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Market Pullbacks May Not Be Worth Waiting For, In Our View

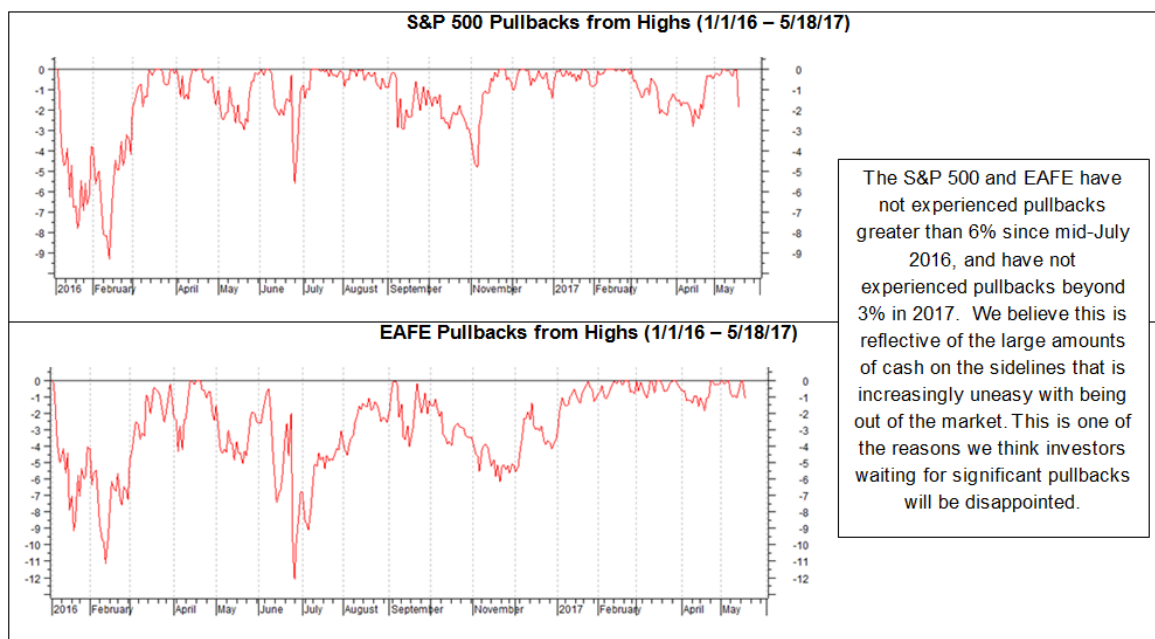
We have noticed that many retail investors are currently sitting on cash and waiting for an opportunity to get back in the market. Many of these people either pulled their money out of the market after the Financial Crisis, or raised cash before or after significant political events like Brexit, or the US and European elections. Psychologically, the degree of cash on the sidelines can cause an investor to join the ‘gloom and doom’ camp, where they no longer cheer for economic progress, but rather look forward to the next economic shortfall or political misstep to justify their bearish positioning. Some in this camp may have felt their prayers were being answered on May 17th, when the S&P 500 registered its steepest decline since September 9th and finally appeared to be taking in all the news coming out of Washington. However, those hopes for a more significant pullback were quickly dashed over the rest of the week as the S&P 500 recovered more than 50% of its decline, and MSCI EAFE made new multi-year highs.

With so much money on the sidelines or hiding in low-risk assets and a lack of market weakness, we think there are two questions worth asking: 1) Is a market pullback likely? and, 2) Is a pullback worth waiting for?

IS A PULLBACK LIKELY?

We believe with fairly high conviction that over the next 12-18 months, the market is likely to experience a pullback. However, we are skeptical that such a pullback will be at the time, to the degree, or for the reasons that many investors have been expecting. One reason we do not prefer significant cash holdings is that the next pullback may happen from higher levels and therefore not present an entry price that is any lower than where the market stands today. A second reason we think investors with cash could be disappointed is that we do not envision a pullback that will be deep enough to justify the decision many investors made when raising cash last summer or fall. That is because, in our view, the recent and significant improvements in economic data and political landscapes around the world have created greater unease for those with cash on the sidelines. Investors with high cash now appear more determined to get invested, leading to pullbacks that have been both shorter and shallower than normal, which can be seen in the two charts below.

