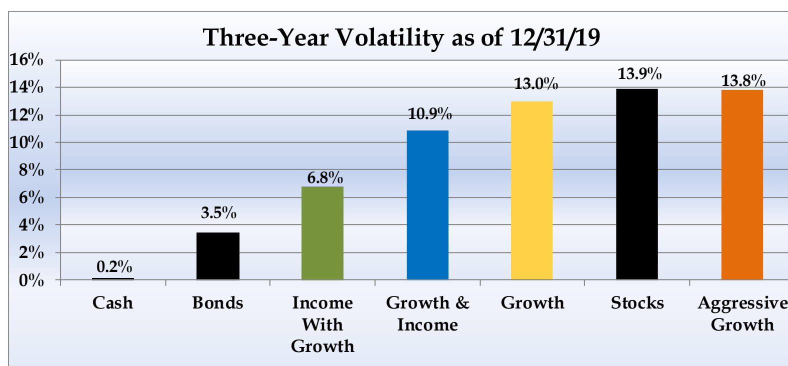
Asset Allocation Quarterly
First Quarter 2020



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.*

The Confluence asset allocation process is centered upon risk management. Our asset allocation strategies offer a broad spectrum of risk profiles, ranging from a relatively 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 by the black bars for reference in the accompanying chart.

We recognize that risk levels and return potential rise and fall over market and economic cycles. Therefore, we apply an adaptive process, one that evaluates the economy, monetary and fiscal policies, 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.

The asset allocation strategies are structured across an array of risk profiles, where the more conservative lean against potential volatility and accept more muted, though typically steadier, returns, while the more aggressive accept inherent volatility in the pursuit of potentially higher returns.

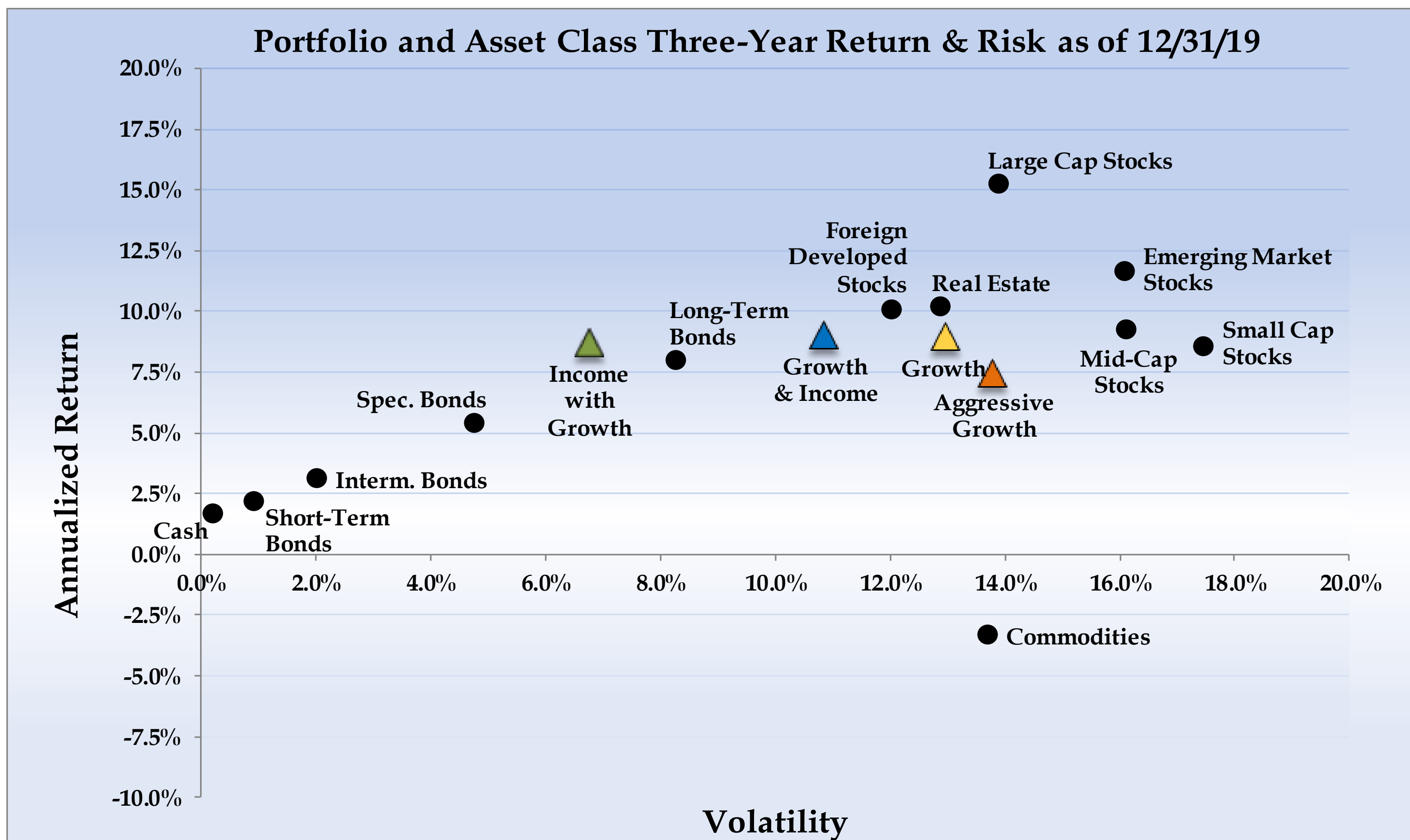
As the following table exhibits, return variance among asset classes from quarter-to-quarter can change dramatically. Over the past three years, we have witnessed healthy gains from U.S. equities, punctuated by a sizable retreat in the fourth quarter of 2018 and tremendous advances over the most recent quarter. Similarly, bonds have generally enjoyed solid returns, particularly through the first nine months of last year. While long-term bonds struggled late last year, over the full three years they have generated outsized returns. Non-U.S. developed and emerging market equities were propelled by favorable valuations and a weaker U.S. dollar in 2017, but the strengthening dollar over the past two years has been an impediment.

