CLS's WEEKLY 3

What You Need To Know About the Markets

APRIL 3, 2018

1. March's slide ensured the first quarterly loss for the stock market after nine consecutive gains.
2. With low expected returns for U.S. stocks and bonds, how can investors enhance performance?
3. Intelligence and credentials don't ensure investing success.

CLS INVESTMENTS

Market Performance

Equities	MARCH	YTD '18	12-MONTH
Total U.S. Market[1]	-2.01	-0.64	+13.81
Domestic Large-Cap Equity[2]	-2.54	-0.76	+13.99
Domestic Small-Cap Equity[3]	+1.29	-0.08	+11.79
International Equity[4]	-1.76	-1.18	+16.53
Developed International Equity[5]	-1.80	-1.53	+14.80
Emerging Market Equity[6]	-1.86	+1.42	+24.93
Fixed Income	**MARCH**	**YTD '18**	**12-MONTH**
U.S. Investment Grade Bonds[7]	+0.64	-1.46	+1.20
Cash Equivalent[8]	+0.13	+0.33	+1.05
Commodities	**MARCH**	**YTD '18**	**12-MONTH**
Commodity[9]	-0.62	-0.40	3.71

[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 3/30/2018

March Market and Portfolio Review

The overall U.S. stock market (Russell 3000 Index) lost just more than 2% for the month, with larger companies (S&P 500 Index) suffering losses at nearly 3%, but smaller companies (Russell 2000 Index) gaining more than 1%. For the quarter, all three indices suffered losses between 0% and 1%.

Overseas markets (MSCI ACWI ex-U.S. Index) also lost 2%, with both developed markets (MSCI EAFE Index) and emerging markets (MSCI Emerging Markets Index) down 2%. There was a difference in quarterly returns, however, with developed markets down 2% but emerging markets up more than 1%.

The bond market (Bloomberg BarCap Aggregate Bond Index) gained 1% and is still down 1% for 2017. The 10-year Treasury yield ended the month at 2.74%.

Commodities (Bloomberg Commodity Index) lost less than 1%, negating their year-to-date gain. Commodities now hold a slight loss on the year.

CLS portfolios performed relatively well in March and overall for the quarter. Our biggest portfolio emphasis, on emerging markets, worked in relative terms for the month and year. Another large portfolio emphasis, on value stocks, has been a net negative for the year. But value stocks have now outperformed growth stocks for two months in a row.

Balance Helped in March

Another winning streak is over.

After a second negative month for the year, the U.S. stock market saw its first losing quarter in more than two years. The "tech wreck" made the month even more notable. Market-leading companies, including Amazon, Alphabet (Google), and Facebook, were all hit hard. It seems the narrative on tech stocks has turned a corner from "do no wrong" to "could be in real trouble."

Also notable is what worked. Small companies, on balance, made money. Sectors such as real estate and energy posted gains, after suffering tough starts to the year. The bond market made money, despite its bad press over the last three months. Yields on 10-year Treasuries rose more than 30 basis points to 2.74%, the bond market only lost slightly more than 1% for the quarter. So, despite the losses in the market and technology sector, balanced portfolios generally held up relatively well last month.

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.*

Three Ways To Potentially Enhance Performance

The bull market is more than nine years old now, and valuations (how much to pay for a dollar of earnings) are now well above long-term averages. Despite their rise over the last year, interest rates remain low by historical standards. Thus, we expect returns to be lower than average for the U.S. stock and bond markets in the years to come. Nonetheless, we believe there are three ways investors can potentially enhance returns:

1. Emphasize active investing over passive purchasing of the overall market. Relative valuations suggest some asset class segments and strategies, including international and value stocks, will offer superior returns in the years ahead.

2. Emphasize factor investing, including the use of smart beta ETFs.

3. Use other asset class segments and strategies, such as alternatives and real assets (commodities, etc.).

In 2017, the U.S. stock market was up more than 20%. Since the bull market began in March 2009, the market's annualized return has been more than 20%. This is exceptional performance and well above the historical norm.

For a frame of reference, let's review the building blocks of U.S. stock market returns. Since 1871, the average trailing 12-month return has been 8.7% per year. That is composed of three building blocks:

1. Dividend yields, which have averaged 4.3% per year since 1871.

2. Growth in yield/earnings, which have averaged 3.9% per year. This growth can be broken down into two components:
   - Inflation, which has averaged 2.1% a year; and
   - Real (after inflation) growth, which has been 1.8% per year.

