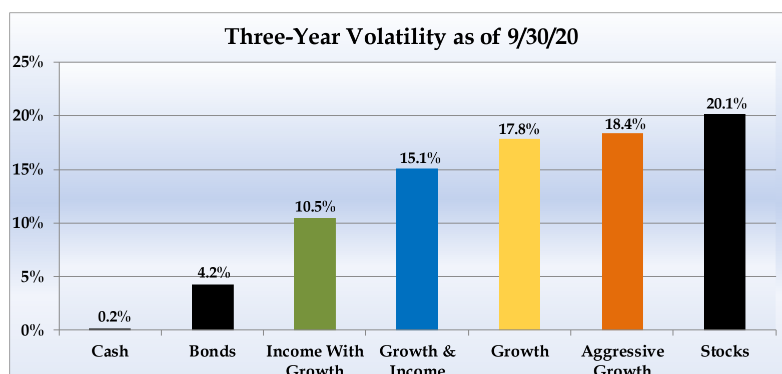
Asset Allocation Quarterly
Fourth Quarter 2020

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.**

As risks change from tepid to turbulent and back, as naturally occurs over market and economic cycles, we attempt to guide the strategies within their respective volatility ceilings. Our evaluation of the economy, monetary and fiscal policies, interest rates, regulation, valuations, and other investment variables in a forward-looking context informs our flexible asset allocation through adaptive diversification. Although we seek return opportunities, we do so within risk constraints that are scaled for each strategy.

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.

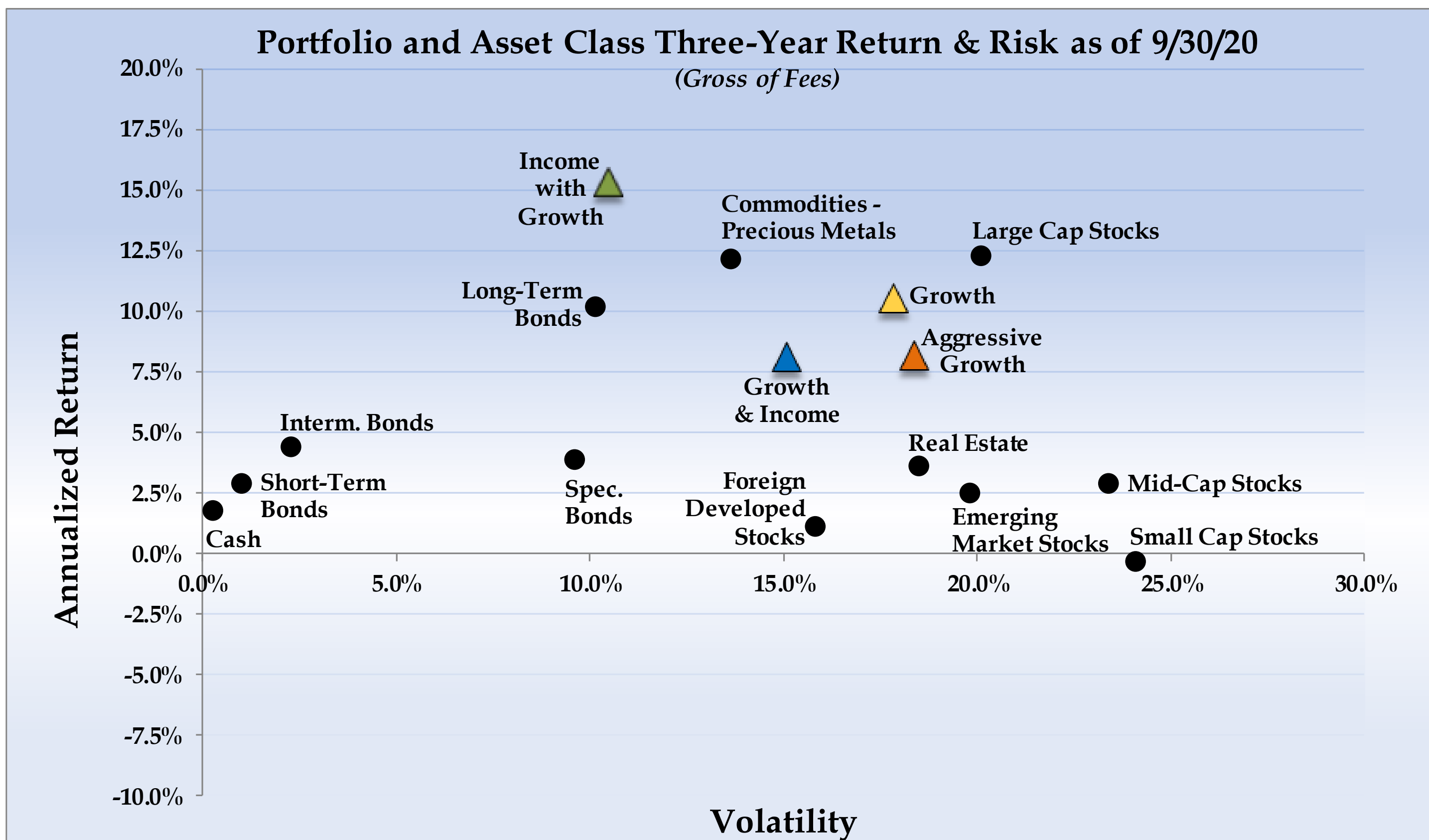
Return variance among asset classes from quarter-to-quarter can change drastically, as the table below displays. Over the past three years, we have witnessed bouts of sizable gains from U.S. stocks punctuated by dramatic retreats. In contrast, bonds exhibited more muted returns, although long-term bonds have occasionally recorded returns that have rivaled stocks. Nevertheless, long-term bonds rarely move in close correlation with equities. Similarly, precious metals have shown a lack of correlated returns to either stocks or bonds, making this segment an attractive diversification element as conditions warrant.

