

# Portfolio Compass



August 7, 2013

## 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.

### Compass Changes

- No changes

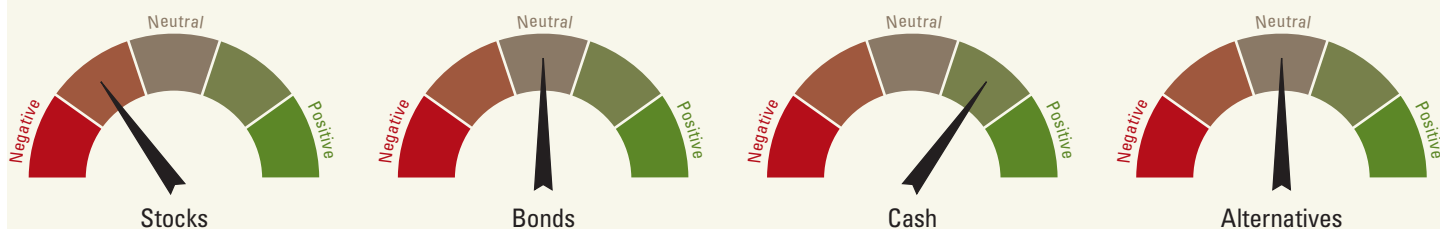
### Investment Takeaways

- We expect the S&P 500 Index to grind higher in the second half of the year with increased volatility.\*
- Bond markets have stabilized to start the third quarter on dovish comments from Federal Reserve (Fed) Chairman Ben Bernanke, mixed economic data, and bond markets largely pricing in an earlier start to a possible reduction in Fed bond purchases.
- 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.
- Supply issues have continued to weigh on municipal bonds but lessen in August, and valuations have reached attractive levels.
- We favor U.S. stocks relative to emerging markets (EM) and developed foreign, as Europe remains mired in recession and EM growth has slowed.
- Our sector views reflect our focus on the U.S. consumer and shift away from export-focused natural resources and the most interest-rate sensitive sectors.
- From a technical perspective, the S&P 500 has broken out of its 1700 resistance level, which establishes a bullish price objective at 1715.

\* As noted in our *Mid-Year Outlook 2013: Investors' Trail Map to the Markets* publication.

### 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

### Focus on the U.S. as Europe Remains in Recession and Emerging Markets Growth Slows

- We expect the S&P 500 to grind higher in the second half of the year with increased volatility, supported by mid-single-digit earnings growth, buybacks, and wide profit margins, as noted in our *Mid-Year Outlook 2013* publication.
- We favor U.S. stocks relative to EM and developed foreign, as Europe remains mired in recession, and the growth trajectory in China and several other key EM countries has deteriorated.
- In terms of market cap, large caps offer lower valuations and the potential for higher yields, but small caps should benefit from greater U.S. focus and may provide an attractive buy-the-dip opportunity.
- Our views of growth and value are more balanced due to our improving outlook for financials, although growth's tendency to outperform in slow-growth environments and our positive view of consumer discretionary are positives for growth.
- We believe the oil commodity near \$105 (WTI crude oil near-term futures as of August 6, 2013) is due for a pullback into the \$90s amid elevated inventories and soft global demand.
- The gold commodity has struggled in recent months with prospects for reduced bond purchases by the Fed, low inflation, rising interest rates, and slowing growth in China.

