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Because we expect interest rates to gradually rise and default rates to remain low, we remain overweight short-term investment grade and high yield corporate bonds relative to long-term debt.

We expect credit risks to remain low as the economy continues to improve, and we expect the Federal Reserve to begin gradually raising interest rates next year. This could disproportionately hurt longer maturity bonds and callable securities.

Understanding Risks In Your Bond Portfolio

We continue to prefer credit risk over duration risk. This means our bond portfolio would underperform if credit spreads widen due to increasing default rates, and/or long-term interest rates fall. We expect the US economic environment to remain positive for corporate sales, earnings, and cash flows, enabling the high yield default rate (currently just under 2%) to remain below its long-term average of around 4% for the foreseeable future. Thus, we remain overweight short-term investment grade and high yield corporate bonds relative to long-term debt.

High-yield bond valuations have improved over the past three months, in our view. The Bank of America Merrill Lynch High Yield Index currently yields 5.87%, well above last June's record low yield of 4.85%. High yield spreads versus Treasuries are currently 4.10 percentage points, above record lows of 2.41 percentage points in June 2007. Although we expect credit risks to remain low as the economy continues to improve, we expect the Federal Reserve to begin gradually raising interest rates next year. This could disproportionately hurt longer maturity bonds and callable securities. Rising interest rates generally increase the risk that a security with a call option will not get redeemed at its early call date and that its duration extends to reflect its final maturity date, which could cause its price to fall more than expected.

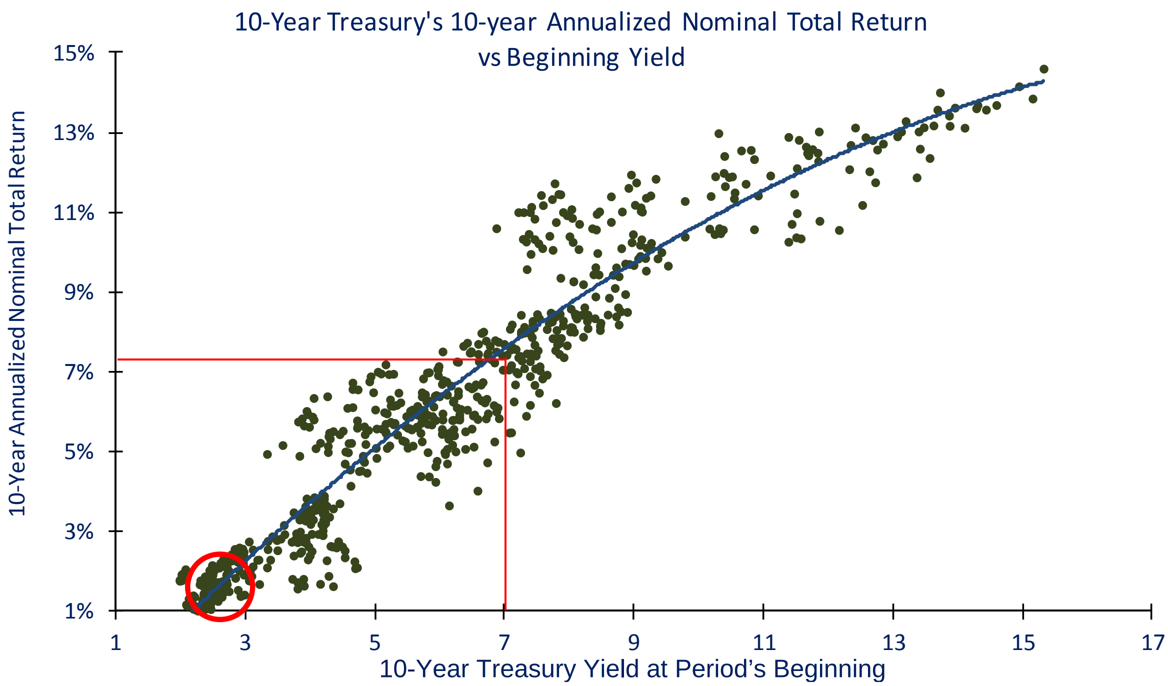
Deflation risk – another major threat to bond portfolios – doesn't appear to be a concern at this time, in our view. Headline CPI inflation is running 1.7% year over year, below the Fed's target of 2%. The Fed's long-run inflation projections, updated last week, are 2%, and the bond market's implied inflation expectations for the next 10 years is 2.04%.

RiverFront's bond portfolios are primarily invested in short-term investment grade (1-3 years) and short-term high yield corporate bonds (1-5 years), both with durations of just over 2 years. Because of these short durations, we underperformed longer-maturity bonds when 30-year Treasury yields fell by nearly one percentage point from last December through August. In our Growth & Income portfolios, we used high-yield's recent sell-off as an opportunity to swap our remaining long-term high yield holdings into short-term high yield. We bought 1.6 times more short-term high yield than we sold from our long-term holdings, so the swap was basically duration neutral and increased the portfolios' overall yield.

We think the bottom line from last week's Fed meeting is that the central bank is unlikely to do anything to jeopardize economic growth or upset financial markets, especially with inflation below the Fed's target levels. In her press conference last Wednesday, Fed Chair Janet Yellen said: *"it's not that the Fed is behind the curve in failing to return the funds rate to normal levels when the economy is recovered. It is rather that, in order to achieve such a recovery... it's necessary and appropriate to have a somewhat more accommodative policy."* In other words, Yellen believes that the economy has not yet fully recovered (as evidence, she cited still-high unemployment, below-target inflation, and ongoing wage stagnation) so it's still ok to stay 'somewhat accommodative.' However, she acknowledged that the economy has shown significant improvement such that the Fed will likely end its quantitative easing asset purchase program next month as scheduled.

There are concerns that when the Fed stops buying Treasuries and agency mortgage-backed securities, some asset prices will fall. While possible, we would point out that the Fed has been reducing its asset purchases since last December — tapering from $85 billion a month then to the just announced $15 billion in October — and this has clearly *not* adversely affected financial markets. Bond yields have remained low, due in part to demand from other central banks and pension funds, and the stock market has made new highs. We expect the pace of stock appreciation to continue slowing, but we still expect stocks to grind higher and remain overweight equities relative to bonds.

THE WEEKLY CHART: PRICE MATTERS® FOR BONDS TOO



Source: RiverFront Investment Group, Calculated based on data from CRSP 1925 US Indices Database ©2014 Center for Research in Security Prices (CRSP®), Booth School of Business, The University of Chicago.

We have found that a bond's yield at the time of purchase explains more than 90% of its total return over the subsequent 10 years. In other words, a low yield (high price) has historically resulted in lower long term returns. Our chart compares the 10-year Treasury yield (horizontal axis) to its annualized 10-year total return (vertical axis) over the next 10 years. For example, the red line starting at 7% corresponds to subsequent 10-year total returns of roughly 7%, on an annualized basis. (Each dot represents a monthly observation starting from 1941 and total returns are comprised of interest income and capital gains.) The circle in the lower left shows the historical record of 10-year returns when 10-year Treasury yields were around the current level of 2.6%. Thus we think the risk for investment-grade bonds are returns that are significantly under 3% for the next 10 years which, on an inflation-adjusted basis, could easily be negative if inflation rises much above its current level of 1.7%.