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MARKET INSIGHTS

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From RiverPoint Capital Management

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June Sound Bites on the Market and Economy

No doubt about it, the first half of 2017 has been good to investors…US stocks and bonds did well and foreign markets were even better. We're pleased to report that our portfolios were positioned well and for the most part were in the right places. Will the solid performance continue in the second half? We'll address this as well as dispel a couple of market myths in this month's Sound Bites.

Very Nice First Half…perhaps not enjoyable as it could be, but nice returns!

As the curtain falls to mark the end of Act I of 2017, investors have to be pleased with the results in these first 6 months. The S&P advanced over 9% and international markets were even better with developed international stocks and emerging market stocks generating total returns of 13% and 19% respectively. These are returns that investors generally would be happy about if we were talking about a full calendar year, let alone just a short 6 months. This outcome certainly is refreshing when compared to the first half of 2016 which was a roller coaster ride to nowhere or to the full calendar year of 2015 when the BEST asset class was the S&P 500 with its' puny 1% gain. Not that this year hasn't been colored with some unusual drama—tweets, talk of impeachment, and extreme partisan rhetoric in Washington as an interesting part of it all—and yet, what's not to like in the results? Headlines about Russia conspiracies and political theatre have taken center stage in the media but have been largely brushed aside by the markets for good reason—lack of true economic and earnings impact which is what the market cares about.

Your portfolios have been positioned in the correct spots…we have tilted our stock portfolios to more growth oriented companies versus the more value oriented and have focused on the associated sectors of the market with strong fundamentals—technology, healthcare, and consumer discretionary which are leading versus the defensive areas and energy which are lagging. We have also increased our exposure to emerging market international stocks through the year which has benefited performance. The key question of course is… will this good trend continue? Our short answer is yes, we believe 2017 will end on a solid note. Our research suggests the returns this year are firmly linked to accelerating earnings growth not hopes and dreams of policies in Washington. In our crystal ball webinar we hosted in January, we stated that we were targeting a 2017 year end price level for the S&P 500 of 2400-2500 based on the fundamental, valuation and technical backdrop. We also suggested we could move several hundred points above this level IF growth policies in Washington such as tax reform, infrastructure spending, and repatriation of foreign earnings took root and looked to be passable in 2018. Well, we're at 2443 on the S&P as of this writing. While the easier money has been made, we're about 3% below the top of our target range supported by market fundamentals such as earnings growth. More important, while we recognize recent economic data shows a slight deceleration in certain categories, we still see an overall mosaic of steady, "goldilocks" like growth for the foreseeable future which is a good environment for stocks. Further we do not see any of the typical signs of market tops—such as poor market breadth, only defensive sectors leading the market, blow-off hot M&A and IPO markets, huge flows into stock funds, deceleration in earnings, widening credit spreads etc.

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These are all absent and this gives us comfort. Sure there are wall of worry items…some will sight oil prices that are falling once again, inflation that is stubbornly low, a flattening yield curve, and eerily low volatility as reasons to worry about a top. We will discuss such items in our upcoming "Half Time Report" webinar in the latter part of July. For now, we will simply say we are comfortable with these metrics at present and look for a solid close to the year…not without bumps, but again with solid end result. If the items we are TRULY worried about surface we will adjust our view accordingly and certainly let you know. Stay tuned and please be on the lookout for our upcoming webinar.

Myth #1…The Market This Year Would Be Nowhere without the "FANG" stocks (aka Facebook, Amazon, Netflix, and Google).

This myth is worse than the one that suggests the market is extremely expensive because this one is just patently false and indisputably so. The returns in the market this year are very BROADLY distributed and that's a fact. This is one of the key reasons we remain positive…there is broad health in stock land. The number of stocks advancing versus declining continues to be in a strong uptrend as do 75% of the stocks in the S&P 500. Further, the "average stock" in the S&P 500 is up just about the same as the overall index, very much UNLIKE the concentrated market of 2015 when the index was up 1.4% but the average stock was down 7%. Now 2015 was a year when it was all about FANG…without the FANG stocks that year, market returns were decidedly negative. ..and such concentration was bothersome. In fact, the 10 largest stocks in the S&P 500 in 2015 accounted for more than 100% of the market's return versus this year where the top 10 account for roughly 30% of the market's return. Again, there is broad participation in the market's success this year and that is a good sign. Don't believe this bubble-like myth being promoted out there.

2017

Point Contribution of 10 Largest S&P Stocks

AAPL	25.1
GOOGL	7.0
MSFT	9.4
BRK/B	0.7
XOM	-4.5
AMZN	11.8
FB	10.5
JNJ	5.2
JPM	-1.1
GE	-3.6
Largest 10 Total	60.7
S&P 500 Point Gain	200.2
Largest 10 % of Total	30.3%

Myth #2…The Quants (quantitative money managers) and the "Data Scientists" have all the answers these days.

Ironically the DATA does not support this hypothesis. Hedge Funds have been going on a hiring frenzy for some time now to hire the best data scientists to construct quantitative models and processes to manage money. The thought is that with all this Big Data out there and all this computing power, who needs traditional investment managers and research analysts to do roll-up-your shirtsleeves analysis? Algorithms programmed into machines can do it better, right? Wrong…or at least the data suggests it isn't so clear. So far this year quant funds have struggled and have returned 1.44% through the first five months according to data tracker HFR versus the 8.7% return for the S&P 500. That's on the heels of a tough year for quants in 2016. Ever heard of Long Term Capital Management that went defunct in the late 1990's? LTCM was a modeled approach to managing money that was founded by Nobel Laureates…unfortunately their holdings didn't behave like their quantitative models suggested and it took heroic effort by Alan Greenspan behind the scenes to keep LTCM's demise from causing global economic mayhem. The problem is you cannot model human behavior perfectly and values of securities stray from their intrinsic worth. That's where good old traditional fundamental research comes into play.

At RiverPoint, we employ a balanced process that is BOTH quantitative and qualitative in approach. We screen for specific fundamental criteria in stocks that our research shows leads to solid long term performance. This gives us an attractive universe from which to select. We then dig in the old fashion way by reading 10k's, talking to management and with analysts and vendors that know the company to determine what we think are the catalysts and risks in the stock and determine an upside price target and a downside risk target. If the fundamentals, valuation, and technical price trends look attractive as does this upside/ downside price target profile…we buy the security. As the saying goes, "moderation in all things". We find a blend of quantitative and qualitative analysis is the best path. If everyone is using the same algorithms ALONE to manage money, the alpha or value added is competed away. It's just not that simple.

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In fact, we find in our qualitative work that some of the highest scoring stocks we examine on a quantitative basis are the worst performers going forward for a time because they were priced for perfection at an extreme such that their financial glide path had to take a pause and just wasn't sustainable. That's where some traditional research can bear fruit. And, this is a great time for such work to add value as correlations amongst stocks are declining significantly as the adjacent chart demonstrates. As the Fed begins to normalize rates and it once again matters how clean your balance sheet is and exactly who can afford to innovate and invest in R&D and capital projects or execute M&A…well, that's a great environment for active managers.

Thanks for your confidence and ongoing support. All the Best from all of us at RiverPoint!

Thanks,
RiverPoint Capital Management

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