Confluence INVESTMENT MANAGEMENT

Fourth 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

"Interest rates are to asset prices what gravity is to the apple. When there are low interest rates, there is a very low gravitational pull on asset prices."

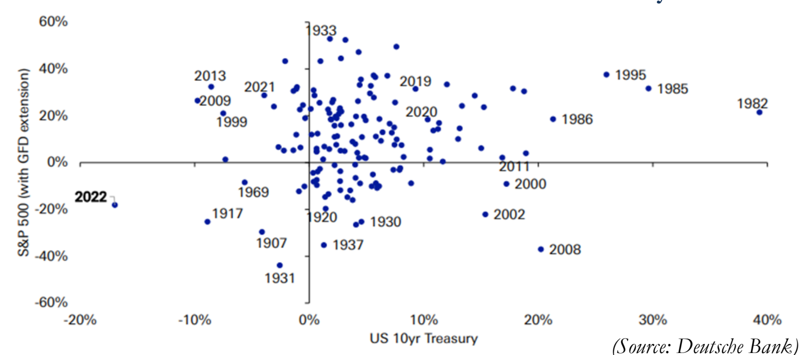
- Warren Buffett

2022 was a difficult year for financial assets as stocks and bonds experienced sharp declines, while commodities rallied. The primary culprit was the persistent rise in inflation that forced the Federal Reserve to shift monetary policy quickly and aggressively to a more restrictive stance. This shift occurred after an elongated period of accommodative policy following the Great Financial Crisis of 2008 that markedly benefited financial assets. The upward adjustment to inflation and inflation expectations as well as tightening Fed policy elevated the risk of a slowdown or recession, which explains the poor performance of financial assets this past year.

Putting the year into perspective, 2022 was the first year since 1872 that the S&P 500 and the 10-year Treasury lost more than 10% on a total return basis for a full calendar year, posting losses of 18.1% and 17.0%, respectively. This chart from Deutsche Bank (*Figure 1*) is a scatterplot of calendar year performance since 1872, demonstrating how 2022 was truly an outlier.

Figure 1

Annual Total Return Performance of the S&P 500 & 10-Year Treasury Since 1872

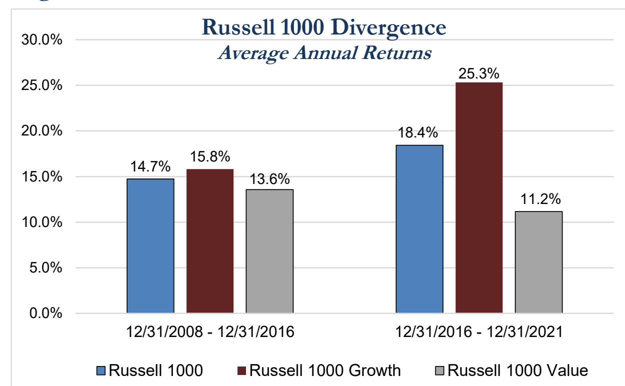


(Source: Deutsche Bank)

Delving deeper, the catalyst behind the headwinds was the sharp and sustained rise in inflation that prompted a dramatic shift in Fed policy. Inflation had been subdued over much of the past four decades as globalization, deregulation, and innovation led to a disinflationary environment which allowed for accommodative monetary policy. That all changed in 2022 as the FOMC increased the fed funds rate by a robust 4.25% over the course of the year and switched from quantitative easing to tapering via liquidating assets to reduce its balance sheet. Underlying these policy changes was a shift in the nature of inflationary pressures. These pressures were initially perceived as "transitory" (resulting from the economy reopening post-COVID and supply constraints) but now appear to stem from structural concerns emanating from geopolitical issues challenging globalization and a shift toward a [more fractured, multipolar world](#).

The protracted length of time and magnitude of the accommodative monetary policies dating back to 2008 provided a strong tailwind that primarily benefited financial assets, specifically domestic equity markets, and fostered speculation which created pockets of excess exuberance. This preceding period should be viewed in context with the losses incurred in 2022. More specifically, from the end of 2008 through 2016, the returns in the domestic markets were broad-based and well above the historical average, which is approximately 10%, with the Russell 1000, Russell 1000 Growth, and Russell 1000 Value indexes generating average annual returns of 14.7%, 15.8%, and 13.6%, respectively. However, a frenzy began to emerge from the end of 2016 through 2021, with the Russell 1000 Index posting an average annual return of 18.4% and a wide divergence developing between growth and value. During this period, the Russell 1000 Growth Index dramatically outperformed the Russell 1000 Value Index at 25.3% versus 11.2%, respectively.

