Confluence
INVESTMENT MANAGEMENT

Third Quarter
2022

Equity Income • Value Equity Strategies

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 strategy is appropriate for clients seeking total return from dividend income and capital appreciation.

Market Commentary

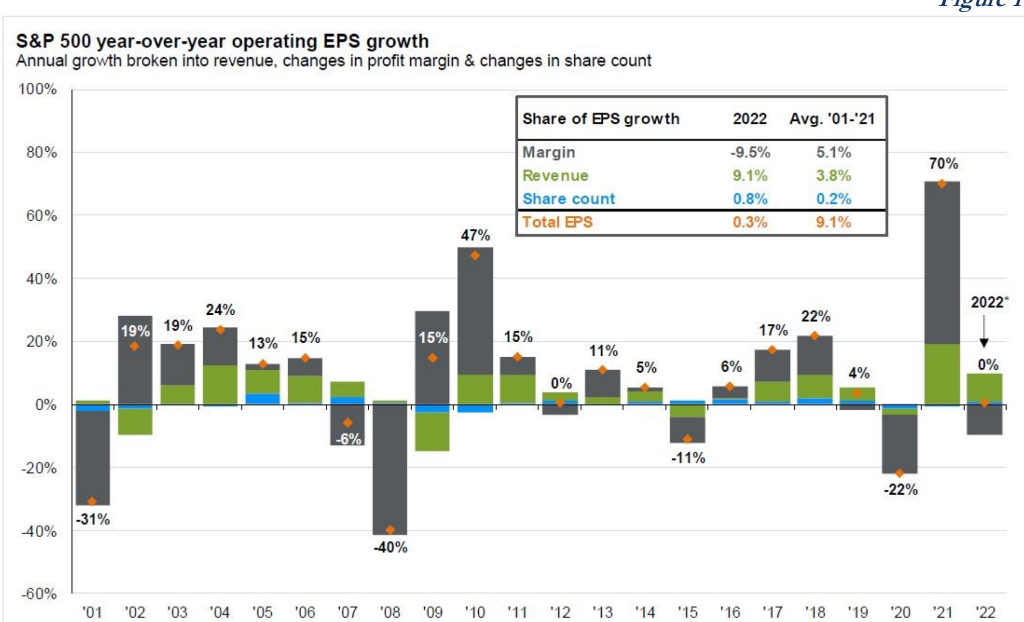
"Waiting for the bottom is folly. What, then, should be the investor's criteria? The answer's simple: if something's cheap — based on the relationship between price and intrinsic value — you should buy, and if it cheapens further, you should buy more."

- Howard Marks, co-founder at Oaktree Capital Group LLC

The broad equity markets remain in bear market territory as investors continue to grapple with inflation and the ensuant monetary policy response. The Federal Reserve remains adamant that it will take the necessary actions needed to curtail inflation, and while market participants appear reticent of that fact, they are eager for the Fed to pivot toward friendlier monetary policy. This is apparent in the handful of market rallies, five thus far in 2022, that were precipitated by a weak economic data point and lifted the markets between 6% and 17%. These rallies have proven to be short-lived as inflation remains stubbornly elevated and the Fed steadfast in its monetary policy tightening. The Fed has raised the federal funds rate in 2022 from a floor of 0-0.25% to 3.00-3.25%, with the latest increase of 75 bps in late September. The net effect has been upward pressure on longer rates as the 10-year Treasury yield is up from 1.52% at the beginning of the year to 3.83% at quarter end, which has weighed on equity markets and resulted in three consecutive quarters of negative returns for the broad market, as measured by the S&P 500 Index (Q1 -4.6%, Q2 -16.1%, and Q3 -4.9%). Such a poor start to the year was last witnessed in 2008 and leaves the S&P 500 down 23.9% for the year.

The policy tools available to the Federal Reserve to stem inflation, and inflation expectations, are limited and primarily influence demand through the level of rates and/or liquidity (Quantitative Easing/Tightening). Thus far in 2022, the policy effects have been limited as the drawdown in equity markets has been driven primarily by a contraction in the multiple that investors are willing to pay for earnings. As reflected by this first chart from J.P. Morgan Asset Management (*Figure 1*), revenue and earnings growth have remained positive despite the sharp pullback in the equity markets. Meanwhile, the chart on the next page (*Figure 2*), also from J.P. Morgan Asset Management, shows the sharp decline in the forward P/E from over 22x to 15.15x. This reflects the dramatic shift in sentiment, as well as concern, for future demand and earnings as Fed policy operates with a lag.

