

Balancing Act

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, 2025, volatility for the S&P 500 was 14.3%. 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 6.3%, we can see the range of outcomes is several multiples higher in stocks relative to bonds.

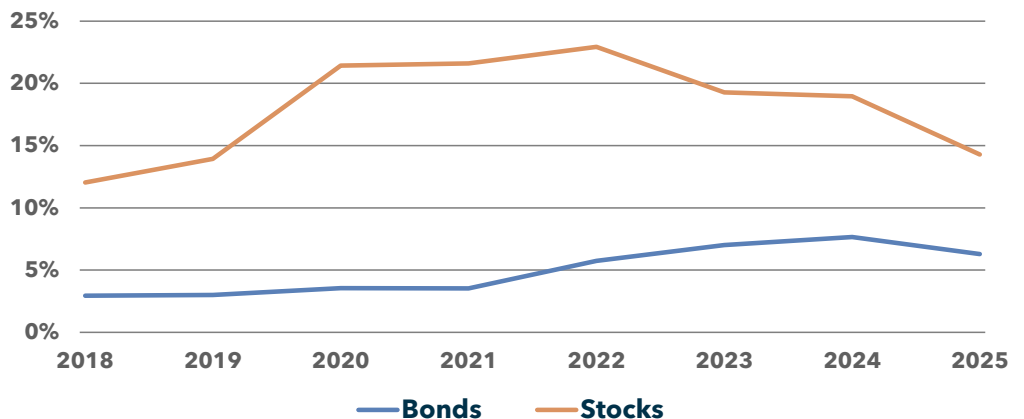
Stocks are not only more volatile, but the nature of this volatility is much different because volatility itself changes. Stock volatility can rise and fall for many reasons as we move through various market, economic, and regulatory cycles. Bonds, on the other hand, not only have much lower volatility 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 changes, but it is more consistent and the changes are milder. 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. Bond market volatility actually changed more when the Fed surprised markets with aggressive tightening in 2022, although it has declined since then, trending toward the longer-term historical level.

As much as stocks and bonds differ from one another in volatility profiles, they also vary in how they respond to market news and circumstances. Broadly speaking, stocks tend to perform better as expectations build for earnings growth and economic expansion, and they usually perform worse in periods of declining earnings or economic contraction. Bonds tend to follow the opposite trends, with prices rising during periods of concern and risk aversion and prices declining during periods of higher growth and inflation.

Three-Year Rolling Volatility

January 2018 - December 2025

(monthly data)



(Sources: Bloomberg, Confluence)

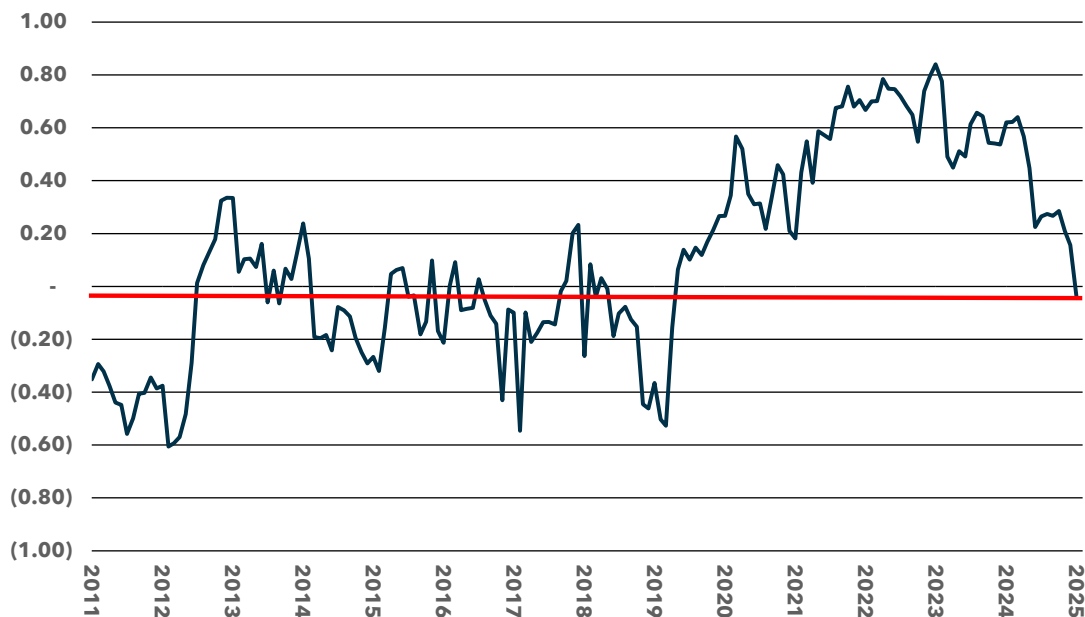
Bonds are represented by the Bloomberg US Aggregate Bond Index; Stocks are the S&P 500 Index.

Diversification

When it comes to managing investment risk, one of the most important concepts is diversification, which involves combinations of asset classes with varying profiles that behave differently from one another across time. By not having too many – or all – of one’s eggs in the same basket, investors can participate in a wider range of opportunities, while avoiding excessive downside from particular events. In portfolio management parlance, we can measure how closely different investments move in tandem together through correlations. A higher correlation reveals investment returns moving in the same direction during the same time frame, with 1.0 reflecting a perfect correlation. Low correlations indicate little relationship between investments, with 0.0 signaling no directional similarity. And finally, negative correlations below 0.0 reveal investment returns that move in opposite directions during the same time frame.

