CLS's WEEKLY 3

What You Need To Know About the Markets

DECEMBER 5, 2017

In This Edition

1. Tax reform should be mildly positive economically, at least in the short term.
2. Politics are emotional, and emotions and investing don't mix well.
3. Real estate is becoming a more attractive asset class. Should investors take note?

CLS INVESTMENTS

Market Performance

Equities	NOVEMBER	YTD '17	12-MONTH
Total U.S. Market[1]	+3.04%	+19.93%	+22.27%
Domestic Large-Cap Equity[2]	+3.07%	+20.49%	+22.87%
Domestic Small-Cap Equity[3]	+2.88%	+15.11%	+18.34%
International Equity[4]	+0.81%	+24.41%	+27.59%
Developed International Equity[5]	+1.05%	+23.06%	+27.27%
Emerging Market Equity[6]	+0.20%	+32.53%	+32.82%
Fixed Income	**NOVEMBER**	**YTD '17**	**12-MONTH**
U.S. Investment Grade Bonds[7]	-0.13%	+3.07%	+3.21%
Cash Equivalent[8]	+0.08%	+0.72%	+0.76%
Commodities	**NOVEMBER**	**YTD '17**	**12-MONTH**
Commodity[9]	-0.46%	-1.24%	+0.54%

[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 11/30/2017

November Market and Portfolio Review

Last week was great for the markets. New highs were reached, market milestones were passed, and the market saw its best day and week of gains in a long time, which is saying a lot given how exceptional the year has already been.

For the month, it was just another in an incredible bull market. The bull market for the S&P 500 is easily the second strongest and second longest ever. But, just because it's old doesn't mean it has to end soon. In my eyes, the bull market appears to be in the seventh inning for a variety of reasons — and, we don't yet know if it will end up in extra innings.

One observation from the week was increased price volatility. News out of Washington, which included historic tax reform, was the catalyst for this movement. More on this in a bit.

First, let's review the numbers. It was another good month for global markets. The overall U.S. stock market (Russell 3000 Index), larger companies (S&P 500 Index), and even smaller companies (Russell 2000 Index) all gained about 3%.

Overseas markets also gained, but lagged the U.S. after trailing considerably the last week of the month. Overall, international markets (MSCI ACWI ex-U.S. Index) ended higher last month by 1%, with developed markets (MSCI EAFE Index) higher by 1% and emerging markets basically unchanged. Emerging markets led the charge all year, but gave back some of their substantial outperformance.

The bond market (Bloomberg BarCap Aggregate Bond Index) was essentially unchanged, too. The 10-year Treasury bond yield ended last month at 2.42%, up from 2.38% from the end of October. Commodities (Bloomberg Commodity Index) were down less than 1%.

CLS portfolios participated in the gains. Our emphasis on international securities, however, caused portfolios to lag the final week and, ultimately, the month. In terms of sector positioning, our emphasis on financials helped, but our emphasis on technology did not. Nonetheless, our high-conviction view that international can continue to outperform the U.S. market remains strongly intact.

S&P 500 Longest 20% Rallies (Bull Markets)

Start	End	Start Price	End Price	% Change	Days
12/4/87	3/24/00	223.92	1527.46	582.15%	4,494
3/9/09	11/30/17	676.53	2598.38	284.07	3,188
6/13/49	8/2/56	13.55	49.74	267.08%	2,607
10/3/74	11/28/80	62.28	140.52	125.63%	2,248
7/23/02	10/9/07	797.70	1565.15	96.21%	1,904
8/12/82	8/25/87	102.42	336.77	228.81%	1,839
10/22/57	12/12/61	38.98	72.64	86.35%	1,512
4/28/42	5/29/46	7.47	19.25	157.70%	1,492
6/26/62	2/9/66	52.32	94.06	79.78%	1,324
5/26/70	1/11/73	69.29	120.24	73.53%	961

Source: BeSpoke

Rusty Vanneman, CFA, CMT

Chief Investment Officer

Rusty Vanneman is responsible for all investment operations at CLS, including investment philosophy, process, people, positioning, and performance. Mr. Vanneman is also responsible for internal and external communications regarding market environment and current investment strategies. He is part of the management team on two mutual funds (one aggressive and one balanced).

