RIVERPOINT
CAPITAL MANAGEMENT | INVESTMENT ADVISORS

MARKET INSIGHTS

From RiverPoint Capital Management

Market Insights is a publication of RiverPoint Capital Management.

Like everything we do, it is designed to bring you talented resources and proactive advice with a single purpose in mind – to help our clients achieve financial security and peace of mind.

Learn more about what we do at www.riverpointcm.com.

RiverPoint Advisors

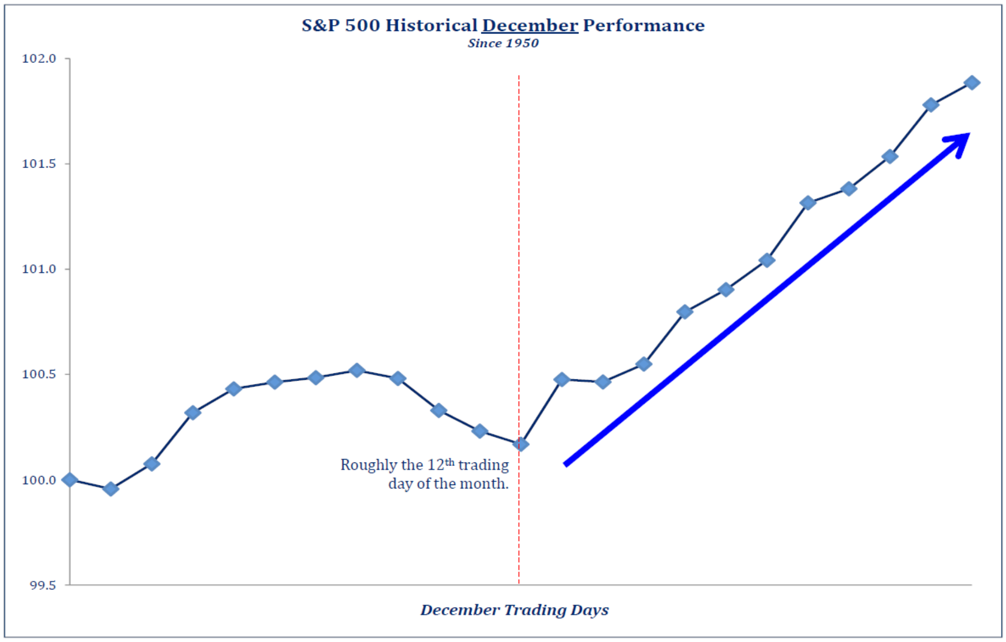
Valerie L. Newell, CPA*
Leon H. Loewenstine, CPA*
Victor R. Lassandro III
Pamela F. Schmitt, CFA, CDFA
Ryan L. Brown
Anthony Roberts III, CFA
J. Jeffrey Krumpelman, CFA
M. Patrick Richter, CFP®
Mindy McLaughlin, CFP®
Adam D. Morton, CFP®
Kristin A. Fishbaugh, CFA
Jonathan A. Bresnen, CFA
Brandon C. Phillips
Kyle M. Moore, CFA
Nolan D. Kamerer
Michael J. Murphy, CFP®
Bradley I. Morgan
Lauren Michalos, CFA
Matt Rice, CFP®, CRPS®

www.riverpointcm.com

*Inactive license to practice public accounting

December Sound Bites on the Market and Economy

Well, we made it through several key headline challenges this year, including **Brexit** and the **US election**, and here we are, once again at Holiday time, in the midst of a traditional "Santa Clause" rally. Many investors are pleasantly surprised about the positive market results in 2016 and this strong close to the year, fearing Santa might not show up in Q4 this time around. Surprise! Based on our forecasts and communications through the year, we are not. Soon we will turn attention to 2017 and what's to come. In that vein, what is on people's minds as we approach the New Year? The following are a couple key items:



Oh no, I think I see bonds in my portfolio!

As interest rates have rallied post-election and the ten year treasury yield has risen from roughly 1.5 percent toward the 2.5 percent level, are bonds now toxic and something to be shunned? In a word, no, from our perspective. **Bonds should still play a VERY important role in a portfolio going forward.** Yes, EVEN IN A RISING RATE environment, IF bond portfolios are managed in the right manner. Bonds still are the only true asset class, other than purely running to cash, that provide true ballast, downside protection and shields against unforeseen disruptions in the market. At Riverpoint, we still embrace allocating a normal level of client assets to bonds. It's how you do it, though, that matters.

