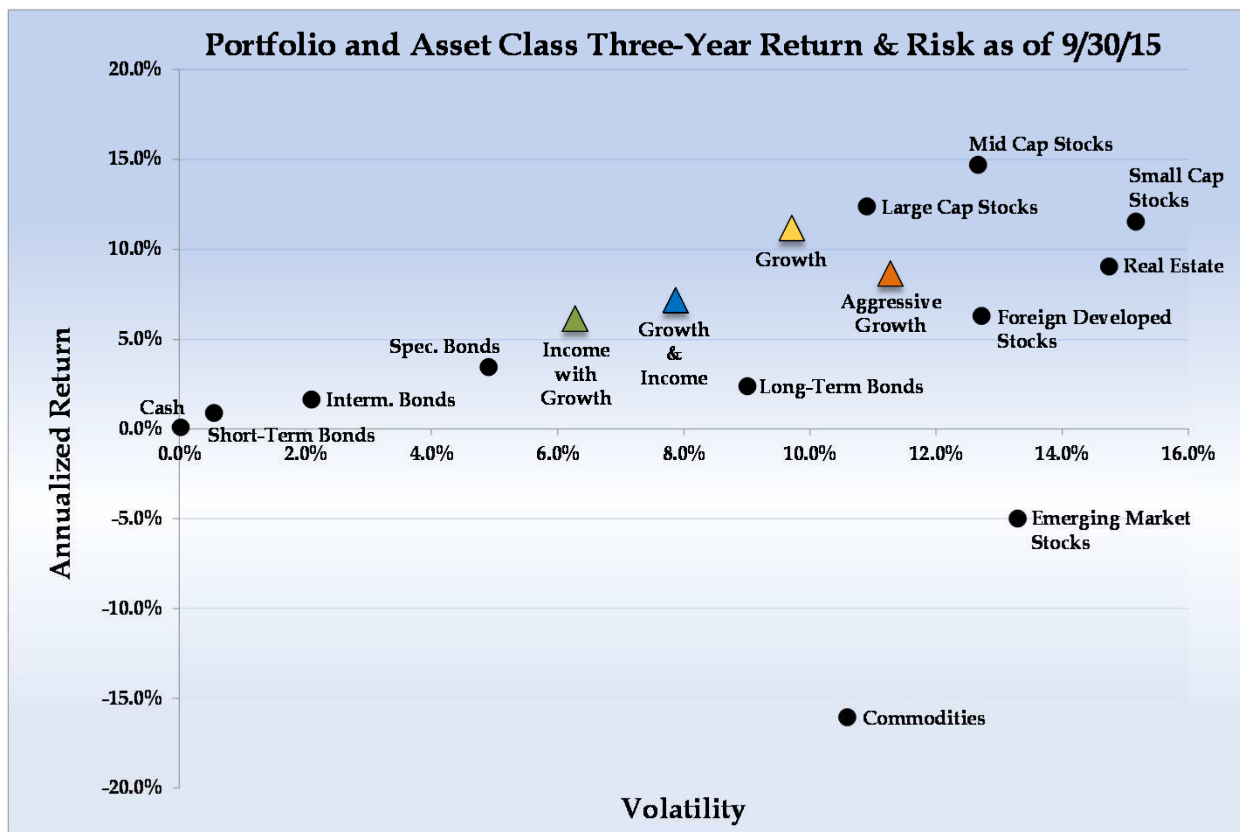
The Confluence asset allocation process is centered upon risk management. Our portfolios offer a broad spectrum of risk profiles, ranging from a fairly conservative posture in Income with Growth (green) to a more risk tolerant profile in Aggressive Growth (orange). The primary asset classes of cash,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

Mean reversion hasn't been the only market force lowering returns across the data points. As the Federal Reserve contemplates withdrawing its extraordinarily easy monetary policy, it has exacerbated the trend of lower returns while nudging volatility higher. As we look forward, we expect the trend to continue for several years.

The good news is that the trends of lower returns and rising volatility are unlikely to flow across all the asset classes at the same time, in the same way. Therefore, there should be opportunities to pursue attractive returns while still keeping an eye on volatility. Our cyclical approach to asset allocation is specifically directed at this effort and we form portfolios focusing not just on the *amount* of diversification, but also seeking the right *kind* of diversification.

A good example of this, which is not overtly visible on this chart, has been our recent bond allocations. High quality bonds, particularly those with longer maturities, performed much differently than equities, oftentimes rising when stocks declined. Therefore, their inclusion played an important role in addressing risk, even if their returns weren't particularly high. Through this kind of effort, we will continue to work to provide portfolios that are attractively positioned across a broad range of asset classes.

