Confluence Balanced Accounts

Pursuing Attractive Returns with Less Risk

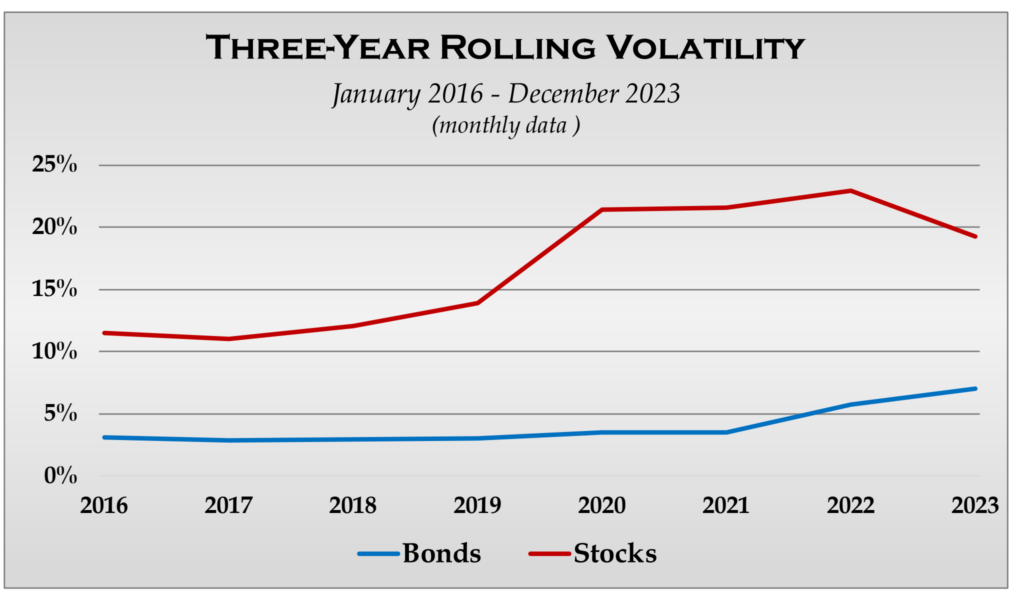
Ralph Waldo Emerson once noted that in life it is the journey, more so than the destination, that matters.

While Emerson isn't generally regarded as a capitalist, this observation is apropos for investors. The view from atop Mt. Everest matters not if one risks too much to get there; the same might be said of the stock market returns for many investors. How, then, can one pursue potentially attractive returns from stock investments, while not risking too much along the way? One of the most simple and straightforward solutions comes from the combination of stocks and bonds.

What's the Risk? *Balancing Return versus Volatility*

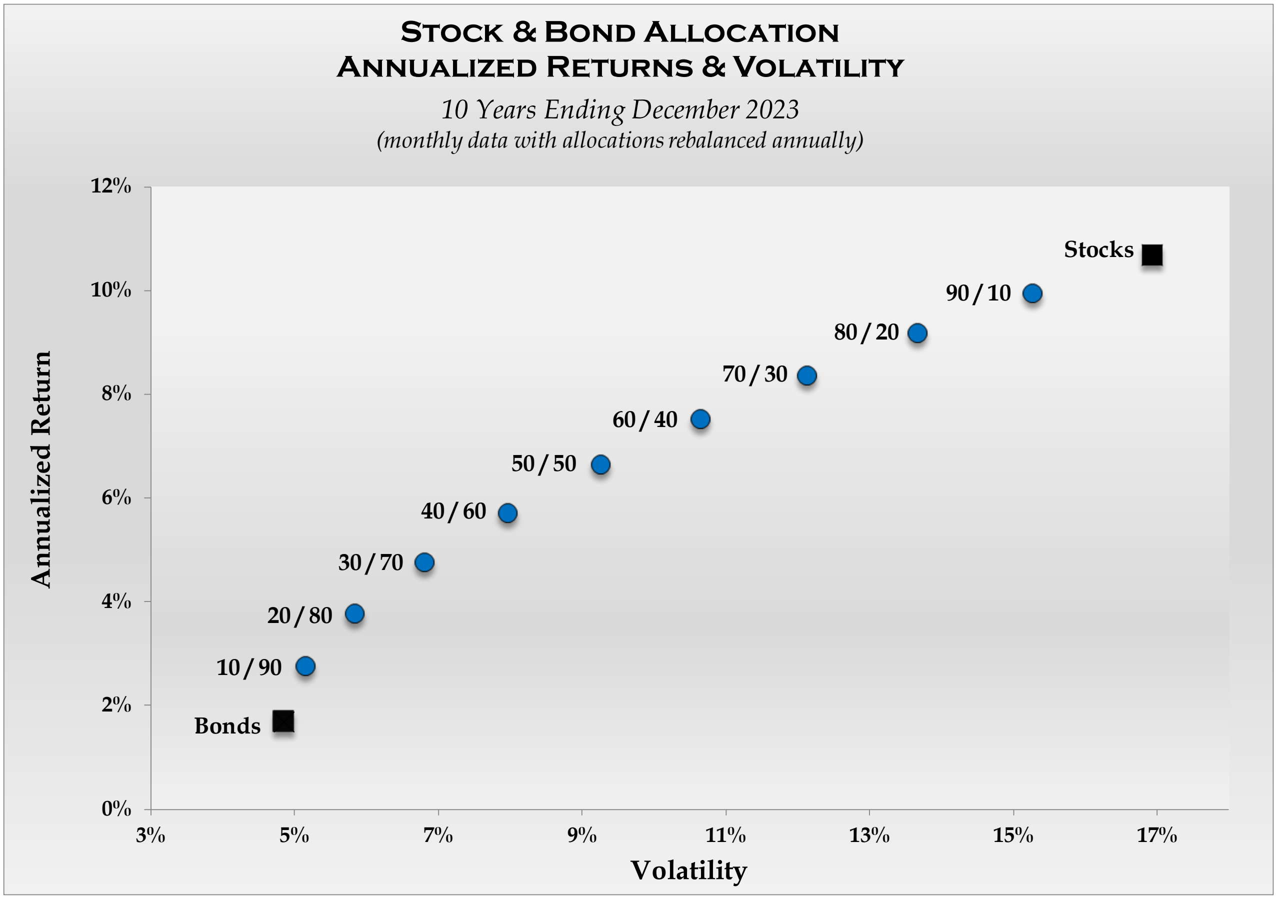
Stocks are much riskier than bonds. Quantitatively, we can measure this by considering volatility, which measures how wide a dispersion of outcomes, both good and bad, may be. It's certainly not a perfect way to evaluate risk, nor is it the only way, but it can be useful in framing the nature and frequency of bumps and turns in an investor's "journey." Looking back over the 10-year period ended December 31, 2023, volatility for the S&P 500 was 16.9%. By itself, that's not particularly helpful. However, when compared with the Bloomberg Aggregate Bond Index, which had volatility over the same time frame of 4.8%, we can see the range of outcomes is several multiples higher in stocks relative to bonds.

