Confluence INVESTMENT MANAGEMENT

Fourth Quarter

2022

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

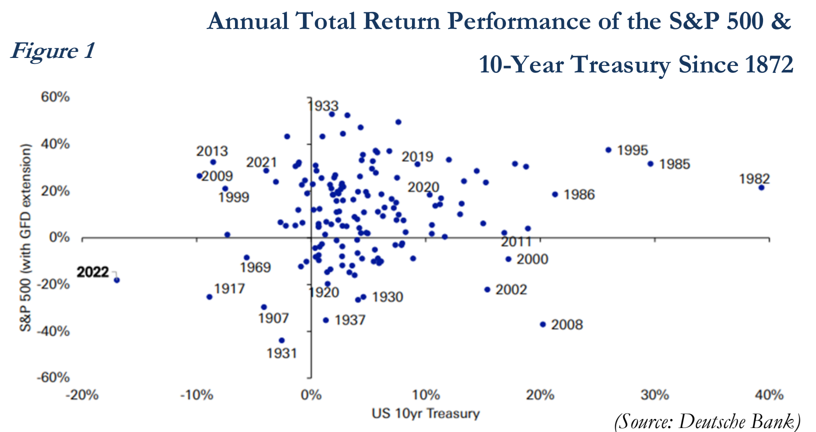
"Interest rates are to asset prices what gravity is to the apple. When there are low interest rates, there is a very low gravitational pull on asset prices."

\- 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**

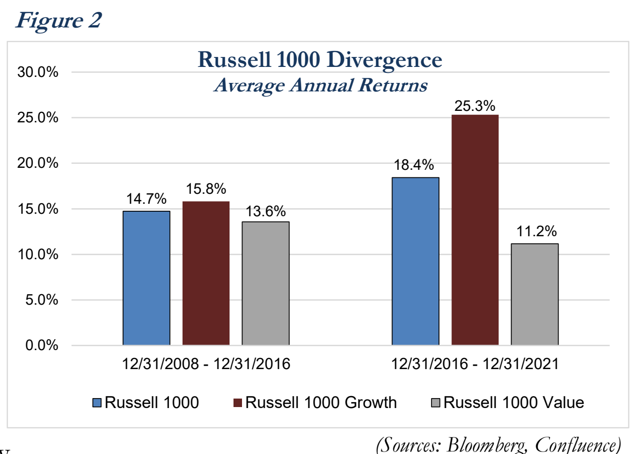


(Source: Deutsche Bank)

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

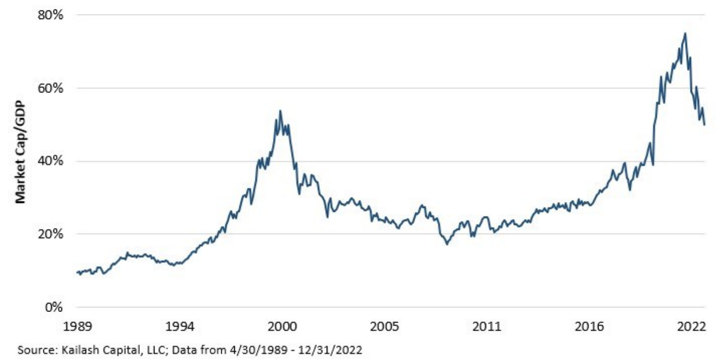
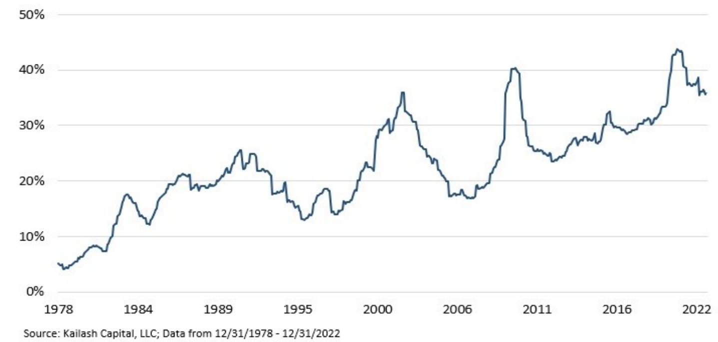


Figure 4



(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)

