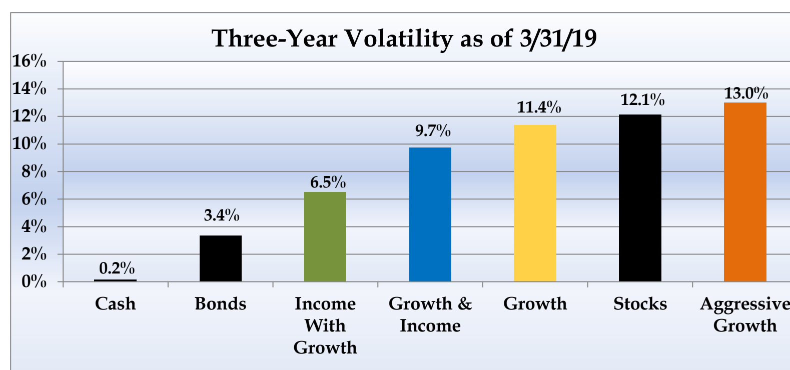
Asset Allocation Quarterly
Second Quarter 2019

The Confluence asset allocation process is centered upon risk management. Our asset allocation strategies 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 by the black bars for reference in the accompanying chart.



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.*

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, 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 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 steadier, returns, while the more aggressive accept inherent volatility in the pursuit of potentially higher returns.

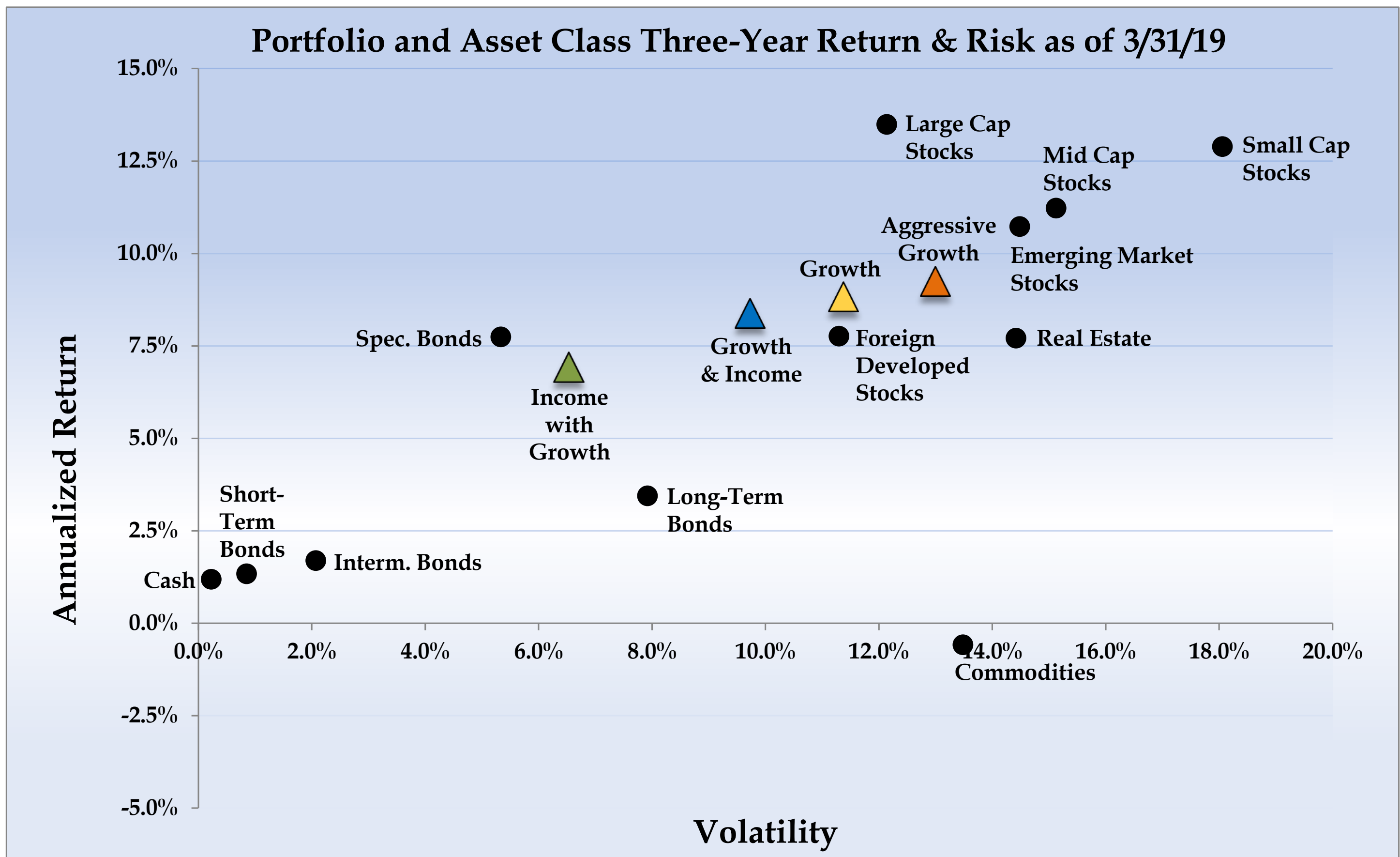
As the following table exhibits, return variance among asset classes from quarter to quarter can change dramatically. Over the past three years, we have witnessed healthy gains from U.S. equities, punctuated by sizable retreats, most notably in the fourth quarter of last year. Similarly, bonds have generally enjoyed solid returns. Although long-term bonds recorded a substantial loss in late 2016 and struggled through the early part of last year, they rallied over the past three months. 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 year has been a headwind.