Quarterly Asset Class Returns as of 9/30/20

	Q4 2017	Q1 2018	Q2 2018	Q3 2018	Q4 2018	Q1 2019	Q2 2019	Q3 2019	Q4 2019	Q1 2020	Q2 2020	Q3 2020
Cash	0.28%	0.35%	0.45%	0.49%	0.56%	0.60%	0.64%	0.56%	0.46%	0.57%	0.02%	0.04%
U.S. Short-Term Bonds	-0.18%	-0.19%	0.29%	0.35%	1.17%	1.22%	1.49%	0.70%	0.61%	1.59%	1.22%	0.27%
U.S. Intermediate-Term Bonds	0.03%	-1.86%	-0.38%	0.21%	1.97%	3.79%	3.94%	2.34%	0.19%	2.42%	4.92%	1.11%
U.S. Long-Term Bonds	2.66%	-3.46%	-1.23%	-0.67%	1.25%	6.17%	6.45%	6.56%	-1.34%	7.24%	5.35%	1.20%
Speculative Grade Bonds	0.41%	-0.91%	1.00%	2.44%	-4.67%	7.40%	2.57%	1.22%	2.61%	-13.12%	9.61%	4.71%
REITs	1.51%	-8.20%	10.04%	1.23%	-6.73%	16.33%	1.24%	7.80%	-0.76%	-27.30%	11.82%	1.44%
U.S. Large Cap Stocks	6.64%	-0.76%	3.43%	7.71%	-13.52%	13.65%	4.30%	1.70%	9.07%	-19.60%	20.54%	8.93%
U.S. Mid-Cap Stocks	6.25%	-0.77%	4.29%	3.86%	-17.28%	14.49%	3.05%	-0.09%	7.06%	-29.70%	24.07%	4.77%
U.S. Small Cap Stocks	3.34%	-0.08%	7.75%	3.58%	-20.20%	14.58%	2.10%	-2.40%	9.94%	-30.61%	25.42%	4.93%
Non-U.S. Developed Stocks	4.23%	-1.53%	-1.24%	1.35%	-12.54%	9.98%	3.68%	-1.07%	8.17%	-22.83%	14.88%	4.80%
Emerging Market Stocks	7.44%	1.42%	-7.96%	-1.09%	-7.46%	9.91%	0.61%	-4.25%	11.84%	-23.60%	18.08%	9.56%
Commodities - Precious Metals	1.95%	0.31%	-5.04%	-5.44%	7.05%	0.55%	8.26%	4.40%	3.49%	2.11%	13.30%	5.39%

