

## RiverFront's 2018 Asset Allocation Strategy: Seeking Value in an Increasingly Pricey Market

Strong investment returns for most asset classes in 2017 pushed US equity asset classes to modestly overvalued levels. The less attractive valuation environment for most equity asset classes is paired with continued low interest rates and relatively unattractive fixed income return prospects, in our view.

Achieving our risk and return objectives in this challenging valuation environment requires, in our opinion, an increased allocation to developed international equities and, for our longer time frame portfolios, emerging markets.

### 2017: GREAT RETURNS RESULT IN LESS ATTRACTIVE VALUATIONS

In 2017, global investors benefited from a powerful combination of economic and monetary conditions - global economic growth accelerated while monetary policy remained extremely accommodative. The combination of faster growth and friendly central banks pushed virtually every asset class higher, with 20% plus returns for most equity asset classes and 3.5% returns for investment grade bonds.

Although exhilarating, these strong returns have resulted in far less attractive valuations based on RiverFront's Price Matters® framework. As shown in the table below, US Large Cap equities finished the year 16.9% over the long term trend, up from a close to trend 3.4% reading at the end of 2016. This represents a more modest level of overvaluation than the 100% over trend seen in the 1999/2000 tech bubble, but nonetheless results in reduced expected returns and increased downside risks over the course of the next ten years according to Price Matters® (please see the section of this report titled "RiverFront's Dynamic Strategic Allocation Process" for more details).

Small and mid-cap stocks underperformed large cap alternatives in 2017, but the 15.7% return of small cap stocks still pushed them to 20.2% above trend. At this level of overvaluation, expected returns over the course of the next 10 years for small and mid-cap stocks are only slightly higher than large caps and downside risks are considerably higher, according to Price Matters®. The Federal Reserve began a gradual process of increasing rates in 2017, but rising treasury yields were largely offset by tighter spreads on corporate bonds and mortgage backed securities. Yields on the average investment grade bond, as measured by the Bloomberg Barclays Aggregate Bond Index, rose only slightly from 2.6% to a still historically unattractive 2.7%.

### RIVERFRONT'S 2018 ASSET ALLOCATION STRATEGY

| Asset Class             | Total Return 2017 | 12/31/2016 Distance from Trend | 12/31/2017 Distance from Trend |
|-------------------------|-------------------|--------------------------------|--------------------------------|
| US Large Cap            | 22.7              | 3.4                            | 16.9                           |
| US Small Cap            | 15.7              | 14.6                           | 20.2                           |
| Developed International | 25.6              | -39.1                          | -29.6                          |
| Emerging Markets        | 37.8              | -22.0                          | -0.9                           |
| Investment Grade Bonds* | 3.5               | 2.6                            | 2.7                            |
| High Yield Bonds*       | 7.5               | 6.2                            | 5.8                            |

\*Fixed income asset classes display yield rather than distance from trend.

Source: CRSP and Bloomberg

Past performance is no guarantee of future results. Shown for illustrative purposes and not indicative of RiverFront portfolio performance. Trend based on Price Matters® calculations. Please see the end of this piece for asset class definitions.

Both US equities and investment grade bonds ended 2017 at somewhat overvalued levels, in our view. As a result, our Price Matters® framework and Mean Reversion Optimization (MRO) process allocated an increasing percentage of portfolio assets in what we believe is the last significantly undervalued asset class in the global marketplace – developed

international equities. The 37.8% return of emerging market equities in 2017 largely closed their undervaluation relative to their long term trend. Even so, we believe a small discount to the long term trend makes this volatile asset class relatively attractive compared to US alternatives for investors with sufficient risk tolerance. Thus our longer term, higher risk level portfolios have a higher strategic weighting in emerging market equities. Our higher strategic weighting in developed international and emerging market equities has been funded through



**Michael Jones, CFA**

CHAIRMAN  
PRESIDENT & CEO, RIVERSHARES



**Deva Meenakshisundaram, FRM**

CHIEF OF QUANTITATIVE ANALYTICS

a reduced weighting in US equities, and by eliminating our strategic weighting to high yield bonds.

