WEEKLY MARKET REVIEW

APRIL 11, 2017

In This Edition

- *How investment decisions today can affect your goals tomorrow.*
- *What does your favorite golfer have to do with factor investing?*

CLS INVESTMENTS

Market Performance

Equities	LAST WEEK	QTD	YTD '17
Total U.S. Market[1]	-0.37%	-0.37%	+5.36%
Domestic Large-Cap Equity[2]	-0.24%	-0.24%	+5.81%
Domestic Small-Cap Equity[3]	-1.52%	-1.52%	+0.91%
International Equity[4]	-0.35%	-0.35%	+7.48%
Developed International Equity[5]	-0.66%	-0.66%	+6.54%
Emerging Market Equity[6]	+0.38%	+0.38%	+11.87%
Fixed Income	**LAST WEEK**	**QTD**	**YTD '17**
U.S. Investment Grade Bonds[7]	+0.16%	+0.16%	+0.98%
Cash Equivalent[8]	+0.01%	+0.01%	+0.11%
Commodities	**LAST WEEK**	**QTD**	**YTD '17**
Commodity[9]	+0.58%	+0.58%	-1.76%

[1]Russell 3000 [2]S&P 500 Index [3]Russell 2000 Index [4]MSCI ACWI ex-U.S. Index [5]MSCI EAFE Index [6]MSCI Emerging Markets Index [7]Bloomberg Barclays Capital U.S. Aggregate Bond Index [8]Bloomberg Barclays Capital 1-3 Month U.S. Treasury Bill Index[9]Bloomberg Commodity

As of 4/7/2017

Week in Review

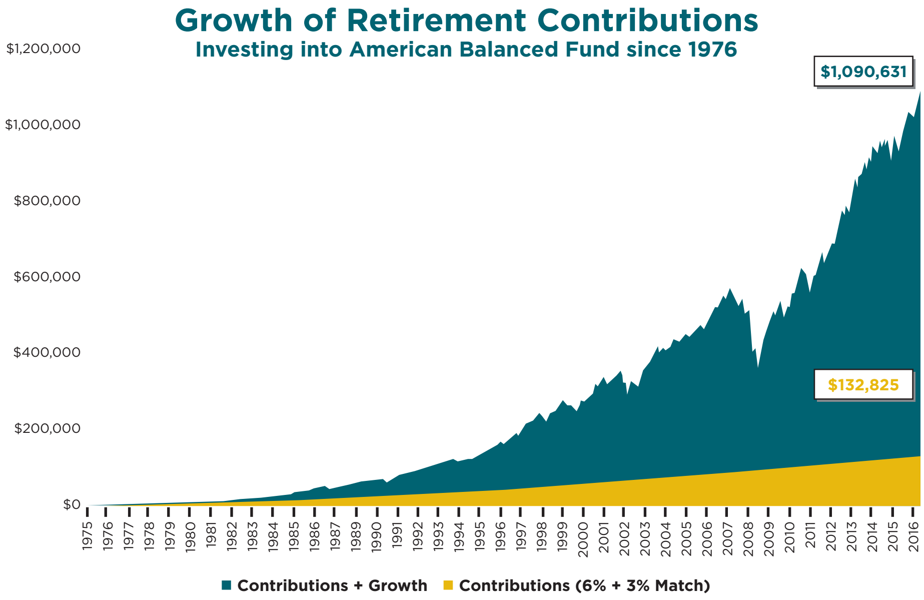
Major stock indices closed lower last week with the exception of emerging markets, which have more than doubled the return of the S&P 500 year-to-date. News out of Syria did little to rattle markets, as geopolitical crises rarely do for any meaningful period of time. Domestic small-cap stocks gave back the most last week, and commodities continued to rebound from their recent slump.

Bond markets cheered the lower-than-expected U.S. nonfarm payrolls report on Friday that showed 98,000 jobs were created in March, about half of the amount expected. Unemployment hit its lowest level since 2007, and hourly wages maintained a decent pace year-over-year.

Today is the Future

CLS recently published our [Quarterly Market Outlook] and [March Market Review] in which we review performance, investment themes, our outlook, and include a number of important tidbits from our team. With that much good commentary already available, I want to focus on why most of us are here in the first place: to help investors succeed in achieving their goals. It can be difficult to maintain a focus on goals that for some may be quite far down the road, but it is important to stay disciplined and realize the choices we make today – both good and bad – affect our futures tomorrow.

At CLS, we are constantly analyzing the importance of staying invested, not jumping from manager to manager, avoiding moving money in and out of the market, trying to time entry and exit points, and many other potentially detrimental actions that sit in the infamous "behavior gap" between investors and market returns. Well, following is another analysis. It is not meant to scold and scare, but to inspire and enthuse.



