# FIXED INCOME (TAX-EXEMPT)

FOURTH QUARTER 2023

## OBJECTIVE

Invests in municipal bond Exchange Traded Funds (ETFs), diversified across maturities and a wide variety of municipalities. These ETFs produce income generally exempt from federal income taxes. Strives to deliver the income and lower volatility traditionally available from a diversified municipal bond portfolio.

## INVESTMENT PHILOSOPHY & PROCESS

Fixed Income Tax-Exempt invests in municipal bond ETFs with domestically oriented, investment-grade benchmarks. These ETFs produce income that is generally exempt from federal income taxes. The investment approach incorporates ETFs with a national, not state-specific, posture. It is constructed to have characteristics similar to a traditional, laddered bond portfolio and its benchmark is the ICE BofA U.S. Municipal Securities Index. The Confluence Fixed Income Strategy Committee may adjust the portfolio duration and maturity to be longer, shorter or in line with this benchmark. The investment committee incorporates its viewpoints regarding Fed policy, the shape of the yield curve, relative yields, credit spreads, default rates and other market factors into the portfolio construction process.

The strategy invests in a range of maturity-date ETFs to construct a portfolio similar to a diversified bond ladder, and complements these positions with traditional fixed income ETFs with more "static" maturity profiles, allowing for more precise exposures to maturities and sectors of the bond market. The Fixed Income Strategy Committee continuously monitors the portfolio, rebalancing at least annually, but may elect to rebalance over shorter time frames at its discretion. The investment committee may direct larger allocations to certain ETFs to alter the nature of maturity exposures in a portfolio.

Fixed Income Tax-Exempt is available as a standalone portfolio and may also be available as part of a Balanced account, which allows investors to combine this fixed income strategy with one of the firm's equity strategies in one portfolio.

## OVERVIEW

- Uses high-quality ETFs following investment-grade benchmarks with domestic orientation that provide income exempt from federal income tax
- Similar characteristics to traditional bond ladder or diversified bond index by combining use of maturity-date ETFs with traditional fixed income ETFs
- Allocations incorporate viewpoints on Fed policy, yield curve shape, relative yields, credit spreads, default rates, etc.
- Nationally diversified across maturities and municipalities; not managed on a state-specific basis
- Available as a standalone portfolio or in Confluence Balanced account combined with value equity strategy
- Strategy assets: $3.3 million[1]

*[1] Total strategy assets include assets under management (AUM) and assets under advisement (AUA). As of 12/31/22, AUM = $0.6 million and AUA = $2.7 million.*

## CURRENT PORTFOLIO[2]

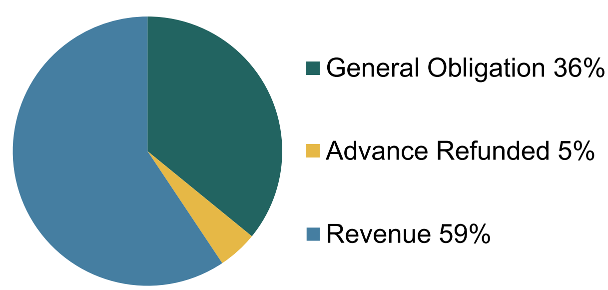
*(As of 10/30/2023 rebalance)*

| CHARACTERISTICS | WEIGHTED AVERAGE |
|---|---|
| SEC Yield | 3.8% |
| Tax-Equivalent SEC Distribution Yield Estimate*<br>**Assumes Federal Income Tax Rate of 35%* | 5.8% |
| Duration | 4.9 |
| Maturity | 10.0 |
| ETF Expense Ratio | 0.19% |

