Confluence
INVESTMENT MANAGEMENT

THIRD QUARTER
2023

# Value Opportunities • Value Equity Strategies

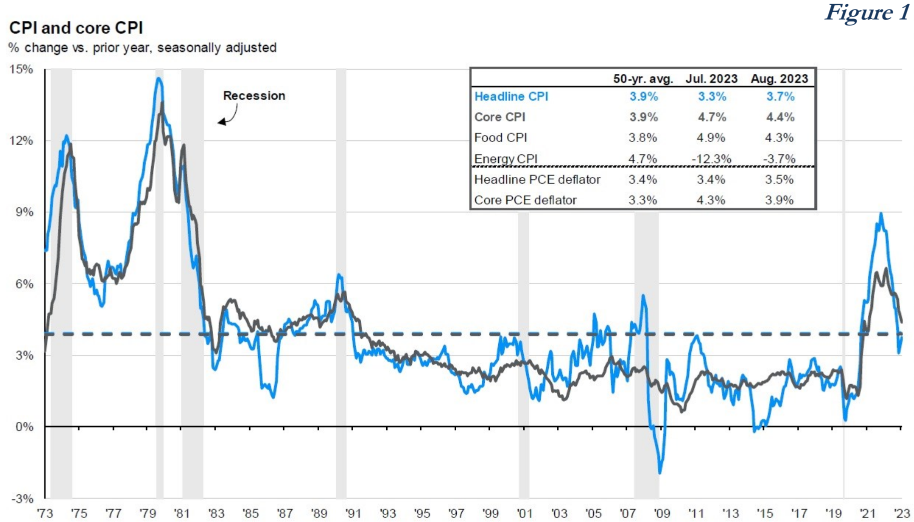
Value Opportunities is a concentrated portfolio of businesses that range in market capitalization. Companies are selected using a bottom-up, fundamental research process that seeks to identify individual businesses that are trading at substantial discounts to our estimate of intrinsic value and have near-term catalysts in which to unlock the value. The portfolio may have concentrations in both individual holdings and/or industries. It typically comprises 8-12 holdings and is expected to result in high annual turnover. The strategy is appropriate for clients seeking an aggressive approach to generating capital appreciation.

## Market Commentary

Economist Milton Friedman once said that monetary policy works with a "long and variable lag," and in 2023 the markets are living Friedman's observation every day.

The equity markets have been choppy through the first three quarters of 2023. One might recall that we entered the year with lots of uncertainty surrounding the surge in inflation witnessed in 2021-2022 along with questions of whether it would persist. There were also elevated concerns of whether the economy was heading into a recession. During the first half of the year, inflation declined and the economy remained resilient, both of which provided the backdrop for a rebound in stocks following a tumultuous 2022. And although inflation has declined, it remains elevated and above the Fed's target, while concerns about the economy still linger. This unevenness was on display in the third quarter as July and early August were positive based on assumptions of a soft landing (no recession and inflation in check), but that posture was questioned in the back half of the quarter as the equity markets pulled back in late August and September.

