

DIRECTIONS

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We've compiled the best commentary from last quarter to help you prepare for the new year. In this quarter's Directions newsletter, you will discover what market volatility really means, the true value of diversified portfolios, and two key ingredients for long-term investment success.



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Learn more about Rusty [here](#).

We see it time and time again – volatile markets drive investor uncertainty and cause impulsive decisions. But whether we're in calm or choppy waters, our message remains the same, "stay balanced!" So, what exactly does that mean, and what makes a "balanced" portfolio the best option?

First, having a "balanced" portfolio is a method of investment allocation and management aimed at balancing the risk an investor takes on with the return potential. Each investor's ideal balance depends on their financial objectives, risk tolerance, and unique circumstances. Balanced portfolios are generally divided between various asset classes, primarily equities and fixed income securities. The mixing of the asset classes depends on the amount of risk weighed against potential return that is appropriate for an investor's personal situation.

Have balanced portfolios worked for long-term investors?

The short answer is yes! Balanced portfolios have absolutely worked, and that's because they always historically worked to reduce risk. According to Investopedia, when you mix any two investments that have less-than-perfect correlation, you get a reduction in overall risk.

How have returns fared?

For long-term investors, despite a relatively poor 2018, I would say they fared pretty well, considering the trailing 10-year return for a globally balanced portfolio (60% stocks and 40% bonds) would be about 7-8% before fees (that return would be even higher for a balanced portfolio that was more domestically focused). For a frame of reference, market history going back to 1900



suggests that a more reasonable expectation for a globally balanced portfolio would be 6-7%. So, returns have been better than the long-term norm, never mind thinking about how difficult the environment was for investors 10 years ago in the depths of the 2008/09 bear market.

What to expect from balanced portfolios moving forward?

We recently published the Capital Market Assumptions (CMAs) below. They're from CLS as well as some other well-known investment management firms and consultants. These CMA's are long-term return expectations, and as you can see, the expected return from U.S. stocks is well

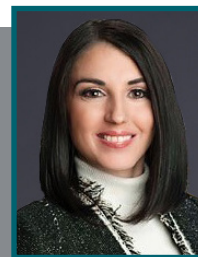
below the long-term average (8-10%) given current valuations (i.e., how much one pays for a dollar of earnings or revenue). International stocks, however, should provide more lift to global equity portfolios, especially emerging markets. Looking at these numbers, a more reasonable return expectation for a globally balanced portfolio might be 4-5% over the next decade.

	CLS	RAFI	GMO	MFS	Rocaton
U.S. Stocks	1.8%	2.6%	-1.7%	2.3%	2.6%
Intl Stocks	3.2%	7.5%	3.0%	6.3%	6.2%
EM	7.6%	9.7%	6.9%	8.4%	9.8%
Bonds	2.5%	3.2%	2.3%	3.6%	3.8%
As of Date	11/27/2018	10/31/2018	10/31/2018	7/31/2018	9/30/2018
Outlook	10 year	10 year	7 year	10 year	10 year

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Volatility is Back: The Return of Normalcy

from Portfolio Manager Shana Sissel, CAIA



A lot has been made about the recent jump in market volatility. A spike on the Chicago Board Options Exchange Volatility Index (VIX), a popular measure of volatility, makes for an impressive headline, but is it really that noteworthy? As investors, we've become complacent in many ways. Since the 2008 financial crisis, we have experienced an extended period of positive market performance with unusually low volatility. The market prognosticators like to point to the VIX as the key measure of volatility for the market, but the VIX has a limited history. The index was launched by the Chicago Board Options Exchange (CBOE) in 1993, and it wasn't until 2004 that trading in VIX futures became possible. To get a real perspective on historical market volatility, market standard deviation measures provide a better picture.

I think we have forgotten that volatility and market corrections are normal market behavior. Chris Davis of Davis Funds illustrated this well in a recent interview with FA Magazine: "On average, you

could expect a five percent correction every 51 trading days. You could expect a 20 percent correction every 630 trading days. We've gone more than 2,400 days without a 20 percent correction."