Quarterly Asset Class Returns as of 3/31/19

	Q2 2016	Q3 2016	Q4 2016	Q1 2017	Q2 2017	Q3 2017	Q4 2017	Q1 2018	Q2 2018	Q3 2018	Q4 2018	Q1 2019
Cash	0.07%	0.10%	0.09%	0.10%	0.20%	0.26%	0.28%	0.35%	0.45%	0.49%	0.56%	0.60%
U.S. Short-Term Bonds	0.66%	0.03%	-0.38%	0.39%	0.30%	0.34%	-0.18%	-0.19%	0.29%	0.35%	1.17%	1.22%
U.S. Intermediate-Term Bonds	2.72%	0.46%	-3.91%	1.26%	1.67%	0.94%	0.03%	-1.86%	-0.38%	0.21%	1.97%	3.79%
U.S. Long-Term Bonds	6.49%	0.90%	-8.37%	1.76%	4.17%	1.46%	2.66%	-3.46%	-1.23%	-0.67%	1.25%	6.17%
Speculative Grade Bonds	5.88%	5.49%	1.88%	2.71%	2.14%	2.04%	0.41%	-0.91%	1.00%	2.44%	-4.67%	7.40%
REITs	6.96%	-1.43%	-2.89%	1.16%	1.52%	0.94%	1.51%	-8.20%	10.04%	1.23%	-6.73%	16.33%
U.S. Large Cap Stocks	2.46%	3.85%	3.82%	6.07%	3.09%	4.48%	6.64%	-0.76%	3.43%	7.71%	-13.52%	13.65%
U.S. Mid-Cap Stocks	3.99%	4.14%	7.42%	3.94%	1.97%	3.22%	6.25%	-0.77%	4.29%	3.86%	-17.28%	14.49%
U.S. Small Cap Stocks	3.79%	9.05%	8.83%	2.47%	2.46%	5.67%	3.34%	-0.08%	7.75%	3.58%	-20.20%	14.58%
Non-U.S. Developed Stocks	-1.46%	6.43%	-0.71%	7.25%	6.12%	5.40%	4.23%	-1.53%	-1.24%	1.35%	-12.54%	9.98%
Emerging Market Stocks	0.66%	9.03%	-4.16%	11.45%	6.27%	7.89%	7.44%	1.42%	-7.96%	-1.09%	-7.47%	9.91%
Commodities	12.67%	-4.15%	5.76%	-5.05%	-5.46%	7.22%	9.90%	2.19%	8.00%	1.34%	-22.94%	14.97%

Source: Morningstar Direct, CIM.*

*This information is presented as supplemental information to the disclosures required by GIPS® standards.
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

The chart above 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 for our asset allocation strategies over the rolling three-year period ending March 31, 2019. While positive returns have been generated by almost all of the primary asset classes over the course of the full 36 months, with the exception of Commodities, the annualized returns mask quarter-to-quarter volatilities. Volatility, as measured by standard deviation, has been much higher for equities than bonds.