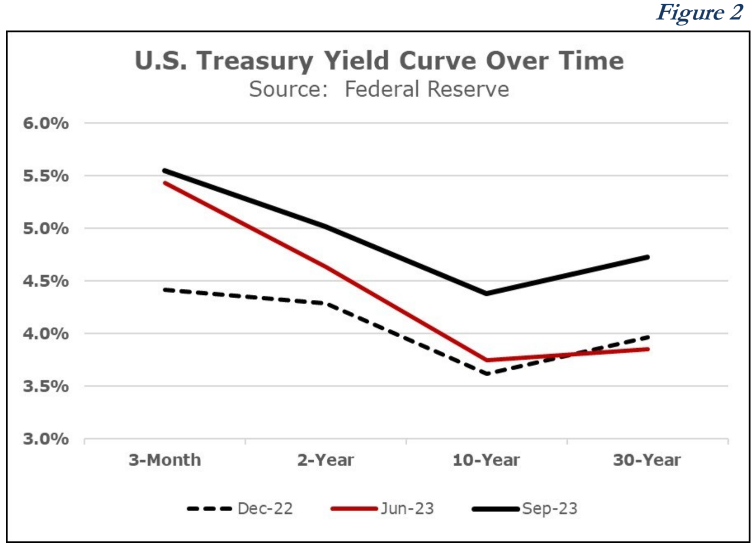
*Figure 1*




*(Source: J.P. Morgan Asset Management; Guide to the Markets®, U.S. 4Q 2023, as of September 30, 2023)*

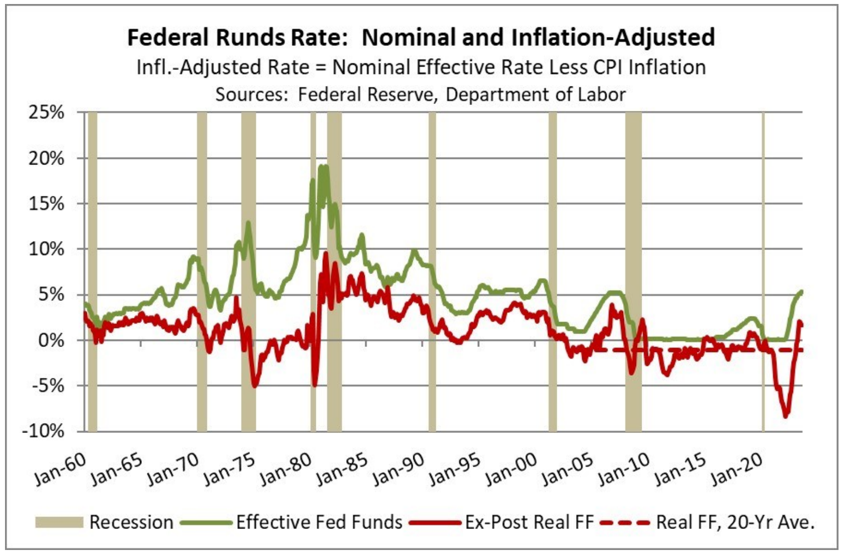
Inflation and interest rates have remained the focal point, with the Fed aggressively raising the Fed funds rate from 0% in early 2022 to 5.5% by July 2023 to combat inflation. While the pace of increases has slowed in 2023, the structure of rates has risen across the board. However, the rise was sharpest on the short end of the curve in the first half of 2023, while the longer end remained relatively stable as the three-month T-bill increased 101 bps, from 4.42% to 5.43%, yet the 10-year Treasury increased only 13 bps, from 3.62% to 3.75% (see *Figure 2*). This trend switched in the third quarter with the longer end of the curve rising while the short end stabilized as the three-month T-bill increased 12 bps, from 5.43% to 5.55%, yet the 10-year Treasury increased 63 bps, from 3.75% to 4.38%. In essence, the yield curve is beginning to flatten. The rise in longer-term rates was likely driven by a shift in the perception that inflation may be stickier than expected and the Fed may need to keep rates higher for longer. This, of course, put pressure on longer-term securities such as equities and long-dated bonds.

*Figure 2*



## Market Commentary continued...

*Figure 3*




Nominal interest rates are now back to levels prior to the Global Financial Crisis of 2008-09 and real interest rates are firmly in positive territory (i.e., nominal interest rates higher than inflation). The market is revealing that the anomaly may have been the past 15-year period of negative real interest rates on the back of excessive stimulus, such as Zero Interest Rate Policy (ZIRP) and Quantitative Easing (QE). We are now back to positive real interest rates, the historical norm, which investors have not experienced for 15 years. This chart (*Figure 3*) from the Confluence macroeconomic team shows real rates dating back to the 1960s.

