Fixed Income Strategy
February 2016

Fixed Income Investment Philosophy

The Confluence fixed income strategy utilizes fixed income Exchange Traded Funds (ETFs) 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. The number of ETFs focused on the fixed income sector has grown substantially over the past decade, allowing Confluence the capability to construct fixed income ETF portfolios that have characteristics similar to a traditional bond ladder or mirror a diversified bond index like the BofA Merrill Lynch U.S. Corporate, Government & Mortgage Index. By investing in certain ETFs we have the ability to shorten or lengthen the combined average maturity, and we can also adjust the exposure to corporate, government agency and U.S. Treasury sectors depending on our viewpoints regarding Fed policy, the shape of the yield curve, relative yields, credit spreads, default rates and other market factors.

Our focus is on fixed income ETFs following investment grade benchmarks with a domestic orientation. We continually monitor the allocations, rebalancing at least annually, but may elect to rebalance over shorter time frames at our discretion. Confluence offers its fixed income strategy as a stand-alone portfolio, and also in balanced accounts combined with equity portfolios.

Benefits Relative to Traditional Fixed Income Portfolios

In the fixed income markets, bigger tends to be better. This rule generally holds true because larger blocks of bonds tend to have better liquidity and pricing relative to smaller block transactions. Oftentimes, a smaller trade is penalized as an odd lot, in which traders incorporate extra costs into purchases and sales to accommodate these smaller transactions. Over time, these additional costs may substantially weigh on returns, particularly for investors making frequent deposits and withdrawals.

These size requirements pose challenges to investors using individual bonds. On the one hand, position sizes need to be large enough to maintain liquidity; on the other, proper diversification requires many positions, with varying maturities and sector exposures. So unless an account is very large, the tradeoff between liquidity and diversification might need to be weighed, creating a less than optimal portfolio. Commingled securities, like mutual funds, are one way to help address these issues. Unfortunately, there are often a number of drawbacks to the commingled approach, including tax inefficiencies, a lack of transparency and less precision with regard to maturities and sector exposures.

As an alternative, Confluence offers a portfolio of fixed income exchange traded funds. We believe these securities help address the need for liquidity, diversification and transparency, while avoiding some of the limitations of mutual funds.

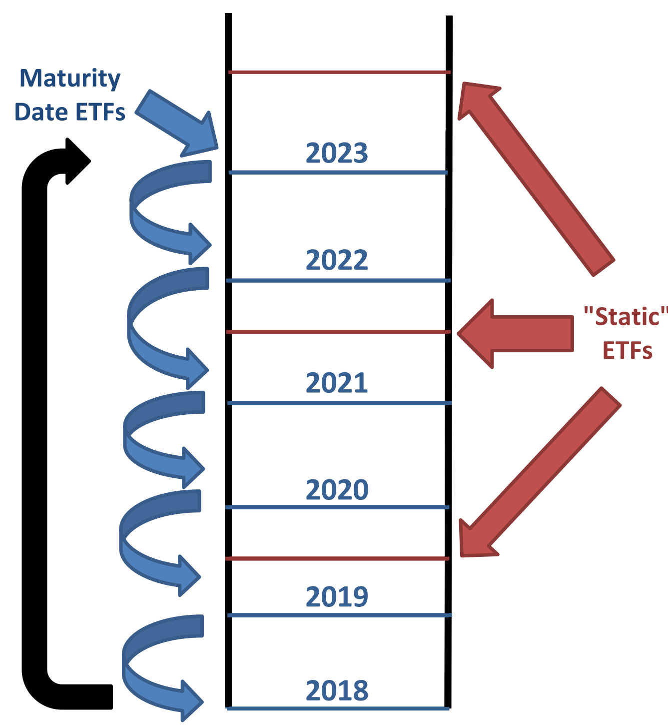
A relatively newer fixed income ETF structure, the maturity date ETF, has recently become more available. In this structure, the fixed income ETF has a finite life, one that is completed by returning capital back to shareholders on a specific date through a final cash distribution. This structure replicates the cash flow pattern of an individual bond, because the ETF "matures" by distributing all of its cash. The following table summarizes differences between the various fixed income securities.

Fixed Income Security Comparison

	Maturity	Diversification	Transparency	Liquidity
Individual Bonds	Yes	Low	High	Poor
Mutual Funds	No	High	Low	Good
Fixed Income ETFs	No	High	High	Good
Maturity Date ETFs	Replicated	High	High	Good

Of course, investors should be aware there are limitations in utilizing fixed income ETFs, too. 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 is also generally good, but can vary depending upon market conditions.

