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

"Interest rates are to asset prices what gravity is to the apple. When there are low interest rates, there is a very low gravitational pull on asset prices."

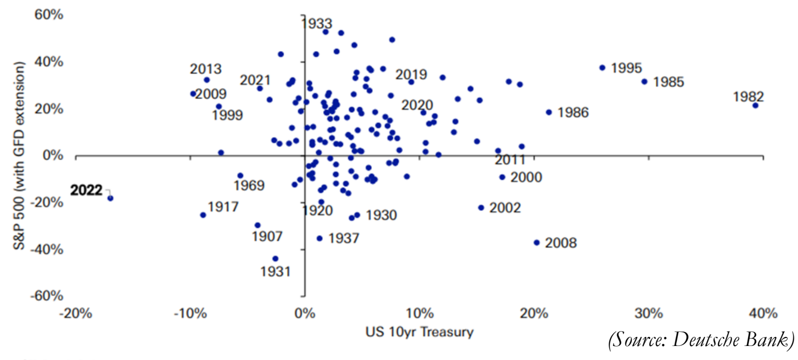
- Warren Buffett

2022 was a difficult year for financial assets as stocks and bonds experienced sharp declines, while commodities rallied. The primary culprit was the persistent rise in inflation that forced the Federal Reserve to shift monetary policy quickly and aggressively to a more restrictive stance. This shift occurred after an elongated period of accommodative policy following the Great Financial Crisis of 2008 that markedly benefited financial assets. The upward adjustment to inflation and inflation expectations as well as tightening Fed policy elevated the risk of a slowdown or recession, which explains the poor performance of financial assets this past year.

Putting the year into perspective, 2022 was the first year since 1872 that the S&P 500 and the 10-year Treasury lost more than 10% on a total return basis for a full calendar year, posting losses of 18.1% and 17.0%, respectively. This chart from Deutsche Bank (*Figure 1*) is a scatterplot of calendar year performance since 1872, demonstrating how 2022 was truly an outlier.

Figure 1

Annual Total Return Performance of the S&P 500 & 10-Year Treasury Since 1872

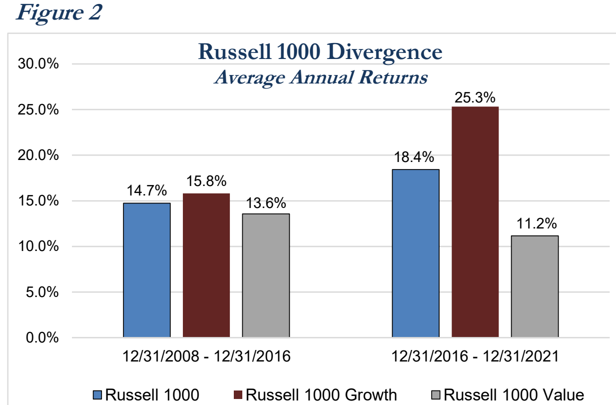


(Source: Deutsche Bank)

Delving deeper, the catalyst behind the headwinds was the sharp and sustained rise in inflation that prompted a dramatic shift in Fed policy. Inflation had been subdued over much of the past four decades as globalization, deregulation, and innovation led to a disinflationary environment which allowed for accommodative monetary policy. That all changed in 2022 as the FOMC increased the fed funds rate by a robust 4.25% over the course of the year and switched from quantitative easing to tapering via liquidating assets to reduce its balance sheet. Underlying these policy changes was a shift in the nature of inflationary pressures. These pressures were initially perceived as "transitory" (resulting from the economy reopening post-COVID and supply constraints) but now appear to stem from structural concerns emanating from geopolitical issues challenging globalization and a shift toward a more fractured, multipolar world.

