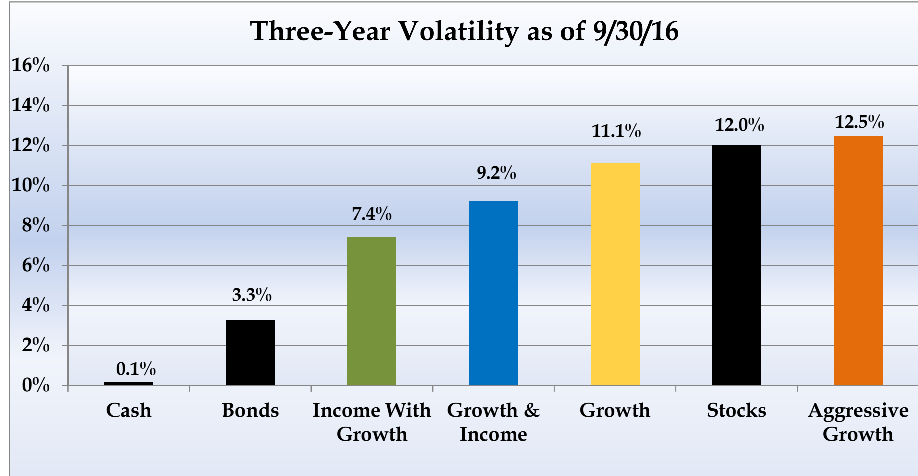
ASSET ALLOCATION QUARTERLY
Fourth Quarter 2016

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.



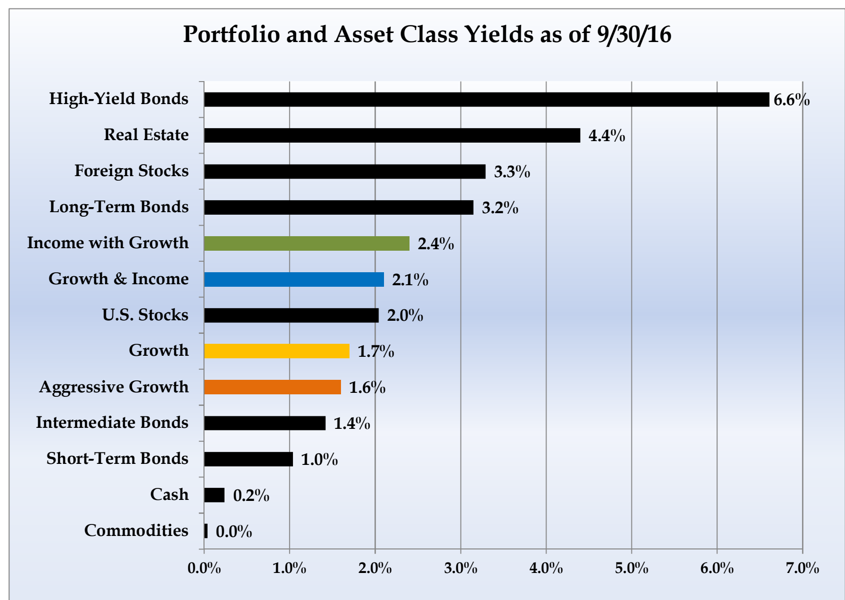
Source: Bloomberg, CIM. Cash is the ML 0-3 Month T-Bill Index; Bonds are the ML Domestic Master Index; Stocks are the S&P 500 Index. See disclosures on page 6* for important details.