		Fundamentals	Technicals	Valuations	Negative	Neutral	Positive	
Style/Capitalization	Large Growth	■	■	■				
	Large Value	■	■	■				
	Favor growth over value for faster earnings growth in slow-growth economy, but with less conviction as our sector mix has become more balanced. Our market cap views are balanced with a slight small bias.							
	Mid Growth	■	■	■				
	Mid Value	■	■	■				
	Greater U.S. focus, the potential for faster earnings growth than large caps, and a likely pickup in acquisition activity help, although above-average valuations and potentially higher stock market volatility are risks.							
	Small Growth	■	■	■				
	Small Value	■	■	■				
Risk of increased stock market volatility remains and valuations are on the high side, but with their U.S. focus, we believe small caps represent an attractive buy-the-dip opportunity.								
Region	U.S. Stocks	■	■	■				
	Large Foreign	■	■	■				
	Small Foreign	■	■	■				
	Emerging Markets	■	■	■				
We favor the United States over large foreign and EM, as Europe remains mired in recession and we believe the market's expectations for recovery remain overly optimistic. Slowing growth in China and a deteriorating growth trajectory in several other key EM economies, including Brazil, contribute to our cautious view of foreign equity markets.								
REITs	REITs	■	■	■				
	Job growth, housing, and yield offset by interest rate risk; valuations have become more reasonable.							
Commodities	Industrial Metals	■	■	■				
	Precious Metals	■	■	■				
	Energy	■	■	■				
	Agricultural	■	■	■				
We believe the oil commodity is due to pull back from current levels near \$105 back into the \$90s. Precious metals have struggled in recent months due to concerns about the Fed, rising interest rates, and slowing growth in key EM countries. Our agriculture commodities view remains neutral, although after recent declines and given seasonal considerations, opportunities may be emerging.								
Other	Non-Correlated Strategies							
	Favor distressed assets for volatile environment, long/short equity vehicles as market increasingly rewards fundamentals. Tempered view of merger-arb/event-driven strategies on corporate activity lull.							

All performance referenced herein is as of August 6, 2013, unless otherwise noted.

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

### Consumer Discretionary, Financials, and Health Care Well Positioned for Second Half

- As highlighted in our *Mid-Year Outlook 2013* publication, we favor the more U.S. and consumer-oriented sectors over the more global, export-focused sectors in the second half as emerging markets growth slows.
- Our recently upgraded consumer discretionary view reflects continued resilience in consumer spending and the benefits of the housing recovery.
- Our financials view has become incrementally more positive due to our focus on the United States, the steeper yield curve, and still-attractive valuations.
- Our recently upgraded health care view reflects our U.S. focus, gradually improving sector growth outlook, and robust product innovation.
- Our recently lowered view of materials and energy reflects China's deteriorating growth trajectory. We expect crude oil to pull back into the \$90s.
- We expect a potential pickup in business spending to help industrials sector performance, but slowing growth in China increases the risk profile.
- We remain cautious on the yield sectors (telecom and utilities) due to their interest rate sensitivity and rich valuations.
- High valuations, emerging markets exposure, and interest rate sensitivity temper our enthusiasm for consumer staples despite favorable seasonals.

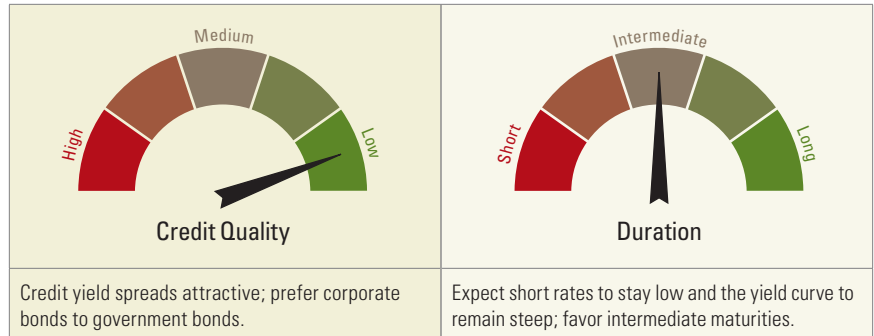
	Fundamentals	Technicals	Valuations	Negative	Neutral	Positive	S&P 500 Weight (%)	
Cyclical	Materials	■	■	■				3.3
	Slower growth and shift toward more consumer-led economy in China temper the growth outlook.							
	Energy	■	■	■				10.4
	We expect crude oil to pull back into the \$90s amid elevated inventories, soft global demand.							
	Industrials	■	■	■				10.3
	Business spending uptick, housing, and U.S. energy renaissance help, but China has become a risk.							
	Consumer Discretionary	■	■	■				12.3
	Wealth effect benefit (housing, stocks), improving labor market, domestic focus offset rich valuations.							
	Technology	■	■	■				17.8
	Watching earnings, macro data, technicals for potentially more positive view; valuations attractive.							
Defensive	Financials	■	■	■				16.8
	Earnings gains, U.S. focus, steeper yield curve, valuations offset regulatory risk, slow loan growth.							
	Utilities	■	■	■				3.3
	Weakness in Q2 Treasury market sell-off highlights interest rate risk; valuations still high.							
	Health Care	■	■	■				12.9
	U.S. focus, gradually improving growth outlook amid policy clarity, and innovation are supportive.							
Consumer Staples	■	■	■				10.4	
Valuations, EM exposure, and interest rate sensitivity are concerning; favorable seasonals.								
Telecommunications	■	■	■				2.5	
Valuations now fair, but interest rate sensitivity, competition, mature wireless market are concerns.								

