CLS's WEEKLY 3

What You Need To Know About the Markets

OCTOBER 10, 2017

In This Edition

1. Which fears are really warranted for financial markets?
2. Managing expectations is good practice for both movie watching and investing.
3. How should investors evalutate when to follow the flow, sell the loved, and buy the unloved?

CLS INVESTMENTS

Market Performance

Equities	LAST WEEK	QTD	YTD '17
Total U.S. Market[1]	+1.27%	+1.27%	+15.36%
Domestic Large-Cap Equity[2]	+1.25%	+1.25%	+15.67%
Domestic Small-Cap Equity[3]	+1.32%	+1.32%	+12.40%
International Equity[4]	+0.46%	+0.46%	+21.69%
Developed International Equity[5]	-0.06%	-0.06%	+19.89%
Emerging Market Equity[6]	+1.99%	+1.99%	+30.33%
Fixed Income	**LAST WEEK**	**QTD**	**YTD '17**
U.S. Investment Grade Bonds[7]	-0.15%	-0.15%	+2.98%
Cash Equivalent[8]	+0.02%	+0.02%	+0.57%
Commodities	**LAST WEEK**	**QTD**	**YTD '17**
Commodity[9]	-0.61%	-0.61%	-3.46%

[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 Index

As of 10/6/2017

Week in Review

Most major equity markets were up over the last week. Domestically, small-caps slightly outperformed large-caps. Domestic stocks also outperformed international in aggregate, but developed international markets notched a slight loss while emerging markets were top performers within equities, up almost 2%.

The bond market had a slight loss as the 10-year Treasury yield rose through the week, getting close to the 2.4% level. Commodities were the laggards for the week as oil and gold prices fell in the face of a strengthening dollar.

On the economic front, the U.S. had its first negative payroll number in seven years, well below expectations. But, the news was generally shrugged off by the markets as data distortions in less stable metrics are expected over the next few months as a result of the hurricanes. More importantly, wage growth increased, unemployment fell, and the Institute for Supply Management's manufacturing index surged above 60 (a 13 year high), leading to a view of a strengthening economy and an increased probability for a Federal Reserve rate hike in December.

"I told the others, they didn't believe me. You're all doomed. You're all doomed." – Crazy Ralph, Friday the 13th Part 2 (1981)

Have you ever heard of paraskevidekatriaphobia? Try saying that three times fast. It is the fear of Friday the 13, which happens to be this Friday. It appears to be a real thing, and some studies show industries, such as airlines, suffer from severe losses on such days. Triskaidekaphobia, the fear of the number 13 itself, seems even more widespread as many buildings, such as hotels and hospitals, skip the 13 floor. Well, I have some bad news for those that have these fears, there is at least one Friday the 13 every year, although it is rarer for it to fall in the Halloween month of October.

Fears of numbers and dates can safely be placed in the category of misplaced. But in relation to financial markets, investors may have legitimate-seeming fears that are also misplaced. So, how can we determine what fears matter? A simple answer is to look at facts and data, which are not typically the focus of sensational news headlines. The data component is key. First, it can be measured. Second, most data series are cyclical in the financial world, allowing investors to generate probabilities for events to happen. Let's evaluate a few typical categories of events for misplaced fears:

Top Three Investment Concerns at CLS

➤ U.S. Stock Market Valuations

- Still at elevated relative levels
- Relative valuation levels usually means to expect below average U.S. market returns
- CLS emphasizes international equities

➤ Global Debt Levels

- Historically high levels, which are still rising
- High debt levels have been associated with lower overall economic growth
- CLS emphasizes emerging markets equities, which tend to have higher growth and lower debt levels

➤ Investor Expectations and Emotions

- Increased volatility and potentially below-average domestic returns
- This increases the need for financial advisors and money managers to set realistic expectations and coach investors through difficult times
- CLS emphasizes the importance of staying balanced and globally diversified

- **Politics:** The U.S. president is in the news constantly, and there are plenty of high-profile elections abroad, particularly in Europe, generating headlines. While some major policy actions (such as lowering the tax rate) may be impactful to the economy and the markets, it is often speculative whether they will actually become legislation. All of the other day-to-day politics is mostly noise.