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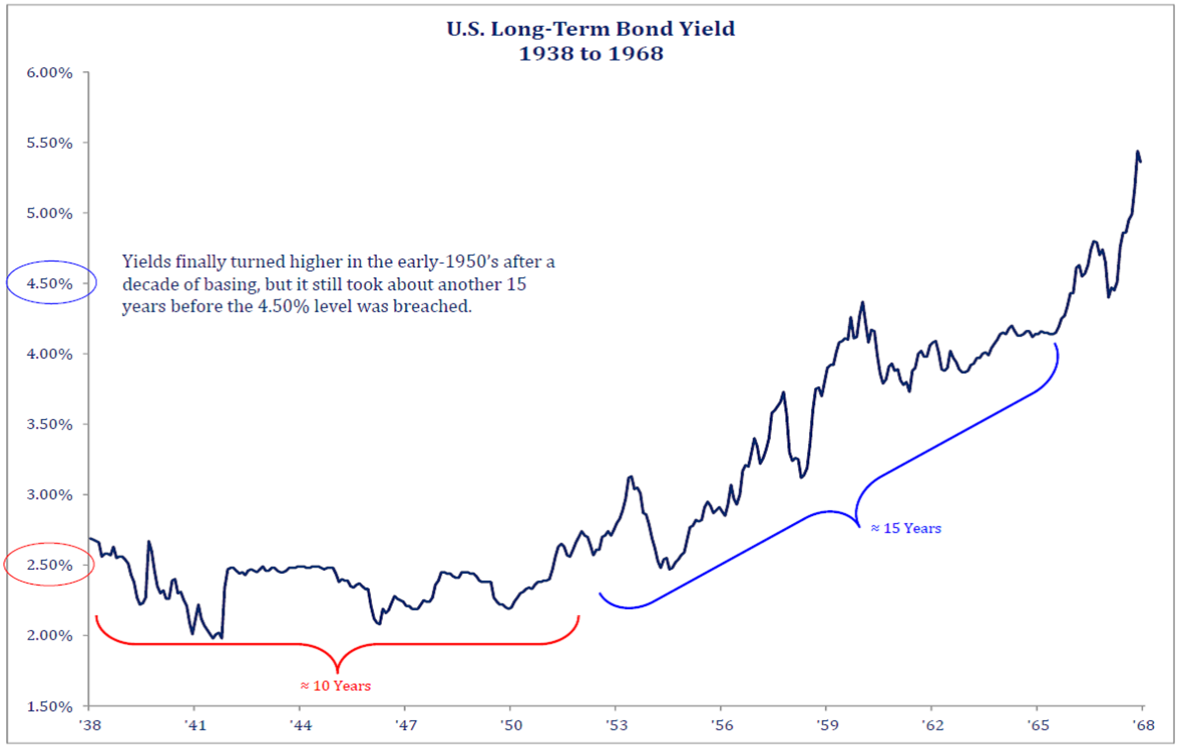
We feel our clients' bond portfolios are well positioned for a rising rate environment. Why? **First**, we focus on buying INDIVIDUAL BONDS. Yes, individual bonds fall in price, on a temporary basis, when rates rise. But, if you hold the individual bonds to maturity, their prices resurrect themselves to par value. And, voila, no price decline at expiration…you earn the yield to maturity as advertised and move-on! **Second**, we structure our clients' individual fixed income portfolios in a "ladder" by purchasing multiple bonds with scattered maturity dates over a multi-year period. In anticipation of rising rates, we have kept these ladders short, generally designing them with bonds that come due in a one to seven year time frame. As rates rise over time, we simply collect the par principal amount and re-invest at the higher rates. The ladder itself acts to reduce interest rate risk. In addition, we take advantage of opportunities to increase yields over what is available in government bonds in a high quality fashion by populating the ladder with high grade corporate bonds. A rather elegant approach in our view—simple but effective. No need to over-think this.



Remember there is a big difference between deflation, good inflation, and bad inflation.

This is true as there is a big disparity between the economic stages of: recession, recovery and expansion. And these two different concepts are tied together. **Deflation** is associated with recession and not a pleasant thing to experience; we think deflation risk is largely behind us as US and global economic data continue to improve both pre and post-election, and fiscal policy in 2017 is likely only to support a further tick-up in growth, albeit still not to impressively robust levels yet. Then there's **good inflation**. The type of inflation that's associated with recovery in the economy and that occurs when the economy is normalizing. Prices begin to increase a bit, thus driving faster revenue growth, and wages begin to rise which generates consumer income growth and stronger demand. Importantly at this stage both price increases and wage growth move in tandem in such a way, that, rather than introducing stress on corporate margins, they drive faster corporate earnings growth. Again, this is the good stuff and the stage of inflation we believe we are just now beginning to experience. **Bad inflation, on the other hand**, occurs when wage and price growth spiral out of control, mortgage rates go through the roof, and the FED is so behind the curve, it has to do an economic smack-down and slam on the brakes by hiking rates in a scary-big way. The facts suggest we are far from this, and it's important not to get sucked-in by likely alarmist headlines about this potential looming out-of-control type of inflation…unless the data supports such angst. Now the challenge to all of us is that as soon as good inflation appears, pundits start to sound the alarm bell that bad inflation is around the bend. Not unlike when we heard those alarmist warnings that "the recession is coming" every day as oil prices swooned in January and the Brexit vote approached in June. Don't believe the headlines…look at the data. Just like we felt the data said "the recovery continues" NOT "the recession is coming" back at these important inflection points in the year, we think the data now signals good inflation not bad inflation. Embrace good inflation…stocks like it.