*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. Net composite returns shown on page 6.**

Portfolio and Asset Class Commentary

The past three years have experienced a roller-coaster of returns, with some enormous gains and some terrifying drawdowns, especially in the equity segments. All risk asset classes exhibited heightened volatility, as measured by standard deviation, and most registered barely positive returns over the past 36 months. As is typical in volatile markets for risk assets, bonds played an important role as portfolio stabilizers. Not only did investment-grade bonds register higher returns with lower risk, but they have often exhibited negative correlation to the S&P 500 during the tumultuous periods of late 2018 and the first six months of this year, underscoring their diversification benefits.

The colored triangles in the chart above represent the Confluence Asset Allocation strategies. Although all strategies generated positive returns over the past three years, the variability in volatility was most heavily influenced by the mix of stocks and bonds held in each strategy. The strategies with higher exposure to bonds produced lower levels of realized volatility, which is the essence of our construct of the strategies whereby each strategy is held to a distinct and unchanging volatility governor. As a result, bonds are used more extensively in strategies with lower volatility ceilings, such as Income with Growth, as compared to the highest volatility ceiling of Aggressive Growth. While this may seem intuitive, it also explains the differential exposures of each strategy to the sub-asset classes. A more volatile sub-asset class is more likely to be employed in a strategy with a higher volatility ceiling. A pertinent example is the differential of returns and risk between the Growth and Aggressive Growth strategies. Over the past three years, Growth had a higher weighting to U.S. large cap stocks whereas Aggressive Growth held larger allocations to mid-cap and small cap stocks. Lower market capitalizations can lead to higher returns, albeit with higher levels of risk. However, given the turbulence in the equity markets, exposures to lower market cap stocks proved to hamper returns.

All strategies retain elevated exposures to stocks as the Asset Allocation Committee [AAC] believes that over the full three-year forecast period a long, slow economic recovery will prove beneficial to equities. However, we recognize the potential exists for a policy misstep or an increase in global geopolitical risk. The AAC regularly assesses and reviews a wide array of data affecting the macroeconomic environment including sentiment, growth prospects, and credit, among other elements. Should we detect an enduring shift, we will naturally adjust the risk exposure in each strategy as appropriate.

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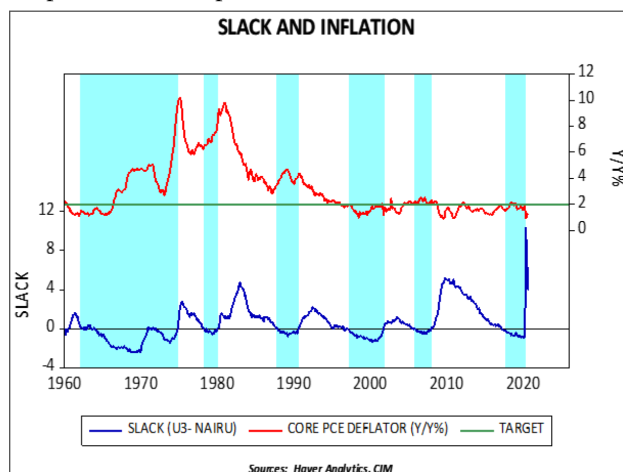
Fourth Quarter 2020 Asset Allocation Outlook

