Fixed Income Strategy

July 2018

Fixed Income Investment Philosophy

The Confluence fixed income strategy utilizes fixed income Exchange Traded Funds (ETFs) to deliver the income traditionally available from a diversified bond portfolio. Shares of 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 market has grown substantially over the past decade, allowing Confluence the experience 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 for trading. 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.

20 Allen Avenue, Suite 300 | Saint Louis, MO 63119 | 314.743.5090
www.confluenceinvestment.com

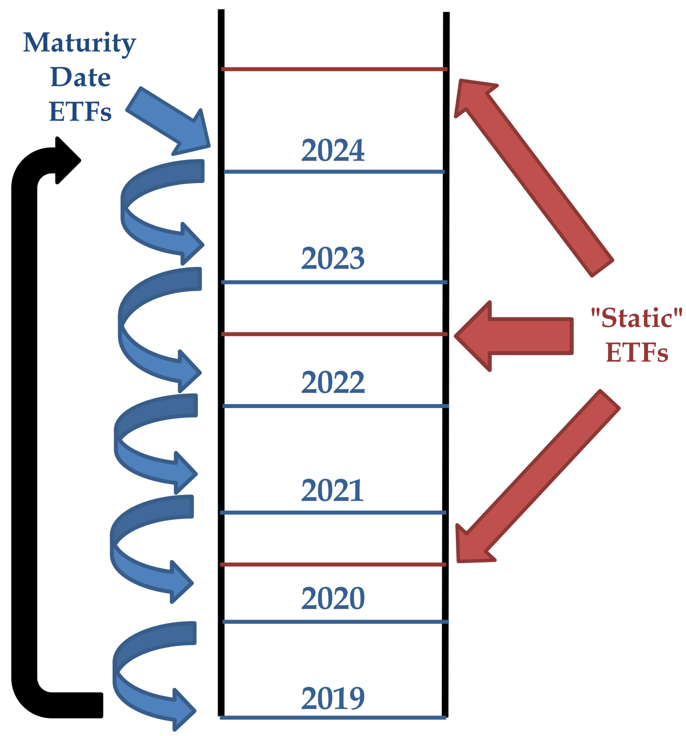
A relatively newer fixed income ETF structure, the maturity date ETF, has recently become more available. In this structure, the fixed income ETF has a finite life, one that is completed by returning capital back to shareholders on a specific date through a final cash distribution. This structure replicates the cash flow pattern of an individual bond, because the ETF "matures" by distributing all of its cash. (And, similar to individual bonds, an ETF investor may receive more or less than the purchase price at the time of final distribution.) 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 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 maturity 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.

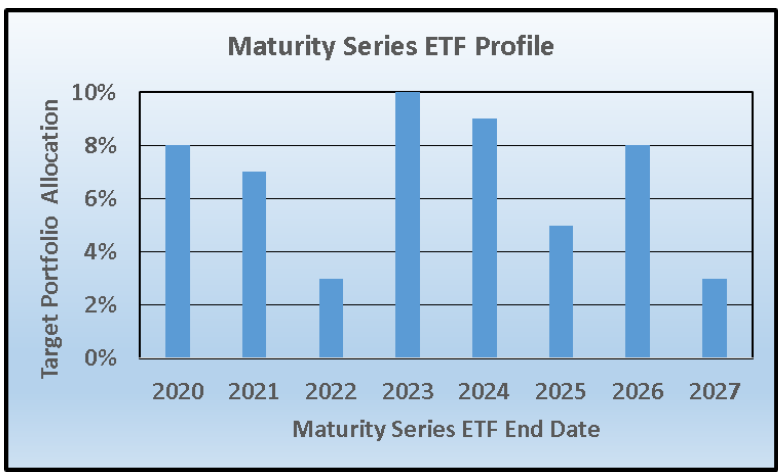
Current Viewpoints

The U.S. economy continues to move forward at a steady pace, showing signs of improvement and strength. For this reason, the Federal Reserve has been gradually raising short-term rates. This tighter monetary policy is worth watching because the Fed has had a pretty consistent record in modern history of raising rates right into a recession. Whether the Fed causes recessions through tighter monetary policy or whether the Fed is merely tempering a cycle that would have happened anyway is an open debate. But, either way, we feel it's important to closely monitor the economic response to the Fed's rate hikes because recessions tend to create significant risk for investors.

For now, it appears the Fed is not moving too fast or going too far with tighter policy. Accordingly, we continue to overweight the portfolio with a large proportion of corporate bonds, while also including smaller allocations to Treasuries and Agency MBS. The stable economy should foster a relatively benign default environment and we believe the incremental yield from corporate bonds is helpful to bond investors. At the same time, inflation remains under control and we believe a diversified exposure across maturities is appropriate.

