MARKET OUTLOOK

1st QUARTER 2016

WELCOME TO THE QUARTERLY MARKET OUTLOOK FOR THE FIRST QUARTER OF 2016.

In this report, we will review market performance in 2015, what worked and what didn't for the global financial markets in an absolute sense, and what didn't work for CLS portfolios in relative terms.

Next, we will review what CLS portfolio managers are thinking in the current environment, focusing on recent questions from financial advisors and investors. And last, we'll discuss the key investment themes we are introducing and building portfolios around in 2016.

Despite a weak December, it was a good quarter for the U.S. stock market. Domestic stocks (Russell 3000) gained over 6%, which put 2015 performance on the positive side of 0%. The 3-year annualized return, however, is still an impressive 15% per year, and the 5-year annualized return is 12%. These numbers indicate that the bull market in stocks is still officially alive. Although, not all segments of the stock market performed the same. U.S. large-cap stocks (S&P 500) performed slightly better, but not by much. For the quarter, the S&P gained 7%. For the year, it gained over 1%. The 3- and 5-year annualized returns were 15% and 13% respectively. It was domestic small-cap stocks (Russell 2000), that notably underperformed. For the quarter, small-cap stocks gained 4%, finishing 2015 down 4%. The 3-year and 5-year annualized returns were 12% and 9% respectively.

International stocks (MSCI ACWI ex-U.S.) meanwhile, which includes both developed (MSCI EAFE) and emerging markets (MSCI Emerging Markets), fared even worse. The ACWI ex-U.S. was up 3% for the quarter, and down 6% for year. The 3- and 5-year annualized returns were 2% and 1%. That was a notable lag versus the U.S. markets – which made it difficult for global investors to keep pace with the U.S. markets. It's important to note that emerging markets have been down 7% per year for the last three years, and down 5% per year for the last five. Emerging markets may have better valuations and growth prospects, but the scoreboard hasn't favored them in recent years. However, we expect that to change in the year(s) ahead.

The bond market – despite both short- and long-term rates rising last year and credit spreads widening – beat the stock market and gained nearly 1%, at least as represented by the Barclay's Capital Aggregate Index. The overall bond market, however, did lose a little bit of ground in the fourth quarter, though not as much as other diversifying asset classes such as commodities (the Bloomberg Commodity Index lost 11% last quarter and 25% for the year), and alternatives (Morningstar Diversified Alternative Index gained 1% last quarter, but finished lower by 4% for the year). Lastly, cash, as represented by the 30-day Treasury bill, has returned essentially 0% for all time frames.

STOCK MARKET	QTD	YTD	1 Year	3 Year	5 Year
Total U.S. Market *Russell 3000*	6.27%	0.48%	0.48%	14.74%	12.18%
Domestic Large-Cap Equity *S&P 500 Index*	7.04%	1.38%	1.38%	15.13%	12.57%
Domestic Small-Cap Equity *Russell 2000 Index*	3.59%	-4.41%	-4.41%	11.65%	9.19%
International Equity *MSCI ACWI ex-U.S. Index*	3.24%	-5.66%	-5.66%	1.50%	1.06%
Developed International Equity *MSCI EAFE Index*	4.71%	-0.81%	-0.81%	5.01%	3.60%
Emerging Market Equity *iShares MSCI Emerging Markets Index*	0.66%	-14.92%	-14.92%	-6.76%	-4.81%
FIXED INCOME					
U.S. Bonds *Barclays Capital U.S. Aggregate Bond Index*	-0.57%	0.55%	0.55%	1.44%	3.25%
Cash Equivalent *Barclays Capital 1-3 Month U.S. Treasury Bill Index*	0.01%	0.03%	0.03%	0.03%	0.05%

Source: Morningstar Direct Performance as of 12/31/2015

Global Value Investing

While U.S. stocks officially remain in one of the longest and strongest bull markets in history, it has not been a good time for global value investing. In fact, it has been reported that global value investing has experienced its weakest streak of relative performance ever in recent years, even compared to the early 1970s or the echnology, media, telecom bubble of the late 1990s.

This environment hasn't necessarily played into our style of investing. At CLS, we strongly believe that global, balanced, risk-budgeted, exchange traded fund (ETF) portfolios help investors succeed over time. But lately, being global and balanced hasn't helped performance.