Quarterly Asset Class Returns as of 12/31/19

	Q1 2017	Q2 2017	Q3 2017	Q4 2017	Q1 2018	Q2 2018	Q3 2018	Q4 2018	Q1 2019	Q2 2019	Q3 2019	Q4 2019
Cash	0.10%	0.20%	0.26%	0.28%	0.35%	0.45%	0.49%	0.56%	0.60%	0.64%	0.56%	0.46%
U.S. Short-Term Bonds	0.39%	0.30%	0.34%	-0.18%	-0.19%	0.29%	0.35%	1.17%	1.22%	1.49%	0.70%	0.61%
U.S. Intermediate-Term Bonds	1.26%	1.67%	0.94%	0.03%	-1.86%	-0.38%	0.21%	1.97%	3.79%	3.94%	2.34%	0.19%
U.S. Long-Term Bonds	1.76%	4.17%	1.46%	2.66%	-3.46%	-1.23%	-0.67%	1.25%	6.17%	6.45%	6.56%	-1.34%
Speculative Grade Bonds	2.71%	2.14%	2.04%	0.41%	-0.91%	1.00%	2.44%	-4.67%	7.40%	2.57%	1.22%	2.61%
REITs	1.16%	1.52%	0.94%	1.51%	-8.20%	10.04%	1.23%	-6.73%	16.33%	1.24%	7.80%	-0.76%
U.S. Large Cap Stocks	6.07%	3.09%	4.48%	6.64%	-0.76%	3.43%	7.71%	-13.52%	13.65%	4.30%	1.70%	9.07%
U.S. Mid-Cap Stocks	3.94%	1.97%	3.22%	6.25%	-0.77%	4.29%	3.86%	-17.28%	14.49%	3.05%	-0.09%	7.06%
U.S. Small Cap Stocks	2.47%	2.46%	5.67%	3.34%	-0.08%	7.75%	3.58%	-20.20%	14.58%	2.10%	-2.40%	9.94%
Non-U.S. Developed Stocks	7.25%	6.12%	5.40%	4.23%	-1.53%	-1.24%	1.35%	-12.54%	9.98%	3.68%	-1.07%	8.17%
Emerging Market Stocks	11.45%	6.27%	7.89%	7.44%	1.42%	-7.96%	-1.09%	-7.46%	9.91%	0.61%	-4.25%	11.84%
Gold	8.22%	-0.77%	3.09%	1.87%	0.95%	-5.49%	-5.00%	7.24%	0.91%	9.01%	3.82%	3.34%