We utilize maturity date ETFs to construct a "bond ladder," one that is similar to those often utilized by investors who invest in individual bonds. Over time, the allocations "roll down the ladder" (illustrated in blue) as the portfolio progresses toward the end dates. We may decide to hold the ETF to its maturity date, or rebalance the position into a new "rung," depending upon our market views.



There are several maturity date ETFs in the 1-10 year range, and the portfolio is positioned to utilize a variety of them to create a diversified exposure, one that targets particular maturities as well as different industries of the bond market.

We complement the maturity date ETFs with traditional fixed income ETFs (illustrated in red), which have a more "static" maturity profile. These ETFs allow for more precise exposures to sectors of the bond market, including corporates, mortgages, commercial mortgage backed securities (CMBS) and Treasuries. In addition, these ETFs can be efficiently adjusted, allowing for portfolio changes that don't necessarily disturb the maturity date ETF ladder.

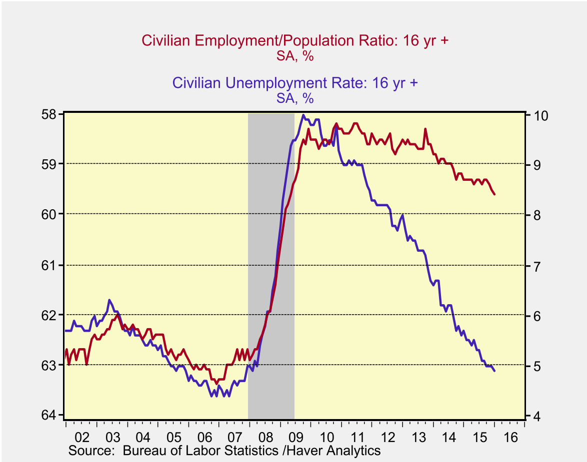
The combination of maturity date ETFs and traditional "static" fixed income ETFs forms a portfolio with many of the familiar characteristics of an individual bond ladder, while avoiding some of the related illiquidity and non-diversification issues. At the same time, the sector exposures and maturity profile can be efficiently managed, all in a highly transparent portfolio.

Current Viewpoints

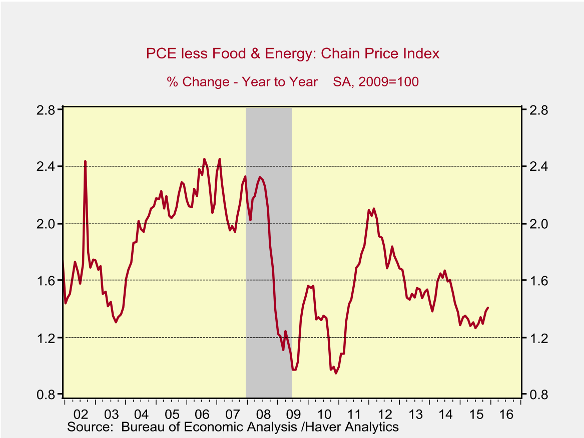
The Federal Reserve (the Fed) hiked the fed funds rate by 25 bps in December 2015. Although it was the first hike in more than nine years, the Fed had long indicated that it was planning on a rate adjustment. In fact, LIBOR rates have been rising since May 2013 when Chairman Bernanke announced the decision to "taper" Quantitative Easing (QE), the deliberate expansion of the central bank's balance sheet. Nevertheless, volatility increased in both the bond and equity markets in the aftermath of the expected rate change due to uncertainty surrounding future monetary policy actions.

More important than the first hike is the expected pace and the path of future hikes. The Fed has signaled that the pace of hikes will be data-dependent, meaning the Fed will only tighten policy rates if economic conditions warrant it. The Fed's mandate serves two goals, first, to maintain full employment, and second, to control inflation. If the pace of hikes is data-dependent, let's look at the health of these two factors.

First, we have seen steady improvements in the labor markets, with the unemployment rate falling to 4.9% according to the most recent data. However, the number of people employed out of the whole population remains low due to retiring baby boomers, discouraged workers and skills mismatches (shown in the chart to the right). Additionally, the number of people who are working part-time due to their inability to find full-time employment, one of the Fed's favorite measures of labor market health, has shown improvements much slower than the headline unemployment rate. Wage growth has also remained anemic as companies expand their use of technology, and globalization has lowered costs across the board. Overall, though, the labor markets are steadily improving.



