Confluence
INVESTMENT MANAGEMENT

FOURTH QUARTER
2020

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

Equity markets ended the year with strength. News that multiple vaccines had been approved for use and would be available (in limited supply) prior to year-end drove double-digit returns in the closing weeks of the year. This final push helped broaden stock participation relative to the more narrowly focused market that had held for most of the year as vaccine news supported the notion that a more normalized economic environment could soon unfold. Nevertheless, the dramatic outperformance of the Technology and Consumer Discretionary sectors for most of the year was still evident in full-year returns as the Russell 3000 Value Index was up 2.9% for the year, while the more Technology-weighted S&P 500 Index rose by 18.4%.

Stocks within the Technology and Consumer Discretionary sectors were the dominant force driving stock market averages in 2020, followed by the Communications Services sector which was driven by strength in video game and social media companies. Within the S&P 500, these three sectors rose 43.9%, 33.3%, and 23.6%, respectively, in 2020. Clearly, investors were attracted to technology and digital-led businesses in 2020 as they were among the few investments benefiting from the current dislocations in the economy. These areas of the market, however, are not particularly fertile for investors seeking income as part of their equity returns. This made it difficult for our Equity Income strategy to keep pace with the S&P 500 given that the index currently has more than half its assets in the Technology, Consumer Discretionary, and Communication Services sectors.

Historically, we've had higher Consumer Discretionary exposure in this portfolio, but many of the dividend payers within this sector are dealing with significant disruption to their traditional business models as a result of COVID-19 and the societal changes it produced. While Consumer Discretionary was a very strong sector for the S&P 500 in 2020, it also saw the greatest reduction in dividend payments with more than half of the sector's dividend payers cutting or suspending dividends during the year. Further, with Amazon accounting for more than 21% of the sector at year end after having appreciated by roughly 66% for the year, this non-dividend payer had a dominant impact on the sector's performance.

During the fog of this unique and largely unprecedented economic environment, investors may be skeptical as to the staying power of dividends and/or their value against far more robust capital appreciation opportunities in certain corners of the market, such as technology, which, given the situation, appear more defensible than they typically do. As long-term managers of dividend-focused portfolios, we know that dividends and dividend-paying stocks cycle in and out of favor. It is why we've always believed that we must focus not just on a company's dividend stream and propensity to pay a dividend, but also on the quality of the company, its management team, and competitive positioning. We look for companies with sustainable competitive advantages that can build value irrespective of how they choose to return capital to shareholders. They, too, can temporarily go out of style, but if their competitive positioning is strong, the intrinsic value should sustain or rise.

In late August, the Federal Reserve announced an official change to its interest rate policy, specifically around inflation and inflation expectations. Going forward, it will allow for greater levels of inflation and will even allow inflation to run hot in the early days of an economic recovery. The Fed will no longer base policy decisions on where it thinks inflation is going but rather will wait to see clear evidence in the data. As such, in the coming quarters, we think investors will gravitate back to dividend-paying stocks as monetary policy works to support economic activity by keeping interest rates low even as the economy gains steam. This change in policy should support broader economic growth and strengthen the underlying fundamentals of dividend-paying stocks and investors' attitudes toward their durability and appeal. At the same time, a prolonged very low interest rate environment greatly narrows the universe of attractive yield-oriented investments and probably stimulates demand for dividend-paying stocks.

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Strategy Commentary

Confluence Equity Income gained 12.2% in the fourth quarter, bringing its full-year 2020 return to 4.6% (both gross of fees). At year-end, Equity Income's yield was 3.0% versus 2.3% for the Russell 3000 Value and 1.6% for the S&P 500. [*Net-of-fees returns were +11.4% QTD and +1.5% YTD. See disclosures on p.3 for fee description; actual investment advisory fees may vary.*]

The top contributors and detractors during the quarter:

Security	Avg Weight (%)	Contribution (%)
Top 5		
Fidelity National Financial, Inc.	3.01	0.74
Chubb Limited	2.37	0.72
U.S. Bancorp	2.48	0.71
Graco Inc.	3.84	0.68
Analog Devices, Inc.	2.46	0.62
Bottom 5		
Viatris Inc.	0.06	0.02
Nestlé S.A.	3.68	(0.06)
Gilead Sciences, Inc.	2.05	(0.16)
Digital Realty Trust, Inc.	3.35	(0.19)
Lockheed Martin Corporation	3.07	(0.23)

The top contributors and detractors for the full year:

Security	Avg Weight (%)	Contribution (%)
Top 5		
Microsoft Corporation	3.78	1.75
The Progressive Corporation	4.46	1.53
Graco Inc.	3.27	1.33
Fastenal Company	3.67	1.26
Linde plc	3.96	1.09
Bottom 5		
Chevron Corporation	1.63	(0.53)
Entergy Corporation	3.10	(0.56)
Kinder Morgan, Inc.	2.55	(1.12)
SL Green Realty Corp.	2.15	(1.33)
Carnival Corporation & Plc	Sold	(1.86)

