YOUR FINANCIAL FUTURE

Your Guide to Life Planning

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Bond Market Perspectives | Week of February 12, 2018

Key Takeaways

- Fixed income markets have faced headwinds along with equities recently, an unusual environment historically.
- Although rising rates may put pressure on high-quality fixed income, it may remain a critical part of well-balanced, diversified portfolios.
- Bonds can provide income, liquidity, and may help smooth out portfolio volatility during periods of equity market stress.

Why Own Bonds?

With rising rates making high-quality fixed income more attractive, many fixed income investors may be asking, why own bonds? Despite headwinds from rates, we believe bonds may still play play a vital role as a portfolio diversifier. As corporate earnings move higher and fiscal stimulus provides a further tailwind, the case for stock investing remains compelling, in our view. However, stock market pullbacks can occur without warning, and as mentioned in our *Outlook 2018: Return of the Business Cycle*, we expect more volatility in the coming year, as is typical with an economy in the latter half of the business cycle. Corrections of 10% or more have been infrequent in recent years but such calm is rare, as investors were recently (and unpleasantly) reminded. The average annual peak-to-trough decline in the S&P 500 Index has been 14% over the past 50 years, highlighting the need for investors to be prepared, and high-quality bonds may help provide diversification for portfolios during these types of market events.

REVISITING THE POTENTIAL BENEFITS OF OWNING BONDS

High-quality bonds provide income for investors, but they can also offer liquidity and help to smooth out portfolio volatility during periods of equity market weakness. A look back at prior stock market pullbacks illustrates how bonds have historically provided good diversification benefits. Figure 1 shows all equity market pullbacks of 10% or more over the last 10 years, with the corresponding returns for stocks and high-quality bonds. The figure also illustrates the hypothetical return of a balanced 60/40 (stock/bond) portfolio and the dampening impact bonds can have on stock weakness.

1 BONDS HAVE HISTORICALLY OUTPERFORMED STOCKS DURING STOCK MARKET PULLBACKS

Pullback Start–End	S&P 500 Index Change	Bloomberg Barclays Index Change	Difference	60/40 Portfolio* Return	60/40 Portfolio vs. All-Equity Portfolio (Difference)
1/26/18–2/8/18	-10.2%	-1.0%	9.2%	-6.5%	+3.7%
11/3/15–2/11/16	-13.3%	1.9%	15.2%	-7.2%	+6.1%
5/21/15–8/25/15	-12.4%	0.0%	12.4%	-7.4%	+5.0%
7/7/11–8/8/11	-17.3%	2.7%	20.0%	-9.3%	+8.0%
5/12/10–6/7/10	-10.3%	1.2%	11.5%	-5.7%	+4.6%
2/9/09–3/9/09	-22.2%	-0.1%	22.1%	-13.4%	+8.8%
1/6/09–1/20/09	-13.9%	0.4%	14.3%	-8.2%	+5.7%
11/13/08–11/20/08	-17.4%	0.4%	17.8%	-10.3%	+7.1%
11/4/08–11/12/08	-15.3%	0.8%	16.1%	-8.8%	+6.5%
10/20/08–10/27/08	-13.9%	-0.1%	13.8%	-8.4%	+5.5%
9/19/08–9/29/08	-11.9%	0.2%	12.1%	-7.0%	+4.9%
8/11/08–9/17/08	-11.4%	2.0%	13.4%	-6.0%	+5.4%
5/19/08–7/15/08	-14.8%	-0.4%	14.4%	-9.1%	+5.7%
Average	**-14.2%**	**0.6%**	**14.8%**	**-8.3%**	**+5.9%**

Source: LPL Research, Bloomberg 02/12/18

Past performance is no guarantee of future results.

*Blended Portfolio: 60% S&P 500 / 40% Bloomberg Barclay's Aggregate Bond Index. The 60/40 mix is considered to represent a balanced asset allocation.

Performance shown reflects hypothetical index returns and does not show the performance of an actual investment. Indexes are unmanaged and this model cannot be invested into directly.

In a few cases, such as our most recent example, both stocks and bonds declined together. This is a rare occurrence historically, but even so, bonds managed to outperform stocks by a wide margin on each occasion. In investing, like other segments of life, our most recent memory serves as our strongest, so the longer-term context is key. In 2008, high-quality bonds provided a buffer but not without volatility, as investment-grade corporate bonds declined for the year and even high-quality mortgage-backed securities suffered brief declines. While not all segments of the bond market perform similarly every time, an allocation to high-quality bonds can potentially be effective at offsetting stock market weakness and may help to limit overall portfolio drawdown.

