CLS's WEEKLY 3

What You Need To Know About the Markets

MARCH 6, 2018

1. We are introducing a new investment theme at CLS.
2. Active management should perform relatively better moving forward - there are four reasons we expect better relative performance.
3. Income-oriented asset classes are overvalued.

CLS INVESTMENTS

Market Performance

Equities	FEBRUARY	YTD '18	12-MONTH
Total U.S. Market[1]	-3.69%	+1.39%	+16.22%
Domestic Large-Cap Equity[2]	-3.69%	+1.83%	+17.10%
Domestic Small-Cap Equity[3]	-3.87%	-1.36%	+10.51%
International Equity[4]	-4.72%	+0.59%	+21.63%
Developed International Equity[5]	-4.51%	+0.28%	+20.13%
Emerging Market Equity[6]	-4.61%	+3.34%	+30.51%
Fixed Income	**FEBRUARY**	**YTD '18**	**12-MONTH**
U.S. Investment Grade Bonds[7]	-0.95%	-2.09%	+0.51%
Cash Equivalent[8]	+0.09%	+0.20%	+0.94%
Commodities	**FEBRUARY**	**YTD '18**	**12-MONTH**
Commodity[9]	-1.73%	+0.22%	+1.58%

[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 2/28/2018

February Market and Portfolio Review

The winning streak is over.

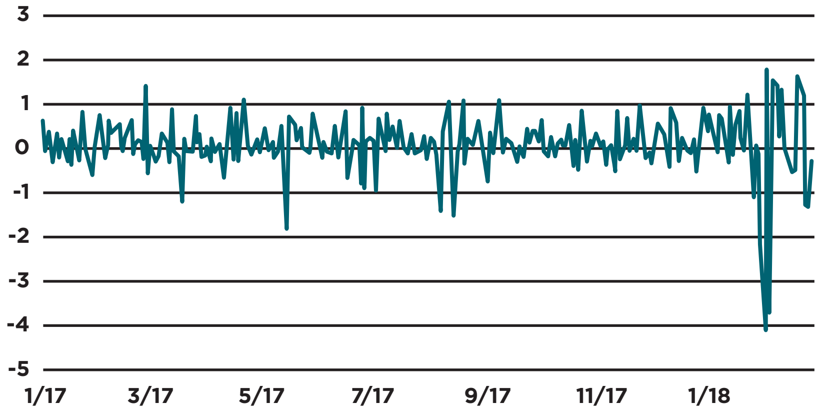
The U.S. stock market finally saw a loss for a calendar month, though not enough to offset the extraordinary gains in January. The loss was deep enough, however, to qualify as the worst month in two years. The market also saw its first correction (loss of 10% or more from price highs) in two years.

Volatility also returned. The chart at the top of the next pageshows daily price changes for the S&P 500 Index. We witnessed daily changes of 1% or more in the stock market over the last four weeks than all those seen since late 2016.

Where to next? Of course, nobody really knows, but February's performance likely indicates a return to more normal market behavior. We will see more volatility and short-term losses. We will see market prices moving two steps forward and one step backward. We will also still likely see the market post a positive return this year — that is always the smart bet given the historical stock market experience. The stock market is typically positive even when it is overvalued, such as it is now, and when it is overdue for a bear market (loss of 20% or more from market highs), again, such as it is now.

This outlook — for increased volatility but continued gains —applies to both the stock and bond markets.

S&P 500 Daily Percent Changes: 2017-2018



Source: Bespoke, as of February 28, 2018

By the end of February, the overall U.S. stock market (Russell 3000 Index) had lost nearly 4% for the calendar month but was still higher by more than 1% on the year. Larger companies (S&P 500 Index) also lost about 4%, but were up by more than 1% for the year. Smaller companies (Russell 2000 Index) also lost close to 4%, but were lower by more than 1% year-to-date.