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

## Fixed Income

### Signs of Stability Emerge

- Bond markets have stabilized to start the third quarter on dovish comments from Fed Chairman Ben Bernanke, mixed economic data, and bond markets largely pricing in an earlier start to a possible reduction in Fed bond purchases.
- We believe intermediate maturity bonds provide a better risk/return trade-off compared to short-term bonds.



		Fundamentals	Technicals	Valuations	Negative	Neutral	Positive	
Tax-Free Bonds	Munis–Short-Term	■	■	■	[Gauge: Needle at Negative]			
	Muni curve is steep, and short-term valuations unattractive.							
	Munis–Intermediate-Term	■	■	■	[Gauge: Needle at Neutral]			
	Supply pressures easing and valuations are attractive.							
	Munis–Long-Term	■	■	■	[Gauge: Needle at Positive]			
	Supply pressures easing and valuations are attractive							
	Munis–High-Yield	■	■	■	[Gauge: Needle at Positive]			
Defaults remain isolated despite Detroit.								

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.)

### Signs of Stability Emerge

- High-yield bonds have quickly recouped most of May-June underperformance but remain attractive over the balance of 2013.
- Higher-yielding, fundamentally sound segments of the bond market such as 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 combination of higher yields and good fundamentals.
- Supply issues have continued to weigh on municipal bonds but may lessen in August, and valuations have reached attractive levels.
- We find high-yield municipal bonds attractive, but high-quality municipal bonds possess more attractive valuations and compelling taxable-equivalent yields.

	Fundamentals	Technicals	Valuations	Negative	Neutral	Positive	
Taxable Bonds – U.S.	Treasuries	■	■	■	■	■	
	More signs of stability as Fed tapering better priced in.						
	TIPS	■	■	■	■	■	■
	Unappealing due to deceleration in inflation and greater interest rate sensitivity.						
	Mortgage-Backed Securities	■	■	■	■	■	■
	Valuations fair; shorter duration a positive.						
	Investment-Grade Corporates	■	■	■	■	■	■
	Yield spreads fair. Credit quality stable.						
	Preferred Securities	■	■	■	■	■	■
	Good income generator. Bank credit quality improving.						
	High-Yield Corporates	■	■	■	■	■	■
	Credit quality metrics good, valuations attractive, and defaults on pace to be low in 2013.						
Taxable Bonds – Foreign	Bank Loans	■	■	■	■	■	
	Attractive due to short-term nature and attractive yield.						
	Foreign Bonds – Hedged	■	■	■	■	■	■
	Yields low compared to domestic bonds and sovereign risks remain.						
	Foreign Bonds – Unhedged	■	■	■	■	■	■
Still low yields and euro currency risk a concern.							
Emerging Market Debt	■	■	■	■	■	■	
Growth concerns still a risk after recent improvement. Valuations fair.							

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.

Distressed investing involves significant risks, including a total loss of capital. The risks associated with distressed investing arise from several factors including: limited diversification, the use of leverage, limited liquidity, and the possibility that investors may be required to accept cash or securities with a value less than their original investment and/or may be required to accept payment over an extended period of time.

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