FOURTH QUARTER 2015 ASSET ALLOCATION OUTLOOK

- **The Federal Reserve decided not to raise rates in the third quarter. Attention now turns to if, when and how it will raise rates going forward. Although we expect the Fed to move gradually and not cause a recession, the likelihood of policy errors has increased.**
- **We continue to believe both growth and inflation are likely to remain low in the United States. Still, we expect U.S. growth to be higher than that of many foreign countries.**
- **Financial market returns are likely to remain lower than the rates earned in recent years. At the same time, we expect volatility will continue to rise.**
- **Our equity allocations remain focused on domestic stocks and include large, mid and small caps.**
- **We continue to favor intermediate and longer maturity bonds, which should continue to provide diversification and reasonable returns in an environment of low growth and low inflation.**
- **Our style guidance remains in favor of growth over value but shifts from 70/30 to 60/40.**

ECONOMIC VIEWPOINTS

Over the summer, investors had to deal with a variety of issues affecting the financial markets. These included Greece and its debt, Middle East turmoil, and currency and equity swings in China. While each of these issues was relevant, none got more attention than the Federal Reserve. Investors watched to see whether or not the Fed would raise short-term rates in September, and what the policy guidance might be going forward. Ultimately, the Fed did not raise rates, acknowledging low inflation, limited wage pressure and weak global growth. This decision created a bit of a relief rally near the end of the quarter, but now all attention shifts to what the Fed may do in the fourth quarter and 2016.

Because we expect economic growth and inflation to remain low, we believe the Fed is inclined to move very slowly and any rate increases are likely to be telegraphed with a high amount of clarity. We don't foresee a recession, but do recognize that the likelihood of Fed policy mistakes has grown—tightening in a low growth environment can be hazardous. Absent a recession, however, the environment should be reasonably good for investors. Broadly speaking, we expect asset returns to remain lower than recent years and volatility to rise. Less return and more risk is far from ideal, but investors should keep in mind that multiple years of easy monetary policy have created unusually high returns and particularly low volatility. As such, if and when the Fed begins to tighten, the overall return/risk profile should remain attractive, but will probably not be as favorable as it has been.

It's also important to factor in ongoing geopolitical frictions. For many years, we've written about the withdrawal of the United States from its superpower role. As this trend has unfolded, we've witnessed rising regional instability around the world, ranging from the European migrant crisis to China's territorial expansion in the South China Sea. In addition, the U.S. also faces its own brand of geopolitical change as 2016 is a presidential election year. Although all these factors have varying amounts of direct impact on the U.S. financial markets, they are sources of potential or perceived risk.

To address rising volatility and geopolitical risk, we maintain a diversified posture, one that includes a variety of asset classes. Diversification is important, but so too is the nature of the exposure. Accordingly, we remain overwhelmingly domestic in our equity allocations. This positioning reflects our belief that the U.S. will lead the global economy, making domestic equities relatively more attractive. However, even as the global leader, we expect fairly modest U.S. economic growth, making intermediate and longer maturities more attractive in our bond allocations. We had most of these positions already in place, and therefore we make few allocation changes this quarter.

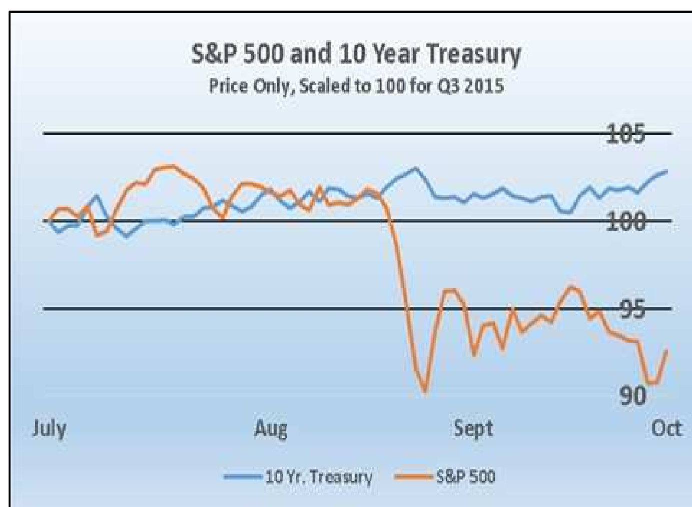
STOCK MARKET OUTLOOK

Stock volatility has continued to rise in 2015, with some indices dipping near correction territory during the late summer only to recover in October to a range not far from where they began the year. China's currency, economic growth, equity market volatility and governmental policies often played in the minds of equity investors, particularly in the third quarter. Even more important to investors was Fed policy. By passing on a rate increase in September, the Fed recognized slow U.S. growth and the drag caused by weak foreign economies. So, going forward, we believe the Fed will move very slowly with great transparency. Its policy will remain important to equity investors who will carefully watch to see if the Fed goes too far or too fast.