- **We believe that we are now in an economic recovery which we expect to be long and slow moving.**
- **The Federal Reserve will likely continue to be aggressively accommodative, as will other global central banks, providing a favorable backdrop for equities.**
- **With an accommodative Fed, we retain elevated relative weightings to equities, yet exposures in the strategies have shifted toward an emphasis on cyclical stocks.**
- **Given the upcoming U.S. elections and the accompanying uncertainty of policies in its wake, we initiated a position in non-U.S. equities. Their favorable valuations and the potential for a softening in the exchange rate for the U.S. dollar make them attractive for U.S.-based investors.**
- **Exposure to gold is retained in each of the strategies given its ability to act as a hedge against geopolitical risks and for its appreciation potential due to global central bank accommodation and in the event of a decline in the exchange rate of the U.S. dollar.**

Economic Viewpoints

Although the upcoming U.S. elections have captured extraordinary attention, whether the nation swings red, blue, or purple is of nominal consequence to equity and debt markets beyond near-term swings. Rather, our forecast rests upon the principal pillar that the U.S. has now entered a recovery, albeit a long and protracted one. We are expecting a sizable bounce in the Q3 GDP print off the jarring Q2 number, followed by low yet steady growth. While a number of publications have offered alphabetic depictions of the economy, such as V-shaped, U-shaped, W-shaped, and L-shaped, our view is that it will resemble a square root sign. The aggressive accommodation by the Fed will be helpful, as will any further fiscal stimulus measures. The Fed's pronouncement following its virtual Jackson Hole meeting at the end of August that it will unbind its hard 2% inflation target in favor of attempting to average this level over time is a marked change, yet will likely have no perceptible impact within our three-year forecast period. Similarly, the Fed has stated its intention of no longer using low unemployment as an indicator of potential inflation. As the accompanying chart illustrates, the level of slack in labor had been useful as a gauge of inflation last century but has been of spurious utility over the past 25 years. While these two policy changes are noteworthy, we find the likelihood for the Fed to engage in a form of yield curve control and leave fed fund rates mired near the zero bound through next year and potentially beyond to be of greater consequence and should be supportive of the economy and markets.



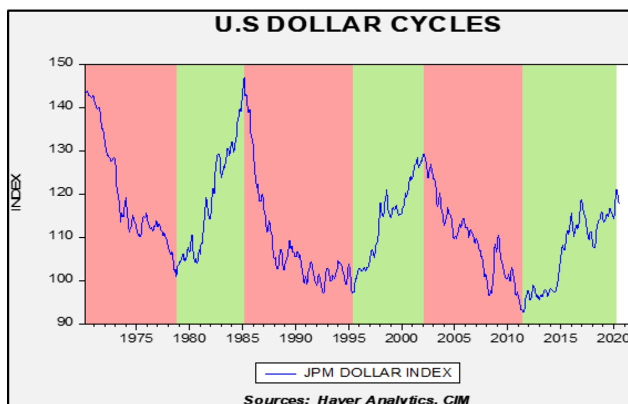
A near-term risk to the stock market is the potential for a presidential election where there is no clear winner. This could cause a significant, though short-term, negative event. Although we believe that over our entire forecast period the support offered by the Fed and market sentiment will be positive for risk assets, our recognition of the possibility of market disruption over the next few months encourages our continued use of gold as well as the introduction of non-U.S. developed market equities and long-term Treasuries, where risk appropriate, to serve as a partial containment for this scenario.

