Small Cap Value

Value Equity Strategies

Third Quarter 2024

Small Cap Value is focused on smaller companies that generally have capitalizations below $3 billion at the time of purchase. These companies are selected using a bottom-up, fundamental research process that seeks to identify individual businesses that possess competitive advantages and that are trading at substantial discounts to our estimates of intrinsic value. The portfolio typically comprises 30-35 holdings and is expected to result in low to moderate turnover. The strategy is appropriate for clients whose primary objective is capital appreciation.

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)

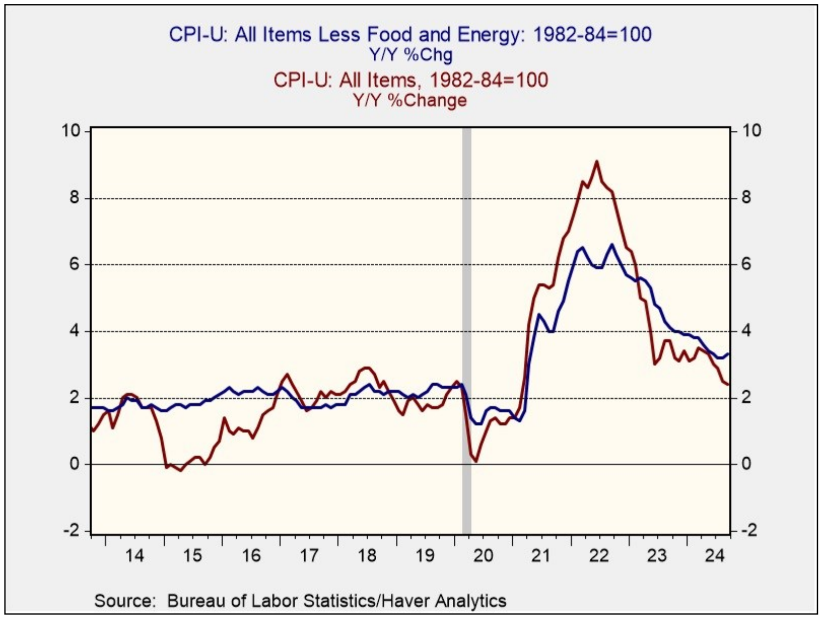
Small and mid-cap stocks, often overlooked during periods of mega-cap dominance, also performed well. The Russell 2000 Index and Russell Midcap Index outperformed the broader market, returning 9.3% and 9.2%, respectively, for the quarter. Small cap businesses, which are more levered than large cap businesses, 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.

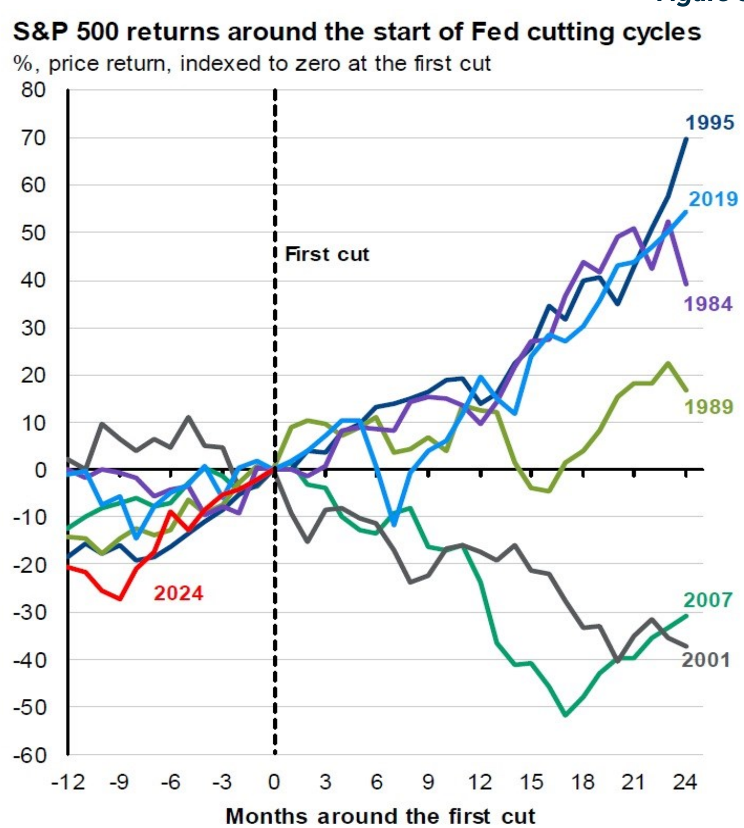
Moreover, there has been much discussion surrounding the historical impact on the equity markets following the first rate cut by the Fed. Many seem to focus on the positive implications for equities that lower rates offer. The reality is more nuanced as each period must consider the economic backdrop, 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