Source: Morningstar Direct, CIM.*

*This information is presented as supplemental information to the disclosures required by GIPS® standards.
Past performance is not indicative of future results. See page 6 for asset class composition/benchmark details and other important disclosures.



Source: Bloomberg, CIM, using monthly data and gross returns.*

Portfolio and Asset Class Commentary

This chart depicts the risk, as measured by the volatility of returns, and the annualized total return for 12 asset classes as well as the composite performance (gross-of-fees) for our asset allocation strategies over the rolling three-year period ending December 31, 2019. The pattern of higher relative volatility and higher relative returns for each sub-asset class has generally held true over the past 36 months, given the reward for risk assets over the period. However, there were several outliers within the equity sub-asset classes. The returns for U.S. large cap stocks clearly outdistanced mid-cap and small cap stocks, yet with lower measured volatility. While the recent accommodation by the Federal Reserve helped produce an economic environment that rewarded risk assets, the advantage to larger capitalization stocks was somewhat surprising in this context. Although some of the large cap outperformance can be attributed to the influence of larger share repurchase programs, investor concerns surrounding trade policies had a clear effect on the relative performance of mid-caps and small caps.

As depicted by the colored triangles, the risk and return of the Confluence strategies were predominantly influenced by their respective exposures to the major asset classes of bonds and stocks. Given the advances of the stock market since 2017, the Confluence Income with Growth strategy, which had the smallest allocation to stocks, generated the lowest level of return, yet with less volatility. The Growth and Aggressive Growth strategies were allocated primarily to stocks over the past three years and, consequently, risks were elevated relative to the more conservative strategies, Income with Growth and Growth & Income, both of which had sizable bond exposures.

Within the relative bond and stock exposures, significant influences on the relative returns and risk for each strategy were the allocations to sub-asset classes. As noted above, large cap stocks outperformed their lower capitalization counterparts, and with lower volatility as well. Due to its higher exposure to mid-cap and small-cap stocks, the Aggressive Growth strategy lagged the return of the Growth strategy, but with higher volatility. Beyond the differential in returns between these two strategies, the four Confluence asset allocation strategies generally conformed to the expectation of higher volatility with the greater assumption of risk over the past three years.

Each of the strategies now reflects a more neutral risk return stance for our three-year cyclical forecast period from their former elevated exposures to risk assets. This posture results from the potential for a policy misstep that could lead to economic difficulties, which would obviously weigh on risk assets. We regularly assess and review an array of data affecting the macroeconomic environment, including sentiment, growth prospects and credit, among other elements, and should we detect an enduring shift we will adjust the risk exposure in each of the strategies as appropriate.