Stocks are not just more volatile, but the nature of stock volatility is much different because it changes. Stock volatility can rise and fall for many reasons as we move through various market, economic, and regulatory cycles. Bonds, on the other hand, not only have much lower volatility, but the level of volatility is also pretty consistent. In this first chart, we illustrate the rolling three-year volatility of monthly returns over the past 10 years. We can see how stock volatility has changed over this 10-year period, with the high end more than twice that of the lower time frames. Bond volatility also varies, but it is more consistent with much milder changes. These characteristics were confirmed during the pandemic in 2020 when stock volatility rose to its highest level in a decade, while bond volatility remained relatively steady. And although bond volatility has risen in recent periods as stock volatility has declined, bond volatility remains well below that of stocks.



(Sources: Bloomberg, Confluence.)
Bonds are represented by the Bloomberg US Aggregate Bond Index; Stocks are the S&P 500 Index.

A time-tested way to address the high and variable nature of stock volatility is to combine stock and bond allocations together. Generally, increasing the proportion of investment allocated to bonds can lower long-term return potential given that stock returns are historically much higher than those of bonds. However, bonds can help lower volatility due to their low and consistent volatility profile along with the fact that some bonds, Treasuries in particular, often rise in price when stock prices have their greatest declines. In our second chart, we combine stocks and bonds in 10% allocation increments and illustrate the return and volatility profiles over the past 10 years. In this illustration, we see that even modest allocations to bonds can significantly lower overall volatility, while at the same time, the inclusion of small stock allocations can meaningfully improve returns relative to a 100% bond exposure. The lesson here is that stocks and bonds have traditionally paired well together when working to address both return and volatility.



(Sources: Bloomberg, Confluence.)

Bonds are represented by the Bloomberg US Aggregate Bond Index; Stocks are the S&P 500 Index. Past performance is no guarantee of future results. Shown for illustrative purposes only and does not represent performance for any specific Confluence investment strategy.

The Confluence Solution: Balanced Accounts

So, how can investors efficiently combine equity and fixed income exposure, while providing diversification and potentially lower volatility?

Confluence's Balanced Accounts allow investors to pair one of our value equity strategies, such as Increasing Dividend Equity Account (IDEA) or Large Cap Value, with our Fixed Income ETF strategy in a single account. Clients indicate the proportion of their portfolio that they would prefer to allocate to each exposure. Equity-to-fixed income ratios are available in increments of 10%, ranging from 80/20 to 30/70. Each side of the allocation is handled in the same way it would be managed as a standalone equity or fixed income account. Accordingly, investors have the benefit of three comprehensive management efforts taking place simultaneously in a single Balanced Account: ***value equity*** portfolio management, ***fixed income*** portfolio management, and ***rebalancing*** procedures.

