



# YOUR FINANCIAL FUTURE

Your Guide to Life Planning

December 2016



Our roads to success may have twists and turns and ups and downs; together we can navigate a course and enjoy the scenery along the way.

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Total returns for the broad bond market year to date are within our midyear forecast of low- to mid-single-digits.

### Weekly Market Commentary | Week of December 19, 2016

This week we take a look back at some of our hits and misses of 2016.

### Understanding Value Investing

Buying on the dips is a favorite strategy of committed stock investors. But when looking for investment bargains, it's important to avoid a value trap.

## Bond Market Perspectives | Week of December 19, 2016

### Highlights

- Total returns for the broad bond market year to date are within our midyear forecast of low- to mid-single-digits.
- Sectors that we liked, including mortgage-backed securities (MBS), investment-grade corporates, high-yield bonds, and bank loans performed well, though staying neutral on emerging market debt (EMD) was a miss.
- We did not anticipate the steep rise in rates following the U.S. presidential election, leading to the 10-year Treasury yield exceeding our forecast.

### 2016 Hits and Misses: Fixed Income Edition

As the year winds down, our weekly commentaries have reviewed how 2016 forecasts played out, and we do the same this week with a review of fixed income. The year 2016 saw extremes in the bond market, such as low to negative rates overseas, along with major macro events (e.g. the Brexit vote) that pulled U.S. rates lower during the first half of the year, until the 10-year Treasury reached an all-time low of 1.36% in July. From then on, improving economic data and rising inflation expectations helped push rates modestly higher, before they spiked on hopes of tax reform and pro-business policies following the election in November, and again moved higher following last week's Federal Reserve (Fed) interest rate hike.

Here we review what we got right, as well as the misses for fixed income in 2016.

### WHAT WE GOT RIGHT

#### Bond Market Forecast

"Our expectation is that average intermediate-term Treasury yields rise by approximately 0.25% to 0.50%, with a lesser probability of a 0.75% increase possible." - [Midyear Outlook 2016](#)

We started the year with our [Outlook 2016](#) calling for flat returns for bonds, with expectations of a 0.25-0.50% increase in the 10-year Treasury yield from its November 2015 level of approximately 2.25%. Our rate forecast turned out to be in line with reality (the 10-year Treasury yield closed at 2.54% on 12/19/16), but the path to higher rates was unexpected. Given the low rate environment at midyear, we upgraded our total return view to low- to mid-single-digits in our [Midyear Outlook](#). The Bloomberg Barclays Aggregate Bond Index has returned 1.52% as of 12/16/16, making it likely that full year total returns may finish within that updated range. We expect the 10-year Treasury yield to end 2017 in the mid 2% range, with a potential for more upside if meaningful stimulus is enacted. Scenario analysis based on this potential interest rate range and the duration of the index indicates low-to mid-single digit returns for the Bloomberg Barclays Aggregate Bond Index.

#### MBS and Investment-Grade Corporate Bonds

"Amid historically low yields, intermediate bonds, with an emphasis on mortgage-backed securities and investment-grade corporate bonds, provide diversification benefits and a favorable trade-off between yield and interest rate risk." - [Midyear Outlook 2016](#)

"MBS are fairly valued but offer the potential for additional yield relative to duration when compared with other high-quality options." - ["Time to Buy Mortgages?" Bond Market Perspectives, May 17, 2016](#)

A strong environment for credit and higher yields than the Bloomberg Barclays Aggregate Bond Index has helped investment-grade corporate bonds (+4.70%, Barclays Aggregate Credit Index as of 12/19/16) outperform the broader bond market year to date. MBS had a tough first half of the year as rates moved lower, but their lower duration (interest rate sensitivity) and higher yield per unit of duration helped them outperform the broader bond market in the second half of the year, as the 10-year Treasury yield climbed from all time lows reached in July (-1.59% for the Barclays Securitized MBS index versus -1.76% for the Barclays Aggregate Index from 7/8/16 through 12/19/16). Moving forward, we continue to believe that investment grade corporate bonds offer value relative to Treasuries. One risk factor to watch for MBS is that as rates rise, fewer people refinance, which could lengthen the average maturity of mortgage loans and increase duration of MBS. However, the yield per unit of duration remains attractive at this point in time, and we maintain a positive view of MBS.

