CLS's WEEKLY 3

What You Need To Know About the Markets

JANUARY 3, 2018

1. Year in review - What worked? What didn't? What's changed?
2. Tax reform's potential impact - What should investors do?
3. Active investment management - The trend from active to passive is not the real story.

CLS INVESTMENTS

Market Performance

Equities	DECEMBER	YTD '17	12-MONTH
Total U.S. Market[1]	+1.00%	+21.13%	+21.13%
Domestic Large-Cap Equity[2]	+1.11%	+21.83%	+21.83%
Domestic Small-Cap Equity[3]	-0.40%	+14.65%	+14.65%
International Equity[4]	+2.24%	+27.19%	+27.19%
Developed International Equity[5]	+1.61%	+25.03%	+25.03%
Emerging Market Equity[6]	+3.59%	+37.28%	+37.28%
Fixed Income	**DECEMBER**	**YTD '17**	**12-MONTH**
U.S. Investment Grade Bonds[7]	+0.46%	+3.54%	+3.54%
Cash Equivalent[8]	+0.09%	+0.82%	+0.82%
Commodities	**DECEMBER**	**YTD '17**	**12-MONTH**
Commodity[9]	+2.99%	+1.70%	+1.70%

[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 12/31/2017

December Market and Portfolio Review

Despite losing some ground during the last week of the year, the overall U.S. stock market finished December with gains and marked the first time the stock market had a positive finish every month of the calendar year. It was a very good year.

The overall U.S. stock market (Russell 3000 Index) gained 1% last month, finishing 2017 with a 21% gain. Larger companies (S&P 500 Index) also gained 1% and finished the year with a 22% gain. Smaller companies (Russell 2000 Index), meanwhile, slid slightly lower (less than -1%) and finished 2017 with a lagging, but still impressive, 15% gain. Value stocks slightly outperformed growth stocks in December, but both finished with approximately 1% gains. For the year, growth stocks were up nearly 30%, while value stocks lagged considerably with a gain of just more than 13%.

Overseas markets gained more than 2% last month (MSCI ACWI ex-U.S. Index) and finished the year with a 27% gain. Developed markets (MSCI EAFE Index) gained less than 2% and finished with a 25% gain on the year. Emerging markets gained nearly 4% in December and finished the year up 37%. International stock markets had a very, very good year.

The bond market (Bloomberg BarCap Aggregate Bond Index) gained less than 1% last month and finished the year higher by nearly 4%. The 10-year Treasury yield ended the year above 2% — essentially unchanged for the month and year, give or take a few basis points.

Commodities (Bloomberg Commodity Index) had a great month, moving up nearly 3% and salvaging the year with an overall gain of 2%.

CLS portfolios experienced strong absolute and relative performance last month. Major asset classes all finished higher, which propelled absolute returns, and our relative performance was driven by our primary portfolio tilts that were nearly all rewarded, including our emphasis on international stocks (especially emerging markets), value stocks, and, to a lesser degree, real assets, such as commodities. Offsetting performance to a degree was our emphasis on financial stocks, which lagged in December

Last Year's Outlook: What Worked, What Didn't, and What's Changing?

Last year saw extraordinary market performance. Returns for globally diversified investment portfolios were very strong, and price volatility was at historic lows. Risk-adjusted returns don't get much better than that.

At CLS, our portfolios performed well in 2017. Not everything worked, of course, but on balance, our portfolio positioning was effective.

At the beginning of the year, our core outlook included an expectation that the U.S. stock and bond markets would post positive, but likely below-average returns. We expected international markets, especially emerging markets, to perform better, if not much better, than U.S. markets. Real assets, such as commodities, were becoming increasingly attractive, and we expected the overall economy to improve slightly. We also expected value-oriented sectors to perform better than growth-oriented sectors — all in an environment with increased price volatility.

In short, we made the right big calls. In fact, if an investor compares any two investment portfolios' performance last year (or most years for that matter), the answers to two questions will explain relative performance:

1. How significantly were the portfolios exposed to the stock market?
2. How much of that exposure was in international stocks?

Depending on the comparison peer group, CLS portfolios likely had more exposure to the global stock market, especially to the international markets, including emerging markets. We had these basic, key calls right.

