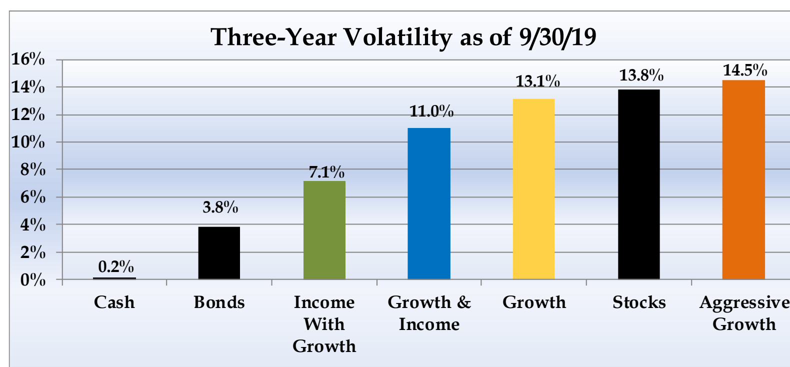
Asset Allocation Quarterly
Fourth Quarter 2019

The Confluence asset allocation process is centered upon risk management. Our asset allocation strategies offer a broad spectrum of risk profiles, ranging from a 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.



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 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.

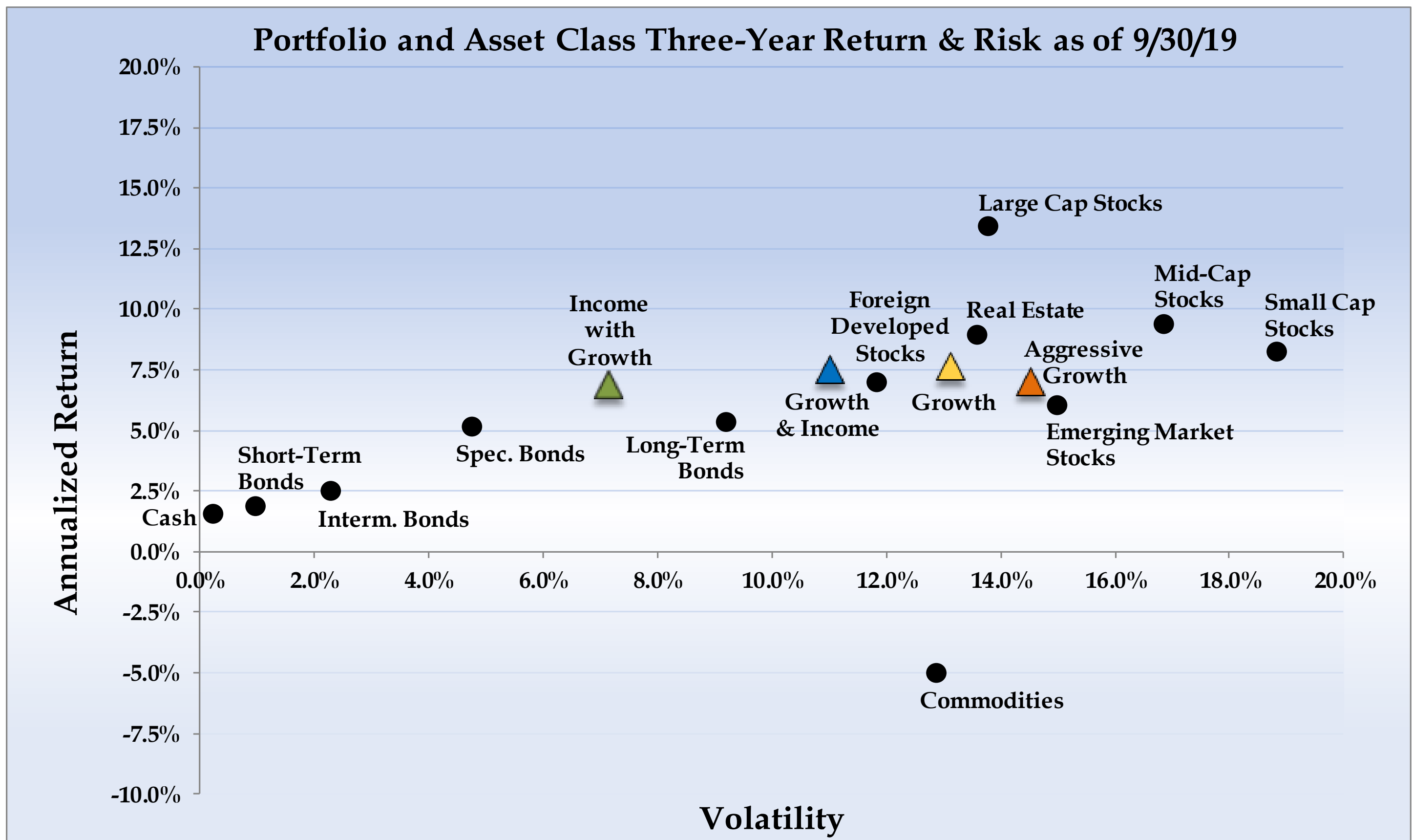
As the following table exhibits, return variance among asset classes from quarter-to-quarter can change dramatically. Over the past three years, we have witnessed healthy gains from U.S. equities, punctuated by a sizable retreat in the fourth quarter of last year and lower returns over the most recent quarter. Similarly, bonds have generally enjoyed solid returns, particularly thus far this year. Although long-term bonds recorded a substantial loss in late 2016 and struggled through the early part of last year, they have generated outsized returns over the past 12 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 21 months has been a headwind.