### High-Yield Bonds and Bank Loans

"With defaults likely to remain low by historical standards in 2016 and valuations adequately compensating for rising default risks, we find value in high yield bonds, a sector that has historically offered a buffer against rising interest rates." - [Outlook 2016](#)

"Investors in bank loans may benefit if Libor continues to rise, given that the floating rates may start to move higher once the 1% Libor floor that many issues carry is exceeded." - ["A Deeper Look at the Rise in Libor," Bond Market Perspectives, August 30, 2016](#)

High-yield bonds have been the best-performing asset class within fixed income year to date, with a total return of 16.4% as of 12/16/16 (Barclays High Yield Bond Index). In addition to beneficial credit fundamentals and low defaults, high yield's correlation to oil prices, which had hurt the asset class previously, turned into a benefit as oil prices started stabilizing in 2016. With the price of oil currently above \$50/barrel, spreads to comparable Treasuries have compressed significantly. However, we now believe the high-yield market is pricing in much of the improved economic outlook and potential benefit from pro-growth policies under Trump, leaving less room for error in the asset class.

We upgraded our view on bank loans in late August, as markets started to price in the impact of money market reform (which went into effect in October 2016), causing Libor\* to move higher. Most bank loans adjust their coupon payments based on a spread to Libor, and many have a floor of 1%. This means that bank loan investors have been receiving the floor rate instead of the ultra-low Libor rates, which is a benefit on a total return basis. However, one of the major advantages of bank loans is that coupon payments adjust based on moves in Libor, and depressed Libor levels meant that the asset class wasn't truly floating, lessening its benefit in a rising rate environment. For the first time since May 2009, Libor is now near 1%, meaning that any further moves higher in rates could result in bank loan yields moving higher, and rates truly floating.

### WHAT WE MISSED

Although we had a number of hits during 2016, we also had a few misses. Like much of the market, we misjudged the market's reaction to Trump's presidential victory in November. We expected that equity markets would pull back, and bonds would rally (sending rates lower) given the uncertainty around Trump's policies. This exact scenario played out on election night with U.S. stocks pulling back as much as 5% pre market (overnight November 8-9) as Trump gained ground, but quickly reversed early the next morning (11/09/16). The 10-year Treasury yield went on to gain 0.34% for the week (moving from 1.81% to 2.15%), the largest relative upward move since records started in 1962. Rates have since continued to move higher as a string of better than expected economic data and the impact of the Fed's recent rate hike have become priced in.

Though many of our sector calls outperformed the broad bond market, EMD, an asset class we remained neutral on, also saw significant outperformance for the year, returning 9.24% year to date (JP Morgan EMBI Index). EMD benefitted from stabilizing oil prices, along with a continuation of loose monetary policy from major overseas central banks, though we continue to be neutral on the asset class overall as the potential impact of changes to trade policy from the incoming Trump administration are still unknown.

### CONCLUSION

The year 2016 was volatile for fixed income markets, but our midyear total return target appears to be on track. High-quality longer duration sectors saw strength as rates fell early in the year, but economically sensitive areas of the market, as well as those with shorter durations, tended to outperform as rates rose in the second half of the year. Our sector positioning, with a focus on investment-grade corporate bonds, MBS, high yield, and bank loans outperformed the broader market; however, we also missed the strong performance in EMD by staying neutral on the asset class and we failed to forecast the impact of Trump's election. Overall our fixed income forecasts performed well for 2016, and we hope for more hits than misses in our soon-to-be-released Outlook 2017.

**The *Bond Market Perspectives* will not be published on December 27, 2016. Look for our next publication on January 3, 2017. We wish you all a joyous holiday season!**

*\*London Interbank Offered Rate (Libor): An interest rate at which banks can borrow funds, in marketable size, from other banks in the London interbank market. The Libor is fixed on a daily basis by the British Bankers' Association.*

### 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. All performance reference is historical and is no guarantee of future results. All indexes are unmanaged and cannot be invested into directly.

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.

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.

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.

High-yield/junk bonds (grade BB or below) are not investment grade securities, and are subject to higher interest rate, credit, and liquidity risks than those graded BBB and above. They generally should be part of a diversified portfolio for 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.

Floating rate 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.

International debt securities involves special additional risks. These risks include, but are not limited to, currency risk, geopolitical and regulatory risk, and risk associated with varying settlement standards. These risks are often heightened for investments in emerging markets.

Yield spread is the difference between yields on differing debt instruments, calculated by deducting the yield of one instrument from another. The higher the yield spread, the greater the difference between the yields offered by each instrument. The spread can be measured between debt instruments of differing maturities, credit ratings, and risk.