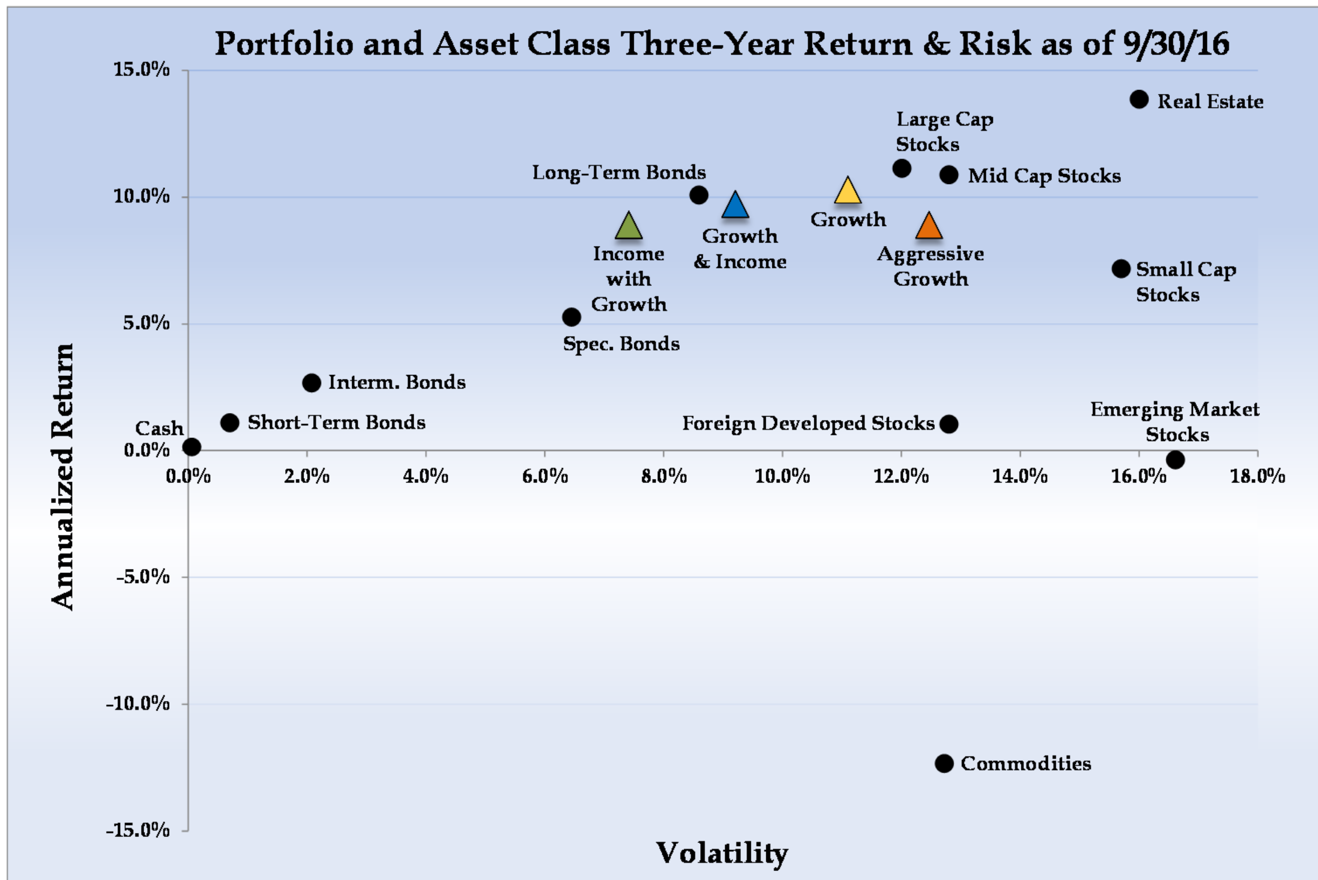
The Confluence asset allocation process is centered upon risk management. Our portfolios offer a broad spectrum of risk profiles, ranging from a fairly conservative posture in Income with Growth (green) to a more risk tolerant profile in Aggressive Growth (orange). The primary asset classes of cash, 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. Because this chart is a snapshot of a single three-year period, one can't see how the circles and triangles have moved across time. However, one can see a wider range of return outcomes at the higher volatility levels. For example, commodities and large cap stocks have similar levels of volatility, yet there is clearly a big difference in returns over the past three years. Of course, when volatility is low, the range of outcomes is much narrower.

For our portfolios, which are illustrated by the colored triangles, the range of return outcomes is also a function of their volatility. Our more conservative, income-oriented portfolios benefited from adjustments we made among shorter and longer maturity bonds, as well as the inclusion of speculative grade bonds at certain times. Real estate also contributed to return, income and diversification. On the other hand, for the portfolios where growth is a primary objective, performance was affected by the wide range of return outcomes generated by higher volatility asset classes. These portfolios benefited by avoiding large exposures to commodities, foreign developed country stocks and emerging markets. However, our allocations to mid and small caps over the past three years have been suboptimal at times relative to the performance of large caps.

While we believe this illustration of three-year return and risk can be helpful in understanding the return and risk of our portfolios and various asset classes, there are some limitations. For example, year-to-date, small caps have delivered higher returns relative to large caps, benefiting the growth-oriented portfolios which have meaningful allocations to small caps. Despite recent outperformance, the three-year performance of small cap stocks is still lower than the large caps. Still, we are focused on long-term investing and recognize that short-term gains aren't always sustained. So, while we're pleased with the recent performance of small caps, we view it against the backdrop of a longer term investment period. We apply this viewpoint across all asset classes as well as to all of the portfolios.