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

Microsoft performed well during the year given its strong positioning in a remote working environment and continued market share gains within its cloud offerings. Shares of Progressive responded to the company's persistent market share gains and strong profitability as car usage is down (as are claims). Although it probably didn't have a material impact on the stock's appreciation this year, we liked the $4.50 special dividend Progressive announced, to be paid out in January 2021. Graco's strength likely relates to the company's exposure to growing areas of the construction market, a pristine balance sheet, and its attractive margin profile despite a largely domestic manufacturing footprint. Fastenal capitalized on its strengths to take market share both in its primary markets and new markets that opened up as numerous industries sought help in securing the necessary personal protective equipment to operate safely along with new sourcing relationships to help fortify supply chains and maintain business continuity. We have long been fans of the Fastenal culture and believe it to be the main source of its competitive advantage. Linde continues to benefit from the consistency of its business, margin gains still emanating from the Praxair merger, and budding enthusiasm toward the prospects of hydrogen as a fuel alternative.

As discussed in a previous report, we sold Carnival Cruise Lines shortly after purchase in early 2020. Assessing the situation in those early days of the pandemic, we felt the uncertainty as to when the company would be able to conduct business in a normalized fashion was too difficult to predict and the risk of material dilution too great. In hindsight, shares have recovered from where we sold them, even after the company raised substantial capital. We sleep well with our decision to sell the stock as the sequence of events that occurred in the early days of our ownership quickly took it out of our investable universe, which requires excess free cash flow generation. SL Green, a leading owner and operator of commercial real estate in Manhattan, saw declines on concerns of urban flight and a prolonged work-from-home environment. The company has some undeniable challenges, but we believe it is operating extremely well given the circumstances. Its limited exposure to retail and restaurant tenants, combined with the positioning of its assets, has allowed it to maintain relatively good rent collections. We expect business fundamentals to gradually improve as vaccine distribution widens and more workers feel comfortable returning to offices.

Kinder Morgan and Chevron were poor performers for the year largely on account of their business exposures. With Energy being the worst sector this year, down 33.7% as measured by the S&P 500, and demand weak as the economy deals with getting COVID-19 under control, the gravitational pull on these companies was too great to overcome. Both held up better than the broader Energy complex, but Energy has been a tough place to have capital this year given the depressed demand, weak balance sheets, and changing attitudes toward investing in the sector. We view Chevron as among the safest dividend payers in the sector with avenues for growth. Kinder Morgan continues to bring down its financial leverage while paying an outsized dividend. We like its distribution assets and believe the market is currently underestimating its longevity.

While an extended low rate environment presents obstacles for investors seeking income, our task is to construct a portfolio of businesses that will generate an above-average income stream of dividends, while also providing ample opportunities for capital appreciation as the recovery unfolds. By most accounts, it looks like a recovery is underway and poised to gain steam as vaccine distribution accelerates and disrupted supply chains regain efficiency. Continued loose monetary policy as well as elevated household savings rates further support an economic recovery in 2021. As always, we're grateful for the trust and confidence you've placed in our team. Rest assured that we have a seasoned team of analyst working diligently to ensure the portfolios are aligned accordingly.

10 Largest Holdings (as of 12/31/20)

Company	Market Capitalization	Portfolio Weight
	($ billions)	
Linde plc	138.3	4.0%
Graco Inc.	12.1	3.9%
The Progressive Corporation	57.9	3.9%
Broadridge Financial Solutions, Inc.	17.7	3.6%
Paychex, Inc.	33.6	3.5%
Nestlé S.A.	339.8	3.4%
Fastenal Company	28.0	3.4%
Snap-on Incorporated	9.3	3.3%
Colgate-Palmolive Company	73.3	3.1%
PepsiCo, Inc.	204.9	3.1%

The listing of "10 Largest Holdings" is not a complete list of all stocks in the portfolio or which Confluence may be currently recommending. 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 12/31/20

	Pure Gross-of-Fees[1]	Net-of-Fees[2]	R3000 Value	S&P 500
Since Inception**	10.4%	7.3%	7.1%	6.9%
20-Year*	9.9%	6.7%	6.9%	7.5%
15-Year*	9.6%	6.4%	7.3%	9.9%
10-Year*	11.7%	8.4%	10.4%	13.9%
5-Year*	11.6%	8.3%	9.7%	15.2%
3-Year*	7.7%	4.5%	5.9%	14.2%
1-Year	4.6%	1.5%	2.9%	18.4%
YTD	4.6%	1.5%	2.9%	18.4%
QTD	12.2%	11.4%	17.2%	12.1%

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

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)

Calendar Year	Pure Gross-of-Fees[1]	Net-of-Fees[2]	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%

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, 2019. 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.
[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 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.

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. 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. Information is presented as supplemental information to the disclosures required by GIPS® standards. Opinions and estimates are as of a certain date and subject to change without notice. Investment or investment services mentioned may not be suitable to an investor and the investor should seek advice from an investment professional, if applicable. Past performance is no guarantee of future results. Investing in securities involves the risk of loss of the amount invested that investors should be prepared to bear. There can be no assurance that any investment objective will be achieved or that any investment will be profitable or avoid incurring losses.* ***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.*