Confluence INVESTMENT MANAGEMENT

SECOND QUARTER
2023

International Growth • International Equity Strategies

International Growth invests primarily in large cap, growth-oriented companies in both developed and emerging markets. The strategy's management team employs both top-down and bottom-up fundamental analysis to identify attractive countries and economic sectors as well as high-quality companies worthy of a long-term investment allocation. The portfolio's primary objective is long-term capital appreciation. The maximum direct exposure to emerging markets is 25% of the portfolio's total value.

Market Commentary: Mid-Year Update

During the past three months, the MSCI World ex-U.S. Index recorded a gain of 3.0%, an above-average return for the April-June measurement period. Dating back to 1999, the average return for the MSCI World ex-U.S. Index during the second quarter is 1.9%. Furthermore, the index was up 11.3% year-to-date, which is well above the January-June average of 1.6% dating back to 1999. These are impressive gains set against a deteriorating global macroeconomic backdrop, a geopolitical environment creating an increase of unusual risks, and tightening monetary policy, all indicating that the cost of capital will remain higher for longer than many had originally predicted. Moreover, the returns for the first half of 2023 are notable given that economic growth, as measured by GDP, has decreased significantly over the course of the past year and has registered only a fraction of the growth rates reached during the post-COVID re-opening of the global economy. However, the downshift in economic advancement has not (yet) manifested itself in the form of higher unemployment in most of the developed world. The rate of unemployment within Canada, Europe, and Japan has remained steady and low during the past year, with wages rising over the period.

While the near-to-medium-term economic backdrop for global stocks remains mixed, there has not been a significant downgrade of the fundamentals that support international equities. According to Bloomberg estimates, earnings-per-share (EPS) growth for the MSCI World ex-U.S. is forecast to reach $158.04 for the full year 2023, an 8.1% increase from last year's index level EPS. For comparison, current Bloomberg year-end 2023 EPS estimates for the S&P 500 Index are $220.18, a 1.4% decrease from 2022. At the end of June, the dividend yield of the MSCI World ex-U.S. stood at 3.3%, which remains twice that of the S&P 500. The mid-year P/E ratio for the MSCI World ex-U.S. is 15.4, a 15% discount to the index's trailing 10-year average P/E ratio compared to the P/E ratio of the S&P 500 at 21.3, which is slightly above the trailing 10-year average for that index. Therefore, a case could be made that should the global economy enter a recession in the back half of 2023 or early 2024, more "bad" news is currently being priced into foreign developed market stocks than their domestic counterparts, based on valuation.

Building on that last point, Confluence's macroeconomic team continues to predict a mild recession will likely occur in the next few quarters based on declining measures of manufacturing data, waning consumer confidence, and slowing velocity of money mixed with restrictive monetary policy. While these preconditions to a recession may not create a macroeconomic backdrop favorable to risk assets, international equities have historically exhibited qualities that protect wealth in down market cycles. Last year, BlackRock released a study using 10-year rolling periods between 1971 and 2021 that showed when returns were less than 4% in the U.S., international equities outperformed 100% of the time (45/45 instances) by an average of 2.4%. Additionally, when returns within the domestic market were less than 6%, international stocks outperformed by an average of 2% in 94% of the measurement periods (60/64 instances). One of the most significant reasons for the stronger relative performance of international equities during economic slowdowns or downturns is a result of the differences in construction between the S&P 500 and foreign developed market benchmarks. Put simply, foreign markets have more exposure to short-duration, profitable companies than the domestic market. The MSCI World ex-U.S. Index has 20% less allocation to the Information Technology sector than the S&P 500 but provides at least 30% greater exposure to Industrials, Financials, and Materials. While these three industry sectors tend to grow more slowly than technology, they also typically generate more stable earnings and pay larger dividends that have been historically beneficial to investors in weak global growth environments.

While we have often discussed benchmark construction as a notable differentiator between foreign developed and domestic equity benchmarks, we were recently asked to quantify the impact that the much larger allocation to technology has made on the relative performance differential between the S&P 500 and the MSCI World ex-U.S. during the most recent and historically extended period of U.S. dollar (USD) strength. The question is especially relevant considering the fervent attention that global investors are currently paying to companies involved with artificial intelligence (AI). For example, shares of Nvidia (NVDA), a U.S.-based designer and builder of world-class graphics processors and related software, have risen nearly 200% on a year-to-date basis (as of this writing).

Market Commentary continued...

