Confluence Investment Management

Second Quarter 2023

Small Cap Value • Value Equity Strategies

Small Cap Value is focused on smaller companies that generally have capitalizations below $3 billion at the time of purchase. 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.

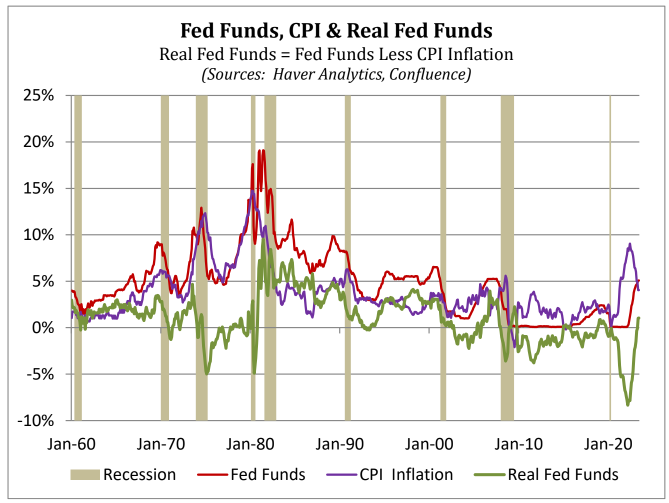
Market Commentary

"The majority of advanced technologies follow a predictable life cycle of hype, disillusionment, realism, and, eventually, productivity."

– Gartner analyst Jackie Fenn, 1995

Risk markets continued their upward trend during the quarter as many of the concerns that pressured the markets in 2022 are gradually receding, while the economy continues to advance. Inflation, and the Federal Reserve's aggressive response, was the primary worry but now that we are past the peak and inflation is trending downward, the Fed has recently decided to pause its rate hikes (*Figure 1*). The domestic debt ceiling also loomed over the financial markets but was resolved in the waning hours in typical Washington, D.C. fashion. The war in Ukraine is progressing more favorably than originally feared and commodity markets have adjusted. Meanwhile, employment remains plentiful and wage growth robust, which have aided the economic advance despite the sharp rise in short-term interest rates and the banking sector stumbles in March. This is likely due to the fact that the last stage of the cycle was not driven by credit expansion but rather liquidity injections, both fiscal and monetary. This would explain why banks were so flush with deposits but have yet to experience credit issues despite the spike in rates. Suffice it to say, the wall of worry has been fading which has boosted investor sentiment as exhibited by the risk markets, per the quilt chart shown below (*Figure 2*).

Figure 1



Risk market returns were broadly positive but widely dispersed with more speculative and longer-duration assets leading the pack. For equity markets, the reduced uncertainty and economic resilience combined with the excess liquidity provided support for equities, but the hype surrounding artificial intelligence (AI) with the release of ChatGPT sparked a frenzy in technology-oriented names, mainly mega caps. These mega cap names have been labeled the "Magnificent Seven" (M7) by none other than CNBC's Jim Cramer and they are Apple (AAPL), Microsoft (MSFT), Amazon (AMZN), Alphabet (GOOG), Nvidia (NVDA), Tesla (TSLA), and Meta (META). In fact, the M7 has added $4.0 trillion (yes, trillion) in market cap year-to-date!

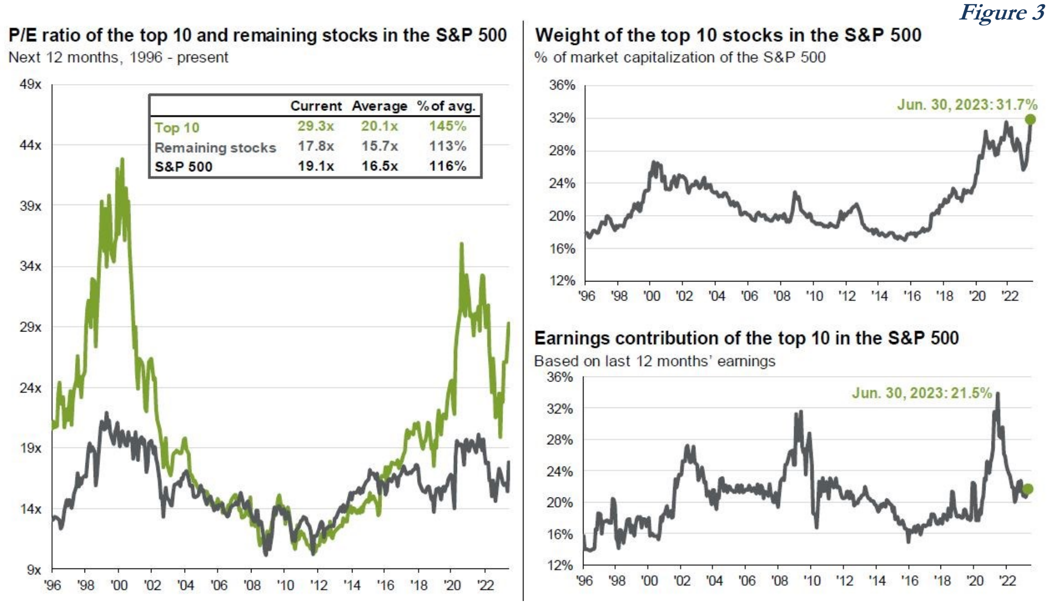
Figure 2 **Quarterly Asset Class Returns as of 6/30/2023**