Overseas markets lost a bit more in February, with the overall international markets (MSCI ACWI ex-U.S. Index) lower by nearly 5%. The gain for the year was reduced to less than 1%. Developed markets (MSCI EAFE Index) had the same returns for the month and year, but emerging markets (MSCI Emerging Markets Index), while still lower by nearly 5% for February, continue to lead the year-to-date returns with gains above 3%.

The bond market (Bloomberg BarCap Aggregate Bond Index) lost just about 1% last month and is now down 2% for 2018. The 10-year Treasury yield ended the month at almost 3%.

Commodities (Bloomberg Commodity Index) lost close to 2% in February, but are slightly higher on the year, as is the stock market.

Despite February's sell-off and losses in an absolute sense, CLS portfolios picked up more relative performance gains last month. Various factors helped performance, but the leading driver for returns remains our international positioning, especially our emphasis on emerging markets. Our emphasis on value over growth stocks and fixed income losses have not helped performance. In the U.S., for example, growth stocks outperformed value stocks by more than 2% in February and now lead by more than 5% for the year. Nonetheless, for a variety of reasons, we still favor our value positioning and, on balance, added more to it last month.

Bottom line: CLS portfolios are off to a decent start in 2018 as portfolios are behaving as expected and performing relatively well.

One of our investment themes is being enhanced. It encompasses more than its predecessor and captures key messages, including CLS's current thinking about the markets and our methodology in selecting investments. These are ways CLS differs from many other investment managers.

Our new investment theme is Be Active. It replaces Global Value, which is being incorporated into the Be Active theme.

Be Active is driven by two core beliefs at CLS:

1. The power of active management when it comes to managing investor portfolios.
2. And, the importance of using actively managed funds to build portfolios.

The Be Active theme should result in clear positioning tilts in CLS portfolios – such as the Global Value expression of emphasizing international equities and value-oriented stocks more than market averages and benchmarks. It will also mean we will own more actively managed ETFs than industry averages.

Be Active dovetails nicely with our Get Smart (Beta) theme that has essentially been in place for a few years and will continue to be a CLS Investment Theme for the foreseeable future.

Since CLS manages approximately 90% of its assets using Risk Budgeting Methodology — strategically targeting risk instead of an asset allocation — the primary level we pull to enhance performance is through security selection, as opposed to making beta bets, i.e., large changes in portfolio risk.

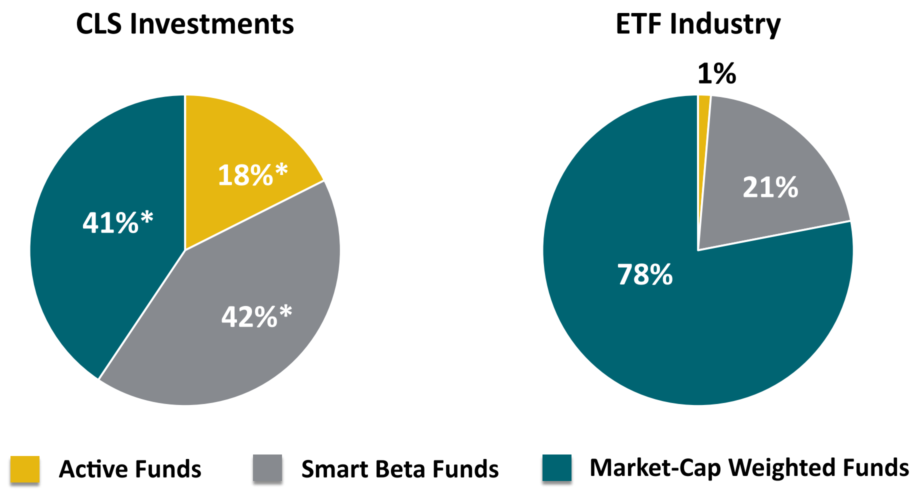
In other words, if we are trying to beat the S&P 500 Index, we are not going to own the SPDR S&P 500 ETF (SPY). Thus, we will emphasize actively managed and smart beta ETFs instead of market-cap ETFs.