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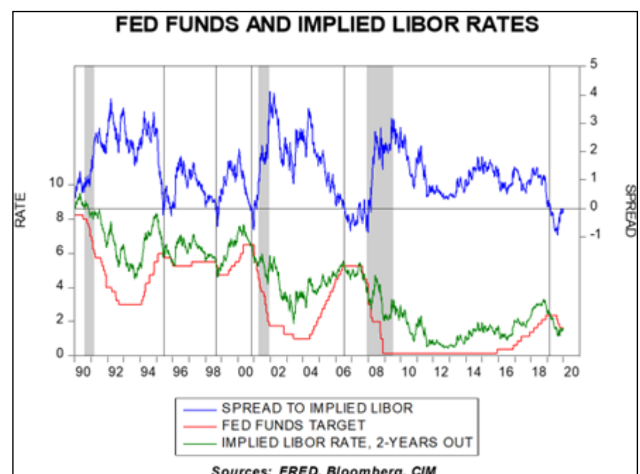
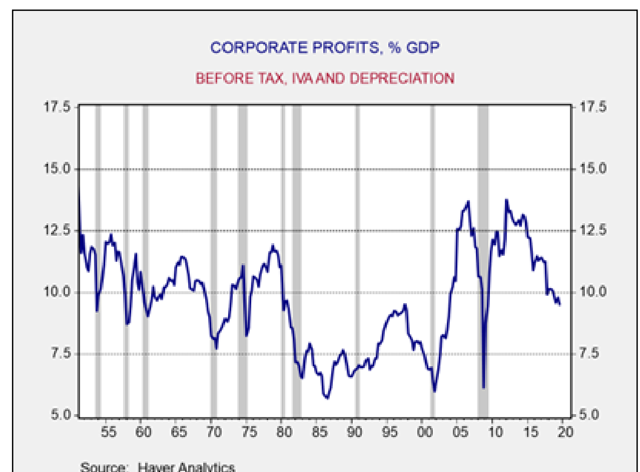
First Quarter 2020 Asset Allocation Outlook

- **The U.S. election season and the more dovish composition of the Federal Reserve Board of Governors should ensure policy accommodation continues in the near-term.**
- **The recent resolution of trade policies with China and the prospect for finalization of USMCA produces an environment where corporate capital can be deployed with less uncertainty.**
- **Although we hold a somewhat sanguine view of the U.S. economy over our three-year cyclical forecast period, we recognize there is the increased potential for a policy mistake that could lead to economic difficulty.**
- **Each strategy reflects a neutral posture, with all risk assets continuing to reside in the U.S. and an equity style exposure of 60% value/40% growth, with an emphasis on larger market capitalizations.**
- **The potential for elevated volatility in global equity markets encourages an allocation to long-term U.S. Treasuries and gold.**

Economic Viewpoints



The recently signed initial trade deal with China, as well as the expectation for enactment of the new North American Trade Pact [USMCA], have helped propel U.S. equities to all-time highs. The trade resolutions hold the potential to encourage businesses to deploy capital toward long-term projects. As evidence, the recently released Q4 2019 Duke University CFO Global Business Outlook finds 12-month capital spending expectations increasing to 4.7% from 0.6% last quarter and R&D spending increasing to 2.7% from 0.6% the prior quarter.[1] Among consumers, the University of Michigan Index of Consumer Sentiment has similarly ratcheted up from 95.5 at the beginning of last quarter to its recent level of 99.1.[2] The business outlook and consumer sentiment figures have also been influenced by the accommodative posture of the U.S. Federal Reserve. The anticipation of two dovish nominees to the Fed's Board of Governors encourages the expectation of continued accommodation through the U.S. election season. The relationship of the fed funds rate versus the implied LIBOR rate two years out underscores the notion that the Fed has reduced rates and stretched its balance sheet to the degree necessary to accommodate favorable economic conditions.



Despite the current rosy economic backdrop, there remain several lingering concerns. The first concern regards corporate profitability. Although broad indices have been propelled higher, corporate earnings have trended lower as the effects of the Tax Cuts and Jobs Act of 2018 roll off, making year-to-year comparisons more challenging. As this chart indicates, prior to taxes, inventory valuation adjustments [IVA] and depreciation, corporate profits as a percentage of GDP have been declining.