	Q3 2020	Q4 2020	Q1 2021	Q2 2021	Q3 2021	Q4 2021	Q1 2022	Q2 2022	Q3 2022	Q4 2022	Q1 2023	Q2 2023
Cash	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.1%	0.5%	0.8%	1.1%	1.2%
U.S. Short-Term Bonds	0.3%	0.2%	0.0%	0.1%	0.1%	-0.5%	-2.6%	-0.6%	-1.5%	0.9%	1.5%	-0.3%
U.S. Intermediate-Term Bonds	1.1%	0.7%	-4.1%	2.4%	-0.1%	-0.2%	-6.5%	-4.4%	-5.0%	2.2%	3.3%	-1.2%
U.S. Long-Term Bonds	1.2%	1.0%	-10.8%	6.7%	-0.1%	2.3%	-10.9%	-11.5%	-9.4%	2.3%	5.7%	-1.4%
Speculative Grade Bonds	4.7%	6.5%	0.9%	2.8%	0.9%	0.7%	-4.5%	-10.0%	-0.7%	4.0%	3.7%	1.6%
REITs	1.4%	11.6%	8.9%	12.0%	1.0%	16.3%	-3.9%	-17.0%	-9.9%	5.2%	2.7%	2.6%
U.S. Large Cap Stocks	8.9%	12.1%	6.2%	8.5%	0.6%	11.0%	-4.6%	-16.1%	-4.9%	7.6%	7.5%	8.7%
U.S. Mid-Cap Stocks	4.8%	24.4%	13.5%	3.6%	-1.8%	8.0%	-4.9%	-15.4%	-2.5%	10.8%	3.8%	4.9%
U.S. Small Cap Stocks	3.2%	31.3%	18.2%	4.5%	-2.8%	5.6%	-5.6%	-14.1%	-5.2%	9.2%	2.6%	3.4%
Int'l Developed Market Stocks	4.8%	16.0%	3.5%	5.2%	-0.4%	2.7%	-5.9%	-14.5%	-9.4%	17.3%	8.5%	3.0%
Emerging Market Stocks	9.6%	19.7%	2.3%	5.0%	-8.1%	-1.3%	-7.0%	-11.4%	-11.6%	9.7%	4.0%	0.9%
Commodities	4.6%	14.5%	13.5%	15.7%	5.2%	1.5%	33.1%	2.0%	-10.3%	3.4%	-4.9%	-2.7%

(Source: (Confluence Asset Allocation Committee. See disclosures on last page for asset class composition.)

Market Commentary continued...