The returns and risk of the Confluence strategies, represented by the colored triangles, were predominantly influenced by their respective exposures to the major asset classes of bonds and stocks. Given the advances of the stock market over the past three years, the Confluence Income with Growth strategy, which had the largest exposure to bonds, exhibited the lowest level of return, yet with a lesser degree of volatility. The Growth and Aggressive Growth strategies were allocated almost exclusively to stocks over the past three years and, consequently, both returns and risk were elevated.

Beyond the allocations to bonds and stocks, a significant factor on the relative returns and risk for each strategy was the allocation to sub-asset classes. As an example, Large Cap and Small Cap Stocks had roughly equivalent returns yet a wide differential of volatility. Exposure to Small Cap Stocks in lieu of Large Cap Stocks would have yielded a higher level of volatility over the past three years, but with a similar return. The aggregation of the stock/bond mix and the shifting exposures to sub-asset classes within the respective mix led to the location of each strategy along the return/risk continuum. Over the past three years, the four Confluence strategies all conformed to the expectation of higher volatility with the greater assumption of risk.

Our three-year cyclical forecast calls for a continuation of a positive economic environment, albeit with more subdued growth, which should reward risk assets. We regularly reassess and review data that can affect our macroeconomic outlook and should 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 then we will naturally adopt a more risk-averse posture for all of the strategies.

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Second Quarter 2019 Asset Allocation Outlook

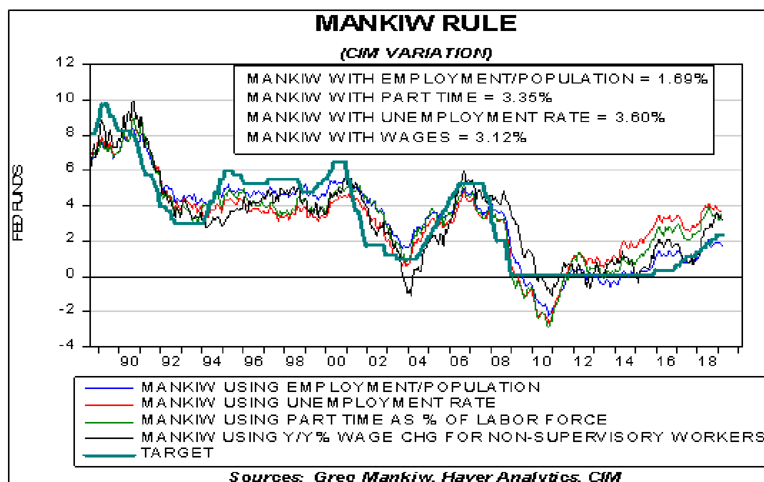
- **The Federal Reserve shifted fully from its hawkish stance at the beginning of the year. We anticipate that the committee will maintain its newly dovish stance with the potential for further monetary accommodation.**
- **Though the employment/population ratio has improved, we find it still indicates slack in the labor force, blunting the full impact of wage growth on inflation.**
- **Should trade agreements be reached with China and the European Union, and Congress approves the replacement for NAFTA, U.S. equity markets will respond positively.**
- **Despite weakness abroad, we expect the U.S. economy to continue to grow through the balance of this year and into next.**
- **The Fed's accommodation and our expectations for continued U.S. growth over the next two years encourages our continued historically high weighting to U.S. equities in the strategies.**

Economic Viewpoints

The Federal Reserve's pivot at the beginning of the year from a hawkish tone to a dovish posture has greatly influenced sentiment and markets. Though we foresee slowing economic growth over our three-year forecast period, we believe that the Fed's accommodation will continue to propel the economy and risk-based assets through the end of this year and into next year's election cycle. We maintain our expectation of 2.7% GDP growth for 2019.