Balanced Account Management

Confluence Balanced Accounts incorporate the diligence and expertise of our investment and operations teams:

- ***Value Equity portfolio:*** Security selection, position sizes, industry and sector exposures, and buy limits (if applicable) are all applied through Confluence's disciplined value equity portfolio management process, a fundamental approach implemented by the firm's deep team of equity analysts.
- ***Fixed Income portfolio:*** Security selection, sector allocations, maturity and duration targets, and laddered maturity exposures are employed through Confluence's fixed income portfolio management, driven by consensus views of the Fixed Income Strategy Committee. Investors may choose between taxable and municipal bond ETF portfolios.
- ***Rebalancing:*** Portfolio allocations are regularly monitored for general market drift. As drift occurs, allocations are rebalanced back to target. Each portfolio has "guardrails" applied to its allocation, and if the proportion drifts beyond the guardrail, the allocation is reset to the stated allocation target. Guardrails are scaled according to the equity allocation target, so accounts with larger equity allocation targets will have a wider drift tolerance, while larger bond allocation targets will have a narrower tolerance.

Customize the Course

The ability to pair the fixed income portfolio with an equity portfolio, available in a range of allocations, creates a multiplicity of options for investors to tailor not only their return objectives, but also their risk profile. Furthermore, flexibility is built into our Balanced Accounts that allows investors to adjust the targeted allocation as their investment objectives and risk tolerances change, in consultation with their financial advisor. Allocation changes can typically be efficiently implemented in the account without having to alter the profiles of separate equity and bond portfolios. In other words, the proportions will change, but the stock and bond portfolios remain intact.

Emerson's good advice about life is applicable to investing. It may not be possible for everyone to take in the view from Everest's summit, but we believe Confluence's Balanced Accounts allow investors to map a good destination without sacrificing the journey.

Components of a Confluence Balanced Account

Value Equity Strategies

Confluence's value equity investment philosophy has been consistently implemented for more than 25 years by a dedicated team of research analysts conducting proprietary research.

- Bottom-up, fundamental approach focused on understanding and valuing individual businesses; emphasis is on identifying competitively advantaged businesses trading at discounts to our estimate of intrinsic value.
- Investment process focuses on managing risk, which Confluence defines as *the probability of a permanent loss of capital*.
- By owning quality businesses at attractive valuations diversified across a variety of market sectors, this discipline is designed to protect investors on the downside while enhancing upside potential.
- Investment options include strategies defined by market cap concentration as well as dividend-focused strategies.

Fixed Income Strategies

The professionals at Confluence were among the first to understand how to utilize fixed income exchange-traded funds (ETFs) in separately managed accounts, with a solid background in understanding the mechanics of ETFs and how to blend the various sectors and maturities to pursue specific objectives.

- Strives to deliver the income and lower volatility traditionally available from a diversified bond portfolio.
- Fixed income ETFs are available in a wide range of maturities across corporate, agency & Treasury sectors; over time, allocations are adjusted across these sectors. Average maturity is dependent upon our interest rate outlook.
- Allocations will incorporate the Fixed Income Strategy Committee's viewpoints regarding Fed policy, the shape of the yield curve, relative yields (known as spreads), default rates, and other market factors.
- Taxable and tax-exempt options are available.

Disclosures

This report was prepared by Confluence Investment Management LLC and reflects the current opinion of the authors. Information is based upon sources and data believed to be accurate and reliable. Opinions, estimates, and forward-looking statements are as of a certain date and subject to change without notice. Actual results could differ materially from the results indicated by this information. References to expected returns are not promises or even estimates of actual returns an investor may achieve. Forecasts of financial market trends are subject to change without notice.

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Indexes are provided as an indication of the performance of a segment of the capital markets. The Bloomberg US Aggregate Bond Index is a broad-based benchmark that measures the investment-grade, US dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate pass-throughs), ABS and CMBS (agency and non-agency). The Standard & Poor's 500 Index (S&P 500®) is an unmanaged market capitalization-weighted index of 500 common stocks chosen for market size, liquidity, and industry group representation to represent U.S. equity performance. Index performance returns do not reflect any management fees, transaction costs or expenses. It is generally not possible to invest directly in an index. Investor performance may vary materially from that of any index. Indexes are trademarks and are the property of their respective owners.

Confluence Investment Management LLC is an independent Registered Investment Advisor that was founded in 2008. References to investment strategy history prior to 2008 occurred while the Portfolio Management Team was affiliated with a prior firm and the Portfolio Management Team members were the primary individuals responsible for selecting the securities to buy and sell.

Confluence Value Equities Investment Committee

Mark Keller, CFA	Tom Dugan, CFA	Tore Stole	Dustin Hausladen	Brett Mawhiney, CFA
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Confluence Fixed Income Strategy Committee

Mark Keller, CFA	David Miyazaki, CFA	Patrick Fearon-Hernandez, CFA	Kaisa Stucke, CFA
Greg Ellston	Bill O'Grady		

About Confluence Investment Management LLC

Confluence Investment Management is an independent Registered Investment Advisor located in St. Louis, Missouri, that provides professional portfolio management and advisory services to institutional and individual clients. Confluence'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, company-specific approach. The portfolio management philosophy begins by assessing risk and follows through by positioning clients to achieve their income and growth objectives.