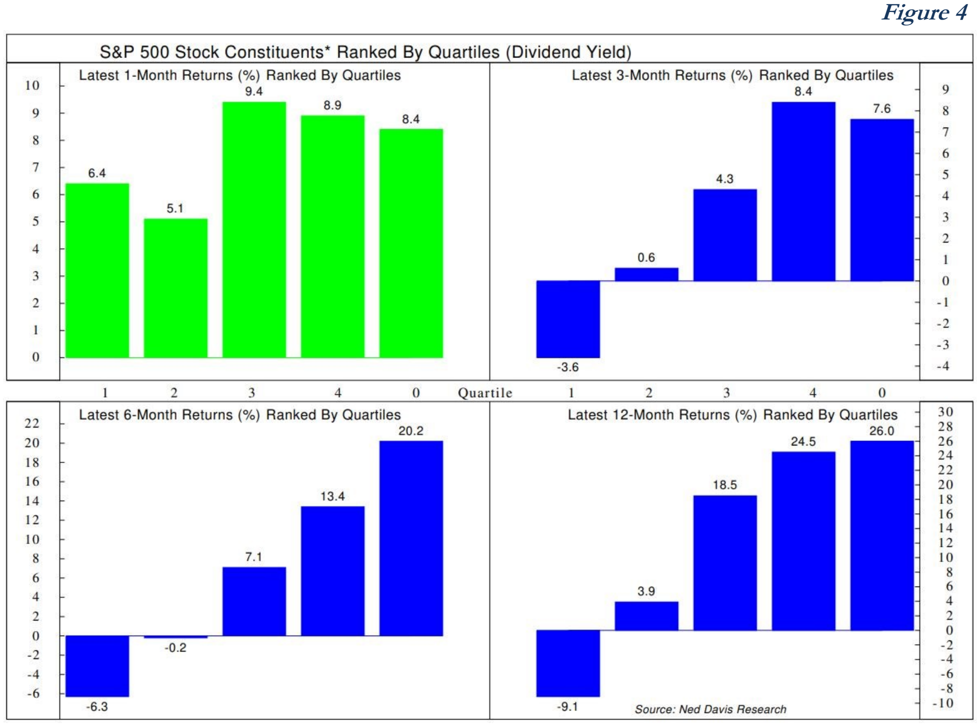
Figure 3



(Source: J.P. Morgan Asset Management; Guide to the Markets®, U.S. 3Q 2023, as of June 30, 2023)

The M7 impact on market cap-weighted indexes like the S&P 500 was meaningful and accounted for approximately 65% quarter-to-date and 73% year-to-date of the overall index return, while the impact on growth indexes was even more significant. The influence and valuations are reflected in the narrow concentration of the top 10 companies in the S&P 500, which now constitute a record 31.7%. J.P. Morgan Asset Management compiled a history of the valuations and weightings of the top 10 stocks, all of which are at the upper end of historical levels, aside from earnings contribution (*Figure 3*). The influence of the M7 is also apparent in the second quarter dispersion between the Russell 1000 Growth Index, up 12.8%, compared to the Russell 1000 Value Index, up 4.1%. More concisely, the difference is also evident in the S&P 500 Equal Weight Index, up 4.0%, versus the S&P 500, up 8.7%.

Figure 4



*Actual Historical Constituents. *Returns through 6/30/2023 (Source: Ned Davis Research)*
Returns of dividend payers in the S&P 500, ranked by quartile from highest dividend yield (bar 1) to lowest (4), compared to all S&P 500 stocks with zero dividends, reflected in the fifth bar (0).

The variance in long-duration versus short-duration (i.e., businesses generating earnings/cash flow in the near-term versus later years) is also reflected in the S&P 500 yield quartiles, with the higher yielding equities lagging the low yield and non-dividend payers (*Figure 4*).

The hype of AI will likely disappoint investors in a similar fashion to prior "revolutions" of the past few hundred years. For example, railroad investors of the late 19th century saw more track laid than what is in existence today. More recently, the advent of the internet in the 1990s immensely benefited the businesses of semiconductors and networking yet the industry leaders in semis and networking, Intel and Cisco, trade at lower levels today than their peak almost 25 years ago. AI, much like the technological advances before it, will likely take the path stated in the quote at the beginning of this report: hype, disillusionment, realism, and, eventually, productivity. For an economy grappling with inflationary pressures driven by low unemployment and a splintering global economy, advances in productivity would be a welcome relief.

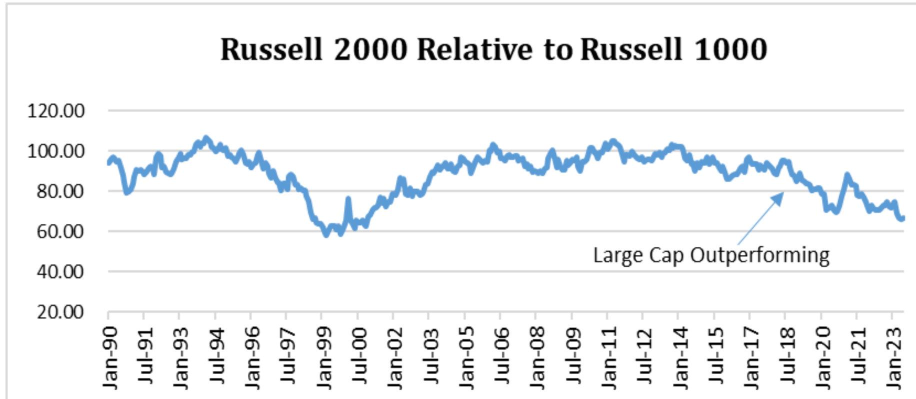
The U.S. economy's avoidance of a recession so far despite the headwinds of monetary policy restraint speaks to its underlying strength. Consumers are benefitting from the tight job market which is leading to strong wage growth while also being supported by the excess savings built up during the pandemic. While inflation has rolled over from its peak, it remains well above the Fed's target of 2%. Future data will impact whether additional rate hikes are needed. For the equity markets, the near-term focus on long-duration, high-growth companies appears at odds with the rise in rates and inflation. The current earnings environment has met or exceeded expectations, but there are a handful of crosscurrents, including rising rates, wage pressures, and the normalization of the supply chain. As always, we remain focused on finding competitively advantaged businesses with pricing power to protect against inflation that are trading at attractive valuations.

