Portfolio Compass

January 7, 2015

Navigating the Markets

The *Portfolio Compass* provides a snapshot of LPL Financial Research's views on equity and alternative asset classes, the equity sectors, and fixed income. This biweekly publication illustrates our current views and will change as needed over a 3- to 12-month time horizon.

Reading the *Portfolio Compass*

Fundamental, technical, and valuation characteristics for each category are shown by colored squares.

Negative, neutral, or positive views are illustrated by a solid black bar positioned over the color scale, while an outlined black bar with an arrow indicates change and shows the previous view.

Rationales for our views are provided beneath each category.

Portfolio Compass is changing! Look for our updated brand and expanded content in upcoming editions.

All performance referenced herein is as of January 6, 2015, unless otherwise noted.

Compass Changes

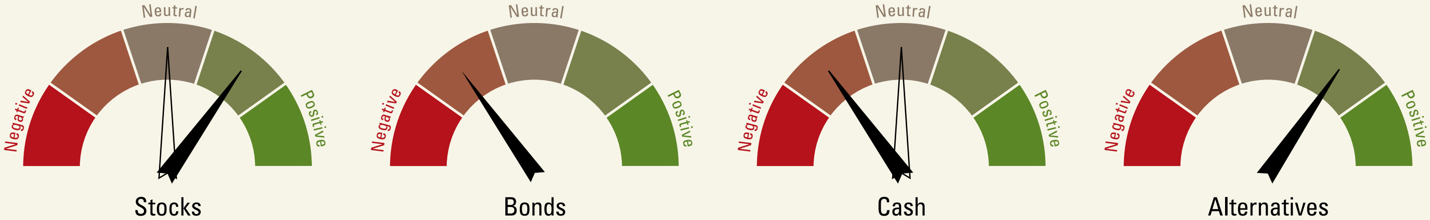
- Upgrading stocks to neutral/positive from neutral and downgrading cash.
- Upgrading large growth and value to neutral/positive and neutral, from neutral and neutral/negative.
- Downgrading small growth and value to neutral and neutral/negative, from neutral/positive and neutral.
- Upgrading healthcare to neutral/positive from neutral; downgrading financials to neutral/negative from neutral.

Investment Takeaways

- We forecast high-single-digit S&P 500 returns in 2015, supported by estimated 5–10% earnings growth.*
- We expect a leadership shift toward large caps in 2015 as the business cycle matures.
- We have upgraded our healthcare view on improved fundamentals and positive technicals.
- A technical rebound opportunity may be emerging in oil, but ongoing supply pressures and technical weakness keep us cautious.
- High-yield bonds have continued to struggle as the energy sector weakens. Widespread energy sector defaults are now widely priced in, in our view, and we find the sector attractive.
- From a technical perspective, if the S&P 500 holds its 100-day moving average, it may present a buy-the-dip opportunity for U.S. equities.

Broad Asset Class Views

LPL Financial Research's views on stocks, bonds, cash, and alternatives are illustrated below. The positions of negative, neutral, or positive are indicated by the solid black compass needle, while an outlined needle shows a previous view.



Equity & Alternative Asset Classes

Favor U.S. Stocks with Large and Mid Cap Focus; Waiting for Opportunities in EM and Oil

- We forecast high-single-digit S&P 500 returns for 2015, supported by estimated 5–10% earnings growth and stable PE ratio amid a favorable economic backdrop.*
- Small caps may continue to recapture some of last year's underperformance in the near term, but we expect a sustained leadership shift toward large in 2015 as the business cycle matures, as noted in our *Outlook 2015: In Transit.*
- We maintain a preference for growth over value, based on cyclical sector exposure and relative valuations.
- We favor U.S. over large foreign, primarily due to our cautious view of Europe in spite of European Central Bank (ECB) actions. Europe is on the verge of another recession and structural impediments to faster growth remain.
- Emerging markets (EM) are one of our best ideas for 2015, with a preference for Asia, but technicals are holding us back in the near term.
- The sharp sell-off in crude oil may provide an intriguing opportunity for a bounce, but we believe caution is warranted due to ongoing supply pressures and technical weakness.
- Our positive alternative investments view reflects our interest in alternative sources of bond-like returns with less interest rate sensitivity, such as merger arbitrage. We believe central bank policy divergence provides an opportunity for global macro.

