RiverFront Investment Group

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THE WEEKLYVIEW

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Strategic Changes, Tactical Nuances

RiverFront's hallmark is our focus on the long-term ramifications of changing prices. "*Our Price Matters® return estimates fall as prices rise and increase as prices fall, consistent with historical market behavior and common sense. As a result, RiverFront's asset allocation process imposes a 'buy low/sell high' discipline – a higher proportion of risky assets are allowed into the portfolio when prices are low and are reduced as their prices rise*." (*Strategic View*, 2/5/14)

Remaining true to our discipline, we have responded to last year's large gains in global equities by adjusting our portfolios' asset allocation mix, especially in those with three- to five-year investment horizons. Based on our latest optimization, the following are our broad strategic recommendations:

1. Maintain high stock weightings relative to bonds, but replace some of last year's biggest gainers (US Small Caps, Higher-Volatility US Large Caps) by raising exposure to less volatile Dividend Payers and Real Estate Investment Trusts (REITs). Both underperformed in 2013 but have higher long-term trend returns than US Large Caps.
2. Add to US Micro Caps, which are near their 88-year trend (US Small Caps are 20% above trend).
3. Maintain exposure to short duration bonds (our average is now about two years) and increase the relative exposure to short-duration high yield in longer-term portfolios.
4. Eliminate Emerging Market (EM) stocks from shorter-term portfolios and reduce EM in longer-term portfolios to lower risk. Add Developed International (further below trend and less volatile than EM) and some core US in growth-oriented portfolios.

We entered December tactically overweight our already aggressive strategic recommendations, knowing that our strategic optimization would likely lower risk.

Tactical Nuances: Our tactical transition began last December 12th and is now largely complete. We entered December tactically overweight our already aggressive strategic recommendations, anticipating that our strategic optimization would likely lower risk. We sold some EM in all portfolios and a small portion of our more volatile US Large Cap exposure in our shorter-term Growth & Income portfolios. The resulting higher cash position allowed us to retain the remainder of our stock positions and benefit from the year-end rally.

The cash we raised last December allowed us to retain the remainder of our stock positions and benefit from the end-of-the-year rally. Avoiding longer-maturity bonds – beneficial in 2013 – has detracted from performance so far this year.

We expected January's pullback would be temporary and thus held off completing our repositioning until the second half of February. Since December 12th, despite the cash, our portfolios have remained more overweight stock risk than our newly optimized strategic models recommend. Our recent changes have absorbed cash but have not increased risk because the stocks we have been buying are generally less volatile than those we sold. Avoiding longer-maturity bonds – beneficial in 2013 – has detracted from performance so far this year.

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Repositioning US Stocks: High Volatility Large Cap US stocks were up more than 40% on a total return basis last year. These stocks had begun the year significantly below trend based on our Price Matters® analysis. However, their 2013 gains and higher volatility have made us more selective in our Large Cap exposure. RiverFront's US Equity team has a bias of cyclical to defensive stocks, favoring Technology (especially Networking), Energy (skewed away from the big Integrated Oils) and Transportation. Defensively, we prefer Consumer Staples (especially Food & Beverage) and have begun to build a position in REITs.

Repositioning International Stocks: We have added exposure to Japan on a currency-hedged basis in our international portfolios. In Europe, where we remain overweight Germany, we have added exposure to Spain and the Nordic region with an emphasis on Norway. Our basic premise is to overweight equities in countries and regions with one or more of the following characteristics: (1) financial conditions are easing rather than tightening; (2) there is evidence of meaningful structural reform being enacted by policy makers; (3) corporate fundamentals are improving; and (4) valuations are reasonable relative to history.

Using our Dynamic Equity Income Model (Benchmark 70% MSCI All Country World Index / 30% Barclay's Capital US Aggregate Bond Index) as a guide, the following table shows our recommended strategic allocation relative to the benchmark and our tactical tilts relative to the strategic allocation.

	Strategic Versus Baseline	Portfolio Positioning	Notes
Total Equity	**OW**	**More OW**	**Favor Equities over Bonds**
US Core Equities	UW		Favor Technology, Networking, Transports, Energy, and Staples
Micro Caps	OW	More OW	Favor Micro Cap over Small/Mid Cap
REITs / MLPs	OW	Less OW	Neutral MLPs, Less REITS than Strategic Recommendation
Total US Equity	**OW**	**More OW**	**Favor Cyclicals over Defensives**
Europe	OW		Favor Nordics, Germany, Spain, Banks
Japan	OW	More OW	Favor Currency Hedged
Developed Asia	OW	UW	Underweight Australia, Hong Kong, Singapore
Emerging Markets	UW	More UW	Favor Asia over LatAm and EMEA*
Total Non US	**OW**	**Less OW**	**Favor Developed over Emerging Markets**
Investment Grade	UW	More UW	1-3 Year Corps only
High Yield / Alt Fixed	OW	More OW	Favor Short Duration US High Yield
Total Fixed Income	**UW**	**More UW**	**Favor Equities over Bonds**

** Europe, Middle East & Africa*
OW –Overweight, UW – Underweight; Source: RiverFront Investment Group as of 2/28/14.

Past performance is no guarantee of future results. Information provided in this report is for educational and illustrative purposes only and should not be construed as individualized investment advice. The investment or strategy discussed may not be suitable for all investors.

RiverFront's Price Matters® discipline compares inflation-adjusted current prices relative to their long-term trend to help identify extremes in valuation.

MSCI All Country World Index (ACWI) is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed and emerging markets. It is not possible to invest directly in an index.

Barclays US Aggregate Bond Index is an unmanaged index that covers the investment grade fixed rate bond market with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities. The issues must be rated investment grade, be publicly traded, and meet certain maturity and issue size requirements. It is not possible to invest directly in an index.

Small, mid- and micro-cap companies may be hindered as a result of limited resources or less diverse products or services and have therefore historically been more volatile than the stocks of larger, more established companies.

International and emerging markets investing includes exposure to risks such as currency fluctuations, foreign taxes and regulations, and the potential for illiquid markets and political instability.

Real Estate Investment Trusts (REITs) investing entails special risks, including credit risk, interest rate fluctuations and the impact of varied economic conditions.

Master Limited Partnership (MLP) investing includes risks such as equity- and commodity-like volatility. Also, distribution payouts sometimes include the return of principal and, in these instances, references to these payouts as "dividends" or "yields" may be inaccurate and may overstate the profitability/success of the MLP. Additionally, there are potentially complex and adverse tax consequences associated with investing in MLPs. This is largely dependent on how the MLPs are structured and the vehicle used to invest in the MLPs. It is strongly recommended that an investor consider and understand these characteristics of MLPs and consult with a financial and tax professional prior to investment.

Fixed Income Securities' value generally declines in a rising interest rate environment.

High-yield securities are subject to greater risk of loss of principal and interest, including default risk, than higher-rated securities.

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