Figure 2



(Sources: Bloomberg, Confluence)

Market Commentary continued...

If readers will recall, the Zero Interest Rate Policy (ZIRP) and Quantitative Easing (QE) policies began in late 2008 and lasted until December 2015 when the first rate increase of 25 bps transpired. The next rate increase did not occur until December 2016, with the Fed signaling additional increases throughout 2017. It was at this point that concerns arose of an economic slowdown or recession, prompting investors to lean toward businesses with higher-growth profiles, which were perceived to be more capable of weathering a slowdown. The rate hikes promptly ended in December 2018 as liquidity concerns surfaced, and the Fed was forced to cut rates from 2.25% to 1.5% in 2019. Of course, this was followed by the events of 2020 which infused mass liquidity (monetary and fiscal) and shifted investor attention to the few businesses that were benefiting from the lockdowns—the same growth-oriented tech names which then rallied through 2021. The Fed's aggressive actions in 2022, raising rates seven times to 4.25%-4.50% by year-end, deflated much of the excess exuberance of the mega-cap tech names as well as other speculative areas, such as the Wall Street Bets/Reddit names, electric vehicles, SPACs, and crypto. This first chart from Kailash Capital (*Figure 3*) reflects the concentration in the largest 30 names by comparing their market caps to GDP over the past 30+ years. The next chart from Kailash (*Figure 4*) demonstrates the speculation that formed in unprofitable businesses in the smaller cap arena.

Figure 3

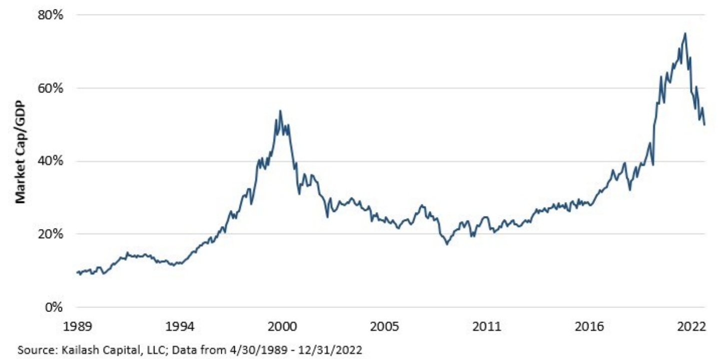
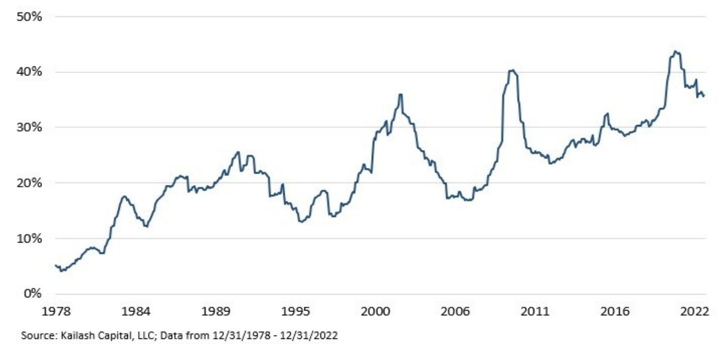


Figure 4



(Source: Kailash Capital)

The curtailment of accommodative monetary policies in 2022 marked the end of the tailwinds for long-duration assets (stocks and bonds), hence, the sharp losses in fixed income and equities, particularly in businesses with cash flow expected in the outer years, i.e., "growth" stocks. The markets also faced geopolitical challenges during the past year as Russia invaded Ukraine, which disrupted commodity markets and drove commodity and materials prices higher. These events led to a market rotation from mega-cap growth toward cyclical value as evidenced by the Russell 1000 Growth posting a loss of 29.1% relative to the Russell 1000 Value's loss of 7.6%. Delving into the sectors, Energy (+65.7%) and Utilities (+1.6%) were the only two sectors to post positive results, while Consumer Discretionary (-37.0%) and Communication Services (-39.9%) were the laggards. The varying sector weightings in the indexes explain the relative performance as the table below from J.P. Morgan Asset Management exhibits (*Figure 5*).