NOT ABOUT YIELD

Today's low-yield environment does not negate the potential diversification benefit of bonds. In mid-2015 and early 2016, the S&P 500 pulled back more than 10%. The Bloomberg Barclays U.S. Aggregate Index was flat or positive on both those occasions, despite yields across the Treasury yield curve being meaningfully lower than where they stand today. In fact, during each stock market pullback in Figure 1, bond market performance was fairly consistent, averaging 0.6%, despite varied levels of interest rates.

Over short-term periods, price movement, not interest income, is the primary driver of bond performance. Interest income accrues slowly, and although it is the primary driver of long-term bond returns, price changes (up or down) often overwhelm the impact of interest income over short periods of time. Therefore, we believe a low-yield environment does not preclude bonds from acting as an effective diversification tool.

CONCLUSION

Low yields may translate into lower long-term bond returns, and rising interest rates could serve as a further headwind for today's bond investors. However, for investors with shorter horizons or those simply unwilling to endure the entirety of stock market swings, bonds may play a diversification role even in today's low-yield and rising interest rate environment. In conjunction with sectors that historically hold up better against rising rates, such as high-yield bonds and bank loans, an allocation to core bonds may still make sense for suitable investors to provide diversification to help mitigate portfolio risk during potential stock market weakness.

Please see our Outlook 2018: Return of the Business Cycle *publication for additional descriptions and disclosures.*

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

All market indices discussed are unmanaged and are not illustrative of any particular investment. Indices do not incur management fees, costs and expenses, and cannot be invested into directly. All performance referenced is historical and is no guarantee of future results.

There is no guarantee that a diversified portfolio will enhance overall returns or outperform a non-diversified portfolio. Diversification does not ensure against market risk.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values and yields will decline as interest rates rise, and bonds are subject to availability and change in price.

Government bonds and Treasury bills are guaranteed by the U.S. government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value. However, the value of fund shares is not guaranteed and will fluctuate.

Bank loan portfolios primarily invest in floating-rate bank loans instead of bonds. In exchange for their credit risk, these loans offer high interest payments that typically float above a common short-term benchmark such as the London interbank offered rate, or Libor.

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, 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, market, and interest rate risk.

Yield curve is a line that plots the interest rates, at a set point in time, of bonds having equal credit quality, but differing maturity dates. The most frequently reported yield curve compares the 3-month, 2-year, 5-year, and 30-year U.S. Treasury debt. This yield curve is used as a benchmark for other debt in the market, such as mortgage rates or bank lending rates. The curve is also used to predict changes in economic output and growth.

INDEX DESCRIPTIONS

The S&P 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.

The Bloomberg Barclays U.S. Aggregate Bond Index is a broad-based flagship benchmark that measures the investment-grade, U.S. dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS, and CMBS (agency and non-agency).

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Weekly Market Commentary | Week of February 12, 2018

KEY TAKEAWAYS

- A perfect storm of investor worries collided over the past six trading days, resulting in an unprecedented bout of market volatility.
- These experiences provide a good opportunity for investors to reassess current allocations relative to long-term targets.
- We maintain our year-end S&P 500 fair value estimate of 2850-2900, representing a move of approximately 10% from current levels.

CORRECTION PERSPECTIVES

After an extraordinary two-year period of market calm, the major U.S. equity markets slipped into correction territory last week. A perfect storm of investor worries collided over the past six trading days, including inflation, monetary policy, and the unwinding of crowded, complex trades. The result was an unprecedented bout of market volatility, highlighted by 1,000-point swings in the Dow Jones Industrial Average and the fastest retreat ever (nine days) from a record level in the S&P 500 Index to a correction.

In light of last week's market action, we think it is appropriate to provide investors with perspective on these developments by answering three basic questions:

1. What happened?
2. Where might stocks go from here?
3. What actions should investors take?

We hope the answers to these questions will provide investors with valuable perspective on the market correction, help them figure out a potential path forward, and facilitate informed long-term decisions relative to diversified portfolios.

WHAT HAPPENED?

Equity markets slipped into a correction (defined as a 10% or more drop from a recent high) for the first time since February 2016 as volatility soared, trading volumes surged, and stock prices plunged. The initial catalyst was higher than expected wage growth in the January jobs report, which increased fears that inflation would accelerate and that the Federal Reserve (Fed) would be more aggressive in 2018. Market interest rates then headed higher, the yield on the benchmark 10-year Treasury climbing approximately 25 basis points (0.25%) in the past two weeks. These developments caused the market's so-called fear gauge, the VIX Volatility Index, to more than double at the most stressful points last week, further accelerating selling pressures.