		Fundamentals	Technicals	Valuations	Negative	Neutral	Positive
Style/Capitalization	Large Growth						
	Large Value						
	We see a shift in leadership to large caps in 2015 as the business cycle matures, but small caps may recover in the near term. Our cyclical sector preferences and valuations favor growth over value.						
	Mid Growth						
	Mid Value						
	Positive mid growth view reflects cyclical sector exposure, earnings growth, and potential up-capture. Mid should benefit from continued healthy acquisition activity.						
	Small Growth						
	Small Value						
	We expect small caps to pare some of this year's underperformance in the near term, though the aging of the business cycle leaves us less optimistic in 2015.						
Region	U.S. Stocks						
	Large Foreign						
	Small Foreign						
	Emerging Markets						
	We favor U.S. over large foreign, primarily due to Europe's sluggish growth and structural constraints. Improving fundamentals and low valuations make EM one of our best ideas for 2015, but we would like to see better technicals and stable oil prices to consider a more positive near-term view.						
REITs	REITs						
	Solid job growth helps, but interest rate risk and above-average valuations keep us neutral.						
Commodities	Industrial Metals						
	Precious Metals						
	Energy						
	Agricultural						
	After its sharp decline, oil is an intriguing opportunity on a potential technical bounce, but supply pressures suggest caution is warranted. Fed tightening, interest rate risk, and technicals keep us neutral on precious metals. Agriculture commodities broadly remain in a downtrend.						
Other	Non-Correlated Strategies						
	Favor long/short equity funds that may participate in rising and falling markets, and event-driven funds for capital structure and merger arbitrage opportunities. Unconstrained eclectic well suited for opportunistic allocations. Global macro may benefit from diverging monetary policies globally.						

* Historically since WWII, the average annual gain on stocks has been 7–9%. Thus, our forecast is in-line with average stock market growth. We forecast a 5–9% gain, including dividends, for U.S. stocks in 2015 as measured by the S&P 500. This gain is derived from earnings per share (EPS) for S&P 500 companies growing 5–10%. Earnings gains are supported by our expectation of improved global economic growth and stable profit margins in 2015.

Unconstrained eclectic strategies have a flexible investment style that does not limit the fund to a single asset class or security type.

Equity Sectors

Upgrading Healthcare but Continue to Favor Cyclical Growth Sectors in 2015

- We continue to favor cyclical growth sectors, which tend to do well during the middle to late stages of the business cycle.
- Fundamentals, valuations, and technicals all support our positive technology view.
- We expect industrials to benefit from improved U.S. business spending and see exposure to Europe and the oil and gas industry as manageable overall.
- We expect the good holiday season and cheap oil to help consumer discretionary near term, but we have tempered enthusiasm some as the business cycle matures.
- We remain focused on cyclical sectors; though solid earnings, innovation, Affordable Care Act (ACA)–related demand, and technicals drive our upgraded healthcare view.
- The stunning drop in oil amid a global supply glut is slowing the U.S. energy renaissance but won't stop it. We are watching the energy sector for potential contrarian opportunities and still favor master limited partnerships (MLP).
- The regulatory environment for financials remains tough and energy lending carries risk, suggesting patience while awaiting higher interest rates.
- Lower commodity costs help consumer staples companies' profit margins, but our preference for cyclicals keeps us cautious on the sector.
- We remain cautious on utilities due to high valuations following market-leading gains in 2014, and the sector's interest rate sensitivity.

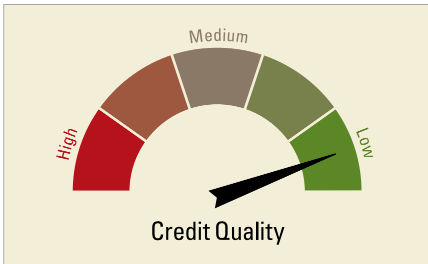
		Fundamentals	Technicals	Valuations	Negative / Neutral / Positive	S&P 500 Weight (%)
Cyclical	Materials					3.2
	Chinese stimulus helps, but we would like to see better growth in China to get more positive.					
	Energy					8.3
	Intriguing potential contrarian opportunity, but supply pressures and technicals suggest caution.					
	Industrials					10.3
	We expect a pickup in business spending; solid earnings season despite headwinds; favor transports.					
	Consumer Discretionary					12.0
	Cheaper oil helps and holiday season should be solid; consumer remains in good shape.					
	Technology					19.6
	Earnings, improving business spending, valuations, and technicals all supportive; more positive bias.					
	Financials					16.5
	Likely steeper yield curve is positive, but interest rate and regulatory climate still challenging.					
Defensive	Utilities					3.3
	Our negative view reflects interest rate risk, rich valuations, and our preference for cyclicals.					
	Healthcare					14.5
	Favorite defensive sector on solid earnings, robust innovation, and ACA-demand lift; positive bias.					
	Consumer Staples					10.0
	Still favor cyclical sectors and Europe's slowdown is a risk, but low commodity prices help margins.					
	Telecommunications					2.3
	Interest rate and business risks remain; valuations are below the S&P 500 and long-term averages.					