Quarterly Asset Class Returns as of 9/30/19

	Q4 2016	Q1 2017	Q2 2017	Q3 2017	Q4 2017	Q1 2018	Q2 2018	Q3 2018	Q4 2018	Q1 2019	Q2 2019	Q3 2019
Cash	0.09%	0.10%	0.20%	0.26%	0.28%	0.35%	0.45%	0.49%	0.56%	0.60%	0.64%	0.56%
U.S. Short-Term Bonds	-0.38%	0.39%	0.30%	0.34%	-0.18%	-0.19%	0.29%	0.35%	1.17%	1.22%	1.49%	0.70%
U.S. Intermediate-Term Bonds	-3.91%	1.26%	1.67%	0.94%	0.03%	-1.86%	-0.38%	0.21%	1.97%	3.79%	3.94%	2.34%
U.S. Long-Term Bonds	-8.37%	1.76%	4.17%	1.46%	2.66%	-3.46%	-1.23%	-0.67%	1.25%	6.17%	6.45%	6.56%
Speculative Grade Bonds	1.88%	2.71%	2.14%	2.04%	0.41%	-0.91%	1.00%	2.44%	-4.67%	7.40%	2.57%	1.22%
REITs	-2.89%	1.16%	1.52%	0.94%	1.51%	-8.20%	10.04%	1.23%	-6.73%	16.33%	1.24%	7.80%
U.S. Large Cap Stocks	3.82%	6.07%	3.09%	4.48%	6.64%	-0.76%	3.43%	7.71%	-13.52%	13.65%	4.30%	1.70%
U.S. Mid-Cap Stocks	7.42%	3.94%	1.97%	3.22%	6.25%	-0.77%	4.29%	3.86%	-17.28%	14.49%	3.05%	-0.09%
U.S. Small Cap Stocks	8.83%	2.47%	2.46%	5.67%	3.34%	-0.08%	7.75%	3.58%	-20.20%	14.58%	2.10%	-2.40%
Non-U.S. Developed Stocks	-0.71%	7.25%	6.12%	5.40%	4.23%	-1.53%	-1.24%	1.35%	-12.54%	9.98%	3.68%	-1.07%
Emerging Market Stocks	-4.16%	11.45%	6.27%	7.89%	7.44%	1.42%	-7.96%	-1.09%	-7.46%	9.91%	0.61%	-4.25%
Gold	-12.70%	8.22%	-0.77%	3.09%	1.87%	0.95%	-5.49%	-5.00%	7.24%	0.91%	9.01%	3.82%

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

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 (gross-of-fees) for our asset allocation strategies over the rolling three-year period ending September 30, 2019. The relative positive returns that have been generated by almost all the primary asset classes over the course of the full 36 months have been accompanied by a commensurately higher level of volatility, as measured by standard deviation, in almost a linear fashion. The clear outliers over this period have been Large Cap Stocks and Commodities, the former recording outsized returns relative to volatility and the latter registering high volatility with sub-optimal returns.

The risk and returns 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 recent 36 months, 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, risks were elevated relative to the Income with Growth and Growth & Income strategies, both of which had exposures to bonds.