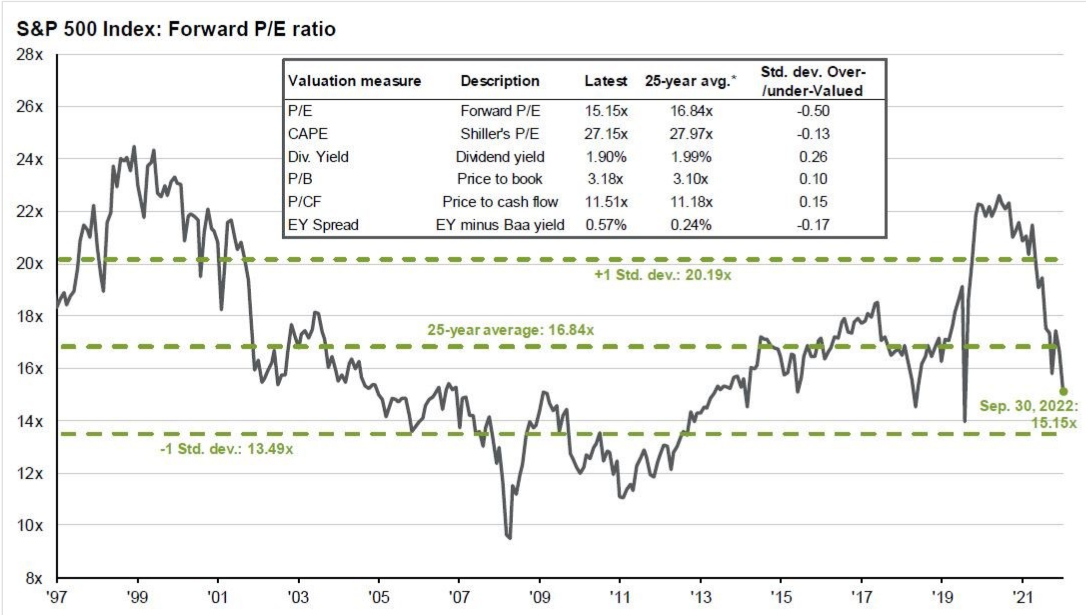
Figure 1



(Chart source: J.P. Morgan Asset Management; Guide to the Markets®, U.S. 4Q2022, as of September 30, 2022)

Market Commentary continued...

Figure 2

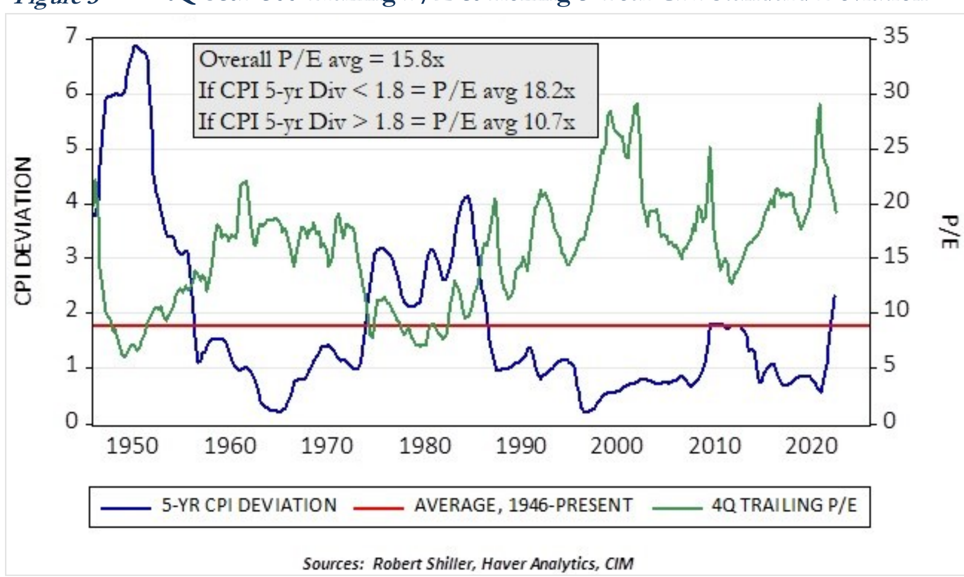


(Chart source: J.P. Morgan Asset Management; Guide to the Markets®, U.S. 4Q2022, as of September 30, 2022)

For investors, the importance of containing inflation is rather straightforward as the present value of a dollar returned in the future is worth less in an inflationary environment. As inflation rises, a higher required return is sought, which elevates the discount rate and lowers the present valuation, i.e., lower earnings multiple. If inflationary expectations become engrained, behavior also changes as purchasing an item at today's price is more advantageous than waiting and paying a higher price later. This lifts current demand and puts additional pressure on supply, causing prices to move even higher and thus triggering an inflation spiral.