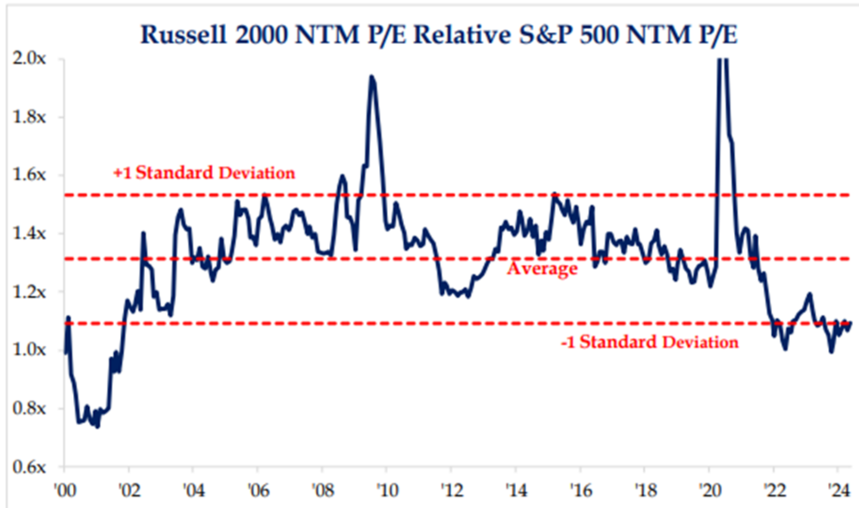
(Source: J.P. Morgan Asset Management; Guide to the Markets®, US 4Q 2024, as of September 30, 2024)

Strategy Commentary

Small cap stocks staged a strong rebound in the third quarter, largely fueled by stellar performance in July. During that month, the Russell 2000 Index and the Russell 2000 Value Index surged by 10.2% and 12.2%, respectively. Although some of these gains were pared back over the remainder of the quarter, both indexes posted strong overall gains of 9.3% and 10.2%. Nearly every sector contributed positively, with the Energy sector being the lone detractor. Confluence's Small Cap Value strategy also delivered solid absolute returns, advancing 6.2% (gross of fees) in the third quarter, though it lagged the broader benchmarks. While the strategy underperformed during the quarter, its year-to-date return of 9.9% (gross of fees) is in-line with the Russell 2000 Value (9.2%) and lags slightly behind the Russell 2000 (11.2%). [*The strategy's net-of-fees returns for the same periods were 5.4% QTD and 7.4% YTD. See disclosures on last page for fee description; actual investment advisory fees may vary.*]

There was also a significant shift in investor sentiment, with attention moving from large cap to small cap stocks. The Russell 2000 Index outpaced the S&P 500 Index by 340 basis points. However, as we've mentioned in previous commentaries, small caps still have a lot of ground to cover before their relative valuations catch up to their larger cap brethren (see *Figure 4*).

Figure 4



(Source: Strategas)

What sparked this enthusiasm for small caps this quarter? The main catalyst was rising optimism surrounding the Federal Reserve's anticipated rate cut, which materialized late in the quarter and marked the first rate cut since the global pandemic began. This move, combined with expectations for further rate cuts, fueled investor confidence in small cap stocks. Historically, small caps tend to benefit more from lower interest rates due to their greater exposure to economically sensitive sectors such as Industrials and Financials as well as their reliance on borrowing and floating-rate debt. When rates are reduced, this debt becomes cheaper, which enhances earnings potential. In contrast, large caps, which typically tend to be more concentrated in technology and carry lower or fixed-rate debt, are less directly impacted by rate changes (see *Figures 5* and *6* below). Additionally, a more favorable financing environment from lower rates could spur merger and acquisition activity, which tends to disproportionately benefit small cap companies.