Sources: *CLS Investments, Morningstar, U.S. Census Bureau*
Assumptions: *9% (Simulating a 6% contribution plus 3% employer match) of U.S. median household income is contributed into the American Balanced Fund Class A (ABALX load waived) every month since 1/1976. U.S. Household income is adjusted annually. For 2016 figures, prior year (2015) median household income is grown by U.S. wage growth (2.2%)*
**This illustration is for imformation purposes only and should not be regarded as a guide to investing.*

The graph above begins a little more than 40 years ago, in 1976, when an *average* investor with an *average* salary invested an *average* amount into what seemed to be an *average* fund. Specifically, 6% of the median U.S. household income invested into a 401(k) with a 3% company match. This money was invested into a fairly new fund at the time, the American Balanced fund (A-share). The 6% contribution with a 3% match never changed for four decades, although the household income grew every year with the national median. The results are pretty tremendous – not what many people consider *average*! More than $1 million from only $133,000 contributed. (The median household income ranged from less than $12,000/year in 1976 to just under $60,000 today.)

So, why is that not the story for most *average* investors? That

Grant Engelbart, CFA, CAIA
Portfolio Manager

Grant Engelbart joined CLS in 2009, and after several roles in operations and investment research, accepted the role of Portfolio Manager in 2013. Mr. Engelbart currently serves as a manager on CLS's aggressive mutual funds in addition to several ETF and mutual fund separate account strategies. Prior to joining CLS, Mr. Engelbart held positions at TD Ameritrade and State Street Corporation.

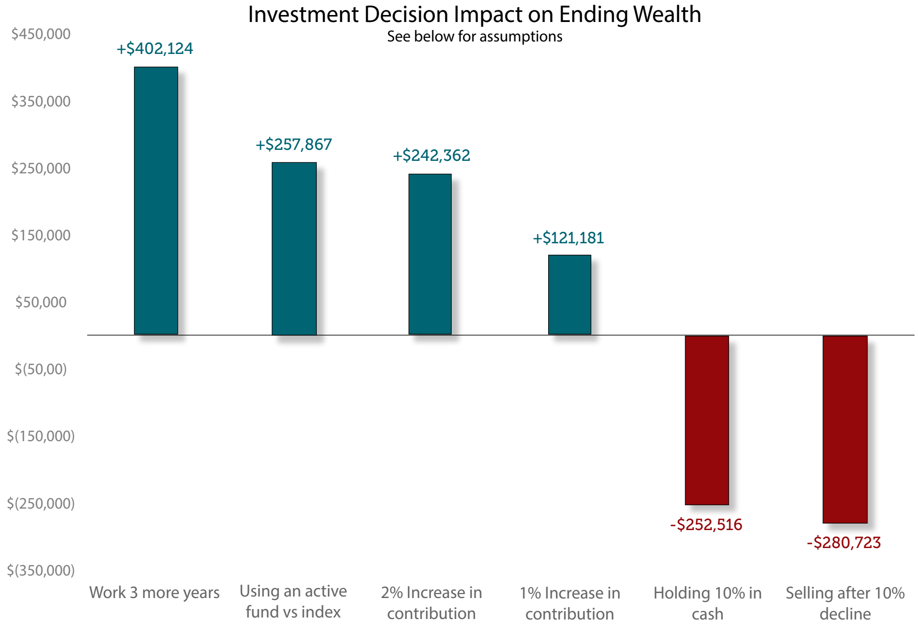
Mr. Engelbart received his Bachelor's degree in Finance from the University of Nebraska-Lincoln. He holds the Chartered Financial Analyst (CFA) designation, Chartered Alternative Investment Analyst (CAIA) designation, and FINRA Series 65 license. He is a member of the CFA Society of Nebraska and the CAIA Chicago Chapter.

darn behavior gap keeps rearing its ugly head. Small changes to that simulation can have stunning results. Let's review a few, both positive and negative:

- **Working longer.** If the hypothetical investor worked just three more years, that large ending base of investment could potentially grow another $400,000 (based on average three-year returns).

- **Active versus index fund.** American Balanced is an actively managed fund with an average expense ratio through this period of 0.68%. That's low for an active fund, but nowhere near the next-to-free index fund expenses today. Importantly, American Balanced more than earned its fee. It added over a quarter million dollars more (in this simulation) than a fee-less index split 65% in stocks and 35% in bonds (average American Balanced allocation) would have. Pretty amazing results, especially with today's mantra of investing in the lowest-cost fund, no matter what. Don't get me wrong; fees are important, but they are not as important as selecting a great manager who earns them back and then some.

- **Increasing contributions.** Saving more is always a great solution (I know seeing this data has inspired me to save more). Increasing your contribution just 2% more with no equivalent employer match can add another quarter million to the end result. At just 8% of savings, this is still well below the 15-20% recommended by many in the industry.