The potential for higher than expected interest rates had equity investors perplexed in many ways. Would higher rates slow down economic activity? Weigh on corporate profits? Pressure price-to-earnings (PE) ratios? Make bonds a more attractive alternative?

One important driver of the market sell-off was that investor sentiment had become too complacent these past two years and bullish sentiment prevailed as the major equity market indexes trudged higher to record price gains, along with the absence of volatility. This extended period of low volatility also led many institutional and individual investors down the path of crowded, complex trades, which used leverage, or borrowed money, to bet on a continuation of market peace. Once market interest rates and the VIX suddenly turned higher, these trades unwound, causing further selling pressure as traders needed to sell other holdings to raise cash to satisfy their debt obligations from their "short volatility" positions. Essentially, selling begot more selling and equity markets around the globe plunged.

WHERE MIGHT STOCKS GO FROM HERE?

What hasn't made as many headlines over the past week is that economic and profit data have been very strong, indicating that the market sell-off is detached from the fundamentals, making the correction normal and healthy. To be sure, recent readings on U.S. gross domestic product (GDP) and employment have been solid, and reports on manufacturing and services have been the highest in more than a dozen years. Consumer and small business confidence are at the highest levels of the expansion as a combination of tax cuts, government spending, and an improved lending environment appear poised to sustain growth in 2018 and 2019. In addition, fourth quarter 2017 earnings are coming in ahead of expectations, and companies are providing positive guidance, leading analysts to raise their forecasts for corporate profits in 2018.

Nevertheless, the markets have corrected. Though unnerving, corrections are a normal part of long-term investing. Indeed, since 1980, we have now experienced 37 corrections, with the S&P 500 falling by an average of 15.6% from peak to trough during the last 36 occurrences. Twelve months later, however, the index made up some ground, rising an average of 16.0% from the low, and after 24 months, the S&P 500 had climbed by an average of 28.0%, reinforcing the necessity for long-term investors not to stray from their diversified strategies during periods of market turmoil **[Figure 1]**.

1 S&P 500 MARKET CORRECTIONS

Market Corrections (1980–Present)						
High Date	S&P 500 High Price	Low Date	S&P 500 Low Price	Correction Return	S&P 500 1 Year After Lows	S&P 500 2 Years After Lows
02/13/80	118.44	03/27/80	98.22	-17.1%	33.0%	10.6%
08/11/81	133.85	09/25/81	112.77	-15.7%	9.4%	50.5%
11/30/81	126.35	03/08/82	107.34	-15.0%	43.2%	48.4%
05/07/82	119.47	08/12/82	102.42	-14.3%	57.7%	57.9%
10/10/83	172.65	07/24/84	147.82	-14.4%	30.3%	61.5%
10/05/87	328.08	10/19/87	224.84	-31.5%	22.9%	52.5%
10/21/87	258.38	10/26/87	227.67	-11.9%	24.0%	51.5%
11/02/87	255.75	12/04/87	223.92	-12.4%	21.4%	56.6%
01/02/90	359.69	01/30/90	322.98	-10.2%	3.7%	28.5%
07/16/90	368.95	08/23/90	307.06	-16.8%	27.3%	36.2%
10/07/97	983.12	10/27/97	876.99	-10.8%	21.5%	47.9%
07/17/98	1,186.75	08/31/98	957.28	-19.3%	37.9%	57.7%
03/24/00	1,527.46	04/14/00	1,356.56	-11.2%	-12.1%	-18.8%
09/01/00	1,520.77	10/12/00	1,329.78	-12.6%	-19.6%	-33.5%
11/06/00	1,432.19	12/20/00	1,264.74	-11.7%	-8.5%	-30.8%
01/30/01	1,373.73	03/22/01	1,117.58	-18.6%	2.7%	-22.7%
05/21/01	1,312.83	09/21/01	965.8	-26.4%	-13.7%	6.5%
03/19/02	1,170.29	05/07/02	1,049.49	-10.3%	-11.4%	6.1%
05/17/02	1,106.59	07/23/02	797.7	-27.9%	23.9%	36.2%
08/22/02	962.7	10/09/02	776.76	-19.3%	33.7%	44.8%
01/14/03	931.66	03/11/03	800.73	-14.1%	40.4%	51.0%
10/09/07	1,565.15	11/26/07	1,407.22	-10.1%	-39.5%	-21.4%
12/10/07	1,515.96	01/22/08	1,310.50	-13.6%	-35.9%	-14.8%
05/19/08	1,426.63	07/15/08	1,214.91	-14.8%	-23.2%	-9.7%
08/11/08	1,305.32	09/17/08	1,156.39	-11.4%	-7.9%	-2.7%
09/19/08	1,255.08	09/29/08	1,106.39	-11.8%	-4.1%	3.5%
09/30/08	1,166.36	10/10/08	899.22	-22.9%	19.7%	30.1%
10/20/08	985.4	10/27/08	848.92	-13.9%	25.3%	39.3%
11/04/08	1,005.75	11/12/08	852.3	-15.3%	27.6%	40.7%
11/13/08	911.29	11/20/08	752.44	-17.4%	45.0%	59.2%
01/06/09	934.7	01/20/09	805.22	-13.9%	41.3%	59.2%
02/09/09	869.89	03/09/09	676.53	-22.2%	68.6%	95.4%
05/12/10	1,171.67	06/07/10	1,050.47	-10.3%	22.4%	22.4%
07/07/11	1,353.22	08/08/11	1,119.46	-17.3%	25.2%	51.1%
05/21/15	2,130.82	08/25/15	1,867.61	-12.4%	16.5%	30.6%
11/03/15	2,109.79	02/11/16	1,829.08	-13.3%	26.6%	?
Average				-15.6%	16.0%	28.0%
Median				-14.2%	22.7%	36.2%
% Higher					72.2%	77.1%

