CLS's WEEKLY 3

What You Need To Know About the Markets

JANUARY 10, 2018

1. After a year of record low volatility in 2017, will it return in 2018?
2. How did fixed income perform in 2017?
3. How should investors prepare for higher interest rates in 2018?

CLS INVESTMENTS

Market Performance

Equities	LAST WEEK	QTD	YTD '18
Total U.S. Market[1]	+2.46%	+2.46%	+2.46%
Domestic Large-Cap Equity[2]	+2.63%	+2.63%	+2.63%
Domestic Small-Cap Equity[3]	+1.61%	+1.61%	+1.61%
International Equity[4]	+2.75%	+2.75%	+2.75%
Developed International Equity[5]	+2.45%	+2.45%	+2.45%
Emerging Market Equity[6]	+3.69%	+3.69%	+3.69%
Fixed Income	**LAST WEEK**	**QTD**	**YTD '18**
U.S. Investment Grade Bonds[7]	-0.32%	-0.32%	-0.32%
Cash Equivalent[8]	+0.02%	+0.02%	+0.02%
Commodities	**LAST WEEK**	**QTD**	**YTD '18**
Commodity[9]	-0.26%	-0.26%	-0.26%

[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 1/5/2018

Week in Review

The equity markets got off to a roaring start in the first week of 2018. The Russell 3000 Growth Index led the way, up 3.21% domestically, while small-caps lagged, sending the Russell 2000 Index up 1.61%. International markets were also strong, with emerging markets leading the way, up 3.69%. Europe performed well and sent the MSCI EAFE Index up 2.45%. Bonds lagged on the week and saw the Bloomberg Barclays U.S. Aggregate Bond Index move down 0.32%. Commodities also lagged, down 0.26%.

Will Volatility Return in 2018?

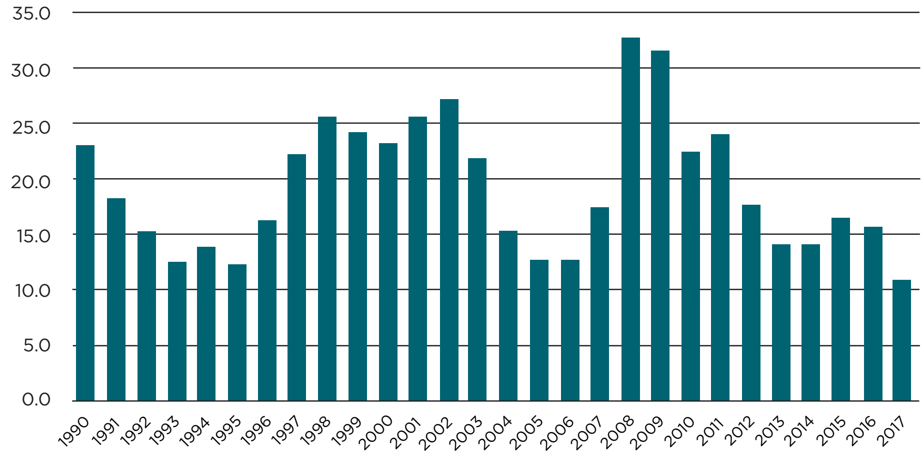
2017 was a great year for the markets, with all the broad asset classes achieving gains. In fact, 2017 saw the highest yearly average return across domestic stocks, international stocks, bonds, and commodities since 2009. Not only were returns high, but the market was surprisingly calm during what felt like an eventful year. So, just how low was volatility? Should investors brace for a bumpy road ahead? Or, will the current calm continue?

Volatility during 2017 was the lowest on record by some accounts, most prominently by the Chicago Board Options Exchange Volatility Index (VIX). Sometimes referred to as the "fear gauge," the VIX is a measure of implied volatility. It measures the amount of annualized risk expected by traders over the next 30 days using the prices of put and call options on the S&P 500. The top table to the right shows the average daily level on the VIX was lower in 2017 than any year since inception of the index in 1990.

Measuring the level of volatility actually realized in the U.S. stock market tells the same story as the VIX. Real volatility experienced in the S&P 500 was also lower than at any other period since 1990. Except for a brief period in the mid-1960s, 2017 was the S&P 500's least volatile period since its inception in the 1920s.

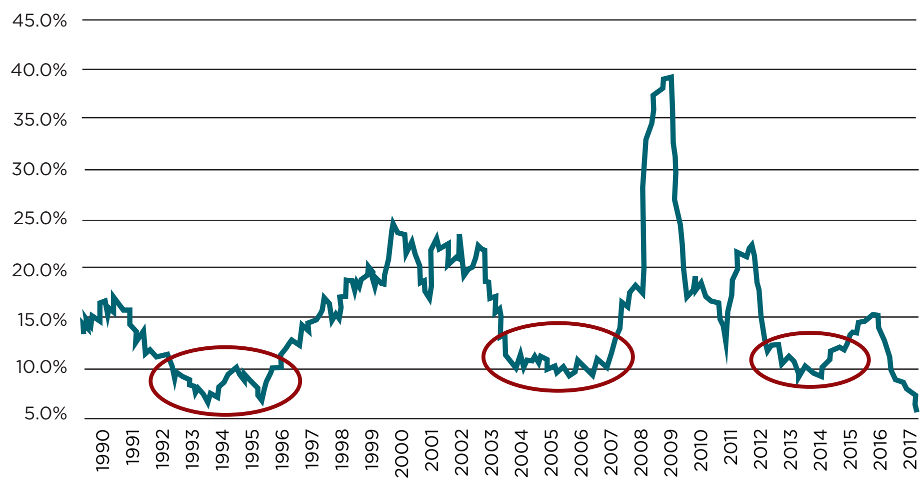
Clearly, these are unusual times. But, the markets are cyclical. When something deviates widely from the norm, there is a general tendency to revert to more average levels. Volatility is possibly an exception to this rule.

