CLS's WEEKLY 3

What You Need To Know About the Markets

FEBRUARY 21, 2018

1. The recent correction was needed and creates opportunity.
2. Worried about inflation? It might be time to get real.
3. What should be evaluated when selecting a successful money manager?

CLS INVESTMENTS

Market Performance

Equities	LAST WEEK	QTD	YTD '18
Total U.S. Market[1]	+4.40%	+2.18%	+2.18%
Domestic Large-Cap Equity[2]	+4.37%	+2.46%	+2.46%
Domestic Small-Cap Equity[3]	+4.49%	+0.63%	+0.63%
International Equity[4]	+4.41%	+1.54%	+1.54%
Developed International Equity[5]	+4.27%	+1.35%	+1.35%
Emerging Market Equity[6]	+5.03%	+3.69%	+3.69%
Fixed Income	**LAST WEEK**	**QTD**	**YTD '18**
U.S. Investment Grade Bonds[7]	-0.21%	-2.12%	-2.12%
Cash Equivalent[8]	+0.02%	+0.15%	+0.15%
Commodities	**LAST WEEK**	**QTD**	**YTD '18**
Commodity[9]	+3.02%	+0.24%	+0.24%

[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 2/16/2018

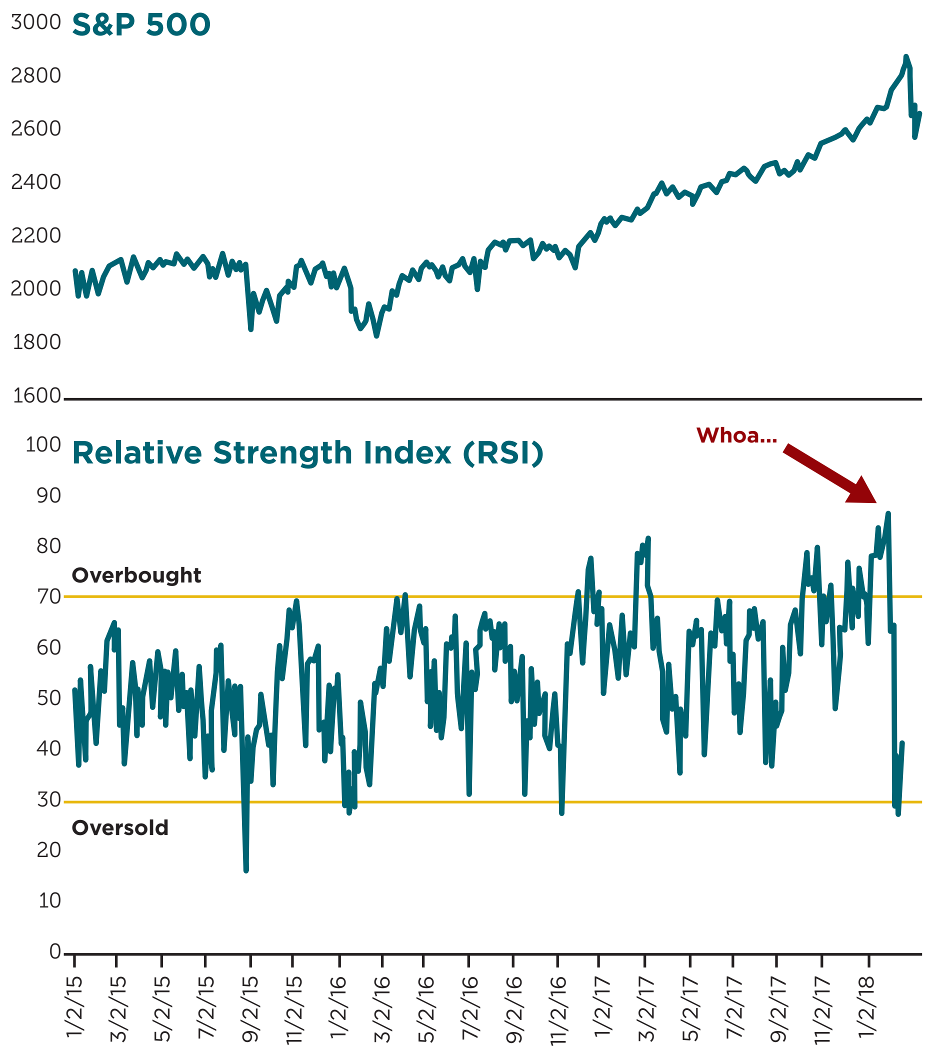
Week in Review

Don't call it a comeback. Stocks rebounded last week, the strongest week in nearly five years, and retraced more than half of the drawdown we saw in weeks prior. Stocks across the spectrum were positive every day. Despite continued data showing signs of inflation (more on this shortly), bonds managed to turn positive Thursday and Friday to end the week close to flat in aggregate. The yield on the 10-year Treasury closed at about 3%. Commodities also rebounded, notching a 3% gain on the back of industrial metal and energy prices.