Nonetheless, we believe this basic approach still makes sense for many investors. Let's break down our beliefs into a bit more detail as they influence our approach to money management:

1. Helping Investors Succeed

We believe global, balanced, risk-budgeted, ETF portfolios, along with clear and transparent communication, help investors achieve success. If portfolios behave as expected, investors are more likely to stay the course.

2. Risk Budgeting

We believe investors must take some risk to achieve their goals, and the best way to do so is by measuring and managing it via risk budgeting. Our proprietary CLS risk budgeting approach is applied to most of the assets we manage, including our AdvisorOne Funds.

3. Global

Over time, we believe diversification across domestic and international markets should provide smoother returns and ultimately higher risk-adjusted performance versus domestic-only portfolios.

4. Balanced

We believe asset allocation – and keeping the proper balance between assets depending on a portfolio's mandate – works for investors. Again, smoother returns should translate into better investor experiences and results.

5. ETFs

We believe ETFs provide numerous potential benefits for investors, including lower costs, tax efficiency, and investment precision.

We also believe in the power of teamwork and discipline. All AdvisorOne Funds are team-managed using disciplined processes that we believe are key to long-term success.

As investment manager and thought leader Cliff Asness said, *"I used to think being great at investing long-term was about genius... Genius is still good, but more and more I think it's about doing something reasonable, that makes sense, and then sticking to it with incredible fortitude through the tough times."*

Asness also talked about the key to Warren Buffett's success when studying his spectacular investing record, *"Of course they*

Rusty Vanneman, CFA

Chief Investment Officer

*Rusty Vanneman joined CLS in September 2012 as Chief Investment Officer. Previously, Mr. Vanneman was Chief Investment Officer and Portfolio Manager at Kobren Insight Management (KIM) in the greater Boston area. His 11-year tenure at KIM included a 5-year span during which the firm was owned by E*TRADE Financial. During this time, Mr. Vanneman was the Senior Market Strategist for E*TRADE Capital. Prior to working at KIM, he was a Senior Analyst at Fidelity Management and Research (FMR Co) in Boston. He was also a Managing Analyst at Thomson Financial. Mr. Vanneman received a Bachelor of Science in Management from Babson College, where he graduated with high distinction. He holds the Chartered Financial Analyst (CFA) designation and is a member of the CFA Institute. He is also a Chartered Market Technician (CMT) and a member of the Market Technician's Association (MTA).*

found he was fantastic — but not quite as fantastic. His track record was phenomenal... but human phenomenal...What was beyond human was him sticking with it for 35 years and rarely, if ever, really retreating from it. That was a nice little lesson that you have to be good, even very good, but sticking with it and not getting distracted is much more the job."

We couldn't have said it better ourselves.

Discipline is the Key to Success

Discipline is the key to investment success, and the truth is that many investors just don't have it. The well-known Dalbar study shows that over the last 20 years, the average investor has underperformed the stock market by over 4% a year. The reason? Investors don't stick to a process; they chase performance. The gap between market returns and investor returns, often called the "behavior gap," is large in nearly every study that examines investor performance.

This is where advisors and consultants come in to help investors improve results. But even some professionals may tend to chase performance. For instance, a 2008 study, *The Selection and Termination of Investment Management Firms by Plan Sponsors*, examined the hiring and firing of investment management firms by 3,400 plan sponsors in the U.S. between 1994 and 2003. The study found that the new hires produced no better returns than their recently fired counterparts. In fact, the fired managers frequently performed better once they were let go.

Another study from 2013, *"Picking Winners? Investment Consultants' Recommendations of Fund Managers,"* analyzed the recommendations of consultants who represented more than 90% of the U.S. market. The researchers showed the average returns of their recommended products were around 1% lower than other products over a 12-year period. Not good.

