Large Cap Value

Value Equity Strategies

Third Quarter 2024

Large Cap Value is focused on seasoned companies that generally have capitalizations above $10 billion. Companies are selected using a bottom-up, fundamental research process that seeks to identify individual businesses that possess substantial competitive advantages and that are trading at discounts to our estimate of intrinsic value. The portfolio typically comprises 23-25 holdings and is expected to result in low to moderate turnover. The strategy is appropriate for clients whose primary objective is capital appreciation and whose secondary objective is dividend income.

Market Commentary

Continued economic strength combined with the disinflationary environment provided a tailwind that helped drive equity markets during the quarter. The broad equity markets posted solid gains as the S&P 500 Index was up 5.9% for the quarter, which brought its year-to-date return to 22.1% — the best performance through three quarters since 1997.

More importantly, equity market returns widened beyond the narrow leadership of the mega-cap technology stocks that has dominated previous periods. The Russell 1000 Growth Index lagged the Russell 1000 Value Index 3.2% versus 9.4%, respectively. The S&P 500 Equal Weight Index also outperformed the S&P 500 with a 9.6% gain for the quarter. While one quarter does not make a trend, and growth is still leading value for the year (Russell 1000 Growth 24.6% versus Russell 1000 Value 16.7%), the broadening of the market into new highs provides for a much healthier environment. In turn, we find it is also a more favorable environment for stock pickers and value-oriented strategies.

Notably, the quarter saw a healthy rotation into previously underperforming sectors. Ten of 11 large cap sectors finished higher in the third quarter, with Utilities (19.4%), REITs (+17.0%), Industrials (11.5%), and Financials (10.7%) leading the market. These sectors have a heavier weight in the value benchmarks and benefited from the decline in interest rates as the 10-year Treasury yield declined from 4.36% to 3.81% during the quarter (see *Figure 1*, sector returns table).

Figure 1 **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	3.3%	2.3%	12.9%	8.5%	10.2%	31.7%	8.8%	2.3%	11.6%	5.9%	2.5%	100.0%
Russell Growth weight	0.4%	0.7%	6.4%	4.6%	14.3%	48.7%	12.8%	0.6%	7.8%	3.7%	0.2%	100.0%
Russell Value weight	6.7%	4.7%	21.1%	14.7%	6.3%	9.1%	4.2%	4.9%	15.5%	8.0%	4.8%	100.0%
Russell 2000 weight	5.3%	4.5%	17.9%	17.0%	10.1%	12.9%	2.7%	6.5%	17.4%	2.8%	2.8%	100.0%
QTD	-2.3	9.7	10.7	11.5	7.8	1.6	1.7	17.0	6.1	9.0	19.4	5.9
YTD	7.5	14.8	21.5	19.6	14.2	29.6	27.8	14.8	13.7	18.6	30.1	21.6

(Source: J.P. Morgan Asset Management; Guide to the Markets®, US 4Q 2024, as of September 30, 2024)

