Confluence INVESTMENT MANAGEMENT

THIRD QUARTER 2022

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

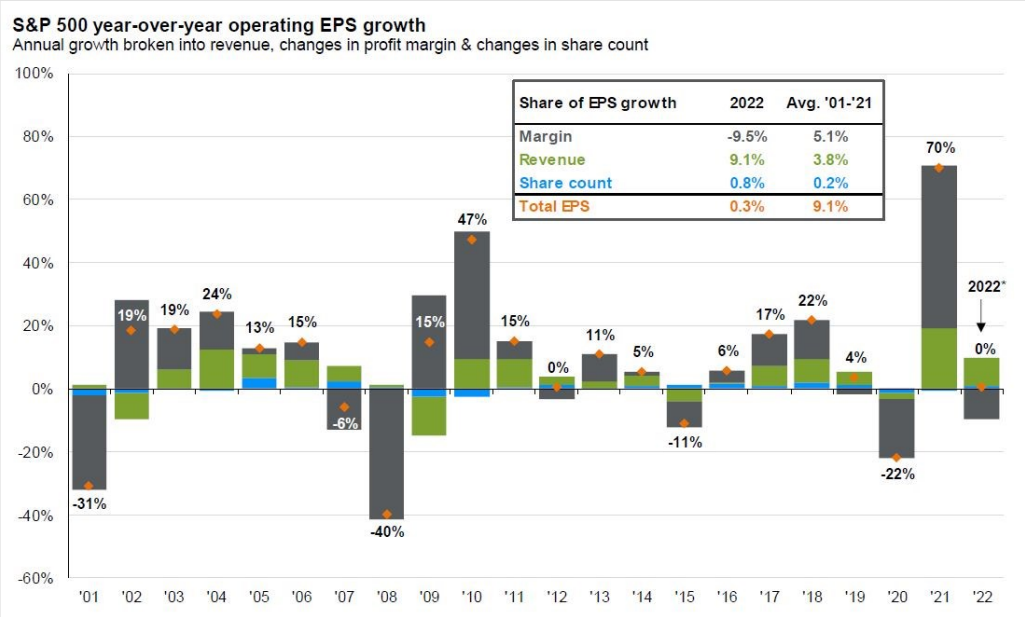
"Waiting for the bottom is folly. What, then, should be the investor's criteria? The answer's simple: if something's cheap — based on the relationship between price and intrinsic value — you should buy, and if it cheapens further, you should buy more."

- Howard Marks, co-founder at Oaktree Capital Group LLC

The broad equity markets remain in bear market territory as investors continue to grapple with inflation and the ensuant monetary policy response. The Federal Reserve remains adamant that it will take the necessary actions needed to curtail inflation, and while market participants appear reticent of that fact, they are eager for the Fed to pivot toward friendlier monetary policy. This is apparent in the handful of market rallies, five thus far in 2022, that were precipitated by a weak economic data point and lifted the markets between 6% and 17%. These rallies have proven to be short-lived as inflation remains stubbornly elevated and the Fed steadfast in its monetary policy tightening. The Fed has raised the federal funds rate in 2022 from a floor of 0-0.25% to 3.00-3.25%, with the latest increase of 75 bps in late September. The net effect has been upward pressure on longer rates as the 10-year Treasury yield is up from 1.52% at the beginning of the year to 3.83% at quarter end, which has weighed on equity markets and resulted in three consecutive quarters of negative returns for the broad market, as measured by the S&P 500 Index (Q1 -4.6%, Q2 -16.1%, and Q3 -4.9%). Such a poor start to the year was last witnessed in 2008 and leaves the S&P 500 down 23.9% for the year.

The policy tools available to the Federal Reserve to stem inflation, and inflation expectations, are limited and primarily influence demand through the level of rates and/or liquidity (Quantitative Easing/Tightening). Thus far in 2022, the policy effects have been limited as the drawdown in equity markets has been driven primarily by a contraction in the multiple that investors are willing to pay for earnings. As reflected by this first chart from J.P. Morgan Asset Management (*Figure 1*), revenue and earnings growth have remained positive despite the sharp pullback in the equity markets. Meanwhile, the chart on the next page (*Figure 2*), also from J.P. Morgan Asset Management, shows the sharp decline in the forward P/E from over 22x to 15.15x. This reflects the dramatic shift in sentiment, as well as concern, for future demand and earnings as Fed policy operates with a lag.