Sources: *CLS Investments, Morningstar*
Assumptions: *Ending wealth is referenced to previous chart value ($1,090,631). Average three-year rolling return is used as a proxy for potential increase if working three more years; contributions are not included. Index fund reference is based on a mix of 39% Russell 3000 TR, 26% MSCI EAFE NR, and 35% BBGBarc Aggregate Bond Index. S&P 500 is used in place of Russell 3000 prior to 1979. Selling after a 10% decline assumes a 10% drawdown from high portfolio value and proceeds are held in cash for six months, ignoring transaction costs.*
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- **Sitting on the sidelines.** If 10% was kept in cash on the sidelines through the period, the $1 million mark would not have been reached.

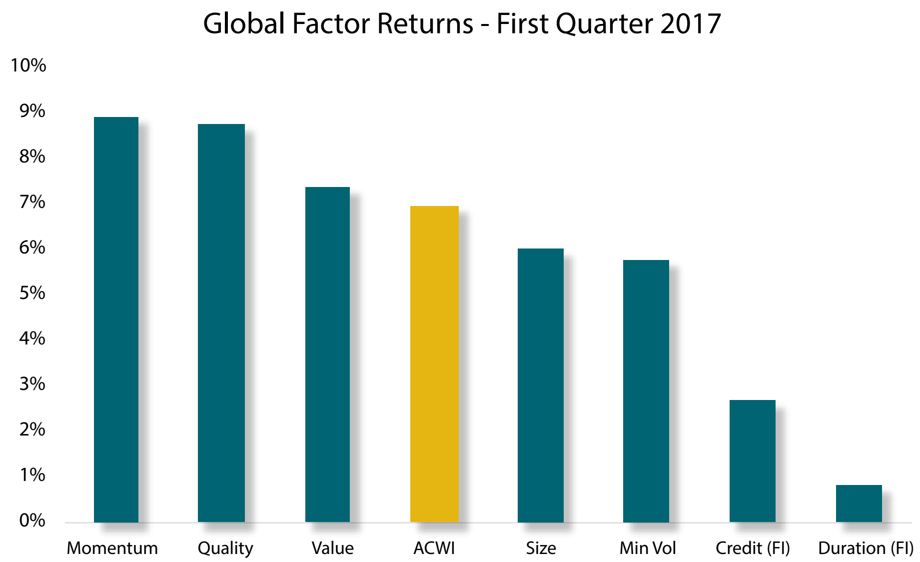
- **Running for the hills.** What if every time there was a 10% decline in your portfolio, you sold out and sat in cash for six months? The ending value of the portfolio would be quite a bit lower, and it would be worse the longer or more frequently you sat out. Amazingly, through this four-decade period there were only six instances where the 10% drawdown would have occurred due to the diversified, balanced nature of the fund. That definitely says something for making sure investors are allocated at the right Risk Budget!

There are hundreds of other decisions that could have derailed this journey to becoming a millionaire. And, the unfortunate truth is that millions of investors who may think they could avoid these decisions ultimately find a way to trip themselves up. In an era where account check-ups can happen every minute at the press of an app, investors feel empowered that they can do it all on their own. The ability to make decisions that can have real and serious consequences is easier than ever, and therefore the need for financial advisors to continue to coach, plan, and inspire investors is greater than ever.

The Factor Masters

"A tradition like no other..."

Spring is in the air, March Madness has ended and the first golf major of the year, the Masters, kicked off the beginning of hopefully a long golfing season. (We get really excited about the changing of the seasons here in Nebraska!) What better way to pay tribute to a golf tournament than to make analogies with investing? (If watching golf is your best cure for insomnia, bear with me, there are still some important non-golf takeaways here.)



