Equity Strategies • Equity Income

Equity Income is focused on businesses across a broad range of market capitalizations that collectively generate an above-average stream of dividend income, while also providing for capital appreciation potential. The businesses are selected using a bottom-up, fundamental research process that seeks to identify individual businesses that have the ability to either pay a high level of dividend income or grow the dividend stream over time. The portfolio typically comprises 30-35 holdings and is expected to result in low to moderate turnover. The portfolio is suitable for clients seeking total return from dividend income and capital appreciation.

Portfolio Commentary

The S&P 500 Index rose 7.7% in the third quarter, and was up 10.6% year-to-date. Meanwhile, Equity Income was up 2.4% in the third quarter, bringing its year-to-date return to 1.7% (both gross of fees). The annualized yield at quarter end for Equity Income was 3.0% compared to 1.9% for the S&P 500. (*The portfolio was up 1.7% and down 0.6% (net of fees), respectively, over the same time periods. Net of fees calculated using the highest applicable annual bundled fee of 3.00%. See performance disclosures on p. 3 for fee description; actual investment advisory fees may vary.*)

The broad equity markets have been strong over the past 18-24 months as the economic backdrop, aided by tax reform and regulatory relief, provided a nice tailwind for earnings growth. Although strength in the domestic economy has been relatively broad based, equity returns have not. At this stage in the bull market, investors are increasingly leaning toward businesses that exhibit above-average sales growth/momentum while paying less attention to valuations. In fact, the Russell Growth indices have been handily outperforming their Value counterparts the past two years (see table below).[1]

Index	2017	2018 (thru Sept)
S&P 500	21.8%	10.6%
Russell 3000 Value	13.2%	4.2%
Russell 3000 Growth	29.6%	17.0%
Dividend Payers*	16.8%	4.0%
Non-Payers*	13.1%	14.8%

**Equal-weighted returns of S&P 500 component stocks*

Delving deeper into the broader market returns, it reveals that only a handful of names have been driving the market, named by the financial media as the FAANG stocks, an acronym for the underlying businesses (Facebook, Amazon, Apple, Netflix and Google). In fact, returns thus far in 2018, through September, are concentrated such that seven stocks in the S&P 500 have contributed 44% of the overall return (shown in the next table).[2] Those stocks are the FAANG stocks plus NVIDIA and Microsoft. As illustrated, the five largest names in the S&P 500 represent 15% of the S&P 500 and have garnered a disproportionate amount of flows as evidenced by their outsized returns, except Facebook. (*Microsoft is the only name mentioned in this paragraph owned in Equity Income.*)

S&P 500 Cap Rank	Symbol	Avg % Wgt	Total Return	Contribution	% Contribution
1	Apple	3.98%	34.92%	1.32%	12.45%
2	Microsoft	3.22%	35.43%	1.03%	9.72%
3	Amazon	2.77%	71.27%	1.47%	13.87%
4	Alphabet - Google	2.59%	14.32%	0.40%	3.77%
5	Facebook	1.83%	(6.80%)	(0.11%)	(1.04%)
32	NVIDIA	0.63%	45.49%	0.24%	2.26%
35	Netflix	0.60%	94.90%	0.35%	3.30%
	Total	**15.62%**		**4.70%**	**44.34%**

[2] *Source: SPDR S&P 500 ETF (SPY)*

This is clearly a period in which the risk profile of the S&P 500 has increased as investors' focus shifts away from managing risk (preserving capital) to the potential of higher returns. Recent market conditions are not in sync with our approach toward seeking risk-adjusted returns in dividend-paying stocks while maintaining a sufficient margin of safety. We manage to a consistent risk profile throughout the cycle with a multi-year time horizon. There are certain periods when the broader market has a change in complexion which would necessitate adjusting one's risk tolerance in order to fully participate. We view risk as the probability of a permanent loss of capital, not volatility or deviation from a stated benchmark. It is important to note that we are long-term investors that strive to beat the markets on average and over long periods but will vary from the market in any given period. We are willing to accept returns that may vary from the broad market, especially during periods driven primarily by multiple/valuation expansion or narrowly focused environments.

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Portfolio Commentary continued...

Over the Equity Income portfolio's nearly 18-year history, maintaining a consistent, valuation driven, fundamental approach has produced attractive long-term results despite select periods of underperformance versus our benchmark. We fully intend to maintain such consistency going forward and take solace in the fact that the companies within this portfolio continue to generate solid returns on capital. Our long history has shown that by protecting capital on the downside we don't need to enhance risk on the upside to outperform over the long-term. To quote Alabama coach Bear Bryant, "Offense sells tickets, but defense wins championships."