The protracted length of time and magnitude of the accommodative monetary policies dating back to 2008 provided a strong tailwind that primarily benefited financial assets, specifically domestic equity markets, and fostered speculation which created pockets of excess exuberance. This preceding period should be viewed in context with the losses incurred in 2022. More specifically, from the end of 2008 through 2016, the returns in the domestic markets were broad-based and well above the historical average, which is approximately 10%, with the Russell 1000, Russell 1000 Growth, and Russell 1000 Value indexes generating average annual returns of 14.7%, 15.8%, and 13.6%, respectively. However, a frenzy began to emerge from the end of 2016 through 2021, with the Russell 1000 Index posting an average annual return of 18.4% and a wide divergence developing between growth and value. During this period, the Russell 1000 Growth Index dramatically outperformed the Russell 1000 Value Index at 25.3% versus 11.2%, respectively.

Figure 2



(Sources: Bloomberg, Confluence)

Market Commentary continued...

Figure 3

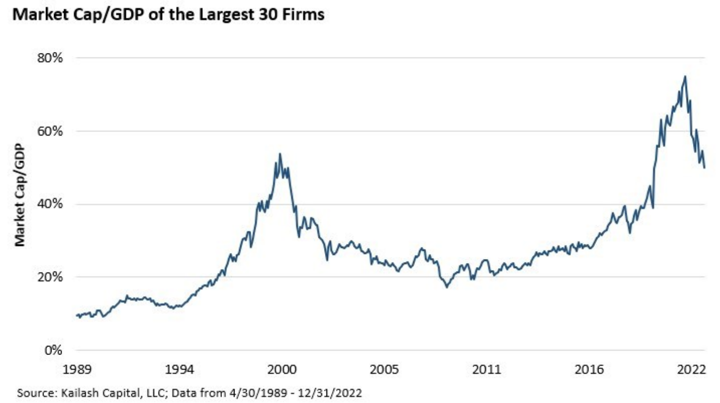


Figure 4

(Source: Kailash Capital)

If readers will recall, the Zero Interest Rate Policy (ZIRP) and Quantitative Easing (QE) policies began in late 2008 and lasted until December 2015 when the first rate increase of 25 bps transpired. The next rate increase did not occur until December 2016, with the Fed signaling additional increases throughout 2017. It was at this point that concerns arose of an economic slowdown or recession, prompting investors to lean toward businesses with higher-growth profiles, which were perceived to be more capable of weathering a slowdown. The rate hikes promptly ended in December 2018 as liquidity concerns surfaced, and the Fed was forced to cut rates from 2.25% to 1.5% in 2019. Of course, this was followed by the events of 2020 which infused mass liquidity (monetary and fiscal) and shifted investor attention to the few businesses that were benefiting from the lockdowns—the same growth-oriented tech names which then rallied through 2021. The Fed's aggressive actions in 2022, raising rates seven times to 4.25%-4.50% by year-end, deflated much of the excess exuberance of the mega-cap tech names as well as other speculative areas, such as the Wall Street Bets/Reddit names, electric vehicles, SPACs, and crypto. This first chart from Kailash Capital (*Figure 3*) reflects the concentration in the largest 30 names by comparing their market caps to GDP over the past 30+ years. The next chart from Kailash (*Figure 4*) demonstrates the speculation that formed in unprofitable businesses in the smaller cap arena.

The curtailment of accommodative monetary policies in 2022 marked the end of the tailwinds for long-duration assets (stocks and bonds), hence, the sharp losses in fixed income and equities, particularly in businesses with cash flow expected in the outer years, i.e., "growth" stocks. The markets also faced geopolitical challenges during the past year as Russia invaded Ukraine, which disrupted commodity markets and drove commodity and materials prices higher. These events led to a market rotation from mega-cap growth toward cyclical value as evidenced by the Russell 1000 Growth posting a loss of 29.1% relative to the Russell 1000 Value's loss of 7.6%. Delving into the sectors, Energy (+65.7%) and Utilities (+1.6%) were the only two sectors to post positive results, while Consumer Discretionary (-37.0%) and Communication Services (-39.9%) were the laggards. The varying sector weightings in the indexes explain the relative performance as the table below from J.P. Morgan Asset Management exhibits (*Figure 5*).