#### INDEX DEFINITIONS

The 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).

The Barclays U.S. Aggregate Credit Index is a broad-based benchmark that measures the investment-grade, U.S. dollar-denominated, fixed-rate, taxable corporate bond market.

The Barclays U.S. Aggregate Securitized MBS Index tracks agency mortgage backed pass-through securities (both fixed-rate and hybrid (ARM) guaranteed by Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC).

The Barclays U.S. High-Yield Index measures the market of USD-denominated, noninvestment-grade, fixed-rate, taxable corporate bonds. Securities are classified as high yield if the middle rating of Moody's, Fitch, and S&P is Ba1/BB+/BB+ or below, excluding emerging market debt.

The JP Morgan Emerging Markets Bond Index is a benchmark index for measuring the total return performance of international government bonds issued by emerging markets countries that are considered sovereign (issued in something other than local currency) and that meet specific liquidity and structural requirements.

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## Weekly Market Commentary | Week of December 19, 2016

**HIGHLIGHTS**

- Our stock market forecast, as described in our *Outlook 2016* publication, was largely on target for the year, while we appropriately maintained our year-end stock market forecast during the February market lows.\*
- Political elections, both in the U.S. and the U.K. made for some of the biggest surprises of the year, and brought some unexpected market impact.
- Other hits included our decision to largely stay on the sidelines with regard to international equity markets, while favoring large caps and growth were among our misses.

*\*As noted in our [Outlook 2016](#), we expected mid-single-digit returns for the S&P 500 in 2016, consistent with historical mid-to-late economic cycle performance. We expected those gains to be derived from mid- to high-single-digit earnings growth over the second half of 2016, supported by steady U.S. economic growth and stability in oil prices and the U.S. dollar. We believed a slight increase in price-to-earnings ratios (PE) above 16.6 would be possible as market participants gain greater clarity on the U.S. election and the U.K.'s relationship with Europe.*

**A LOOK BACK AT 2016 HITS AND MISSES**

This week we take a look back at some of our hits and misses of 2016. We certainly had some of both in what was a difficult year to forecast the equity markets.

First, the year got off to one of the worst starts ever with a 10.5% stock market correction during the first five weeks of the year as oil prices collapsed. Then we got unexpected election outcomes. In the U.K., the Brexit vote and the stock market's post-vote resilience were both largely unexpected. Similarly, few predicted Trump's victory (which apparently surprised even the president-elect himself). That surprise was followed by another--one of the strongest post-election stock market rallies in history.

Against that unpredictable backdrop for stocks, we got some things right and some things wrong. Here is a look back at the hits and misses of 2016.

**WHAT WE GOT RIGHT**

**Stock market forecast.** One could argue this forecast belongs in the "hit and miss" category but we give ourselves the benefit of the doubt on this one. We called for mid-single-digit returns for the S&P 500 this year, writing in *Outlook 2016: Embrace the Routine*:

"Stocks, we believe, will not collapse, as many think, or soar, as many hope, but may offer near historical routine returns."

Through December 16, 2016, the S&P 500 is up 10.7% year to date (12.8% including dividends). Sure, that's a little above our forecast but it is right in line with long-term average historical returns, and is above our forecast for (and actual) bond market returns (and we would certainly rather miss on the low side if we're going to miss). And after five straight weeks of gains, it would not be a surprise if we got a little dip over the next two weeks.

Later in the year, as the major averages hit a series of new highs and valuation concerns became widespread, we noted that stock valuations were reasonable given the stage of the business cycle and low interest rates and inflation. This is still our view which has, up to this point, been right.

**Response to early 2016 volatility.** We did not anticipate the sharp downturn early in 2016. However, we made the right decision to maintain our year-end forecast at that time while many Wall Street strategists cut their year-end forecasts. We also stood by our call for continued economic growth, i.e., no recession, and to generally maintain portfolio risk levels near benchmarks. Further, the catalysts we cited in our February 16, 2016, [Weekly Market Commentary, "Data-Driven Perspective on a Rough Start to 2016"](#) all played out, including: higher oil prices, improving credit markets, evidence of a more pragmatic Federal Reserve, and stable Chinese capital flows and currencies.

