Confluence INVESTMENT MANAGEMENT

SECOND QUARTER 2021

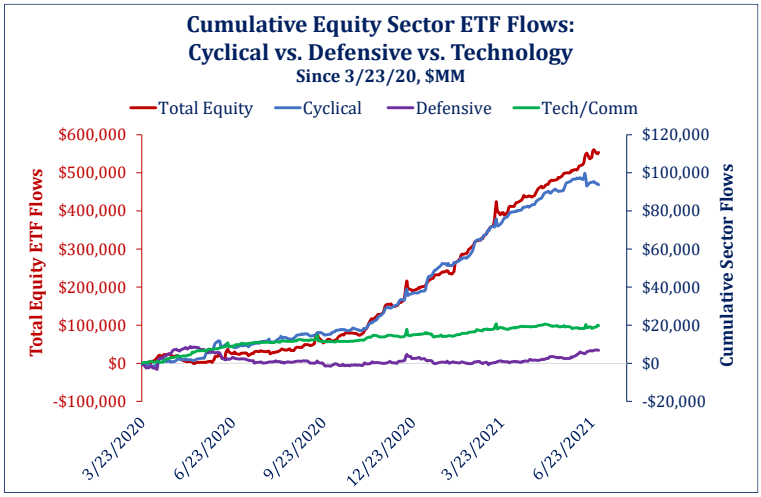
Small Cap Value • Value Equity Strategies

Small Cap Value is focused on companies that generally have capitalizations below $2 billion. These companies are selected using a bottom-up, fundamental research process that seeks to identify individual businesses that possess competitive advantages and that are trading at substantial discounts to our estimates of intrinsic value. The portfolio typically comprises 30-35 holdings and is expected to result in low to moderate turnover. The strategy is appropriate for clients whose primary objective is capital appreciation.

Market Commentary

Small caps posted their fifth consecutive quarterly gain following the sharp sell-off in Q1 2020 with the Russell 2000 and Russell 2000 Value Indexes up 4.3% and 4.6%, respectively, in Q2. The economic recovery has clearly been beneficial to equity investors as the massive monetary and fiscal policies and the gradual reopening of businesses dramatically improved investor sentiment. The U.S. reopening is further ahead than Europe, which has also aided small businesses as they are more dependent on domestic revenue. This has resulted in year-to-date index returns of 17.5% for the Russell 2000 and 26.7% for the Russell 2000 Value.

While we expect the economic recovery to ultimately transition into an expansionary stage, we would anticipate a few bumps along the way as reopening a $20+ trillion economy is not a simple task. Thus far, there have been some supply chain disruptions and tightness in freight/transportation as well as difficulty finding employees, which are causing shortages and price spikes in certain segments of the economy. These issues have led to headline price inflation levels above the Federal Reserve's target and introduced concerns of whether the issues are transitory or structural. It has also sparked some dissention at the Fed as a couple Fed governors have spoken off script, mentioning the possibility of tightening monetary policy sooner than the Fed chair has espoused. These events have led to added volatility over the past few months as witnessed by the sharp rotations in and out of the cyclical/lower-quality areas of the market and into higher-quality segments.



(Source: Strategas)

The preceding chart is a shorter-term look at the March 2020 lows to June 2021, reflecting the sharp rotation of ETF flows into the cyclical segments relative to Defensives and Tech & Communications, which started in late summer 2020 and lasted through May 2021. It also reflects the reversal in June as investors grapple with inflation expectations and the Federal Reserve's response.

(Source: Bloomberg, Morgan Stanley Research)

Of course, economic cycles have always impacted businesses and resulted in investor rotation based on their near-term prospects. As the chart above illustrates, investors tend to rotate into the higher-quality segments leading into recessions as their stable cash flows and growth prospects offer some ballast relative to the more cyclical/lower-quality segments which have more volatile cash flow streams and often more leverage. However, once an end to the recession is anticipated, the cyclical and leveraged businesses provide better prospects for cash flow growth, hence a rotation back to the cyclical/ lower-quality segments often occurs. The trends are also reflected in the "Value" versus "Growth" styles as Value has a much heavier weighting in the cyclical sectors compared to Growth's weighting in Information Technology and Health Care. The chart above depicts the past two cycles' rotations between high and low quality. These trends are often amplified for small capitalization businesses relative to their large capitalization brethren as smaller businesses have less liquidity and financial flexibility.