Inflation, the Fed's second policy mandate, has remained non-existent. While many feared the increased liquidity from QE would create hyper-inflation, in reality, inflation has remained well below the Fed's target of 2%. The chart to the left shows historical inflation rates as represented by the core personal consumption deflator (core PCE), which is inflation excluding food and energy prices. The Fed has tended to tighten policy when this rate has exceeded 2% and loosen policy when the rate has been below 2%. The current rate stands at 1.4%. Although QE created more liquidity at the bank level, stricter lending standards and a reluctance to borrow meant that this money was not lent out. At the same time, globalization has mitigated wage and cost pressures. If production became too expensive domestically, it was fairly easy to move production to a lower cost country. Also, low interest rates made it easy to substitute capital goods and technology for labor. We do not expect inflationary pressures to surface in the near future.



Since the rate hike in December, economic data have weakened somewhat, which may slow the expected pace of hikes. Given the continued slow economic growth environment, the Fed will likely be careful in raising rates. Even in the expected rising fed funds environment, longer term Treasury securities remain attractive for an investor seeking to reduce risk. In recent months, Treasury securities have increasingly moved in the opposite direction of equities. Although credit spreads have widened, we remain cautiously optimistic about credit risk. Current investment grade bond yields are attractive; however, if a recession occurs, which we don't expect, credit spreads will widen.

Illustrative Portfolio Construction

Selected Positions from Fixed Income ETF Portfolio [1] *As of February 2016*			
Name	**ETF Average Maturity**	**ETF Portfolio Yield to Maturity**	**ETF Number of Holdings**
MATURITY DATE ETFs			
iShares iBonds Invest Grade Corp Bond ETF 2023 (ex-Financials)	6.6	3.0%	173
iShares iBonds Invest Grade Corp Bond ETF 2018	1.7	1.6%	201
iShares iBonds Corporate Bond ETF 2023	6.6	3.5%	259
iShares iBonds Invest Grade Corp Bond ETF 2020 (ex-Financials)	3.7	2.5%	189
Guggenheim BulletShares Invest Grade Corp Bond ETF 2018	2.6	2.2%	324
Guggenheim BulletShares Invest Grade Corp Bond ETF 2019	3.7	2.6%	295
TRADITIONAL FIXED INCOME ETFs			
iShares 7-10 Year Treasury Bond ETF	8.4	1.6%	25
iShares 20+ Year Treasury Bond ETF	26.6	2.4%	31
SPDR Barclays Intermediate Term Invest Grade Corp Bond ETF	4.8	3.0%	3,030
iShares MBS Bond ETF	5.5	2.0%	330
iShares Intermediate Invest Grade Corp Bond ETF	4.7	2.7%	3,425
iShares Treasury 3-7 Year Treasury Bond ETF	4.8	1.2%	73
Weighted Average ETF Yield to Maturity	2.4%		
Weighted Average ETF Maturity	8.2 years		
Number of Portfolio Positions	16		

[1]The illustration of maturity date ETFs and static traditional fixed income ETFs is not a complete list of ETFs in the portfolio or which Confluence may be currently recommending. Furthermore, application of the investment strategy as of a later date will likely result in changes to the listing. The illustrative portfolio attributes do not represent actual trading as actual investment results may vary from the illustration due to inherent limitations in ETF securities that do not perfectly replicate a selected fixed income asset class. Fixed income allocations in client accounts may vary based on individual client considerations and market fluctuations. The allocation of assets in the illustrative portfolio may be changed from time to time due to market conditions and other factors. The investments held by the portfolios are not guaranteed and do carry a risk of loss of principal. Each asset class has specific risks associated with it and no specific asset class can prevent a loss of capital in market downturns.

The above ETFs are utilized in creating a separately managed account (SMA) portfolio. There are investment risks in investing in this strategy, including credit and interest risks. Besides Confluence fees for investment management, clients may be charged brokerage commissions, transaction fees, and other related costs and expenses. Clients may incur certain charges imposed by custodians, brokers, third party investment and other third parties such as fees charged by managers, custodial fees, deferred sales charges, odd-lot differentials, transfer taxes, wire transfer and electronic fund fees, and other fees and taxes on brokerage accounts and securities transactions. Mutual funds and exchange traded funds also charge internal management fees, which are disclosed in a fund's prospectus.

About Confluence Investment Management LLC

Confluence Investment Management LLC is an independent, SEC Registered Investment Adviser located in St. Louis, Missouri. Confluence provides professional portfolio management and advisory services to institutional and individual clients.