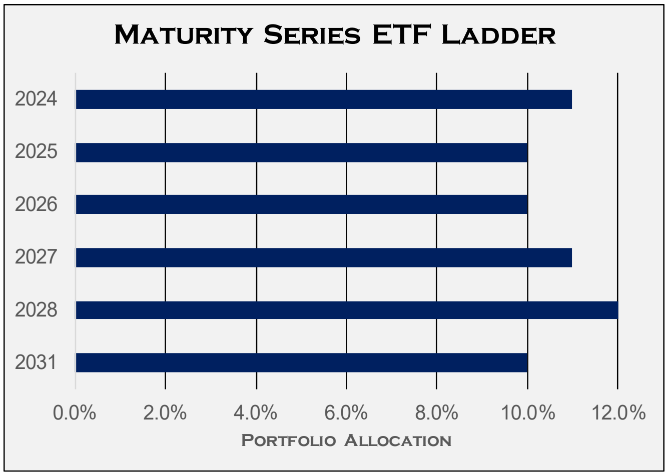
| RATING CATEGORIES | WEIGHT |
|---|---|
| AAA | 19.5% |
| AA | 59.2% |
| A | 19.1% |
| BBB | 2.1% |
| BB or Below | 0.1% |

| 5 LARGEST HOLDINGS | WEIGHT |
|---|---|
| Dimensional National Municipal Bond ETF - DFNM | 20.0% |
| Invesco National AMT-Free Municipal Bond ETF - PZA | 15.0% |
| Invesco BulletShares 2028 Municipal Bond ETF - BSMS | 12.0% |
| Invesco BulletShares 2027 Municipal Bond ETF - BSMR | 11.0% |
| Invesco BulletShares 2024 Municipal Bond ETF - BSMO | 11.0% |

### SECTOR ALLOCATION



## Maturity Series ETF Profile




Fixed Income Tax-Exempt utilizes a portfolio structure similar to that of a "bond ladder," a tactic often used when purchasing individual bonds. With our approach, we instead create a ladder of maturity-series ETFs. These ETFs hold large pools of bonds that mature near to, but always before, a specified end date. Accordingly, with the passage of time, the average maturity of this kind of ETF naturally shortens, thereby replicating some characteristics of an individual bond. It's not exactly the same, particularly because it doesn't mature at a par value. However, the maturity-series ETF has more credit risk diversification, while oftentimes also providing liquidity improvement, relative to an individual bond.

The strategy has ladder "rungs" from end dates ranging between 2023 and 2028. We believe this laddered approach positions investors to participate in a wider range of yields, while also providing a mechanism to help address the risk of rising interest rates. If rates were to rise, the shortest "rung" could be sold, or allowed to reach its end date. The proceeds could then be redeployed into a longer "rung," one with a higher yield.

## October 2023 Market Observations & Recent Portfolio Changes[3]

- The municipal bond market continues to adjust to Fed policy, with higher yields across a wide range of maturities. With inflation declining cyclically, we believe the Fed is at or near the end of its tightening cycle.
- Municipal bond yields mirrored the increases in yields on Treasuries, albeit with larger increases in the shorter and longest maturities.
- After a cyclical decline in inflation, we expect the longer-term trend to move higher than the Fed's preferred 2% level, probably into the 3-4% range. This may limit the Fed's ability to lower rates.
- With the municipal yield curve still inverted and our expectation for higher long-term inflation, we continue to apply a shorter duration. Still, we modestly extended the portfolio's duration this quarter.

The Confluence Fixed Income Tax-Exempt strategy gross return in the third quarter was -2.0%, which was above the benchmark return of -3.8%. On a year-to-date time frame, the Fixed Income Tax-Exempt gross return was -0.3%, which also outperformed the benchmark return of -1.0%. The strategy's return in the third quarter was once again delivered through shorter duration, which helped to protect the portfolio from higher interest rates, which rose across the entire municipal bond yield curve. [*Strategy net-of-fees returns for the same periods were -2.7% QTD and -2.6% YTD. See disclosures on last page for fee description; actual investment advisory fees may vary.*]

At the sector level, general obligation bonds (GOs) underperformed, while revenue bonds outperformed. The portfolio has been significantly underweight in its allocation to GOs. However, given the record amount of federal stimulus over the past three years in the form of the American Rescue Plan Act, the Infrastructure Investment and Jobs Act, and the Inflation Reduction Act, which will pour billions of stimulus to state and local governments, the case for a sizable underweight to GOs is waning.