Pullbacks Have Been Short and Shallow



Source: RiverFront Investment Group; Metastocks. Past performance is no guarantee of future results. It is not possible to invest directly in an index. Standard & Poor's 500 Index (S&P 500) measures the performance of 500 large cap stocks, which together represent about 75% of the total US equities market. The MSCI EAFE Index is an equity index which captures large and mid cap representation across Developed Markets countries around the world, excluding the US and Canada

Finally, a pullback may not come for the reasons many investors expect. The old saying “a watched pot never boils” has an application to markets, in our view. Markets are most affected by the unexpected, and investors are becoming accustomed to Trump’s war with the media. With so much media attention currently focused on President Trump, the market is constantly assessing the likelihood of his administration achieving their economic agenda. For example, small-caps and material stocks, which were viewed as the obvious and disproportionate beneficiaries of Trump’s tax and infrastructure plans, have already retraced 80-100% of their relative post-election gains. In fact, we may have gotten close to the point that the bigger surprise to Wall Street would be the President’s economic agenda getting back on track.

IS A PULLBACK WORTH WAITING FOR?

We believe the answer is “no” for investors with time horizons beyond five years. That is because, for investors with longer time horizons, we believe successful timing of a market entry or exit level (market timing) can be difficult, costly, ultimately may not materially impact long-term returns, and may conflict with the efforts of an investment manager.

Market Timing is Difficult: Market timing, which involves dramatic shifts in a portfolio’s asset allocation based on the price movements of a market, is notoriously hard. Professional market timers regularly admit that only about half of their trades are profitable. At RiverFront, we do not regard the tactical portion of our investment process as market timing, since our trades are typically smaller shifts and generally based on reasons that extend beyond simple price movements.

The experience of market timers is less predictable than that of long-term investors, who have historically benefitted from the fact that the US large-cap stocks have risen in value 62 months out of 100 since 1926 (source: CRSP). The odds have been even better for investors when market valuations are close to fair value when measured by our Price Matters® methodology, as they are now (Table 1). Given the different investment experiences of these two groups of investors, it begs the question, why would a long-term investor accept historically poorer odds by trying to time the market?

Table 1: Returns of Large-Cap Stocks When Valuations Are Close to Fair Value (plus or minus 10%) Using RiverFront’s Price Matters® Methodology

| Time Period | Historical Probability of Positive Returns (%) | Average Returns Over Given Time Period |
|-------------|--|--|
| 1 Year | 69% | 5.5% |
| 3 Year | 75% | 8.0% |
| 5 Year | 85% | 7.8% |
| 10 Year | 100% | 7.3% |

Source: RiverFront Investment Group, calculated based on data from CRSP 1925 US Indices Database ©2017 Center for Research in Security Prices (CRSP), Booth School of Business, The University of Chicago. Data from Jan 1926 through March 2017.

The information above is provided for illustrative purposes only and intended to demonstrate a tool used by RiverFront to evaluate asset classes using historical data. Past performance is no guarantee of future results. The above information is not intended as an investment recommendation, nor does it represent in any way the experience of an actual investor or portfolio.

Market Timing Can Be More Costly in Today’s Environment: When an investor is being “paid to wait” as their cash is accumulating interest at the bank or yield on short-term bonds, the long-term costs of market timing can be less punitive. However, today’s low interest rate environment does not pay an investor to wait, and in fact, we believe it imposes somewhat of a penalty on money that remains on the sidelines. With short-term rates at less than 1% and inflation running over 2%, as measured by the Consumer Price Index (ex-food and energy), cash on the sidelines loses purchasing power every day it remains idle.

Market Timing May Not Materially Impact Returns of Long-Term Investors: In our view, the longer an investor’s time horizon, the less important market timing is. We believe the old Wall Street adage that “successful investing is not about timing, but about time in” holds merit for most long-term investors for two reasons. First, over long time horizons, the US stock market has generally recovered its losses, as evidenced this year with most broad US market indexes hitting all-time highs. Second, long-term investing gives the investor the benefit of experiencing what Albert Einstein called “one of the most powerful forces in the universe”: compound interest. Compound interest allows a \$100 dollar investment growing at 10% annually to return more than 6.7 times an investor’s initial money after 20 years. Investors who employ market timing tend to be un-invested or underinvested more frequently and are thus unlikely to experience the full benefits of compound growth. Table 2 shows how missing out on the first 1, 2 or 3 years of a 20-year time horizon can impair potential long-term returns. In our view, the risks posed by a strategy focused solely on market timing are simply not worth the potential return for the long-term investor. If done successfully, the positive impact to the portfolio is unlikely to be significant; but, if done unsuccessfully, the negative repercussions could be substantial.