*Mr. Vanneman joined CLS in September 2012 as Chief Investment Officer. Previously, he served as 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 and he served as 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 degree in Management from Babson College where he graduated with high distinction. He has held the Chartered Financial Analyst (CFA) designation since 1994, and is a member of the CFA Institute. He has also been a Chartered Market Technician (CMT) subce 1999, and a member of the Market Technician's Association (MTA). In addition, Mr. Vanneman authored the book "Higher Calling: A Guide to Helping Investors Achieve Their Goals." He was named one of the Top 10 Portfolio Managers to Watch by Money Management Executive in 2017.**

Did you know? Rusty had a brief stint as a cowboy near Valentine in Cherry County, Nebraska.

**CLS Investments, LLC ("CLS") Chief Investment Officer, Rusty Vanneman, CFA, CMT, was selected as a "Top 10 Fund Managers to Watch" in 2017 by Money Management Executive. Money Management Executive is an unbiased, third-party publication covering the asset management industry. Money Management Executive chose the list of managers to watch by screening Morningstar data from funds with a single manager, ranked as having the best three-year annualized returns in their respective categories. The list of managers was published March 27, 2017. Money Management Executive is not affiliated with CLS. Ratings and awards may not be representative of any one client's experience and are not indicative of CLS's future performance.*

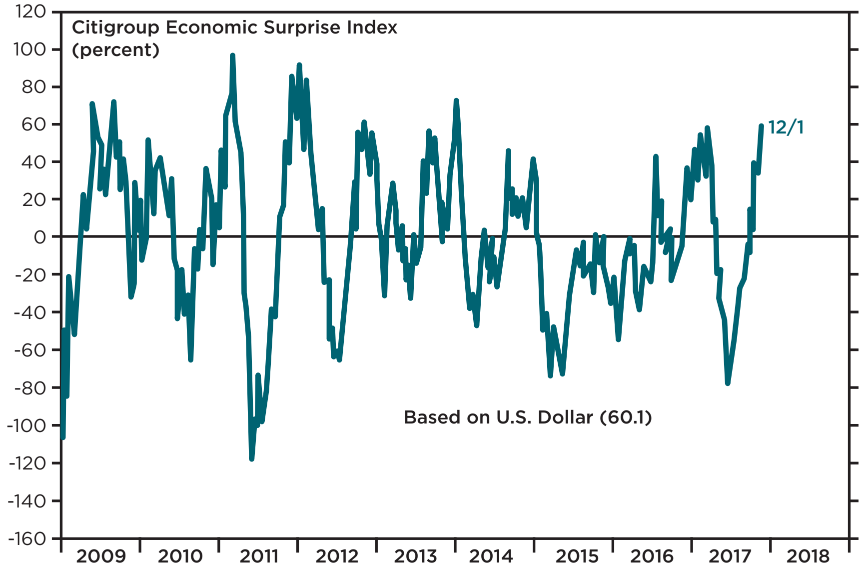
The big news to close the week, of course, was massive tax reform passed by Congress. While the House and Senate still need to reconcile their two bills, reform passed the two chambers quicker than many expected.

At CLS, we invest by taking advantage of what the market gives us. At the moment, it's hard to tell what this tax reform will provide. Short-term, it should have a modestly positive impact on the economy. Some studies suggest the overall U.S. economy could benefit, but early estimates point to less than a quarter point of gross domestic product (GDP). That's a plus, but not necessarily a game changer.

Longer-term, however, the federal debt will continue to loom large, and it's unclear whether the economy will grow fast enough to generate sufficient tax revenue to offset the lower tax rates. If it doesn't, our national debt, which is already holding back long-term economic growth expectations, will only get worse. Money spent to pay off debt isn't being spent on productive investments, such as infrastructure.

Lastly, and most importantly, while some commentators say recent market gains are being driven by the potential for tax reform, I strongly disagree. Economic and earnings data have been fantastic, consistently above expectations, and accelerating. That's the stuff of market gains.

Citigroup Economic Surprise Index



Source: Citigroup, as of December 1, 2017

For example, above is a chart of the Citigroup Economic Surprise Index. It shows economist expectations have been too negative given the strength of actual economic data. The economy is stronger than most expected, and by some measures it could be argued it's as strong as it has been in more than a decade. Another case in point is that consumer confidence in the U.S. just reached a 17-year high.

Political Bias Doesn't Help Investors

One last point on tax reform or any political policy: politics can impact investment decision-making, and in my 30 years in the markets, I have yet to see a strong political bias help an investor make good long-term investment decisions.

