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CHIEF INVESTMENT STRATEGIST

Adding to US Small Caps

Last week, we increased our weighting in US small cap stocks, which we currently like both strategically and tactically. For us, the strategic case for small caps lies in their history of higher returns versus large caps and their current starting point relative to the long-term trend. To illustrate this, we use data from The Center for Research in Security Prices at the University of Chicago (CRSP). CRSP has current data on over 3,200 US stocks and a history of indexes going back to 1926. They break the data into deciles and define small caps as deciles 6 to 10. We estimate the trend for small caps is 8.2% over inflation versus 6.4% for large caps. As you can see from the chart below, their small cap index starts with a value of 1 and is now over 1000 after adjusting for inflation. For reference, large caps have risen from 1 to around 250 over the same period – such is the power of compounding at a higher rate over a long period. We cannot know if these trends will persist, but we expect small caps to continue to grow at a faster rate than large caps. We believe small caps enjoy a faster return profile in part because many of the successful companies get bought by larger companies at premium prices.

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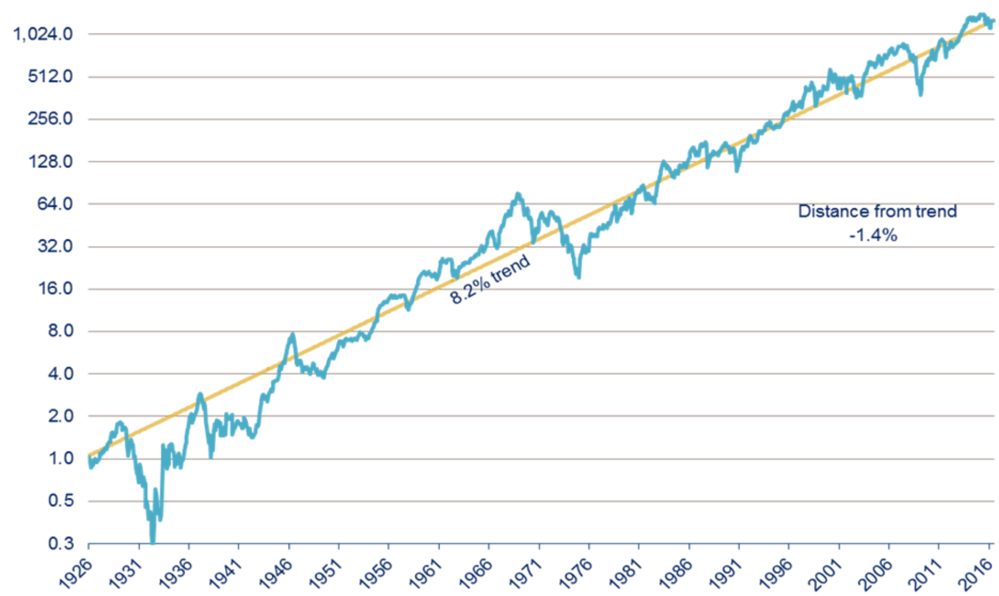
SMALL CAP STOCKS REAL TOTAL RETURN INDEX