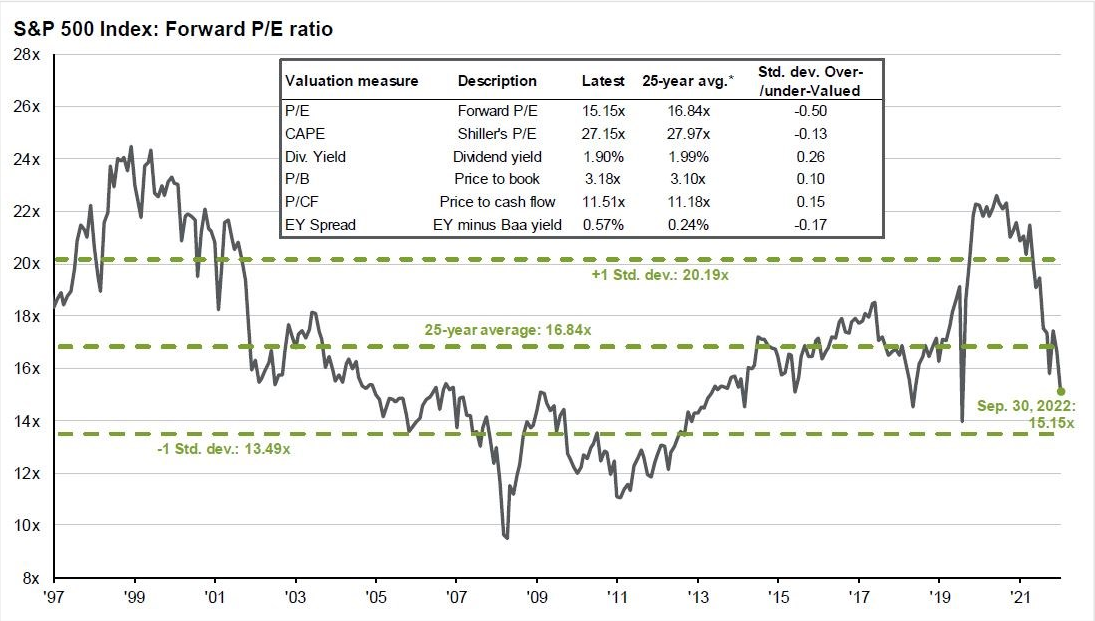
Figure 1



(Chart source: J.P. Morgan Asset Management; Guide to the Markets®, U.S. 4Q2022, as of September 30, 2022)

Market Commentary continued...

Figure 2

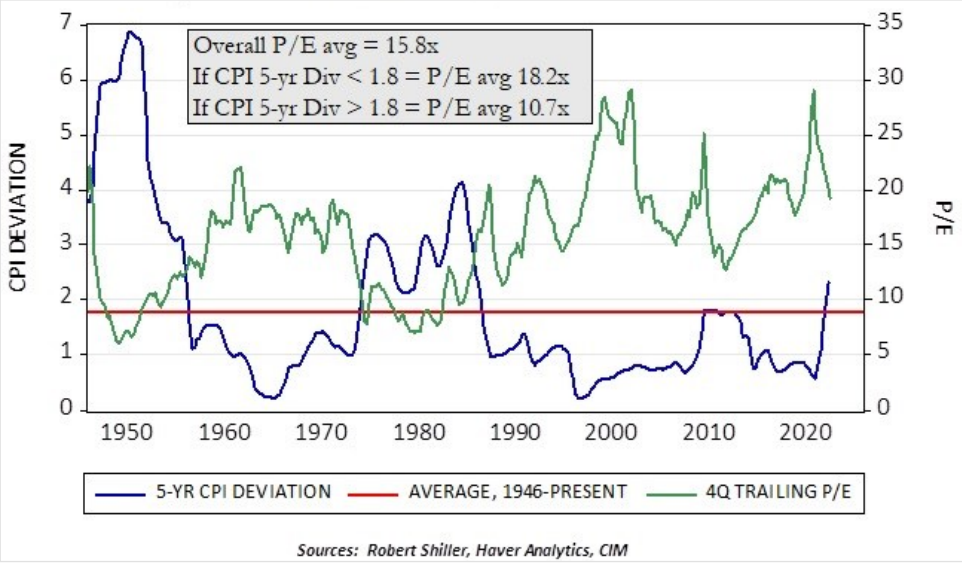


Valuation measure	Description	Latest	25-year avg.*	Std. dev. Over-/under-Valued
P/E	Forward P/E	15.15x	16.84x	-0.50
CAPE	Shiller's P/E	27.15x	27.97x	-0.13
Div. Yield	Dividend yield	1.90%	1.99%	0.26
P/B	Price to book	3.18x	3.10x	0.10
P/CF	Price to cash flow	11.51x	11.18x	0.15
EY Spread	EY minus Baa yield	0.57%	0.24%	-0.17

(Chart source: J.P. Morgan Asset Management; Guide to the Markets®, U.S. 4Q2022, as of September 30, 2022)

For investors, the importance of containing inflation is rather straightforward as the present value of a dollar returned in the future is worth less in an inflationary environment. As inflation rises, a higher required return is sought, which elevates the discount rate and lowers the present valuation, i.e., lower earnings multiple. If inflationary expectations become engrained, behavior also changes as purchasing an item at today's price is more advantageous than waiting and paying a higher price later. This lifts current demand and puts additional pressure on supply, causing prices to move even higher and thus triggering an inflation spiral.