Figure 5 **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	**5.2%**	**2.7%**	**11.7%**	**8.7%**	**9.8%**	**25.7%**	**7.3%**	**2.7%**	**15.8%**	**7.2%**	**3.2%**	**100.0%**
Russell Growth weight	1.7%	1.5%	3.3%	8.1%	14.2%	43.2%	6.8%	1.6%	13.5%	6.1%	0.1%	100.0%
Russell Value weight	8.4%	4.3%	20.1%	10.5%	6.0%	8.3%	7.3%	4.5%	17.4%	7.4%	5.8%	100.0%
Russell 2000 weight	6.8%	4.3%	17.2%	15.6%	10.4%	12.7%	2.6%	6.4%	16.9%	3.6%	3.5%	100.0%
4Q22	22.8	15.0	13.6	19.2	-10.2	4.7	-1.4	3.8	12.8	12.7	8.6	7.6
2022	65.7	-12.3	-10.5	-5.5	-37.0	-28.2	-39.9	-26.1	-2.0	-0.6	1.6	-18.1

(Source: J.P. Morgan Asset Management; Guide to the Markets®, U.S. 1Q 2023, as of December 31, 2022)

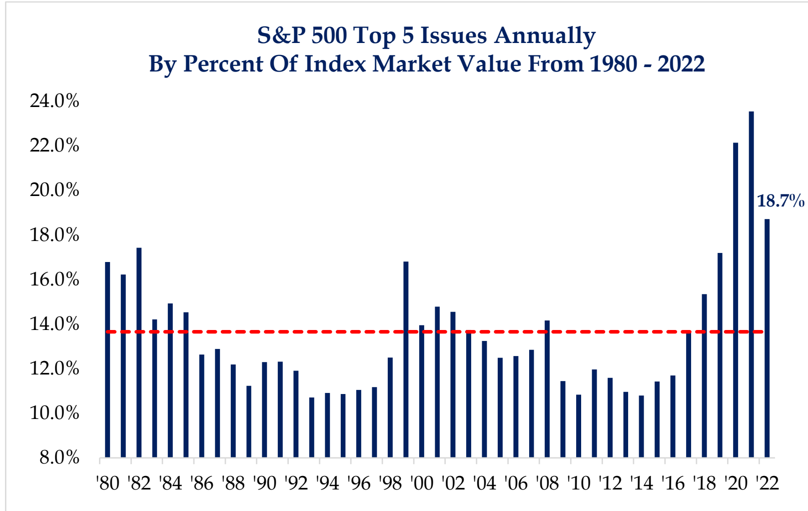
As we move into 2023, there is an elevated probability of a recession sometime this year (see our *Current Perspectives* report, "The 2023 Outlook: A Recession Year") as the Fed remains in tightening mode as policymakers seek to contain inflation and maintain credibility. No one knows the exact level of rates needed to tame inflation or inflation expectations, despite the constant fodder amongst economists, but equity markets have historically been a leading indicator for the economy. The sharp drop in equity markets in 2022 may have already marked the coming recession. More importantly, with monetary policy normalizing, the value of fundamental analysis and investing with a margin of safety will likely regain focus, which should benefit good active management. Meanwhile, the pullback is presenting more attractive valuations for high-quality companies. Of course, we will continue to stay focused on our investment philosophy, which has always been centered on business and valuation analysis.

Strategy Commentary

The equity markets had a Hollywood finish to close out a rather difficult year for investors. For the fourth quarter of 2022, the S&P 500 Index posted a 7.5% gain and the Russell 3000 Value Index posted an even stronger gain of 12.2%. Unfortunately, the strong finish did not overcome the severe weakness of the preceding quarters and the two indexes ended the year in negative territory, with the S&P 500 down 18.1% at year-end and the Russell 3000 Value down 8.0%. Confluence Equity Income also posted a strong fourth quarter gain of 10.3% and was down 7.9% for the year (both gross of fees). [*The strategy's net-of-fees returns for the same periods were 9.5% QTD and -10.6% YTD. See disclosures on last page for fee description; actual investment advisory fees may vary.*]

As discussed in the previous section, the rise in inflation, and the ensuing change in monetary policy to contain it, weighed on financial assets in 2022. The preceding multi-year strength of equities and the undercurrent of geopolitical shifts produced a seismic rotation in leadership within domestic equities. The primary beneficiary was commodities, reflected in the dramatic outperformance of the Energy sector. Meanwhile, the mega-cap growth names, which garnered an abundance of investor flows, began to abate. As the work from Strategas reflects in this chart (*Figure 6*), the top five names in the S&P 500 increased their weighting from low double-digits in 2016 to over 22% in 2021 and retreated to 18.7% in 2022.