Beyond the allocations to bonds and stocks, significant influences on the relative returns and risk for each strategy were the allocations to sub-asset classes. As an example, Large Cap Stocks and Real Estate had roughly equivalent volatility yet a wide differential of return. Exposure to Real Estate in lieu of Large Cap Stocks would have yielded a lower return over the past three years, but with a similar level of volatility. 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 asset allocation strategies all conformed to the expectation of higher volatility with the greater assumption of risk.

While we retain a relatively sanguine view of the U.S. economy over our three-year cyclical forecast period, we recognize there is increased potential for an economic downturn. Should this occur, it would weigh on risk assets. Accordingly, this quarter we have reverted to a more neutral posture in the strategies by decreasing their formerly elevated exposures to risk assets. We regularly assess and review data that can affect the macroeconomic environment and where there is change in growth prospects, a variation in the degree of leverage employed or a shift in central bank policy, we will naturally adapt the risk exposure in each of the strategies.

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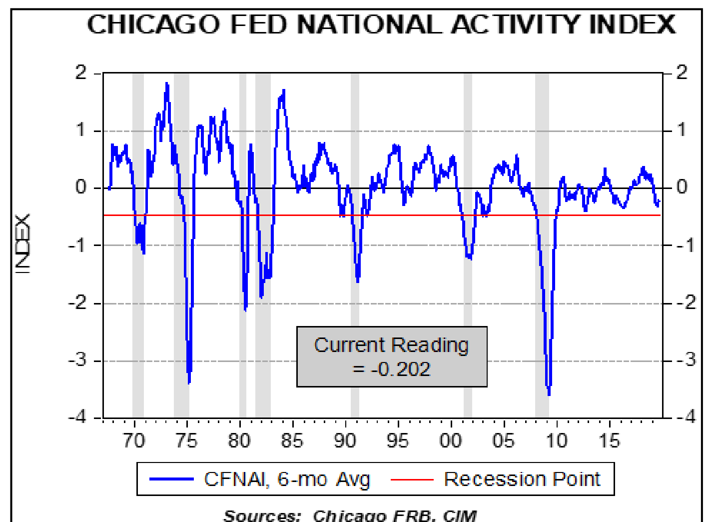
Fourth Quarter 2019 Asset Allocation Outlook

- **The U.S. Federal Reserve and other central banks are expected to continue their accommodative postures, especially considering issues stemming from trade impediments.**
- **While we retain a relatively sanguine view of the U.S. economy over our three-year cyclical forecast period, we recognize there is increased potential for an economic downturn.**
- **Each strategy reflects a more neutral posture, with risk exposure being trimmed and all residing in the U.S.**
- **Within equities, our style guidance has shifted to 60% value/40% growth.**
- **The prospect of trade-based earnings compression leads us to lean toward firms with larger market capitalizations, particularly those with more defensive characteristics.**
- **Heightened geopolitical uncertainty and the potential for elevated volatility in global equity markets encourages an increased allocation to long-term U.S. Treasuries and gold.**

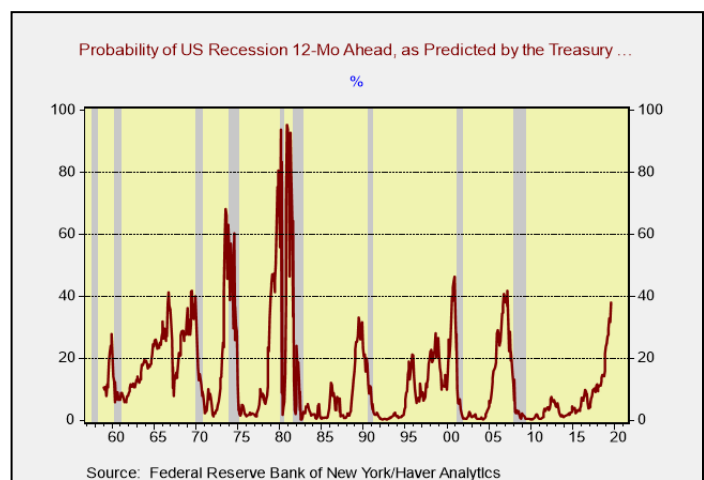
Economic Viewpoints

The overall economic picture, while still positive, has exhibited recent signs of lethargy. Sentiment remains elevated, though some important surveys are lower than earlier in the year. As an example, the Duke University CFO Global Business Outlook for Q3 2019 indicates less optimism and has trended down from this period last year.[1] Earnings may come under pressure, particularly from trade, as firms continue to absorb the cost of tariffs and reorder supply chains. In addition, as the accompanying chart illustrates, the Chicago Fed's National Activity Index is measuring softness at a level last seen in 2015.