This chart from the Confluence Investment Management macro team (*Figure 3*) shows the negative impact on P/E multiples during periods of volatile or uncertain inflation. The graph maps the deviation of the Consumer Price Index (CPI) from the five-year rolling CPI and reflects an inverse relationship of lower multiples when the deviation is higher. Investors naturally prefer lower levels of inflation, and inflation expectations, as reflected by the higher multiples afforded in those environments.

Figure 3 **4Q S&P 500 Trailing P/E & Rolling 5-Year CPI Standard Deviation**



Reining in inflation and expectations of inflation has been the policy aim of the Federal Reserve's actions to date. While the impact to the economy will take time to be fully felt, the key issue is how staunch Fed Chair Powell will remain should inflation stay elevated and the economy retracts. The answer may not lie with economics but rather behavioral science as his desire to remain in good stead in Washington is also a factor. For equity investors, the market declines have been sharp and broad-based, with the Energy sector as the exception, and now provide even more compelling valuations for long-term investors. Fortunately, these types of environments often create opportunities for long-term, fundamental investors to uncover some great companies trading at attractive valuations.

Strategy Commentary

The third quarter of 2022 marked the third consecutive quarterly decline for the equity markets as inflation remained elevated and the Fed continued to tighten monetary policy. For the quarter, the S&P 500 Index was down 4.9% and the Russell 3000 Value Index was down 5.6%. The back-to-back-to-back negative quarters are the first for the S&P 500 since the Great Financial Crisis of 2008-2009 and put the index down 23.9% for the year, while the Russell 3000 Value is now down 18.0% for the year. Confluence Equity Income also posted a loss for the quarter of 5.3% and is down 16.5% for the year (both gross of fees). [*The net-of-fees returns for the same periods were -6.0% QTD and -18.3% YTD. See disclosures on last page for fee description; actual investment advisory fees may vary.*]

The pressure on equity markets continues to be caused by stubbornly high inflation which has forced the Federal Reserve to tighten more aggressively than expected. This was evident again in September when the Fed raised the federal funds rate to a target of 3.00-3.25%, marking the third consecutive increase of 75 bps since mid-June. Despite the Fed's hawkishness, the S&P 500 rallied over 17% between mid-June and mid-August as investors displayed their eagerness for a pivot. Unfortunately, the persistence of inflation did not allow for a pivot and many of the same trends continued through the third quarter.

More specifically, the pullback has been primarily an adjustment to the multiple that equity investors were willing to pay for earnings as revenue and earnings growth remained positive (see previous charts in **Market Commentary** section). The multiple adjustments combined with the geopolitical issues surrounding Russia and oil supplies have negatively impacted investor sentiment but benefited the Energy sector. We have included an excerpt from J.P. Morgan's *Guide to the Markets®* as of September 30, 2022 (*Figure 4*), which reflects the sector weightings and performance of the indexes and reveals that the defensive sectors (Utilities, Consumer Staples, and Health Care) fared relatively well, while Energy was up a whopping 34.9%, far outperforming the other sectors.