Source: LPL Research, Ned Davis Research, 2/9/18

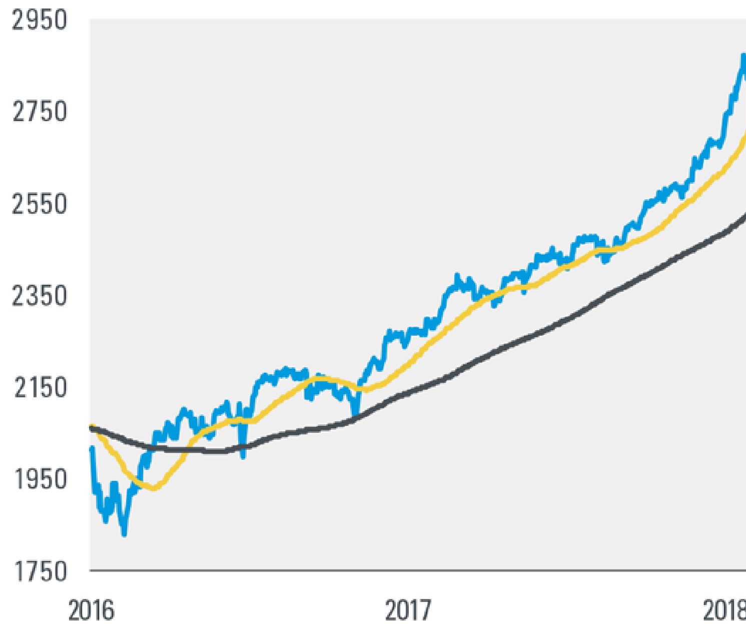
The S&P 500 is an unmanaged index which cannot be invested into directly. Unmanaged index returns do not reflect fees, expenses, or sales charges.

Index performance is not indicative of the performance of any investment. Past performance is no guarantee of future results.

Investors should be aware that market recoveries are often a relatively long process taking place over several weeks or months, without one clear identifiable catalyst. One unique characteristic of the current environment is that the equity markets had been so strong, that even though we've entered a correction, the S&P 500 still remains above its 200-day moving average (MA), an important technical support level that historically has helped determine the direction of stock prices during volatile periods [Figure 2]. Frequently, the index needs to fall below this level to "wash out" the weak hands before consolidating and then trending higher. Only one of these past 36 corrections concluded with the S&P 500 above its 200-day MA.

2 **THE S&P 500 REMAINS ABOVE THE 200-DAY MOVING AVERAGE**

- S&P 500
- 50-Day Moving Average
- 200-Day Moving Average



Source: LPL Research, FactSet 02/12/18

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We are preparing for the possibility over the next several days or weeks to see the index reach an average correction of about 15%, and possibly a bit more. However, considering the still solid economic backdrop, well below average levels for interest rates and inflation, strong trends for corporate profits, and the still positive technical analysis picture for the S&P 500, we suspect stocks may soon stabilize with little additional downside from current levels. Simply stated, if this correction were a baseball game, we believe we would be approaching the seventh inning stretch.

WHAT ACTIONS SHOULD INVESTORS TAKE?