- **Nuclear Threat and Terrorist Attacks:** Fears around nuclear weapons have resurfaced after several tests out of North Korea, and terrorist attacks continue around the globe. But, nuclear action has a low probability and consequences are hard to evaluate and measure. Terrorist attacks do not typically impact economic growth or company earnings. *The key takeaway is*: If you can't measure it, keep it separate from financial markets. That said, cybersecurity attacks (hackings) have been on the rise recently, and those may warrant a watchful eye.

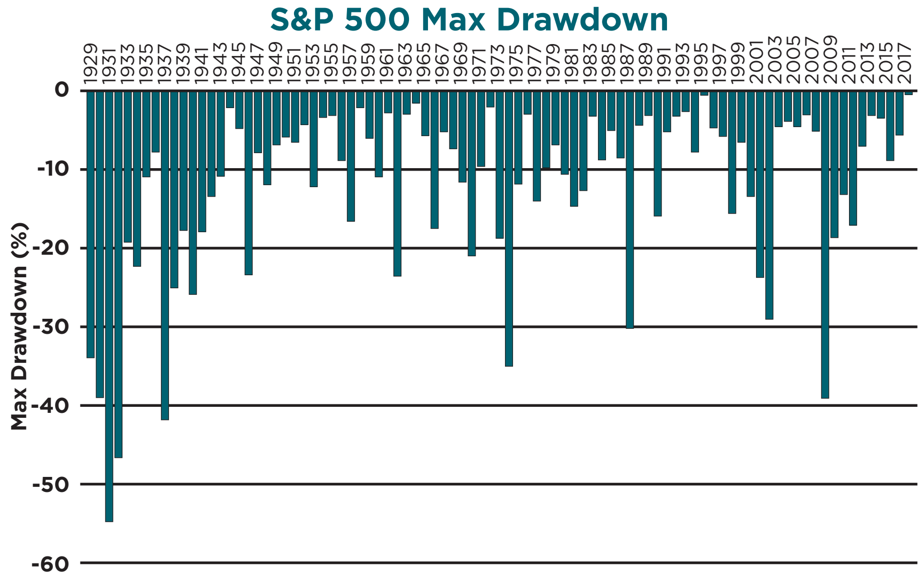
- **Weather:** Weather is hard to predict, although meteorologists may have you thinking otherwise. But, if a natural disaster does occur, its long-term effects are not always clear. While it may have an immediate negative impact on short-term economic growth, longer-term growth may benefit as industries, such as construction, boost productivity. Thus, since we cannot predict the weather or quantify the long-term effects, it may not be a good market movement indicator.

At CLS, we evaluate a long list of potential concerns that may impact the markets and investors (the ones listed above are on our list). But, we whittle it down to our Top Three Investment Concerns, which are published as part of our Monthly Perspectives. Currently, we are concerned with U.S. stock market valuations, global debt levels, and investor expectations and emotions. A summary of each is presented here, but following the link above will provide more detail about each concern and how CLS is addressing them. If you are questioning the last one, have no fear, we take a deeper dive into managing future expectations in the next section.

"The light that burns twice as bright burns half as long, and you have burned so very, very brightly, Roy." – Eldon Tyrell, Blade Runner (1982)

As you may know, I love watching movies. But, I am often disappointed with great movies because I hype them up in my mind to unreachable expectations. A recent example is *"The Big Sick"*. It was a great movie, but the great reviews and high praise from trusted colleagues elevated my expectations and I ended up feeling disappointed after watching. I am trying to learn from my mistakes for the highly anticipated *"Blade Runner 2049,"* which hit theaters last weekend (I have not watched many trailers or read reviews in an attempt to keep expectations at reasonable levels).

The markets are no different. Investors often have high expectations for market returns, which often leads to disappointment when the market doesn't deliver. These expectations are elevated by the same forces driving those of movies — colleagues discussing their successes, sensational media headlines, and analyst and economist forecasts (similar to critics' movie reviews). In addition, as bull markets heat up, continuing to grind higher and higher, expectations continue to rise. Then any type of negative market action may cause an unwarranted investor reaction — for example, selling investments in a panic as they hit bottom.