We did not, however, call value-oriented stocks correctly as they did not outperform. Technology, or technology-oriented, stocks outperformed, including the big four: Apple, Facebook, Alphabet (Google), and Amazon. While CLS had exposure to each company, we did not have as much as our benchmarks due to their higher valuation, and thus gave up some relative performance.

Meanwhile, commodities posted gains last year, but did not enhance risk-adjusted performance. That was not the right call, but we were likely early on this prediction. We continue to believe that commodities remain attractive as prospects to improve overall risk-adjusted portfolio performance.

The stock market also saw its lowest price volatility in decades. We missed on that by a mile as we consistently expected more price volatility. Nonetheless, our prediction didn't hurt performance in any material way. It was just a wrong call.

Moving forward, our outlook will not change much, but the degree of emphasis in some cases will be altered slightly. We favor value stocks a little more than we did last year. We favor real assets, such as commodities, a little more. We still favor international and expect potential outperformance in the years ahead, but that expected return differential has slimmed somewhat given the strong relative returns in international stocks this year.

We still think it's the right call to expect more price volatility in the markets. In fact, the longer the market is fairly quiet and sedate, the more investors should prepare for volatility, perhaps significant volatility, in the future. It's how the markets typically work, rotating from high- to low-volatility periods over and over again. Volatility is cyclical, like everything else in the markets.

Even with expected volatility, which could also mean not only losses but large, destabilizing gains in the year(s) ahead, long-term investors should hold the course with current portfolios. However, investors who need to pay short-term liabilities and have stock market exposure in the funds needed to pay those bills should get more conservative. In my strong opinion, it is just prudent to always expect near-term losses even though the market has a positive return approximately 75% of the time over any one-year time frame.

Tax Reform: What Should Investors Do Now?

The Tax Cuts and Jobs Act is the most significant tax reform passed in the U.S. in decades. Given its significance, it is unfortunate it was finalized so late in the year as there were action items, or at least prospective action items, to consider before year-end for many taxpayers. Its late passage did not provide much opportunity for investors to discuss their situations with tax accountants. Accelerating deductions, for instance, might have been a helpful course of action for some investors.

At CLS, where we manage investments and not individual tax situations, we have a broader perspective on the impact of the tax reform law. Before making any investment decisions, as always, we will wait to see what the market gives us to work with. There will be winners and losers, and the early views and popular narratives won't necessarily play out as expected. It's usually best for us to buy what's on sale instead of guessing what may come to be.

Nonetheless, here are our current thoughts on the matter. While it is the largest tax reform legislation in decades, its impact on the economy and markets probably won't be as significant, nor as positive as many expect. We expect only a mildly positive impact on the economy and markets in nominal terms over the short term.

All else being equal, putting more money in people's hands is a good thing. They can decide best how to spend it. This element of the legislation will have a positive impact on the economy as the money spent will surely have a multiplier effect as it flows through the economy. This all said, we are money managers not economists at CLS, and our general growth expectation follows the basic consensus that the law may improve the economy's GDP by a quarter point (the highest number I've seen is 0.7%). So, that's good.

Higher growth is also good for the stock market, all else being equal, but the stock market is a discounting mechanism and usually ahead of actual growth. The market isn't about rewarding past growth, it is about the prospect of future growth and returns. Most likely, there's a strong chance that much of the legislation's impact on potential economic growth has already been baked into stock market gains.

However, with higher corporate profits anticipated due to lower corporate taxes, we expect corporate activity to reward shareholders. While it would be great to see corporations spend more on future growth via capital expenditures (and some of that will surely happen), we expect a significant part of the windfall will be spent on stock buybacks. It's just a quicker way for shareholders to get paid. In addition, we expect employees will see an uptick in wage growth, too, given the windfall and current high rate of corporate profitability — but, I've expected that before and have yet to see it happen.

Okay, so investors should expect a mild bullish bump to the market given tax reform. What about longer-term? Here, we have three longer-term concerns about the law.

First, the economy is doing very well without tax reform. Many think the economy could do better (somebody is always hurting economically somewhere), but in historic and overall terms, the economy is strong. Fiscal policy changes, such as tax reform, are pro-cyclical, meaning they should provide an economic boost. However, since the economy is already strong, there's a chance reform could lead to inflation. While conventional views about inflation have not played out in recent years (the "Amazonification" of the economy is one leading reason), it is still intuitively true that a strong economy coupled with tight labor and real estate markets will result in inflationary pressures. We therefore expect the potential increase in inflation could be more influential than the increase in nominal GDP growth. In other words, while the economy might grow because of tax reform, that growth may end up an illusion if inflation increases more than GDP.