For investors, low or negative correlations across investments can be very helpful in managing overall portfolio risk. In the chart below, we show the correlation of rolling one-year returns of stocks and bonds during the time frame following the Great Financial Crisis. Generally speaking, correlations between stocks and bonds tend to be low or negative. However, extraordinary changes in Fed policy during and after the pandemic created higher levels of correlation, and the Fed’s decisions dominated both stocks and bonds. Nevertheless, in more recent years, the correlations have begun to move lower toward the long-term level. For investors, this suggests growing potential advantages from combining stocks and bonds.

**Stock and Bond One-Year Rolling Correlation
Monthly Returns 2011 to 2025**



(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.

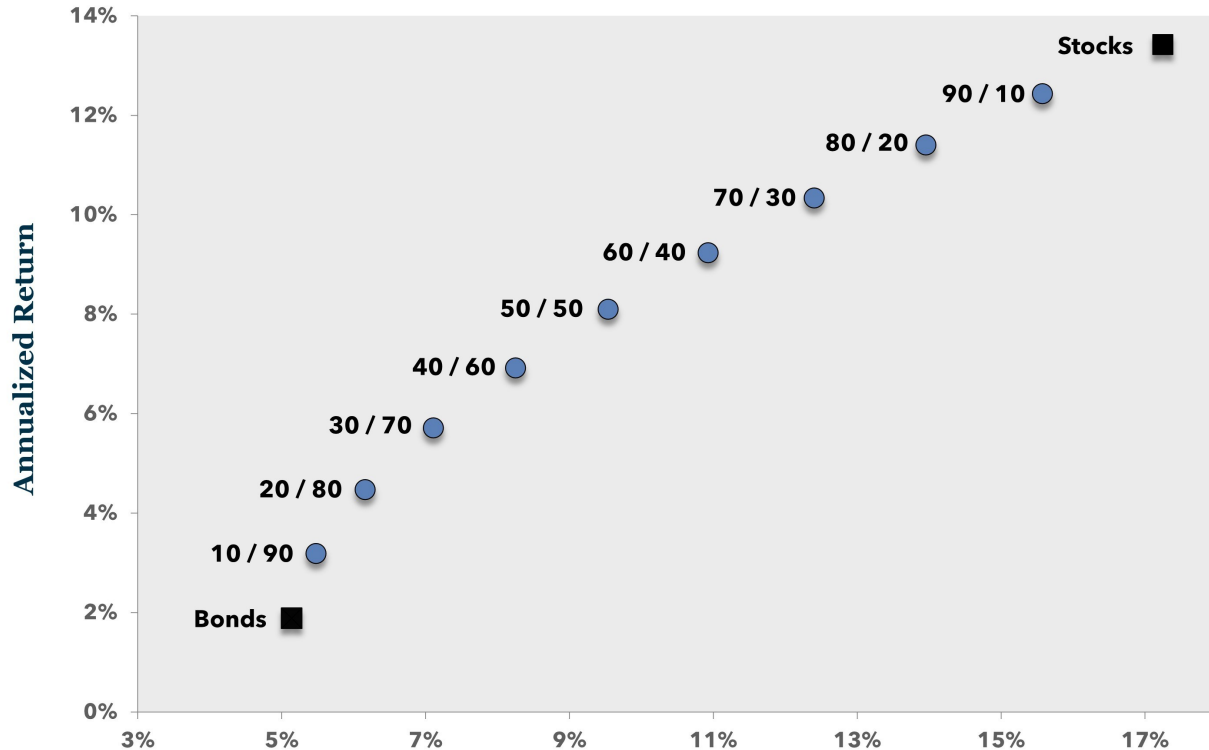
Stock and Bond Allocations

With an understanding of volatility and correlation, we turn to a practical illustration that shows how different proportions of stocks and bonds have worked together over the past 10 years. Not surprisingly, greater allocations to stocks experienced higher volatility, while larger bond allocations generally exhibited lower volatility. More importantly, the combination of the two has been particularly helpful and highlights the utility of correlation.

As demonstrated by the illustration on the next page, for very conservative investors who typically use only bonds, including a small proportion of stocks – perhaps 10-20% – helped improve returns by a good margin without a meaningful change in volatility. This meant more return for little incremental risk. Meanwhile, for aggressive investors, adding a small proportion of bonds – again, around 10-20% – helped lower volatility without a big decrease in return. So, less risk for a relatively modest decline in return. Taken all together, this indicates that the combination of stocks and bonds can play a significant role in most investors’ portfolios.

Annualized Returns & Volatility

10 Years Ending December 2025
(monthly data with allocations rebalanced annually)



(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 to achieve diversification and potentially reduce volatility?

Confluence's Balanced Accounts allow investors to pair one of our value equity strategies – such as Equity Income, IDEA, or Large Cap Value – with our Fixed Income ETF strategy in a single account. Clients determine 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 diversification, 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 on the Value Equities Investment Committee.
- **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 allocations will have a wider drift tolerance, while larger bond allocations 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 30 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.

Confluence Value Equities Investment Committee

Mark Keller, CFA John Wobbe Tom Dugan, CFA Dustin Hausladen Brett Mawhiney, CFA John Koenig, CFA
Dan Winter, CFA Tore Stole Joe Hanzlik Blair Brumley, CFA Ben Kim, CFA

Confluence Fixed Income Strategy Committee

Mark Keller, CFA David Miyazaki, CFA Patrick Fearon- Daniel Ortwerth, CFA
Greg Ellston Kaisa Stucke, CFA Hernandez, CFA

Disclosures

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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 Treasury, government-related, and corporate bonds, 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 US 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.

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.