The litmus test for our forecast will be the Fed's upcoming meeting in Chicago on June 4-5, where the committee will be examining and evaluating its strategies, tools and communications surrounding its formulation of monetary policy. They have been on record regarding their views that labor market conditions are close to maximum employment, yet several members have mentioned the amount of slack that exists in the economy as measured by the employment/population ratio.

We expect the Fed will take a more nuanced approach to inflation targeting, allowing CPI-U to advance above its 2% hurdle until the shortfalls recorded over the past decade are back-filled. If our thesis is confirmed, the potential for a decrease in the fed funds rate later this year becomes a likelihood as indicated by the line on the chart showing the Mankiw Rule model using the employment/population ratio. This will hold short-term advantages for the economy and risk assets, but with long-term ramifications for inflation and, thereby, future bond and stock prices.

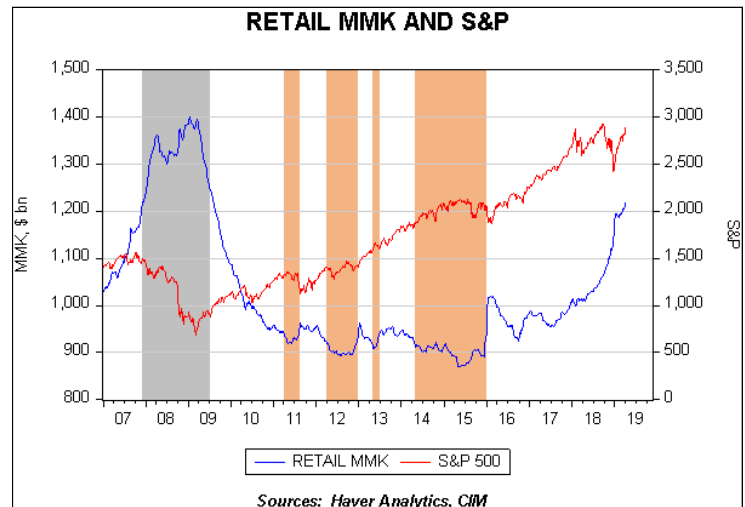


The current administration continues to engage in trade negotiations with China and the European Union (EU), and the new NAFTA, now USMCA, is under consideration by Congress. A favorable resolution of any or all of these would be positive for U.S. equities, where the market is still discounting long-term effects of trade barriers. Note that our expectations are not for a return to globalization. Rather, we fully anticipate general de-globalization efforts by the current administration as it seeks bilateral trade agreements favorable to the U.S. in contrast to the multilateral trade deals that were the basis of the globalization trend since the 1980s.

Beyond the U.S., our expectations are for continued softness in global growth and the potential for recession in several jurisdictions, the most notable being Italy and potentially Germany. The European Central Bank (ECB) has indicated that any tightening moves it harbored for this year have been pushed back until next year, at the earliest. Germany will be electing a new chancellor this fall and the ECB will have a new president on November 1, both of whom will exert influence on fiscal and monetary policies. Further influences emanate from China, with its economic stimulus measures and its stated willingness to accept trade measures from the EU. Although our thesis calls for a weakening U.S. dollar over our three-year forecast period, and we can envision an environment where European markets become attractive, there are too many near-term unknowns in Europe that encourage our posture of keeping risk assets in the U.S. for the foreseeable future.

Stock Market Outlook

Despite U.S. corporate profitability growth having slowed from last year's torrid pace, it has been growth nonetheless. Margins remain high and, in an era of continued deregulation, have the potential to expand further. The decrease in earnings estimates for the first and second quarters have created the possibility for positive earnings surprises. Moreover, our expectations that the Fed will become even more dovish, and potentially politicized in advance of next year's election season, adds more conviction for our historically high U.S. equity allocations in the strategies. A further element that would stoke the equity furnace is the fear of missing out by retail investors.



According to Morningstar, over the last twelve months investors have pulled nearly $425 billion out of U.S. equity separate accounts and mutual funds. Should retail investors replace their fear of the market with the fear of missing out, the U.S. equity market would become turbocharged. Although our consensus over our full three-year forecast period is certainly less rosy, we are encouraged to retain our historically high weighting to equities in the strategies for the time being.