For example, we recently wrote about the potentially negative impact of tax reform on residential real estate in high-tax states, such as New York. This was not an out-of-the box view; it was, quite frankly, a consensus stance. But, we were strongly rebuked as being too political. This shows the kind of bias that can cloud our abilities to make sound judgements.

We believe investing and politics don't mix. I recall a study from about ten years ago that showed politically conservative investors outperformed politically liberal investors. Who knows if the study was even correct, but intuitively it seemed correct to me at the time. Among my high-net-worth clients, who included an even mix of political views and biases, it seemed the study could be on to something.

Then, President Obama was elected. More conservative investors, in general, became less optimistic and more defensive in their portfolios. And, of course, more liberal investors became more optimistic and more aggressively positioned. Another study I read a few years ago confirmed Democratic investors had more money invested in stocks than Republicans. Given the stock market's performance since 2008, it's easy to see if the prior study was updated it would surely have shown a different conclusion.

Then, President Trump was elected. Many conservative investors jumped back into the markets a year ago, and many politically liberal investors pulled back. Well, the market has had an epic run over the last twelve months. Many investors got whipsawed due to their political views when they should have just held steady.

Investors just typically give way too much credit to the political party of the president. There is so much more that goes into the markets and impacts how they move. Granted it's easier to see the visible fist of the government than the invisible hands of the market, but ultimately we see the key to long-term stock market returns are fundamental factors, such as earnings and valuations.

Time to Invest in Real Estate?

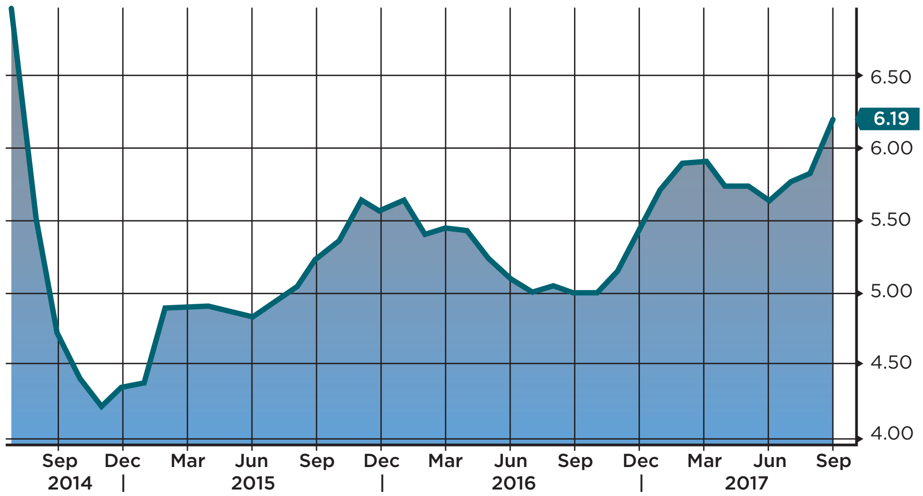
When talking to investors, one of the most common topics I'm asked about is real estate. It makes sense. For most investors, their homes and properties are their most significant assets.

As an investment manager, I believe there are two practical points to discuss: the impact of the national housing market on economic growth and inflation and what opportunities that presents for stock market investors.

At the national level, the real estate market is doing fine, if not very well as of late. Sales have clearly picked up recently. Sales of new, single-family homes hit a 10-year high in October, and there is strong demand across the country. Buying interest remains high, fueled by strong consumer confidence and growing wage growth.

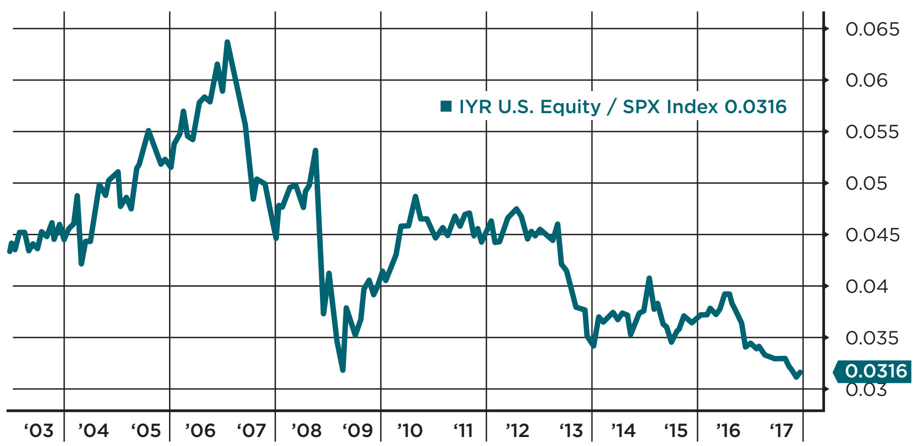
The only problem with housing sales, however, is the supply of homes for sale. Inventories have fallen for 29 straight months on a year-over-year basis. They are down more than 10% over the last year alone. A key industry stat - how many months' supply of existing homes is available - dropped to 3.9 months in October. This refers to the length of time it would take to sell the current inventory at the most recent sales pace. A general rule of thumb is less than five months suggests a tight supply. Yet, demand remains strong nationally, with nearly 50% of existing homes on the market selling in less than a month.