Average Yearly VIX Level



Source: Bloomberg, as of 12/29/2017

S&P 500 Rolling 1-Year Realized Volatility



Source: Bloomberg, from 1/8/1988 to 12/29/2017
**Note that the red ovals represent timeframes that volatility reached -1 standard deviation.*

The concept of volatility clustering suggests periods of large price movements are likely followed by more large moves, and small price movements are followed by more small moves. This phenomenon is evident throughout history. The realized volatility chart above shows there have been three periods of extended low volatility in the last 30 years. Each period has been meaningfully longer than the current one. This suggests that while anything is possible, rolling the calendar over to 2018 will not necessarily bring a return of large price swings.

It's important for investors to avoid complacency and greed. Corrections are a healthy aspect of the market, and there will be more on the horizon, whether they happen this year or not. Sticking with a financial plan can be the best way to navigate this uncertainty.

Fixed Income Year in Review

Another year is in the books; another year the bond market bears were sorely disappointed. Despite the Federal Reserve (Fed) actively tightening monetary policy, U.S. bonds were firmly positive.

As we entered 2017, the Fed projected three hikes to the benchmark rate, and that is exactly what happened. Previously in this cycle, the Fed undershot its projected activity. On top of moving short-term rates higher, it also began to normalize the balance sheet in the fourth quarter. This process does not involve selling debt into the open market; it simply allows a pre-specified amount to mature without being rolled into new issues.

These activities would generally be thought of as negatives for the bond market, with many citing them as reasons to be bearish. Despite these headwinds, the Bloomberg Barclays Aggregate Bond Index, a popular proxy for the bond market, managed a return of 2.75% on the year. This is the best performance for bonds since 2014 when the market recovered from the Taper Tantrum.

A notable side effect of tightening was short-term rates rising faster than long-term rates, which is referred to as yield curve flattening. This alone is not a problem. But, if short-term rates rise above long-term rates, this would constitute an inversion of the yield curve, which has historically been very accurate in foreshadowing both economic and market weakness. This topic was recently debated at the Fed's policy meeting, as shown in the release of the official minutes last week . It is too soon to tell how this story will end.

In the meantime, it has generally paid off to take risks in bond allocations. Investors were better off holding highly rate-sensitive, long-maturity bonds instead of short-maturity bonds. Investment-grade credit outperformed government bonds, and high-yield bonds outperformed investment-grade. Taking on currency risk also paid off for international bond exposure as the dollar was down nearly 10%.

Josh Jenkins, CFA
Portfolio Manager

Joshua Jenkins manages CLS's moderate- to low-risk mutual funds and income-focused separate account strategies. He is a Portfolio Manager on the Milestone Treasury Obligations Fund, AdvisorOne CLS Growth and Income Fund, and AdvisorOne CLS Flexible Income Fund.

Mr. Jenkins joined CLS in 2013 as a Research Analyst and accepted the role of Portfolio Manager in 2015. Prior to joining CLS, he was an Analyst for Auriga, USA, LLC in New York City.

Mr. Jenkins received his Bachelor of Science degree in Finance from the University of Nebraska at Lincoln and holds the Chartered Financial Analyst (CFA) designation. He is a member of the CFA Society of Nebraska.

Did you know? Josh ran a 76-mile relay race for NorthStar.

How to Prepare for Higher Rates (Without Buying Bitcoin)

This content for this section was provided by Marc Pfeffer, CLS Senior Portfolio Manager.

Most of us need to pay attention to both sides of our balance sheets. On the borrowing side, we may have a mortgage, car loans, and possibly credit card debt. On the asset side, we may have savings, investment income, and dividends from stocks or other investments.

Generally, when the Fed is raising rates, the economy is on very solid footing. Jobs are plentiful, our investments are moving higher, and inflation is headed, or expected to head, higher.

When interest rates move up, fixed income investments are generally impacted the most. Rates on savings accounts and money market funds move higher, floating-rate securities reset higher, and credit spreads narrow, which means the rate on corporate debt versus that of the safest debt, U.S. Treasuries, compresses as corporations generally have a higher survival rate in a thriving economy than a weaker one.

The Fed raised rates three times in 2017, yet most fixed income asset classes had positive returns. As previously mentioned in other articles the team has written, the Bloomberg Barclays U.S. Aggregate Bond Index returned nearly 4% in 2017. Investors need not fear higher rates. Moreover, long-term interest actually declined slightly last year, flattening the yield curve significantly.

So, what are some of our recommendations?

- CLS serves as an investment advisor to a money market fund that is now yielding more than 1%.
- For high-net-worth investors, a customized municipal portfolio might be a good option.
- Inflation-linked bonds, such as Treasury Inflation Protection Securities (TIPS), should outperform conventional nominal Treasury bonds. We have been buyers for a while now.
- The financial sector has been beaten down for years, but it rebounded over the last several months. It should outperform many sectors as rates continue to rise.
- Lastly, we look at actively managed, fixed income ETFs, such as the SPDR® DoubleLine Total Return ETF (TOTL) and the Janus Henderson Short Duration Income ETF (VNLA). These have shorter durations than many other active, fixed income counterparts.

Just a few more reasons to own fixed income in diversified portfolios.

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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1099-CLS-1/9/2018