Broadly speaking, the third quarter was pretty rough for bond investors. After a very difficult 2022, the first half of 2023 provided some helpful stability. However, as the Fed continued to tighten in the third quarter, bond market expectations adapted to a "higher for longer" posture, which put tremendous downward pressure on bonds, especially municipal bonds with longer maturities that are no longer necessarily priced to their earliest call.

Looking forward, inflation is poised for a cyclical decline, allowing the Fed latitude to stop raising short-term rates and perhaps fostering lower bond market volatility. Still, the yield curve remains inverted and we believe the longer-term trend for inflation is higher, probably in the 3-4% range, which would limit the Fed's ability to ease short-term rates and could cause incremental increases in long-term rates.

We continue to believe a shorter duration profile is appropriate, as it captures higher short-term yields, while avoiding longer maturity interest rate risk. However, this quarter we recognize that longer rates have become more attractive and thus we have modestly extended duration by increasing the weight to an ETF with a 10-year duration. Although the portfolio remains underweight GOs, it is a more modest underweight than it has been over the past year. The duration has been raised roughly 0.8 years to 4.9 years, which remains shorter than the benchmark duration of 6.2 years.

**Confluence Fixed Income Strategy Committee**

Mark Keller, CFA | Gregory Ellston | Patrick Fearon-Hernandez, CFA
David Miyazaki, CFA | William O'Grady | Kaisa Stucke, CFA

**For more information contact a member of our sales team:**

Ron Pond, CFA | *West*
Director of Sales
(314) 526-0759
rpond@confluenceim.com

Wayne Knowles | *ID, MT, WY*
Advisory Director
(314) 526-0914
wknowles@confluenceim.com

Jason Gantt | *East*
Sr. Regional Sales Director
(314) 526-0364
jgantt@confluenceim.com

Michael Kelnosky | *North-Central*
Regional Sales Director
(314) 526-0622
mkelnosky@confluenceim.com

Jim Taylor | *Mid-South*
Regional Sales Director
(314) 526-0469
jtaylor@confluenceim.com

Jason Robertson | *FL & SC*
Regional Sales Director
(314) 526-0776
jrobertson@confluenceim.com

*Internal Sales Desk: (314) 530-6729*
Denis O'Grady
dogrady@confluenceim.com

Matt Winter
mwinter@confluenceim.com

Colin Kalish
ckalish@confluenceim.com

## Performance Composite Returns[4] (For Periods Ending September 30, 2023)

| | Since Inception** | 10-Year* | 5-Year* | 3-Year* | 1-Year | YTD | QTD |
|---|---|---|---|---|---|---|---|
| **Fixed Income Tax-Exempt** *Pure Gross-of-Fees[5]* | 1.0% | 1.0% | 0.3% | (3.0%) | 2.6% | (0.3%) | (2.0%) |
| *Max Net-of-Fees[6]* | (2.0%) | (2.0%) | (2.7%) | (5.9%) | (0.5%) | (2.6%) | (2.7%) |
| **Benchmark (BofA/Muni)** | 2.6% | 2.4% | 1.1% | (2.2%) | 2.9% | (1.0%) | (3.8%) |