In short, performance tends to revert. Several studies on manager performance show that over 3 to 5 years, prior winners are more likely to trail losers, and prior losers are more likely to outperform. In the article, *"The Truth About Performance Records"* by Andrew Hunt, there are various explanations, including style cycles and fund flows. *"When certain managers are successful, they see greater inflows which drive up their securities to overvalued levels – hence momentum and then mean reversion. Out of favor managers and portfolios undergo the opposite. The damaging effects of hubris among top performers (in contrast to the self-help and humility among laggards) may also have something to do with it."*

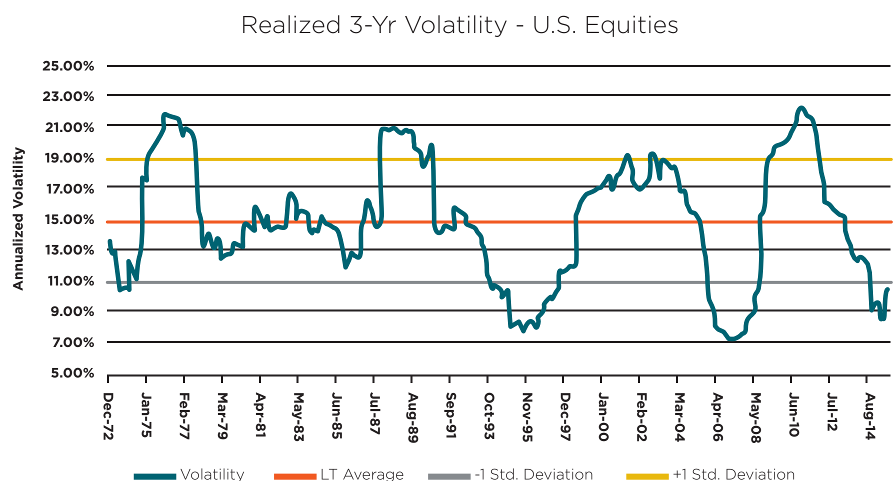
It was noted in the article that when it comes to picking managers, it's important to consider other material factors such as investment philosophy, process, organizational culture, and alignment with client interests to help distinguish weak short-term returns from other, more serious problems.

What is CLS Thinking?

Let's answer some of the most frequent questions we have received from advisors and investors heading into year-end.

<u>US. Stock Market Outlook</u>

Nearly seven years into a bull market, U.S. stocks aren't cheap. In turn, return expectations need to be tempered. Yields are below average, nominal growth is expected to remain below



average, and valuations are above average. All suggest lower, albeit positive, returns.

However, one thing we do expect is higher volatility. The markets have actually seen below-average volatility in recent years, as can be seen in the chart on the previous page. Volatility, like returns, reverts.

The calendar year cycle (i.e., seasonal factors) typically produces a positive first quarter for the stock market. But the presidential election cycle tends to run the other way for the first six months of election years. Thus, let's call cyclical factors a scratch and not necessarily supportive of more gains.

International Stock Market Outlook

International stocks, in both developed (such as Japan or Europe) and emerging markets, look a lot better. And that makes sense given that they have lagged the U.S. stock market by 80% since the 2008 financial crisis.

Now, however, international markets are on sale and expected returns are substantially higher.

Our own proprietary in-house expected return tool suggests international ETFs should outperform by 8% or more per year over the next 10 years. That's substantial, and I don't think it's far-fetched. Other value-oriented firms, such as Research Affiliates (RA) and GMO, have published similar numbers.

Yields are also higher overseas. The U.S. yields about 2%, while international markets yield 3% on average. That provides a nice head start. International companies tend to not only pay higher dividends but also grow their dividends faster. International yielders will further benefit from falling rates in their respective countries while U.S. yielders will face headwinds in a rising-rate environment.

Lastly, economic reforms are generally more positive for international markets. For instance, the opening of markets abroad is enhancing efficiency of international investing and narrowing the gap between domestic and international. Countries like China and Japan are implementing favorable reforms that make it easier for internal and external investors to be more active, leading to greater stability.

Bond Market Outlook

We expect bond market returns to also be below average, but positive. And in certain parts of the fixed income market, total returns may even be competitive versus some segments of the U.S. stock market.

Short-term rates will continue to rise, but slowly. The Federal Reserve (Fed) is expected to increase short-term rates throughout 2016.

Longer-term rates, however, are likely to stay range-bound and won't move dramatically higher given conflicting economic data. Coupon collection should offset potential price declines to allow for small positive returns in most fixed income asset classes.

Despite the expectation of muted returns, bonds still make sense for investors to own. They still provide diversification and income, and they could even generate stronger-than-expected returns if there is notable economic and/or market weakness.

Alternatives Outlook

Although we think bonds still serve a role in balanced portfolios, and will likely generate better returns than many investors believe, we are still looking to increase our exposure to alternatives.