Our second concern is debt, which is quickly increasing. It is reasonable to expect high levels of debt to translate into a ceiling on economic growth as the debt will eventually need to be repaid one way or another. This has been a problem for years and is one reason economic growth has been below average, interest rates have been much lower than the long-term averages, and the U.S. dollar is getting weaker. High debt levels will likely continue to put pressure on these asset classes.

Lastly, while we are generally positive on the overall prospect of real assets, such as real estate, it is interesting to note the new tax law could have a negative impact on the real estate market in high-tax states, such as New York, New Jersey, and California. These states arguably have the largest impact on stock market direction given the amount of money investors from those states have invested in the market. If high-end real estate in those states come under pressure, the stock market will likely feel selling pressure as well. It's something to watch.

Active Management

A popular investment trend is the pronounced move from actively managed to passively managed funds. While the trend is technically correct, it's not the full story.

Let's define *active* and *passive*. A passive portfolio is one where success is defined as matching the underlying benchmark's return as closely as possible. To use a technical term, passive portfolios keep "tracking error" to the benchmark as close to zero as possible.

An actively managed fund is one where decisions are actively made to achieve a higher risk-adjusted return than the underlying benchmark. It takes skill to run either passively or actively managed funds well, but it typically takes fewer resources to manage passive funds.

The real story about the move from active to passive funds, however, is that investors are moving from higher-fee to lower-fee portfolios. Exchange traded funds (ETFs) generally have lower costs than mutual funds. They are the better technology and mark a natural evolution of professionally managed, diversified investment portfolios. Mutual funds are good, but ETFs are generally better. In turn, ETFs are likely to keep taking market share from mutual funds, and so the apparent trend from active to passive will continue to be talked and written about. However, the trend is really much more about money flowing from mutual funds to ETFs than active to passive funds.

That said, actively managed funds have not performed well versus the overall market in recent years. There are multiple reasons for this. First and foremost, their higher costs are a permanent disadvantage when compared to benchmarks without management fees. Also, actively managed funds typically hold cash balances in portfolios to help manage cash flows due to shareholder activity. With the

RustyVanneman, 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) since 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.*

market moving higher, this "cash drag" typically doesn't help them. These are common arguments in defense of actively managed funds, and while there is some truth to them, it should be noted passively managed index mutual funds also have fees and have to manage to shareholder activity.

In my opinion, the move away from active is partly about optics. With U.S. large-cap growth stocks doing very well (the S&P 500 is a good proxy for large-cap, U.S. growth stocks), handily outperforming other market exposures since the bull market began nearly nine years ago, it quickly appears that many actively managed portfolios are underperforming. This may not truly be the case, however, as many funds' investment mandate is to perform versus a vastly different benchmark. In other words, once relative performance starts to move away from the S&P 500 to other international benchmarks and asset classes, as it did in 2017 to some extent, actively managed funds will appear to perform better. To re-state, once the S&P 500 starts to consistently underperform other asset classes, expect more articles on "the resurgence of actively managed funds."

It is important to note that active management is alive and well. To be truly passive, an investor would have to be in the global investable benchmark, which is split about equally between domestic and international exposure and stocks and bonds. Few invest in that benchmark and for many good reasons. A passive investor should, arguably, be invested in the whole investable global market. The S&P captures only 80% of the U.S. stock market, which translates into about 20% of the overall global investable market. The Dow Jones Industrials Average (DIJA), a benchmark I personally dislike, is even worse, capturing less than 10% of the overall world market. Few investors' portfolios look like the global investable market.

Investors are making active decisions regarding their portfolios. This makes sense given their personal financial situations and unique investment considerations, including emotional and financial capabilities to take more on market risk. Being active isn't just about "beating the market," it is about building an appropriate portfolio for an investor's unique goals and considerations.

At CLS, we believe in using low-cost ingredients when building portfolios. This means we use passively managed funds, but we are clearly active managers. We are active because we build portfolios to investors' specified Risk Budgets, and we actively manage those portfolios depending on how return and risk expectations are changing in the marketplace. This won't change anytime soon.

Thank You

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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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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