A second concern involves the rally in equities to spur hitherto reluctant retail investors to experience the fear of missing out [FOMO] and lead to performance chasing. While investors pulled $600 billion out of U.S. equity funds and separately managed accounts in 2019, over the past month the trend has reversed and flows have turned markedly positive, according to Morningstar's asset flow data. Should this be the first salvo in a rush to invest, a true melt-up in equity markets could occur. If history is any guide, FOMO is notorious for leading to self-destructive investor tendencies. The third concern is that the Fed, in conjunction with the U.S. Treasury, begins to use exchange rates as a policy tool. Although this would make future tariff threats more potent, adjustments in terms of trade have deleterious ramifications for corporate and investor behavior.

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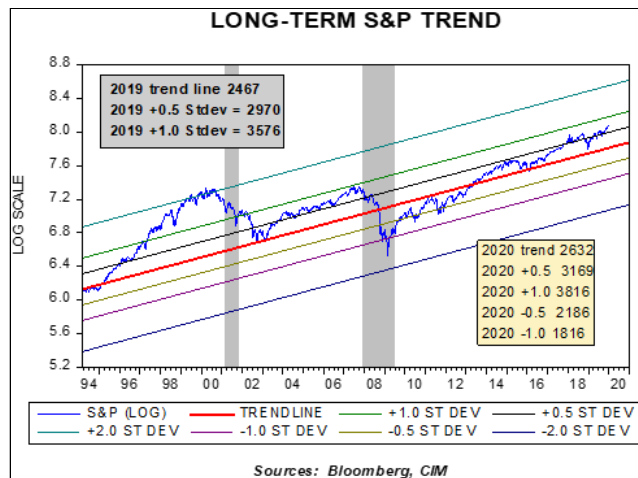
[1] https://www.cfosurvey.org/wp-content/uploads/2019/12/2019-Q4-US-Key-Numbers.pdf
[2] http://www.sca.isr.umich.edu/

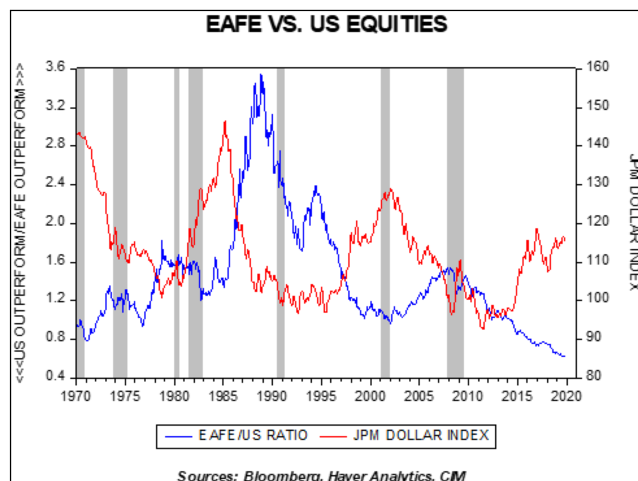
Although these factors of concern are present, they do not reflect our base case for continued economic health and extension of the record economic expansion. Rather, they are intended to underscore the importance of continually monitoring data to ascertain whether our asset allocations are appropriate or in need of adjustment. While diversification among asset classes is a hallmark of modern portfolio theory, allocations based upon stagnant assumptions may yield spurious results. Accordingly, expected returns, risk, and yields require regular updates to provide proper diversification among asset classes, which is the crux of our asset allocation process.

Stock Market Outlook

While we hold a favorable view of the equity markets near-term, we recognize that beyond the next 12 months pressures may continue to mount in terms of corporate earnings growth. In addition, should the potential for investors to yield to FOMO be realized, a market melt-up could ensue. In such an event, valuations would become extremely stretched, leading to the potential for a subsequent significant retrenchment in equity prices. Finally, a politicized Fed in conjunction with the U.S. Treasury to incorporate exchange rates as a policy tool would have serious implications for corporate and investor behavior. Although we have a neutral allocation to U.S. equities, our concentration in each of the strategies is on large capitalization, higher quality segments of U.S. stocks. Within large cap sectors, we established an overweight to Communication Services and retain the overweights to Technology and Health Care.