Fundamentally, stocks remain in good shape, although earnings growth has slowed significantly for many companies. Valuations are reasonable and tend to reflect a degree of risk aversion. This trend has helped curb a cycle of excessive valuation. We continue to favor domestic equities over foreign ones, given our belief that the U.S. should lead global growth trends. We recommend exposures across capitalization sizes and our favored large cap sectors include technology and consumer discretionary, while we are underweight energy, healthcare, financials, basic materials and telecom. Our style bias continues to favor growth over value, although we dial down the bias this quarter from 70/30 to 60/40, reflecting our changing preference for a more balanced posture.

BOND MARKET OUTLOOK

For many years, bond investors have lamented the low interest rate environment and the challenges in pursuing reasonable returns in fixed income portfolios. While it's true that returns have declined, bonds continue to offer lower levels of volatility and meaningful diversification relative to equities and other asset classes. These characteristics are often overlooked, but when volatility and risk rise in the markets, they become more apparent…and appreciated.



Source: Bloomberg, CIM

The chart to the right illustrates this point. The prices of the S&P 500 (in red) and the 10-year Treasury (in blue) are scaled to a common value (100) at the beginning of the third quarter. Two characteristics are noteworthy. First, the Treasury price changes are comparatively mild, remaining within a four percent range during the quarter. In contrast, the stock index was much more volatile, with a range of almost 13 percent. Second, note how the 10-year Treasury moved in opposite direction of the S&P 500 (this is called a negative correlation). Having investments in securities that don't behave in the same manner is an important part of managing risk. So, even while bond returns have not been particularly high, their contributions in a portfolio have been significant.

As we move into a period when financial market volatility is likely to rise, bonds can continue to play an important role in helping to address risk. We maintain allocations to intermediate and longer maturities, which we believe can perform well in a low growth environment. We also remain overweighted toward high quality corporate bonds, which we expect to have relatively mild default rates.

OTHER MARKETS

Real estate faced headwinds earlier in the year when interest rates moved higher and investors became concerned about tighter Fed policy. However, this asset class has benefited from the recent decline in interest rates. We continue to believe real estate can play a constructive role in portfolios, particularly where income is an objective. Occupancy and rental rates are keeping fundamentals strong, while foreign investors continue to move into the space.

Our view toward commodities has begun to improve at the margin. However, we remain out of this asset class given large amounts of excess supply capacity for most commodities around the world. Furthermore, China's slowing growth continues to limit demand and we don't believe the correction in commodities has yet reached a point where an allocation is appropriate.

Fourth 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	24%	-	-	(2%)	-	-	-	-
Long Term Bonds	24%	-	27%	7%	7%	-	-	-
Speculative Grade Bonds	4%	-	-	(5%)	-	-	-	-
Real Estate	12%	-	4%	(4%)	5%	-	5%	-
U.S. Large Cap Stocks	7%	-	20%	-	40%	-	15%	-
U.S. Mid Cap Stocks	12%	-	27%	(6%)	26%	-	15%	-
U.S. Small Cap Stocks	15%	-	20%	10%	20%	-	58%	-
Foreign Developed Country Stocks	-	-	-	-	-	-	5%	-
Emerging Market Stocks	-	-	-	-	-	-	-	-
Commodities	-	-	-	-	-	-	-	-
Total	*100%*		*100%*		*100%*		*100%*	

**Q3 2015 Report incorrectly stated the following Income with Growth allocations: Interm. Term Bonds 25%; Long Term Bonds 25%; Spec. Grade Bonds 2%.

INCOME WITH GROWTH

The Income with Growth portfolio benefited from allocations to intermediate and longer maturity bonds, which have held up well recently. Low economic growth, low inflation and rising geopolitical risks have increased the appeal of bonds. We expect these trends to continue. Still, the portfolio's bond allocation lagged Treasuries a bit, which have performed particularly well. Looking forward, our view toward high quality corporate bonds remains positive as we believe the incremental yield is attractive while default risk should remain relatively low. We believe real estate and speculative grade bonds are also likely to perform well in an environment of low rates.

The equity allocations remain diversified across large, mid and small cap stocks, with more emphasis on smaller caps. Although this equity asset class tends to have higher volatility, we believe it also brings higher growth potential. We believe growth in foreign economies is likely to be generally lower than the U.S., therefore we prefer domestic equities and continue to exclude foreign equities.