### RIVERFRONT'S 2018 STRATEGIC ASSET ALLOCATION TARGETS

| Asset Classes                        | Investment Time Horizon<br>Equities/Fixed Income (%) | 3-5 Years | 5-7 Years | 7-10           | 7-10           | 10+ Years |
|--------------------------------------|--|-----------|-----------|----------------|----------------|-----------|
|                                      |  | 30/70     | 50/50     | Years<br>70/30 | Years<br>80/20 | 100/0     |
| US Large Cap*                        |  | 24%       | 34%       | 34%            | 34%            | 30%       |
| US Small & Mid Cap                   |  |           |           |                |                | 3%        |
| Developed International**            |  | 12%       | 23%       | 36%            | 45%            | 53%       |
| Emerging Markets                     |  |           |           | 8%             | 9%             | 12%       |
| Investment Grade – Short Term        |  | 41%       | 17%       | 6%             | 2%             |           |
| Investment Grade – Intermediate Term |  | 15%       | 22%       | 11%            | 8%             |           |
| High Yield                           |  |           |           | 3%             |                |           |
| Treasuries                           |  | 6%        | 2%        |                |                |           |

\* Around 50% allocation to Dividend Growth Stocks

\*\*No hedging for portfolios with investment horizons above 5Yrs

*Strategic Asset Allocations shown above and below are a guide used by RiverFront in managing the Firm's asset allocation portfolios and do not reflect the actual asset allocations of the current RiverFront portfolios.*

In our view, investment grade bonds are only slightly more attractive than in 2017, and our expectation is for interest rates to rise over the next few years. We think rates will be pushed higher,, by the Federal Reserve's continued moves to raise rates and global central banks retreating from large scale bond purchases (a policy known as quantitative easing or "QE"). The unattractive potential returns for bonds are reflected in our underweight strategic weighting to the asset class and a shorter maturity target for the bonds in our strategies, as compared to their long term composite benchmarks.

Our Mean Reversion Optimization (MRO) asset allocation methodology seeks to build portfolios that can generate positive nominal returns at their investment horizon (3-5 years, 5-7 years, etc.) even in stressful economic and market scenarios. With most domestic equity asset classes trading above their long term trend levels, downside risks in a stressful economic and market environment are potentially increased. To offset higher downside risks in the equity portion of our portfolio, the MRO process reallocated out of inflation indexed bonds (also known as Treasury Inflation Protected Securities or TIPS) and into short/intermediate investment grade bonds and long maturity treasuries. As was illustrated in the financial crises of 2008, TIPS may not provide reliable protection from some stressful equity market environments. As equity risks increase, our MRO process seeks a more reliable offset to potential downside in our equity positions.

### CHANGES IN STRATEGIC ASSET ALLOCATION TARGETS 2018 COMPARED TO 2017

| Asset Classes                        | Investment Time Horizon<br>Equities/Fixed Income (%) | 3-5 Years | 5-7 Years | 7-10           | 7-10           | 10+ Years |
|--------------------------------------|--|-----------|-----------|----------------|----------------|-----------|
|                                      |  | 30/70     | 50/50     | Years<br>70/30 | Years<br>80/20 | 100/0     |
| US Large Cap*                        |  | -5%       | -4%       | -4%            | -2%            | -4%       |
| US Small & Mid Cap                   |  | -1%       | -2%       | -2%            | -3%            |           |
| Developed International**            |  | +4%       | +5%       |                | +2%            | +2%       |
| Emerging Markets                     |  |           |           | +4%            | +3%            | +2%       |
| Investment Grade – Short Term        |  | +18%      | +2%       | +6%            | +2%            |           |
| Investment Grade – Intermediate Term |  | -9%       | +7%       | -1%            |                |           |
| High Yield                           |  | -6%       | -3%       | -3%            | -2%            |           |
| Treasuries                           |  | +6%       | +2%       |                |                |           |
| TIPS                                 |  | -7%       | -7%       |                |                |           |