FOURTH QUARTER 2016 ASSET ALLOCATION OUTLOOK

- **Although presidential elections gather a lot of attention from investors, we believe the specific person or party getting elected in this cycle may be less important than the forces driving the elections.**
- **The Fed is likely to raise rates gradually and we don't expect the tighter policy to create a recession.**
- **Our equity allocations remain primarily domestic, although we believe emerging markets present an attractive return/risk opportunity for risk-tolerant investors.**
- **We include a range of maturities in our fixed income allocations.**
- **Our commodities allocation remains focused on gold to help address certain geopolitical and currency risks.**
- **Our style guidance remains modestly in favor of growth over value at 60/40.**

ECONOMIC VIEWPOINTS

For over 16 years, including many prior to forming Confluence, we've worked together providing quarterly reports about our asset allocation models. And every four years we face a presidential election that often attracts an outsized amount of attention from investors. We frame it as outsized because the outcome of most presidential elections alone is generally not of great consequence to the markets. Elections certainly do have broad consequences, but the financial markets usually adjust pretty quickly.

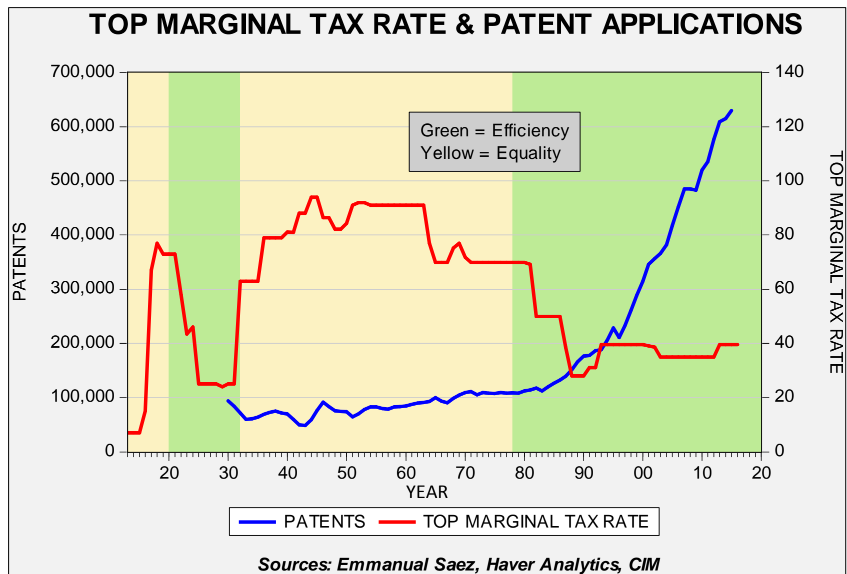
This isn't to say presidential elections are insignificant. But right now, the specifics of who occupies the White House is perhaps less important than understanding the changing force voters are exerting on the U.S. political system. So, regardless of which party takes the helm, both are going to have to deal with this force, which we expect to continue and grow well beyond this election cycle. What does this force look like? It's complex and multifaceted, but we think it's essentially a transition. We believe our economic philosophy is shifting away from an emphasis on efficiency, and more toward one of equality. We expect this shift to take years, and last for perhaps decades. If we are near the beginning of the transition, as we believe we are, there a few things for an investor to monitor.

To begin, let's consider what we mean by "efficiency" in the economy. With efficiency, tax rates and regulation are lower, fostering greater competition and innovation. Patent applications rise, along with technological developments that drive new products and processes. Business efficiency and profitability rise, while those building better mousetraps earn and keep significant wealth. Global trade rises as businesses seek to shift production to areas of lower cost, while simultaneously growing into new markets. Technology and globalization create obsolescence in the labor force, along with the creative destruction of existing plants, equipment and processes. Innovation and competition lower inflation, which benefits the broad population, but high returns on capital accrue disproportionately to those who have capital. In a nutshell, you get the Internet, iPhone and low prices, while workers are displaced and the wealthy become wealthier. We've been in the efficiency cycle for almost 40 years.

In contrast, with an "equality"-focused economy, tax rates and regulations rise, lowering incentives to innovate. Competition declines as a more rigid regulatory framework gains prominence. New product development declines, employment becomes more predictable and there's less obsolescence. Global trade slows, creating more inflation. The income gap narrows between the wealthy and the poor. Here we see much longer cycles between the new iPhones, and they're even more expensive with fewer meaningful upgrades. The retail industry is less threatened by Amazonian forces and participation in the labor market can stabilize and even grow. We may be heading into this environment. The chart on the next page illustrates the efficiency/equality transition.