2017 likely to be a year in which diversification actually works.

Actually this started in the second half of 2016. After dominating the global equity markets over the last several years and actually starting to view itself as "all it", the S&P 500 is NOT the leader of the pack as we approach year-end. Specifically, US small cap stocks in the Russell 2000 are up more than 20 percent in early December and emerging market stocks, that comprise the MSCI Emerging Market ETF, are up almost 13 percent. This compares favorably to the S&P 500 return of almost 11 percent. So it's not like the S&P is flaming out in a whimper, it's just these other indices are doing a bit better. We think this is likely to continue in 2017. We believe the S&P 500 will do well and generate mid-to-high single digit returns in 2017, but we think small caps and emerging market stocks could best the S&P in the 2017 calendar year, each for different specific reasons But, in each case, such out performance expectations are based on the fundamentals, valuation levels and

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technical price trends in these asset classes. While **small caps** have reached all-time highs, this is after under performing the S&P 500 over the last six years, so they were due. Further, unlike profit margins in large cap land, margins in small cap stocks remain well below peak levels. Small caps benefit from handsome EPS growth potential and should be out-sized beneficiaries of a less restrictive regulatory agenda by the new White House administration. Investors will also find them intriguing in the sense that they are less exposed to potential shots across the bow via implementation of tariffs and trade barriers with their more domestic revenue profiles versus large caps. Finally, they have appeal as beneficiaries of takeout activity under an administration more supportive of merger activity. The story is quite different in the **emerging markets** but there are equally positive elements to point to. EM stocks are just now getting back to price levels seen a year ago and breaking a down trend that has been in place for five years…so there is runway here, despite the relatively strong showing so far this year. Further, the fundamental data of these commodity based countries is getting less-worse at a minimum. This positive trend supports a good look, and one could argue they are attractively valued. After having exited emerging market stocks in the summer of 2015 and avoiding much of the weak showing in this asset class that year, we are just now re-introducing modest exposure to this arena based on this fact set. We will continue to move in measured fashion in building back a more normal 5 percent position in EM equities if these positive developments continue. Stay tuned.

Words of wisdom to live by…or at least to invest by.

We want to leave you in this issue with a couple of simple but prolific quotes by the brilliant investor, Ben Graham. The first quote of his to share with you is: ***"You are neither right nor wrong because the crowd disagrees with you. You are right because your data and reasoning are right."***

These are words we try to incorporate in our investment process and a key philosophy or element in our work that kept us focused on the facts at several points when many investors were convinced we were in store for a recession in 2016. We just didn't see it in the data and refrained from taking the newspaper headline head-fake to become more defensive. We will do so only when the data signals such a tact is appropriate. We forecast an S&P 500 level of 2175 for year end 2016 back in December 2015, and felt, if anything, the risk was to the upside and we COULD see 2300 in the S&P. We thought GDP growth would be north of 2.2 percent, that EPS growth would improve in the second half, largely as a result of stabilizing oil prices in the $40-$50 range, that the Fed was likely to be VERY measured and hike just once or maybe twice and that the 10 year would stay below 3 percent for the year but rise. This forecast was published in our 2015 Crystal Ball Webinar we sent you in January, 2016. We are pleased that this forecast was pretty close to actual. But more importantly we are more gratified that this forecast was based on the facts at the time (that didn't change much through the year). And though the headlines were HORRIBLE in the midst of the terrible January start to the year (e.g. "January, 2016…Worst Start to Year in History"), we did not waiver from our positioning for growth. This conviction was based on the facts as we saw them…advice that Ben Graham embraced and that served our portfolios well during the year.

Mr. Graham's second quote is a zinger: ***"The investor's chief problem-even his worst enemy-is likely himself."*** We will come out shortly with our forecast and anticipated strategy points for 2017. We will continue to be vigilant on viewing the facts as we see them as we approach the coming year to guard against becoming our own worst enemy and to drive good results. Thank you for your continued confidence. Happy Holidays. Enjoy!!

Thanks,

RiverPoint Capital Management