The data in the top chart below compares CLS holdings to ETF industry averages.

As of December 31, 2017:

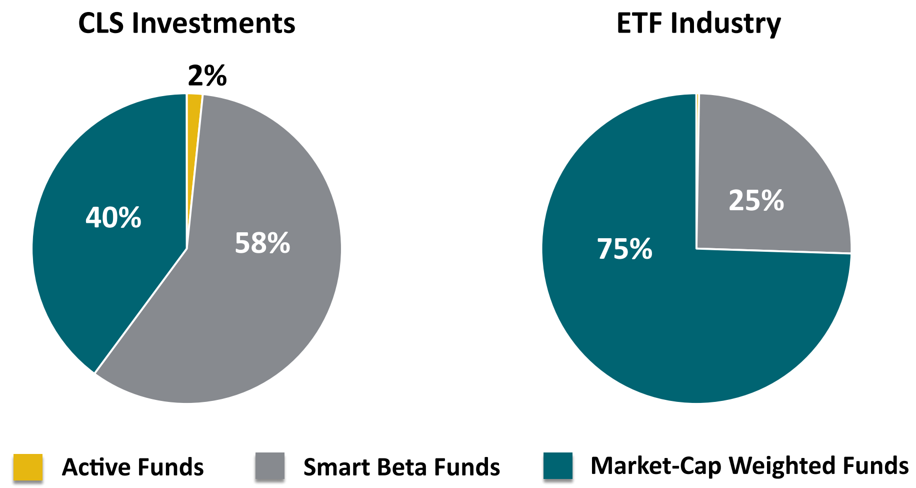
- CLS held about 40% of its assets in market-cap-weighted ETFs, about half the industry average. Expect the CLS holdings in market-cap-weighted funds to drop this year.
- CLS held slightly more assets in smart beta ETFs than in market-cap-weighted — 2x the industry average. Expect that number to increase.
- CLS held nearly 20% in actively managed ETFs — far above the

ETF Assets, as of 12/31/2017



*Sum of each segment may be lesser or greater than 100% due to rounding.

Equity ETF Assets, as of 12/31/2017



industry average. Also expect that number to increase.

By breaking down CLS holdings between equity and fixed income, we note CLS is emphasizing smart beta significantly more within equity holdings, and actively managed significantly more within fixed income.

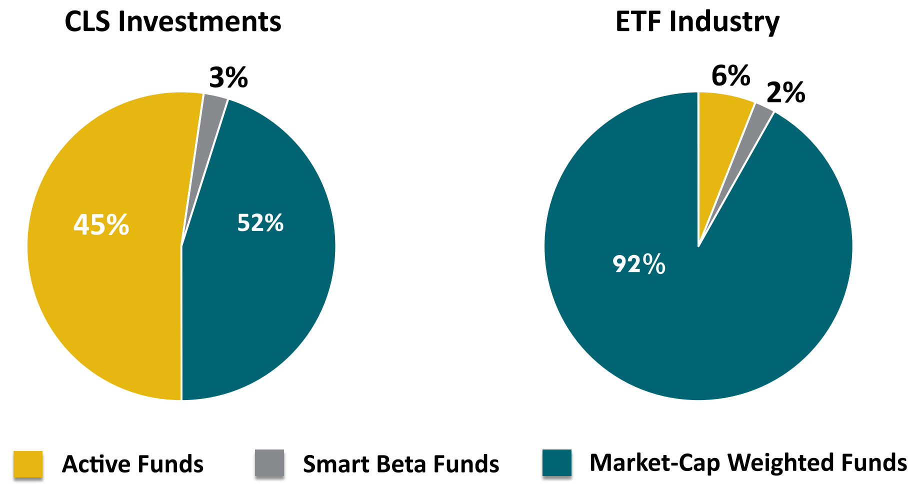
Within equities, smart beta is quickly approaching two-thirds of our holdings. Smart beta quantifies key criteria, or factors, used by active managers to build portfolios and creates rules to capture those factors in order to construct indices tracked by smart beta funds.