Figure 5 **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	**5.2%**	**2.7%**	**11.7%**	**8.7%**	**9.8%**	**25.7%**	**7.3%**	**2.7%**	**15.8%**	**7.2%**	**3.2%**	**100.0%**
Russell Growth weight	1.7%	1.5%	3.3%	8.1%	14.2%	43.2%	6.8%	1.6%	13.5%	6.1%	0.1%	100.0%
Russell Value weight	8.4%	4.3%	20.1%	10.5%	6.0%	8.3%	7.3%	4.5%	17.4%	7.4%	5.8%	100.0%
Russell 2000 weight	6.8%	4.3%	17.2%	15.6%	10.4%	12.7%	2.6%	6.4%	16.9%	3.6%	3.5%	100.0%
4Q22	22.8	15.0	13.6	19.2	-10.2	4.7	-1.4	3.8	12.8	12.7	8.6	7.6
2022	65.7	-12.3	-10.5	-5.5	-37.0	-28.2	-39.9	-26.1	-2.0	-0.6	1.6	-18.1

(Source: J.P. Morgan Asset Management; Guide to the Markets®, U.S. 1Q 2023, as of December 31, 2022)

As we move into 2023, there is an elevated probability of a recession sometime this year (see our *Current Perspectives* report, "The 2023 Outlook: A Recession Year") as the Fed remains in tightening mode as policymakers seek to contain inflation and maintain credibility. No one knows the exact level of rates needed to tame inflation or inflation expectations, despite the constant fodder amongst economists, but equity markets have historically been a leading indicator for the economy. The sharp drop in equity markets in 2022 may have already marked the coming recession. More importantly, with monetary policy normalizing, the value of fundamental analysis and investing with a margin of safety will likely regain focus, which should benefit good active management. Meanwhile, the pullback is presenting more attractive valuations for high-quality companies. Of course, we will continue to stay focused on our investment philosophy, which has always been centered on business and valuation analysis.

Strategy Commentary

The small capitalization equity markets had a strong finish to close out a rather difficult year for investors. For the fourth quarter of 2022, the Russell 2000 Index posted a 6.2% return and the Russell 2000 Value Index gained 8.4%. Unfortunately, the strong finish did not overcome the severe weakness of the preceding quarters and the two indexes ended the year in negative territory, with the Russell 2000 down 20.5% at year-end and the Russell 2000 Value down 14.5%. Confluence Small Cap Value also posted a very strong fourth quarter gain of 10.1% and was down 16.3% for the year (both gross of fees). [*The strategy's net-of-fees returns for the same periods were 9.2% QTD and -18.8% YTD. See disclosures on last page for fee description; actual investment advisory fees may vary.*]

As discussed in the previous section, the rise in inflation, and the ensuing change in monetary policy to contain it, weighed on financial assets in 2022. The preceding multi-year strength of equities and the undercurrent of geopolitical shifts produced a seismic rotation in leadership within domestic equities. The primary beneficiary was commodities, which is reflected in the dramatic outperformance of the Energy sector. Meanwhile the mega-cap growth names, which garnered an abundance of investor flows, began to abate. According to data from Strategas, the top five names in the S&P 500 increased their weighting from low double-digits in 2016 to over 22% in 2021 and retreated to 18.7% in 2022.

The skew toward mega-caps is also evident when comparing the market cap of the Russell 2000 to the Russell 1000. This first Kailash Capital chart (*Figure 6*) depicts the relative weighting falling well below one standard deviation, indicating heavy concentration in large caps.

The suppression of interest rates and quantitative easing facilitated the funding of numerous unprofitable businesses. These "zombie" companies have become a larger percentage of the small cap market as the Fed's accommodative policies aided the liquidity that kept unprofitable businesses afloat. The earlier chart in the market commentary section (*Figure 4*) shows the growing weight of unprofitable small cap businesses, which coincides with elongated easy monetary policy. These policies have disproportionately impacted the small cap indexes as the excesses encouraged speculation, which is often focused on small, unprofitable businesses with boundless prospects. This time was no different. The second chart on this page (*Figure 7*) reflects the dramatic outperformance of the negative earners going into 2022.