Our first piece of advice for investors is don't panic. Unwinding the leveraged short volatility trade is messy, which has magnified the intensity of the recent sell-off. We also believe it masks the solid fundamental backdrop, which may cause suitable investors to sell (unnecessarily) into further market weakness. Instead, we encourage investors to view the recent market correction as an opportunity to reassess portfolios and look for spots to either deploy cash or rebalance to longer-term allocation targets.

Second, we were not particularly surprised by recent market volatility given: 1) last year's absence of volatility, 2) the market's propensity to test a new Fed chair, and 3) historical trading patterns during midterm election years. Yet, we also have emphasized in our *Outlook 2018: Return of the Business Cycle* publication that the transition from monetary policy leadership to fiscal policy leadership may provide opportunities. We believe the combination of improving business fundamentals and the benefits of fiscal reform, federal spending, and reduced regulation will continue to support growth in the economy and corporate profits for at least the next year.

Third, we expect market interest rates to only nudge higher in 2018. Market dislocations occur when rates surge, like the recent move in the benchmark 10-year Treasury yield to 2.85%. Remember, the current interest rate, based on the 10-year Treasury, is still at the low end of our year-end forecast range of 2.75%-3.25%. A gradual move higher based on

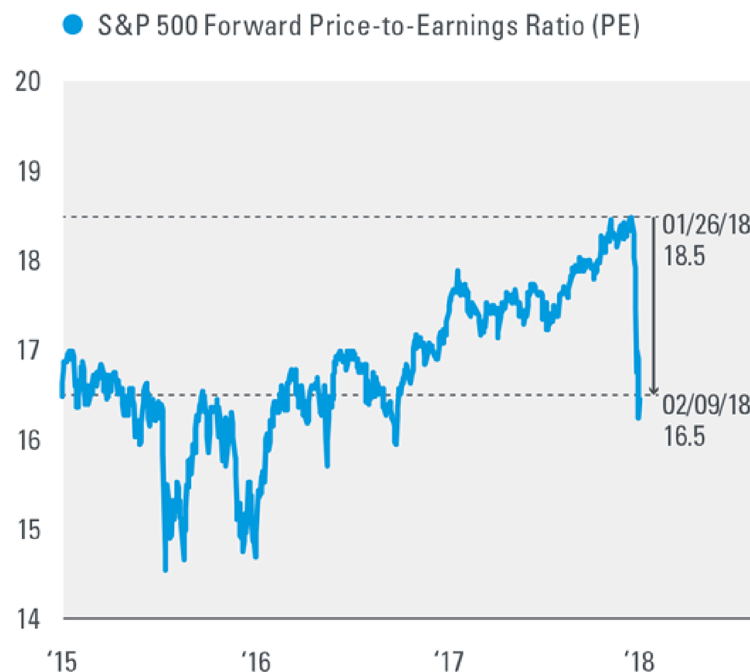
improved economic activity, slightly higher pricing measures, rising deficit spending, and a Fed that remains measured in the tightening cycle, remains in play, but higher yields may also attract more buyers, especially considering the yield advantage of Treasuries over other developed market debt.

Despite the equity market correction, the U.S. Treasury yield curve steepened last week, a market signal pointing toward future economic growth; and credit spreads, the interest rate difference between corporate debt and Treasuries, remained narrow, suggesting a lack of stress and a vote of confidence for future economic output.

Investors may want to consider reviewing fixed income allocations given these developments. We continue to believe bonds play an important role in portfolios, providing sources of income, liquidity, and the potential to smooth out portfolio performance during periods of equity market volatility.

Finally, we encourage investors to view the recent equity market weakness relative to the many positive fundamental equity market trends, including strong economic growth and corporate profits. Considering these positive fundamental trends, we remain favorable on the longer-term investing environment for equities. Fourth quarter earnings season has been very strong and corporate guidance for 2018 profitability is positive and upward sloping, causing consensus earnings projections to accelerate. Even before the recent equity weakness, forward-looking market PE ratios declined as earnings per share forecasts increased to levels that we believe are more attractive to long-term investors [Figure 3].

3 RISING EARNINGS ESTIMATES AND FALLING STOCK PRICES HAVE CLIPPED STOCK VALUATIONS



Source: LPL Research, FactSet 02/09/18

Indexes are unmanaged and cannot be invested into directly. Past performance is no guarantee of future results. Estimates may not develop as predicted.

Forward Price-To-Earnings is a measure of the price-to-earnings ratio (PE) using forecasted earnings for the PE calculation. While the earnings used are just an estimate and are not as reliable as current earnings data, there is still benefit in estimated PE analysis. The forecasted earnings used in the formula can either be for the next 12 months or for the next full-year fiscal period.