Figure 3 **4Q S&P 500 Trailing P/E & Rolling 5-Year CPI Standard Deviation**



This chart from the Confluence Investment Management macro team (*Figure 3*) shows the negative impact on P/E multiples during periods of volatile or uncertain inflation. The graph maps the deviation of the Consumer Price Index (CPI) from the five-year rolling CPI and reflects an inverse relationship of lower multiples when the deviation is higher. Investors naturally prefer lower levels of inflation, and inflation expectations, as reflected by the higher multiples afforded in those environments.

Reining in inflation and expectations of inflation has been the policy aim of the Federal Reserve's actions to date. While the impact to the economy will take time to be fully felt, the key issue is how staunch Fed Chair Powell will remain should inflation stay elevated and the economy retracts. The answer may not lie with economics but rather behavioral science as his desire to remain in good stead in Washington is also a factor. For equity investors, the market declines have been sharp and broad-based, with the Energy sector as the exception, and now provide even more compelling valuations for long-term investors. Fortunately, these types of environments often create opportunities for long-term, fundamental investors to uncover some great companies trading at attractive valuations.

Strategy Commentary

The third quarter of 2022 marked the third consecutive quarterly decline for the equity markets as inflation remained elevated and the Fed continued to tighten monetary policy. For the quarter, the Russell 2000 Index was down 2.2% and the Russell 2000 Value Index was down 4.6%. The back-to-back-to-back negative quarters are the first for the Russell 2000 since the Great Financial Crisis (GFC) of 2008-2009 and put the index down 25.1% for the year, while the Russell 2000 Value is now down 21.1% for the year. Confluence Small Cap Value also posted a loss for the quarter of 6.9% and is down 24.0% for the year (both gross of fees). [*Net-of-fees returns for the same periods were -7.6% QTD and -25.7% YTD. See disclosures on last page for fee description; actual investment advisory fees may vary.*]

The pressure on equity markets continues to be caused by stubbornly high inflation which has forced the Federal Reserve to tighten more aggressively than expected. This was evident again in September when the Fed raised the federal funds rate to a target of 3.00-3.25%, marking the third consecutive increase of 75 bps since mid-June. Despite the Fed's hawkishness, the broad market, as measured by the S&P 500, rallied over 17% between mid-June and mid-August as investors displayed their eagerness for a pivot. Unfortunately, the persistence of inflation did not allow for a pivot and many of the same trends continued through the third quarter.

More specifically, the pullback has been primarily an adjustment to the multiple that equity investors were willing to pay for earnings as revenue and earnings growth remained positive (see previous charts in **Market Commentary** section). The multiple adjustments combined with the geopolitical issues surrounding Russia and oil supplies have negatively impacted investor sentiment but benefited the Energy sector. We have included an excerpt from J.P. Morgan's *Guide to the Markets®* as of September 30, 2022 (*Figure 4*), which reflects the sector weightings and performance of the indexes and reveals that the defensive sectors (Utilities, Consumer Staples, and Health Care) fared relatively well, while Energy was up a whopping 34.9%, far outperforming the other sectors.

Figure 4 **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	**4.5%**	**2.5%**	**11.0%**	**7.9%**	**11.7%**	**26.4%**	**8.1%**	**2.8%**	**15.1%**	**6.9%**	**3.1%**	**100.0%**
Russell Growth weight	1.6%	1.4%	3.0%	7.2%	17.1%	42.9%	7.4%	1.6%	12.2%	5.7%	0.0%	100.0%
Russell Value weight	7.8%	4.1%	20.0%	10.0%	6.0%	8.8%	8.0%	4.8%	17.3%	7.2%	6.0%	100.0%
Russell 2000 weight	6.1%	4.0%	17.3%	14.8%	10.2%	12.8%	2.7%	6.4%	18.9%	3.4%	3.4%	100.0%
QTD	2.3	-7.1	-3.1	-4.7	4.4	-6.2	-12.7	-11.0	-5.2	-6.6	-6.0	-4.9
YTD	34.9	-23.7	-21.2	-20.7	-29.9	-31.4	-39.0	-28.8	-13.1	-11.8	-6.5	-23.9