3. Change in valuations (investors now pay a bit more for a dollar of dividends or earnings) has added another 0.5% per year.

The current environment doesn't appear to be as strong.

- Yields are half their long-term average.

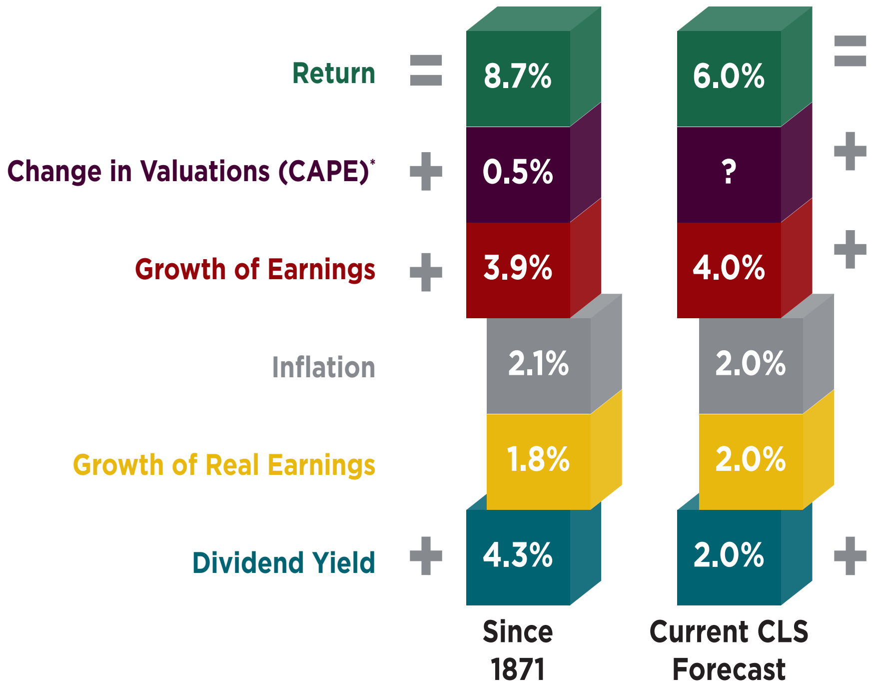
- Earnings growth has recently been strong, but our longer-term expectation is overall growth and inflation will be similar to their long-term averages. We believe global debt, an older population, and lower productivity will all contribute to lower growth and inflation.

Yield and earnings growth add up to 6% per year. That's a reasonable return expectation. Until the wildcard — valuations — comes in. Valuations tend to be the biggest driver of returns over 10-year time frames.

Valuations, which are currently well above average, are far more likely to contract than expand over the next 10 years. At CLS, we expect valuations to reduce U.S. stock market returns by 1%-2% per year over the next 10 years.

Since the bond market currently has a yield of approximately 3%, the

Building Blocks Of Return



expected return of most balanced portfolios of U.S. stocks and bonds is likely to be well below long-term averages and what investors are used to. But in a prospective low-return environment for U.S.-based, balanced portfolios, there are three ways to potentially enhance returns. All are captured in our CLS Investment Themes:

Be Active: Use active management

- Instead of passively buying the market, investors could emphasize areas with more attractive valuations, such as international equities and value stocks.

- CLS portfolios will be overweight to areas in the market where relative valuations are attractive, such as international and value stocks (these are currently our largest portfolio overweights). As always, the CLS Monthly Chart Pack will provide a good indication of what we're over/underweight and are likely buying/selling.

- CLS portfolios will also emphasize actively managed ETFs (currently, CLS portfolios are 20% actively managed ETFs — versus the industry average of 1%).

Be Smart: Emphasize factors

- Historically, an equal-weighting of the five dominant equity factors (value, quality, momentum, small-caps, and minimum volatility) has added 2% per year excess return on average. That average is closer to 5% when the stock market is lower.

- CLS portfolios will also strongly emphasize smart beta ETFs (currently, CLS portfolios are near 45% smart beta ETFs — about double the industry average). More on smart beta can be found here.

