

# CLS's WEEKLY 3

## What You Need To Know About the Markets

MAY 31, 2018

1. Commodities are beating stocks this year. What to expect moving forward.
2. Why investors should consider emerging markets.
3. What puts the "smart" in smart beta?



### Market Performance

Equities	LAST WEEK	QTD	YTD '18
Total U.S. Market <sup>1</sup>	+0.30	+3.64	+2.97
Domestic Large-Cap Equity <sup>2</sup>	+0.33	+3.37	+2.58
Domestic Small-Cap Equity <sup>3</sup>	+0.03	+6.52	+6.43
International Equity <sup>4</sup>	-1.16	+0.50	-0.69
Developed International Equity <sup>5</sup>	-1.53	+1.32	-0.23
Emerging Market Equity <sup>6</sup>	-0.02	-2.65	-1.27
Fixed Income	LAST WEEK	QTD	YTD '18
U.S. Investment Grade Bonds <sup>7</sup>	+0.74	-0.55	-2.01
Cash Equivalent <sup>8</sup>	+0.03	+0.26	+0.59
Commodities	LAST WEEK	QTD	YTD '18
Commodity <sup>9</sup>	+0.60	+4.24	+3.82

<sup>1</sup>Russell 3000 <sup>2</sup>S&P 500 Index <sup>3</sup>Russell 2000 Index <sup>4</sup>MSCI ACWI ex-U.S. Index <sup>5</sup>MSCI EAFE Index <sup>6</sup>MSCI Emerging Markets Index <sup>7</sup>Bloomberg Barclays Capital U.S. Aggregate Bond Index <sup>8</sup>Bloomberg Barclays Capital 1-3 Month U.S. Treasury Bill Index <sup>9</sup>Bloomberg Commodity Index

As of 5/25/2018

### Week in Review

U.S. stocks led the way last week with a slightly positive gain. Emerging market stocks were pretty much flat on the week despite the continued volatility stirred by talk of trade wars and geopolitical risk in North Korea.

Bonds rose the most on the week, with the yield on the 10-year Treasury note falling to 2.93% from 3.06%. Commodities ended higher, despite oil being dragged down on news of OPEC potentially raising output.

President Trump's decision to cancel the North Korea summit caused stocks to pause and gold to rally. Energy stocks took a hit on the above-mentioned OPEC news, and home values showed an increase of 9% over the prior 12-month period, ending April, which was the fastest pace since 2006. Real estate markets were up close to 3% on the news.

## Take a Real Look at Real Assets

I was once told that commodities have no place in portfolios and that they have not added any value in many years. I agree with 50% of this statement.

True: Over the last several years, commodities have not added any value to portfolios. Shown below are the total returns of an ETF that tracks the common Bloomberg Commodity Index and the S&P 500 Index. For five years in a row (beginning in 2011), commodities saw negative returns and were outpaced by large U.S. stocks by an average of almost 28% per year. Not a good time to have even the smallest amount allocated to commodities.

False: Commodities should never be included in portfolios. There's an old saying: Diversification is always working – even when you don't want it to. Commodities have a strong correlation to inflation and expected inflation in the markets. They tend to add value when inflation creeps up and erodes returns of traditional stocks and bonds. For example, during the late '70s and early '80s, the yield on short-term Treasuries was in double digits. Parking money in the bank seemed like a good idea until inflation also reached double digits and erased investors' gains. Meanwhile, commodities were up 21% annually during the 1970s.

Now, do commodities belong in an investor's portfolio at all times? I tend to say no, but there are times investors may want a 5% (or so) allocation to these real assets:

### 1. Periods of rising inflation or rising inflation expectations

- a. Most market watchers would agree we are in such a period now, with oil nearing \$80 a barrel, gas prices rising, and inflation breakeven rates moving higher.
- b. Commodities can help hedge portfolios against inflation.

### 2. When volatility bottoms out and rises

- a. 2017 saw minimal volatility, but 2018 has been very different. Realized volatility has reached the highest levels seen since 2009.
- b. Even though volatility in the commodities market is quite high, commodities have a 0.5 approximate correlation to stocks and bonds. When combined with a global, multi-asset portfolio, commodities can help reduce overall volatility.

Currently, CLS believes these conditions may hold true for a while, making now a good time to review the benefits of commodities in portfolios.

Year	Commodities	S&P 500	Difference
2008	-36.79%	-37.00%	0.21%
2009	18.64%	26.46%	-7.82%
2010	16.61%	15.06%	1.55%
2011	-14.52%	2.11%	-16.63%
2012	-1.90%	16.00%	-17.90%
2013	-10.81%	32.39%	-43.20%
2014	-19.04%	13.69%	-32.73%
2015	-27.81%	1.38%	-29.19%
2016	12.65%	11.96%	0.69%
2017	1.16%	21.83%	-20.67%
YTD 2018	4.04%	2.58%	1.46%

Source: Morningstar

## Emerging Markets: Where Do They Go From Here?

CLS is not afraid to be different. In fact, we strive to be different, and we believe that helps our clients' bottom line and improves their investing experience. In that vein, we are focusing on the developing world in our portfolios, particularly because most investors are under-allocated to this area.

It hasn't been an easy few weeks to keep that focus. It has been a choppy ride for emerging market investors. Talk of trade wars and other geopolitical risks have dominated the news and caused whipsaws, as they always will. However, it's important to remember that in the long run, markets tend to be driven by valuations and fundamentals. With this said, let's take a minute or two to review.

- Emerging markets make up more than one-third of the world's GDP, but only 10% of the global market-cap.
- It is often difficult to invest in some of these countries as they may restrict foreign capital, but the growth dynamics alone should prompt investors to consider them.