For the equity markets, the rise in longer-term rates during the quarter put downward pressure on stocks, with little discrimination across market capitalization, style, or region. The broad equity markets marked by the S&P 500 Index were down 3.27%, with little difference between Growth and Value as the Russell 3000 Growth and Russell 3000 Value indexes were also down 3.34% and 3.15%, respectively. Small cap stocks also posted negative returns, with the Russell 2000 Index down 5.13%, as did international equities, with the MSCI World ex-U.S. Index down 4.10%. Looking at sector performance, all but Energy and Communication Services posted a negative third quarter with the interest rate-sensitive sectors of Utilities and Real Estate faring the worst, both down a little over 9%. On a year-to-date basis, the outsized strength of the "Magnificent 7" (M7) mega-caps (Alphabet, Amazon, Apple, Meta, Microsoft, NVIDIA, and Tesla) to start the year is still skewing the returns of the S&P 500, up 13.06%, and the sectors in which they reside (Consumer Discretionary–Amazon and Tesla; Technology–Apple, Microsoft, and NVIDIA; Communication Services–Alphabet and Meta), as well as the Russell 1000 Growth, up 24.98%. Meanwhile, the S&P 500 Equal Weight Index was up only 1.79% year-to-date, in line with the year-to-date returns of the Russell 1000 Value, up 1.79%, and the Russell 2000, up 2.54%.

*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** | **4.7%** | **2.4%** | **12.8%** | **8.3%** | **10.7%** | **27.5%** | **8.9%** | **2.4%** | **13.4%** | **6.6%** | **2.4%** | **100.0%** |
| Russell Growth weight | 0.6% | 0.7% | 6.6% | 6.0% | 16.0% | 42.1% | 11.6% | 0.9% | 11.3% | 4.3% | 0.0% | 100.0% |
| Russell Value weight | 9.1% | 4.8% | 20.6% | 13.2% | 5.0% | 9.1% | 5.0% | 4.7% | 15.3% | 8.3% | 4.9% | 100.0% |
| Russell 2000 weight | 8.5% | 4.6% | 16.1% | 17.1% | 10.6% | 13.3% | 2.4% | 6.1% | 14.9% | 3.6% | 2.9% | 100.0% |
| **QTD** | 12.2% | -4.8% | -1.1% | -5.2% | -4.8% | -5.6% | 3.1% | -9.5% | -2.7% | -6.0% | -9.2% | -3.3% |
| **YTD** | 6.0% | 2.6% | -1.6% | 4.5% | 26.7% | 34.7% | 40.4% | -8.1% | -4.1% | -4.8% | -14.4% | 13.1% |

*(Source: J.P. Morgan Asset Management; Guide to the Markets®, U.S. 4Q 2023, as of September 30, 2023)*

The lingering concerns around inflation and recession have been swirling since early 2023 and are not likely to be resolved any time soon. This apprehension will tend to result in swings between optimism of soft landings and pessimism of hard landings, with these bouts causing continued choppiness for investors. The optimist can lean on the fiscal policies that are providing a tailwind for the economy, which are large spending programs such as the Infrastructure Bill, Inflation Reduction Act, and the CHIPS Act (Creating Helpful Incentives to Produce Semiconductors) as well as the strong labor market. The pessimist can point to the headwinds the economy is facing, such as higher rates, oil prices, the return of student loan payments, and inflation. We don't consider ourselves prognosticators in calling markets over the near-term, but the return of real rates should be welcome to savers. It should also place the importance of risk management and fundamentals closer to the forefront for investors as we navigate an environment that is no longer awash with easy money (ZIRP and QE).

### Strategy Commentary

In the third quarter, the lagged effects of monetary policy started to emerge here and there as interest rates on loans reset and higher interest offered on money market funds began to compete with the long-term funding needed to cover federal spending deficits. Then, in September, the markets finally started believing the Fed's "higher for longer" message with 10-year Treasury yields approaching 5% and expectations of big rate cuts in 2024 beginning to fade.