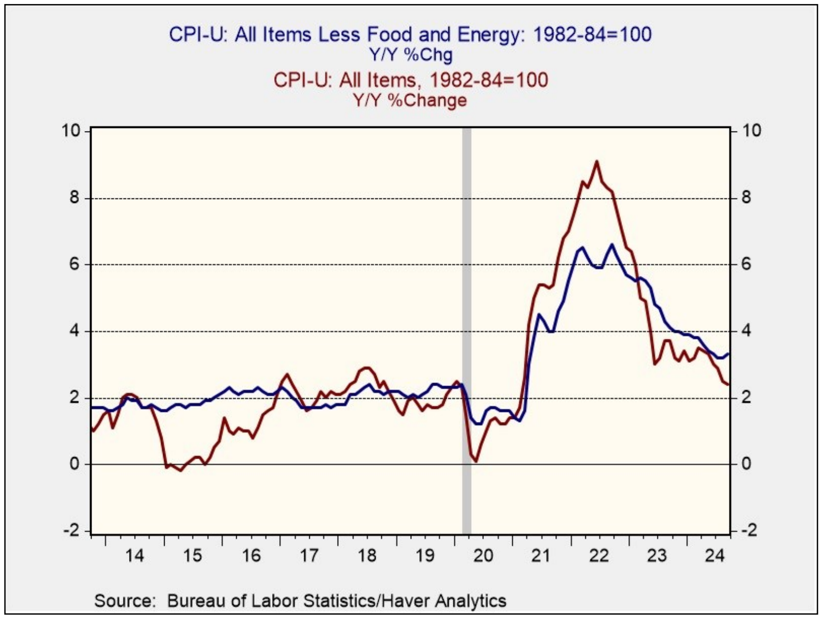
Small and mid-cap stocks, often overlooked during periods of mega-cap dominance, also performed well. The Russell 2000 Index and Russell Midcap Index outperformed the broader market, returning 9.3% and 9.2%, respectively, for the quarter. Small cap businesses, which are more levered than large cap businesses, benefited from the decline in short-term interest rates which should provide some earnings relief for floating rate debt as well as the perceived reduced probability of a recession. Despite the marginal outperformance of small caps, we believe they still offer an attractive valuation relative to large caps.

See GIPS Report on pages 5-6

Market Commentary continued...

The continued improvement in inflation levels also allowed the Federal Reserve to alter course and make its first interest rate cut this year. On September 18, 2024, 420 days after the last rate hike, the FOMC cut rates by an aggressive 50 bps. This followed the rapid increase in rates that started in March 2022 at 0% and lasted until July 2023, the last increase of which brought the fed funds rate to 5.25%. Of course, this action was needed to stem the rapid ascent of inflation following the liquidity infusion induced by the pandemic (see *Figure 2* from the Confluence macroeconomic team).

Figure 2



The equity markets have been rallying following the rate cut as the fixed income markets have been selling off (i.e., yields migrating upward). This indicates that equity investors are more optimistic that the Fed can tame inflation and avoid a recession, while fixed income investors are becoming more concerned about inflation. The aggressiveness of the 50 bps rate cut seems to have sent a mixed message regarding the strength of the economy and inflationary pressures over the near term.

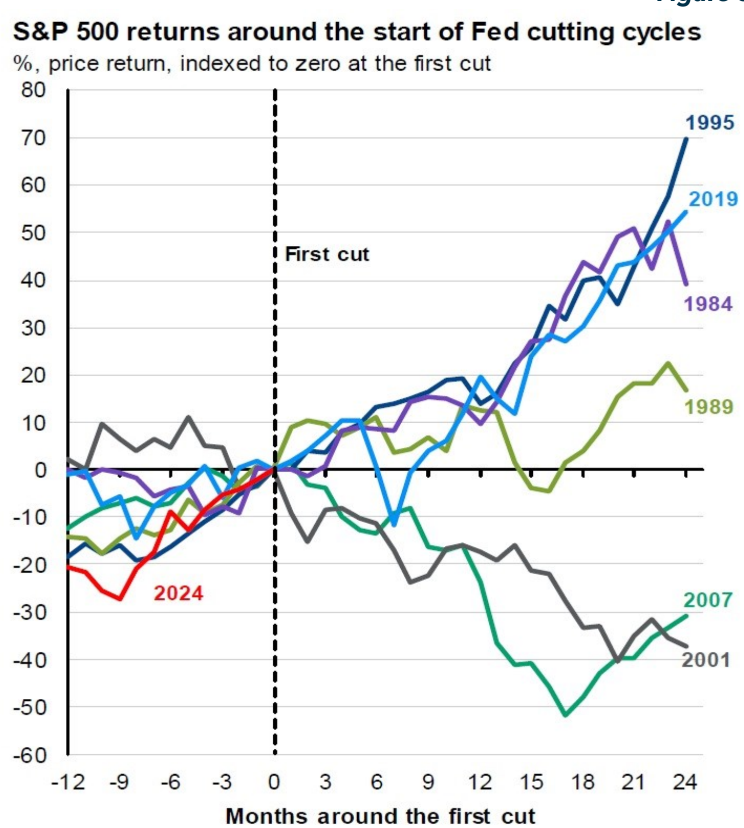
Moreover, there has been much discussion surrounding the historical impact on the equity markets following the first rate cut by the Fed. Many seem to focus on the positive implications for equities that lower rates offer. The reality is more nuanced as each period must consider the economic backdrop, employment, inflationary trends, valuation, and geopolitical events. The next chart (*Figure 3*) reflects the last six cycles dating back to 1984. Looking at this chart, the verdict is mixed six months after the first cut, with half posting positive returns and half posting negative returns. The current environment is unique given the low levels of unemployment, higher valuations, and recent experience with inflation.