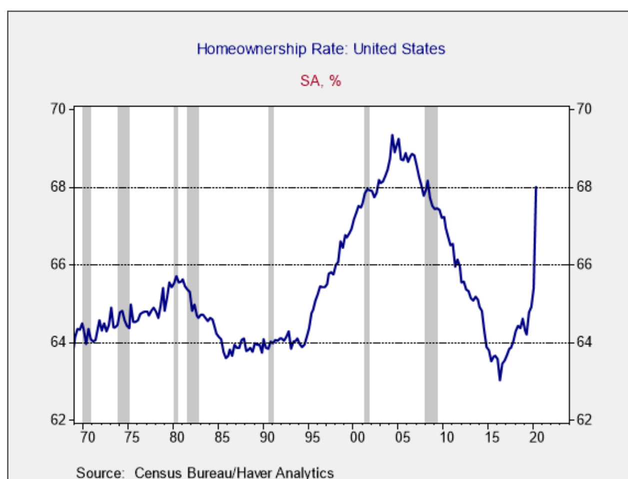
Looking beyond the U.S., global economic indicators paint a similar portrait to that of the U.S., as one would expect given the reach of COVID-19. The recently released *World Economic Outlook* by the IMF provided modestly improved expectations for global growth, though unevenly applied. As examples, China is certainly ahead of the rest of the world in terms of the dynamics brought about by COVID-19 and could be the sole major economy that records positive growth this year, the EU and U.K. are potentially facing a hard Brexit at year-end which carry realignment implications, and the new Prime Minister in Japan is examining new methods to bring inflation to target and boost domestic consumption. Overall, however, the world appears to be recovering from the economic ravages of the disease and the forecast over the next three years is encouraging.

Stock Market Outlook

Although our forecast is for low, steady growth, we believe the Fed's continual support will be positive for stocks. Some have accused the Fed of engaging in volatility suppression, and we see no change in direction at this juncture. With inflation dormant, household balance sheets being repaired, and consumer demand increasing, especially as we work through and beyond COVID-19, we anticipate attractive returns for stocks over our three-year forecast period. Over the next couple months, however, there is potential for volatility to spike should there not be a clear victor in the U.S. presidential election. Nevertheless, as we showed in the chart in last quarter's edition of this publication, the longer-term return differential for stocks between an incumbent Republican being reelected or a Democratic challenger being elected is marginal. Though there will be clear leaders and laggards among companies, industries, and sectors given changes in policies, the overall stock market is more affected by economic activity and monetary policy than by political victors.

Given our positive outlook, we remain relatively overweight equities. Within equities, however, we made several changes to geographic, sector, and industry exposures. The allocations to U.S. mid-cap equities were reduced in favor of introducing exposure to non-U.S. developed market stocks. Not only does this change shield against potential short-term volatility that could be created by a contested U.S. presidential election, but it also stands to benefit over our forecast period through the combination of attractive relative valuations and the potential for a weakening in the exchange rate of the U.S. dollar. The European Union's proposed issuance of €750 billion in bonds to fund its COVID-19-related recovery program may be the catalyst that makes the euro a complementary currency, thereby ending the dollar's ascendant cycle that has prevailed since the Great Financial Crisis. For U.S.-based investors, dollar weakness produces a very strong tailwind for returns on foreign stocks. This extends to emerging markets stocks as valuations are attractive and a resurgent Chinese economy holds enormous potential for other emerging markets that contribute to the global supply chain. The stimulus measures by the Chinese government adopted at the beginning of the summer are already having an effect and its economy is expected to exhibit positive growth in 2020.





Within the U.S., we emphasize cyclical stocks in the strategies and remove the tacit tilt toward growth. The sector overweights to Technology and Communication Services have been replaced by overweights to Industrials and Materials. The overweight to Consumer Discretionary that was introduced at the end of March remains. The strategies also have dedicated exposure to the housing sector. Our belief is that the strength of this segment will remain durable throughout the forecast period given the demographic demand.

Bond Market Outlook

We expect the historically low yields and spreads on corporate bonds to prevail over the next three years as the Fed remains ultra-accommodative and supportive of the corporate bond market. Within that ultra-accommodative posture, we expect the Fed to exert a form of yield curve control, possibly out to the 10-Year maturity, as a form of financial repression. We further anticipate that the large-scale asset purchases of Treasuries and agencies will continue as a form of unlimited quantitative easing and that, as necessary, the Fed will backstop the corporate bond market, including some elements of speculative grade bonds. Consequently, spreads should remain close to current levels and could moderately tighten. As noted previously, comments by the Fed following its virtual Jackson Hole meeting are that it will no longer try to rein in inflation if it runs hot for several months and will not be utilizing low unemployment numbers as a harbinger of inflation. These policies are now established and will be followed regardless of the resident of the White House or the makeup of the legislature. Accordingly, we are likely to be range-bound over the course of our three-year forecast period. However, increasing debt issuance by the Treasury, agencies, and corporations could lead to oversupply and problems down the road for the Fed's attempt to backstop the shadow banking system.