- Emerging markets sell at a 15% discount to the rest of the world.
  - Because markets are volatile, companies are new, politics can change on a whim, and currencies may be unstable, the investment world assigns a discount to emerging markets – not a bad deal for investors.
  - Currently, emerging markets are selling at a 79% discount to the rest of the world, which means they have attractive valuations.
- Emerging markets are keeping monetary policy loose, while other developed nations, such as the U.S., are starting to slowly tighten.
- Emerging markets have had a strong rebound in corporate earnings growth, signaling solid fundamentals.

These are all good reasons to consider increasing your investment in these areas for the long run. CLS has been tilting

toward emerging markets for a few years, so where are we now?

- We are comfortable with our allocation and not looking to add much at this time.
  - Valuations are attractive, but they have started to creep closer to the average from their bottom, which we participated in.
  - Momentum, in the short run, has broken down and moved lower. That encourages us to focus more on other areas, such as developed international.

Overall, emerging markets are still a significant focus in our portfolios and one way CLS differentiates itself from other firms. Going forward, it will be interesting to see whether short-term noise settles down and allows us to continue to focus on long-term growth opportunities.

## What Makes Smart Beta Smart?

In 2001, the consulting firm Towers Watson introduced the phrase “smart beta” to the masses, long before today’s phenomenon existed. The description: “Smart beta is simply about trying to identify good investment ideas with better structure . . . smart beta strategies should be simple, low cost, transparent and systematic.” At CLS, we believe in the idea that smart means taking some of the best ideas of active management and placing them within a better structure: the ETF. We also believe smart can beat traditional market-cap by weighting securities differently. Basically, taking the proven concepts of factor investing (value, size, etc.) and placing them in a security that is more tax-efficient and less prone to manager biases produces a solid outcome.

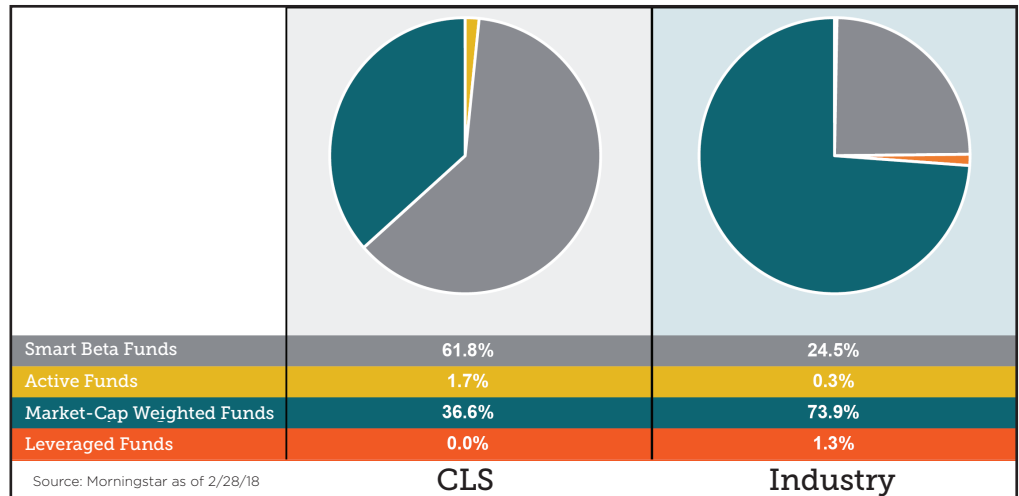
The recently released smart beta survey findings from FTSE Russell showed adoption rates across the globe hit record highs at 48% in 2018. That shows this relatively new way of investing is not going away and will continue to become more prevalent in portfolios.

Also noted in the survey was the use of multi-factor smart beta products. These products, which combine several factors in one convenient package, are the most evaluated and widely adopted of all strategies, besting single factors alone.

As ETF strategists, we are often quite different from our competition. Not only in the investments we choose, but the way we manage them. Risk Budgeting is unique; we don’t use leverage, and we do not make large

“beta bets” with clients’ money. That means we must have strong security selection to add value. The below equity ETF properties illustrate our significant differences to industry standards.

likely look much different from other managed portfolios available, and as more products come to shelf, we will continue to evaluate and conduct due diligence to determine whether they warrant investment.



- CLS has 2.5x the smart beta exposure as the industry average.
- CLS has nearly 6x the exposure to actively managed ETFs.
- CLS has essentially half of the exposure to market-cap-weighted ETFs.
- CLS has no exposure to leveraged ETFs, while the industry has just over 1%.

CLS continues to be at the forefront of utilizing these new tools as we believe the combination of proven factors of returns and alternative weighting to traditional market-cap will help control risk, improve diversification, and enhance returns. CLS’s ETF portfolios will



## Case Eichenberger, CIMA Client Portfolio Manager

*Case Eichenberger co-manages CLS's American Funds strategies, works closely with CLS's separate account strategies (Master Manager), and communicates with advisors and their clients both remotely and in-person.*

*Since joining CLS in 2007, Mr. Eichenberger has held various roles, including Relationship Representative and Internal Wholesaler. In 2015, he accepted the role of Client Portfolio Manager.*

*Mr. Eichenberger received his Bachelor of Science degree in Business Administration from Midland University. He holds the FINRA Series 6, 63, and 65 licenses and Certified Investment Management Analyst (CIMA®) designation. During the accreditation process, he attended the Wharton School of Business at the University of Pennsylvania.*

*Mr. Eichenberger is a member of Greater Omaha Young Professionals and a volunteer for Habitat for Humanity.*

*Did you know? [Case comes from a long line of educators.](#)*

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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Beta is a measure of the volatility, or systematic risk of a security or a portfolio in comparison to the market as a whole. 1561-CLS-5/31/2018