A transition from efficiency to equality will take time and transcend several election cycles. The speed and depth of the transition are difficult to predict, but we feel the political parties are likely to feel ongoing pressure to change the established system of efficiency. Too many voters feel as though the current environment is unacceptable. Politicians and parties will adjust or lose their positions of governance.

Although we may be at the beginning of a transition, we don't believe it's likely to create a recession over our projected forecast period of three years. On that front, we believe Fed policy is more immediately relevant. Although the Fed has telegraphed a moderate pace of raising rates, forward interest rates indicate a broad expectation that the Fed will go even slower. In this instance, our expectations are more aligned with the market, and we believe the economy is likely to continue along its path of slow growth for quite a while.



STOCK MARKET OUTLOOK

Although the aforementioned transition to equality may lower growth in corporate profits and increase inflation, we expect a gradual pace of change, allowing equities to perform reasonably well. Looking forward, we believe the return/risk profile of stocks is generally constructive and we continue to diversify across capitalization sizes. This quarter we trim the small cap exposure in some portfolios, recognizing its recent strong performance. We are also beginning to utilize emerging market equities across more portfolios as we see potential upside from favorable currency trends and low valuations. Still, emerging market equities are highly volatile, so we utilize only a limited allocation, except where risk tolerance is high.

With regard to our large cap sector weights, we remain overweight energy but pare back the exposure after the sector's very strong performance. We are also overweight the technology, industrial and consumer discretionary sectors, while being underweight financials, utilities and telecom. (We continue to allocate to real estate as a separate asset class; see comments in the Other Markets section below.) These sector views are formed from our work on valuations and industry fundamentals. Our growth/value posture remains at 60/40.

BOND MARKET OUTLOOK

As the economy shifts from efficiency to equality, we will be keeping close tabs on inflation, which tends to create significant risks for bond investors. However, we do not anticipate inflation to emerge quickly or without a measure of warning. Excess global supply capacity remains high for many industries and inflation is unlikely to build unless global trade is dialed down. Such a trend is possible but not yet in place. Accordingly, we continue to believe bond investors can utilize a combination of short, intermediate and long maturities in their portfolios. Bonds continue to provide excellent diversification and can help to address market volatility when combined with other asset classes.

At this point we do not anticipate a recession and do not expect large increases in bond defaults. Therefore, we continue to believe corporate bonds are relatively attractive. Still, our focus remains on investment grade corporate bonds, which we prefer over speculative grade bonds.

OTHER MARKETS

We expect real estate fundamentals to remain generally strong and believe this asset class can benefit from ongoing low interest rates. Still, this asset class has performed very well and we trim the exposure in some portfolios this quarter. Looking forward, the return/risk remains attractive, particularly where income is an objective.

Commodities continue to provide diversification and we focus our commodities allocation on gold. Gold helps to address some of the risks emerging from global central bank policies aimed at depreciating currencies. This precious metal can also help address certain geopolitical risks and can perform well in the event the U.S. dollar weakens relative to other major currencies.

Fourth Quarter 2016	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%	(2%)	-	-	-	-	-	-
Intermediate Term Bonds	-	-	10%	10%	-	-	-	-
Long Term Bonds	35%	-	16%	(5%)	7%	-	5%	-
Speculative Grade Bonds	-	-	-	-	-	-	-	-
Real Estate	15%	-	5%	(5%)	5%	-	5%	(5%)
U.S. Large Cap Stocks	15%	4%	25%	-	40%	-	-	-
U.S. Mid Cap Stocks	16%	4%	19%	-	18%	-	17%	-
U.S. Small Cap Stocks	9%	(6%)	15%	(5%)	20%	(5%)	58%	-
Foreign Developed Country Stocks	-	-	-	-	-	-	-	-
Emerging Market Stocks	-	-	5%	5%	5%	5%	10%	5%
Commodities	5%	-	3%	-	3%	-	3%	-
Total	*100%*		*100%*		*100%*		*100%*	

INCOME WITH GROWTH

In the Income with Growth portfolio, the fixed income allocation remains focused on longer maturity bonds as we recognize concerns regarding tighter Fed policy and the potential to negatively affect bonds. However, we believe the Fed's tightening path should be relatively mild and even more gradual than its current guidance. Against this backdrop we expect ongoing slow growth, low inflation and relatively low global interest rates. Therefore, we continue to believe longer maturity bonds can play an important role in this portfolio, particularly because of the contribution to diversification.