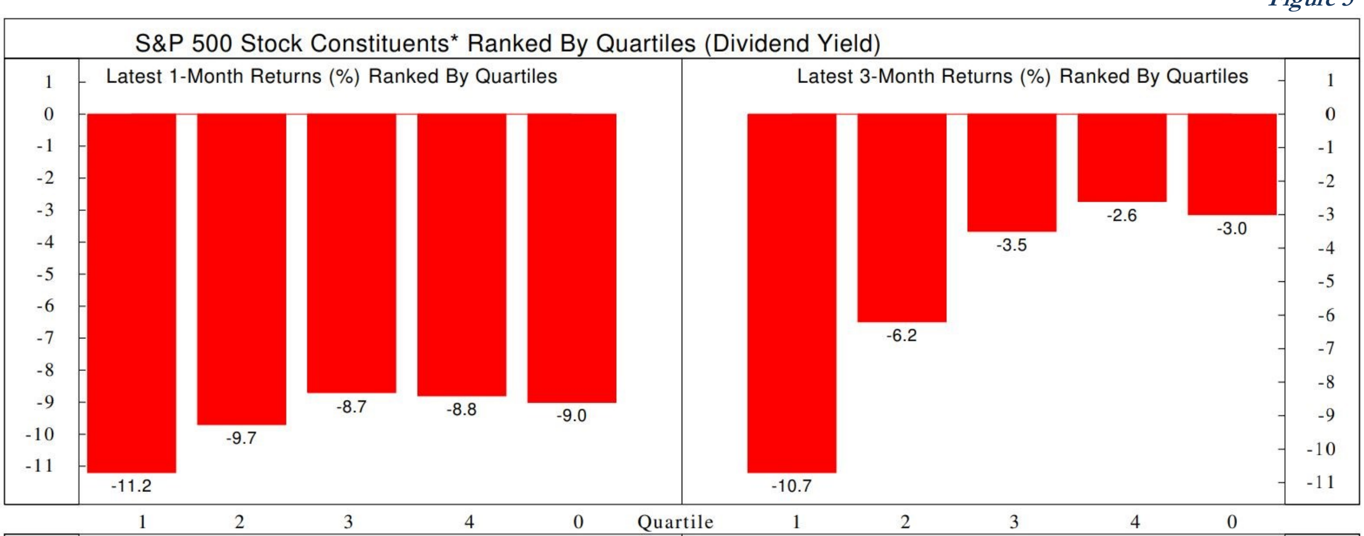
Figure 4 **Returns and Valuations by Sector**

	Energy	Materials	Financials	Industrials	Cons. Disc.	Tech.	Comm. Services*	Real Estate	Health Care	Cons. Staples	Utilities	S&P 500 Index
S&P weight	4.5%	2.5%	11.0%	7.9%	11.7%	26.4%	8.1%	2.8%	15.1%	6.9%	3.1%	100.0%
Russell Growth weight	1.6%	1.4%	3.0%	7.2%	17.1%	42.9%	7.4%	1.6%	12.2%	5.7%	0.0%	100.0%
Russell Value weight	7.8%	4.1%	20.0%	10.0%	6.0%	8.8%	8.0%	4.8%	17.3%	7.2%	6.0%	100.0%
Russell 2000 weight	6.1%	4.0%	17.3%	14.8%	10.2%	12.8%	2.7%	6.4%	18.9%	3.4%	3.4%	100.0%
QTD	2.3	-7.1	-3.1	-4.7	4.4	-6.2	-12.7	-11.0	-5.2	-6.6	-6.0	-4.9
YTD	34.9	-23.7	-21.2	-20.7	-29.9	-31.4	-39.0	-28.8	-13.1	-11.8	-6.5	-23.9

(Source: J.P. Morgan Asset Management; Guide to the Markets®, U.S. 4Q2022, as of September 30, 2022)

Confluence's Equity Income strategy is displaying the defensive characteristics that have historically been associated with high-quality businesses paying above-average dividends. However, yields on the 10-year Treasury rose from 2.98% to 3.83% in the third quarter, putting more pressure on higher-yielding names. The following charts (*Figure 5*) depict the dividend payers by quartile, per Ned Davis Research, which reflect the relative underperformance of the higher dividend payers compared to the lower or non-dividend payers (Quartile 0) during the month of September and third quarter 2022.

Figure 5



*Actual Historical Constituents.

Quartile 1 (Highest Dividend Yield); Quartile 4 (Lowest Dividend Yield). 5th Bar (0) = 0 Dividend Yield (All S&P 500 Stocks with Zero Dividends)

(Source: Ned Davis Research; Returns through 9/30/2022)

Strategy Commentary continued...

During the quarter, we completed the sale of 3M Company (MMM) to provide proceeds for a new position. We have become increasingly concerned about litigation coming on two fronts for the company: (1) its long-past production and use of "PFAS" chemicals, which have now been detected in groundwater (though the effects on human health are still in question), and (2) past production and sale by a 2008-acquired operation (Aearo Technologies) of combat arms earplugs, used in the last couple decades by the U.S. military but alleged to have been defective. Given the distractions and uncertainties, we liquidated our position.