We remain concerned about the longer-term pressure on structural inflation given the fracturing of global trade. Deglobalization elevates trade barriers, supply chains become less efficient, and production costs increase, which lead to higher prices for goods and services. In essence, these changes would reverse the disinflationary effects previously afforded by globalization over the past few decades, which would likely result in inflation running above the Fed's current 2% target and pressure longer-term rates. For investors, it elevates the importance of protecting purchasing power.

The Confluence macroeconomic team has been writing about these trends for quite some time. To stay abreast of these developments, we encourage readers to [subscribe to our newsletters](#).

As always, we remain focused on fundamentals and steadfast on the protection of capital by concentrating on competitively advantaged businesses that have historically displayed an ability to maintain margins and returns on capital — attributes which are important given the concerns of inflation.

Figure 3



(Source: J.P. Morgan Asset Management; Guide to the Markets®, US 4Q 2024, as of September 30, 2024)

Strategy Commentary

Equity markets advanced during the third quarter of 2024. Returns were broad-based, with all S&P sectors in the green, except for Energy. Perhaps the most noteworthy development during the quarter was a rotation out of the Magnificent 7 (M7) that began a few weeks into July.

During the third quarter, the S&P 500 Index increased 5.9%, while the Russell 1000 Value Index advanced 9.4%. Confluence's Large Cap Value strategy grew 10.1% (gross of fees). The S&P 500's lagging return during the period is largely a function of the rotation away from the M7. Year-to-date, the S&P 500 is up 22.1%, the Russell 1000 Value Index is up 16.7%, and Confluence Large Cap Value is up 15.2% (gross of fees). [*The strategy's net-of-fees returns for the same periods were 9.3% QTD and 12.6% YTD. See disclosures on last page for fee description; actual investment advisory fees may vary.*]

A cursory read of our prior commentaries may leave the impression that we are obsessed with the M7, a collection of mega-cap, technology-oriented companies. In truth, it's more of a mathematical reality that must be confronted when discussing equity market performance. The emergence of a small handful of companies with market capitalizations over $1 trillion means that the S&P 500 returns are materially driven by less than 2% of its constituents. Beginning around the second week of July through the end of the quarter, the M7 collectively underperformed the rest of the market. Why is this relevant? Consider that a 1% change in the value of the M7 represents a shift of roughly $150 billion in market value. For context, that approximates the value of the entirety of AT&T (T) or Pfizer (PFE). A 1% change in Apple (AAPL) alone is around $30 billion, similar in size to the total value of The Hershey Company (HSY) or Delta Air Lines (DAL). With such an immense amount of capital in the M7, even a small rotation away from these stocks is very meaningful, making this an interesting development to monitor.

Primary contributors to the strategy's performance in the third quarter included Masco Corp. (MAS), Oracle (ORCL), and Starbucks (SBUX).

We've discussed Masco, a manufacturer of branded home improvement and building products, in each quarterly commentary this year. In Q1, the company was a standout performer as the market got excited about stabilizing end markets. However, in Q2, it was a primary detractor when the market grew worried about the timing of a recovery. Not to fear! Masco delivered a better-than-expected quarter and returned to the winner's circle in Q3. This is a great example of why we do not get too high or too low based on short-term results and performance. The reality is that Masco owns high-quality brands in attractive categories (Behr paint, Delta faucets) and it sells these products through deep relationships with strong retailers, such as Home Depot (HD). Over the short-term, Masco's stock price will be subject to the market's current opinion on macroeconomics and the housing cycle. Over the long-term, it is far more important that Masco continues to make high-quality products that consumers want to buy, and that its management team operates the business efficiently and allocates capital intelligently.