Because of their narrow focus, sector investing will be subject to greater volatility than investing more broadly across many sectors and companies.

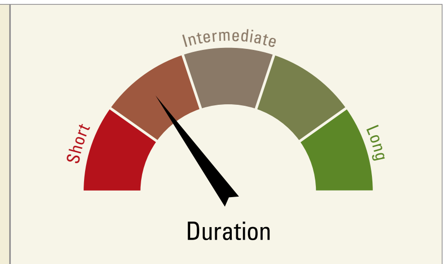
Fixed Income

Similar Themes to Start 2015

- The decline in oil prices has kept growth fears alive, along with rising default risks.
- Although high-quality bond strength continues early in 2015, we find it imprudent to chase recent strength. Still lower yields and now higher valuations suggest low future returns for high-quality bonds.
- Municipal valuations relative to Treasuries cheapened over Q4 2014, but municipal bonds now enter a seasonally favorable time of year. January has historically been one of the better months for tax-exempt bonds due to above-average reinvestment needs from maturing bonds.



Credit yield spreads fair; prefer corporate bonds to government bonds.



Yields near lows of 2014 argue for more defensive stance.

		Fundamentals	Technicals	Valuations	Negative / Neutral / Positive
Tax-Free Bonds	Munis–Short-Term				
	Relative valuations improving due to strength in intermediate and long, but yields are still very low.				
	Munis–Intermediate-Term				
	Valuations are more attractive after supply-induced lag relative to Treasuries.				
	Munis–Long-Term				
	VValuations are more attractive but partically offset by low absolute yields.				
	Munis–High-Yield				
	Default risk is low, but long-term bond strength may linger near-term and provide support.				

Continued on next page.

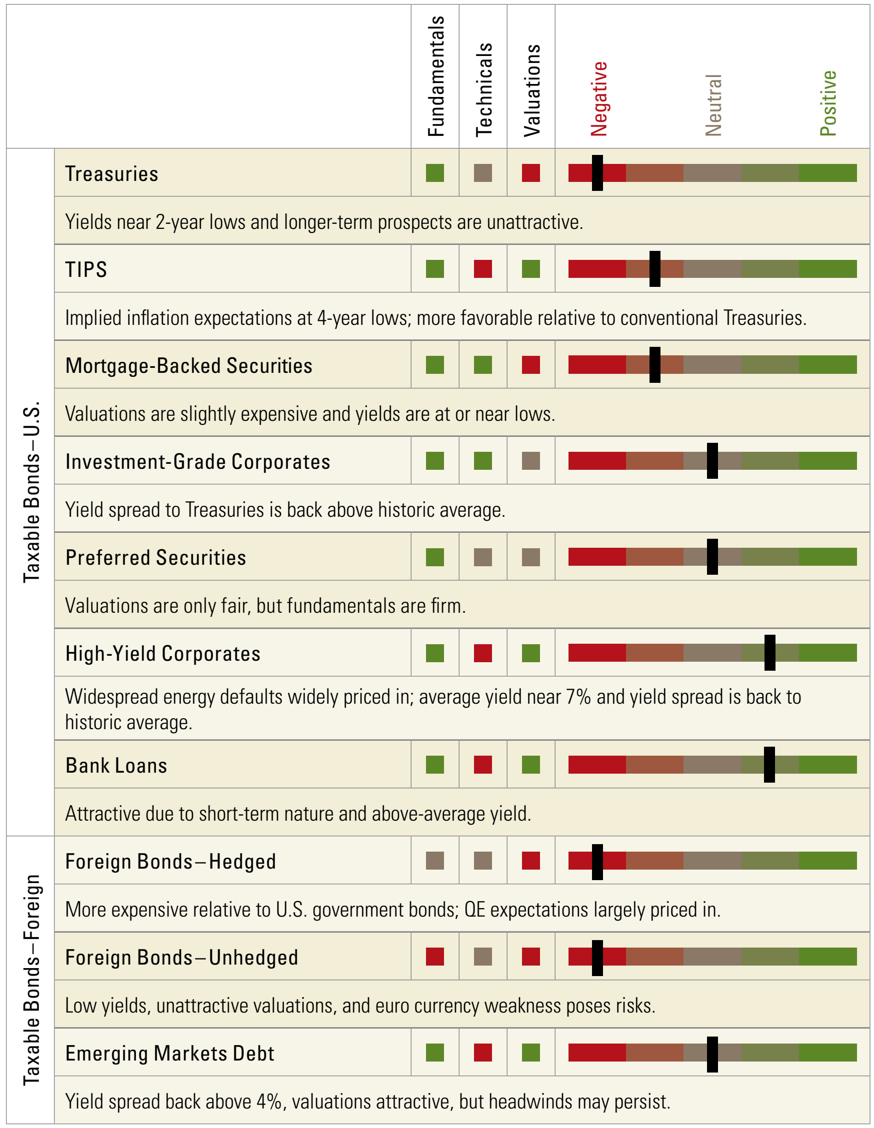
For the purposes of this publication, intermediate-term bonds have maturities between 3 and 10 years, and short-term bonds are those with maturities of less than 3 years.

All bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise and are subject to availably and change in price. High-yield/junk bonds are not investment-grade securities, involve substantial risks, and generally should be part of the diversified portfolio of sophisticated investors. Municipal interest income may be subject to the alternative minimum tax. Federally tax-free but other state and local taxes may apply. Corporate bonds are considered higher risk than government bonds but normally offer a higher yield and are subject to market, interest rate, and credit risk, as well as additional risks based on the quality of issuer coupon rate, price, yield, maturity, and redemption features.

Fixed Income (CONT.)

Similar Themes to Start 2015

- For fixed income allocations, we emphasize a blend of high-quality intermediate bonds coupled with less interest rate–sensitive sectors such as high-yield bonds and bank loans.
- High-yield bonds remain volatile after Q4 2014 weakness, as the energy sector declined. Widespread defaults in the energy sector are now widely priced in, however. We find the sector attractive and believe weakness is overdone. Longer term, strong earnings, low defaults, and more attractive valuations should help support the sector.
- Although high-quality bond strength continues early in 2015, we find it imprudent to chase recent strength. Still lower yields and now higher valuations suggest low future returns for high-quality bonds.
- EM debt has been hit by lower oil prices and oil-dependent EM nations may see revenue crimped. Valuations are attractive, however, with the average yield spread over 4%.



High-yield spread is the yield differential between the average yield of high-yield bonds and the average yield of comparable maturity Treasury bonds.

All bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise and are subject to availably and change in price. High-yield/junk bonds are not investment-grade securities, involve substantial risks, and generally should be part of the diversified portfolio of sophisticated investors. Mortgage-backed securities are subject to credit, default risk, prepayment risk that acts much like call risk when you get your principal back sooner than the stated maturity, extension risk, the opposite of prepayment risk, and interest rate risk. International and emerging market investing involves risks such as currency fluctuation and political instability and may not be suitable for all investors.
Bank loans are loans issued by below investment-grade companies for short-term funding purposes with higher yield than short-term debt and involve risk. Treasury Inflation-Protected Securities (TIPS) help eliminate inflation risk to your portfolio as the principal is adjusted semiannually for inflation based on the Consumer Price Index—while providing a real rate of return guaranteed by the U.S. government. Corporate bonds are considered higher risk than government bonds but normally offer a higher yield and are subject to market, interest rate, and credit risk, as well as additional risks based on the quality of issuer coupon rate, price, yield, maturity, and redemption features. Foreign Bonds – Hedged: Non-U.S. fixed income securities generally from investment-grade issuers in developed countries, with hedged currency exposure. Foreign Bonds – Unhedged: Non-U.S. fixed income securities normally denominated in major foreign currencies.

DEFINITIONS:

EQUITY AND ALTERNATIVES ASSET CLASSES

Large Growth: Stocks in the top 70% of the capitalization of the U.S. equity market are defined as large cap. Growth is defined based on fast growth (high growth rates for earnings, sales, book value, and cash flow) and high valuations (high price ratios and low dividend yields).

Large Value: Stocks in the top 70% of the capitalization of the U.S. equity market are defined as large cap. Value is defined based on low valuations (low price ratios and high dividend yields) and slow growth (low growth rates for earnings, sales, book value, and cash flow).