Within investing styles, we maintain our neutral posture between value and growth. Among sectors, Materials continue to be overweight. We removed the overweight to the Energy and Health Care sectors in favor of overweights to Industrials, where earnings and growth metrics are attractive, and Technology, which was reconfigured late last year as part of the Communication Services realignment and offers a favorable position for the latter stages of an economic cycle.

The latter stages of an economic cycle are typically favorable for mid-cap stocks, which are decidedly overweight in each of the strategies. Attractive valuations using traditional measures of P/E and P/B for the S&P 400 Mid-Cap Index relative to the S&P 500 further our decision to overweight this sub-asset class. The Growth and Aggressive Growth strategies are both overweight to small cap stocks owing to the likelihood of continued elevated M&A activity over the course of the year.

Outside the U.S., we are cautious over the near term. Relative valuations are attractive overseas and our view is for a decline in the value of the U.S. dollar versus major currencies, which would provide a tailwind for returns. However, the cauldron of factors influencing Europe over the course of this year encourages us to remain on the sidelines in the near term. Therefore, we hold all risk assets in the U.S. with no allocation to foreign equities in any of the strategies.

Bond Market Outlook

The dovish and potentially politicized Fed going into the election season guides our view that the yield curve will return to its traditional slope over the course of the year, principally through a reduction in short-term rates. Through our full three-year forecast period, we are positive on longer term rates as long Treasuries have significantly attractive yields relative to those from other developed countries. While we harbor concerns regarding the nearly $5 trillion in corporate debt maturing between 2019 and 2023, compounded by the change in interest expense deductibility in 2022 from 30% of EBITDA to 30% EBIT, these concerns are offset by overall corporate health and the recognition that bonds can be refinanced at a competitive price. We extend the duration of bond holdings in the strategies with income objectives, and retain the laddered structure as a nucleus beyond the short-term segment. We eliminated our former position in speculative grade bonds due to concerns about embedded risks in certain sectors as well as our expectations for spread widening over the full forecast period from their current low levels.

Other Markets

While REITs experienced tremendous total returns in the first quarter, our consensus forecast is for them to only deliver returns commensurate with dividends over the next three years. Accordingly, we reduced the allocation by half in the only strategy where REITs are deployed. We retain the remaining small allocation for the diversified income stream they provide.

We maintain a modest allocation in gold given its ability to offer a hedge against geopolitical risk and the safe haven it can afford during an uncertain climate for the U.S. dollar.

Second Quarter 2019	**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	12%	(12%)	5%	-	-	-	-	-
Long Term Bonds	20%	9%	10%	5%	-	-	-	-
Speculative Grade Bonds	-	(4%)	-	-	-	-	-	-
Real Estate	5%	(5%)	-	-	-	-	-	-
U.S. Large Cap Stocks	33%	-	35%	-	45%	-	20%	-
U.S. Mid Cap Stocks	25%	15%	30%	-	25%	-	38%	-
U.S. Small Cap Stocks	-	-	15%	-	23%	-	35%	-
Foreign Developed Country Stocks	-	-	-	-	-	-	-	-
Emerging Market Stocks	-	-	-	-	-	-	-	-
Commodities	3%	-	3%	-	5%	-	5%	-
Total	*100%*		*100%*		*100%*		*100%*	

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

Income with Growth

The prior 24% allocation to intermediate term bonds was reduced by half in favor of increasing long bond exposure to 20%. The laddered maturity structure still occupies a substantial portion of the bond exposure in the Income with Growth strategy. We eliminated the former 4% weight to speculative grade bonds due to potential embedded risk and our view that spreads will widen over our three-year forecast period. We reduced REIT exposure from 10% to 5%; while they offer a diversified income stream for this strategy, the tremendous price appreciation of the last quarter dulls our expectation that REITs will deliver much beyond dividends with a marginal growth rate. We further elevate the historically high equity weight for the strategy by adding 15% to mid-cap stocks, where we find valuations attractive relative to large caps and believe they offer advantages in the latter stages of an economic cycle. We retain the modest 3% gold weighting for its potential to reduce overall strategy risk accruing from geopolitical uncertainty and its attractiveness in the event of a decline in the U.S. dollar.