Alternatives come in many packages, ranging from long/short funds to managed futures to merger arbitrage. In our opinion, one of the most important attributes of an alternative strategy is the diversification benefit it brings to a portfolio. There are other reasons to own alternatives, including potential hedges against inflation and to seek absolute returns, but the ability to manage risk is most attractive. Historically, alternatives have provided some level of protection in down markets (even in rising-rate environments).

Currently, CLS holds about 4% of its portfolios in alternatives (this includes commodities), with a bias to grow that position in 2016.

Commodities Outlook

We believe there are strategic and even tactical reasons to own commodities.

By strategic, we mean having some level of long-term allocation to the asset class. Given that commodities beat to a different drum than stocks, they can provide powerful portfolio diversification benefits. They also tend to be an effective hedge against inflation. They typically outperform in Fed rate hiking cycles. Their expected returns – thanks to being so beaten down in recent years – are also rising.

That brings us to the tactical decision of how much to over- or underweight the strategic allocation. Currently, there is good debate among CLS portfolio managers about when to increase allocations. Everybody recognizes that commodities have been beaten down and the best investment opportunities can come from such environments, but the preferred timing for increased exposures is where the debate centers. In sum, expect increased allocations in CLS portfolios in 2016 but at varying speeds depending on the strategy or portfolio.

Investment Themes

X-Factor

We expect lower U.S. stock market returns in the year(s) ahead and will therefore be emphasizing factor-based ETFs, otherwise known as "smart beta" ETFs. These ETFs have a rules-based approach to building a portfolio, which emphasizes a factor, such as value, growth, or high quality. Factor-based ETFs capture the essence of active management but at a fraction of the cost. We believe this emphasis will enhance returns in the year(s) ahead. CLS is already an industry leader in the usage of smart beta ETFs, and this emphasis is likely to grow.

In addition, we expect market volatility will increase in the year(s) ahead. Market volatility has been at historically low levels in recent years, and this usually sets the stage for increased volatility. If that is the case, additional risk management, via factor-based risk management, should fortify our risk budgeting approach.

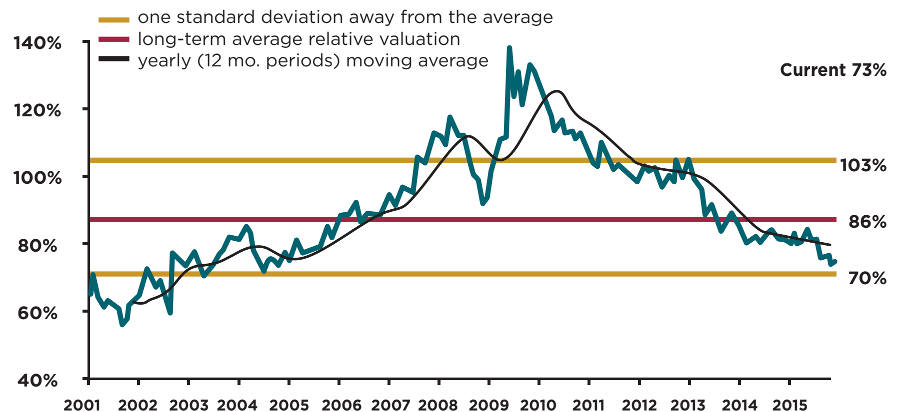
International Opportunities

In a low-growth world, valuations, yields, monetary policies, and reforms play greater roles, and international markets are more likely to benefit from these factors than U.S. markets going forward. Currently in international markets, valuations are lower, dividend yields are higher, reforms are taking hold, and central banks are providing greater support. The chart below reflects that valuations for Emerging Markets look relatively attractive to the rest of the world.

While these benefits are powerful, some international markets are facing certain headwinds. For example, some emerging market economies aren't growing as once expected. A diversified approach to international investing may be complemented by targeted allocations in particular countries, regions, and sectors. We expect wider performance dispersion between countries when reforms and policies have an outsized effect.

Creative Diversification

Given the low level of interest rates, we continue to be creative in how we diversify our equity-dominated portfolios. We can do this in two ways. First, we can be tactical in our fixed income exposures, which we have been. We have actively managed our duration (i.e., interest rate sensitivity), credit, and sector exposures. Currently, our portfolios are less interest-rate sensitive than the overall bond market, and our overall credit quality is higher than in years past. Second, we can use alternative asset class segments and strategies, which can include managed



futures, hedge fund strategies, and currencies. This could also mean increased exposure to commodities, which have been beaten down over the last several years (many commodities are at multi-year price lows).