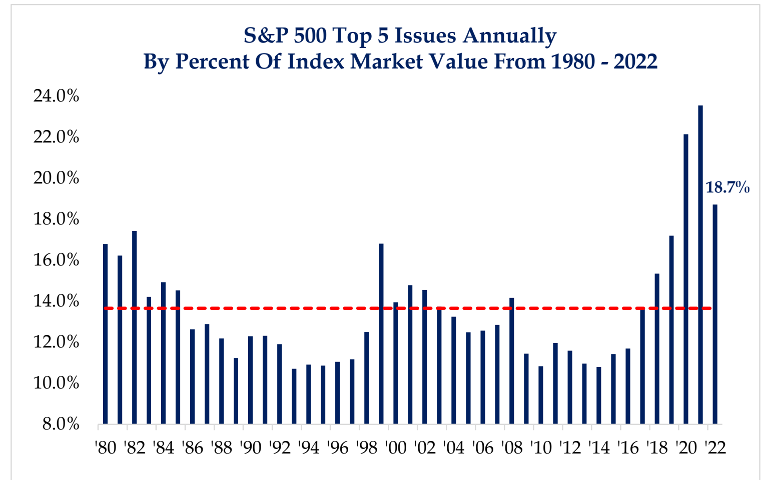
As we move into 2023, there is an elevated probability of a recession sometime this year (see our *Current Perspectives* report, "The 2023 Outlook: A Recession Year") as the Fed remains in tightening mode as policymakers seek to contain inflation and maintain credibility. No one knows the exact level 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 Confluence Value Opportunities strategy gained 6.8% in the fourth quarter of 2022 and ended the year down 22.3% (both gross of fees), trailing the S&P 500 Index, which was up 7.5% in Q4 and declined 18.1% for the full year. [*Net-of-fees returns for the same periods were 6.0% QTD and -24.6% YTD. See disclosures on last page for fee description; actual investment advisory fees may vary.*]

It appears that the irrational exuberance of 2020 finally deflated in 2022. Like most speculative frenzies throughout history, this one was fueled gradually by the Fed's zero interest rate policy (ZIRP) for over a decade, which supported highly valued, high-growth technology companies (e.g., FAANG+). We have often discussed how the speculative party really got going in 2017 and led to a blowout in 2020, propelled by trillions of dollars in pandemic stimulus (see *Figures 3-4* in the previous section). As the work from Strategas reflects in this chart (*Figure 6*), the top five names in the S&P 500 increased their weighting from low double-digits (11% in the early days of ZIRP in 2010) to over 22% in 2021 and retreated to 18.7% in 2022.

Figure 6



(Source: Strategas; 12/31/2022)

While high inflation and dramatic rate increases from the Fed brought this party to an end in 2022, the good news is that Confluence's value equity portfolios watched the craziness from the sidelines. Although a negative return for the year is never desired, Value Opportunities avoided the speculation and permanent losses discussed above, so the high-quality, growing businesses in the portfolio should more quickly rebound and continue to compound for the long term. Put another way, our quality value investment philosophy aims to own stocks that bounce like tennis balls coming out of a down market, not like tomatoes that go splat at the bottom.

For the full year, Value Opportunities underperformed the S&P 500 primarily due to our holdings in the Industrials sector (specifically Clarivate) along with having no exposure to the Energy and Health Care sectors, which outperformed in 2022. The portfolio did have strong outperformance from the Consumer Discretionary holdings, with Dollar Tree up for the year, while the index's largest holdings in the sector, Amazon and Tesla (with market caps of $1.7 trillion and $1.1 trillion to begin 2022!), were down 50% and 65%, respectively, in 2022.

With a concentrated portfolio of 10-12 stocks, performance relative to a benchmark in any given year is usually driven by one or two holdings. In 2022, our relative underperformance came primarily from Clarivate, which was added to the portfolio in February after declining over 50% from its 2021 high, so a refresher on our investment rationale for Clarivate is in order.

Clarivate (CLVT) operates a collection of subscription-based services focused largely on analytics in the areas of scientific and academic research, patent intelligence and compliance standards, pharmaceutical and biotech intelligence, and trademark, domain, and brand protection. Clarivate curates and sells trusted data that is highly valued and caters to academia, healthcare, and legal customers, which are defensive sectors. This comes from the company's ability to monetize historical and often irreplicable data. Its model is built on the concept of "build once and sell multiple times," which typically generates incremental margins producing high returns on capital and excess free cash flow. Clarivate possesses three important attributes that we focus on for investment: strong moat, high returns on capital, and solid free cash flow.

Despite these attributes, Clarivate's shares have performed poorly over the last year as management made a few large, yet important, acquisitions over a short period which elevated leverage and produced inconsistent results. These are shorter-term integration issues that when completed we anticipate will provide greater scale and enhance the value proposition to customers. While the leverage is higher than desired, the business model's 90%+ customer retention and 80%+ recurring revenue stream provide management with the ability to scale back debt without hindering the business. As management executes operationally over the next few years by driving free cash flow, deleveraging the balance sheet, and allocating capital to shareholders, this should create a catalyst for Clarivate's stock which is currently trading at a significant discount to our estimate of intrinsic value.

Strategy Commentary continued...