Our investment approach is focused on understanding and valuing individual businesses with the emphasis of owning great businesses at bargain prices. Businesses that exhibit the attributes we look for (substantial competitive advantages, pricing power, free cash flow generation, high returns on invested capital) are often difficult to find in commodity-oriented or highly-regulated businesses in which pricing is contingent on factors outside management's control. This will often result in over/ under weighting certain areas of the market that either offer more attractive valuations or have superior underlying attributes. Subsequently performance in any given time frame will be impacted by the market's perception of the value of these individual businesses compared to the broad market.

Lastly, the investment objective for Equity Income is a balance between capital appreciation and dividend income. Dividend-paying companies, especially higher yielding, are facing headwinds as the Federal Reserve strives to normalize monetary policy by raising interest rates and reducing its balance sheet. This normalization process is providing alternatives to yield-seeking investors who previously had few options outside of dividend-paying stocks during the Zero Interest Rate Policy (ZIRP) that lasted for approximately eight years. Our focus is on businesses that generate above-average returns on capital that have the ability to maintain and grow their dividends which will ultimately be recognized by investors. With that said, Equity Income's performance over the past 12-18 months has been more in line with the value indices, which is not atypical in this type of market.

Looking forward, we expect continued economic expansion as monetary policy remains accommodative and fiscal policy leans toward a friendlier business climate, resulting in a more optimistic business outlook. We also expect inflation and inflation expectations to remain in check near current levels, which supports market valuations. We continue to work diligently to put cash to work in a prudent fashion but acknowledge it is taking a little longer than normal. As always, we remain focused on company-specific fundamentals and growth prospects, and believe the current market will continue to provide us with opportunities to buy quality companies at reasonable prices.

The portfolio's top-performing and worst-performing positions during the quarter were as follows:

Security	Avg Wgt	Return	Contrib
Top 5			
Progressive Corp.	5.17	20.10	0.97
Broadridge Financial Solutions Inc.	4.99	15.01	0.74
Microsoft Corp.	4.88	16.42	0.74
Fastenal Co.	3.42	21.35	0.64
Pfizer Inc.	2.81	22.47	0.57
Bottom 5			
Weyerhaeuser Co.	2.96	(10.57)	(0.33)
Kraft Heinz Co.	2.83	(11.34)	(0.34)
Rayonier Inc.	2.86	(11.91)	(0.38)
Martin Marietta Materials Inc.	2.93	(18.32)	(0.59)
Polaris Industries	3.67	(16.92)	(0.68)

(Attribution data shown from a sample account)

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10 Largest Portfolio Holdings (as of 9/30/18)

Company	Market Capitalization ($ billions)	Portfolio Weight
The Progressive Corporation	41.4	4.6%
Microsoft Corporation	877.0	3.9%
Fastenal Company	16.6	3.6%
Paychex, Inc.	26.5	3.5%
Pfizer Inc.	258.3	3.4%
Johnson & Johnson	370.7	3.4%
Praxair, Inc.	46.2	3.3%
Northern Trust Corporation	22.8	3.3%
Diageo plc	86.9	3.3%
Polaris Industries Inc.	6.3	3.2%

The listing of "10 Largest Holdings" is not a complete list of all stocks 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. Sector weightings and holdings of individual client portfolios in the program may differ, sometimes significantly, from these listings. Contact Confluence for a complete list of holdings.

All investments carry a certain degree of risk, including possible loss of principal. It is important to review your investment objectives, risk tolerance and liquidity needs before choosing an investment style or manager. Equity securities are subject to market risk and may decline in value due to adverse company, industry or general economic conditions.

Performance Composite Returns For Periods Ending 9/30/18

	Pure Gross-of-Fees[1]	Net-of-Fees[2]	S&P 500	R3000 Value
QTD	2.4%	1.7%	7.7%	5.4%
YTD	1.7%	(0.6%)	10.6%	4.2%
1-Year	7.6%	4.4%	17.9%	9.4%
3-Year*	14.2%	10.8%	17.3%	13.7%
5-Year*	11.0%	7.7%	13.9%	10.6%
10-Year*	11.1%	7.8%	12.0%	9.8%
15-Year*	9.9%	6.7%	9.7%	8.9%
Since Inception**	10.6%	7.4%	6.1%	7.2%

*Average annualized returns
**Inception is 10/1/2000

Confluence claims compliance with the Global Investment Performance Standards (GIPS®).
The Equity Income Strategy was incepted on October 1, 2000 and the current Equity Income Composite was created on August 1, 2008. Performance presented prior to August 1, 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. Results are based on fully discretionary accounts under management, including those accounts no longer with the firm. 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] Pure gross returns are shown as supplemental information to the disclosures required by the GIPS ® standards.

[2] Net of fee performance was calculated using the highest applicable annual bundled fee of 3.00% applied quarterly (2.75% prior to 7/1/08). This fee includes brokerage commissions, portfolio management, consulting services and custodial services. The Confluence fee schedule for this composite is as follows: 0.60% on the first $500,000; 0.55% on the next $500,000; and 0.50% 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.

