

# Portfolio Compass



April 16, 2014

## Navigating the Markets

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

All performance referenced herein is as of April 15, 2014, unless otherwise noted.

\* As noted in our *Outlook 2014: The Investor's Almanac* publication.

### Compass Changes

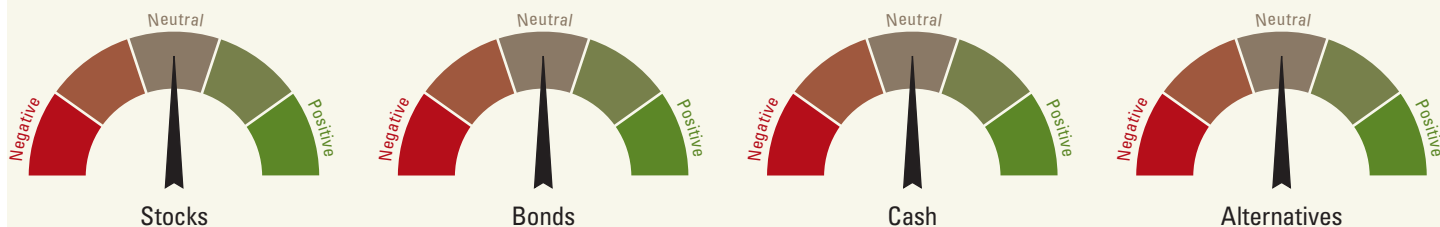
- No changes

### Investment Takeaways

- Our 2014 stock market forecast calls for gains of 10–15%, derived from earnings per share (EPS) for S&P 500 companies growing 5–10% and a modest rise in the price-to-earnings ratio (PE).\*
- We favor small caps and cyclical sectors, and U.S. over international, as we expect U.S. economic growth to improve over the course of 2014.
- We see the current pace of bond market gains as unsustainable. A clearer picture of any economic bounce back from adverse weather may not be available until May, which may leave bonds range bound.
- Municipal bonds have benefited from very low supply, but we expect performance to slow after a good start to 2014.
- High-yield bond valuations suggest caution, but we still find higher-yielding, fundamentally sound segments of the bond market such as high-yield bonds, bank loans, and preferred securities attractive.
- Technicals are the primary driver of our recently upgraded agricultural commodities view.
- From a technical perspective, the S&P 500 Index is testing support at 1828. A price close back above 1850 would establish a potential buy-the-dip opportunity.

### 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 Small Caps as Bull Market to Continue in 2014\*

- Our 2014 stock market forecast remains for gains of 10–15% despite recent stock market declines, based on our forecast for 5–10% earnings growth and modest PE multiple expansion as economic growth and the market’s confidence in that growth improve.\*
- We favor small caps for their potential to capture stock market gains this year amid potential improving economic growth in 2014 and an expected gradual increase in stock market valuations.
- We maintain a preference for growth over value and cyclical sectors over defensives.
- We favor U.S. stocks relative to emerging markets (EM) and developed foreign. Technical indicators have turned positive on EM, which bears watching. However, funding current account deficits has become more challenging for several key EM countries as the Federal Reserve (Fed) and other central banks rein in liquidity.
- Prospects for improved overseas growth in 2014 do suggest a potentially more positive international equity view at some point during the year. Europe has emerged from recession but is growing only modestly, and structural impediments to faster growth remain.
- Technical strength was the primary driver of our recently upgraded agricultural commodities view. Fundamental concerns and recent technical deterioration keep us neutral on precious and industrial metals.

Absolute Return has a goal of providing positive returns in all market conditions. It tends to have low volatility, and have a very low correlation to bonds and stocks.

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

		Fundamentals	Technicals	Valuations	Negative	Neutral	Positive
Style/Capitalization	Large Growth	■	■	■			
	Large Value	■	■	■			
	We have become more positive on small caps at the expense of large in recent months. We maintain a preference for growth over value, but we expect 2014 to be more about cyclical versus defensive.						
	Mid Growth	■	■	■			
	Mid Value	■	■	■			
	Our positive mid growth view reflects consumer-focused cyclical equity sector exposure and the potential for more up-capture. Mid should continue to benefit from additional acquisition activity.						
	Small Growth	■	■	■			
	Small Value	■	■	■			
We favor small caps for potential to capture stock market gains, as we expect economic growth and stock valuations to improve in 2014, though small cap valuations and broad market volatility are risks.							
Region	U.S. Stocks	■	■	■			
	Large Foreign	■	■	■			
	Small Foreign	■	■	■			
	Emerging Markets	■	■	■			
We favor the U.S. over large foreign and EM, as Europe's growth remains meager, while growth in several key EM economies has been uneven, and funding current account deficits has become more difficult. But prospects for better overseas growth suggest a more positive view at some point this year.							
REITs	REITs	■	■	■			
	Strong YTD performance is unlikely to be sustained as interest rate declines subside.						
Commodities	Industrial Metals	■	■	■			
	Precious Metals	■	■	■			
	Energy	■	■	■			
	Agricultural	■	■	■			
Technical strength drove our recent agriculture upgrade. Crude oil (WTI) is testing the high end of its range near \$104 and may be poised to reverse lower. Precious metal risk factors include Fed tapering, low inflation, potential higher interest rates, and a strong US dollar.							
Other	Non-Correlated Strategies						
	We favor long/short equity vehicles as the market rewards fundamentals. Absolute return strategies have protected well this year. Unconstrained eclectic strategies, which enable managers to implement differentiated investment styles, are well suited for opportunistic allocations.						