Thus far in 2022, the portfolio has been led by strength from Progressive (PGR), an insurer; Chevron (CVX), an integrated oil company; Lockheed Martin (LMT), a defense contractor benefiting from a less uncertain geopolitical environment; Kinder Morgan (KMI), an energy infrastructure and pipelines entity; and Southern Company (SO), a utility provider. The laggards are more sensitive to either interest rates or the economy: Cisco Systems (CSCO), a provider of networking hardware and software; Fastenal (FAST), an industrial distributor; Home Depot (HD), a retailer for home maintenance and building materials; Digital Reality Trust (DLR), a datacenter REIT; and SL Green Realty (SLG), an office REIT with properties in New York City. [*See contribution data on the next page.*]

Outlook

As we mentioned in our last commentary, after decades of subdued inflation, the Federal Reserve is now witnessing elevated levels and has been forced to act accordingly. The Fed's actions have naturally generated additional uncertainty around the impact these moves will have on the economy, which is weighing on investor sentiment. This uncertainty will likely continue as the market grapples with the pace and magnitude of future tightening, resulting in a continuation of the recent volatility. If anything, the past few years have reinforced the fallacy of prognostication and highlight the importance of adhering to a disciplined process. At current levels, we believe the markets are providing attractive valuations for long-term, fundamental investors, and we intend to take advantage of opportunities as they present themselves. As always, we remain focused on our core strength, which is analyzing and valuing businesses.

Contribution[1]

(YTD as of 9/30/2022)

The top contributors and detractors for the portfolio thus far in 2022 are shown in this table:

Security	Avg Weight (%)	Contribution (%)
Top 5		
Progressive Corp.	4.64	0.45
Chevron Corp.	2.19	0.34
Lockheed Martin Corp.	3.37	0.23
Kinder Morgan Inc.	2.15	0.03
Southern Co.	3.04	0.01
Bottom 5		
Cisco Systems Inc.	2.53	(1.03)
Fastenal Co.	3.66	(1.05)
Home Depot Inc.	3.01	(1.11)
Digital Realty Trust Inc.	2.61	(1.27)
SL Green Realty Corp.	2.69	(1.63)

(Contribution data shown from a sample account, based on individual stock performance and portfolio weighting)

Performance Composite Returns[2] (For Periods Ending September 30, 2022)

	Since Inception**	20-Year*	15-Year*	10-Year*	5-Year*	3-Year*	1-Year	YTD	QTD
Equity Income *Pure Gross-of-Fees[3]*	9.9%	9.8%	8.7%	10.2%	7.0%	5.8%	(6.1%)	(16.5%)	(5.3%)
Max Net-of-Fees[4]	6.7%	6.7%	5.5%	7.0%	3.8%	2.7%	(8.9%)	(18.3%)	(6.0%)
Russell 3000 Value	6.6%	8.7%	5.7%	9.1%	5.1%	4.3%	(11.8%)	(18.0%)	(5.6%)
S&P 500	6.3%	9.8%	8.0%	11.7%	9.2%	8.1%	(15.5%)	(23.9%)	(4.9%)