The strong upward revisions to analysts' earnings estimates for the S&P 500 during fourth quarter earnings season, along with the drop in stock prices, have clipped more than 10% off of stock valuations in only a couple of weeks. On a forward PE basis, the S&P 500 has gone from 18.5 times to 16.5 times, according to FactSet. Though 16.5 times is still above historical averages, we believe market PE multiples must be viewed relative to interest rates and inflation, both of which

remain well below their long-term trends. Given that the market PE is now 2 points cheaper, we consider current stock valuations attractive and suspect valuations may ultimately once again approach their recent peak before the end of this bull market.

CONCLUSION

Given the market's steady increase, the lack of volatility, and the bullish sentiment that prevailed, we believe the correction was a logical response. Though unsettling, market corrections are typical, having now occurred 37 times over the past 38-plus years. These experiences provide a good opportunity for investors to reassess the market environment and examine allocations relative to long-term targets.

Despite this recent correction, we maintain our fair value estimate of 2,850-2,900 for the S&P 500, representing a move of approximately 10% from current levels. We continue to position portfolios toward beneficiaries of the current monetary and fiscal policy dynamics, including value, small caps, financials, industrials, and technology, along with our previous guidance favoring emerging market equities.

Special thanks to Ryan Detrick and Jeffrey Buchbinder for their contributions to this commentary.

As noted in Outlook 2018: Return of the Business Cycle, LPL Research's S&P 500 Index total return forecast of 8-10% (including dividends), is supported by a largely stable price-to-earnings ratio (PE) of 19 and LPL Research's earnings growth forecast of 8-10%. Earnings gains are supported by LPL Research's expectations of better economic growth, with potential added benefit from lower corporate tax rates. Please see the Outlook 2018: Return of the Business Cycle publication for additional descriptions and disclosures.

IMPORTANT DISCLOSURES

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There is no guarantee that a diversified portfolio will enhance overall returns or outperform a non-diversified portfolio. Diversification does not protect against market risk. Rebalancing a portfolio may cause investors to incur tax liabilities and/or transaction costs and does not assure a profit or protect against a loss.

Investing in stock includes numerous specific risks including: the fluctuation of dividend, loss of principal, and potential liquidity of the investment in a falling market.

Because of its narrow focus, specialty sector investing, such as healthcare, financials, or energy, will be subject to greater volatility than investing more broadly across many sectors and companies.

Small cap stocks may be subject to a higher degree of risk than more established companies' securities. The illiquidity of the small cap market may adversely affect the value of these investments.

International investing involves special risks such as currency fluctuation and political instability and may not be suitable for all investors. These risks are often heightened for investments in emerging markets.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values and yields will decline as interest rates rise, and bonds are subject to availability and change in price.

All investing involves risk including loss of principal.

DEFINITIONS

The 200-day moving average (MA) is a popular technical indicator which investors use to analyze price trends. It is the security or index's average closing price over the last 200 days.

Yield curve is a line that plots the interest rates, at a set point in time, of bonds having equal credit quality, but differing maturity dates. The most frequently reported yield curve compares the 3-month, 2-year, 5-year and 30-year U.S. Treasury debt. This yield curve is used as a benchmark for other debt in the market, such as mortgage rates or bank lending rates. The curve is also used to predict changes in economic output and growth.

The PE ratio (price-to-earnings ratio) is a measure of the price paid for a share relative to the annual net income or profit earned by the firm per share. It is a financial ratio used for valuation: a higher PE ratio means that investors are paying more for each unit of net income, so the stock is more expensive compared to one with lower PE ratio.

Earnings per share (EPS) is the portion of a company's profit allocated to each outstanding share of common stock. EPS serves as an indicator of a company's profitability. Earnings per share is generally considered to be the single most

important variable in determining a share's price. It is also a major component used to calculate the price-to-earnings valuation ratio.

INDEX DESCRIPTIONS

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.

The Dow Jones Industrial Average (DJIA) Index is comprised of U.S.-listed stocks of companies that produce other (nontransportation and nonutility) goods and services. The Dow Jones Industrial Averages are maintained by editors of The Wall Street Journal. While the stock selection process is somewhat subjective, a stock typically is added only if the company has an excellent reputation, demonstrates sustained growth, is of interest to a large number of investors, and accurately represents the market sectors covered by the average. The Dow Jones averages are unique in that they are price weighted; therefore, their component weightings are affected only by changes in the stocks' prices.