Morningstar Direct data as of 9/30/17

At CLS, we do not believe a bear market is on the horizon, but we do foresee below-average returns in the years to come. And, let's not forget that short-term market corrections are not out of the ordinary. A bear market is unlikely because there are no signs of an economic recession — global economic growth is stable and strengthening in many countries and corporate earnings have rebounded in 2017 after several years of weakness. So, why should expectations be curtailed?

1. U.S. stock market valuations are at record highs, which would suggest a higher probability of reversion to the mean and weaker performance ahead.
2. Since 1929, the U.S. market has never experienced a full year with such a small maximum drawdown as we have had in 2017, see the chart above.
3. This is the first year since 1970 that the U.S. market has not had a single monthly negative total return.
4. The U.S. market hit its sixth consecutive high last Thursday, the longest streak in 20 years and the Chicago Board of Exchange Volatility Index (a measure of expected stock swings) fell to an all-time low, passing the last record set in 1993, according to the [Wall Street Journal](#).

All of these statistics suggest this is not the time to get comfortable. Markets are cyclical in nature and a reversal of direction may come sooner than later. This is why it is important to stress a balanced and globally diversified approach to investing that focuses on targeting risk based on both ability and willingness to take it on. Such an approach will help moderate expectations and help investors stay invested for the long run.

What is the Herd Buying These Days?

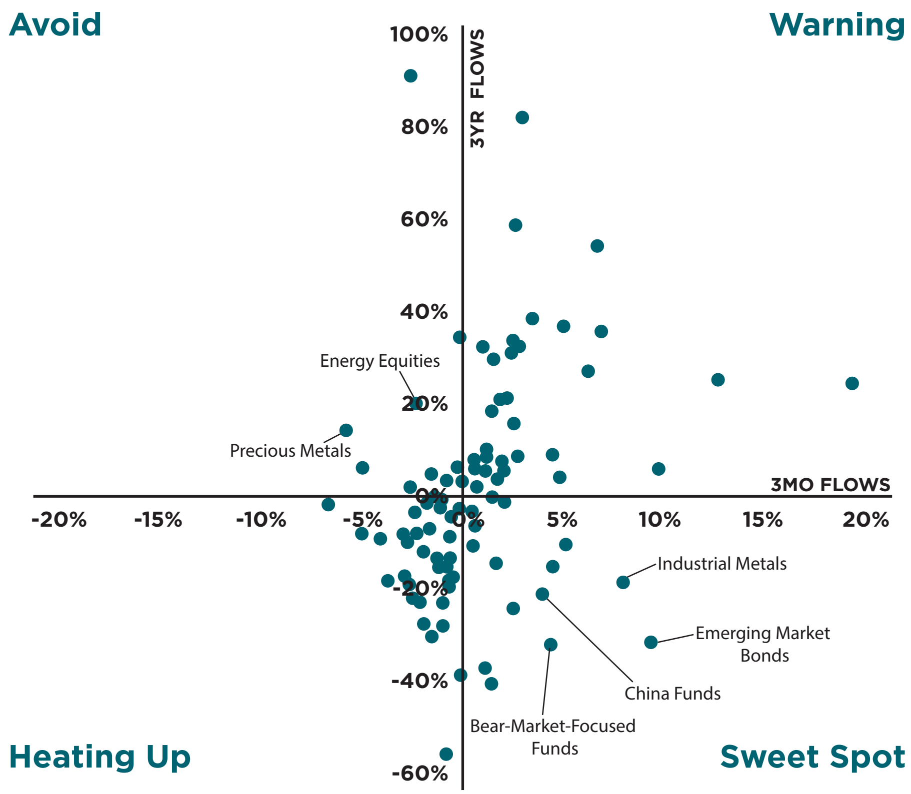
"Ever wonder why fund managers can't beat the S&P 500? 'Cause they're sheep - and the sheep get slaughtered. I been in the business since '69. Most of these high paid MBA types, they don't add up to dog xxxx. Gimme guys who are poor, smart, and hungry. And no feelings. You win some, you lose some, but you keep on fighting... and if you need a friend, get a dog."
– Gordon Gekko, Wall Street (1987)

You have to be different to win in the game of markets. Investors often flock together like sheep into the best performing investments, and they all fall off the cliff together when those investments turn over. Some may believe they are different by investing in unique positions they may have read about or seen in the news (if you see it in the news, it is actually old information). So, while they think they are wolves, they are actually sheep in wolves' clothing.