Real estate/REITs may result in potential illiquidity and there is no assurance the objectives of the program will be attained. The fast price swings of commodities will result in significant volatility in an investor's holdings. International and emerging markets involve special risks such as currency fluctuation and political instability. The price of small and mid-cap stocks are generally more volatile than large cap stocks. Value investments can perform differently from the market as a whole. They can remain undervalued by the market for long periods of time. Precious metal investing is subject to substantial fluctuation and potential for loss. These securities may not be suitable for all investors. Alternative strategies may not be suitable for all investors and should be considered as an investment for the risk capital portion of the investor's portfolio. The strategies employed in the management of alternative investments may accelerate the velocity of potential losses. Stock investing may involve risk including loss of principal.

## Equity Sectors

### Favor Cyclical Sectors in 2014 for Improving U.S. Economy

- We continue to favor the cyclical sectors for their potential to capture further stock market gains as economic growth improves.
- Our consumer discretionary view remains positive as spending continues to increase, albeit modestly. March retail sales gains are encouraging.
- We expect improved U.S. business spending and global growth in 2014 to help industrials, including transports within the sector.
- Our positive business spending outlook and attractive valuations result in our positive technology sector bias.
- Uneven growth in EM and valuations remain concerns for materials, but technicals are strong and drove our recent shift to neutral.
- Our financials view is neutral. We see the U.S. focus, valuations, and the potential for a steeper yield curve as positives, although regulation and mortgage risk remain concerns. Our regional bank view is positive.
- Our neutral health care view reflects our focus on cyclical sectors balanced against robust product innovation trends and a likely uptick in demand from the Affordable Care Act (ACA).
- We remain cautious on telecom and utilities due to their interest rate sensitivity, though telecom valuations have become attractive.
- We do not expect the year-to-date utilities strength—largely driven by falling interest rates—to be sustained.
- Our modestly negative consumer staples view reflects our preference for cyclical sectors in 2014.

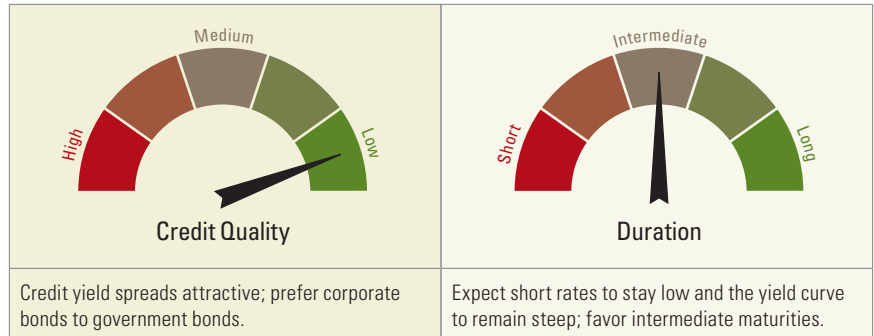
	Fundamentals	Technicals	Valuations	Negative	Neutral	Positive	S&P 500 Weight (%)	
Cyclical	Materials	■	■	■				3.5
	Uneven growth in EM and high valuations remain concerns, but technicals are strong.							
	Energy	■	■	■				10.4
	A sector to watch on earnings/natural gas rebound as oil tests the high end of its latest range.							
	Industrials	■	■	■				10.7
	We expect a business spending pickup in 2014; housing, the U.S. energy boom, and better global growth help.							
	Consumer Discretionary	■	■	■				11.9
	Solid earnings, the wealth effect (stocks, homes), and job gains are positives; watching valuations.							
	Technology	■	■	■				18.6
	Positive bias on attractive valuations, favorable technicals, and positive business spending outlook.							
Defensive	Financials	■	■	■				16.2
	Valuation and a likely steeper yield curve offset regulatory risks; positive start to earnings season.							
	Utilities	■	■	■				3.2
	Negative view reflects slow growth, interest rate risk, and our preference for cyclical sectors.							
	Health Care	■	■	■				13.1
	Favorite defensive sector; favorable product trends and ACA demand lift; favor biotech on weakness.							
Consumer Staples	■	■	■				9.9	
We favor cyclical sectors. While valuations are lower, input prices have become a wildcard.								
Telecommunications	■	■	■				2.5	
Interest rate and business risks remain, but valuations have fallen well below 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