Mid Growth: The U.S. mid cap range for market capitalization typically falls between $1 billion and $8 billion and represents 20% of the total capitalization of the U.S. equity market. Growth is defined based on fast growth (high growth rates for earnings, sales, book value, and cash flow) and high valuations (high price ratios and low dividend yields).

Mid Value: The U.S. mid cap range for market capitalization typically falls between $1 billion and $8 billion and represents 20% of the total capitalization of the U.S. equity market. Value is defined based on low valuations (low price ratios and high dividend yields) and slow growth (low growth rates for earnings, sales, book value, and cash flow).

Small Growth: Stocks in the bottom 10% of the capitalization of the U.S. equity market are defined as small cap. Growth is defined based on fast growth (high growth rates for earnings, sales, book value, and cash flow) and high valuations (high price ratios and low dividend yields).

Small Value: Stocks in the bottom 10% of the capitalization of the U.S. equity market are defined as small cap. Value is defined based on low valuations (low price ratios and high dividend yields) and slow growth (low growth rates for earnings, sales, book value, and cash flow).

U.S. Stocks: Stock of companies domiciled in the U.S.

Large Foreign: Large cap foreign stocks have market capitalizations greater than $5 billion. The majority of the holdings in the large foreign category are in the MSCI EAFE Index.

Small Foreign: Small cap foreign stocks typically have market capitalizations of $250 million to $1 billion. The majority of the holdings in the small foreign category are in the MSCI Small Cap EAFE Index.

Emerging Markets: Stocks of a single developing country or a grouping of developing countries. For the most part, these countries are in Eastern Europe, Africa, the Middle East, Latin America, the Far East, and Asia.

REITs: REITs are companies that develop and manage real estate properties. There are several different types of REITs, including apartment, factory-outlet, health care, hotel, industrial, mortgage, office, and shopping center REITs. This would also include real estate operating companies.

Commodities – Industrial Metals: Stocks in companies that mine base metals such as copper, aluminum, and iron ore. Also included are the actual metals themselves. Industrial metals companies are typically based in North America, Australia, or South Africa.

Commodities – Precious Metals: Stocks of companies that do gold- silver-, platinum-, and base-metal mining. Precious metals companies are typically based in North America, Australia, or South Africa.

Commodities – Energy: Stocks of companies that focus on integrated energy, oil and gas services, oil and gas exploration and equipment. Public energy companies are typically based in North America, Europe, the United Kingdom, and Latin America.

Merger Arbitrage: A hedge fund strategy in which the stocks of two merging companies are simultaneously bought and sold to create a riskless profit. A merger arbitrageur looks at the risk that the merger deal will not close on time, or at all. Because of this slight uncertainty, the target company's stock will typically sell at a discount to the price that the combined company will have when the merger is closed. This discrepancy is the arbitrageur's profit.

Long/Short: An investment strategy generally associated with hedge funds. It involves buying long equities that are expected to increase in value and selling short equities that are expected to decrease in value.

EQUITY SECTORS

Materials: Companies that engage in a wide range of commodity-related manufacturing. Included in this sector are companies that manufacture chemicals, construction materials, glass, paper, forest products and related packaging products, metals, minerals and mining companies, including producers of steel.

Energy: Companies whose businesses are dominated by either of the following activities: The construction or provision of oil rigs, drilling equipment, and other energy-related service and equipment, including seismic data collection or the exploration, production, marketing, refining, and/or transportation of oil and gas products, coal, and consumable fuels.

Industrials: Companies whose businesses: Manufacture and distribute capital goods, including aerospace and defense, construction, engineering and building products, electrical equipment, and industrial machinery; provide commercial services and supplies, including printing, employment, environmental, and office services; provide transportation services, including airlines, couriers, marine, road and rail, and transportation infrastructure.

Consumer Discretionary: Companies that tend to be the most sensitive to economic cycles. Its manufacturing segment includes automotive, household durable goods, textiles and apparel, and leisure equipment. The service segment includes hotels, restaurants and other leisure facilities, media production and services, consumer retailing and services, and education services.

Technology: Companies that primarily develop software in various fields such as the internet, applications, systems, and/or database management and companies that provide information technology consulting and services. Technology hardware and equipment include manufacturers and distributors of communications equipment, computers and peripherals, electronic equipment and related instruments, and semiconductor equipment and products.

Financials: Companies involved in activities such as banking, consumer finance, investment banking and brokerage, asset management, insurance and investment, and real estate, including REITs.