Now that the accommodative policies are ending, the viability of unprofitable businesses is being questioned. While the selloff in small caps has been rather indiscriminate, we subscribe to the belief that fundamentals and valuations have historically been the driver of long-term returns. When they become the focus again, active managers seeking companies with free cash flow generation at attractive valuations will likely be rewarded as they have been in the past, as seen on the third chart which dates back to 1978 (*Figure 8*).

Figure 6

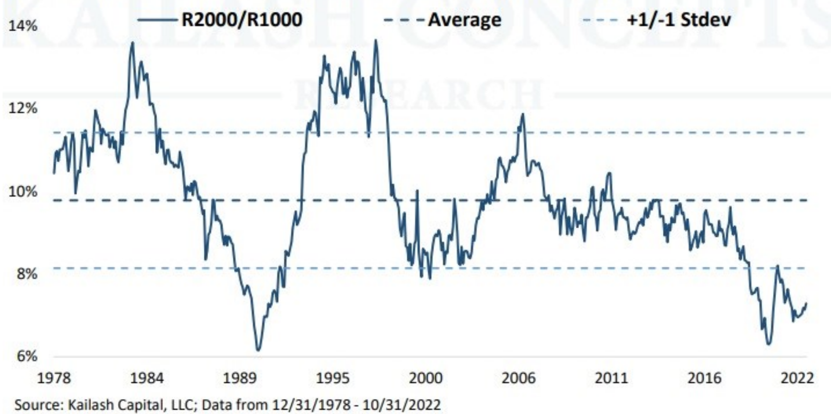
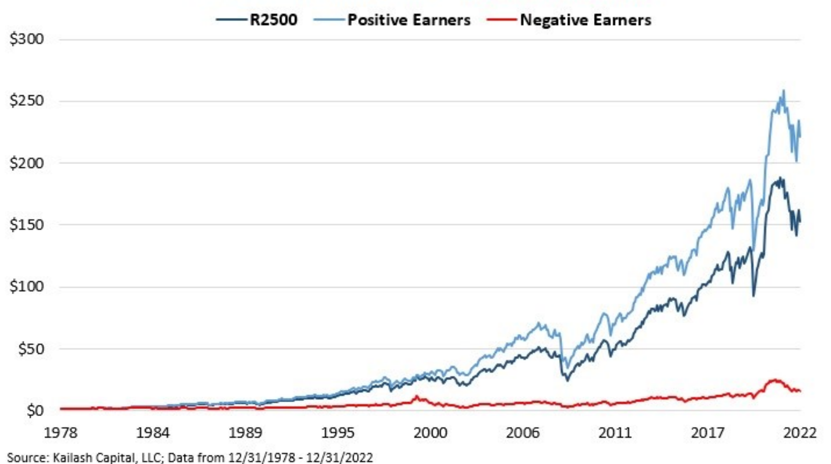


Figure 7

Figure 8

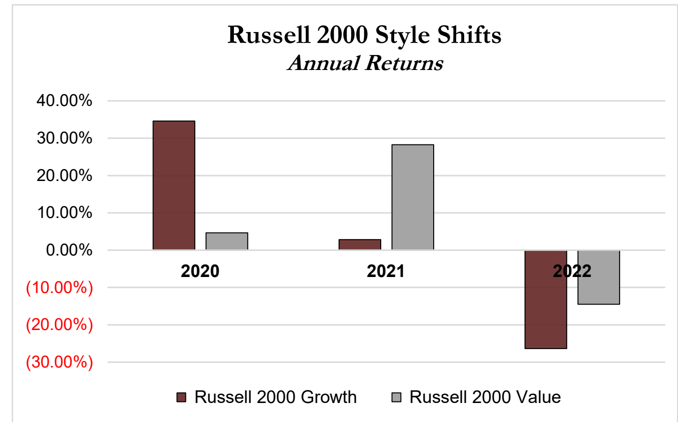


(Source: Kailash Capital)

Strategy Commentary continued...

The distortions in the small cap indexes also drove the dramatic back and forth between Growth and Value as sentiment drove valuations and returns and caused businesses to move in and out of growth and value as well as capitalization (small and large). These style shifts are represented here by the moves in the Russell 2000 Growth and Russell 2000 Value indexes between 2020-2022 (*Figure 9*).