As a result, the S&P 500 declined in August and September for a return of -3.3% in the third quarter but is still up 13.1% in 2023, driven almost entirely by the Magnificent 7 (M7) mega-cap stocks (Apple, Microsoft, Amazon, NVIDIA, Google, Tesla, and Meta), with the NYSE FANG+ Index up approximately 66% year-to-date. Meanwhile, the Russell 3000 Value and the S&P 500 Equal Weight indexes are up only 1.6% and 1.8%, respectively, this year. By comparison, the Value Opportunities strategy is up 14.1% year-to-date (gross of fees), so it has outperformed both the Russell 3000 Value and the S&P 500 despite the huge returns from the M7 stocks. [*The strategy's net-of-fees return for the same period was 11.5% YTD. See disclosures on last page for fee description; actual investment advisory fees may vary.*]

The top contributors to performance year-to-date have been Vontier Corp. (VNT), which continues to rebound from an unduly low valuation in late 2022, and NXP Semiconductors (NXPI) as it continues to grow earnings. Additionally, Spectrum Brands (SPB) has outperformed with the divestiture (discussed last quarter) closing in June, and Azek Co. (AZEK) is up strong in 2023 on sustained demand for composite decking. The primary detractors to performance year-to-date have been Dollar Tree (DLTR), due to concerns in retail about consumer demand, and Clarivate (CLVT), a research data provider that continues the slow process of consolidating its acquisitions and reinvesting for growth. [*See contribution table on next page.*]

During the third quarter, we purchased Progressive Corp. (PGR), an auto insurer, and sold commercial insurance broker BRP Group (BRP) at a price slightly lower than where we initially bought it in Q4 2020, as the catalyst from strong growth at BRP has been offset by high acquisition-related debt ratios that we believe will take a few years to work down.

Progressive is the second largest auto insurer in the U.S. with a 14% market share, just behind State Farm. The company has several competitive advantages that have driven dramatic growth over the past 20 years. First and foremost, Progressive is arguably one of the best underwriters in auto insurance with cumulative knowledge from 30 years of incremental fine tuning on underwriting algorithms, new business acquisition, marketing spend, etc. Additionally, with distribution split about evenly between independent insurance agents and direct-to-consumer over the internet, Progressive has tremendous advertising scale to drive new business. Lastly, Progressive has a strong culture of profitable underwriting and growth built on excellent data analysis, which is alive and well with the current management team. Given Progressive's superior underwriting capability, the company usually adjusts rates to adequate levels ahead of competitors and then takes market share when competitors respond to underwriting losses with large rate increases, prompting customers to shop around. We are currently in the middle of one of these cycles as auto insurers are raising rates over 10% annually in response to higher auto repair and auto replacement costs.

We were able to add Progressive to the Value Opportunities portfolio when it sold off in mid-July after the company reported uncharacteristic reserve additions due to a lack of auto repair capacity. In standard fashion at Progressive, management quickly identified the trend, took the additional rate increases needed, and is now focused on key profitability metrics. As competitors work to raise rates over the next 12-24 months in response to losses, Progressive should be able to take additional market share, providing a solid catalyst for the stock.

During the quarter, we also sold NXP Semiconductors in order to purchase a new position that is still in progress, which we will discuss once completed. NXPI is a great business that we initially added to the portfolio in August 2016 around $80. With solid execution and strong earnings growth over the past seven years, the stock was trading at a fair valuation, in our estimation, so we decided to sell the position around $200 in order to purchase a new opportunity.

### Outlook

With short-term (and now long-term) interest rates rising, higher oil prices, student loan payments resuming, weak economies in Europe and China, and an inverted yield curve, there is much talk about a potential recession in the U.S. While the stock market can be consumed with fears of recession, in reality, they are a part of the long-term economic growth cycle. In fact, the U.S. has had 34 recessions over the past 170 years, a period of tremendous economic growth. With our investment philosophy and the high-quality businesses we own, a recession should not bring fear of economic collapse, rather we view it as a once-in-a-decade opportunity to buy great companies at attractive prices. As a result, we continue to stay focused on doing just that and remain committed to our process with a long-term investment horizon.

