

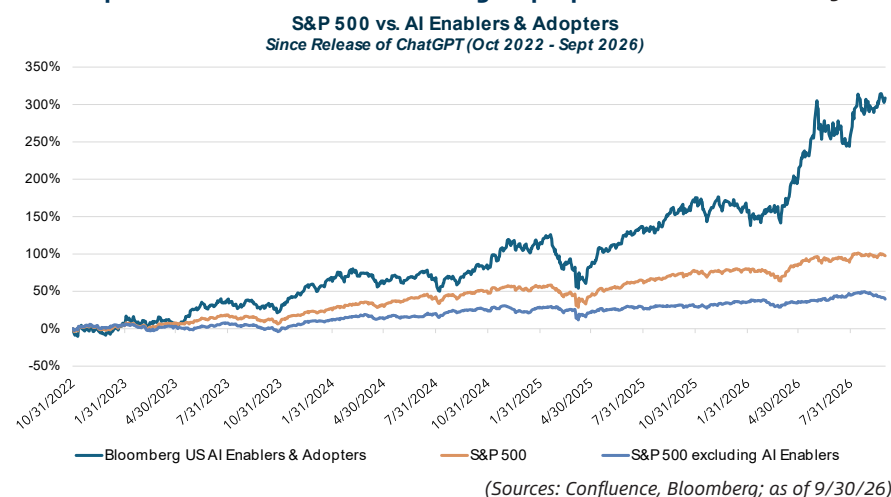
Striving for a Consistent Risk Profile: Quality and Value

"In the short run, the market is a voting machine, but in the long run, it is a weighing machine."

- Benjamin Graham

Advances in AI have captured investors' imaginations and opened a wide gap between the beneficiaries and the rest of the market. The resulting concentration in mega-cap technology businesses has exposed the limitations of how many "passive" indexes are constructed, and it is a reminder of how fluid their risk profiles can be. It also highlights how differently active managers may define fundamental attributes such as quality and value, and how firmly they adhere to their stated philosophy and process. The late stages of extended market cycles test that commitment, and the end of the cycle reveals it.

Narrow pockets of the market are driving disproportionate returns Figure 1



At Confluence, one of our key tenets is maintaining a consistent risk profile throughout market cycles by adhering to our philosophy and process. That philosophy was adopted at inception in 1994 at our predecessor firm and remains in place today. It has successfully navigated both the internet boom and bust of the late 1990s and early 2000s and the Global Financial Crisis of 2008-09. It rests on understanding and valuing individual businesses, with an emphasis on owning competitively advantaged companies at attractive prices: **quality and value**.

Ours is a fundamental approach that defines risk as the probability of a permanent loss of capital, not as tracking error to an index. Many indexes are heavily influenced by sentiment, and thus their risk profiles shift over time, while we actively strive to keep ours constant, and tracking error is the natural result. Over more than three decades, our pattern has been consistent: underperformance during the momentum-driven late stages of bull markets, and outperformance in down markets, when fundamentals and valuation reassert themselves.

Russell 1000 Value Risk Profile Changes in Just 13 Months

Figure 2

Pre-June 2025 Reconstitution				Post-June 2026 Reconstitution			
Name	Wgt (%)	PE	Yield	Name	Wgt (%)	PE	Yield
Berkshire Hathaway Inc. (Class B)	3.7%	25x	0.0%	Amazon.com, Inc.	5.9%	27x	0.0%
JPMorgan Chase & Co.	3.0%	14x	2.0%	Apple Inc.	5.4%	33x	0.4%
Exxon Mobil Corp.	1.8%	16x	3.6%	Microsoft Corp.	3.9%	22x	1.0%
Walmart Inc.	1.7%	38x	0.8%	Berkshire Hathaway Inc. (Class B)	2.6%	24x	0.0%
Johnson & Johnson	1.5%	15x	3.4%	JPMorgan Chase & Co.	2.5%	15x	1.8%
The Procter & Gamble Co.	1.3%	25x	2.3%	Intel Corp.	1.7%	130x	0.0%
Bank of America Corp.	1.2%	12x	2.3%	Johnson & Johnson	1.7%	22x	2.5%
Philip Morris International Inc.	1.1%	24x	4.4%	Exxon Mobil Corp.	1.6%	12x	3.3%
UnitedHealth Group Inc.	1.0%	13x	1.6%	Cisco Systems, Inc.	1.3%	27x	2.4%
Cisco Systems Inc.	1.0%	17x	3.3%	Walmart Inc.	1.3%	39x	0.8%
Top 3	8.5%	18x	1.9%	Top 3	15.2%	27x	0.5%
Top 10	17.3%	20x	2.4%	Top 10	27.8%	35x	1.2%

(Sources: Confluence, FactSet, iShares Russell 1000 Value ETF (IWD))

How Does Confluence Define and Measure Quality?