Utilities: Companies considered electric, gas or water utilities, or companies that operate as independent producers and/or distributors of power.

Healthcare: Companies in two main industry groups: Healthcare equipment and supplies or companies that provide healthcare–related services, including distributors of healthcare products, providers of basic healthcare services, and owners and operators of healthcare facilities and organizations or companies primarily involved in the research, development, production, and marketing of pharmaceuticals and biotechnology products.

Consumer Staples: Companies whose businesses are less sensitive to economic cycles. It includes manufacturers and distributors of food, beverages and tobacco, and producers of non-durable household goods and personal products. It also includes food and drug retailing companies.

Telecommunications: Companies that provide communications services primarily through a fixed line, cellular, wireless, high bandwidth, and/or fiber-optic cable network.

FIXED INCOME

Credit Quality: One of the principal criteria for judging the investment quality of a bond or bond mutual fund. As the term implies, credit quality informs investors of a bond or bond portfolio's credit worthiness, or risk of default.

Duration: A measure of the sensitivity of the price (the value of principal) of a fixed-income investment to a change in interest rates. Duration is expressed as a number of years. Rising interest rates mean falling bond prices, while declining interest rates mean rising bond prices. The bigger the duration number, the greater the interest rate risk or reward for bond prices.

Munis – Short-Term: Bonds issued by various state and local governments to fund public projects. The income from these bonds is generally free from federal taxes. These bonds generally have maturities of less than three years.

Munis – Intermediate: Bonds issued by various state and local governments to fund public projects. The income from these bonds is generally free from federal taxes. These bonds generally have maturities of between 3 and 10 years.

Munis – Long-Term: Bonds issued by various state and local governments to fund public projects. The income from these bonds is generally free from federal taxes. These bonds generally have maturities of more than 10 years.

Munis – High-Yield: Bonds issued by various state and local governments to fund public projects. The income from these bonds is generally free from federal taxes. These bonds generally offer higher yields than other types of bonds, but they are also more vulnerable to economic and credit risk. These bonds are rated BB+ and below.

Treasuries: A marketable, fixed-interest U.S. government debt security. Treasury bonds make interest payments semiannually and the income that holders receive is only taxed at the federal level.

TIPS (Treasury Inflation-Protected Securities): A special type of Treasury note or bond that offers protection from inflation. Like other Treasuries, an inflation-indexed security pays interest every six months and pays the principal when the security matures. The difference is that the underlying principal is automatically adjusted for inflation as measured by the consumer price index (CPI).

Mortgage-Backed Securities: A type of asset-backed security that is secured by a mortgage or collection of mortgages. These securities must also be grouped in one of the top two ratings as determined by a accredited credit rating agency, and usually pay periodic payments that are similar to coupon payments. Furthermore, the mortgage must have originated from a regulated and authorized financial institution.

Investment-Grade Corporates: Securities issued by corporations with a credit rating of BBB or higher. Bond rating firms, such as Standard & Poor's, use different designations consisting of upper- and lower-case letters A and B to identify a bond's investment-grade credit quality rating. AAA and AA (high credit quality) and A and BBB (medium credit quality) are considered investment-grade.

Preferred Stocks: A class of ownership in a corporation that has a higher claim on the assets and earnings than common stock. Preferred stock generally has a dividend that must be paid out before dividends to common stockholders and the shares usually do not have voting rights.

High-Yield Corporates: Securities issued by corporations with a credit rating of BB+ and below. These bonds generally offer higher yields than investment-grade bonds, but they are also more vulnerable to economic and credit risk.

Bank Loans: In exchange for their credit risk, these floating-rate bank loans offer interest payments that typically float above a common short-term benchmark such as the London Inter-Bank Offered Rate, or LIBOR.

Foreign Bonds – Hedged: Non-U.S. fixed income securities generally from investment-grade issuers in developed countries, with hedged currency exposure.

Foreign Bonds – Unhedged: Non-U.S. fixed income securities normally denominated in major foreign currencies.

Emerging Markets Debt: The debt of sovereigns, agencies, local issues, and corporations of emerging markets countries and subject to currency risk.

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide or be construed as providing specific investment advice or recommendations for any individual. To determine which investments may be appropriate for you, consult your financial advisor prior to investing. All performance referenced is historical and is no guarantee of future results. All indexes are unmanaged and cannot be invested into directly.

Past performance is no guarantee of future results.

Stock investing involves risk including loss of principal.

Preferred stock investing involves risk, which may include loss of principal.

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

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