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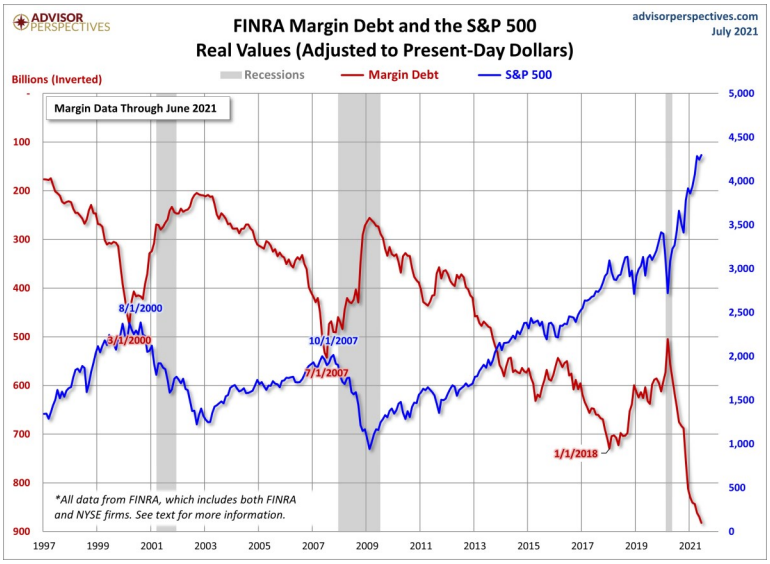
Market Commentary continued...

As mentioned last quarter, while the current cycle is typical, the excess liquidity appears to be inducing pockets of excess exuberance that is exacerbated using margin debt (see margin debt chart below from *Advisor Perspectives*).



(Source: Advisor Perspectives)

This is best illustrated by the Reddit/WallStreetBets (WSB) trading frenzy that focused on GameStop (GME) and AMC Entertainment (AMC), which pushed shares up over 2,500% and 1,000% in the first six months of 2021! This helped lift other brick-and-mortars and struggling subpar businesses, many of which were components of the Russell 2000 indexes, with GME and AMC as top components. The unintended consequence is that many index investors may unknowingly own these meme stocks as well as others. Research firm Strategas produced the following chart that reflects, at its peak, that 40% of businesses in the Russell 3000 were not generating earnings, the highest level compared to the past few recessions.

(Source: Strategas)

Strategy Commentary

Confluence Small Cap Value posted a positive second quarter, up 3.4% (gross of fees). Year-to-date, the strategy also performed well, posting a 12.7% return (gross of fees). The start to the year would typically be deemed positive, but this is an atypical period and underscores our investment philosophy which focuses on quality companies that generate free cash flow and trade at attractive valuations. [*Net-of-fees returns for the same periods were +2.7% QTD and +11.0% YTD. See disclosures on p.4 for fee description; actual investment advisory fees may vary.*]

There were a couple changes during the quarter as we purchased Core Laboratories (CLB) and American Outdoor Brands (AOUT) with proceeds from the sales of Resources Global Professionals (RGP) and Avanos Medical (AVNS).

Core Laboratories is a market-leading energy services company providing critical reservoir description services in testing rock and fluids from oil and natural gas wells for national oil companies (NOCs) and multinational exploration & production companies (E&Ps). The company has an extensive and unparalleled lab network, placing science and geology experts in regions all over the world to study hydrocarbon deposits and become experts on a particular field. With this market-leading position and field expertise, Core Labs enjoys network effects with a vast proprietary and growing library of field geology and well flow information. The company aggregates well data and uses this information to learn more about a basin to hone its knowledge to provide greater reservoir insights for its customers. This virtuous circle strengthens its competitive advantage. The company's stable reservoir description business has a distinct competitive advantage with its highly skilled workforce and is furthered by its growing and extensive well data library. Unlike much of the energy industry, Core Labs has an asset-light business model with less than 4% of sales being spent annually on capital expenditures. Despite the energy downturn, the company has consistently generated free cash flow and has an attractive valuation with limited downside risk.

American Outdoor Brands is a recent spin-off from Smith & Wesson Brands (SWBI) and consists of the non-firearms business. It offers outdoor products and accessories for rugged outdoor enthusiasts. The business is currently an industry-leading provider of shooting, reloading, gunsmithing, and gun cleaning supplies, specialty tools and cutlery, fishing accessories, survival products, and electro-optics products. AOUT was an underappreciated business within a larger company that serves the large-scale recreational market with leading brands in niche areas. It was spun-out debt free and generates solid free cash flow, which provides added flexibility for management to generate shareholder value.