Table 2: Compound Interest: Investing early can make a big difference in long-term returns

| Years | Invested Full 20 years | Miss First Year | Miss First Two Years | Miss First Three Years |
|-----------|------------------------|-----------------|----------------------|------------------------|
| 0 | \$100 | \$100 | \$100 | \$100 |
| 1 | \$110 | \$100 | \$100 | \$100 |
| 2 | \$121 | \$110 | \$100 | \$100 |
| 3 | \$133 | \$121 | \$110 | \$100 |
| 4 | \$146 | \$133 | \$121 | \$110 |
| 18 | \$556 | \$505 | \$459 | \$418 |
| 19 | \$612 | \$556 | \$505 | \$459 |
| 20 | \$673 | \$612 | \$556 | \$505 |

Source: RiverFront Investment Group. The table above is intended for illustrative purposes only as an example of how compound interest works. It is not intended as an investment recommendation and is not reflective of any actual or hypothetical investor portfolio or experience.

Market Timing Can Conflict With the Efforts of an Investment Manager: The motivation for waiting on the sidelines is often a result of investors feeling like they already missed out on a bull market. While it may be true that some markets can hit levels of overvaluation that make them poor investments, investment managers with broad mandates are paid to identify and seek to avoid those markets. At RiverFront, we have been reducing our exposure to US equities, recognizing that the US bull market is now 9 years old, and we have been buying equities in developed markets outside the US, such as Europe and Japan, where we believe valuations are still considerably cheaper than they are in the United States.

AN ALTERNATIVE STRATEGY TO MARKET TIMING

Long-term investing deserves entry and exit strategies that are consistent with the investor's goals and objectives and are based on a sounder footing than one's ability to forecast market movement over short periods of time. **We believe the goal of a long-term investor should be to get invested as soon as possible, while minimizing the risk of committing all their capital prior to a significant market pullback.**

There are a number of strategies that can be used to accomplish this goal, and the strategy we have devised blends what we believe to be the best ideas from several strategies and tailors them to the long-term investor. It is a three-pronged plan we describe as: Immediately, Opportunistically, and Eventually.

- **Immediately:** Based on our view that the US market is around fair value and markets outside the US remain 'cheap', we prefer an approach of putting a portion of our cash to work immediately.
- **Opportunistically:** After not experiencing a pullback of greater than 3% thus far in 2017, we believe there is probably a pullback on the horizon. Therefore, we are inclined to hold onto a portion of our cash for an opportunity to invest at lower levels. Considering the short and shallow nature of pullbacks over the past six months, we set modest pullback targets of 3-6%.
- **Eventually:** For the final portion of cash, we often set a date or series of dates over the next 3 to 6 months to invest the remaining proceeds. Once the dates are selected, we believe it is important to adhere to the investment discipline regardless of the market levels at those times.

Important Disclosures

Past results are no guarantee of future results and no representation is made that a client will or is likely to achieve positive returns, avoid losses, or experience returns similar to those shown or experienced in the past.

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

Market Cap index information calculated based on data from CRSP 1925 US Indices Database ©2017 Center for Research in Security Prices (CRSP®), Booth School of Business, The University of Chicago. Used as a source for cap-based portfolio research appearing in publications, and by practitioners for benchmarking, the CRSP Cap-Based Portfolio Indices Product data tracks micro, small, mid- and large-cap stocks on monthly and quarterly frequencies. This product is used to track and analyze performance differentials between size-relative portfolios. CRSP ranks all NYSE companies by market capitalization and divides them into ten equally populated portfolios. Alternext and NASDAQ stocks are then placed into the deciles determined by the NYSE breakpoints, based on market capitalization. The series of 10 indices are identified as CRSP 1 through CRSP 10, where CRSP 10 has the largest population and smallest market-capitalization. CRSP portfolios 1-2 represent large cap stocks, portfolios 3-5 represent mid-caps and portfolios 6-10 represent small caps.

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.

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.

Diversification does not ensure a profit or protect against a loss.

In a rising interest rate environment, the value of fixed-income securities generally declines.

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.

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Index Definition

Consumer Price Index (ex Food and Energy) is an aggregate of prices paid by urban consumers for a typical basket of goods, excluding food and energy. This measurement, known as "Core CPI" is widely used by economists because food and gas have very volatile prices.

It is not possible to invest directly in an index.

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