The VIX is a measure of the volatility implied in the prices of options contracts for the S&P 500. It is a market-based estimate of future volatility. When sentiment reaches one extreme or the other, the market typically reverses course. While this is not necessarily predictive, it does measure the current degree of fear present in the stock market.

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Diversification: A Big Word, With Bigger Investment Implications

The process of diversifying -- or dividing your money among different types of investments -- is based on the idea that different asset classes tend to react differently to similar market conditions.

In today's market environment, diversification is more important than ever.[1] But what is the thinking behind this big word? The process of diversifying -- or dividing your money among different types of investments -- is based on the idea that different asset classes tend to react differently to similar market conditions. So by diversifying your portfolio, you may help reduce the risk that a loss in one asset class will drag down your entire portfolio.

The Right Mix May Help You Manage Risk

Source: ChartSource®, DST Systems, Inc. Results include total annual returns for the period January 1, 1926, through March 31, 2016. Bonds are represented by a composite of the total returns of long-term U.S. government bonds, derived from yields published by the Federal Reserve through 1972, the Barclays Long-Term Government Bond index through 1975, and the Barclays U.S. Aggregate index thereafter. Stocks are represented by the S&P 500 index. It is not possible to invest directly in an index. Past performance is not a guarantee of future results. © 2016, DST Systems, Inc. All rights reserved. Not responsible for any errors or omissions.

Diversify Within and Among Asset Classes

To diversify your portfolio, first select among major asset classes, such as stocks and bonds.[2] The chart above shows how diversifying your portfolio with stocks and bonds may help reduce risk over time, although past performance is no guarantee of future results. Second, consider diversifying within an asset class, such as stocks. For example, if your primary objective is growth, you might choose to invest the majority of your money in "blue-chip" stocks and small-cap stocks.[3] You may also want to consider adding foreign investments to your portfolio mix.[4] Foreign investments make up more than half of the world's total market, so if you are not investing overseas, you may be limiting your opportunities.

Sometimes Less Is More

Diversification is often described as putting your eggs in different baskets. The mix of "baskets" you choose should depend on your goals, time frame for those goals, and ability to tolerate risk. Long-term investors may choose more stock investments, while shorter-term investors may select a mix weighted toward bonds and cash investments such as certificates of deposit.[5]

No matter what combination you choose, make sure each investment plays a specific role in your overall objective. In investing, more is not always better -- strategic diversification is the key.

This communication is not intended as investment advice and should not be treated as such. Each individual's situation is different. You should contact your financial professional to discuss your personal situation.

[1]*There is no guarantee that a diversified portfolio will enhance overall returns or outperform a non-diversified portfolio. Diversification does not ensure against market risk.*

[2]*Investing in stocks involves risks, including loss of principal. 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.*

[3]*Securities of smaller companies may be more volatile than those of larger companies. The illiquidity of the small-cap market may adversely affect the value of these investments.*

[4]*Foreign investments involve greater risks than U.S. investments, including political and economic risks and the risk of currency fluctuations, and may not be suitable for all investors.*

[5]*CDs may be FDIC insured and may offer a fixed rate of return if held to maturity.*

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Midcap Funds: Why They May Be the "Just Right" Investment for You

The middle ground occupied by midcap companies and their stocks represents unique risk/return characteristics for investors.

Midcap stocks have the potential to provide performance similar to that of small-cap stocks with less of their volatility.[1] For investors looking to more fully diversify their stock investments, midcap stocks may be a sound choice. Midcap stocks are stocks of those companies with market capitalization (stock price times number of shares outstanding) of between $1.6 billion and $6.8 billion.[2] As their name implies, midcap companies fall between small-cap and large-cap companies. The middle ground occupied by midcap companies and their stocks represents unique risk/return characteristics for investors.

The Potential for Strong Returns, Less Volatility

One attractive attribute of midcap stocks is the potential to deliver performance that is on par with or better than that of small-cap stocks, typically with less risk (as measured by standard deviation).[3] For example, over the past 30 years, midcap stocks have delivered an annualized return of 13.10% compared with 12.01% for small-cap stocks.[3]

In addition, midcap stocks typically have earnings growth rates on par with those of small-cap stocks but more rapid than those of large-cap stocks. Moreover, midcap stocks typically maintain lower price-to-earnings (P/E) ratios than their large-cap counterparts. Combined, these features may mean that midcap investors can buy the potential for significant growth at attractive prices, although past performance is no guarantee of future results.