At the end of March, the international developed markets had outperformed the S&P 500 on a one-year trailing basis by more than 5.5%. However, the recent surge in tech driven by AI has nullified the relative performance advantage that foreign stocks have enjoyed during the past year. So, a renewed and sustained upward move for technology will present a headwind to international equities for which investors should be prepared. But, to what degree? Well, even if the foreign developed market Info Tech sector stocks performed in line with their domestic counterparts, the S&P 500 would still generate more alpha given the much higher allocation within the benchmark. Additionally, from May 31, 2011, through December 31, 2022, the S&P 500 Information Technology sector recorded an annualized performance return of 16.8% versus 6.8% for the MSCI World ex-U.S. IT sector. Stated another way, while foreign developed technology stocks performed very well during the strong USD period, domestic tech did much better. Conversely, investors should also be aware of the impact that tech can have on relative returns should the sector succumb to rotational risk and/or experience negative effects from a global recession. Year-to-date, the S&P 500 has recorded a gain of 16.9%. However, the S&P 500 ex-Information Technology Index has gained roughly half of that amount (8.5%). Hence, a change in macroeconomic conditions, geopolitics, monetary policy, or investor preference could cause market leadership to transition during the next several quarters. If so, an acute understanding of how stock markets worldwide are constructed in terms of sectors will become a significant component of positioning portfolios to reduce risk and benefit from stable earnings.

Worth noting: Confluence Staff Economist Thomas Wash recently penned a *Bi-Weekly Geopolitical Report* that provides a broad understanding of how AI works and lays the groundwork for how this new technology could change how we invest in the future.

Quarterly Trade Summary

In mid-June, we purchased United Kingdom-based Haleon and sold Infosys. Haleon, established in the summer of 2022, is a multinational consumer healthcare company that most clients may not realize they are already familiar with. Although officially classified by MSCI as a Consumer Staples company, it was created following the merger of consumer healthcare businesses GlaxoSmithKline and Pfizer. Haleon operates with five divisions, including Oral Health (27%), Pain Relief (24%), Digestive Health (19%), Vitamins, Minerals and Supplements (15%), and Respiratory Health (15%). Some of Haleon's largest brands include Sensodyne, Advil, Tums, Centrum, and Theraflu/Flonase. Today, it operates in more than 170 countries and is the market leader in most consumer categories it serves. It should be a significant beneficiary of the growing global demand for over-the-counter treatment options for minor ailments. We expect Haleon's dividend yield to exceed an annualized level of 2.5% as company management has stated their desire to return 30% of adjusted earnings to shareholders. During the past year, the company has generated more than 1.6 billion GBP of free cash flow to be used to pay dividends, grow the business, and de-lever.

The Haleon purchase was funded by proceeds from the sale of Infosys, originally purchased in January 2021. In April, Infosys delivered financial results that were below consensus in terms of revenue, operating profit, and EPS. Additionally, the near-to-medium term sales expectations have weakened for the company as a result of the global slowdown in spending and deal delays/cancellations. The sale of Infosys decreased the direct emerging market allocation within the International Growth strategy to 7.5%.

Performance Review

For the second quarter of 2023, the MSCI World ex-U.S. Index gained 3.0%, while the Confluence International Growth strategy was up 3.8% (gross of fees). Year-to-date, International Growth returned 11.9% (gross of fees) versus the benchmark at 11.3%. *[The strategy's net-of-fees returns for the same periods were 3.0% QTD and 10.2% YTD. See disclosures on last page for fee description; actual investment advisory fees may vary.]*

During the quarter, both the MSCI World ex-U.S. Growth Index (+3.0%) and the MSCI EAFE Quality Index (+1.6%) were outpaced by the MSCI World ex-U.S. Value Index (+3.1%). However, on a one-year trailing basis, both the MSCI EAFE Quality (+19.7%) and MSCI World ex-U.S. Growth (+19.4%) have outperformed the stocks within the MSCI World ex-U.S. Value Index (+15.5%). Nevertheless, on a three-year trailing basis, the MSCI World ex-U.S. Value Index (+12.1%) maintains a performance advantage over the MSCI World ex-U.S. Growth (+6.2%) and MSCI EAFE Quality (+8.3%).