Home Price Index Year/Year Change



Source: Bloomberg via Enduring Investments, data is from November 30, 2011 through September 30, 2017

Real Estate Sector Performance



Source: Bloomberg, data from December 31, 2002 to November 27, 2017

Housing prices are therefore likely to keep going up, as they have in recent years and perhaps at faster rates.

The top chart above is a chart of the Shiller 20-City Home Price Index year-over-year change covering the last three years.

Rising home prices will eventually translate into inflationary pressures, which we haven't seen much of in recent years. Inflation expert Mike Ashton from Enduring Investments said recently: *"...as home prices rise, it isn't just the value of the investment in the home that is rising but also its cost as a consumption item. Because shelter to rent is a substitute for shelter that you own, rising home prices tends to imply that rents also accelerate. Recently, 'Owner's Equivalent Rent' has been decelerating somewhat, although only coming back to our model. But the gradual acceleration* *in the home price increase implies that shelter inflation is not going to continue to moderate, but rather should continue to put upward pressure on core inflation, of which 42% consists of 'Rent of Shelter.'"*

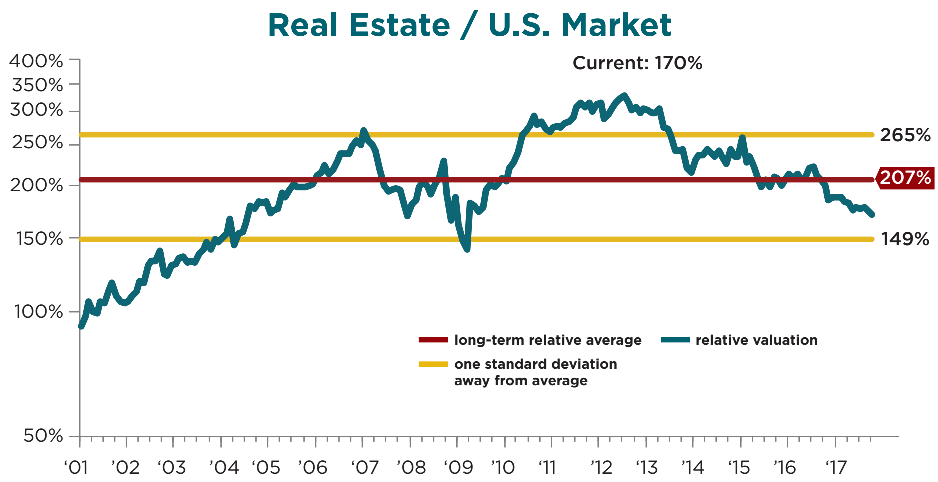
If real estate prices are rising, stock market investors may benefit from investing more in real estate stocks, which is commonly done through Real Estate Investment Trusts (REITs). REITs are interesting investment vehicles that allow investors to invest in both real estate property and mortgages. REITs offer more than residential real estate. They include residential and commercial properties both domestically and around the world.

At CLS, we are increasingly intrigued by REITs as an asset class that we can emphasize in portfolios, perhaps as much as we have been in more than a decade. We like to buy markets on sale, so REITs are a good fit. Real estate has clearly underperformed in recent years. As the bottom graph on the previous page shows, the sector has trailed the S&P 500 over the last 10-plus years.