## Contribution[1]

***(YTD as of 9/30/2023)***

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

| Security | Avg Weight (%) | Contribution (%) |
|---|---|---|
| **Top 5** | | |
| Vontier Corp. | 8.74 | 4.05 |
| NXP Semiconductors N.V. | *Sold* | 3.53 |
| Spectrum Brands Holdings Inc. | 10.63 | 3.13 |
| Azek Co. Inc. | 7.02 | 2.70 |
| Progressive Corp. | 3.45 | 2.33 |
| **Bottom 5** | | |
| Keysight Technologies Inc. | 0.33 | 0.02 |
| SL Green Realty Corp. | *Sold* | (0.01) |
| BRP Group Inc. | *Sold* | (0.30) |
| Clarivate plc | 8.13 | (1.42) |
| Dollar Tree Inc. | 9.01 | (2.29) |

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

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

| | Since Inception** | 20-Year* | 15-Year* | 10-Year* | 5-Year* | 3-Year* | 1-Year | YTD | QTD |
|---|---|---|---|---|---|---|---|---|---|
| **Value Opportunities** *Pure Gross-of-Fees[3]* | 9.6% | 9.1% | 8.9% | 7.5% | 2.0% | 4.5% | 21.8% | 14.1% | (3.9%) |
| *Max Net-of-Fees[4]* | 6.5% | 5.9% | 5.7% | 4.3% | (1.1%) | 1.4% | 18.2% | 11.5% | (4.6%) |
| **S&P 500** | 6.6% | 9.7% | 11.3% | 11.9% | 9.9% | 10.1% | 21.6% | 13.1% | (3.3%) |
| **Russell 3000 Value** | 6.9% | 8.2% | 8.5% | 8.3% | 6.0% | 11.2% | 14.0% | 1.6% | (3.2%) |