On the plus side, GDP prints have been positive as have corporate earnings surprises over the latest quarter. The Federal Reserve shaved a quarter-point from the fed funds rate in each of its past two meetings and announced the curtailment of the reduction of its balance sheet beginning on August 1. Owing to recent primary dealers funding pressures, the Fed also expanded its overnight reverse repurchase facility, effectively increasing its balance sheet. It also announced a $60 billion per month increase in the balance sheet through February 2020.

While we believe the Fed will continue to exhibit an accommodative stance, with the potential for further cuts to the fed funds rate and expansion of its balance sheet to preserve short-term funding needs, the Fed may have been too tardy in its pivot to easing. Consequently, there is the potential for a decrease in economic activity.



This chart estimates the probability of recession, a year into the future, based on the yield curve. The current level would be consistent with a recession later next year. In general, the financial indicators of the business cycle are signaling an increased likelihood of recession. On the other hand, purely economic indicators are still signaling a modest expansion. Overall, we would not shift portfolios to a fully defensive posture until both types of indicators indicate recession.

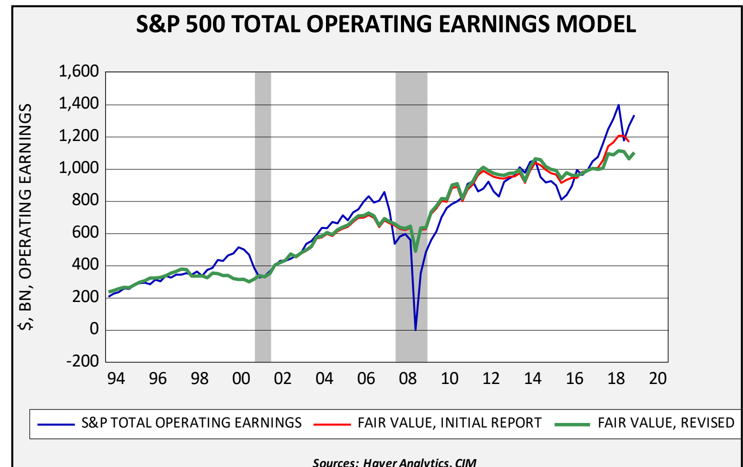
[1] https://www.cfosurvey.org/wp-content/uploads/2019/09/2019-Q3-US-Key-Numbers-1.pdf

Global economic conditions are similarly mixed. In his last maneuver as chair of the European Central Bank, Mario Draghi furthered the ECB's ultra-easy monetary policy. Similarly, the Bank of Japan noted it may take preemptive action against economic risks through greater easing. Germany's GDP declined slightly last quarter and is expected to remain sluggish, especially as its export-oriented economy is influenced by trade tensions. Conversely, the global appetite for yield has helped to lower financing costs. Globally there is roughly $15 trillion of negative-yielding debt, representing almost a quarter of total debt outstanding. This helps support global economies, making it easier for marginal companies to remain solvent, yet with distortions that could hold longer term consequences.

Against this varied backdrop, we find it prudent to lessen our historically high allocations to risk-based assets, preferring to adopt a more neutral posture with associated offsets as detailed in the strategy section of this document (p.5). In deference to global economic uncertainty, all risk exposures remain in the U.S.

Stock Market Outlook

In the U.S., earnings growth is likely to be more restrained than what we have experienced over the past three years. As noted above, the CFO survey by Duke University is more muted, with optimism regarding the U.S. economy as well as their own companies lower than prior quarters. Another complication to the earnings picture is the revision to the Bureau of Economic Analysis [BEA] profit calculations. Prior to the revision the operating earnings for the S&P 500 were marginally elevated, yet within model ranges. However, due to the revision, our model suggests that absent a durable catalyst, pressure on earnings growth is likely. As a result, we are reducing our allocations to risk assets and concentrating in the larger capitalization, higher quality segments of U.S. stocks.



