CLS's WEEKLY 3

What You Need To Know About the Markets

JANUARY 17, 2018

1. A quick look at average stock returns following two consecutive years of double-digit gains.

2. What are the diversification benefits of investing in emerging markets?

3. Review the two measures for analyzing activeness in CLS portfolios.

CLS INVESTMENTS

Market Performance

Equities	LAST WEEK	QTD	YTD '18
Total U.S. Market[1]	+1.64%	+4.14%	+4.14%
Domestic Large-Cap Equity[2]	+1.61%	+4.28%	+4.28%
Domestic Small-Cap Equity[3]	+2.06%	+3.70%	+3.70%
International Equity[4]	+0.90%	+3.67%	+3.67%
Developed International Equity[5]	+1.20%	+3.68%	+3.68%
Emerging Market Equity[6]	+0.60%	+4.32%	+4.32%
Fixed Income	**LAST WEEK**	**QTD**	**YTD '18**
U.S. Investment Grade Bonds[7]	-0.18%	-0.50%	-0.50%
Cash Equivalent[8]	+0.02%	+0.03%	+0.03%
Commodities	**LAST WEEK**	**QTD**	**YTD '18**
Commodity[9]	+0.99%	+0.72%	+0.72%

[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 1/12/2018

Week in Review

Stocks worldwide continued to post solid gains through the second week of 2018. The Russell 3000 Index was up 1.6% with small-caps beating out large-caps. International stocks were also strong. Developed markets were up 1.2%, and emerging markets rose 0.6%. Global, value-based stocks were the best performing smart beta strategy, advancing 1.6%, while minimum-volatility stocks finished up at 0.2%. Bonds also sold off as yields on the 10-year U.S. Treasury moved higher by 8 basis points to yield 2.55%.

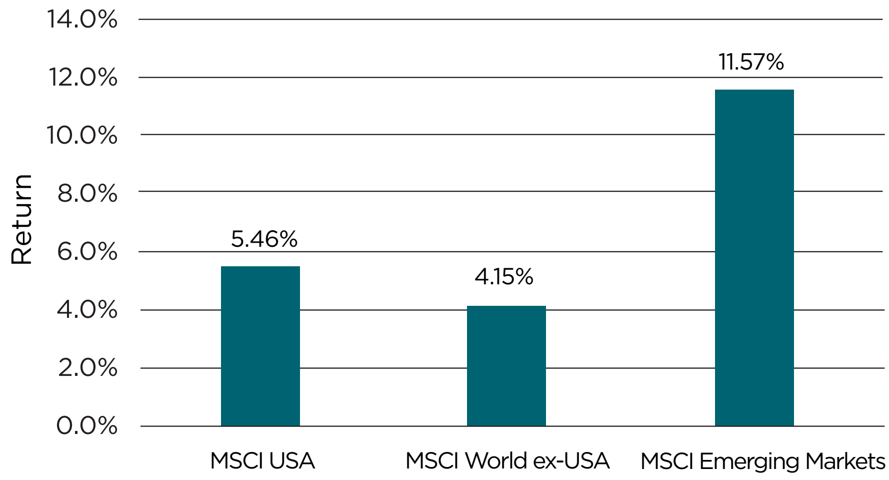
Why Double-Digit Gains Are Less Likely In 2018

Two weeks into 2018 and investors have already seen strong returns for equity markets. Optimism for global growth persists, and economic data suggests the overall U.S. economy is on solid footing. Investor sentiment for equity markets seems to be at all-time highs, and market volatility continues to stay fairly muted.

So with all that optimism, will 2018 be a repeat of 2017? Statistically, I would argue such odds are a bit out there. If history is a guide, based on the analysis presented on the right, U.S. stocks have only returned 5.5% on average after experiencing two consecutive years of double-digit gains. International developed stocks have returned just 4.1% on average. Emerging markets have generally bucked the trend, averaging another 11.6% after two years of double-digit gains.

Although I could be wrong and stocks "melt up" another 10-20%, investors should remember banking on such an outcome may fly in the face of the cyclical nature of markets. As we typically highlight in much of our commentary, as assets become more expensive from a valuation standpoint, the amount investors should expect to earn incrementally decreases. That is a major factor as to why we continue to expect muted returns for both stocks and bonds over the next 12 months.