Strategy Commentary

The small cap equity markets posted positive results for the quarter, with the Russell 2000 and Russell 2000 Value indexes up 5.2% and 3.2%, respectively, bringing their year-to-date returns to 8.1% and 2.5%, respectively. While the small cap indexes may not have been impacted by the mega cap M7 names, the AI hype and shift to faster-growth/longer-duration equities certainly benefited the Russell 2000 Growth Index, with a posted quarterly return of 7.1% and year-to-date of 13.6%. The Confluence Small Cap Value strategy was up 2.7% in the quarter and 5.5% year-to-date (both gross of fees). [*The strategy's net-of-fees returns for the same periods were 2.0% QTD and 3.9% YTD. See disclosures on last page for fee description; actual investment advisory fees may vary.*]

As we have discussed in prior commentaries, small cap businesses have not performed as well as their large cap brethren over the last few years (see *Figure 5*). The past decades of easy monetary policy—Zero Interest Rate Policy (ZIRP) and Quantitative Easing (QE)—when rates were held on the floor and the Federal Reserve's balance sheet swelled, were intended to spark more risk taking. Thus, it should be no surprise that the result was less prudent allocations of capital. This is very apparent in the small cap and venture capital/early-stage equity environment in which unprofitable businesses were able to continue attracting capital despite not producing earnings. These unprofitable entities, or "zombie" companies, have risen more than twofold in the small cap market as their percentage of the overall market has grown from the low-20s to mid-40s (see *Figure 6*). Meanwhile, the venture capital or early-stage funding markets have produced an outsized number of unicorns (companies valued at over $1 billion) that are not generating sufficient cash flow.

Figure 5



(Source: Confluence, FactSet)

Figure 6

(Source: J.P. Morgan Asset Management; Guide to the Markets®, U.S. 3Q 2023, as of June 30, 2023)

The collapse of the two regional banks, Silicon Valley Bancshares (SIVB) and First Republic (FRC), which served the venture capital and early-stage businesses, was a sign that the change in monetary policy may be bringing much needed prudence to capital allocation. This would be a welcome event to the small cap businesses that had to compete with the zombie companies for customers and capital.

Regarding the swings in investor sentiment, it is not atypical at turning points in the cycle to witness these quick rotations and wide dispersions within the market as investors attempt to predict the next move. At Confluence, we subscribe to a pragmatic and long-term investment approach that is focused on understanding businesses and determining their worth with an emphasis on acquiring competitively advantaged companies trading at a discount to their intrinsic value. This often steers us away from commodity-oriented and highly regulated industries as their competitive landscapes inherently hinder their ability to generate above-average returns on capital over long periods. This philosophy instead guides us toward entities operating in niche or oligopolistic arenas that can dictate their own pricing, which often allows them to produce above-average returns on capital. It is a process that tends to produce a higher -quality portfolio of businesses that can compound over longer periods but may vary from the indexes over the short-run, as we have witnessed.

Strategy Commentary continued...

During the quarter, we sold the position in FARO Technologies (FARO). FARO is a small cap technology company that we purchased in the summer of 2020. It had previously been managed by one of its academic co-founders and needed to modernize its operating and sales structure. FARO had pioneered laser scanner products in the industry but needed to revamp its technology product offering. The company brought in a seasoned, well-respected management team and that combined with its niche laser scanner and tracker products for the metrology, surveying, and construction markets initially led us to invest in the company. Although the new management team was able to refresh the product lines, outsource the manufacturing, and reduce the company's operating cost structure, it was slow to gain market traction to grow its revenues and lift operating margins adequately. After continued revenue disappointments, geographic market weakness, and delays in operating margin improvements, CEO Mike Berger announced in May that he was retiring at the end of the quarter. He and his management team were integral to the business in repositioning its products and growing revenues. As such, we lost faith in the company's ability to improve its revenue and profitability in the near term and decided to sell our position.