The strategies with income as an objective remain positioned with a laddered bond core and with exposure to agency mortgage-backed securities and a general overweight to corporate bonds. Although we believe the bond market will prove transcendent regarding the upcoming election, where it is risk appropriate, we have employed zero-coupon long-term Treasuries to provide a stabilizer over the next quarter in the event of elevated election-related equity market volatility.

Other Markets

As with the prior quarter, our expectations for REITs is that they will earn their dividend in the aggregate. Cell towers, data centers, and storage will offset weakness exhibited by the office/retail segment, which represents less than 20% of the REIT index. We maintain that REITs provide a varied and diversified source of income and are consequently utilized in strategies where income is a component.

Gold has been incorporated across all strategies since the fourth quarter of last year and continues to maintain a healthy allocation. It remains an important diversifier against heightened geopolitical risk and will benefit as central banks across the planet continue to be accommodative. Given the substantive move in silver last quarter, we elected to remove it from the more conservative strategies as its price appreciation caused the gold/silver ratio to move closer to its mean. However, we retain silver in strategies designed for growth as we believe it is risk appropriate and its industrial uses make it attractive in an economic recovery.

Fourth 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	6%	(5%)	-	-	-	-	-	-
Intermediate Term Bonds	15%	-	12%	-	-	-	-	-
Long Term Bonds	5%	5%	-	-	-	-	-	-
Speculative Grade Bonds	5%	-	-	-	-	-	-	-
Real Estate	5%	-	5%	-	-	-	-	-
U.S. Large Cap Stocks	27%	-	35%	-	50%	-	30%	-
U.S. Mid Cap Stocks	10%	(10%)	15%	(9%)	10%	(10%)	10%	(10%)
U.S. Small Cap Stocks	-	-	10%	-	14%	3%	24%	-
Foreign Developed Country Stocks	10%	10%	6%	6%	7%	7%	5%	5%
Emerging Market Stocks	-	-	3%	3%	5%	-	15%	5%
Commodities - Precious Metals	15%	-	12%	-	12%	-	14%	-
Total	*100%*		*100%*		*100%*		*100%*	

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

Income with Growth

We made several changes to the Income with Growth strategy this quarter. In the bond sleeve, short-term bond exposure was cut nearly in half in favor of increased exposure to intermediate-term corporates and an introduction of mortgage-backed securities. Additionally, due to the potential of a hung U.S. presidential election and the near-term disruption in equities it could cause, the strategy now has an allocation to zero coupon long-term Treasuries to bolster the risk mitigation provided by the allocation to gold. In addition, half of the strategy's U.S. mid-cap stock exposure was moved to non-U.S. developed market stocks. Beyond avoiding near-term election risk, in the longer-term, this move leans toward the attractive valuations overseas and, should the dollar weaken, benefits for U.S.-based investors. In U.S. stocks, we retain the neutral posture of the growth/value baseline. However, in the large cap segment, the prior overweight sectors that had produced a tacit growth tilt were removed in favor of more cyclically oriented overweights.

Growth & Income

The allocation changes to the Growth & Income strategy this quarter involved moving slightly more than a third of the U.S. mid-cap stock exposure to non-U.S. stocks. Despite this move, the U.S. mid-cap and small cap stock exposures remain slightly overweight. The non-U.S. stock allocation includes both developed and emerging market exposure. This move was made not only due to the near-term potential for heightened U.S. equity volatility stemming from the upcoming elections, but more importantly to capture favorable valuations overseas and benefits for U.S.-based investors should the dollar weaken. In U.S. stocks, we retain the neutral posture of the growth/value baseline. However, in the large cap segment, the prior overweight sectors that had produced a tacit growth tilt were removed in favor of more cyclically oriented overweights. Gold continues to be positioned to both mitigate against heightened geopolitical risk as well as its potential benefit from global central bank accommodation.