A complete list of composite descriptions and/or fully compliant GIPS® presentations are available upon request. Additional information regarding policies for calculating and reporting performance are available upon request. The annual composite dispersion is an equal weighted standard deviation calculated for accounts in the composite for the entire year. The Equity Income Composite contains fully discretionary Equity Income wrap accounts. Equity Income is a value-based, bottom-up portfolio that invests in stocks from all market capitalizations based on their ability to generate an above average stream of dividend income, while also providing capital appreciation potential.

	Pure Gross-of-Fees[1]	Net-of-Fees[2]	S&P 500	R3000 Value	Difference (Gross-S&P500)	# of Portfolios	Composite Assets (000s)	Total Firm Assets (000s)	Composite 3yr Std Dev	S&P 500 3yr Std Dev	R3000V 3yr Std Dev	Composite Dispersion
2017	17.5%	14.0%	21.8%	13.2%	(4.4%)	7,423	$2,177,984	$5,944,479	8.4%	9.9%	10.3%	1.1%
2016	18.0%	14.5%	12.0%	18.4%	6.0%	5,272	$1,549,506	$4,413,659	9.4%	10.6%	11.0%	0.4%
2015	0.1%	(2.9%)	1.4%	(4.1%)	(1.3%)	3,528	$939,550	$3,175,419	9.4%	10.5%	10.7%	0.4%
2014	11.4%	8.1%	13.7%	12.7%	(2.2%)	2,834	$858,027	$2,589,024	8.4%	9.0%	9.4%	0.4%
2013	26.1%	22.4%	32.4%	32.7%	(6.3%)	1,947	$606,780	$1,955,915	10.5%	11.9%	12.9%	1.3%
2012	17.8%	14.3%	16.0%	17.6%	1.8%	1,200	$337,610	$1,272,265	13.5%	15.1%	15.8%	0.6%
2011	5.1%	2.0%	2.1%	(0.1%)	3.0%	918	$225,088	$937,487	18.6%	18.7%	21.0%	1.0%
2010	16.1%	12.7%	15.1%	16.3%	1.1%	555	$128,855	$751,909	20.2%	21.9%	23.5%	0.8%
2009	18.8%	15.3%	26.5%	19.8%	(7.7%)	459	$85,079	$533,832	18.1%	19.6%	21.3%	0.8%
2008	(18.9%)	(21.2%)	(37.0%)	(36.2%)	18.1%	346	$44,339	$291,644	12.0%	15.1%	15.5%	N/A
2007	1.5%	(1.3%)	5.5%	(1.0%)	(4.0%)	2,490	$381,383		6.2%	7.7%	8.3%	0.8%
2006	15.3%	12.1%	15.8%	22.3%	(0.5%)	3,122	$489,578		5.7%	6.8%	7.0%	0.8%
2005	0.4%	(2.3%)	4.9%	6.9%	(4.5%)	3,775	$536,505		8.4%	9.0%	9.7%	0.6%
2004	12.1%	9.1%	10.9%	16.9%	1.3%	2,811	$425,234		10.2%	14.9%	14.8%	1.1%
2003	32.1%	28.5%	28.7%	31.1%	3.4%	1,204	$168,181		11.0%	18.1%	16.0%	0.9%
2002	0.6%	(2.1%)	(22.1%)	(15.2%)	22.7%	342	$36,726		N/A	N/A	N/A	0.8%
2001	11.6%	8.6%	(11.9%)	(4.3%)	23.5%	32	$6,341		N/A	N/A	N/A	0.2%
2000**	13.5%	12.8%	(7.8%)	3.9%	21.4%	2	$125		N/A	N/A	N/A	N/A

**Results shown for the year 2000 represent partial period performance from October 1, 2000 through December 31, 2000. N/A- Composite Dispersion: Information is not statistically meaningful due to an insufficient number of portfolios in the composite for the entire year. N/A- 3yr Std Dev: Composite does not have 3 years of monthly performance history.

Portfolio Benchmarks

S&P 500 Index – A capitalization-weighted index of 500 stocks. The Index is designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

Russell 3000® Value Index – A capitalization-weighted index designed to measure performance of those Russell 3000® Index companies with lower price-to-book ratios and lower forecasted growth values.

About Confluence Investment Management LLC

Confluence Investment Management LLC is an independent Registered Investment Advisor located in St. Louis, Missouri that was founded in 2007. Confluence provides professional portfolio management and advisory services to institutional and individual clients. The firm'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, fundamental company-specific approach. Confluence's portfolio management philosophy begins by assessing risk and follows through by positioning clients to achieve their income and growth objectives. The Confluence team has more than 400 years of combined financial experience and 200 years of portfolio management experience.