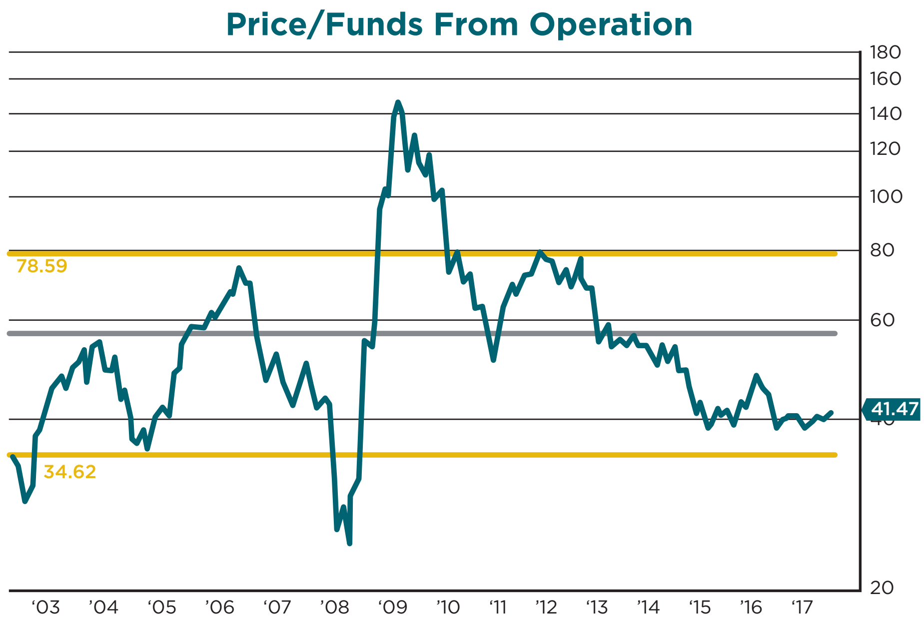
Despite years of underperformance, REITs are finally starting to look attractive when reviewing relative valuations. Currently, using our standard relative valuation package from our monthly Chart Pack, REITs are trading well below their relative valuation average since 2001 (using the data in the top chart to the right, they are at a 170% premium to the overall stock market, which favorably compares to the 207% premium they have averaged since 2001).

Those are the traditional valuation metrics we use when reviewing investments at CLS. Many, however, think price-to-FFO (funds from operations) is a more effective method of valuing real estate. We don't disagree, and on this measure, real estate looks even more attractive.

The problem, however, is real estate prices keep slipping backwards in terms of relative performance.



Source: CLS Investments, LLC, as of October 31, 2017



Source: Factset
*Note that the timeframe is 15 years as of October 31, 2017

Time to Invest in Real Estate?

Momentum is still not strong. Once prices start to improve on a relative basis though, CLS will likely start buying this sector again. We have been underweight to real estate relative to the overall market in recent years, which has helped performance, but we will likely become overweight in the months ahead.

In sum, this example (to the right) of how we examine an asset class is an excellent, though simplified, illustration of how we build and manage investment portfolios.

As always, a sincere thank you for reading. If you have any questions or feedback, please let me know.

Stay balanced.

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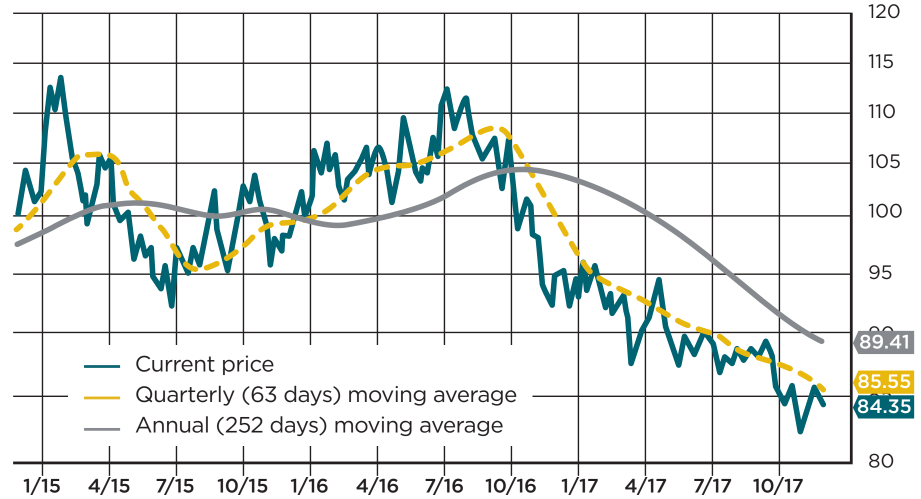
Vanguard REIT ETF (VNQ-USA)



Source: CLS Investments, LLC

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.

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