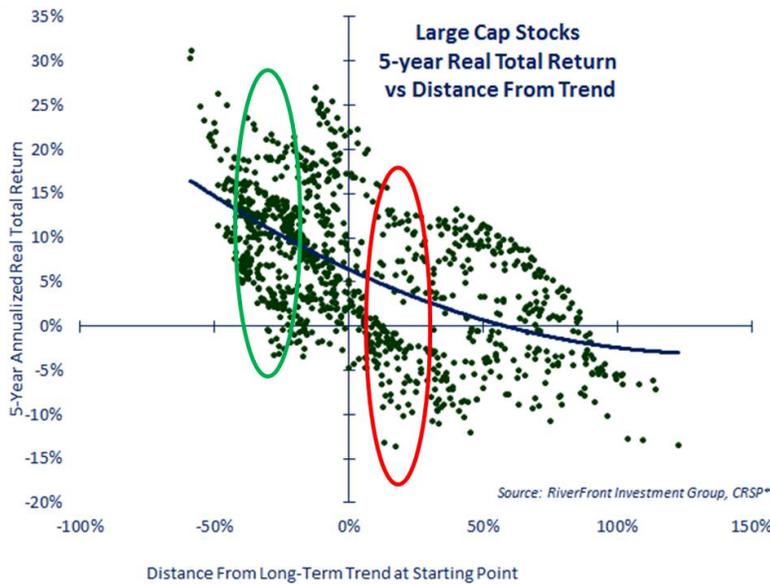
\* Around 50% allocation to Dividend Growth Stocks

\*\*No hedging for portfolios with investment horizons above 5Yrs

## RIVERFRONT'S DYNAMIC STRATEGIC ALLOCATION PROCESS

Each year RiverFront updates our Price Matters® models and recalculates potential return and downside risk estimates for all of the major asset classes. These capital market assumptions are incorporated into our Mean Reversion Optimization process to produce updated strategic asset allocation targets for each of our portfolios. These longer term strategic targets are combined with shorter term tactical adjustments to set our overall asset allocation strategy. The following chart provides an example of how Price Matters® and changing valuation levels impact our expectation of risk and return. Each dot on the scatter plot to the right and on the following page measures two things: (1) the vertical axis measures all the real return outcomes over five-year holding periods; and (2) the horizontal axis reflects the distance from the trend: to the right of the center line, the index is above trend and to the left is below trend. The green oval marks historical periods beginning -25% to -35% below the long term trend, a level corresponding to US valuations in 2011 and current valuations in developed international equities. Historical returns for periods beginning that far below trend ranged between best case returns of 25%+ per annum over inflation and worst case losses of about -5% per annum.

### LARGE CAP US PRICE MATTERS® EXPECTED RETURNS



Source: RiverFront Investment Group, CRSP. Chart as of Dec 2017. Please see the end of this presentation for important disclosure information. Shown for illustrative purposes only, not indicative of RiverFront portfolio performance. Past performance is no guarantee of future results. The red circles are drawn to show returns that are approximately 10% above trend (approximately the current trend valuation) and approximately 29.6% below trend (the current developed international valuation). The slope of the line represents the average 5-year return of all times in the history of the data when an investment started from the value on the horizontal axis.

Average returns for those historical periods were about 13% per annum over inflation, fairly close to the 15.7% real returns posted by US large caps since 2011.

By contrast, the red oval marks historical periods that began close to the current 15% to 20% above trend that we calculate for large cap equities. Average returns for these historical periods are only 4.5% to 5.0% compared to the 6.0% to 6.5% long term trend return, and we accordingly reduce our expected returns to this level. Upside potential in the best case scenarios from history is lower than average, with a maximum historical returns of about 15% over inflation. Downside risk in the stressful economic and market scenarios from history are higher than average, with losses of as much as -10% to -12% per annum. Reduced upside and increased downside consistent with this historical data is incorporated into our Capital Market Assumptions (CMAs) for US equities. Developed international returns for periods that begin -25% to -35% below trend are very similar to US large cap returns from similar starting valuations. Our Price Matters® CMAs for developed international incorporate much higher expected returns and muted downside risks consistent with this historical experience.