| Calendar Year | Pure Gross-of-Fees[5] | Max Net-of-Fees[6] | Benchmark (BofA/Muni) | Difference (Gross-Benchmark) | # of Portfolios | Composite Assets (000s) | Total Firm Assets (000s) | Composite 3yr Std Dev | Benchmark 3yr Std Dev | Composite Dispersion |
|---|---|---|---|---|---|---|---|---|---|---|
| 2010** | (3.4%) | (4.1%) | (4.5%) | 1.1% | 1 | $48 | $751,909 | N/A | N/A | N/A |
| 2011 | 6.5% | 3.3% | 11.2% | (4.7%) | 1 | $51 | $937,487 | N/A | N/A | N/A |
| 2012 | 2.0% | (1.0%) | 7.3% | (5.3%) | 1 | $52 | $1,272,265 | N/A | N/A | N/A |
| 2013 | (1.1%) | (4.1%) | (2.9%) | 1.7% | 1 | $52 | $1,955,915 | 2.4% | 4.4% | N/A |
| 2014 | 4.0% | 0.9% | 9.8% | (5.8%) | 3 | $600 | $2,589,024 | 2.2% | 4.1% | N/A |
| 2015 | 1.9% | (1.2%) | 3.6% | (1.7%) | 4 | $2,678 | $3,175,419 | 2.1% | 3.7% | 0.0% |
| 2016 | (0.8%) | (3.8%) | 0.4% | (1.3%) | 5 | $2,983 | $4,413,659 | 3.3% | 3.4% | 0.1% |
| 2017 | 4.1% | 1.0% | 5.4% | (1.3%) | 5 | $3,073 | $5,944,479 | 3.4% | 3.2% | 0.0% |
| 2018 | 0.8% | (2.2%) | 1.0% | (0.2%) | 4 | $2,961 | $5,486,737 | 3.5% | 3.3% | 0.0% |
| 2019 | 5.5% | 2.4% | 7.7% | (2.2%) | 3 | $2,931 | $7,044,708 | 2.2% | 2.4% | 0.0% |
| 2020 | 5.4% | 2.3% | 5.3% | 0.2% | 3 | $3,210 | $6,889,798 | 3.9% | 4.1% | 0.0% |
| 2021 | 0.8% | (2.2%) | 1.8% | (1.0%) | 3 | $3,274 | $7,761,687 | 4.0% | 4.0% | 0.0% |
| 2022 | (10.6%) | (13.2%) | (9.0%) | (1.5%) | 2 | $513 | $6,931,635 | 6.3% | 6.6% | 0.0% |

**Average annualized returns*
***Inception is 10/1/2010*

**Portfolio Benchmark:**
***BofA/Muni*** – ICE BofA U.S. Municipal Securities Index (Domestic Master) *(Source: Bloomberg)*

## Disclosures

[2] **Current Portfolio—**Sector allocations shown represent the model portfolio as of 10/30/23 and do not represent the precise allocation in an actual client account. Allocations in client accounts may vary based on individual client considerations and market fluctuations. Investments 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. Individual client portfolios may differ, sometimes significantly, from these listings. Yield data source: Morningstar; 30-day SEC yield of the model portfolio as of 10/30/23. Duration and maturity figures shown are based on all holdings in the model portfolio as of the rebalance date. ETF expense ratio is in addition to Confluence management fees. Rating categories reflect S&P ratings; source: Morningstar.

[3] **Market Observations & Recent Portfolio Changes—**The investment or strategy discussed may not be suitable for all investors. Investors must make their own decisions based on their specific investment objectives and financial circumstances. Opinions expressed are current as of the date shown and are subject to change.

[4] **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, 2022. 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 Fixed Income Tax-Exempt strategy was incepted on October 1, 2010, and the current Fixed Income Tax-Exempt Composite was created on May 1, 2014. 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.

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

[6] Net-of-fee performance was calculated using the highest applicable annual bundled fee of 3.00% applied quarterly. This fee includes brokerage commissions, portfolio management, consulting services and custodial services. The Confluence fee schedule for this composite is as follows: 0.40% on the first $500,000; 0.35% on the next $500,000; and 0.30% 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. Subsequent to May 1, 2014, 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.

Performance prior to May 1, 2014, is based on the Fixed Income Tax-Exempt–Direct Composite which was created on October 1, 2010. The Fixed Income Tax-Exempt–Direct Composite includes accounts that pursue the Fixed Income Tax-Exempt strategy, but do not have bundled fees. Gross returns from the Fixed Income Tax-Exempt-Direct Composite include transaction costs and net-of-fee performance was calculated using the highest applicable annual bundled fee of 3.00% applied quarterly. 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 Fixed Income Tax-Exempt Composite contains fully discretionary Fixed Income Tax-Exempt wrap accounts. The Fixed Income Tax-Exempt portfolio utilizes bond ETFs to earn tax-exempt income.

**Results shown for the year 2010 represent partial period performance from October 1, 2010, through December 31, 2010. 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.