(Source: J.P. Morgan Asset Management; Guide to the Markets®, U.S. 4Q2022, as of September 30, 2022)

As we have mentioned in prior quarterly commentaries, the small capitalization indexes have witnessed an increasing number of unprofitable businesses embracing the public markets given the excess liquidity flowing from the adoption of the Fed's Zero Interest Rate Policy (ZIRP) and Quantitative Easing (QE) following the Great Financial Crisis. This chart from Strategas (*Figure 5*) shows that over 40% of small cap companies in the Russell 2000 are non-earners.

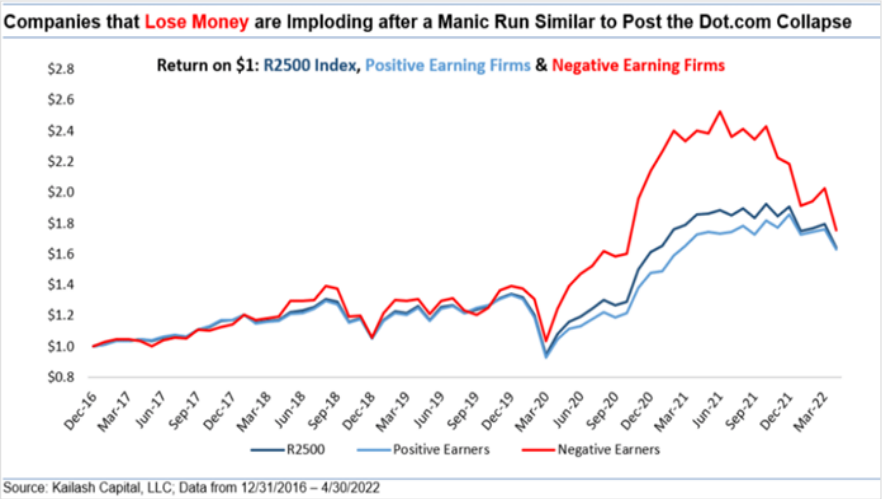
Figure 5

(Source: Strategas; 7/7/2022)

Strategy Commentary continued...

Not only have non-earners become a large percentage of the indexes, but they have also had a manic run over the past couple of years (see *Figure 6* from *Kailash Concepts*). The worm is now turning but it may take some time before fundamentals become the focus again. Thus far in 2022, selling has been rather indiscriminate, but we subscribe to the belief that fundamentals and valuations have historically been the driver of long-term returns. As we've discussed in previous quarters, when they become the focus again, active managers that seek companies with free cash flow generation at attractive valuations will likely be rewarded, as they have been historically in past periods.

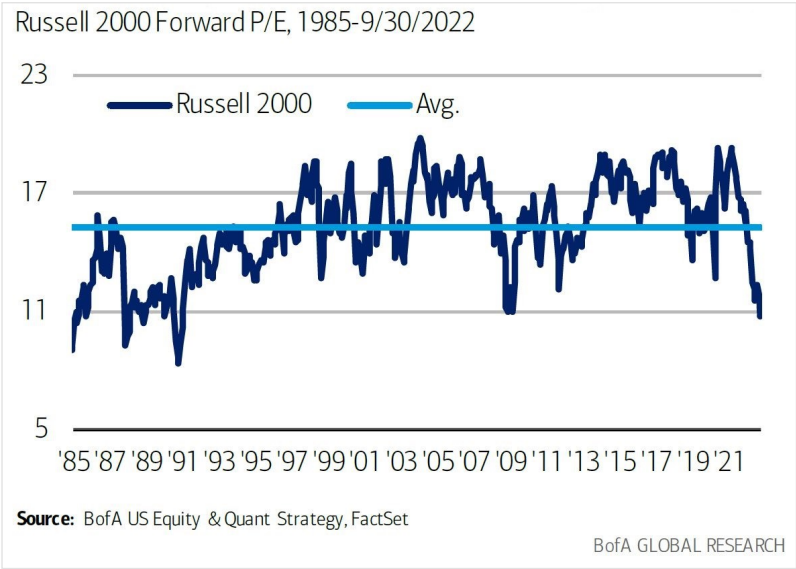
Figure 6



The sharp drawdown in small capitalization stocks puts them at attractive valuations. As the final graph depicts (*Figure 7*), valuation levels have not been this attractive since 1990.