Be Creative: Use other asset classes

- Broaden portfolios into other asset class segments and strategies, such as alternatives and real assets (commodities, etc.).

- Balanced portfolios at CLS will have more than 10% invested in alternatives and commodities combined in the months and years ahead.

Recently, I heard a presentation by behavioral finance expert Terrance Odean. He covered a handful of major investor behavioral biases, including some that impair investor performance, including overconfidence, limited attention, and one of the biggest killers of all, recency bias.

Recency bias is another way of categorizing the common investor behavior of "performance chasing" — this often means buying securities after they have gone up in price and selling after they have gone down.

While it might sound like a good strategy to buy the stock or fund with the best recent numbers, it usually isn't. For example, many studies show relative performance over three-year time periods usually reverts. In other words, if one fund beat another fund over the last three years, it's likely they will reverse positions in the coming year(s).

Odean shared a study that offers a fantastic example of investors selecting securities with one primary criterion: the highest return. The study, "Why Does The Law of One Price Fail? An Experiment on Index Mutual Funds" by Choi, Laibson, and Madrian, was written in March 2008. Its participants were selected from three populations: Harvard University staff, Harvard students, and Wharton MBA and Ph.D. students. Each group had above-average financial literacy, and the students, on average, were in the top 1%-2% of all college students ranked by test scores. In short, it was a smart bunch with great credentials and a good basic understanding of finance.

Each participant was asked to pick one of the following S&P 500 Index funds (all identical portfolios) to invest in. They were provided two data points to make their decisions: prospectuses (which they did report reading) and the basic information below.

The data given to them, besides name, ticker, and minimum investment balance, were the expense ratio (cost per year), the front-end sales load (the sales change on initial purchase), the approximate annual fee on a $10,000 investment over the course of the year, the fund's inception date, and the fund's return since its respective inception date. Each fund had different costs and inception dates.

Which of the four would you choose?

To be fair, in real life, one element not captured in the study is the level of service an investor might get in selecting the fund — as some firms surely have better service than others and deserve to charge more. But in this study, the question of service wasn't really a factor.

The results: The Phoenix Insight Fund was the most picked. This fund had the highest return since the inception date, and it also had the highest annual costs! Meanwhile, the fund with the lowest return since inception, but also the lowest fees, was the least picked.

This is remarkable. Each fund was essentially identical and managed to match the return of the S&P 500 over time. If each fund had the same mandate and return before fees, then the best selection is the fund with the lowest costs, and therefore, the highest return after fees. That is the Allegiant S&P 500 Index Fund. The results from the study:

- 18% selected the Allegiant fund.
- 25% selected the UBS fund.
- 19% selected the Morgan Stanley fund.
- 38% selected the Phoenix Insight fund.

Which Fund Would You Pick?

Mutual Fund and Share Class	Symbol	Inception Date	Min. Opening Balance	Expense Ratio	Front-End Load	Approximate Fee on $10K Investment	Longest-Horizon Return in Prospectus
Panel B: Harvard staff experiment (2007)							
Allegiant S&P 500 Index Fund - Class A	AEXAX	10/15/98	$500	0.60%	2.50%	$255	3.08%
Morgan Stanley S&P 500 Index Fund - Class A	SPIAX	9/26/97	$1,000	0.64%	5.25%	$530	3.64%
Phoenix Insight Index Fund - Class A	HIDAX	4/19/96	$500	0.73%	5.75%	$581	7.34%
UBS S&P 500 Index Fund - Class A	PSPIX	10/2/98	$1,000	0.70%	2.50%	$356	3.80%

Source: Choi, Laibson, & Madrian, 2010

This study shows that no matter how intelligent, credentialed, or financially literate an investor may be, the temptation to chase performance and select the investment with the highest return is strong.

Warren Buffett once said something along the lines that when it comes to investing success, IQ points above 120 are essentially wasted. High math skills are not required to be a good investor. In fact, they are often a hindrance. Instead, understanding how markets and investments work, along with basic statistics, including probabilities, is a very good start to being a successful investor. Temperamental factors, such as discipline and patience, are also crucial to success.

It's easy to chase performance, but it requires discipline and patience to stick with an investment philosophy through good times and not-so-good times. It's the investor who can stay the course who typically wins in the end.

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 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.