Calendar Year	Pure Gross-of-Fees[3]	Max Net-of-Fees[4]	R3000 Value	S&P 500	Difference (Gross-R3000V)	# of Portfolios	Composite Assets (000s)	Total Firm Assets (000s)	Composite 3yr Std Dev	R3000V 3yr Std Dev	S&P 500 3yr Std Dev	Composite Dispersion
2000**	13.5%	12.8%	3.9%	(7.8%)	9.7%	2	$125		N/A	N/A	N/A	N/A
2001	11.6%	8.6%	(4.3%)	(11.9%)	16.0%	32	$6,341		N/A	N/A	N/A	0.2%
2002	0.6%	(2.1%)	(15.2%)	(22.1%)	15.8%	342	$36,726		N/A	N/A	N/A	0.8%
2003	32.1%	28.5%	31.1%	28.7%	0.9%	1,204	$168,181		11.0%	16.0%	18.1%	0.9%
2004	12.1%	9.1%	16.9%	10.9%	(4.8%)	2,811	$425,234		10.2%	14.8%	14.9%	1.1%
2005	0.4%	(2.3%)	6.9%	4.9%	(6.4%)	3,775	$536,505		8.4%	9.7%	9.0%	0.6%
2006	15.3%	12.1%	22.3%	15.8%	(7.1%)	3,122	$489,578		5.7%	7.0%	6.8%	0.8%
2007	1.5%	(1.3%)	(1.0%)	5.5%	2.5%	2,490	$381,383		6.2%	8.3%	7.7%	0.8%
2008	(18.9%)	(21.2%)	(36.2%)	(37.0%)	17.4%	346	$44,339	$291,644	12.0%	15.5%	15.1%	N/A
2009	18.8%	15.3%	19.8%	26.5%	(1.0%)	459	$85,079	$533,832	18.1%	21.3%	19.6%	0.8%
2010	16.1%	12.7%	16.3%	15.1%	(0.1%)	555	$128,855	$751,909	20.2%	23.5%	21.9%	0.8%
2011	5.1%	2.0%	(0.1%)	2.1%	5.2%	918	$225,088	$937,487	18.6%	21.0%	18.7%	1.0%
2012	17.8%	14.3%	17.6%	16.0%	0.2%	1,200	$337,610	$1,272,265	13.5%	15.8%	15.1%	0.6%
2013	26.1%	22.4%	32.7%	32.4%	(6.6%)	1,947	$606,780	$1,955,915	10.5%	12.9%	11.9%	1.3%
2014	11.4%	8.1%	12.7%	13.7%	(1.3%)	2,834	$858,027	$2,589,024	8.4%	9.4%	9.0%	0.4%
2015	0.1%	(2.9%)	(4.1%)	1.4%	4.3%	3,528	$939,550	$3,175,419	9.4%	10.7%	10.5%	0.4%
2016	18.0%	14.5%	18.4%	12.0%	(0.4%)	5,272	$1,549,506	$4,413,659	9.4%	11.0%	10.6%	0.4%
2017	17.5%	14.0%	13.2%	21.8%	4.3%	7,423	$2,177,984	$5,944,479	8.4%	10.3%	9.9%	1.1%
2018	(8.9%)	(11.6%)	(8.6%)	(4.4%)	(0.3%)	7,772	$1,945,646	$5,486,737	9.7%	11.1%	10.8%	0.5%
2019	31.0%	27.1%	26.2%	31.5%	4.7%	8,249	$2,725,466	$7,044,708	10.8%	12.0%	11.9%	0.8%
2020	4.6%	1.5%	2.9%	18.4%	1.8%	7,557	$2,440,128	$6,889,798	17.1%	20.0%	18.5%	0.8%
2021	27.2%	23.5%	25.3%	28.7%	1.9%	7,508	$3,048,035	$7,761,687	16.6%	19.3%	17.2%	0.5%

*Average annualized returns

**Inception is 10/1/2000

See performance disclosures on last page.

Portfolio Benchmarks

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.

S&P 500® Index – A capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. *(Source: Bloomberg)*

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Disclosures

Market & Strategy Commentary—Individual holding performance and contribution methodology as well as a list of every holding's contribution to the strategy can be obtained by contacting Confluence. Material is published solely for informational purposes and is not an offer to buy or sell or a solicitation of an offer to buy or sell any security or investment product. Opinions and estimates are as of a certain date and subject to change without notice. Past performance is no guarantee of future results.

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Indices: The Russell 3000 Value Index and S&P 500 Index are shown as additional information. These indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only & do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance.

[1] **Contribution—**Table showing the top 5 contributors/detractors reflects the strategy's best and worst performers, based on each holding's contribution to the sample account for the period stated. Holdings identified do not represent all of the securities purchased, sold or recommended. Individual client portfolios in the strategy may differ, sometimes significantly, from these listings. Contact Confluence for a complete list of holdings.

[2] **Performance Composite Returns—Confluence Investment Management LLC claims compliance with the Global investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. Confluence Investment Management LLC has been independently verified for the periods August 1, 2008, through December 31, 2021. The verification report is available upon request. A firm that claims compliance with the GIPS standards must establish policies and procedures for complying with all the applicable requirements of the GIPS standards.**

Verification provides assurance on whether the firm's policies and procedures related to composite maintenance, as well as the calculation, presentation, and distribution of performance, have been designed in compliance with the GIPS standards and have been implemented on a firm-wide basis. Verification does not provide assurance on the accuracy of any specific performance report.

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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. Confluence Investment Management LLC is an independent registered investment adviser. 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.

[3] Pure gross returns are shown as supplemental information to the disclosures required by the GIPS® standards.

[4] 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 is available upon request. Policies for valuing investments, calculating performance, and preparing GIPS Reports are available upon request. The annual composite dispersion is an equal-weighted standard deviation, using gross-of-fee returns, calculated for the accounts in the composite for the entire year. The three-year annualized standard deviation measures the variability of the composite gross returns over the preceding 36-month period. 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.

**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.