Growth & Income

The largest change to the Growth & Income strategy was moving the 5% position in short-term bonds to long-term bonds, which now have a 10% allocation. The bond ladder still serves as the nucleus of the intermediate section and comprises a third of the total bond exposure. Overall, we lengthen duration from last quarter owing to our forecasts for a return to a normally sloped yield curve with yield compression across maturities. The allocation to stocks remains at historically high levels due to expectations for an accommodative Fed and continued corporate profitability. The split among capitalizations remains intact from last quarter, with mid-cap stocks at 30% and small cap stocks at 15%, representing a sizable overweight to both sub-asset classes. We retain the small weighting to gold as a hedge against geopolitical risk and due to the opportunity it affords against a potentially weaker U.S. dollar.

Growth

Beyond a reshuffling of sector exposures in large cap stocks, there are no changes to the Growth strategy this quarter, where the allocation to U.S. stocks is at its maximum. Among the large cap sectors, we eliminated Energy and Health Care in favor of overweights to Industrials and Technology. We maintain the overweight to the Materials sector, which has existed since late 2017. The Industrials overweight underscores our thesis for an advancing equity market caused by a dovish Fed and continued corporate profitability, while the Technology overweight is due to its potential in the latter stages of an economic cycle. The style bias between growth and value stocks remains neutral. Mid-cap and small cap stocks still represent 25% and 23%, respectively, as valuations are attractive and we expect the high level of M&A activity to continue. We retain the 5% gold allocation as a hedge against geopolitical risk and for its return potential in the event of a decline in the U.S. dollar.

Aggressive Growth

The Aggressive Growth strategy maintains its maximum exposure to U.S. stocks given our forecast for a dovish Fed and continued improvement in corporate profitability throughout the year. Mid-cap stocks represent a 38% exposure, while small cap stocks are 35%. Both allocations are consistent with our expectations for a continuation of the high level of M&A activity coupled with attractive valuations relative to large caps. The growth and value style bias remains neutral, though the composition of large cap sectors changed this quarter. While the overweight to Materials continues, we removed the overweights to Energy and Health Care. In their place, we introduce overweights to Industrials, which underscores our thesis for an advancing equity market, and Technology, due to its potential in the latter stages of an economic cycle. We retain the 5% gold allocation as a hedge against geopolitical risk and for its return potential in the event of a decline in the U.S. dollar.

Performance & Disclosures

as of 3/31/19

Strategy	Quarter	YTD	1 - Year	3 - Year	5 - Year	10 - Year	ITD
Income Taxable with Growth - Gross of Fees	9.0%	9.0%	7.6%	6.9%	6.5%	10.4%	9.6%
Income Taxable with Growth - Net of Fees	8.2%	8.2%	4.4%	3.8%	3.3%	7.1%	6.3%
Benchmark - 40% S&P 500 and 60% ML Bond Index	7.2%	7.2%	6.8%	6.7%	6.2%	8.7%	8.2%
Growth and Income Taxable - Gross of Fees	10.8%	10.8%	2.3%	8.4%	7.3%	11.6%	7.0%
Growth and Income Taxable - Net of Fees	9.9%	9.9%	-0.7%	5.2%	4.2%	8.3%	3.8%
Benchmark - 70% S&P 500 and 30% ML Bond Index	10.4%	10.4%	8.3%	10.1%	8.6%	12.3%	8.5%
Growth - Gross of Fees	11.8%	11.8%	1.1%	8.8%	7.7%	12.3%	6.8%
Growth - Net of Fees	10.9%	10.9%	-1.9%	5.6%	4.5%	9.0%	3.7%
Benchmark - S&P 500	13.6%	13.6%	9.5%	13.5%	10.9%	15.9%	10.1%
Aggressive Growth - Gross of Fees	11.9%	11.9%	-0.8%	9.3%	6.7%	12.1%	6.7%
Aggressive Growth - Net of Fees	11.0%	11.0%	-3.7%	6.0%	3.5%	8.8%	3.6%
Benchmark - S&P 500	13.6%	13.6%	9.5%	13.5%	10.9%	15.9%	10.2%

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 4/16/2019 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 thru 3/31/19. 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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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.