A headwind for the portfolio relative to the index during the past quarter was the underweight allocation to Japan. MSCI Japan recorded a quarterly return (+6.4%) of more than double the MSCI World ex-U.S. return. This level of outperformance, combined with the fact that the weight of Japan within the benchmark is more than 20% versus our allocation of just 8.2%, created a relative performance hurdle for our strategy. Yet, the large portfolio overweight allocation to Ireland, a country that outperformed the MSCI World ex-U.S. Index, helped offset our Japanese positioning.

In the second quarter, the two best-performing countries within our portfolio, on an absolute basis, were the Netherlands (+16.8%) and Australia (+10.3%), while India (-9.1%) and Singapore (-3.0%) recorded the two worst returns. From a sector standpoint, Communication Services (+18.1%) and Information Technology (+6.8%) were the strongest sectors during the quarter, and Consumer Discretionary (-0.3%) and Materials (+0.3%) were the weakest.

Performance Review continued...

From a relative standpoint, the most accretive country allocation was the overweight to Ireland (+51 bps), followed by the overweight to Denmark (+39 bps). An underweight allocation to Japan detracted 67 bps from performance, while an underweight to the United Kingdom subtracted 41 bps. From a sector perspective, our underweight allocation to Communication Services added 66 bps of relative performance, followed by the underweight allocation to Health Care (+42 bps). On the downside, the underweight allocation to Consumer Discretionary detracted 66 bps, and the underweight allocation to Industrials detracted 34 bps.

The top contributors and detractors for the portfolio in 2023 are shown in the accompanying table.[1]

Security	Avg Weight (%)	Contribution (%)
Top 5		
LVMH Moët Hennessy Louis Vuitton	5.52	1.52
DSV A.S.	4.19	1.24
POSCO Holdings Inc.	2.95	0.97
L'Oréal S.A.	3.10	0.90
Taiwan Semiconductor Manufacturing Co.	2.76	0.90
Bottom 5		
TotalEnergies S.E.	2.74	(0.17)
Rio Tinto plc	2.52	(0.19)
CNH Industrial N.V.	2.45	(0.22)
Infosys Ltd.	*Sold*	(0.33)
Chubb Ltd.	2.39	(0.33)

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

What We Are Watching

In a recent *Confluence of Ideas* podcast episode, Confluence Chief Market Strategist Bill O'Grady described the current global risk environment as a "fat tails world," where "risks are not normally distributed." In other words, the chances of unusual risks are elevated. As such, part of our responsibility as stewards of our clients' capital is to apply our combined experience, skills, and knowledge to navigate the challenges that the global market can present. In the specific case of our international strategies, the formal and full-time incorporation of top-down macroeconomic and geopolitical analysis within our investment process provides another lens of perspective to discern today's investing environment. Before we dive more deeply into the subject matters that we are most closely monitoring, a report issued that discusses the positioning of equities within hedge funds warrants mentioning. The report cites brokerage data from Goldman Sachs (GS, $320.88) that shows hedge funds currently have their lowest exposure to the U.S. stock market since records began in 2013, while their allocation to European stocks is at a record high. The positioning is based partially on concerns relating to the high valuations of U.S. technology.

A significant risk that has overshadowed global equity markets for the past 18 months has been the war in Ukraine. Russian President Putin, in addition to the events unfolding on the battlefield, has experienced an attempted coup by Yevgeny Prigozhin and his Wagner Group mercenaries. Not only has this led to questions surrounding Putin's control inside Russia, but Russian Foreign Minister Sergei Lavrov, Dmitry Medvedev, the former Russian president and deputy chairman of the Security Council of Russia, among others, continue to threaten the world with the use of nuclear weapons if certain events (delivery of F-16 fighter jets to Ukraine, as an example) were to occur. World leaders, including President Biden and Chinese President Xi, have warned Moscow not to use these weapons, but that has not stopped the Russians from continuing their threats. The renewal of the Black Sea Grain Initiative is also an important hurdle to clear as failure to renew could reignite food inflation in many developing economies.