The equity allocation remains diversified across capitalization sizes. We believe equities can perform reasonably well in a low growth environment. Higher valuations may create somewhat muted returns at times, but we believe many companies have a variety of ways to grow and deliver attractive returns. This quarter, we make a slight shift away from small caps and toward mid and large caps, recognizing the strong recent performance from small caps. Real estate contributes to portfolio yield, while the commodities allocation to gold helps address geopolitical risk and global currency volatility.

GROWTH & INCOME

This quarter, we shift the bond allocation in the Growth & Income portfolio to include some intermediate maturity bonds. As part of this adjustment, which reduces some of the overall interest rate risk, we are able to include a limited allocation to emerging market equities. Emerging equities are typically one of the highest volatility asset classes, so our inclusion necessitated the need for exposure to less volatile asset classes to help manage the overall portfolio volatility. We continue to believe a low growth, low inflation environment is constructive for bonds across a range of maturities.

We believe emerging equities provide an opportunity to participate in the potential recovery of an asset class that has struggled in recent years. The asset class may benefit from global currency trends, as well as an improvement in valuation. Still, we recognize the higher volatility and maintain a diversified posture across large, mid and small caps for most of the equity allocation. Real estate and gold add to diversification and help address currency and geopolitical risks.

GROWTH

The Growth portfolio remains diversified across domestic equities, including small, mid and large caps. However, the lion's share of the equity allocation is in large caps, which tend to have lower relative volatility. We expect the low growth environment to continue over the next few years and we believe equities can perform well in this scenario.

This quarter we add a relatively small position to emerging market equities as we believe this asset class, which has underperformed for several years, potentially has some attractive upside. Emerging market equities have a different, perhaps higher, growth profile relative to domestic equities. In addition, valuations have room to increase, particularly if the U.S. dollar weakens. Still, we utilize a small allocation given the high volatility of this asset class. We continue to include long maturity bonds, which have provided significant diversification. We also include real estate and gold to further diversify the portfolio.

AGGRESSIVE GROWTH

The Aggressive Growth portfolio has benefited in recent quarters from its large allocation to small caps. Small caps have delivered higher returns than large caps so far this year, and we believe this trend can continue. Even in a low growth environment, many smaller companies are finding ways to create value for their shareholders. Absent a significant decline in economic growth, we believe many of these companies can continue to thrive.

We trim the allocation to real estate, which has performed well since the last recession. With higher valuations, we see real estate becoming more appropriate where income and diversification are priorities. For aggressive investors, we shift the real estate allocation into emerging markets. Emerging equities are highly volatile, but we believe the asset class provides high growth potential and a pathway to higher valuations. We increase the allocation to position risk-tolerant investors for potential upside. Still, even aggressive investors should be mindful of risk and we include long-term bonds and gold for diversification.

Performance & Disclosures

As of 9/30/16

Strategy	Quarter	YTD	1 - Year	3 - Year	5- Year	ITD
Aggressive Growth - Gross of Fees	5.9%	11.1%	16.0%	8.9%	12.2%	6.6%
Aggressive Growth - Net of Fees	5.1%	8.6%	12.6%	5.7%	8.9%	3.5%
Benchmark - S&P 500	3.9%	7.8%	15.4%	11.2%	16.4%	9.2%
Growth - Gross of Fees	4.7%	10.3%	15.5%	10.3%	12.4%	6.6%
Growth - Net of Fees	3.9%	7.8%	12.1%	7.0%	9.1%	3.5%
Benchmark - S&P 500	3.9%	7.8%	15.4%	11.2%	16.4%	9.1%
Growth and Income Taxable - Gross of Fees	3.6%	11.8%	15.2%	9.7%	11.3%	7.0%
Growth and Income Taxable - Net of Fees	2.9%	9.3%	11.8%	6.5%	8.0%	3.8%
Benchmark - 70% S&P 500 and 30% ML Bond Index	2.8%	7.4%	12.5%	9.2%	12.4%	8.0%
Income Taxable with Growth - Gross of Fees	2.3%	12.0%	14.0%	8.9%	9.7%	10.9%
Income Taxable with Growth - Net of Fees	1.6%	9.5%	10.6%	5.7%	6.5%	7.7%
Benchmark - 40% S&P 500 and 60% ML Bond Index	1.8%	6.8%	9.5%	7.1%	8.4%	8.8%

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 9/30/16. 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 2016. 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.