The strength was felt overseas, too. European earnings and production continued to show strength, the Japanese economy grew for the eighth straight quarter, and emerging markets rebounded sharply. South Africa doesn't make the weekly market review often, but the country's stock market surged higher by nearly 12% last week as its embattled leader (finally) decided to step down.

We have written a lot about the recent market volatility, but you can't blame us since we haven't seen a market correction in so long. I want to touch on it again. I contend the drawdown should *excite* rather than scare investors — of all goals and time frames.

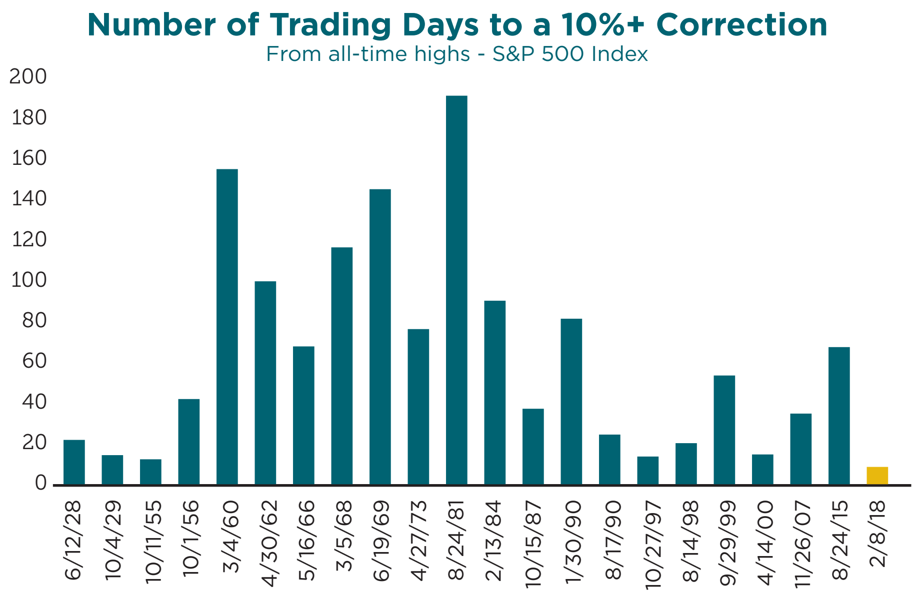
January was a strong month, very strong. Almost 80% of all stocks in the MSCI All Country World Index were positive, and more than 20% of all stocks were up more than 10% in January alone — and that's coming off of a stellar 2017! High fliers, such as Amazon and Netflix, were higher by 24% and 40% respectively. There were definite signs of excessive buying, and they are evident in one of my favorite indicators and displayed in the image to the right.



Source: Bloomberg

Relative strength, or RSI, is a measure of the strength of a rally or decline and is also an "oscillator" (hear me out) meaning it bounces between 0 and 100. Typically, we say stocks are "overbought" when the RSI gets above 70 or "oversold" when it falls below 30 (yellow lines on the chart). High RSI can be good as it shows there is a lot of momentum in the market. But, the market got too hot. By some measures, RSI hit the highest level ever. There was a lot of chatter in the news about inflation fears causing the market to fall, which definitely has some truth. But, the reason could also be the market simply needed to blow off some steam. What makes investors uncomfortable is the speed at which that occurred. By my calculations, this was the quickest (as measured by trading days) correction of 10% or more from all-time highs. That speed can catch the unprepared — or those in the wrong Risk Budget — off guard.

But, where do we go from here? Valuation multiples have dropped and earnings are growing, making valuations overall more attractive. Emerging markets and other attractively valued areas of the world have also fallen off their highs, making them even more attractive. A lot of the technical "froth" has been squeezed out quickly by the speed of the decline (note, we are nearly oversold now according to the RSI chart above). Although it may not feel this way to investors at or near retirement, this drawdown is a good thing. Those who have waited to invest should be getting in, and those who have been invested should feel much better about the longevity of this bull market. However, this should be a wakeup call to those investors who may be taking too much (or too little) risk. Of course, we could fall further from here, but I'll leave you with a couple of quick stats: **Investors who bought the S&P 500 10% below its peak without waiting for a bottom have historically experienced positive 3-, 6-, and 12-month returns 75% of the time, and the median returns are 6%, 12%, and 18%.**



Source: Bloomberg

Grant Engelbart, CFA, CAIA

Portfolio Manager

Grant Engelbart manages CLS's aggressive mutual funds and several ETF and mutual fund separate account strategies, including CLS's American Funds portfolios. He also leads the alternative broad asset class team and serves on several committees across CLS's parent company, NorthStar Financial Services Group, LLC.