We believe emphasizing factors will enhance performance over time, and perhaps more so in choppy and lower markets (the historical base rate experience). Smart beta allows us to access active management in a disciplined and dependable fashion at a fraction of the price. Essentially, we're having our cake and eating it too.

Within equities, we fully anticipate greater growth in our portfolios between now and several years from now will be in actively managed ETFs. The simple reason is more quality offerings are coming to market. More top investment firms are entering the ETF landscape and bringing top talent and deep resources. These trends make the future arguably brighter for ETF investors.

Within fixed income, meanwhile, nearly half of our holdings are actively managed, but only 3% are in smart beta. That is also above

Fixed Income ETF Assets, as of 12/31/2017



average versus the industry on both counts.

Conceptually, we love the idea of smart beta in fixed income. But it's much harder to pull off since so many underlying bonds trade so infrequently. In other words, some smart beta approaches to fixed income might look great on paper, but don't work when transaction costs in the real world are factored in.

Smart beta and actively managed funds are so attractive in fixed income because the benchmarks are not that useful. The most popular is the Bloomberg Aggregate Bond Index, but it has two flaws. First, it does not capture all of the bond market. For example, it doesn't include inflation-linked bonds and includes few high yield or international. So, it's missing most of the global bond market. Second, it is weighted by the debt outstanding of a single issuer. In other words, the issuers with the most debt have the largest weights in the index. While that conceptually captures the bond market, it's not necessarily the best way to think about building a fixed income investment portfolio. These are important reasons it's generally considered easier for actively managed bond funds to outperform the bond market.

So, within fixed income, as with equities, we emphasize managers or factors we believe will add value over time in terms of risk-adjusted performance. But we will likely have a greater emphasis on active within fixed income as active managers are better able to navigate the less liquid bond markets than smart beta strategies.

Bottom line: Look for our exposure to both smart beta and actively managed ETFs to increase, within equities and fixed income, in the years ahead.

All About Active Management

What exactly is active management? Why and when should we use it? And, what is all the fuss about "passive versus active" management that generates so many headlines and articles?

In my opinion, there is too much chatter and ink spilled on the "active versus passive" debate. The discussion is misleading and confusing to most investors. It's a complex subject, and I believe understanding it can be enhanced if we are all on the same page, first regarding how the terms are defined.

Passive management refers to portfolios that aim to match the return of their underlying benchmarks. Success is defined by matching the benchmark's return (to get a little technical, the fund would have no "tracking error" if the benchmark's return was matched). That means a passively managed fund that outperforms its underlying benchmark could be a poorly managed fund. The decision-makers on the fund are passive in making judgments about the markets and their future direction, and officially have no view on market risks, fundamentals, or valuations.

An active fund, however, aims to outperform its underlying benchmark. Success is defined by achieving a higher, or risk-adjusted, return over time. Managers make active decisions about where the market presents opportunity. Instead of being like the benchmark, they are trying to be different.
The next key item to define when referring to passive or active portfolios, is to determine whether the subject is the overall investment portfolio or the underlying holdings of the portfolio.

At the overall investor portfolio level, I would argue all investor portfolios are actively managed. There must be some judgement on how a portfolio is allocated based on the investor's objectives, constraints, investment universe, risk tolerance, and many other unique considerations. To be truly passive, one would own the global market (both stocks and bonds), and that is rarely the case.

The active versus passive debate becomes more significant when reviewing the ingredients or underlying holdings that make up investor portfolios. In this case, active and passive funds are both fair game. Some investors prefer active management; some prefer passive. At CLS, we use both. It depends on the situation.