Figure 6



(Source: Strategas; 12/31/2022)

Equity Income's objective is to generate an above-average income stream, which can protect purchasing power, while also providing the potential for capital appreciation. The balance between capital appreciation and yield has historically provided ballast in weak markets, which was the case in 2022. Although dividend growth is not Equity Income's primary focus, the strategy has delivered reasonable dividend payments which help protect against inflation (see table below, *Figure 7*).

Figure 7 **Annual Dividend Statistics for Equity Income Portfolio at 12/31** ***(Dividend Growth Using Announcement Date)*** [1]

			Dividend Change from Prior Year**			
			# of companies with			
Year	**Holdings**	**Avg. Yield+**	Increase	Flat	Decrease	Avg. Growth
2009	39	4.2%	25	9	5	-0.5%
2010	35	4.1%	24	10	1	6.3%
2011	34	4.3%	25	6	6	6.9%
2012	36	4.4%	26	7	3	4.5%
2013	34	3.4%	25	9	0	9.3%
2014	33	3.4%	29	4	0	13.0%
2015	34	4.2%	27	7	0	8.4%
2016	33	3.4%	25	6	2	2.2%
2017	33	3.1%	25	6	1	10.1%
2018	34	3.5%	30	4	0	13.9%
2019	34	3.0%	32	2	0	9.4%
2020*	36	3.4%	26	10	0	4.4%
2021	36	2.8%	30	6	0	5.4%
2022	34	3.3%	31	2	1	6.4%
Average-14 yrs		3.6%	27	7	1	7.2%

** '2020' excludes impact of temporary dividend suspensions during the pandemic of 2020. ** 'Dividend Change from Prior Year' excludes impact of special dividends and spin-offs.*
+ 'Avg. Yield' is the average dividend yield of portfolio holdings at 12/31, calculated based on annualized current dividend plus any special dividend paid during the year.

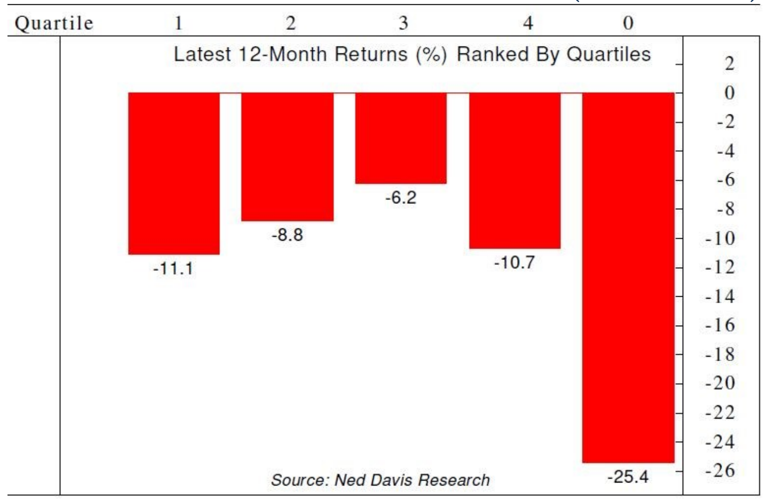
Dividend history for the Equity Income portfolio beginning with the first full year of data following the inception of Confluence Investment Management (strategy inception is 10/1/2000).

Strategy Commentary continued…

Dividend-paying businesses fared much better in 2022 as shorter-duration assets (i.e., bonds or equities with current cash flow streams) helped protect against rising inflation and interest rates by returning cash to owners sooner rather than later.