Mr. Engelbart first joined CLS as an intern in 2007. He returned in 2009 and held several roles in trading and investment research prior to accepting the role of Portfolio Manager in 2013. He previously held positions at TD Ameritrade and State Street Corporation.

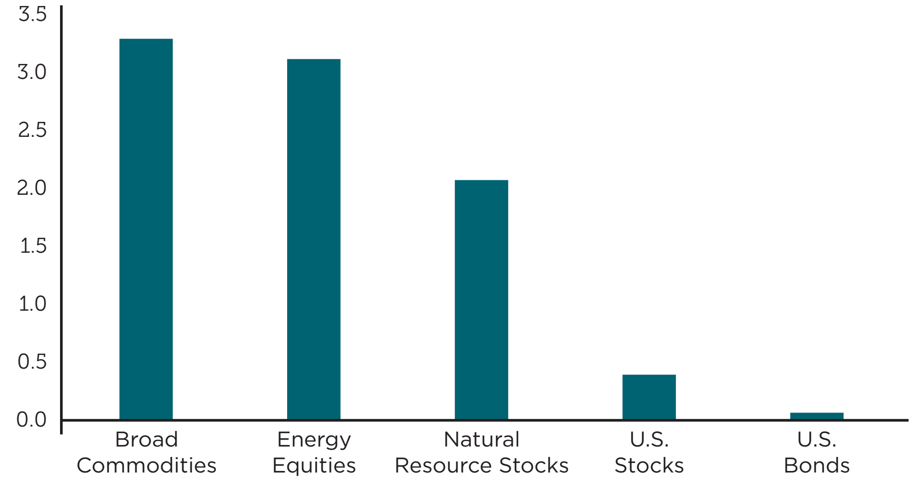
Mr. Engelbart received his Bachelor of Science degree in Finance from the University of Nebraska at Lincoln. He holds the Chartered Financial Analyst® (CFA) designation, Chartered Alternative Investment Analyst (CAIA) designation, and FINRA Series 65 license. He is a member of the CFA Society of Nebraska and the CAIA Chicago Chapter.

Did you know? Grant invested in his first fund at age 13.

Is It Time to Get Real?

Inflation has been anticipated since the unprecedented measures taken by the Federal Reserve in the depths of the financial crisis (more than a decade ago!) Many economists point to signs of inflation starting to appear in consumer and producer price index reports, as well as wage growth. Inflation has been eerily nonexistent over the past several years, with the exception of certain standouts, such as tuition and medical costs. As a result, asset classes typically associated with being inflation hedges have been unloved and now present opportunities. These asset classes are often called "real assets" because they are tied to a tangible, real asset. Commodities, natural resource companies, real estate, and sometimes infrastructure are considered examples of real assets.

60-Month Rolling CPI Sensitivity



Source: Ned Davis Research
The chart illustrates the beta coefficient of a moving 60-month regression of excess returns (vs. MSCI World Index returns) against the percentage point change in the year/year change of the Consumer Price Index (CPI).

Sensitivities to inflation change over time, but using the past five years as a guide, commodities have shown strong sensitivity to moves in the Consumer Price Index (CPI) as have companies involved in the production, distribution, and storage of commodities, known as natural resource companies. Real estate and infrastructure have certain pricing power over the long term related to moves in inflation, which can also help (think rental inflation or toll bridges, etc.).

CLS has been looking carefully at these asset classes, in addition to Treasury Inflation Protected Securities (TIPS) on the fixed income side. Whether inflation returns or not, relative valuations in these real asset classes are some of the most attractive out there. If you would like to learn more, please check out our real asset whitepaper. It should also be mentioned we offer a strategy that focuses on these asset classes, Focused Real Assets, in addition to our increasing exposure across CLS portfolios.

The content in this section was provided by CLS Portfolio Manager Kostya Etus, CFA.