Another contributor during Q3 was Oracle. For decades, Oracle has been a leader in on-premise enterprise technology applications. Over 90% of the Fortune 100 runs on Oracle databases. This has been a high-margin, cash-generative, albeit low-growth business. However, over the past few years the company has done an exemplary job of expanding its technology offerings and taking advantage of higher-growth secular trends such as AI and cloud-based software. While Amazon (AMZN), Microsoft (MSFT), and Alphabet (GOOG) are competing fiercely to fence companies into their tech ecosystems, Oracle has taken advantage of the fact that many enterprises are reluctant to put all their eggs into one technology basket. In fact, Oracle has established strategic partnerships with all three of those companies, allowing customers to mix and match services. Successfully navigating this technology transition is a testament to Oracle's management and has lifted the company's revenue growth rate, which the market has rewarded.

Starbucks was also a top contributor to the Large Cap Value strategy in Q3, propelled by the announcement that the company would replace its embattled CEO with a highly respected restaurant executive. In many ways, Starbucks is a victim of its own success. Rising popularity of coffee in China has invited fierce local competition. In the US, the pandemic trained customers to rely on drive-thru and mobile orders, which boosted traffic but clogged operations. Stores have become hectic, transactional, and less enjoyable for both consumers and baristas. The prior CEO, who had no relevant restaurant experience, was not equipped to solve these challenges. For that reason, the market was excited when the board announced they would replace him with Brian Niccol, the six-year CEO of Chipotle Mexican Grill (CMG), who is credited with leading that company to overcome similar challenges.

Strategy Commentary continued…

Primary detractors from performance in the quarter included NXP Semiconductors (NXPI), Alphabet (GOOG), and Martin Marietta Materials Inc. (MLM).

NXPI is a designer and manufacturer of analog semiconductors. Analog chips process continuous signals (like sound, temperature, and power) and are designed into a wide array of commercial and industrial applications with long life cycles. This is a dramatically different industry from digital semiconductors, which are designed for processing speed, are extremely capital intensive to fabricate, and often have short life cycles. The analog industry is still cyclical, however, and this year the market requires a bit of a breather following more robust growth over the past few years. Against this backdrop, NXPI shares have lagged. NXPI has done a good job maintaining relatively stable revenue, in contrast with some of its competitors that have experienced more volatile swings. Regardless of the cycle, there is long-term secular demand for the types of chips NXPI makes. Further, we believe NXPI trades at an unwarranted valuation discount to its peers.

Alphabet (i.e., Google) was another detractor to performance during Q3. Valuation of the stock had gotten a bit ahead of itself, and while its most recent quarterly results were fine, the stock gave back some of its recent performance. The market also reacted negatively to rumors that the Department of Justice may attempt to break up the company. Of course, the reasons why Google finds itself in the regulatory crosshairs are the same reasons that make it a great business. Our sum-of-the-parts analysis values Google well in excess of the current market value, thus alleviating any concerns over a potential breakup.

Lastly, Martin Marietta was a modest detractor as well. We discussed the addition of this natural resource-based building materials company to the portfolio last quarter. It supplies aggregates, including crushed stone, sand, gravel, cement, concrete, and asphalt. These resources become the literal foundation upon which modern civilization is constructed. As we noted in last quarter's letter, this is an industry that must contend with volatile volumes depending on short-term demand. However, we expect strong demand over the long term due to infrastructure projects, onshoring, and the need for residential construction.

We completed the addition of Paycom (PAYC) during the quarter, and we continue to build another position that we look forward to discussing once complete.