In general, active management strategies have underperformed passively managed strategies. While many studies show active managers usually add value — before fees and adjusting for cash holdings — the net return experience for investors has generally favored passively managed funds.

Despite this track record, we think active management will perform better in the years ahead in terms of relative performance. There are two ways to measure this. The more common and less precise measurement considers how all funds (regardless of mandate or underlying benchmark) perform versus the S&P 500. In recent years, the S&P 500, which represents U.S.-based, large-cap, growth-oriented companies, have outperformed nearly every other asset class. Thus, many commentators naively suggested active management wasn't working. Under this definition and measurement though, I do believe active management is poised to shine in the years ahead. As we have written numerous times, the S&P 500 is now expensive relative to other market indices and asset classes, and given the cyclical nature of the markets, it will likely underperform in the years ahead.

The second, clearer method of measuring active management's success considers the market environment. I believe actively managed funds will perform better in the current and expected market environment for four reasons. (Two are often cited; two are not.)

1. **Lower costs.**
   Actively managed funds are more expensive than passively managed funds. That remains an advantage for passive. But fees are coming down for actively managed funds, so the biggest advantage for passive is starting to diminish.

2. **Active managers keep lower cash balances than they used to.**
   Mutual fund managers tend to keep some cash in portfolios to meet shareholder cash flows. This "cash drag" is underappreciated, but can add up. For example, a fund with a 5% cash position when the market was up 20% last year gave

up 1% in relative performance — that's more than the typical expense ratio difference. This cash drag, however, tends to be a leading reason behind the apparent outperformance of actively managed funds in down markets.

However, actively managed funds don't carry around the cash like they used to as there are many ways to equitize cash now. So, while actively managed funds' cash positions remain a net advantage for passive funds, this advantage is also dwindling.

The following two reasons are not often discussed when comparing performance between actively managed and passively managed funds:

3. **Actively managed funds tend to have smaller-cap tilts relative to passively managed funds.** Generally speaking, the bulk of passively managed funds are market-cap weighted, meaning larger companies have the largest portfolio weights. Most active managers build portfolios with an equal-weighted construction process in mind. This creates a smaller-cap bias versus the broad market benchmarks. As a result, all else equal, passive funds will generally outperform when large-caps outperform small-caps, such as they have in recent years.

   Currently, small-caps look attractive on a relative valuations basis and are expected to outperform over the next 10 years. If this occurs, it will be a net advantage for actively managed funds.

4. **Actively managed funds tend to have value tilts relative to passively managed funds.** Since the bulk of passively managed funds are market-cap weighted, and thus tend to flow into companies with higher growth rates and valuations, growth-oriented companies tend to have the largest portfolio weights. Most active managers build portfolios with some sort of valuation sensitivity when selecting securities and building portfolios. In general, and speaking in the aggregate, passive funds don't consider company fundamentals or valuations, but active funds do. As a result, passive funds will tend to outperform when growth stocks outperform value stocks, such as they have in recent years.

   Currently, value stocks — after arguably the longest stretch of underperformance ever — look attractive on a relative valuations basis and are expected to outperform over the next 10 years. If this occurs, and I believe value could generate significant relative outperformance, it will be a nice tailwind for actively managed funds.

Let me also address two reasons why many feel that active managers will shine in the years ahead, that I don't necessarily agree with. First, when market volatility picks up, as we expect it to, it will create more opportunities for active managers. But that doesn't mean it will necessarily be easier for all active managers to succeed. Relative performance is still a zero-sum game. Increased volatility is an opportunity to outperform, but it's also an opportunity to *under*perform. More volatility means the difference between outperforming and underperforming strategies will get wider. Thus, due diligence of managers will become more important than it has been in recent years.

Related to volatility is the concept of dispersion, which is a measure of the difference in returns between economic or industry sectors. While this condition creates more opportunities for good managers to add value, it also creates opportunities for underperformance. Again, this is an environment for some managers to outperform by more – at the expense of active managers to underperform by more.