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Strategy Commentary continued...

For the quarter, the portfolio performed inline with the respective indexes but had a wide dispersion of returns across holdings with Core Laboratories up 42% and Cannae (CNNE) down 14%. Core Labs was a new purchase, discussed above, while Cannae is underperforming in 2021 as the market is valuing the company at a significant discount to the publicly traded value of its portfolio holdings. The chairman of Cannae, Bill Foley, has a long track record of successfully acquiring, growing, and then monetizing good businesses. As Cannae's portfolio of companies continues to grow in intrinsic value, we feel confident that Foley and the team will find a way to eventually monetize these holdings at full value, which we believe should provide material upside to Cannae's stock price from current levels.

Going forward, we expect the economy to continue its recovery and equity markets to maintain a positive bias; however, the abrupt stop and subsequent start of the economy will present challenges, from the supply chain to finding employees, which we believe will likely produce volatility in the economic data and equity markets. Of course, we remain focused on our core strength which is analyzing and valuing businesses. We continue to strive for finding good investment ideas and generating solid long-term results for our clients regardless of the environment.

The top contributors and detractors during the quarter:

Security	Avg Weight (%)	Contribution (%)
Top 5		
Core Laboratories N.V.	3.29	1.32
Perficient, Inc.	2.67	0.83
Brown & Brown, Inc.	4.27	0.63
Morningstar, Inc.	4.36	0.60
Movado Group, Inc.	3.94	0.45
Bottom 5		
Winnebago Industries, Inc.	3.49	(0.41)
Avanos Medical, Inc.	*Sold*	(0.42)
James River Group Holdings, Ltd.	2.55	(0.50)
RE/MAX Holdings, Inc.	3.14	(0.51)
Cannae Holdings, Inc.	3.73	(0.58)

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

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10 Largest Holdings (as of 6/30/21)

Company	Market Capitalization	Portfolio Weight
	($ billions)	
Core Laboratories N.V.	1.80	4.3%
Morningstar, Inc.	11.04	4.1%
Movado Group, Inc.	0.74	4.1%
Kadant Inc.	2.04	3.9%
Frontdoor, Inc.	4.27	3.7%
American Outdoor Brands, Inc.	0.49	3.7%
John Bean Technologies Corporation	4.53	3.6%
Perficient, Inc.	2.66	3.6%
BRP Group, Inc.	2.56	3.4%
RBC Bearings Incorporated	5.03	3.3%

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 June 30, 2021)

	Pure Gross-of-Fees[1]	Net-of-Fees[2]	R2000	R2000 Value
Since Inception**	12.2%	9.0%	10.0%	10.5%
25-Year*	11.9%	8.7%	9.3%	10.0%
20-Year*	10.8%	7.6%	9.3%	9.2%
15-Year*	10.5%	7.3%	9.5%	7.9%
10-Year*	11.7%	8.4%	12.3%	10.8%
5-Year*	12.7%	9.4%	16.4%	13.6%
3-Year*	8.2%	5.0%	13.5%	10.2%
1-Year	38.3%	34.2%	62.0%	73.2%
YTD	12.7%	11.0%	17.5%	26.7%
QTD	3.4%	2.7%	4.3%	4.6%

**Average annualized returns*
***Inception is 10/1/1994*

Portfolio Benchmarks

Russell 2000® Index – A capitalization-weighted index measuring performance of approximately 2,000 companies in the Russell 3000® Index.

Russell 2000® Value Index – A capitalization-weighted index designed to measure performance of those Russell 2000® Index companies with lower price-to-book ratios and lower forecasted growth values.

(Source: Bloomberg)