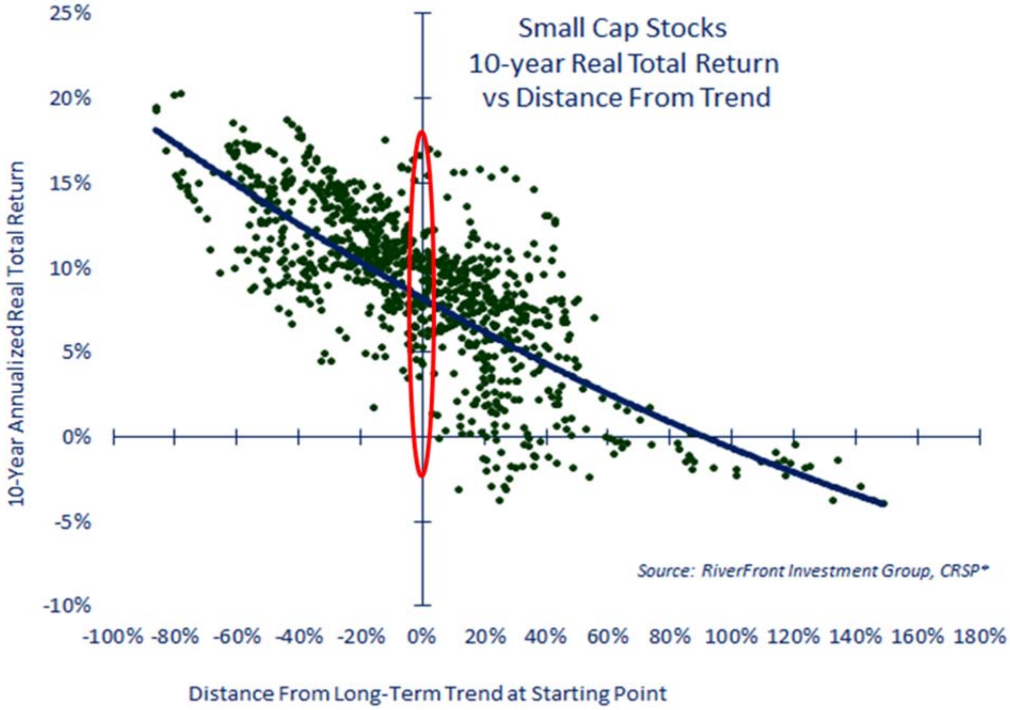


Source: RiverFront Investment Group, calculated based on data from CRSP 1925 US Indices Database ©2016 Center for Research in Security Prices (CRSP®), Booth School of Business, The University of Chicago. Past performance is no guarantee of future results. It is not possible to invest directly in an index. Small 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.

Our Price Matters® discipline accepts the faster trend, but also looks at the current distance from trend. For most of the last 3 years, small caps have been well above trend, making them less attractive to us. What excites us now is that a year of falling small cap prices has allowed the trend to catch up so that as of the end of June, this index is 1.4% below trend. Small caps are volatile and can deviate significantly from trend, but the history of long-term return outcomes from starting points at or below trend is impressive (see Weekly Chart on page 2).

To help us with the challenge of making strategic return assumptions, we find it helpful to learn what we can from history. Having established a trend, we can look at the range of outcomes from all the previous times that began with the same distance-from-trend. In the scattergram below, we ask two questions: What was the distance-from-trend at every month end since 1926; and what was the subsequent 10-year real return? Each dot represents an answer and given the persistence of the trend, it is not surprising that distance-from-trend affects returns.

THE WEEKLY CHART: ATTRACTIVE RISK/REWARD FROM CURRENT LEVELS



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The observations to the right of the center line show that 10-year returns decrease as small caps get further above trend, and the observations to the left show the opposite. As of June 30th, small caps are close to the trend and the observations in the red oval show the 10-year real return outcomes when small caps start close to the trend, which have ranged from 4% to 17% per year above inflation. This range of returns and the absence of negative 10-year real return outcomes is attractive to us, especially since this data series includes difficult times such as the Great Depression, WWII, and the inflation of the 1970s and early 1980s.

For the tactical decision of when to buy, we try to be mindful of current fundamentals, price momentum (the trend) and investor sentiment. The relative earnings of US small caps (S&P 600) have been in a steady uptrend since the 2009 lows versus large caps (S&P 500). We believe this trend is likely to continue and that the decline in relative price performance over the last year presents an opportunity. We look at the slope of the 200-day moving average to gauge the trend, and we use relative strength as a measure of investor sentiment. Small caps (as measured by the S&P 600 small cap index) peaked in the summer of 2015 and fell some 25% to a low this past February, causing their 200-day moving average to decline and making us tactically cautious. Since February, they have stabilized and recovered, allowing the moving average to start rising again in June. With a rising 200-day moving average and current sentiment readings, we believe the odds favor better than average returns in the next 3 months, so we are adding to an asset class that we like strategically.

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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.

Strategies seeking higher returns generally have a greater allocation to equities. These strategies also carry higher risks and are subject to a greater degree of market volatility.

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

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Index Definitions:
It is not possible to invest directly in an index.

The Standard & Poor's 500 (S&P 500) Index is an American stock market index based on the market capitalizations of 500 large companies having common stock listed on the NYSE or NASDAQ.

The Standard & Poor's SmallCap 600 (S&P 600) Index covers roughly the small-cap range of US stocks, using a capitalization-weighted index.

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