The concentration on higher quality also leads to a continuation of the skew to value relative to growth, as well as the retention of a quality factor geared toward companies that meet the required criteria of profitability, quality of earnings, and low leverage. The particular elements of the quality factor include return on equity, as a measure of profitability, changes to net operating assets over the past two years as a criterion for earnings quality, and the ratio of debt-to-book value of equity to determine financial leverage.



Beyond the U.S., despite attractive valuations and solid fundamentals among many non-U.S. companies, the weighting remains void until a durable catalyst for U.S. dollar weakness is recognized. As that occurs, tailwinds associated with a decline in the U.S. dollar will be extremely beneficial for U.S.-based investors.

Bond Market Outlook

The Fed's increasingly accommodative posture combined with the global appetite for yield will likely lead to a continuation of a normally sloped and range-bound yield curve over the course of the next several quarters. Over our three-year forecast period, we regard long-term Treasuries as relatively attractive given the global yield appetite and the potential for gravitational pull exerted by the sheer amount of global bonds outstanding with negative yields. Additionally, should we experience more volatile markets for global equities, longer term U.S. Treasuries should prove resilient. Although nearly $5 trillion of corporate debt will be maturing before 2023, according to Moody's, our caution is directed toward speculative grade, or high yield, corporate bonds where we expect spread widening to occur.

The duration of bond holdings in the strategies remains relatively long, stemming from our forecast for an accommodative Fed, a lack of inflationary pressure, and global demand for bonds. In the strategies with income objectives we retain the laddered structure as the core beyond the short-term segment in these strategies.

Other Markets

The combination of our forecast for rates, the lack of excesses in the real estate segment, and the more diversified pool of REIT enterprises leads to our constructive view on the segment. As a result, REITs are included across the array of the strategies.

The prior elevated allocation to gold is retained given its ability to offer a hedge against geopolitical risks combined with the safe haven it can afford during an uncertain climate for both equities and the U.S. dollar.

First Quarter 2020	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	17%	10%	10%	-	6%	6%	-	-
Long Term Bonds	33%	-	18%	-	15%	3%	15%	3%
Speculative Grade Bonds	-	-	-	-	-	-	-	-
Real Estate	5%	-	5%	-	5%	5%	11%	11%
U.S. Large Cap Stocks	23%	(10%)	35%	-	40%	(14%)	30%	(14%)
U.S. Mid Cap Stocks	10%	-	20%	-	20%	-	20%	-
U.S. Small Cap Stocks	-	-	-	-	-	-	10%	-
Foreign Developed Country Stocks	-	-	-	-	-	-	-	-
Emerging Market Stocks	-	-	-	-	-	-	-	-
Commodities	10%	-	10%	-	12%	-	12%	-
Total	*100%*		*100%*		*100%*		*100%*	

See page 6 for disclosures and important details regarding portfolio allocations.

Income with Growth

Two changes were made to the Income with Growth strategy this quarter. We trimmed the exposure to U.S. large cap equities in favor of an increased weight to intermediate-term bonds. This change moved the formerly elevated risk exposure to neutral, consistent with the other strategies. While the emphasis on the long end of the yield curve continues, the strategy retains the laddered maturity structure for the intermediate-term corporate bond exposure as well as a modest allocation to REITs. Among U.S. equities, a tilt in favor of value versus growth remains along with an allocation to the quality factor focusing on profitability, earnings quality and lower leverage. Within large cap sectors, we established an overweight in Communication Services, while continuing the Technology and Health Care overweights. The neutral weight to mid-cap stocks is unchanged. We maintain the exposure to gold due to its potential to reduce overall strategy risk accruing from geopolitical uncertainty, along with the opportunity it affords in the event of a decline in the U.S. dollar or increased global equity market volatility.