Figure 9



(Sources: Bloomberg, Confluence)

For the year, Confluence Small Cap Value performed well against the Russell 2000 but marginally lagged the Russell 2000 Value. As we discussed last quarter, the underweighting and underperformance in Energy, specifically Core Laboratories (CLB), has been a detractor to relative performance against the value index.

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, 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 in order to hone its knowledge and 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, increased 8% in 2022 versus North American drilling that increased 33% in the same time frame. Despite all the press to the contrary, the U.S. has significantly increased its hydrocarbon production relative to international producers. Core Labs also services the North American market through its perforating guns used in the fracking process, and that market remains competitive. Along with greater worldwide recession concerns that would dampen hydrocarbon demand, Core Labs has had to negotiate covenant waivers with its lenders for the short term, which has put pressure on its stock price. Nevertheless, Core Labs is a leader in its industry, and its near-term prospects should follow the international rig count as it continues to slowly rebound. We have confidence in the company's market position and ability to execute.

During the fourth quarter, we completed the purchase of Hagerty (HGTY), a specialty insurance company founded in 1984. The car enthusiast is likely all too familiar with Hagerty as its primary focus is insuring classic and collector cars. The company serves as a Managing General Agent (MGA), which means it's an intermediary between insurance companies and retail agents, and thus it does not take underwriting risk. However, it does have a captive reinsurance subsidiary and 45% of sales are directly to the end customer. Hagerty's long history has allowed it to accumulate an extensive dataset that affords the company better unit economics than other auto insurers, with significantly lower customer acquisition costs and lower loss ratios. Its customer service is the gold standard, which results in lower churn, and the large, contracted partnership with State Farm should grow its policies by 30% next year. On the product front, Hagerty is in the early innings of rolling out online and offline marketplaces for collector cars and it also has an upcoming positive contractual change in the revenue share agreement with Markel for its reinsurance business. We expect the net effect of these contractual events and new products should position Hagerty very well for 2023 despite economic volatility.

There were a number of changes during the year as the market dislocations allowed us to upgrade several names in the portfolio. New additions are MGP Ingredients (MGPI), AZEK Company (AZEK), Hayward Holdings (HAYW), Spectrum Brands Holdings (SPB), and Hagerty (HGTY), while Natus Medical (NTUS), Thermon Group (THR), Phibro Animal Health (PAHC), and Nathan's Famous (NATH) were sold from the portfolio in 2022.

Outlook

Looking ahead, after decades of expanding globalization which helped subdue inflation, we are now witnessing a trend toward deglobalization and elevated levels of inflation. This has prompted the Fed to aggressively alter monetary policy to a more restrictive stance and give indications of further action. These conditions have naturally generated additional uncertainty around the impact these moves will have on the economy, which has weighed 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. Equity markets are leading indicators, thus with the lows reached in late September the markets may have already discounted the coming recession. But if the past few years have taught us anything, it is the fallacy of prognostication and 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 which, in turn, emphasizes competitively advantaged businesses trading at a discount to our estimate of intrinsic value.

Contribution[1]

(YTD as of 12/31/2022)

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

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

Security	Avg Weight (%)	Contribution (%)
Top 5		
Marten Transport Ltd.	3.40	0.70
MGP Ingredients Inc.	2.43	0.70
Natus Medical Inc.	*Sold*	0.57
SJW Group	3.41	0.52
AZEK Co. Inc.	1.20	0.36
Bottom 5		
Morningstar Inc.	3.16	(1.32)
American Outdoor Brands Inc.	2.12	(1.36)
Cannae Holdings Inc.	2.57	(1.37)
John Bean Technologies Corp.	3.02	(1.51)
FARO Technologies Inc.	1.65	(1.54)

Performance Composite Returns[2] (For Periods Ending December 31, 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]	10.9%	9.1%	10.5%	8.7%	9.2%	3.5%	0.7%	(16.3%)	(16.3%)	10.1%
Max Net-of-Fees[4]	7.8%	6.0%	7.3%	5.5%	5.9%	0.4%	(2.2%)	(18.8%)	(18.8%)	9.2%
Russell 2000	8.5%	7.1%	9.4%	7.1%	9.0%	4.1%	3.1%	(20.5%)	(20.5%)	6.2%
Russell 2000 Value	9.3%	7.7%	9.0%	6.8%	8.5%	4.1%	4.7%	(14.5%)	(14.5%)	8.4%

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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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.

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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.