GROWTH & INCOME

The Growth & Income portfolio has a bond allocation oriented toward longer maturities. This profile has been beneficial because longer maturity bonds recently outperformed shorter maturities. As we look forward, we believe economic growth and inflation are likely to remain low, creating an attractive environment for longer maturity bonds.

This quarter, we make a few adjustments in the portfolio. We are reducing the exposure to real estate and speculative grade bonds and shifting more of the portfolio into longer maturity bonds. This shift allows for another change, which involves a partial adjustment out of mid caps and into small caps. Small cap stocks have recently underperformed, but we believe many smaller companies have a higher growth profile. Because small caps also have higher volatility, increasing this allocation required other allocation changes to maintain a consistent risk profile in the overall portfolio. We note that equity allocations remain entirely domestic, reflecting our expectation that U.S. growth should outpace many foreign economies.

GROWTH

Growth investors have experienced rising volatility in the equity markets in recent quarters. We believe this trend is likely to continue, caused in part by expected tighter monetary policy from the Fed. A policy decision from the Fed to raise rates during a time of relatively low economic growth would be unusual. Normally, the Fed moves rates higher during periods of robust economic growth. Accordingly, we are carefully monitoring the Fed and the economy. We don't foresee a recession, but recognize an economic contraction is often one of the greatest risks for equity investors.

To address rising volatility, we maintain an allocation to longer maturity bonds. This asset class has provided ballast in the portfolio, oftentimes performing much differently than equities. Real estate has also provided a measure of diversification. We believe this diversified profile is helpful during times of rising uncertainty. At the same time, the equity allocations remain diversified across large, mid and small cap stocks. We believe equities can perform well in a low-growth, low-inflation environment. Our bias remains in favor of large caps, which tend to have lower volatility compared to small and mid caps. The allocation remains entirely domestic as we believe the U.S. economic environment is more favorable relative to most foreign countries.

AGGRESSIVE GROWTH

We continue to closely monitor Fed policy as it would be unusual for the Fed to raise rates when economic growth and inflation are relatively low. Normally, this type of policy is enacted when growth or inflation is high. Still, we expect the Fed to move slowly and at this point we don't foresee a recession. Recessions tend to create high-risk environments for equity investors, so it's an important matter even for risk-tolerant investors. If the economy remains on a low-growth trajectory, we believe the return/risk profile for equities is attractive.

In the Aggressive Growth portfolio, we remain diversified across large, mid and small caps, with a strong bias toward small caps. We believe the growth and return profile for small caps is higher, albeit with greater amounts of risk. Our foreign allocation remains very limited, because even with relatively low growth we expect the U.S. economic environment to be better than that of most foreign countries. For aggressive investors, who can tolerate rising currency, geopolitical and economic risks, we include a small allocation to foreign developed stocks to take advantage of low valuations and potential recoveries.

Performance & Disclosures

As of 9/30/15

Strategy	Quarter	YTD	1 - Year	3 - Year	5- Year	ITD
Aggressive Growth - Gross of Fees	-8.7%	-6.4%	-0.5%	8.7%	8.4%	5.5%
Aggressive Growth - Net of Fees	-9.4%	-8.4%	-3.5%	5.5%	5.2%	2.3%
Benchmark - S&P 500	-6.4%	-5.3%	-0.6%	12.4%	13.3%	8.5%
Growth - Gross of Fees	-6.5%	-4.9%	1.5%	8.9%	9.0%	5.4%
Growth - Net of Fees	-7.2%	-7.0%	-1.5%	5.7%	5.7%	2.3%
Benchmark - S&P 500	-6.4%	-5.3%	-0.6%	12.4%	13.3%	8.2%
Growth and Income Taxable - Gross of Fees	-4.7%	-3.8%	1.5%	7.2%	8.1%	5.9%
Growth and Income Taxable - Net of Fees	-5.4%	-6.0%	-1.5%	4.0%	4.9%	2.7%
Benchmark - 70% S&P 500 and 30% ML Bond Index	-4.1%	-3.3%	0.6%	9.2%	10.4%	7.4%
Income Taxable with Growth - Gross of Fees	-1.8%	-2.6%	1.9%	6.2%	7.3%	10.5%
Income Taxable with Growth - Net of Fees	-2.6%	-4.8%	-1.1%	3.0%	4.2%	7.2%
Benchmark - 40% S&P 500 and 60% ML Bond Index	-1.8%	-1.3%	1.7%	6.0%	7.3%	8.7%

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 9/30/15. 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 September 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.