Figure 7

Small Cap Forward P/E Well Below the Long-Term Average



For Confluence's Small Cap Value strategy, the underweighting and underperformance in Energy, specifically Core Laboratories (CLB), has been a detractor to relative performance. Core Labs is a leading provider of critical reservoir description services in testing rocks and fluids from oil and natural gas wells for Exploration & Production companies (E&Ps). It has an extensive and unparalleled lab network by 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, CLB 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 advantages, which is an asset-light model serving a capital-intensive industry. The company's business is especially valuable for offshore and international drilling, with approximately 80% of its revenue coming from outside the U.S. The international drilling rig count, a good proxy for future business, has increased 5% year-to-date versus North American drilling that has increased 30% year-to-date. Despite all the press to the contrary, the U.S. has significantly increased its hydrocarbon production relative to international producers. CLB also services the North American market through its perforating guns used in the fracking process, and that market remains competitive. Although the international rig count was down slightly through June 30, it has subsequently increased 7% through September. Along with greater worldwide recession concerns that would dampen hydrocarbon demand, CLB has had to negotiate covenant waivers with its lenders for the short term, which has put pressure on its stock price. Nevertheless, CLB is a leader in its industry, and its near-term prospects should follow the international rig count as it continue to slowly rebound. We have confidence in the company's market position and ability to execute.

There were several changes to the portfolio this quarter as we sought to upgrade the holdings in terms of quality and valuation. We added Azek Company (AZEK), a manufacturer of wood-alternative decks; Hayward Holdings (HAYW), which produces pool equipment and associated automated systems; and Spectrum Brands (SPB), a consumer products and home essentials company. Proceeds were provided by the sales of Natus Medical (NTUS), Thermon Group (THR), and Phibro Animal Health (PAHC).

Outlook

After decades of subdued inflation, the Federal Reserve is now witnessing elevated levels and has been forced to act accordingly. The Fed's actions have naturally generated additional uncertainty around the impact these moves will have on the economy, which is weighing 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. If anything, the past few years have reinforced the fallacy of prognostication and highlight 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.

Contribution[1]

(YTD as of 9/30/2022)

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

Security	Avg Weight (%)	Contribution (%)
Top 5		
MGP Ingredients Inc.	2.04	0.65
Marten Transport Ltd.	3.61	0.59
Natus Medical Inc.	*Sold*	0.55
RBC Bearings Inc.	3.70	0.13
Nathan's Famous Inc.	0.62	0.07
Bottom 5		
Cannae Holdings Inc.	2.58	(1.32)
Morningstar Inc.	3.21	(1.33)
American Outdoor Brands Inc.	2.07	(1.54)
FARO Technologies Inc.	1.76	(1.55)
John Bean Technologies Corp.	3.15	(1.59)

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

Performance Composite Returns[2] (For Periods Ending September 30, 2022)

	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]*	10.7%	9.0%	10.2%	7.5%	8.8%	2.6%	0.1%	(18.7%)	(24.0%)	(6.9%)
Max Net-of-Fees[4]	7.5%	5.8%	7.0%	4.3%	5.5%	(0.4%)	(2.8%)	(21.1%)	(25.7%)	(7.6%)
Russell 2000	8.4%	6.7%	9.4%	6.4%	8.5%	3.5%	4.3%	(23.5%)	(25.1%)	(2.2%)
Russell 2000 Value	9.1%	7.4%	8.8%	5.7%	7.9%	2.9%	4.7%	(17.7%)	(21.1%)	(4.6%)

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%

**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)*

Confluence Value Equities Investment Committee

Mark Keller, CFA	Tom Dugan, CFA	John Wobbe	Dustin Hausladen	Blair Brumley, CFA
Daniel Winter, CFA	Tore Stole	Joe Hanzlik	Kaisa Stucke, CFA	Brett Mawhiney, CFA

For more information contact a member of our sales team:

Ron Pond, CFA | *Northwest*
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

Steve Mikez | *Southwest*
Sr. Regional Sales Director
(314) 526-0776
smikez@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

Denis O'Grady | *Mid-South & East*
Regional Sales Associate (Internal)
(314) 743-5294
dogrady@confluenceim.com

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.

Investment or investment services mentioned may not be suitable to an investor and the investor should seek advice from an investment professional, if applicable. It is important to review your investment objectives, risk tolerance, and liquidity needs before choosing an investment style or manager. All investments carry a certain degree of risk, including possible loss of principal, that investors should be prepared to bear. Equity securities are subject to market risk and 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 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.

[1] **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.

[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.

GIPS® is a registered trademark of CFA Institute. CFA Institute does not endorse or promote this organization, nor does it warrant the accuracy or quality of the content contained herein.

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.