Thanks for reading. Stay balanced.

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CLS is not affiliated with any of the companies listed above. While some CLS portfolios may contain one or more of the specific funds mentioned, CLS is not making any comment as to the suitability of these, or any investment product for use in any portfolio. A client's risk budget is derived from the client's specific answers to CLS's Confidential Client Profile questionnaire, which establishes the client's financial goals, ability to handle risk, and overall investment time horizon. The individual client risk budget is expressed as a percentage of the risk of a well-diversified equity portfolio.

The S&P 500® Index is an unmanaged composite of 500-large capitalization companies. This index is widely used by professional investors as a performance benchmark for large-cap stocks. The Russell 3000 Index is an unmanaged index considered representative of the U.S. stock market. The index is composed of the 3,000 largest U.S. stocks. The Russell 2000 is an index comprised of the 2,000 smallest companies on the Russell 3000 list and offers investors access to small-cap companies. It is a widely recognized indicator of small capitalization company performance. The MSCI EAFE International Index is a composite index which tracks performance of international equity securities in 21 developed countries in Europe, Australia, Asia, and the Far East. The MSCI All-Countries World Index, excluding U.S. (ACWI ex US) is an index considered representative of stock markets of developed and emerging markets, excluding those of the US. The Barclay's Capital U.S. Aggregate Bond® Index measures the performance of the total United States investment-grade bond market. The Barclay's Capital 1-3 Month U.S. Treasury Bill® Index includes all publicly issued zero-coupon U.S. Treasury Bills that have a remaining maturity of less than 3 months and more than 1 month, are rated investment grade, and have $250 million or more of outstanding face value. The Bloomberg Commodity Index is made up of 22 exchange-traded futures on physical commodities and represents 20 commodities that are weighted to account for economic significant and market liquidity. The Morningstar Diversified Alternatives Index is designed to provide diversified exposure to alternative asset classes while enhancing risk-adjusted portfolio returns when combined with a range of traditional investments. It allocates among a comprehensive set of alternative underlying ETFs that employ alternative and non-traditional strategies such as long/short, market neutral, managed futures, hedge fund replication, private equity, infrastructure or inflation-related investments. The Equity Baseline Portfolio (EBP) is a blended index comprised of 60% domestic equity (represented by the Russell 3000 Index) and 40% international equity (represented by the MSCI ACWI ex US Index), rebalanced daily. An index is an unmanaged group of stocks considered to be representative of different segments of the stock market in general. You cannot invest directly in an index.

An ETF is a type of investment company whose investment objective is to achieve the same return as a particular index, sector, or basket. To achieve this, an ETF will primarily invest in all of the securities, or a representative sample of the securities, that are included in the selected index, sector, or basket. ETFs are subject to the same risks as an individual stock, as well as additional risks based on the sector the ETF invests in. Bonds are a type of debt instrument issued by a government or corporate entity for a defined period of time at a fixed interest rate. Bonds may be subject to unsystematic risks including, but are not limited to, call risk and reinvestment risk. High yield bonds, or junk bonds, will be subject to an even greater degree of these risks as well as subject to the credit risk.

Alternative investing refers to the practice of investing in any asset class other than stocks, bonds, or cash (otherwise known as the "traditional" asset classes). Alternative investments may include managed futures, real estate, commodities, derivatives, etc. Unsystematic risks will heavily depend on the specific investment and may include, but are not limited to, business risk, liquidity risk, and capital risk. Emerging market investing refers to the practice of investing in a developing market of a foreign nation. The pre-requisites of this practice include a market within the foreign nation along with some form of regulatory body. Emerging markets involve greater risk and potential reward than investing in more established markets. Diversifiable risks for emerging markets include, but are not limited to, political risk, currency risk, and liquidity risk.

The 12-month outlooks contain probabilities based on calculations from CLS portfolio managers and research analysts. The outlook includes equal-weighted portfolio manager forecasts in five different return categories. The analyst team is equal weighted to count as a single portfolio manager vote. Historical probabilities for the categories are also researched. Overall views presented have been adjusted based on perceived value by each portfolio manager and analyst.

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