Growth

The asset class changes to the Growth strategy this quarter involved removing half of the U.S. mid-cap stock exposure and reallocating to U.S. small cap stocks and non-U.S. developed market stocks. This move was encouraged by mid-caps being priced closer to fair valuation and more attractive valuations available in small caps and overseas. In addition, the non-U.S. developed market exposure not only holds near-term benefits for risk reduction if the U.S. elections cause elevated volatility but longer-term advantages for U.S.-based investors should the dollar weaken. In U.S. stocks, we retain the neutral posture of the growth/value baseline. However, in the large cap segment, the prior overweight sectors that had produced a tacit growth tilt were removed in favor of more cyclically oriented overweights. Gold continues to be positioned to both mitigate against heightened geopolitical risk as well as its potential benefit from global central bank accommodation, while silver holds attendant benefits and demand from industrial uses.

Aggressive Growth

In the Aggressive Growth strategy, half of the U.S. mid-cap stock exposure was removed and reallocated to non-U.S. developed market and emerging market stocks. U.S. mid-caps had moved closer to fair valuation, while attractive relative valuations are available from overseas stocks. In addition, non-U.S. stocks hold the potential for near-term benefits for risk reduction if the U.S. elections cause elevated volatility and longer-term advantages for U.S.-based investors should the dollar weaken. In U.S. stocks, we retain the neutral posture of the growth/value baseline. However, in the large cap segment, the prior overweight sectors that had produced a tacit growth tilt were removed in favor of more cyclically oriented overweights. Gold continues to be positioned to both mitigate against heightened geopolitical risk as well as its potential benefit from global central bank accommodation, while silver holds attendant benefits and demand from industrial uses.

Performance & Disclosures

as of 9/30/20

Strategy	ITD	10 - Year	5 - Year	3 - Year	1 - Year	YTD	QTD
Income Taxable with Growth - Gross of Fees	10.6%	9.0%	10.7%	11.1%	19.4%	15.5%	5.3%
Income Taxable with Growth - Net of Fees	7.3%	5.8%	7.4%	7.8%	15.9%	12.9%	4.5%
Benchmark - 40% S&P 500 and 60% ML Bond Index	8.6%	7.9%	8.4%	8.5%	10.9%	7.1%	4.0%
Growth and Income Taxable - Gross of Fees	7.6%	9.1%	10.1%	8.1%	13.0%	8.1%	5.7%
Growth and Income Taxable - Net of Fees	4.4%	5.9%	6.8%	4.9%	9.6%	5.7%	4.9%
Benchmark - 70% S&P 500 and 30% ML Bond Index	9.0%	10.9%	11.4%	10.5%	13.3%	6.5%	6.5%
Growth - Gross of Fees	8.1%	10.5%	12.0%	10.5%	22.4%	15.1%	7.7%
Growth - Net of Fees	4.9%	7.2%	8.7%	7.2%	18.8%	12.6%	6.9%
Benchmark - S&P 500	10.6%	13.7%	14.1%	12.3%	15.1%	5.6%	8.9%
Aggressive Growth - Gross of Fees	7.6%	9.6%	10.8%	8.1%	17.4%	10.8%	7.0%
Aggressive Growth - Net of Fees	4.4%	6.3%	7.5%	4.9%	13.9%	8.3%	6.2%
Benchmark - S&P 500	10.7%	13.7%	14.1%	12.3%	15.1%	5.6%	8.9%

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 10/20/2020 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 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 contains 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 returns and volatility calculations utilize monthly data through 9/30/20. 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/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 - Precious Metals (S&P GS Precious Metals Total Return).

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