The release of the June Consumer Price Index (CPI) data in the U.S. revealed that inflationary pressures continue to show signs of abatement, a result of the implementation of more restrictive monetary policy. Chinese export growth also recorded a larger-than-expected decline (-12.4%) in June, thus providing yet another indication that global demand for goods is softening and creating more inflation relief. The slowdown in domestic inflation has investors conjecturing that the Federal Reserve may be nearing an end to its interest rate hiking cycle. This would then likely shift investor attention to the world's other central banks as investors are expecting central banks in advanced economies to take a more hawkish stance in the coming months. The Bank of Canada raised interest rates to their highest level in 22 years on July 12, 2023, while the European Central Bank and the Bank of England are both considering additional rate hikes. There is also speculation that the Bank of Japan will end its yield curve control program later this year. The expectation of a possible narrowing interest differential between the U.S. and other advanced economies led to a broad decline in the U.S. dollar, with the U.S. Dollar Index falling to its lowest level since April 2022 following the release of the June CPI report. Other factors that are also beginning to have an impact on the relative strength of the USD versus the world's other major currencies include the significant decrease in U.S. Treasuries held by Japan and China, as well as the slow and continuous decline in the use of the USD to settle global trade. U.S. Treasury data shows that Japan now holds roughly $1.1 trillion in U.S. Treasuries, a decrease of 15% since the beginning of 2021. China's U.S. Treasury holdings have declined by 21% to only $869 billion during this same time frame. The IMF also estimates that the USD share of Global Foreign Exchange Reserves has fallen from 73% to 59% over the past 22 years. Furthermore, efforts are being made by China, Russia, Brazil, Saudi Arabia, and many other sovereign nations to settle trade in currencies besides the USD.

Another important development that has transpired during the past several weeks has been the re-opening of official face-to-face visits between Chinese and U.S. authorities. U.S. Secretary of State Anthony Blinken met with his Chinese counterpart Wang Yi to steady relations between the two countries. Treasury Secretary Janet Yellen also held talks in China with her counterparts in early July in another effort to stabilize relations between the two superpowers. These meetings are a welcome precursor to a possible meeting this fall between President Biden and Chinese President Xi.

Portfolio Characteristics[2] (as of 6/30/2023)

10 Largest Holdings	Weight
LVMH Moët Hennessy Louis Vuitton	3.8%
DSV A.S.	3.7%
CyberArk Software Ltd.	3.4%
L'Oréal S.A.	3.3%
Novo Nordisk A.S.	3.2%
POSCO Holdings Inc.	3.2%
ICON plc	3.2%
Taiwan Semiconductor Manufacturing	3.1%
Waste Connections Inc.	3.1%
Accenture plc	3.1%

Sector Allocation	Weight
Consumer Discretionary	8.0%
Consumer Staples	12.9%
Energy	7.6%
Financials	18.6%
Health Care	10.0%
Industrials	15.1%
Information Technology	13.1%
Materials	10.4%
Communication Services	2.0%
Cash	2.3%

10 Largest Countries	Weight
Canada	13.1%
United Kingdom	12.4%
France	11.8%
Switzerland	10.9%
Ireland	10.7%
Japan	8.2%
Denmark	7.0%
Singapore	4.6%
Israel	3.4%
South Korea	3.2%

Performance Composite Returns[3] (For Periods Ending June 30, 2023)

	Since 10/1/99	20-year*	15-year*	10-year*	5-year*	3-year*	1-year	YTD	QTD
International Growth *Pure Gross-of-Fees[4]*	6.3%	8.9%	4.6%	6.8%	7.7%	9.4%	20.1%	11.9%	3.8%
Max Net-of-Fees[5]	3.2%	5.6%	1.5%	3.7%	4.5%	6.1%	16.5%	10.2%	3.0%
MSCI World ex-U.S. (Net)	4.2%	6.6%	3.3%	5.4%	4.6%	9.3%	17.4%	11.3%	3.0%