Year-to-date, the portfolio strength came from Azek (AZEK), Spectrum Brands (SPB), and Hayward (HAYW). AZEK is a manufacturer of composite decks, a market that is seeing stabilization. SPB finally closed on the sale of its home improvement business for $4.3 billion in cash, which allows it to dramatically improve the balance sheet and focus on its pet and home & garden businesses. HAYW provides pool equipment and has been able to maintain margins despite the expected slowdown in new builds. The main detractors were Bank of Marin (BMRC), Veritex (VBTX), and FARO Technologies (FARO). Veritex and Bank of Marin are community banks that were being pressured by funding costs, i.e., deposit rates, given the sharp rise in short-term rates. Lastly, we discussed FARO above. *[See contribution table on next page.]*

Outlook

Going forward, the markets still need to contend with inflation that persists above the Fed's target as the economy remains resilient in the face of the Fed's restraint. And while many of the uncertainties have receded, risk markets have responded accordingly. The markets await further data on whether the Fed's recent pause will be temporary or the first step before easing. At Confluence, we are not prognosticators but rather business analysts that remain committed to our philosophy of investing in quality businesses trading at attractive valuations.

Contribution[1]

(YTD as of 6/30/2023)

The top contributors and detractors for the portfolio thus far in 2023 are shown in this table:

Security	Avg Weight (%)	Contribution (%)
Top 5		
Azek Co. Inc.	3.96	1.69
Spectrum Brands Holdings Inc.	3.94	1.13
Hayward Holdings Inc.	3.09	0.94
John Bean Technologies Corp.	2.93	0.87
Frontdoor Inc.	*Sold*	0.83
Bottom 5		
Movado Group Inc.	3.07	(0.42)
SJW Group	4.01	(0.54)
Bank of Marin BanCorp	*Sold*	(0.64)
Veritex Holdings Inc.	*Sold*	(0.82)
FARO Technologies Inc.	*Sold*	(0.84)

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

Performance Composite Returns[2] (For Periods Ending June 30, 2023)

	Since Inception**	25-Year*	20-Year*	15-Year*	10-Year*	5-Year*	3-Year*	1-Year	YTD	QTD
Small Cap Value *Pure Gross-of-Fees[3]*	11.0%	9.1%	10.2%	9.6%	8.7%	3.0%	8.2%	8.0%	5.5%	2.7%
Max Net-of-Fees[4]	7.8%	5.9%	7.0%	6.4%	5.4%	(0.0%)	5.0%	4.8%	3.9%	2.0%
Russell 2000	8.6%	7.2%	8.9%	8.4%	8.2%	4.2%	10.8%	12.3%	8.1%	5.2%
Russell 2000 Value	9.3%	7.6%	8.3%	7.7%	7.3%	3.5%	15.4%	6.0%	2.5%	3.2%

Calendar Year	Pure Gross-of-Fees[3]	Max Net-of-Fees[4]	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%
2021	16.9%	13.4%	14.8%	28.2%	2.1%	378	$124,263	$7,761,687	20.2%	23.3%	25.0%	1.3%
2022	(16.3%)	(18.8%)	(20.5%)	(14.5%)	4.1%	361	$98,842	$6,931,635	21.6%	26.0%	27.3%	0.5%

**Average annualized returns* ***Inception is 10/1/1994* *See performance disclosures on last page.*

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)*

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Disclosures

Market & Strategy Commentary—*Figure 2*: Asset class representation: Cash (ICE BofA 3M T-Bill); Short-Term Bonds (ICE BofA 1-3 Year US Corp&Govt); Intermediate-Term Bonds (ICE BofA 5-10 Year US Corp&Govt); Long-Term Bonds (ICE BofA 10+Yr US Corp&Govt); Speculative Grade/High-Yield Bonds (ICE BofA US High Yield Master); REITs (FTSE NAREIT Equity); Large Cap (S&P 500); Mid-Cap (S&P MidCap 400); Small Cap (S&P Small Cap 600); Foreign Developed Country (MSCI EAFE); Emerging Markets (MSCI Emerging Markets); Commodities (S&P GSCI). Data source: Morningstar Direct.

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All investments carry a certain degree of risk, including possible loss of principal. It is important to review your investment objectives, risk tolerance & liquidity needs before choosing an investment style or manager. Equity securities are subject to market risk & may decline in value due to adverse company, industry or general economic conditions. There can be no assurance that any investment objective will be achieved.

Indices: The Russell 2000 and Russell 2000 Value 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] **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. 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.

[2] **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 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.

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

[4] 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 $3 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.

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