Paycom is a cloud-based Human Resource Management (HRM) platform. Its software helps companies fulfill payroll and HR functions more efficiently. This is a founder-led business that has grown profitably for over two decades. Just a few years ago, Paycom traded for exorbitant valuation multiples, in our assessment. However, the company recently introduced a new service offering that was not well-received by the investment community. Why? Because although it was popular among clients and improved customer retention, it reduced the revenue growth rate of Paycom. This disappointed the growth/momentum-oriented shareholder base, and the stock sold off. We viewed this as an opportunity to add an attractive business at a fair price. Further, it's a prime example of a management team making decisions through a long-term lens.

Outlook

The final stretch of 2024 will likely be dominated by the election news cycle, with great hand wringing in all directions over the implications of each possible outcome. While we are interested observers of current events, we try not to worry about things outside our control. What *is* within our control is constant evaluation and critical analysis of the businesses contained in the strategy. We believe these are high-quality businesses. Do new data points support our view? Are competitive moats widening or shrinking? Is pricing power exercised or are competitive pressures building? Is shareholder capital treated as a precious resource or squandered? These are the most important questions because the answers will determine long-term value creation. Therefore, these are the things we "worry" about.

Contribution[1]

The top contributors and detractors for the portfolio in Q3 2024 and year-to-date are shown in the following tables:

(QTD as of 9/30/2024)

Security	Avg Weight (%)	Contribution (%)
Top 5		
Masco Corp.	5.71	1.39
Oracle Corp.	5.19	1.09
Starbucks Corp.	3.58	0.90
Lowe's Cos. Inc.	3.80	0.84
S&P Global Inc.	4.27	0.67
Bottom 5		
Constellation Brands	3.72	0.01
Markel Corp. Inc.	4.69	(0.03)
Martin Marietta Materials Inc.	3.65	(0.03)
Alphabet Inc.	4.15	(0.45)
NXP Semiconductors N.V.	4.33	(0.50)

(YTD as of 9/30/2024)

Security	Avg Weight (%)	Contribution (%)
Top 5		
Oracle Corp.	4.71	2.58
Masco Corp.	5.65	1.45
Berkshire Hathaway Inc. (Class B)	4.47	1.21
TJX Cos. Inc.	4.38	1.18
Alphabet Inc.	4.58	0.93
Bottom 5		
Dun & Bradstreet Holdings Inc.	2.13	0.08
Illinois Tool Works Inc.	5.03	0.05
Constellation Brands	2.91	(0.01)
Keysight Technologies Inc.	3.86	(0.06)
Clarivate plc	*Sold*	(0.63)

Performance Composite Returns[2] (For Periods Ending September 30, 2024)

	Since Inception**	30-Year*	25-Year*	20-Year*	15-Year*	10-Year*	5-Year*	3-Year*	1-Year	YTD	QTD
Large Cap Value *Pure Gross-of-Fees*[3]	11.4%	11.4%	9.7%	10.5%	13.0%	10.9%	11.5%	8.5%	27.9%	15.2%	10.1%
Max Net-of-Fees[4]	8.2%	8.2%	6.5%	7.3%	9.6%	7.6%	8.2%	5.3%	24.1%	12.6%	9.3%
S&P 500	10.8%	10.8%	8.2%	10.7%	14.1%	13.4%	16.0%	11.9%	36.3%	22.1%	5.9%
Russell 1000 Value	9.8%	9.8%	7.7%	8.5%	11.2%	9.2%	10.7%	9.0%	27.7%	16.7%	9.4%