Midcap stocks may also share the following potential advantages:

- Midcap companies are established businesses -- These companies have survived the formative years and may bear less of the entrepreneurial risk associated with many small-cap companies.
- Midcap stocks are underfollowed by Wall Street -- Investment analysts typically don't follow midcap stocks as closely as they do large-cap stocks. As a result, investment professionals who follow midcaps may be able to obtain a unique view of a company.
- Midcap companies hold potentially defensible competitive positions -- Well-known brand names (such as Domino's Pizza, Autozone, and Hershey's) could make it harder for new kids on the block to compete against these pros.

Just Right for You?

One way to participate in the potential long-term benefits of midcap investing is to buy shares of a midcap stock. Keep in mind, however, that midcap stocks have the potential to experience significant volatility. Therefore, be sure to consider your time horizon and comfort level with risk before investing.

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[1]*Past performance is no guarantee of future results. Securities of smaller companies may be more volatile than those of larger companies. The illiquidity of the small-cap market may adversely affect the value of these investments. Midcap companies often have greater price volatility, lower trading volume, and less liquidity than larger, more established companies. These companies tend to have smaller revenues, narrower product lines, less management depth and experience, smaller shares of their product or service markets, fewer financial resources, and less competitive strength than larger companies. For these and other reasons, investments in midcap companies carry more risk than investments in large-cap companies.*

[2]*Sources: Standard & Poor's, S&P Dow Jones Indices, S&P U.S. Indices Methodology, January 2018.*

[3]*Based on annualized returns for the 30-year period ended December 31, 2017. Midcap stocks are represented by the S&P Midcap 400, an unmanaged index designed to measure the performance of 400 mid-sized companies in the United States. Small-cap stocks are represented by the S&P SmallCap 600, an unmanaged index designed to measure the performance of 600 small-size companies in the United States. Individuals cannot invest directly in any index. Past performance is no guarantee of future results.*

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Plan sponsors are beginning to see the value in "thinking outside the glidepath" when it comes to their target-date fund offerings.

DC Plan Trends: Sponsors Focused on Improving Participant Outcomes

Defined contribution plan sponsors are rethinking ways to improve investment offerings in an attempt to elevate retirement outcomes for plan participants. The Towers Watson *2014 U.S. Defined Contribution Sponsor Survey* revealed a few key themes.

Improving Portfolio Diversification

Historically, DC investment options have leaned heavily toward single, stand-alone actively managed funds, each with a style and market-cap bias. Realizing the inefficiency in this siloed approach, 40% of plan sponsors acknowledged that combining several investment strategies together in a custom-built, diversified investment structure offered a more efficient approach to active management. For plan participants, such an approach could maximize their buying power and simplify investment selection by offering fewer, more diversified options that may lead to better long-term outcomes.

Assessing Custom TDFs

Plan sponsors are beginning to see the value in "thinking outside the glidepath" when it comes to their target-date fund offerings. They fully recognize the value of TDFs as default investments and the role they play in anchoring participant accounts. As a result, many want to have more control over the structure and implementation of their TDF offerings. The 2014 study found that 49% of plan sponsors see the value of featuring a custom TDF series. Of those, 22% have already implemented a custom TDF solution, while 27% are exploring the possibility of doing so.

Reevaluating TDF Selection Criteria

Interest in customization aside, plan sponsors' criteria for selecting TDFs currently are driven largely by standard investment metrics -- e.g., the glide path roll-down of equity exposure (71%), active versus passive management (47%), and portfolio construction (47%) -- rather than the more holistic assessments of how successful the TDF is at improving the retirement outcomes of plan participants as measured by improved income replacement ratios (12%) and retirement success rates under various drawdown scenarios (8%).

Outsourcing DC Plan Oversight

Recognizing a) the heightened complexity of investment approaches and governance requirements and b) the ever-increasing pressure to facilitate successful retirement outcomes for plan participants, a third of DC plan sponsors surveyed are currently taking advantage of outsourcing solutions or considering delegating all or a portion of their investment oversight to a third-party provider.

Considering Broader Investment Themes

When asked what types of investments/investment themes they are considering for the future, plan sponsors responded with a litany of options from expanding bond offerings and broadening equity exposure (to include more international and emerging markets opportunities), to inflation-protection offerings (e.g., diversified real return, Treasury inflation-protected securities, and real estate investment trusts) and lifetime income options, both in and out of plan. Plan sponsors were united in saying they would not be adding company stock to their plan lineups.

Source: Towers Watson, "Plan Sponsors Raising the Bar: Investment Trend Highlights, 2014 U.S. Defined Contribution Sponsor Survey and Commentary," October 2014.

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