**Technical and sentiment.** Our use of technical indicators and sentiment measures to help guide our asset allocation decisions proved helpful in 2016. At the February 2016 lows, the number of bulls in the American Association of Individual Investors (AAII) was near financial crisis lows in March 2009, suggesting the worst might have been over (and it was). Market breadth indicators helped us stay positive toward equities during the early summer ahead of the Brexit vote. Historical seasonal patterns supported sticking with stocks after Trump's victory, as large market declines after elections have been extremely rare, with recessions providing (2000 and 2008) the only exceptions going back to the 1952 election.

**International developed.** We came into 2016 expecting an opportunity to emerge in international developed equities, as represented by the MSCI EAFE Index, but that opportunity never came. Still, we were better off on the sidelines in tactical portfolios where we remained for virtually the entire year. Simply put, quantitative easing (QE) in Europe was not enough to overcome geopolitical challenges and sluggish economic growth. Developed international markets have returned just 0.5% year to date, well behind the S&P 500.

## WHAT WE MISSED

**Election outcomes.** The two big election outcomes--the Brexit vote in the U.K. and the U.S. presidential election--were among the two biggest things we got wrong; though we certainly were not alone. In both cases, stocks reacted better than we expected (though based on futures markets the S&P 500 did correct about 6% overnight during Election night). We had expected a pullback to potentially provide an opportunity to get more positive on U.S. equities, but that pullback never really came. The one that did--the post-Brexit vote decline--was essentially over in two days and totaled only 4% based on closing prices.

**Value.** After getting growth over value right in 2015, we stuck with that positioning too long in 2016. A sizable portion of the value outperformance this year (the Russell 3000 Value Index has returned 16.3% year to date) has come from financials in the post-election rally. As the year progressed we did turn more positive on both financials and energy, the two biggest value sectors, and recommend a balanced style approach in 2017.

**Small caps.** Our preference for large caps over small during the year was mostly business cycle driven, which was totally outweighed by policy considerations. The unexpected Republican sweep opened up a strong avenue toward comprehensive tax reform. In addition, small cap companies pay higher tax rates than their large cap global counterparts, so they have more to gain from the lower corporate tax rates that are likely forthcoming. Smaller companies are also more insulated from potential protectionist trade policy, so Trump's victory likely drove some rotation from large into small caps (despite tax repatriation of overseas cash, a likely to be proposed piece of tax reform more beneficial to larger cap companies). Though certainly a missed opportunity, the double-digit returns in U.S. large caps still provided attractive absolute returns, despite trailing small caps, as measured by the Russell 2000, by about 9% year to date.

## HIT AND MISS

**Earnings.** We were overly optimistic in our S&P 500 earnings growth forecast for 2016, which was in line with consensus according to Thomson Reuters at mid- to high-single-digits, underestimating the depth of the energy downturn and strength of the U.S. dollar. However, we accurately forecasted the second half earnings rebound which, assuming the historical pattern of upside holds, will reach a mid- to high-single-digit range in the fourth quarter of 2016 (and was close in the third quarter with a more than 4% year-over-year increase). More on earnings in our Outlook 2017 due out later this week.

In emerging markets (EM), over the full year our optimism was largely warranted, with the MSCI Emerging Markets Index returning 10.5% year to date. We maintained previously established, modest exposure to EM in several portfolios during the year, which helped performance, although allocations added during the year have not added value yet due to the post-election sell-off on trade war fears.

**Return of active management and diversification.** Active management continued to struggle for most of the year, although the second half is shaping up better than the first. Among the factors helping active managers include: 1) higher dispersion among individual stocks and sectors, 2) rising interest rates, 3) individual company fundamentals are increasingly driving stock prices, and 4) better performance of value stocks, as many managers have a valuation discipline.

Diversification has added a little bit of value this year, after detracting most of the past five years. Diversifying into small and midcap stocks was helpful, while EM equities had only a marginal negative impact, though lagging developed international markets (based on the MSCI EAFE Index) detracted from performance when used as a diversifier.

## SECTOR LEVEL REPORT CARD

With 11 S&P equity sectors, there will always be hits and misses. Here are the ones that were most impactful:

**Technology.** We were right to favor technology (+14.9% year to date) due to attractive valuations, some favorable product trends, and encouraging earnings prospects. Although the sector has outperformed in 2016, we believe recent weakness related to global trade and access to labor may be overdone.

**Industrials.** We were right to recommend industrials this year, as the sector has returned +19.5% year to date. We cited improved economic growth and, later in the year, prospects for infrastructure spending which we anticipated regardless of the U.S. election outcome. A boost in defense spending under President-elect Trump would also provide support.