Figure 5

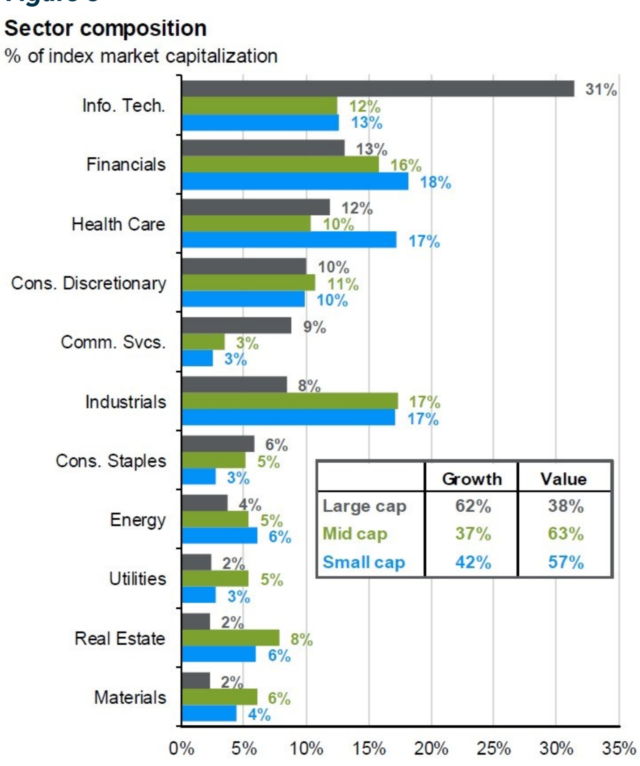
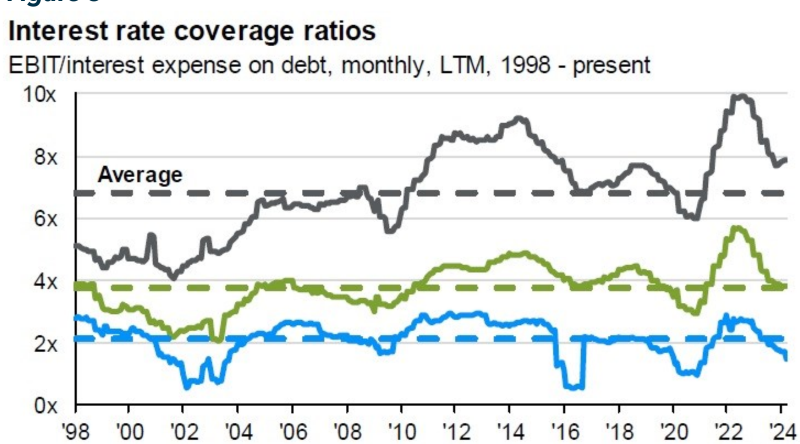


Figure 6



(Figures 5 and 6, Source: J.P. Morgan Asset Management; Guide to the Markets®, US 3Q 2024, as of July 31, 2024)

Strategy Commentary continued...

While the third quarter saw a strong rebound for small cap stocks, much of the rally was driven by "risk-on" sentiment rather than improvements in underlying company fundamentals. This trend weighed on our relative performance as lower quality, highly leveraged companies benefited the most from the broad market surge.

A prime example of this is the Real Estate (REIT) sector, which was the top-performing sector in the Russell 2000 Index, gaining 17% and contributing 110 basis points to the index's overall performance. We have zero exposure to this area because REITs, in general, are highly leveraged, low-ROIC business that do not generally meet our quality standard.

From a stock selection standpoint, on the downside, two of our top detractors were Movado Group (MOV) and TripAdvisor (TRIP). Movado Group, a designer and seller of watches, showed some fundamental improvement during the quarter, but the broader watch category continues to face challenges due to softening consumer spending. Despite the tough environment, MOV's strong financial position — with nearly half of its market cap in cash — has allowed it to invest strategically for future growth under the leadership of an owner-operator management team.

TripAdvisor's stock continues to struggle after the fallout from a rejected deal and a broader slowdown in the travel industry. Adding to this is the overhang of Liberty Media's controlling interest, as Liberty is facing its own financial obligations, causing uncertainty around what it might do with its ownership in TRIP. However, the fundamentals of TRIP's business remain intact. We believe that once Liberty's situation is resolved, the overhang should lift and the stock's value proposition should come back into focus.

On the positive side, our underweight position in the Energy sector — the worst performing group — helped our relative performance. Our only holding in this space, Core Laboratories (CLB), a leading provider of analytical services to the oil and gas industry, posted performance in-line with the sector's broader weakness.