As with the past several quarters, we express near-term caution regarding non-U.S. developed and emerging markets. Despite valuations for non-U.S. stocks generally being attractive relative to U.S. counterparts, the elevated level of global economic uncertainty encourages our purely domestic exposure. Within investing styles, we have initiated a 60/40 tilt to value over growth and have introduced an allocation to a quality factor focusing on profitability, earnings quality and lower leverage. Additionally, we have modified the large cap equity sector weightings, retaining a slight overweight to Technology and introducing overweights to the Consumer Staples and Health Care sectors. Among market capitalizations, current exposures now favor large capitalization companies over mid-cap and small cap. Although trailing valuations of lower market cap companies appear attractive, the potential for earnings compression leads us to lean toward firms with larger market capitalizations, particularly those with more defensive characteristics.

Bond Market Outlook

The more accommodative posture of the Fed combined with the global appetite for yield should lead to a normally sloped yield curve over the course of the next several quarters. Over our three-year forecast period, we regard longer term Treasuries as relatively attractive given the global yield appetite and the potential for gravitational pull exerted by $15 trillion of bonds outstanding with negative yields. Additionally, longer term U.S. Treasuries should prove resilient in the event of more volatile global equity markets. Although nearly $5 trillion of corporate debt will be maturing before 2023, 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 with income objectives has been extended slightly, accruing from our forecast for an accommodative Fed, a slowing economy, lack of inflationary pressure and global demand for bonds. We retain the laddered structure as a nucleus beyond the short-term segment in these strategies.

Other Markets

Despite the outsized returns that many REITs have enjoyed during 2019, the combination of our forecast for rates, the lack of excesses in the segment and the more diversified pool of enterprises leads to our constructive view on REITs. As a result, REITs are included in the income-oriented strategies given the diversified income stream they provide.

We have increased the prior allocation to gold 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.

Fourth 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	-	-	-	-	-	-	-	-
Intermediate Term Bonds	7%	-	10%	5%	-	-	-	-
Long Term Bonds	33%	8%	18%	8%	12%	12%	12%	12%
Speculative Grade Bonds	-	-	-	-	-	-	-	-
Real Estate	5%	-	5%	5%	-	-	-	-
U.S. Large Cap Stocks	33%	-	35%	-	54%	9%	44%	24%
U.S. Mid Cap Stocks	10%	(15%)	20%	(15%)	20%	(15%)	20%	(33%)
U.S. Small Cap Stocks	-	-	-	(10%)	-	(13%)	10%	(10%)
Foreign Developed Country Stocks	-	-	-	-	-	-	-	-
Emerging Market Stocks	-	-	-	-	-	-	-	-
Commodities	10%	7%	10%	7%	12%	7%	12%	7%
Total	*100%*		*100%*		*100%*		*100%*	

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

Income with Growth

Income with Growth saw several changes this quarter. We increased the exposure to long-term Treasuries due to our expectations that the yield curve will become more traditionally sloped combined with their historic resilience in the face of global economic uncertainty. We retain the laddered maturity structure for the intermediate-term corporate bond exposure as well as a modest allocation to REITs. Among U.S. equities, we reduced the former overweight to mid-cap stocks and introduced a tilt in favor of value versus growth, along with an allocation to the quality factor focusing on profitability, earnings quality and lower leverage. Within large cap sectors, we established overweights to Consumer Staples and Health Care due to favorable valuations and their more defensive characteristics. Although we trimmed a portion of the Technology sector, it remains slightly overweight. We increased 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

Growth & Income allocations reflect a more neutral posture than last quarter. Within bonds, we increased the Treasury exposure in the intermediate-term and long-term maturities due to our expectations for a return to a normal slope of the yield curve as well as the historic resilience exhibited by longer dated U.S. Treasuries in the face of global economic uncertainty. We retain the laddered maturity structure for intermediate-term corporate bonds. Among stocks, all risk assets remain in the U.S. REITs occupy 5% given the diversified income stream they afford. Large cap stocks dominate the equity exposure, with a tilt in favor of value versus growth. We introduced an allocation to the quality factor focusing on profitability, earnings quality and lower leverage. Within large cap sectors, we are overweight Consumer Staples and Health Care for their favorable valuations and more defensive characteristics. Although we trimmed the Technology sector, it remains slightly overweight. We increased the gold allocation as a hedge against geopolitical risks and for its attractiveness should the U.S. dollar decline or global equity markets experience increased volatility.