Average 1-Year Return Following Two Consecutive Years of Double Digit Returns



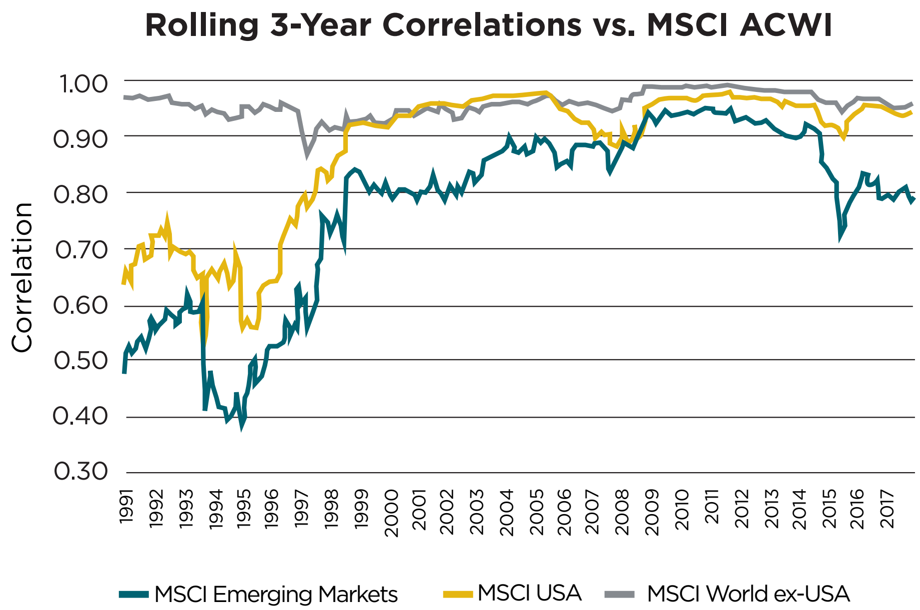
Source: MSCI. Based on gross annual returns from 1970 to 2017 for the MSCI USA Index and MSCI World ex-USA Index; MSCI Emerging Markets Index gross annual returns from 1988 to 2017.

One More Reason Not to Ditch Emerging Markets

Emerging markets have enjoyed another stellar start to the year. The MSCI Emerging Markets Index is up more than 4.3% as of January 12, 2018. Emerging market stocks have been led higher again by Asian-oriented emerging market stocks with China up more than 7.3% in just two weeks.

Although emerging market stocks were hot last year, valuations tend to point to lower returns in the coming years as various components of the market become more fairly valued versus their historical averages.

This does not necessarily mean investors should move away from emerging markets toward areas such as international developed stocks or U.S. stocks. One reason is the diversification benefits emerging market stocks offer relative to both U.S. and international developed stocks.



Source: MSCI. Based on rolling 36-month correlations versus MSCI ACWI Index. Data from 1988 to 2017.

Although emerging markets have historically had higher levels of risk as defined by volatility and our own Risk Budgeting Methodology, their correlations relative to U.S. stocks have arguably been something of a "free lunch" for investors. This has been even more noticeable over the last five years despite the historical assumption that emerging markets are more exposed to movements in the dollar and commodity prices.

The key takeaway for investors to remember is that although seeking out reasonable performance over time can play into a decision to own (or not own) an asset, finding great opportunities to help manage risk through diversification is just as important, if not more so, to ensuring a balanced ride along the way.

Actively Measuring Active Management

At CLS, we pride ourselves on two important components to managing money effectively over time. The first is staying true to our philosophy of Risk Budgeting. This means we put risk at the forefront of our asset allocation decision-making instead of return alone. The second is making sure we actively manage money to add value over a benchmark. This means we strive to bias our investors' portfolios to the areas we have the highest amount of conviction regarding the odds of beating the market.

There are many ways to measure whether investors' portfolios are truly actively managed. To name a few: style analysis, r-squared, and reviewing excess returns to determine how much came from beta (excess return that's a function of the risk taken relative to the market) versus alpha (excess returns generally not correlated with market-related decisions).

We believe there are two important ways to properly assess active management in portfolios. They include:

1. **Tracking error (or active risk)**
   This is intended to measure how much variation investors should see in a portfolio's excess returns relative to its benchmark. For example, a portfolio with expected excess returns of 1% and a 2% tracking error should see those excess returns two-thirds of the time within a +/- 2% range of the 1% expected excess return (so up to +3% excess return or minus -1% excess return) for any given year.
2. **Active share**
   This is similar to tracking error, but it measures how different an investor's portfolio may look from its benchmark based on the weight of each security compared to its weight in the benchmark. Portfolios with high levels of active share tend to have more concentrated biases in areas of the market that the manager feels more strongly will outperform.

Both metrics can be very powerful tools for managers and investors to ensure the portfolio maintains a healthy level of decision-making consistent with the long-term goals and objectives of the end investor. At CLS, we continue to strive to ensure we meet this important mandate in addition to managing for Risk Budgets through the use of the metrics briefly mentioned above.

Joseph Smith, CFA
Senior Market Strategist

Joe Smith specializes in quantitative research, risk management, and ETF due diligence. He serves as Senior Market Strategist for the CLS AdvisorOne International Equity Fund, CLS 's Thematic Growth Strategy, and CLS's Core Plus ETF Strategy.

Prior to joining CLS in 2015, Mr. Smith worked at Russell Investments where he served as an Analyst responsible for asset allocation research, portfolio construction, optimization design, and risk management research. He later joined Russell ETFs as Manager of ETF Product Development and Research, a role in which he developed quantitative indexing strategies implemented as ETFs. Mr. Smith also worked for Charles Schwab Investment Management as a Senior Product Specialist supporting product management activities for the Schwab ETFs fund family. In addition, he worked for CLS during the summer of 2014 as an Investment Analyst.

Mr. Smith received his Bachelor of Science degree in Economics from the University of Washington. He later received his Master of Business Administration from the Tepper School of Business at Carnegie Mellon University.

Mr. Smith holds the Chartered Financial Analyst (CFA) designation and is a member of the CFA Society of San Francisco, Pittsburgh, and Nebraska. He is also a member of the Society of Quantitative Analysts and the Quantitative Work Alliance for Applied Finance, Education and Wisdom.

Did you know? In grad school, Joe spent 40 days in nine countries.

1115-CLS-1/17/2018