Among our top individual contributors during the quarter were Baldwin Insurance Group (BWIN) and Cavco Industries (CVCO). Baldwin Insurance Group is an insurance broker that has been a standout performer, advancing strongly in both the third quarter and year-to-date. The company was in "debt purgatory," but recent refinancing efforts, coupled with strong financial results, have rebuilt investor confidence, which is reflected in the rising stock price. Our internal estimate of intrinsic value has also moved up accordingly, and the stock remains attractive.

Cavco Industries, a leader in manufactured homes, benefited from lower interest rates but also saw improving fundamentals, including a recovery in order trends from trough levels. We believe CVCO's industry has high barriers to entry and lower risk compared to traditional homebuilders, with the industry operating as an oligopoly. This positions CVCO well to address the affordable housing environment.

There were no changes to the Small Cap Value portfolio during the quarter. The team diligently continues to work to uncover new opportunities and hopes to add promising investments to the portfolio soon.

Outlook

Looking ahead, it's still too early to predict the market's direction, and we anticipate continued short-term volatility, especially with the US presidential election on the horizon. What seems certain is that rate cuts are expected to extend into next year. Once political uncertainties subside, investor focus will shift toward economic growth. Whether the economy undergoes a "soft landing" or a "hard landing" will play a critical role in the future market performance. These scenarios are complex and difficult to forecast, and we do not attempt to make macroeconomic predictions or attempt to time the market.
Instead, we remain committed to our core investment process of conducting deep, focused research to identify companies with durable competitive advantages and strong market positions. Businesses led by capable management teams and bolstered by strong financial standing are best positioned to control their own destinies and navigate uncertain economic environments. Our disciplined, patient approach has helped us manage small cap portfolios through various market cycles over the past 30 years, delivering attractive risk-adjusted returns. We appreciate the continued trust and confidence you place in our team.

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		
Baldwin Insurance Group Inc.	3.64	1.24
Cavco Industries Inc.	3.83	0.84
Stewart Information Services Corp.	3.70	0.73
UFP Technologies Inc.	3.25	0.66
Hayward Holdings Inc.	2.69	0.60
Bottom 5		
Edgewell Personal Care Co.	2.89	(0.29)
Allient Inc.	1.62	(0.45)
Ecovyst Inc.	1.83	(0.51)
TripAdvisor Inc.	2.51	(0.56)
Movado Group Inc.	2.19	(0.57)

(YTD as of 9/30/2024)

Security	Avg Weight (%)	Contribution (%)
Top 5		
UFP Technologies Inc.	3.43	2.22
Baldwin Insurance Group Inc.	1.71	1.52
Brown & Brown Inc.	3.75	1.46
Stewart Information Services Corp.	3.87	1.05
Sapiens International Corp. N.V.	2.98	0.98
Bottom 5		
Ecovyst Inc.	2.22	(0.74)
Winnebago Industries Inc.	3.16	(0.75)
Allient Inc.	2.04	(0.85)
Movado Group Inc.	2.53	(1.07)
TripAdvisor Inc.	3.42	(1.18)

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
Small Cap Value *Pure Gross-of-Fees[3]*	10.8%	10.8%	10.4%	9.0%	10.1%	7.9%	5.1%	1.3%	18.0%	9.9%	6.2%
Max Net-of-Fees[4]	7.7%	7.7%	7.3%	5.8%	6.9%	4.7%	2.0%	(1.7%)	14.5%	7.4%	5.4%
Russell 2000	8.9%	8.9%	8.3%	8.5%	10.6%	8.8%	9.4%	1.8%	26.7%	11.2%	9.3%
Russell 2000 Value	9.6%	9.6%	9.1%	7.7%	9.8%	8.2%	9.2%	3.7%	25.9%	9.2%	10.1%