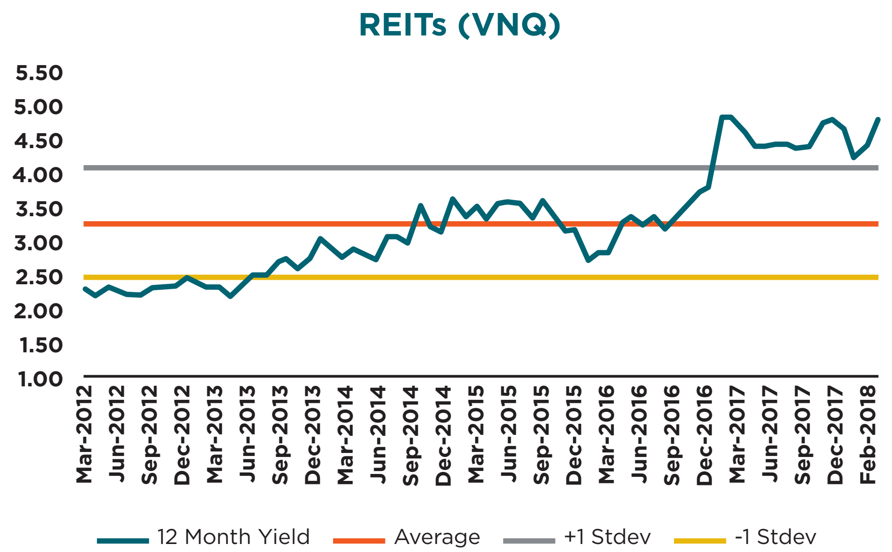
At CLS, the contrarian in us likes the fact that most of the world is moving towards passively managed funds and away from active management. While the move to passive has been in large part about lower investment management costs, which is beneficial for investors, it is also another version of performance chasing. As we have often written, performance-chasing behavior costs investors even more than fees over time and is the leading reason investors underperform long-term.

Income Investors Beware

As the Baby Boomer generation retires, more investors have moved away from the accumulation (growth) phase of their investing careers toward the distribution (income) phase. Thus, the overall demand for income-oriented strategies is increasing. We have witnessed this at CLS regarding our own income strategies, including the popular Active Income X Strategy ("X" being a target yield after fees).

What isn't fully understood or appreciated by many income investors, however, is the risk that income investing often entails. This cannot be stressed enough. For a frame of reference, while the overall bond market assumes 10-20% of the long-term volatility of the stock market, many income-oriented strategies assume approximately two-thirds of that volatility over time — and even more during times of market stress.

During the recent market correction, for example, the drawdown (distance from price high to low) was even more severe for some income-oriented asset class segments than the overall stock market, undermining the perception that income-oriented asset classes are safer. While the traditional income asset class, bonds (as defined by the Bloomberg Aggregate Bond Index), only lost 2%, many popular asset classes lost significantly more, including master limited partnerships (MLPs), real estate investment trusts (REITs), high-dividends stocks, and others.



Source: Bloomberg, as of February 28, 2018

Once investors move away from traditional, investment-grade bonds, additional risks are often introduced, if not significantly increased. These include credit, leverage, equity, and liquidity risk.

While interest rates have risen for Treasury bonds this year, and one might expect that higher yields will be easier to achieve, we feel the overall income investing environment is currently very risky. Major income-oriented asset classes are relatively expensive, and given the recent market break, they seem susceptible to more price shocks in the near-to-intermediate future.

The only exceptions regarding expensive valuations and yields are REITS. The chart below shows current yields (teal line) have been well above the average (orange line) since early 2012. The gray line suggests current yields are one standard deviation point above the long-term average, and thus, relatively attractive.

No other income-oriented asset class looks attractive to us at this point. Bottom line, for most income oriented asset classes, valuations are not attractive, nor are current risks.

Stay tuned for more upcoming communications regarding the current environment for income investing.

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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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.*

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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