### Strength Carries Into Q2 but May Be Unsustainable

- After a soft finish to March, bond strength resumed in early April due to a more dovish Fed, still-simmering Ukraine-Russia tensions, and equity volatility. Bonds enjoyed broad-based gains over the first quarter of 2014, but the current pace is unsustainable, and we expect performance to slow.
- We expect economic data to take on renewed focus, but a clearer picture of any bounce back from adverse weather may not become available until May, which may leave bonds range bound.
- We believe intermediate-maturity bonds provide a better risk/return trade-off compared with short-term bonds.
- Municipal bonds have benefited from very low supply, but we expect performance to slow after a good start to 2014. However, the sector remains attractive over the longer term.



		Fundamentals	Technicals	Valuations	Negative	Neutral	Positive	
Tax-Free Bonds	Munis-Short-Term	■	■	■	[Gauge: Needle in Negative zone]			
	Credit yield spreads are attractive; prefer corporate bonds to government bonds.							
	Munis-Intermediate-Term	■	■	■	[Gauge: Needle in Neutral zone]			
	Our preferred maturity exposure, but valuations are now higher.							
	Munis-Long-Term	■	■	■	[Gauge: Needle in Neutral zone]			
	Limited supply is a positive, but interest rate risk and soft demand are risks.							
Munis-High-Yield	■	■	■	[Gauge: Needle in Negative zone]				
Defaults are low but susceptible to interest rate risk.								

continued on next page

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

### Strength Carries Into Q2 but May Be Unsustainable

- EM debt benefited from a drop in long-term yields and a more benign Fed, but valuations are becoming expensive, and performance may slow.
- High-yield bond spreads continue to hover near 4%, a post-recession low. Higher valuations suggest caution, but we still find higher-yielding, fundamentally sound segments of the bond market such as high-yield bonds, bank loans, and preferred securities remain among the more attractive fixed income options.
- Among high-quality bonds, we favor investment-grade corporate bonds due to the potential for higher yields and good fundamentals.

	Fundamentals	Technicals	Valuations	Negative	Neutral	Positive	
Taxable Bonds – U.S.	Treasuries	■	■	■	■	■	
	Yields are near the low end of the trading range, and additional gains are likely limited.						
	TIPS	■	■	■	■	■	
	Low actual inflation and above-average interest rate risk are negatives.						
	Mortgage-Backed Securities	■	■	■	■	■	
	Valuations are fair-to-expensive but benefit from continued Fed purchases.						
	Investment-Grade Corporates	■	■	■	■	■	
	Yield spread to Treasuries is below average, but credit quality is stable.						
	Preferred Securities	■	■	■	■	■	
	Good income generator. Bank credit quality is still improving.						
High-Yield Corporates	■	■	■	■	■		
Valuations are slightly expensive, but credit quality metrics are good, and defaults are low.							
Bank Loans	■	■	■	■	■		
Attractive due to short-term nature and attractive yield.							
Taxable Bonds – Foreign	Foreign Bonds – Hedged	■	■	■	■	■	
	Yields are low compared with domestic bonds.						
	Foreign Bonds – Unhedged	■	■	■	■	■	
	Low yields, unattractive valuations, and lingering euro risks.						
Emerging Market Debt	■	■	■	■	■		
Valuations are becoming expensive, and interest rate risk is growing.							

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 availability 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 \$250M to \$1B. 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 & gas services, oil & gas exploration and equipment. Public energy companies are typically based in North America, Europe, the UK, and Latin America.

**Merger Arbitrage** is 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** is 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 & 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.

**Health Care:** 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:** An individual bond's credit rating is determined by private independent rating agencies such as Standard & Poor's, Moody's and Fitch. Their credit quality designations range from high ('AAA' to 'AA') to medium ('A' to 'BBB') to low ('BB', 'B', 'CCC', 'CC' to 'C').

**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 semi-annually 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 interbank 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 Market Debt:** The debt of sovereigns, agencies, local issues, and corporations of emerging markets countries and subject to currency risk.

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## 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.

This research material has been prepared by LPL Financial.

To the extent you are receiving investment advice from a separately registered independent investment advisor, please note that LPL Financial is not an affiliate of and makes no representation with respect to such entity.

Not FDIC or NCUA/NCUSIF Insured   No Bank or Credit Union Guarantee   May Lose Value   Not Guaranteed by any Government Agency   Not a Bank/Credit Union Deposit
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