Still, we are monitoring a relatively new phenomenon: policy impediments to global trade. We have long been of the opinion that global trade played a central role in lowering inflation in the U.S. Inflation ran high in the 1970s and lowering it became of paramount importance to policymakers. Globalization offered a partial solution, but came at the cost of certain U.S. jobs. Given the severity of inflation, the U.S. population accepted the trade. But, today, after over three decades without disruptive inflation, the priority is tipping back toward U.S. jobs. And, recent policy decisions indicate a belief that scaling back global trade is a solution. We don't expect lowering global trade will foster significant job growth; however, we do believe sustained trade barriers could awaken inflation.

As mentioned, our preference right now is to include a broad range of maturity exposures. Yet we also know that bond prices would likely decline if inflation were to emerge, particularly longer maturity ones. Our strategy is to utilize a time-tested approach, one that creates a "bond ladder" with maturity-series ETFs. [We complement this ladder with traditional fixed income ETFs.] Although these ETFs are not the same as bonds, their structure creates a similar profile. These ETFs do not mature in the way bonds do; instead, they are invested in bonds with maturities close to their end dates. As their end dates near, these ETFs tend to behave similarly to short-term bonds and ultimately similarly to cash-equivalents. At the end date, the cash held in the ETF is distributed at NAV. Accordingly, with each passing day, the ETF marches a little closer to its end date in a manner similar to a bond moving toward its maturity.



The portfolio also includes traditional fixed income ETFs (not shown) that complement this ladder.

The laddered structure allows for exposure to various maturities, while also providing a mechanism to participate in potentially higher interest rates in the future. If rates were to rise, the shortest "rung" should experience relatively low price volatility and can become available to help fund a new rung with a longer end date. For example, we recently sold the 2019 maturity series ETF and initiated a position in the 2027 maturity series.

Historically, the bond allocations have provided investors with income, stability and a measure of predictability. We expect bonds to continue to play this role. However, changing trade policy raises the possibility of rising inflation in the future. We believe a bond ladder structure can help to address some of that risk.

Illustrative Portfolio Construction

Positions from Fixed Income Taxable Portfolio (1) *As of July 2018*			
Name	Average ETF Maturity	Current 30-Day SEC Yield	ETF Number of Holdings
MATURITY DATE ETFs			
iShares iBonds Mar 2020 Term Corporate ex-Financials ETF	1.4	2.8%	220
Invesco BulletShares 2020 Corporate Bond ETF	2.4	3.0%	348
Invesco BulletShares 2021 Corporate Bond ETF	3.3	3.2%	365
Invesco BulletShares 2022 Corporate Bond ETF	4.3	3.4%	341
iShares iBonds Mar 2023 Term Corporate ex-Financials ETF	4.3	3.3%	205
Invesco BulletShares 2024 Corporate Bond ETF	6.0	3.8%	225
Invesco BulletShares 2025 Corporate Bond ETF	6.7	4.0%	205
iShares iBonds Dec 2025 Term Corporate ETF	6.9	4.0%	333
iShares iBonds Dec 2026 Term Corporate ETF	8.0	4.1%	312
iShares iBonds Dec 2027 Term Corporate ETF	8.9	4.2%	295
TRADITIONAL FIXED INCOME ETFs			
SPDR Portfolio Intermediate Term Corporate Bond ETF	5.1	3.7%	3,756
iShares MBS ETF	7.2	2.9%	700
iShares 7-10 Year Treasury Bond ETF	8.4	2.7%	14
iShares 10+ Year Credit Bond ETF	23.4	4.7%	1,616
iShares 20+ Year Treasury Bond ETF	25.7	2.9%	32
Weighted Average SEC Yield	3.3%		
Weighted Average ETF Maturity	8.1 years		
Number of Portfolio Positions	16		

(1) Confluence claims compliance with the Global Investment Performance Standards (GIPS®). All information above is presented as supplemental information to the disclosures required by the GIPS® standards. A GIPS®-compliant presentation and/or list of composite descriptions can be requested by contacting Confluence. The table of maturity-date ETFs and static traditional fixed income ETFs shows a complete list of ETFs in the portfolio as of the date shown. 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. There can be no assurance that a purchase of the securities in this portfolio will be profitable, either individually or in the aggregate, or that such purchase will be more profitable than alternative investments. Past performance is no guarantee of future results. Yield calculation: model portfolio 30-day SEC yield (Source: Morningstar).

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. 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 Registered Investment Adviser located in St. Louis, Missouri. Confluence provides professional portfolio management and advisory services to institutional and individual clients. The firm's portfolio management philosophy begins by addressing risk, and follows through by positioning clients to achieve income and growth objectives.