Confluence
INVESTMENT MANAGEMENT

Fixed Income Strategy

Fixed Income Investment Policy

The Confluence fixed income strategy strives to deliver the income and lower volatility traditionally available from a diversified bond portfolio. An appropriate benchmark comparison is a broadly diversified bond index like the Merrill Lynch Government/Credit Index. We may vary the allocation to adjust the exposure to corporate, government agency and U.S. Treasury sectors. We may also adjust the combined average maturity to be longer, shorter or in line with this benchmark. The allocations will incorporate our viewpoints regarding Fed policy, the shape of the yield curve, relative yields, credit spreads, default rates and other market factors.

Our focus is on fixed income Exchange Traded Funds (ETFs) following investment grade benchmarks with a domestic orientation. We continuously monitor fixed income allocations, rebalancing at least annually, but may elect to rebalance over shorter time frames at our discretion.

Benefits Relative to Traditional Fixed Income Portfolios

In the fixed income markets, bigger tends to be better. This rule generally holds true because larger accounts trading big blocks of bonds tend to have better liquidity and pricing relative to smaller accounts with smaller transactions. Oftentimes, a smaller trade is penalized as an odd lot, in which traders incorporate extra costs into purchases and sales to accommodate these smaller transactions. Over time, these additional costs may substantially weigh on returns, particularly for investors making frequent small deposits and withdrawals.

These size requirements pose challenges to those who invest directly into individual bonds. On one hand, position sizes need to be large enough to maintain liquidity; on the other hand, proper diversification requires many positions, incorporating many different bonds, with varying maturities and sector exposures. Unless an account is very large, the tradeoff between liquidity and diversification might need to be weighed, and deposits and withdrawals will only complicate the portfolio management effort.

To address these challenges, bond investors have historically utilized investments that commingle clients together into a single security, like a mutual fund. This approach allows the investor to avoid the hazards of "odd lot" trading, while allowing for diversification through the use of several mutual funds. Unfortunately, there are often a number of drawbacks to the commingled approach, including tax inefficiencies, a lack of transparency and less precision with regard to maturities and sector exposures.

As an alternative, Confluence offers a separately managed account invested in fixed income exchange traded funds. Fixed income ETFs are not bonds, but are pro-rata interests in publicly traded bond funds. Like mutual funds, ETFs do an excellent job of delivering the traditional low volatility and income of the bond market. Furthermore, smaller transactions with ETFs are not penalized for liquidity like odd lot bond trades. There are also other benefits a fixed income ETF portfolio offers, including:

- <u>Individual cost lots</u>, which may help limit tax inefficiencies often associated with mutual funds.
- <u>Full transparency</u> and the ability to direct specific exposures to certain maturities and/or sectors, like Treasuries, corporate bonds or Agency mortgage-backed securities.
- <u>Trading efficiencies</u>, which easily accommodate large or small deposits without disrupting or compromising proper diversification. Maturity ladders and sector exposures may be repositioned without incurring excessive liquidity costs.
- <u>Diversification</u> through the use of multiple ETFs helps limit exposure to individual bond issuers and can help avoid concentrated allocations to particular maturities or sectors.
- <u>High quality</u> ETFs focus on investment grade bond exposure, limiting or avoiding exposure to high-risk, speculative grade bonds.

Of course, investors should be aware there are limitations in utilizing fixed income ETFs, too. There may be times when the performance of an ETF may vary relative to its targeted benchmark. And while ETFs generally trade very close to their net asset values, during times of market disruption, they can trade at discounts or premiums, which can directly affect an investor's performance. Liquidity is also generally good, but can vary depending upon market conditions. A fixed income ETF also does not mature like an individual bond. These and various other differences highlight the fact that fixed income ETFs may vary in performance relative to direct investments in bonds.

The table below lists some of the fixed income ETFs we may utilize in our separately managed accounts. As the illustration shows, we can direct larger allocations to certain ETFs to alter the amount of credit or interest rate risk in a portfolio. (Data from July, 2011.)

	Name	Weighted Average Maturity	Current SEC Annual Yield	Number of Holdings
	iBoxx Inv. Grade Corporate Bond	12.2 yr	4.5%	704
Overweight to lengthen average maturity ⇒	**Vanguard Interm. Corp. Bond**	7.5 yr	3.9%	642
	SPDR Barclays Interm. Credit Bond	5.2 yr	3.4%	635
	iShares Barclays Interm. Credit Bond	4.9 yr	3.7%	1,639
	Vanguard Short Term Corporate Bond	3.0 yr	2.3%	822
Overweight to shorten average maturity ⇒	**iShares Barclays MBS Bond**	2.9 yr	3.3%	222
	iShares Barclays 1-3 Year Treasury Bond	1.9 yr	1.9%	699

** SEC yield reflects the income earned by the fund during the most recent 30-day period, minus the fund's expenses for that period.*

The above ETFs are utilized in creating a separately managed account (SMA) portfolio. There are investment risks in investing in this strategy, including credit and interest risk. Besides Confluence fees for investment management, clients may be charged brokerage commissions, transaction fees, and

other related costs and expenses. Clients may incur certain charges imposed by custodians, brokers, third party investment and other third parties such as fees charged by managers, custodial fees, deferred sales charges, odd-lot differentials, transfer taxes, wire transfer and electronic fund fees, and other fees and taxes on brokerage accounts and securities transactions. Mutual funds and exchange traded funds also charge internal management fees, which are disclosed in a fund's prospectus.