Price Matters® CMAs for various global asset classes are incorporated into our MRO process, and we produce Price Matters® Efficient Frontier allocation targets for all of our portfolios. Each asset allocation target seeks to provide a positive return at the strategy's time horizon (3-5 year, 5-7 year, 7-10 year, 10+ years) even in stressful market scenarios. The Price Matters® Efficient Frontier calculates the tradeoff for each of these strategies between long term outperformance potential and shorter term investment risk. We select a baseline allocation target for each of our portfolio strategies at the point on its Price Matters® Efficient Frontier that we believe provides the best tradeoff between potential return and investment risk. Throughout the year we tactically adjust the allocation strategy up and down the Price Matter® Efficient Frontier based upon shorter term momentum and sentiment conditions across the different asset classes.

## CONCLUSION

We think a less attractive valuation environment for most equity asset classes paired with continued low interest rates creates a more challenging valuation environment for our asset allocation strategies. As US equities push above their long term trend valuation, we have relied upon an increased allocation to developed international equities and, for our longer time-frame portfolios, emerging markets. Developed international equities represent the most attractive asset class in the global marketplace, based on our Price Matters® framework, and RiverFront's 2018 outlook for continued strong performance from international equities thanks to reform efforts in France and Japan. However, our tactical risk management processes will seek to protect investor portfolios if our expectations prove overly optimistic.

### Important Disclosures:

*Information or data shown or used in this material was received from sources believed to be reliable, but accuracy is not guaranteed. Strategic allocations may vary from portfolio composition or actual portfolio allocation throughout the year, depending on RiverFront's investment decisions.*

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

*RiverFront's Mean Reversion Optimization process incorporates Price Matters® asset class assumptions to quantitatively simulate potential outcomes of combining asset classes based on probability and historical data. It is based on the concept of mean reversion, which is the tendency of a variable to converge on an average value over time. RiverFront's Mean Reversion Optimization Process (MRO) uses Monte Carlo simulations to produce potential outcomes based on probability and historical experience. For equity asset classes, long-term expected real returns are modeled as a function of distance from trend, potential inflation environments and, for certain asset classes, fixed income returns. Long-term expected returns for fixed income asset classes are based on the simulated inflation environment and the historical relationship between inflation and the level of interest rates. These return expectations are used by RiverFront to assist in portfolio allocation and security selection. RiverFront relies on historical data to create these simulations; however, there is no guarantee that these outcomes will occur. Despite our best efforts, there is no certainty that the assumptions for the model will accurately estimate asset class return rates going forward. Extreme market movements are modeled consistent with historical experience, but future crises could occur more frequently than this historical experience would indicate. Some asset classes have relatively short histories. Actual long-term results for each asset class may differ from our assumptions, with those for classes with limited histories potentially diverging more. The analysis does not use all asset classes. Other asset classes may provide different returns or outcomes than those used.*

*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 Investment Group, LLC, is an investment adviser registered with the Securities Exchange Commission under the Investment Advisers Act of 1940. The company manages a variety of portfolios utilizing stocks, bonds, and exchange-traded funds (ETFs). RiverFront also serves as sub-advisor to a series of mutual funds and ETFs. Opinions expressed are current as of the date shown and are subject to change. They are not intended as investment recommendations.*

*RiverFront is owned primarily by its employees through RiverFront Investment Holding Group, LLC, the holding company for RiverFront. Baird Financial Corporation (BFC) is a minority owner of RiverFront Investment Holding Group, LLC and therefore an indirect owner of RiverFront. BFC is the parent company of Robert W. Baird & Co. Incorporated ("Baird"), a registered broker/dealer and investment adviser.*

*These materials include general information and have not been tailored for any specific recipient or recipients. Accordingly, these materials are not intended to cause RiverFront Investment Group, LLC or an affiliate to become a fiduciary within the meaning of Section 3(21)(A)(ii) of the Employee Retirement Income Security Act of 1974, as amended or Section 4975(e)(3)(B) of the Internal Revenue Code of 1986, as amended.*

