The Investor's Challenge: Volatility = Emotion

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We observe that investment plans, in which acceptable returns, time horizons, and tolerance for volatility are agreed upon, are usually made with calm deliberation by the rational side of our nature. However, plans are often changed by two primary emotions: fear and greed. In our experience, the urge to tinker with or abandon a well-thought-out plan rarely occurs when the portfolio behaves broadly in line with the plan on an annual basis. We plan with our rational brains and react with our emotions. History is very clear about two things (1+2) and we have observed two more (3+4):

1. Stock returns over time display consistent volatility so that returns are more often lumpy than smooth.
2. All of the major stock markets regions and intra region asset classes that we have studied, and which form the basis of our strategic asset allocation, have a fairly consistent trend, in our view. The longer the data, the more reliable the trend.
3. Mutual fund flows (as a representation of the investor base) consistently follow performance. The more outsized the returns, the greater the magnitude of inflows near or at the top – greed. For example, flows into stock funds peaked in 1999 and 2000, and outflows reached a crescendo in the second half of 2008.
4. As a mirror image of the above, outflows follow market declines and underperformance by asset classes.

If we acknowledge that emotion is an investor's enemy, then we believe adherence to predetermined, continuously refined disciplines will help us to manage our emotions and succeed in meeting our goals. Here we highlight the two disciplines that form the core of how we make decisions: value and momentum. In terms of value, we look in the parts of the market where fear resides, usually because the outlook seems uncertain. When prices fall enough relative to historical trends that we believe the fear is presenting a long-term opportunity, we buy.

Our discipline for determining value gives us the emotional fortitude to accumulate from forced sellers or fearful investors. Using this process, we cannot be sure that value will be unlocked over a short period of time, but we can be confident that it should over the time frames targeted by our portfolios. As the father of value investing, Benjamin Graham, wrote, value itself presents a "margin of safety" and thus poses better risk/reward potential over longer periods of time. At RiverFront this is the essence of our Price Matters® process. In our experience, the primary challenge is when it takes longer for the returns to come through, and clients either lose patience or trust in our process.

Momentum or "trend following" investors broadly believe there will always be trends which persist long enough to allow them to buy once upward momentum has been established, and sell when the trend has clearly rolled over and broken down. The process is to extract the piece in the middle. This requires strict adherence to a set of *predetermined* trading rules, often written in computer code and executed following computer-driven signals. Again, emotion is extracted. If done well, sustained trends are partially captured on the way up and avoided on the way down. Momentum investors struggle, often getting "whipsawed" when the trends are not clearly defined, or if markets crash, such as in 1987 when a clear down trend had not been established.

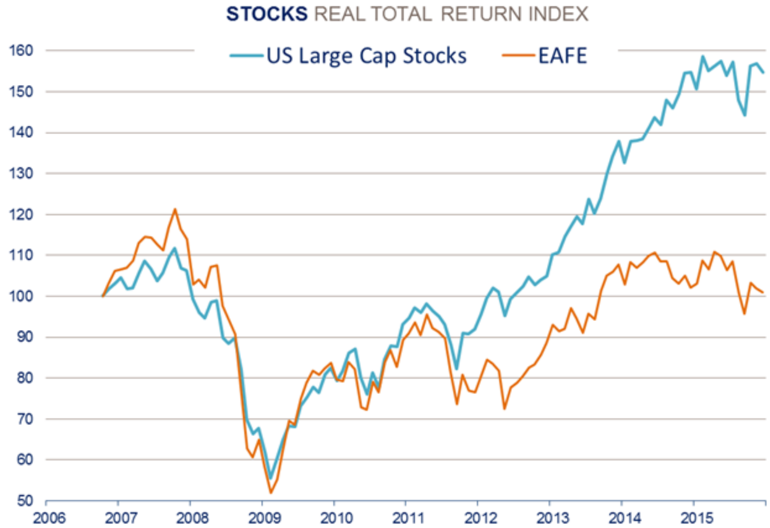
RiverFront Combines Value and Momentum to Combat Volatility: Our goal in combining the two is to smooth out both returns and emotions. Our Price Matters® value discipline, designed in the early 2000s and continuously refined ever since, determines our strategic allocation, optimizing portfolio models for different time frames. We use momentum and investor sentiment to tactically adjust our portfolios around their strategic allocations. In the last nine months the risk management side of our tactical process has been fully engaged. We only seek to make tactical calls with 20-30% of portfolios' holdings.

Our Risk Management Journey in 2015/2016: The first move was in July when we risk-managed Master Limited Partnerships (MLPs) out of the portfolio, and then used the extreme pessimistic sentiment that subsequently occurred in August to add some international stocks to the portfolio, after the S&P 500 found support at 1860.

To protect the portfolios on the downside after adding equities, we set moving stop losses as the market rallied back towards (S&P 500) 2100. When the market traded down to our first trigger of 2050 in early November, we raised between 6 and 11 percent cash and cash equivalents. Entering 2016, our risk models indicated that the odds of having a positive return over the next three months had deteriorated below the long term average of 62.2% on the S&P 500, so we set stop losses at 1985 and 1940 as support levels, both of which were triggered in the first few days of January.

Over the last week, we were able to reinvest approximately half of the cash as investor fear once again reached a crescendo, and our trend and sentiment model gave us a signal that the odds of having a positive return had greatly improved. Reinvesting gave us the chance to re-position the portfolio's stocks. We added both US and International stocks favoring the latter and introducing a more domestic focus to our non-US portfolio. For our shorter time horizon, more risk-adverse portfolios, we remain committed to risk managing them more aggressively during periods of uncertainty. We have set an 1812 stop loss (the recent January 20th intraday low) in case volatility persists and we have mistimed our re-entry into the market.

THE WEEKLY CHART: MIND THE GAP – INTERNATIONAL HAS "MARGIN OF SAFETY"



The big gap in performance since 2011, suggests to us that International can catch up in a positive environment and has less downside risk if things deteriorate.

Source: RiverFront Investment Group, MSCI. Data from Jan 1970 through Aug 2015. Past performance is no guarantee of future results. The MSCI EAFE Index measures the equity market performance of developed markets, excluding the US & Canada. The index consists of indices from approximately 22 developed markets. It is not possible to invest directly in an index.

Important Disclosure Information:

Investments in international and emerging markets securities include exposure to risks such as currency fluctuations, foreign taxes and regulations, and the potential for illiquid markets and political instability.

Technical analysis is based on the study of historical price movements and past trend patterns. There are no assurances that movements or trends can or will be duplicated in the future.

Master Limited Partnerships (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.

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

RiverFront Investment Group, LLC, is an investment advisor registered with the Securities Exchange Commission under the Investment Advisors Act of 1940. The company manages a variety of portfolios utilizing stocks, bonds, and exchange-traded funds (ETFs). Any discussion of the individual securities is provided for informational purposes only and should not be deemed as a recommendation to buy or sell any individual security mentioned. Opinions expressed are current as of the date shown and are subject to change. They are not intended as investment recommendations.

Standard & Poor's (S&P) 500 Index measures the performance of 500 large cap stocks, which together represent about 75% of the total US equities market. It is not possible to invest directly in an index.