To truly be different, you have to go against the herd. You have to invest opposite to what everyone else flocks to. Sounds simple, right? It is actually very difficult and uncomfortable for most investors. But, stepping out of that comfort zone, leaving feelings behind, and doing what logic suggests is how legends are made.

One of our key areas of analysis is evaluating behavioral movements in the markets. Behavioral analysis is comprised of technical analysis, which is the study of price action, and investor sentiment, which focuses on what investors are thinking, saying, and doing. Investor sentiment can be evaluated in two ways: investor sentiment surveys, which Rusty hit on in the last Weekly 3, and investment flows, what people are actually buying and selling.

Morningstar Category Net Asset Flows (%)



Morningstar Direct data as of 8/31/17

We have tested flows data and found short-term (three month) flows have a positive relationship with future returns, making it good advice to "follow the flow." On the other hand, long-term (three-year) flows have a negative relationship with future returns. "Sell the loved, buy the unloved." A good way to see where the herd is moving these days is to examine percentage flows for Morningstar Categories for mutual funds and ETFs.

The accompanying scatter plot contains too many categories to provide labels, but I will highlight some of the key observations. Some of the "sweet spot" categories (+3 month, -3 year) include emerging market bonds, bear-market-focused funds, China and Pacific Asia international markets, and select commodity sectors (agriculture and industrial metals). The areas to avoid based on this analysis (-3 month, +3 year) include precious metals (such as gold) and energy equities.

Note that many of the loved categories with positive flows on the three-year also have positive three-month flows ("warning" quadrant). In these instances, investors would want to wait for the three-month flows to reverse before selling. Similarly, many of the unloved categories with a negative three-year flow are also negative on the three-month ("heating up" quadrant) and will become sweeter when those three-month flows reverse.

This is one of many different types of analysis that we use to help make investment decisions.

Kostya Etus, CFA

Portfolio Manager

Konstantin "Kostya" Etus specializes in international investments. He is a co-manager on two mutual funds (aggressive allocation and international) and manager on various separate account strategies, including Core Plus ETF and SRI/ESG. In addition, he manages 529 plans.

Mr. Etus has eight years of investment experience, including six at CLS. He began his career at CLS in 2011 as a trading specialist and became a research/portfolio analyst in early 2013. In 2016, he was promoted to Portfolio Manager. Prior to working at CLS, Mr. Etus worked as an associate financial analyst at ConAgra Foods, Inc., managing the company's global cash network.

He graduated from the University of Nebraska at Omaha with a Bachelor of Science degree in business administration and obtained Master of Investment Management and Financial Analysis and Master of Business Administration degrees from Creighton University. He holds the Series 65 securities registration and the Chartered Financial Analyst® (CFA) designation.

Did you know? Kostya grew up in Soviet Russia.

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 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 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 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 MSCI EAFE 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 Emerging Markets Index is a composite index which tracks performance of large and mid-cap firms across 21 countries classified as emerging market countries. The Bloomberg Barclay's Capital U.S. Aggregate Bond® Index measures the performance of the total United States investment-grade bond market. The Bloomberg 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 exchange-traded futures on physical commodities and represents commodities that are weighted to account for economic significant and market liquidity. 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.

The graphs and charts contained in this work are for informational purposes only. No graph or chart should be regarded as a guide to investing. 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. This material does not constitute any representation as to the suitability or appropriateness of any security, financial product or instrument. There is no guarantee that investment in any program or strategy discussed herein will be profitable or will not incur loss. This information is prepared for general information only. It does not have regard to the specific investment objectives, financial situation, and the particular needs of any specific person who may receive this report. Investors should seek financial advice regarding the appropriateness of investing in any security or investment strategy discussed or recommended in this report and should understand that statements regarding future prospects may not be realized. Investors should note that security values may fluctuate and that each security's price or value may rise or fall. Accordingly, investors may receive back less than originally invested. Past performance is not a guide to future performance. Individual client accounts may vary. Investing in any security involves certain non-diversifiable risks including, but not limited to, market risk, interest-rate risk, inflation risk, and event risk. These risks are in addition to any specific, or diversifiable, risks associated with particular investment styles or strategies.

3052-CLS-10/10/2017