### Principal Risks:

*Stocks represent partial ownership of a corporation. If the corporation does well, its value increases, and investors share in the appreciation. However, if it goes bankrupt, or performs poorly, investors can lose their entire initial investment (i.e., the stock price can go to zero). Bonds represent a loan made by an investor to a corporation or government. As such, the investor gets a guaranteed interest rate for a specific period of time and expects to get their original investment back at the end of that time period, along with the interest earned. Investment risk is repayment of the principal (amount invested). In the event of a bankruptcy or other corporate disruption, bonds are senior to stocks. Investors should be aware of these differences prior to investing.*

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

*Dividends are not guaranteed and are subject to change or elimination.*

*Using a currency hedge or a currency hedged product does not insulate the portfolio against losses. Investing in foreign companies poses additional risks since political and economic events unique to a country or region may affect those markets and their issuers. In addition to such general international risks, the portfolio may also be exposed to currency fluctuation risks and emerging markets risks as described further below.*

*Changes in the value of foreign currencies compared to the U.S. dollar may affect (positively or negatively) the value of the portfolio's investments. Such currency movements may occur separately from, and/or in response to, events that do not otherwise affect the value of the security in the issuer's home country. Also, the value of the portfolio may be influenced by currency exchange control regulations. The currencies of emerging market countries may experience significant declines against the U.S. dollar, and devaluation may occur subsequent to investments in these currencies by the portfolio.*

*Foreign investments, especially investments in emerging markets, can be riskier and more volatile than investments in the U.S. and are considered speculative and subject to heightened risks in addition to the general risks of investing in non-U.S. securities. Also, inflation and rapid fluctuations in inflation rates have had, and may continue to have, negative effects on the economies and securities markets of certain emerging market countries.*

*Inflation and rapid fluctuations in inflation rates have had, and may continue to have, negative effects on the economies and securities markets of certain emerging market countries.*

*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.*

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

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

*Treasury Inflation Protected Securities (TIPS) are Treasury securities that are indexed to inflation in an effort to protect investors from the negative effects of inflation. The principal value of TIPS is periodically adjusted according to the rate of inflation as measured by the Consumer Price Index (CPI), while the interest rate remains fixed. TIPS will decline in value when real interest rates rise. Portfolios that invest in TIPS are not guaranteed and will fluctuate in value. The Consumer Price Index (CPI) is an unmanaged index representing the rate of inflation in U.S. consumer prices as determined by the U.S. Bureau of Labor Statistics. There can be no guarantee that the CPI or other indexes will reflect the exact level of inflation at any given time. It is not possible to invest directly in an unmanaged index.*

**Index Definitions:**

*Bloomberg Barclays US Aggregate Bond Index (Barclays Agg) 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.*

*Standard & Poor's 500 Index (S&P 500) measures the performance of 500 large cap stocks, which together represent about 80% of the total US equities market.*

*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.*

**Asset Class Definitions:**

| Asset Class             | Indices   |   |
|-------------------------|---|---|
| US Large Cap            | Large Cap Real Return Index, source CRSP        | See definition above  |
| US Small Cap            | Small Cap Real Return Index, source CRSP        | See definition above  |
| Developed International | MSCI EAFE (IN US\$) Real Total Return Index     | The MSCI EAFE Index is designed to represent the performance of large and mid-cap securities across 21 developed markets, including countries in Europe, Australasia and the Far East, excluding the U.S. and Canada.     |
| Emerging Markets        | MSCI Emerging Market Equities Real Return Index | MSCI Emerging Markets Index measures equity market performance of emerging markets. The index consists of 23 countries representing 10% of world market capitalization.   |
| Investment Grade Bonds* | Bloomberg Barclays US AGG Bond TR USD           | See definition above  |
| High Yield Bonds*       | BofAML US HY Master II TR USD                   | BofAML US HY Master II TR USD is a measure of the broad high yield market. The index tracks the performance of U.S. dollar denominated below investment grade corporate debt publicly issued in the U.S. domestic market. |

*It is not possible to invest directly in an index.*

Copyright ©2018 RiverFront Investment Group. All rights reserved.

ID: 424231, Expiration: 2/9/2019