Quality starts with a durable competitive advantage. Successful businesses attract imitators, and competition steadily erodes profits, so a company that can protect its margins and earn above-average returns on capital over time is the exception.

The clearest evidence of such an advantage is pricing power: the ability to raise prices without losing customers. When customers would rather pay more than switch, the business is offering something competitors can't easily match. Pricing power should show up in the financial statements as above-average margins that hold, or even expand, through inflationary periods.

Profit margins alone are not enough. They must convert into free cash flow and high returns on invested capital. After all, an investment is simply an outlay of cash today for an expected return of cash in the future, and businesses should be measured accordingly.

Every business requires capital to start, grow, and even maintain itself. That capital comes from equity investors, lenders, or reinvested profits. It funds manufacturing capacity, geographic expansion, research and product development, acquisitions, and routine maintenance. Over time it accumulates on the balance sheet as invested capital, the total amount of money tied up in the business, most simply calculated as total debt plus total shareholders' equity.

How that capital is financed matters. Companies with conservative balance sheets are positioned to succeed across market cycles, while heavily indebted companies are far more sensitive to swings in their end markets.

To create shareholder value, a business must earn more on its invested capital than it costs to finance. The wider the spread between returns on invested capital (ROIC) and the cost of capital, the more cash the business generates per dollar invested and the more options it has: reinvest, pay dividends, repurchase shares, pay down debt, make acquisitions, or save for a rainy day.

In short, we define quality businesses as those that generate above-average ROIC, are conservatively financed, and produce free cash flow. The example below compares the metrics of our Large Cap Value holdings with the benchmark. Most Confluence Value Equity strategies share similar characteristics.

Confluence Large Cap Value Metrics vs. Russell 1000 Value

Figure 3

R1000 Value Quintile	Companies	Multi-year Median							Current		
		FY-2, FY-1, FY0, FY+1							FY-3, FY-2, FY-1, FY0		FY0
		Sales Growth	EBITDA Growth	Net Income Growth	EPS Growth	EBITDA Margin	Net Income Margin	FCF Margin	ROIC	Yield	Net Debt/EBITDA
1st	175	6%	5%	3%	8%	22%	12%	11%	7%	0.8%	1.1x
2nd	174	5%	6%	7%	8%	23%	14%	12%	7%	1.3%	1.7x
3rd	174	5%	7%	5%	7%	27%	14%	11%	7%	1.9%	2.4x
4th	174	6%	7%	7%	8%	25%	12%	12%	9%	1.8%	2.0x
5th	174	7%	9%	7%	8%	20%	11%	11%	7%	1.0%	1.7x
R1000 Value	871	6%	7%	6%	8%	23%	12%	12%	7%	1.3%	1.8x
Confluence LCV	24	5%	8%	6%	9%	29%	20%	18%	15%	1.1%	1.7x

(Sources: Confluence, FactSet, iShares Russell 1000 Value ETF (IWD); as of 9/30/26)

Table reflects median metrics of index holdings by YTD performance quintile. Shading reflects relative strength of attributes: above-average (green), average (yellow), and below-average (red). The companies owned in Confluence Large Cap Value (LCV) have stronger, more consistent fundamentals than those in the Russell 1000 Value, including double the ROIC.

Confluence Defines Value: Absolute Value, Not Deep or Relative Value

Identifying companies that are likely to generate high ROIC is only part of the puzzle. The next piece is finding those that the market has undervalued and avoiding those it has overvalued.