Calendar Year	Pure Gross-of-Fees[3]	Max Net-of-Fees[4]	S&P 500	R1000 Value	Difference (Gross-S&P500)	# of Portfolios	Composite Assets (000s)	Total Firm Assets (000s)	Composite 3yr Std Dev	S&P 500 3yr Std Dev	R1000V 3yr Std Dev	Composite Dispersion
2004**	15.7%	12.6%	10.9%	16.5%	4.8%	1,052	$197,447		13.7%	14.9%	14.8%	1.0%
2005	(1.6%)	(4.3%)	4.9%	7.1%	(6.5%)	1,064	$188,332		8.7%	9.0%	9.5%	0.6%
2006	17.8%	14.5%	15.8%	22.2%	2.0%	957	$198,952		5.8%	6.8%	6.7%	0.6%
2007	5.9%	3.0%	5.5%	(0.2%)	0.4%	834	$174,711		6.7%	7.7%	8.1%	0.6%
2008	(27.0%)	(29.1%)	(37.0%)	(36.8%)	9.9%	119	$25,562	$291,644	13.2%	15.1%	15.4%	N/A
2009	28.6%	24.8%	26.5%	19.7%	2.2%	149	$53,387	$533,832	17.7%	19.6%	21.1%	1.4%
2010	12.1%	8.8%	15.1%	15.5%	(3.0%)	192	$76,040	$751,909	19.7%	21.9%	23.2%	0.4%
2011	6.4%	3.2%	2.1%	0.4%	4.3%	228	$89,145	$937,487	17.1%	18.7%	20.7%	0.3%
2012	19.0%	15.4%	16.0%	17.5%	3.0%	249	$143,568	$1,272,265	13.5%	15.1%	15.5%	0.4%
2013	37.6%	33.6%	32.4%	32.6%	5.2%	373	$208,844	$1,955,915	10.6%	11.9%	12.7%	0.9%
2014	10.7%	7.5%	13.7%	13.4%	(2.9%)	618	$278,339	$2,589,024	8.6%	9.0%	9.2%	0.5%
2015	1.6%	(1.4%)	1.4%	(3.8%)	0.2%	858	$352,556	$3,175,419	10.1%	10.5%	10.7%	0.5%
2016	8.6%	5.4%	12.0%	17.3%	(3.4%)	1,003	$396,038	$4,413,659	10.0%	10.6%	10.8%	0.4%
2017	16.1%	12.6%	21.8%	13.6%	(5.7%)	1,049	$380,737	$5,944,479	9.0%	9.9%	10.2%	0.6%
2018	(4.6%)	(7.4%)	(4.4%)	(8.3%)	(0.2%)	1,029	$364,805	$5,486,737	10.4%	10.8%	10.8%	0.6%
2019	34.5%	30.5%	31.5%	26.5%	3.0%	1,118	$525,944	$7,044,708	11.8%	11.9%	11.8%	0.6%
2020	13.0%	9.7%	18.4%	2.8%	(5.4%)	1,229	$647,076	$6,889,798	18.8%	18.5%	19.6%	0.9%
2021	26.8%	23.0%	28.7%	25.1%	(1.9%)	1,251	$738,402	$7,761,687	18.2%	17.2%	19.1%	0.6%
2022	(15.5%)	(18.0%)	(18.1%)	(7.6%)	2.7%	1,274	$609,865	$6,931,635	21.0%	20.9%	21.3%	0.6%
2023	16.9%	13.4%	26.3%	11.4%	(9.4%)	1,281	$611,018	$7,200,019	17.8%	17.3%	16.5%	0.7%

**Average annualized returns   **Inception is 10/1/1994. Additional years of performance available on our website.   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 1000® Value Index – A capitalization-weighted index designed to measure performance of those Russell 1000® Index companies with lower price-to-book ratios and lower forecasted growth values. *(Source: Bloomberg)*

Confluence Value Equities Investment Committee

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

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See Territory Map on the Confluence website for sales coverage.

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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Indexes: The S&P 500 and Russell 1000 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—**Contribution data shown from a sample account, based on individual stock performance and portfolio weighting. 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, 2023. 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 Large Cap Value Strategy was incepted on October 1, 1994, and the current Large 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: 0.60% on the first $500,000; 0.55% on the next $500,000; and 0.50% 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 Large Cap Value Composite contains fully discretionary Large Cap Value wrap accounts. Large Cap Value is a value-based, bottom-up portfolio that utilizes stocks with market capitalizations typically exceeding $10 billion.

**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.

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