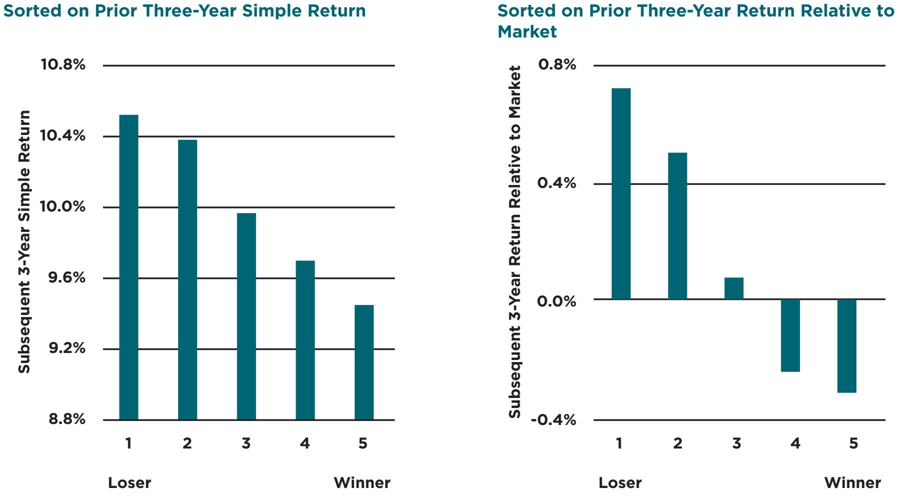
"You're entirely bonkers. But I'll tell you a secret. All the best people are." — Alice Kingsley, Alice in Wonderland (2010)

At our most recent Investment Committee Meeting, we had the privilege to meet Brent Leadbetter from Research Affiliates, who discussed a presentation titled "Alice in Factorland," which summarized a series of research papers published by the firm on factor investing as a real-life application. One paper, titled "The Frolly of Hiring Winners and Firing Losers," focused on the evaluation of money managers.

Avoid Performance Chasing

From investment gurus to retail investors, everyone is susceptible to behavioral biases, and one of the hardest to avoid is performance chasing. When evaluating managers, a common practice is to review historic returns. But, making a selection based only on past performance has proven to be worse than meaningless — it actually works against the investor. The chart below shows investing in mutual funds with the best 3-year trailing returns ('winner' bars) results in the worst performance over the subsequent three years, as well as underperformance of the broad market. The worst funds tend to do the best going forward. This happens because strong performers hold overvalued securities, while poor performers become cheaper in value. Valuations are one of the most accurate predictors of future returns.

Mutual Fund Performance for Quintiles Based on Past Return, Controlling for Historical Expense Ratios, United States, Jan. 1990-Dec. 2016



Source: Research Affiliates, LLC, using data from Morningstar Direct. Note: To estimate future fund performance, controlling for past expense ratios, we first sort funds into five groups based on historical average expense ratio. Within each of the expense-ratio groups, we sort funds into five groups (quintiles) based on prior three-year performance. We then average the performance of the different quintiles (based on the past return) across the five expense-ratio groups.

Look To the Future

In order to overcome the performance-chasing trap, it is good practice to measure expected returns as a supplement to historic performance to find investments that can continue to outperform. One way to do this is to break down the factor exposures that a fund is allocated to (such as size, value, and momentum). This allows a valuation assessment of an investment's top factor allocations, which can help set expectations of future returns for the fund. For example, if the fund is tilted toward the value factor, and the value factor is currently undervalued relative to its own history (it is out of favor), then the fund manager has a higher likelihood of outperforming in the future.

Be Thrifty

It is good practice to buy cheap investments in terms of valuations, but also in terms of fees. If there is one thing that has proven to be as strong of a predictor of future returns as valuations are, it is expense ratios. Funds with higher fees tend to underperform peers with lower fees because the higher fees are a consistent performance drag — and we all know the power of compounding (10 basis points of expense translates into more than 10 basis points of performance loss). Additionally, but to a lesser degree, higher portfolio turnover adds to expenses and tends to lead to underperformance of peers with lower turnover.

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 index of 500-large capitalization companies. This index is widely used by professional investors as a performance benchmark for large-cap stocks. The Russell 2000 Index is an index comprised of the 2,000 smallest companies on the Russell 3000 Index and offers investors a benchmark for small-cap stocks. The MSCI ACWI ex U.S. Index (MSCI All-Countries World Index, excluding U.S.) is an index considered representative of stock markets of developed and emerging markets, excluding those of the U.S. The MSCI EAFE Index is an index which tracks performance of international equity securities in developed countries in Europe, Australia, Asia, and the Far East, excluding the U.S. and Canada. The MSCI Emerging Markets Index is an index which tracks performance of large and mid-cap firms across countries classified as emerging market countries. The Bloomberg Barclays Capital U.S. Aggregate Bond Index measures performance of the U.S. investment-grade bond market. The Bloomberg Barclays 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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1255-CLS-2/21/2018