Current Viewpoints

Historically, economic growth tends to be higher than average in the period following a recession. However, this recovery has proven to be quite different. Growth has been quite limited, particularly when stimulus shocks (e.g., homebuyer incentives, cash for clunkers, quantitative easing by the Fed, etc.) are removed. As we look forward, we may be entering into a prolonged period when the baseline real GDP growth rate for the U.S. economy is perhaps closer to 2%, a level well below the long-term average of 3%. This lower growth environment may persist for several quarters, as consumers continue to deleverage and government (federal and local) spending declines. This lower growth environment suggests limited job creation and the unemployment rate may remain elevated in the 8-9% range.

Lower U.S. economic growth is likely to translate into lower global growth, particularly with Europe challenged by a variety of sovereign debt issues. At the same time, worldwide production capacity remains substantial. The combination of low growth and excess production capacity indicates inflation is unlikely to be a problem any time soon. Certain commodities may experience substantial price spikes from time to time, but widespread inflation is a low probability, absent widespread protectionist policies.

With low growth, high unemployment and low inflation, we expect the Federal Reserve to maintain low levels of interest rates for an extended period, perhaps even for several years. For this reason, we do not believe a "bond bubble" ever formed. But low bond yields also indicate low returns for bond investors. We do not advocate "reaching for yield," but do believe there are prudent ways to improve returns. These include a substantial exposure to corporate bonds. (Despite the weak economy, many corporations have strong fundamentals and we expect default rates to remain low.) Agency mortgage-backed securities can also be additive to returns, particularly now that large refinancing waves appear to have largely passed through. And finally, we favor short and intermediate maturities, while avoiding longer maturity exposures. This strategy allows for reinvestment in higher yields, which may manifest several years down the road.

Summary

Investing in today's fixed income markets is challenging, given how low interest rates are. Still, bonds continue to offer lower levels of volatility, a characteristic of high importance to many investors. There are a variety of investment strategies that may be helpful in addressing low interest rates. A portfolio of fixed income ETFs, one that incorporates specific maturity and sector exposures, is one way to implement these strategies with a high level of transparency and relatively low trading costs. Over time we believe such a portfolio can play a constructive role in pursuing the objectives of fixed income investors.

Illustrative Portfolio

Top Fixed Income ETF Positions	
iShares Barclays 1-3 Year Treasury Bond Fund	
SPDR Barclays Intermediate Term Credit Bond Fund	
iShares Barclays Intermediate Credit Bond Fund	
iShares Barclays MBS Bond Fund	
Vanguard Intermediate Term Corporate Bond Fund	
Vanguard Short-Term Corporate Bond Fund	
iShares iBoxx $ Investment Grade Corporate Bond Fund	
Current SEC Yield	**3.6%**
Weighted Average Maturity	**6.7 Years**

The illustration of "Top Fixed Income ETF Positions" is not a complete list of ETFs in the portfolio or which Confluence may be currently recommending. Furthermore, application of the investment strategy as of a later date will likely result in changes to the listing. The illustrative portfolio attributes do not represent actual trading as actual investment results vary from the illustration due to inherent limitations in ETF securities that do not perfectly replicate a selected fixed income asset class. Fixed income allocations in client accounts may vary based on individual client considerations and market fluctuations. The allocation of assets in the illustrative portfolio may be changed from time to time due to market conditions and other factors. The investments held by the portfolios are not guaranteed and do carry a risk of loss of principal. Each asset class has specific risks associated with it and no specific asset class can prevent a loss of capital in market downturns.

About Confluence Investment Management LLC

Confluence Investment Management LLC is an independent, SEC Registered Investment Advisor located in St. Louis, Missouri. Confluence provides professional portfolio management and advisory services to institutional and individual clients. Our investment philosophy is based upon independent, fundamental research that integrates our evaluation of market cycles, macroeconomics and geopolitical analysis with our value-driven, fundamental company-specific approach. Confluence's portfolio management philosophy begins by assessing risk, and follows through by positioning clients to achieve their income and growth objectives.

The Confluence team is comprised of experienced investment professionals who are dedicated to a high level of service and communication to our clients. The Confluence team has more than 200 years of combined financial experience and 80 years of portfolio management experience.