**Consumer.** Our caution toward both consumer sectors was well placed as both consumer sectors have underperformed year to date, especially consumer staples (+6.0%). Consumer discretionary (+7.8%) caution was largely due to its better historical performance during the early part of business cycles. Our preference for cyclical sectors as economic growth improved was the primary reason for our negative consumer staples view.

**Healthcare.** Our positive view on healthcare (-1.7%) in 2016 has missed the mark. We underestimated the impact the drug pricing controversy would have on the biotech and pharmaceutical industries. Recent indications that reducing drug prices may be a priority for the president-elect, on top of the uncertainty surrounding the future of the Affordable Care Act, have led to recent underperformance and our tempered optimism for the sector in recent weeks.

## CONCLUSION

As we turn the page to 2017 we look forward to potentially another solid year of stock market performance for investors

and, hopefully, more hits than misses in our soon-to-be-released *Outlook 2017*.

**The *Weekly Market Commentary* will not be published on December 26, 2016. Look for our next publication on January 3, 2017. We wish you all a joyous holiday season!**

#### IMPORTANT DISCLOSURES

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*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.*

*All indexes are unmanaged and cannot be invested into directly.*

*Because of their 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.*

*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.*

*Investing in foreign and emerging markets securities involves special additional risks. These risks include, but are not limited to, currency risk, political risk, and risk associated with varying accounting standards. Investing in emerging markets may accentuate these risks.*

*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.*

*Active Management may involve more frequent buying and selling of assets and will tend to generate higher transaction cost. Investors should consider the tax consequences of moving positions more frequently.*

*All investing involves risk including loss of principal.*

#### 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 MSCI Emerging Markets Index captures large and mid cap representation across 23 emerging markets (EM) countries. With 822 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.*

*The MSCI EAFE Index (Europe, Australasia, Far East) is a free float-adjusted, market-capitalization index that is designed to measure the equity market performance of developed markets, excluding the United States and Canada.*

*The Russell 3000 Index measures the performance of the largest 3,000 U.S. companies representing approximately 98% of the investable U.S. equity market.*

*The Russell 2000 Index measures the performance of the small cap segment of the U.S. equity universe. The Russell 2000 Index is a subset of the Russell 3000 Index representing approximately 10% of the total market capitalization of that index.*

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Investors looking to avoid a value mistake may want to compare a stock's recent trend with a peer group or with a broad market index.

## Understanding Value Investing

As volatility in the stock market continues, some investors may be tempted to buy on the dips. But this practice raises an important question: Is a low price by itself a true measure of a value stock? If an investor plans to hold a stock for the long term, how can an investor gauge its future potential compared with the broader market?

### Value Investing Defined

Value stocks are those that have fallen out of favor in the marketplace and are considered bargain priced compared with book value, replacement value, or liquidation value. Value fund managers typically invest only when they believe the underlying company has good fundamentals. Many value investors think that a majority of value stocks are created because investors overreact to negative events, which can include:

- Disappointing earnings.
- A negative outlook for the industry.
- A regulatory setback.
- Substantive litigation.

The idea behind value investing is that stocks of good companies will bounce back in time when a company overcomes a short-term obstacle and investors ultimately recognize fair value. But this recognition may take time or, in some instances, may never materialize.

### Comparative Analysis

Investors looking to avoid a value mistake may want to compare a stock's recent trend with a peer group or with a broad market index. Here are some other suggestions:

- Consider whether a stock has dropped more than the average stock in the S&P 500 during the past three months.
- Examine whether earnings estimates are being revised downward faster when compared with a peer group.
- Compare analyst estimates of future profit margins to historical margins. If expectations for future profits exceed past earnings, the company could end up disappointing investors.

Another technique for potentially avoiding a value mistake is to look for stocks paying dividends. Dividends historically have been seen as a sign of management's confidence in healthy cash flow over the long term, as well as an indicator that management's interests align with shareholders. Even if a stock price languishes for a period of time, a dividend provides an investor with something in the way of a return. Note that dividends are not guaranteed, and a company can reduce or eliminate a dividend at any time.

Perhaps the best strategy for avoiding a value mistake is to combine value stocks with growth stocks, international stocks, and other types of equities to pursue diversification. Although there are no guarantees, owning some of each could help to balance an equity portfolio over the long term.<sup>1</sup>

<sup>1</sup>*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. Investing in stocks involves risks, including loss of principal.*

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