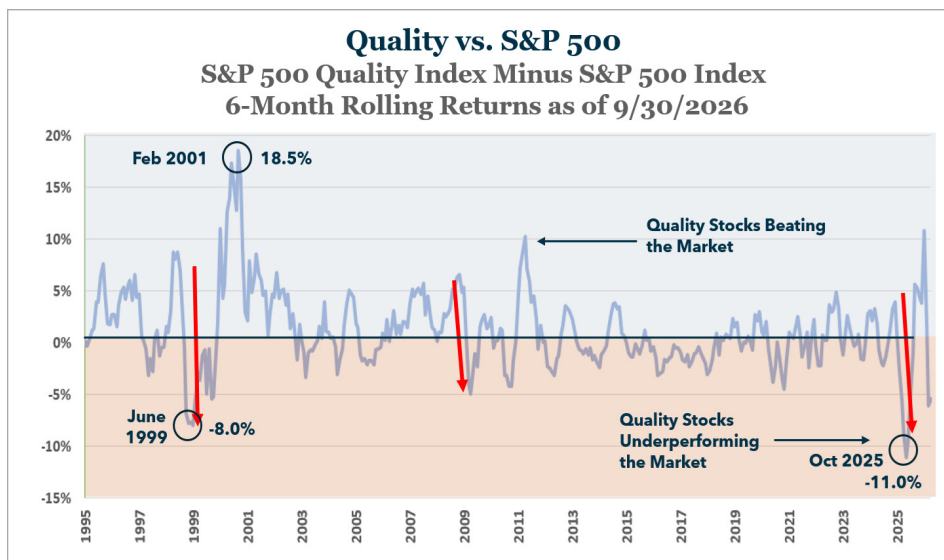
Like most investors, we want to own growing businesses, but earning above-average returns is difficult if we overpay for them. So, we begin with extensive valuation work to determine what a business is worth, then require a discount to that value before we buy. We call this approach Absolute Value, distinct from Deep Value or Relative Value. We are not looking for the statistically cheapest stocks or stocks that are merely cheaper than their peers. Rather, we seek quality businesses priced below what they are actually worth.

Our process is anchored on a basic question: “What would an intelligent, well-informed, all-cash buyer pay for this business?” Answered properly, it provides a sound estimate of intrinsic value. Fortunately, the markets offer ample examples of comparable businesses that have been acquired, which lets us analyze the valuation metrics buyers actually paid and apply them to businesses with similar attributes. The relevant metrics vary by industry, such as EV/EBITDA, P/E, EV/NOPAT, P/B, and free cash flow (FCF) yield.* Purchasing at a discount to our estimate of intrinsic value establishes a margin of safety that helps protect our clients’ assets while providing upside potential.

The Long View

Market sentiment can swing wildly over short periods, but we firmly believe investors are rewarded over the long term for owning a portfolio of high-ROIC businesses purchased at attractive prices – in short, a disciplined focus on quality and value. Importantly, these businesses keep creating value even when they are out of favor. Management teams can continue to reinvest in profitable growth, make sensible acquisitions, repurchase stock at lower prices, or raise the dividend, all of which increase intrinsic value.

Figure 4



(Sources: Confluence, FactSet; as of 9/30/26)

Quality and Value in Today’s Market

Today’s investing environment has rewarded AI-related companies, while largely ignoring everything else. Meanwhile, many high-quality companies with growing earnings and healthy fundamentals that are not associated with AI have lagged.

At Confluence, our absolute value approach of buying quality companies at a discount to intrinsic value is designed to limit the impact of market sentiment. Our priority is building and protecting wealth, with a focus on maintaining a consistent risk profile at every stage of the investment process.

Our Value Equity strategies are guided by the same philosophy and disciplined process that have successfully managed through more than 30 years of market cycles and historically delivered strong performance during bear markets. With markets constantly evolving, we are positioning for long-term wealth creation.

* EV/EBITDA: Enterprise Value to Earnings Before Interest, Taxes, Depreciation, and Amortization; P/E: Price to Earnings; EV/NOPAT: Enterprise Value to Net Operating Profit After Taxes; P/B: Price to Book (value)

Mark Keller, CFA Tore Stole Tom Dugan, CFA Dustin Hausladen Brett Mawhiney, CFA John Koenig, CFA
Dan Winter, CFA John Wobbe Joe Hanzlik Blair Brumley, CFA Ben Kim, CFA

Related Reports from the Value Equities Investment Committee:

- [A Moving Yardstick: Dynamic Risk Profiles of the Indexes](#) (October 2026)
- [A Narrow Market](#) (July 2026)
- [Understanding the Benchmark: The Russell 1000 Value Index](#) (January 2026)
- [Shining a Light on Indexes: How to Help Investors Better Achieve Their Goals](#) (July 2020)

For more information, contact a member of our Sales Team:

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DISCLOSURES

Figure 1: Index data utilized: Bloomberg US AI Enablers and Adopters Price Return Index (BUSAIIE), Goldman Sachs US 500 Excluding Artificial Intelligence Enablers Price Return Index (SPXXAI), and S&P 500 Index (SPX). Returns through 9/30/2026.

Figure 2: Reflects constituents of the iShares Russell 1000 Value ETF (IWD). Pre-June Reconstitution data as of 5/31/2025 and 5/31/2026 and Post-Reconstitution data as of 6/30/2025 and 6/30/2026.

Figure 3: Russell 1000 Value constituents as of 9/30/26, using iShares Russell 1000 Value ETF (IWD).

Figure 4: Rolling 6-month returns utilizing the S&P 500 Quality Index (SPXQUT) minus the S&P 500 Index (SPX), 6/30/1995 through 9/30/2026.

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