Calendar Year	Pure Gross-of-Fees[3]	Max Net-of-Fees[4]	R2000	R2000 Value	Difference (Gross-R2000)	# of Portfolios	Composite Assets (000s)	Total Firm Assets (000s)	Composite 3yr Std Dev	R2000 3yr Std Dev	R2000V 3yr Std Dev	Composite Dispersion
2004**	23.2%	19.9%	18.3%	22.2%	4.9%	572	$101,835		12.7%	19.0%	17.5%	1.4%
2005	8.2%	5.3%	4.6%	4.7%	3.6%	722	$111,469		9.0%	15.1%	14.1%	1.6%
2006	19.1%	15.9%	18.4%	23.5%	0.8%	694	$117,282		7.1%	13.8%	12.3%	1.1%
2007	(1.7%)	(4.4%)	(1.6%)	(9.8%)	(0.1%)	543	$84,018		7.5%	13.2%	12.6%	1.1%
2008	(21.8%)	(24.0%)	(33.8%)	(28.9%)	12.0%	61	$8,568	$291,644	14.0%	19.8%	19.1%	N/A
2009	29.6%	25.8%	27.2%	20.6%	2.4%	54	$9,823	$533,832	20.9%	24.8%	25.6%	2.3%
2010	24.6%	20.9%	26.9%	24.5%	(2.3%)	83	$19,208	$751,909	23.3%	27.7%	28.4%	1.5%
2011	(0.9%)	(3.8%)	(4.2%)	(5.5%)	3.3%	85	$18,032	$937,487	21.8%	25.0%	26.0%	1.2%
2012	16.0%	12.6%	16.3%	18.1%	(0.4%)	105	$26,346	$1,272,265	15.6%	20.2%	19.9%	0.3%
2013	27.4%	23.6%	38.8%	34.5%	(11.5%)	113	$31,217	$1,955,915	12.2%	16.4%	15.8%	0.5%
2014	9.3%	6.1%	4.9%	4.2%	4.4%	140	$34,077	$2,589,024	8.6%	13.1%	12.8%	0.6%
2015	(1.7%)	(4.7%)	(4.4%)	(7.5%)	2.7%	158	$34,928	$3,175,419	10.3%	14.0%	13.5%	0.4%
2016	23.7%	20.0%	21.3%	31.7%	2.4%	198	$56,608	$4,413,659	11.6%	15.8%	15.5%	1.2%
2017	19.5%	16.0%	14.6%	7.8%	4.9%	354	$103,862	$5,944,479	10.8%	13.9%	14.0%	0.9%
2018	(8.6%)	(11.3%)	(11.0%)	(12.9%)	2.5%	400	$88,885	$5,486,737	13.1%	15.8%	15.8%	0.8%
2019	27.0%	23.2%	25.5%	22.4%	1.5%	449	$124,071	$7,044,708	14.5%	15.7%	15.7%	0.8%
2020	4.5%	1.4%	19.9%	4.6%	(15.4%)	400	$122,151	$6,889,798	21.6%	25.3%	26.1%	1.5%
2021	16.9%	13.4%	14.8%	28.2%	2.1%	378	$124,263	$7,761,687	20.2%	23.3%	25.0%	1.3%
2022	(16.3%)	(18.8%)	(20.5%)	(14.5%)	4.1%	361	$98,842	$6,931,635	21.6%	26.0%	27.3%	0.5%
2023	5.7%	2.6%	16.9%	14.6%	(11.1%)	277	$75,681	$7,200,019	18.2%	21.1%	21.8%	0.9%

**Average annualized returns   **Inception is 10/1/1994. Additional years of performance available on our website.   See performance disclosures on last page.*

Portfolio Benchmarks

Russell 2000® Index – A capitalization-weighted index measuring performance of approximately 2,000 companies in the Russell 3000® Index.

Russell 2000® Value Index – A capitalization-weighted index designed to measure performance of those Russell 2000® Index companies with lower price-to-book ratios and lower forecasted growth values. *(Source: Bloomberg)*

Confluence Value Equities Investment Committee

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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.

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.

Indexes: The Russell 2000 and Russell 2000 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 Small Cap Value Strategy was incepted on October 1, 1994, and the current Small 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: 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 Small Cap Value Composite contains fully discretionary Small Cap Value wrap accounts. Small Cap Value is a value-based, bottom-up portfolio that utilizes stocks with market capitalizations typically less than $3 billion. *Smaller capitalization companies, due to their size, are generally more vulnerable to adverse general market or economic developments than larger, more established companies.*

**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.

The investment strategies described herein are those of Confluence Investment Management. These materials are being provided for illustrative and informational purposes only. The information contained herein is obtained from multiple sources that are believed to be reliable. However, such information has not been verified, and may be different from the information included in documents and materials created by the sponsor firm in whose investment program a client participates. Some sponsor firms may require that these Confluence materials are preceded or accompanied by investment profiles or other documents or materials prepared by such sponsor firms, which will be provided upon a client's request. For additional information, documents and/or materials, please speak to your Financial Advisor.