This chart (*Figure 8*), per Ned Davis Research, highlights the strength of dividend payers to non-payers in 2022. It shows the returns of dividend payers in the S&P 500, ranked by quartile from highest dividend yield (bar 1) to lowest (4), compared to companies that did not pay a dividend, reflected in the fifth bar marked "0" (all S&P 500 stocks with zero dividends).

Figure 8 **S&P 500 Stock Constituents* Ranked by Quartiles (Dividend Yield)**



*Actual Historical Constituents. *Returns through 12/31/2022*

There were only a few portfolio changes during the year as T. Rowe Price Group (TROW) was added early in the fourth quarter using proceeds from the earlier sales of Pfizer (PFE) and 3M Corporation (MMM). TROW is a top-tier asset manager that stands out with a culture, brand, distribution, and investment performance that drives solid organic growth. Given these attributes, the only opportunities to buy TROW come in down markets which precede falling assets under management (AUM) and earnings, as was the case in 2022. While the shares are off substantially, TROW maintains a pristine balance sheet that includes excess cash of $11.00+ per share and trades at attractive valuations. When the bear market turns, we expect TROW will continue to organically grow AUM faster than the industry and stock market returns.

In 2022, the portfolio was led by strength from Progressive (PGR), an insurer; Chevron (CVX), an integrated oil company; and Lockheed Martin (LMT), an aerospace and defense company. The laggards were more sensitive to interest rates and included Digital Reality Trust (DLR), a datacenter REIT; SL Green Realty (SLG), an office REIT with properties in New York City; and Microsoft (MSFT), which pulled back after posting strong gains in past years. [*See contribution data on the next page.*]

Outlook

Looking ahead, after decades of growing globalization which helped subdue inflation, we are now witnessing a trend toward deglobalization and elevated levels of inflation. This has prompted the Fed to aggressively alter monetary policy to a more restrictive stance and give indications of further action. These conditions have naturally generated additional uncertainty around the impact these moves will have on the economy, which has weighed 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. Equity markets are leading indicators, thus with the lows reached in late September the markets may have already discounted the coming recession. But if the past few years have taught us anything, it is the fallacy of prognostication and 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 which, in turn, emphasizes competitively advantaged businesses trading at a discount to our estimate of intrinsic value.

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Contribution[2]

(YTD as of 12/31/2022)

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

Security	Avg Weight (%)	Contribution (%)
Top 5		
Lockheed Martin Corp.	3.50	1.10
Progressive Corp.	4.83	1.04
Chevron Corp.	2.30	0.92
Gilead Sciences Inc.	1.90	0.48
Chubb Ltd.	2.86	0.42
Bottom 5		
Broadridge Financial Solutions Inc.	3.07	(0.87)
Fastenal Co.	3.62	(0.98)
Microsoft Corp.	3.13	(0.99)
Digital Realty Trust Inc.	2.47	(1.31)
SL Green Realty Corp.	2.58	(2.01)

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

Performance Composite Returns[3] (For Periods Ending December 31, 2022)

	Since Inception**	20-Year*	15-Year*	10-Year*	5-Year*	3-Year*	1-Year	YTD	QTD
Equity Income *Pure Gross-of-Fees[4]*	10.3%	10.1%	9.6%	11.1%	7.9%	7.0%	(7.9%)	(7.9%)	10.3%
Max Net-of-Fees[5]	7.1%	6.9%	6.4%	7.8%	4.7%	3.9%	(10.6%)	(10.6%)	9.5%
Russell 3000 Value	7.1%	8.8%	7.0%	10.1%	6.5%	5.8%	(8.0%)	(8.0%)	12.2%
S&P 500	6.5%	9.8%	8.8%	12.6%	9.4%	7.6%	(18.1%)	(18.1%)	7.5%

Calendar Year	Pure Gross-of-Fees[4]	Max Net-of-Fees[5]	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%
2022	(7.9%)	(10.6%)	(8.0%)	(18.1%)	0.2%	7,457	$2,609,193	$6,931,635	19.1%	21.5%	20.9%	0.4%

**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] **Annual Dividend Statistics—***Figure 7:* Dividend growth based on when the increase was announced. Annual dividend income history is available upon request.

[2] **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.

[3] **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.

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

[5] 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.