Across the Value Opportunities portfolio, from a company-specific perspective, the strongest contributors in 2022 were J&J Snack Foods (new position in Q2), Dollar Tree, AZEK (new position in Q4), Markel, and Spectrum Brands (new position in Q4), while the weakest contributors were Clarivate (new position in Q1), NXP Semiconductors, Frontdoor (sold in Q2), Vontier, and BRP Group. Upon a closer look, the weakest performers in 2022 had year-end valuations that are extremely attractive for quality growing businesses, with price-to-forward-earnings multiples of 10.2x, 12.2x, and 7.0x for Clarivate, NXP, and Vontier, respectively. [*See contribution data on the next page.*]

With the market hitting new lows in October, we were able to opportunistically put our cash holdings to work with the purchases of AZEK and Spectrum Brands Holdings (SPB).

AZEK is a branded leader in the manufacturing and sale of composite decking and exterior trim. Composite deck building materials offer many benefits over wood, primarily due to the low maintenance and long life span of composites, and its popularity is also driven by customer desire to use more sustainable, recycled products. The superior attributes of composite materials have slowly transitioned end markets away from the use of wood products, creating a structural tailwind for AZEK that could last many years. Management at AZEK operates with a clear strategy to drive above-market growth through further adoption of composite decking, material science innovation, multi-channel expansion, and a best-in-class consumer experience. Based on these attributes, AZEK has a long runway for growth. With concerns in October about a housing downturn from rising mortgage rates, we had an opportunity to add this strong, growing company to the portfolio at an attractive valuation.

In December, we added Spectrum Brands to the portfolio. Spectrum is a consumer packaged goods company that has evolved dramatically over the past five years. The company currently sells value-focused consumer goods under many widely recognized brands in several segments, including Global Pet Care (Tetra, Nature's Miracle, Furminator), Home & Garden (Spectracide, Black Flag, Cutter), Home & Personal Care (Black & Decker small appliances, Remington razors), and Hardware & Home Improvement (Kwikset locks, Pfister faucets), after divesting the Battery (Rayovac) and Global Auto Car (Armor All, STP) segments in 2018. Spectrum currently has an agreement to sell the hardware and locks business to ASSA ABLOY (a Swedish commercial lock manufacturer with little presence in the U.S. residential lock market), but the Justice Department has challenged the deal. ASSA ABLOY is eager to close on the acquisition and has agreed to additional divestitures. If this $4.3 billion deal does go through it will more than offset Spectrum's $3.2 billion of debt, even before plans to also sell the Home & Personal Care business. As a result, Spectrum will have a strong balance sheet, excess cash flow, and will be well-positioned to focus on its two remaining higher margin, growth businesses: Global Pet Care and Home & Garden. If the deal is blocked, then we expect Spectrum will look for other ways to monetize this valuable asset. Either way, the sell-off gave us an opportunity to add this business to the portfolio at a valuation that is a significant discount to our estimate of intrinsic value, with a potential catalyst to unlock that value.

Outlook

The speculative craze in 2020 has many similarities to the tech bubble of 2000, one being that it could take a few years to wash out the die-hard speculators, many of whom are relatively new to investing. From an economic perspective, two key differences from 2000 versus today are the currently high inflation and rising interest rates, but these will likely moderate in 2023, with or without a mild recession like the one the U.S. experienced in 2001.

As markets work off the excess speculation, long-term investors are again attracted to our type of investing—owning great companies with high returns on capital, strong free cash flow, and solid balances sheets that are selling at reasonable valuations. We have not waivered from our focus on these types of businesses. Furthermore, this market sell-off has provided opportunities to buy more of these high-quality businesses at attractive prices, which we believe should drive continued outperformance over the long term.

Contribution[1]

(YTD as of 12/31/2022)

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

Security	Avg Weight (%)	Contribution (%)
Top 5		
J & J Snack Foods Corp.	5.24	1.30
Dollar Tree Inc.	11.42	1.27
AZEK Co. Inc.	1.01	0.74
Markel Corp.	11.86	0.71
Spectrum Brands Holdings Inc.	0.28	0.35
Bottom 5		
BRP Group Inc.	8.30	(2.79)
Vontier Corp.	7.38	(3.16)
Frontdoor Inc.	*Sold*	(3.22)
NXP Semiconductors N.V.	11.51	(3.64)
Clarivate plc	7.79	(4.56)

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

Performance Composite Returns[2] (For Periods Ending December 31, 2022)

	Since Inception**	20-Year*	15-Year*	10-Year*	5-Year*	3-Year*	1-Year	YTD	QTD
Value Opportunities *Pure Gross-of-Fees[3]*	9.3%	9.5%	7.8%	8.4%	(1.0%)	(3.1%)	(22.3%)	(22.3%)	6.8%
Max Net-of-Fees[4]	6.2%	6.3%	4.6%	5.2%	(4.0%)	(6.0%)	(24.6%)	(24.6%)	6.0%
S&P 500	6.2%	9.8%	8.8%	12.6%	9.4%	7.6%	(18.1%)	(18.1%)	7.5%
Russell 3000 Value	7.1%	8.8%	7.0%	10.1%	6.5%	5.8%	(8.0%)	(8.0%)	12.2%

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)*

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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.

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Indices: The S&P 500 Index and Russell 3000 Value Index 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 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.