| Calendar Year | Pure Gross-of-Fees[3] | Max Net-of-Fees[4] | S&P 500 | R3000 Value | Difference (Gross-S&P500) | # of Portfolios | Composite Assets (000s) | Total Firm Assets (000s) | Composite 3yr Std Dev | S&P 500 3yr Std Dev | R3000V 3yr Std Dev | Composite Dispersion |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 2000** | 43.6% | 40.7% | (11.1%) | 7.3% | 54.8% | 1 | $74 | | N/A | N/A | N/A | N/A |
| 2001 | 1.1% | (1.7%) | (11.9%) | (4.3%) | 13.0% | 79 | $7,097 | | N/A | N/A | N/A | 0.4% |
| 2002 | (14.8%) | (17.1%) | (22.1%) | (15.2%) | 7.3% | 107 | $7,786 | | N/A | N/A | N/A | 0.9% |
| 2003 | 40.4% | 36.5% | 28.7% | 31.1% | 11.7% | 126 | $23,976 | | 25.2% | 18.1% | 16.0% | 0.9% |
| 2004 | 4.8% | 2.0% | 10.9% | 16.9% | (6.1%) | 189 | $25,252 | | 20.1% | 14.9% | 14.8% | 1.0% |
| 2005 | 4.4% | 1.6% | 4.9% | 6.9% | (0.5%) | 179 | $23,399 | | 11.7% | 9.0% | 9.7% | 0.8% |
| 2006 | 27.0% | 23.6% | 15.8% | 22.3% | 11.3% | 171 | $19,132 | | 7.6% | 6.8% | 7.0% | 1.7% |
| 2007 | 2.1% | (0.7%) | 5.5% | (1.0%) | (3.4%) | 197 | $20,510 | | 8.4% | 7.7% | 8.3% | 0.7% |
| 2008 | (22.3%) | (24.5%) | (37.0%) | (36.2%) | 14.7% | 29 | $8,299 | $291,644 | 18.6% | 15.1% | 15.5% | N/A |
| 2009 | 31.5% | 27.6% | 26.5% | 19.8% | 5.0% | 37 | $14,001 | $533,832 | 25.2% | 19.6% | 21.3% | 2.0% |
| 2010 | 6.9% | 3.7% | 15.1% | 16.3% | (8.2%) | 51 | $7,429 | $751,909 | 27.9% | 21.9% | 23.5% | 0.7% |
| 2011 | (1.7%) | (4.6%) | 2.1% | (0.1%) | (3.8%) | 53 | $7,694 | $937,487 | 23.7% | 18.7% | 21.0% | 0.6% |
| 2012 | 28.5% | 24.7% | 16.0% | 17.6% | 12.5% | 53 | $9,576 | $1,272,265 | 18.3% | 15.1% | 15.8% | 0.9% |
| 2013 | 32.3% | 28.3% | 32.4% | 32.7% | (0.1%) | 76 | $18,299 | $1,955,915 | 13.5% | 11.9% | 12.9% | 0.4% |
| 2014 | 31.6% | 27.7% | 13.7% | 12.7% | 17.9% | 110 | $31,040 | $2,589,024 | 11.4% | 9.0% | 9.4% | 0.9% |
| 2015 | 2.3% | (0.7%) | 1.4% | (4.1%) | 1.0% | 554 | $113,587 | $3,175,419 | 10.8% | 10.5% | 10.7% | 0.3% |
| 2016 | 15.4% | 12.0% | 12.0% | 18.4% | 3.4% | 959 | $207,565 | $4,413,659 | 10.9% | 10.6% | 11.0% | 0.5% |
| 2017 | 14.5% | 11.1% | 21.8% | 13.2% | (7.3%) | 1,737 | $359,636 | $5,944,479 | 9.8% | 9.9% | 10.3% | 0.8% |
| 2018 | (18.8%) | (21.2%) | (4.4%) | (8.6%) | (14.4%) | 1,494 | $236,097 | $5,486,737 | 11.9% | 10.8% | 11.1% | 0.8% |
| 2019 | 28.6% | 24.7% | 31.5% | 26.2% | (2.9%) | 1,129 | $230,991 | $7,044,708 | 13.6% | 11.9% | 12.0% | 0.7% |
| 2020 | 9.5% | 6.2% | 18.4% | 2.9% | (8.9%) | 745 | $165,389 | $6,889,798 | 20.0% | 18.5% | 20.0% | 1.3% |
| 2021 | 6.9% | 3.8% | 28.7% | 25.3% | (21.7%) | 532 | $132,656 | $7,761,687 | 18.3% | 17.2% | 19.3% | 1.2% |
| 2022 | (22.3%) | (24.6%) | (18.1%) | (8.0%) | (4.1%) | 331 | $61,497 | $6,931,635 | 21.1% | 20.9% | 21.5% | 0.9% |

**Average annualized returns* ***Inception is 4/1/2000* *See performance disclosures on last page.*

**Portfolio Benchmarks**

***S&P 500® Index*** – A capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

***Russell 3000® Value Index*** – A capitalization-weighted index designed to measure performance of those Russell 3000® Index companies with lower price-to-book ratios and lower forecasted growth values. *(Source: Bloomberg)*

### Confluence Value Equities Investment Committee

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## 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.

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 S&P 500 and Russell 3000 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, 2022. 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 Value Opportunities Strategy was incepted on April 1, 2000, and the current Value Opportunities 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 Value Opportunities Composite contains fully discretionary Value Opportunities wrap accounts. Value Opportunities is a concentrated, value-based, bottom-up portfolio that utilizes stocks from all market capitalizations with a focus on near-term catalysts. Catalysts include reorganizations, turnarounds, and other unique situations that are anticipated to come to fruition in approximately 6-18 months. This short-term investment time frame often leads to high turnover. *Because of the concentrated positions, the portfolio is more susceptible to movements of any one holding.*

**Results shown for the year 2000 represent partial period performance from April 1, 2000, through December 31, 2000. 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.