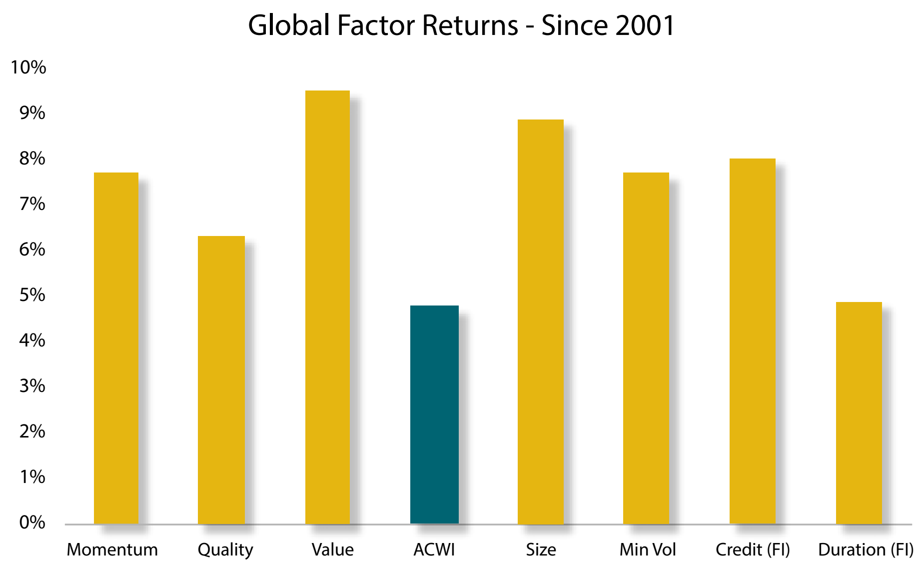
Source: *Morningstar, MSCI*

If you have been around CLS for a bit, you've noticed a heavy dose of writing and commentary on smart beta and factor-based ETFs. It can still be a vague subject, so it's always helpful to review and reinforce. A return factor (sometimes called "premium") is the return above a benchmark that is earned by a specific characteristic of stocks or bonds. An easy example is: undervalued stocks outperform over time. We look at seven global factors – five equity and two fixed income (FI) – each of which is displayed in the chart to the right. The MSCI ACWI Index is also displayed as a reference point.

1. **Momentum.** Momentum is the tendency for recently outperforming securities or assets to continue to outperform in the future. Momentum is generally most consistent when measured over 6- and 12-month time frames. So far this year, momentum has rebounded and is the best performing global factor, up nearly 9% through quarter end. Momentum has strong long-term performance as well, but it can be prone to painful reversals. Here comes the golf analogy: The world's number one golfer, *Dustin Johnson*, was untouchable in recent tournaments going into the Masters and clearly had very strong momentum (unfortunately a back injury forced him to withdraw).
2. **Quality.** Quality has several definitions, but generally points to investing in higher quality companies as measured by metrics such as debt, financial leverage, earnings variability, and return on equity or assets. Quality companies have also seen a strong rebound this year, performing just behind momentum. On the golf side, *Sergio Garcia* was second in both greens in regulation and driving accuracy and, of course, took home the trophy. Quality performance from Sergio.
3. **Value.** Perhaps the best known factor, value is the tendency for securities with low valuations to outperform those with higher valuations. It is usually measured by a price multiple, such as price-to-earnings (P/E), price-to-book value (P/B), or price-to-sales (P/S), among others. Value outperformed on a global basis in the first quarter, which was helpful for our Global Value investment

theme. It should be noted that most of this outperformance occurred overseas. The greatest value pick of all might have been at the Masters 20 years ago when a 21-year-old golfer tore the course apart and won by an astonishing 12 strokes. *Tiger Woods* went on to win a few more.

4. **Size.** The size factor is the tendency for small-cap companies to outperform larger ones. This factor has generated some controversy from time to time, but in general there is a risk premium for investing in smaller companies. Smaller companies had a tremendous run last year. They gave a little back last quarter but still had a strong showing. Size has historically shown exceptional performance, even adjusting for risk. Golf wise – *Ricky Fowler* gets my vote here. He's really not all that small, but he's definitely no *John Daly*. He packs some serious distance.
5. **Minimum Volatility.** Securities exhibiting low volatility have tended to outperform (particularly on a risk-adjusted basis) over time. Some of this has to do with their tendency to cushion the downside, one of the reasons ETFs targeting this factor are used in our Protection portfolio. Minimum volatility has lagged somewhat this year, but a 6% return in one quarter is nothing to frown about. Minimum volatility and quality have been considered defensive factors, which are an important part of a portfolio for managing downside risk.



Source: *Morningstar, MSCI. As of 3/31/2017*

6. **Credit.** This is one of our two fixed income factors. Taking credit risk, i.e., allocating to bonds that are *not* "risk free" (U.S. government-issued), has rewarded investors over time.
7. **Duration.** Extending the duration (roughly similar to the maturity of a bond) generally results in higher returns. There are a number of theories for this that I won't go into here. The fact that bearing duration risk is rewarding over time may come as a surprise to many who are hiding in short-duration, fixed income, or avoiding bonds altogether. Duration can also surprisingly be defensive – when stocks fall and bonds rise, longer-term bonds often rise more. Long-term Treasuries were up more than 30% in 2008. In golf, there is no better choice than *Fred Couples* for duration. He keeps tearing up the Masters even at age 57.

Please excuse the terrific (perhaps terrible?) pun, but at CLS we pride ourselves on being factor *masters*. Our portfolios are constructed to take advantage of these factor exposures that have proven to deliver alpha over time. Smart beta ETFs are constructed in the same way, typically taking advantage of one to several different factors. This is why we will continue to build portfolios with these smart building blocks – to fight for extra return and manage risk. It may not be as exciting as the final round of the Masters, but the payoff for investors can be lucrative.

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