Growth & Income

The neutral risk posture for the Growth & Income strategy is unchanged from last quarter. Within bonds, our expectations for the continuation of a normally sloped and range-bound yield curve lead to continued emphasis on the long-end of the curve, with a laddered maturity structure for intermediate-term corporate bonds. Among stocks, all risk assets remain in the U.S. and REITs occupy a modest allocation given the diversified income stream they afford. Large cap stocks dominate the equity exposure, with a tilt in favor of value versus growth, and we maintain the quality factor focusing on profitability, earnings quality and lower leverage. We are now overweight Communication Services along with the former overweights to Technology and Health Care within the large cap sectors, while preserving the neutral weight to mid-cap stocks. We maintain the gold allocation as a hedge against geopolitical risks and for its attractiveness in the event of increased global equity market volatility or a decline in the U.S. dollar.

Growth

The changes to the Growth strategy enhance its neutral risk posture from the prior quarter, with risk reduction through a slight increase in long-term Treasuries and the introduction of exposures to intermediate-term bonds and REITs. The intermediate bond exposure is split equally between corporate bonds and mortgage-backed securities, which are viewed favorably in a range-bound yield curve environment. All equity exposure remains in the U.S. We reduced the former elevated allocation to large cap stocks, and they continue to skew toward value with an allocation to the quality factor focusing on profitability, earnings quality and lower leverage. Within large cap sectors, we preserve the former overweights to Technology and Health Care, while initiating an overweight to Communication Services. The neutral weight to mid-cap stocks is unchanged. We maintain the exposure to gold for its potential to reduce overall strategy risk accruing from geopolitical uncertainty, along with its attractiveness should the U.S. dollar decline or global equity markets experience increased volatility.

Aggressive Growth

In the Aggressive Growth strategy, we reduced the U.S. large cap equity allocation, in favor of a position in REITs and an increase in the long-term Treasury exposure. Among stocks, which remain all U.S.-based, the tilt to value continues along with the allocation to the quality factor focusing on profitability, earnings quality and lower leverage. Large cap equities now occupy most of the exposure in the strategy, and within the sectors we established an overweight to Communication Services, while retaining the overweights to Technology and Health Care. The neutral weights to both mid-cap and small cap stocks are unchanged. We maintain the exposure to gold as a hedge against geopolitical risks and due to the opportunity it affords in the event of a decline in the U.S. dollar or increased global equity market volatility.

Performance & Disclosures

as of 12/31/19

Strategy	ITD	10 - Year	5 - Year	3 - Year	1 - Year	YTD	Quarter
Income Taxable with Growth - Gross of Fees	9.9%	8.3%	7.0%	8.7%	20.7%	20.7%	3.4%
Income Taxable with Growth - Net of Fees	6.6%	5.1%	3.8%	5.5%	17.1%	17.1%	2.6%
Benchmark - 40% S&P 500 and 60% ML Bond Index	8.5%	7.8%	6.7%	8.7%	17.8%	17.8%	3.6%
Growth and Income Taxable - Gross of Fees	7.4%	8.8%	7.6%	9.0%	21.9%	21.9%	4.5%
Growth and Income Taxable - Net of Fees	4.2%	5.6%	4.4%	5.8%	18.3%	18.3%	3.7%
Benchmark - 70% S&P 500 and 30% ML Bond Index	9.1%	10.8%	9.2%	12.0%	24.6%	24.6%	6.3%
Growth - Gross of Fees	7.3%	9.4%	7.8%	8.9%	23.9%	23.9%	6.3%
Growth - Net of Fees	4.1%	6.2%	4.6%	5.7%	20.2%	20.2%	5.5%
Benchmark - S&P 500	10.8%	13.6%	11.7%	15.3%	31.5%	31.5%	9.1%
Aggressive Growth - Gross of Fees	7.1%	9.0%	7.1%	7.5%	22.5%	22.5%	5.9%
Aggressive Growth - Net of Fees	3.9%	5.7%	3.9%	4.3%	18.8%	18.8%	5.1%
Benchmark - S&P 500	10.9%	13.6%	11.7%	15.3%	31.5%	31.5%	9.1%

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 1/21/2020 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 12/31/19. 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 (S&P GSCI Total Return).

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