Calendar Year	Pure Gross-of-Fees[1]	Net-of-Fees[2]	R2000	R2000 Value	Difference (Gross-R2000)	# of Portfolios	Composite Assets (000s)	Total Firm Assets (000s)	Composite 3yr Std Dev	R2000 3yr Std Dev	R2000V 3yr Std Dev	Composite Dispersion
1994**	(3.3%)	(3.9%)	(1.9%)	(3.0%)	(1.4%)	389	$41,690		N/A	N/A	N/A	N/A
1995	24.2%	20.8%	28.4%	25.8%	(4.3%)	267	$34,667		N/A	N/A	N/A	0.8%
1996	20.7%	17.4%	16.5%	21.4%	4.2%	249	$39,188		N/A	N/A	N/A	1.0%
1997	46.5%	42.5%	22.4%	31.8%	24.1%	353	$63,832		N/A	N/A	N/A	1.1%
1998	(4.2%)	(6.8%)	(2.5%)	(6.5%)	(1.6%)	1,080	$111,513		N/A	N/A	N/A	1.7%
1999	(7.1%)	(9.6%)	21.3%	(1.5%)	(28.4%)	745	$69,869		N/A	N/A	N/A	1.2%
2000	34.4%	30.7%	(3.0%)	22.8%	37.4%	374	$47,699		N/A	N/A	N/A	1.7%
2001	12.6%	9.6%	2.5%	14.0%	10.1%	395	$56,254		N/A	N/A	N/A	0.7%
2002	(11.4%)	(13.8%)	(20.5%)	(11.4%)	9.1%	434	$48,944		N/A	N/A	N/A	0.7%
2003	36.2%	32.5%	47.3%	46.0%	(11.1%)	464	$71,199		15.4%	21.6%	18.4%	0.9%
2004	23.2%	19.9%	18.3%	22.2%	4.9%	572	$101,835		12.7%	19.0%	17.5%	1.4%
2005	8.2%	5.3%	4.6%	4.7%	3.6%	722	$111,469		9.0%	15.1%	14.1%	1.6%
2006	19.1%	15.9%	18.4%	23.5%	0.8%	694	$117,282		7.1%	13.8%	12.3%	1.1%
2007	(1.7%)	(4.4%)	(1.6%)	(9.8%)	(0.1%)	543	$84,018		7.5%	13.2%	12.6%	1.1%
2008	(21.8%)	(24.0%)	(33.8%)	(28.9%)	12.0%	61	$8,568	$291,644	14.0%	19.8%	19.1%	N/A
2009	29.6%	25.8%	27.2%	20.6%	2.4%	54	$9,823	$533,832	20.9%	24.8%	25.6%	2.3%
2010	24.6%	20.9%	26.9%	24.5%	(2.3%)	83	$19,208	$751,909	23.3%	27.7%	28.4%	1.5%
2011	(0.9%)	(3.8%)	(4.2%)	(5.5%)	3.3%	85	$18,032	$937,487	21.8%	25.0%	26.0%	1.2%
2012	16.0%	12.6%	16.3%	18.1%	(0.4%)	105	$26,346	$1,272,265	15.6%	20.2%	19.9%	0.3%
2013	27.4%	23.6%	38.8%	34.5%	(11.5%)	113	$31,217	$1,955,915	12.2%	16.4%	15.8%	0.5%
2014	9.3%	6.1%	4.9%	4.2%	4.4%	140	$34,077	$2,589,024	8.6%	13.1%	12.8%	0.6%
2015	(1.7%)	(4.7%)	(4.4%)	(7.5%)	2.7%	158	$34,928	$3,175,419	10.3%	14.0%	13.5%	0.4%
2016	23.7%	20.0%	21.3%	31.7%	2.4%	198	$56,608	$4,413,659	11.6%	15.8%	15.5%	1.2%
2017	19.5%	16.0%	14.6%	7.8%	4.9%	354	$103,862	$5,944,479	10.8%	13.9%	14.0%	0.9%
2018	(8.6%)	(11.3%)	(11.0%)	(12.9%)	2.5%	400	$88,885	$5,486,737	13.1%	15.8%	15.8%	0.8%
2019	27.0%	23.2%	25.5%	22.4%	1.5%	449	$124,071	$7,044,708	14.5%	15.7%	15.7%	0.8%
2020	4.5%	1.4%	19.9%	4.6%	(15.4%)	400	$122,151	$6,889,798	21.6%	25.3%	26.1%	1.5%

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 Small Cap Value Strategy was incepted on October 1, 1994, and the current Small Cap Value 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: 1.00% on the first $500,000; 0.90% on the next $500,000; and 0.75% 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 Small Cap Value Composite contains fully discretionary Small Cap Value wrap accounts. Small Cap Value is a value-based, bottom-up portfolio that utilizes stocks with market capitalizations typically less than $2 billion. *Smaller capitalization companies, due to their size, are generally more vulnerable to adverse general market or economic developments than larger, more established companies.*

**Results shown for the year 1994 represent partial period performance from October 1, 1994, through December 31, 1994. 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 and/or performance was calculated quarterly prior to January 2001.

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 2000 and Russell 2000 Value Indexes 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.*