Calendar Year	Pure Gross-of-Fees[4]	Max Net-of-Fees[5]	MSCI World ex-US	Difference (Gross-MSCI World ex-US)	# of Portfolios	Composite Assets (000s)	Total Firm Assets (000s)	Composite 3yr Std Dev	MSCI World ex-US 3yr Std Dev	Composite Dispersion
1999**	26.6%	25.6%	17.4%	9.2%	131	$48,987	-	N/A	N/A	N/A
2000	(15.0%)	(17.6%)	(13.4%)	(1.7%)	58	$15,193	-	N/A	N/A	3.0%
2001	(18.1%)	(20.5%)	(21.4%)	3.3%	42	$7,128	-	N/A	N/A	1.1%
2002	(17.9%)	(20.4%)	(15.8%)	(2.1%)	32	$4,654	-	17.1%	16.1%	0.7%
2003	40.2%	36.1%	39.4%	0.8%	26	$4,642	-	18.1%	17.7%	0.9%
2004	18.7%	15.2%	20.4%	(1.6%)	25	$5,004	-	15.4%	15.3%	1.1%
2005	18.2%	14.7%	14.5%	3.8%	25	$6,651	-	12.1%	11.3%	0.5%
2006	29.5%	25.6%	25.7%	3.8%	35	$11,866	-	11.6%	9.5%	1.1%
2007	23.4%	19.7%	12.4%	10.9%	49	$16,292	-	12.5%	9.7%	2.9%
2008	(37.8%)	(39.6%)	(43.6%)	5.8%	76	$14,221	-	20.7%	19.5%	1.5%
2009	31.8%	27.9%	33.7%	(1.8%)	114	$28,437	-	23.0%	23.9%	2.1%
2010	13.2%	9.9%	8.9%	4.3%	168	$60,558	-	24.3%	26.3%	1.3%
2011	(11.4%)	(14.1%)	(12.2%)	0.8%	253	$80,988	-	20.1%	22.3%	0.6%
2012	16.1%	12.7%	16.4%	(0.3%)	254	$94,222	-	17.6%	19.0%	0.6%
2013	19.1%	15.6%	21.0%	(1.9%)	291	$113,801	-	14.4%	16.0%	0.6%
2014	(1.7%)	(4.6%)	(4.3%)	2.6%	177	$88,982	-	11.4%	12.7%	0.7%
2015	(2.1%)	(5.0%)	(3.0%)	0.9%	191	$81,898	-	11.5%	12.3%	0.4%
2016	(5.1%)	(7.9%)	2.7%	(7.8%)	113	$39,444	-	12.0%	12.3%	0.7%
2017	25.2%	21.4%	24.2%	1.0%	62	$28,303	-	11.1%	11.7%	0.8%
2018	(13.5%)	(16.1%)	(14.1%)	0.6%	30	$15,707	$5,486,737	11.7%	11.1%	0.2%
2019	30.1%	26.3%	22.5%	7.6%	24	$14,419	$7,044,708	12.5%	10.8%	0.3%
2020	20.6%	17.1%	7.6%	13.1%	25	$15,512	$6,889,798	18.0%	18.1%	0.4%
2021	14.3%	10.9%	12.6%	1.7%	24	$16,158	$7,761,687	16.7%	17.2%	0.9%
2022	(16.5%)	(19.0%)	(14.3%)	(2.2%)	24	$16,094	$6,931,635	20.7%	20.1%	0.8%

*Average annualized returns **Since 10/1/1999 *See performance disclosures on last page.*

Portfolio Benchmarks

MSCI World ex-U.S. (Net) Index – Free float-adjusted market capitalization index designed to measure developed market equity performance, excluding the U.S. Performance results presented net of estimated foreign withholding taxes on dividends, interest and capital gains. *(Source: Bloomberg)*

(Prior to March 31, 2020, the S&P/BNY ADR Index was shown as a secondary benchmark. This index was removed to simplify the presentation, being less widely recognized and relevant than the primary benchmark. recognized and relevant than the primary benchmark.)

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Indices: The MSCI World ex-U.S. Index is shown as additional information. This index is unmanaged. An investor cannot invest directly in an index. It is shown for illustrative purposes only & does 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 (net), based on each holding's contribution to the sample account for the period stated. Individual client portfolios in the strategy may differ, sometimes significantly, from these listings.

[2] **Portfolio Characteristics—**Listings of countries and holdings do not represent all of the countries/stocks currently or previously owned in the portfolio or which Confluence may be currently recommending. Sector/country weightings and holdings of individual client portfolios in the program may differ, sometimes significantly, from these listings.

[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 International Growth Strategy was incepted on October 1, 1997, and the current International Growth Composite was created on May 1, 2018. Performance presented prior to May 1, 2018, occurred while the Portfolio Management Team was affiliated with a prior firm and was independently verified for the periods of 10/1/1999 through 12/31/2017. The Portfolio Management Team members were the primary individuals responsible for selecting securities to buy and sell. Composite performance is typically net of foreign withholding taxes on dividends, interest income and capital gains with some exceptions based on custodian treatment. 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. 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. Prior to year-end 2018, the annual composite dispersion was an asset-weighted standard deviation calculated for 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 International Growth Composite contains fully discretionary International Growth wrap accounts. The International Growth portfolio invests in U.S.-listed shares of large capitalization, growth-oriented, non-U.S. companies from developed markets with up to 25% from emerging markets.

**Results shown for the year 1999 represent partial period performance from October 1, 1999, through December 31, 1999. 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.