Growth

The former risk-tolerant posture in the Growth strategy over the past several years was reconfigured into a more neutral position with appropriate hedges. While equity exposure remains in the U.S., we eliminated the allocation to small cap stocks in favor of long-term U.S. Treasuries, which have historically exhibited resilience during periods of global economic uncertainty. Large cap stocks represent the majority of the equity exposure. Equities are now skewed toward value and we introduced an allocation to the quality factor focusing on profitability, earnings quality and lower leverage. Among large cap sectors, we established overweights to Consumer Staples and Health Care due to favorable valuations and their more defensive characteristics. Although we trimmed a portion of the Technology sector, it remains modestly overweight. We increased the exposure to gold as a hedge against geopolitical risks and due to its attractiveness in the event of increased global equity market volatility or a decline in the U.S. dollar.

Aggressive Growth

In the Aggressive Growth strategy, half of the small cap equity allocation was repositioned in long-term Treasuries given the resilience they have historically offered during periods of global economic uncertainty. Among stocks, which remain all U.S.-based, we introduced a tilt to value along with an allocation to the quality factor focusing on profitability, earnings quality and lower leverage. Large caps now occupy most of the strategy's exposure. Within large cap sectors, we are overweight Consumer Staples and Health Care for their favorable valuations and more defensive characteristics. Although we trimmed the Technology sector, it remains modestly overweight. We increased the gold allocation for its potential to act as a hedge against geopolitical uncertainty, along with its attractiveness should the U.S. dollar decline or global equity markets experience increased volatility.

Performance & Disclosures

as of 9/30/19

Strategy	ITD	10 - Year	5 - Year	3 - Year	1 - Year	YTD	Quarter
Income Taxable with Growth - Gross of Fees	9.8%	8.3%	7.2%	6.8%	11.3%	16.7%	3.2%
Income Taxable with Growth - Net of Fees	6.5%	5.1%	4.0%	3.7%	8.0%	14.1%	2.4%
Benchmark - 40% S&P 500 and 60% ML Bond Index	8.4%	7.7%	6.6%	7.3%	8.5%	13.6%	2.2%
Growth and Income Taxable - Gross of Fees	7.1%	8.9%	7.8%	7.5%	3.1%	16.6%	1.5%
Growth and Income Taxable - Net of Fees	3.9%	5.7%	4.6%	4.3%	0.1%	14.0%	0.8%
Benchmark - 70% S&P 500 and 30% ML Bond Index	8.7%	10.5%	8.8%	10.4%	6.5%	17.2%	1.9%
Growth - Gross of Fees	6.9%	9.4%	7.9%	7.6%	1.2%	16.6%	0.9%
Growth - Net of Fees	3.7%	6.1%	4.7%	4.4%	-1.8%	14.0%	0.2%
Benchmark - S&P 500	10.2%	13.2%	10.8%	13.4%	4.2%	20.6%	1.7%
Aggressive Growth - Gross of Fees	6.7%	8.9%	7.1%	7.0%	0.0%	15.6%	0.4%
Aggressive Growth - Net of Fees	3.6%	5.7%	4.0%	3.8%	-3.0%	13.0%	-0.3%
Benchmark - S&P 500	10.3%	13.2%	10.8%	13.4%	4.2%	20.6%	1.7%

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 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 10/15/2019 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 9/30/19. 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).

The Asset Allocation Committee

Mark Keller | Bill O'Grady | Gregory Ellston | David Miyazaki | Patty Dahl | Kaisa Stucke | Patrick Fearon-Hernandez

For more information contact one of our sales team members:

Wayne Knowles | Southeast
(919) 604-7604
wknowles@confluenceim.com

Ron Pond | Southwest
(858) 699-7945
rpond@confluenceim.com

Steve Mikez | North-Central
(480) 529-8741
smikez@confluenceim.com

Jason Gantt | Northeast
(203) 733-9470
jgantt@confluenceim.com

Jim Taylor | Mid-South
(630) 605-7194
jtaylor@confluenceim.com

Confluence Investment Management LLC is an independent Registered Investment Advisor located in St. Louis, Missouri. Confluence provides professional portfolio management and advisory services to institutional and individual clients. The firm's investment philosophy is based upon independent, fundamental research that integrates evaluation of market cycles, macroeconomics and geopolitical analysis with the firm's value-driven approach. Confluence's portfolio management philosophy begins by addressing risk and follows through by positioning clients to achieve income and growth objectives.