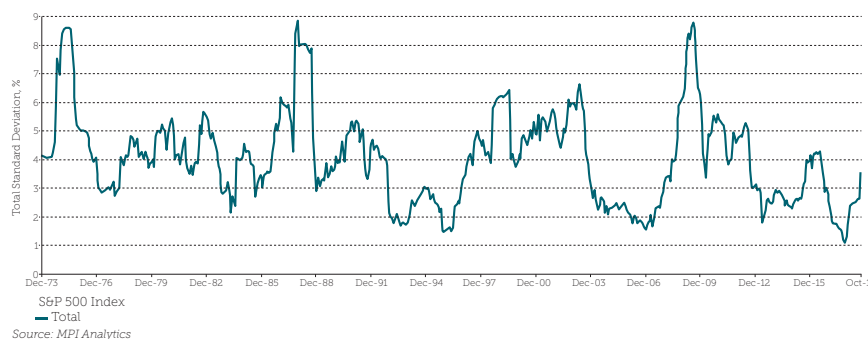
As a Patriots fan, I understand this complacency. As New Englanders panic that the end of an era is near every time Tom Brady has an off game, investors wonder if the next correction will signal a coming recession. While that will likely be true at some point, investors need to focus on the long term. Corrections are normal. The market cycle is real. Recessions happen. Market timing rarely succeeds. Instead of trying to read the market tea leaves, we should focus instead on the

opportunities these corrections present to us. Lower equity prices typically mean the risk inherent in equities is lower. While we all worry about the risk today, we miss the opportunity to reduce our overall portfolio risk for tomorrow.

The timeless advice from the "Oracle of Omaha," Warren Buffett, seems most fitting after this recent sell-off. "Be fearful when others are greedy and greedy when others are fearful." Don't let the sensational headlines distract from a basic principal of investing. Volatility is our friend, so let's celebrate its return rather than fear it.

12 Month Rolling Standard Deviation

December 1973 - October 2018



Defense Wins Championships

from Senior Portfolio Manager, Kostya Etus, CFA



There are several variables investors can control when investing, including the cost, time until withdrawals, how we react to volatility, and how much risk we take on. Unfortunately, we tend to focus most on returns, which we have no control over.

One of the most important elements investors can control is risk, and it can have a significant impact on returns. CLS focuses on measuring and targeting specific risk levels (Risk Budgeting). We do not make allocation changes based on market moves (performance chasing). By holding risk steady over the long term, we can match specific client needs and help control client emotions. Ultimately, CLS believes that keeping clients invested for the long run is the best way to achieve financial goals.

Additionally, we build globally diversified, balanced portfolios. A diversified approach can help defend against significant price drops in any one asset class. A consistent level of risk combined with a diversified approach results in a powerful

matchup that is hard to beat. Take a look at the table below, which shows yearly risk and return for two portfolios starting in the year 2000:

- ▶ The diversified portfolio consists of 60% equities and 40% bonds, with the equity portion broken up into 60% U.S. stocks and 40% international stocks.
- ▶ The non-diversified portfolio is the S&P 500 Index.
- ▶ The diversified portfolio generally underperforms in the up years but outperforms in down years – a defensive approach.
- ▶ There were many more up years than down over the last 18 years; and yet,

	Diversified Portfolio		Non-Divers. Portfolio	
Starting Value	\$10,000		\$10,000	
Year	Return	Std Dev	Return	Std Dev
2000	-2%	10%	-9%	17%
2001	-6%	11%	-12%	20%
2002	-7%	11%	-22%	21%
2003	22%	8%	29%	11%
2004	11%	6%	11%	7%
2005	7%	5%	5%	8%
2006	14%	5%	16%	6%
2007	9%	5%	5%	10%
2008	-23%	16%	-37%	21%
2009	23%	15%	26%	22%
2010	12%	11%	15%	19%
2011	1%	10%	2%	16%
2012	12%	8%	16%	11%
2013	14%	6%	32%	8%
2014	6%	6%	12%	8%
2015	-1%	8%	1%	14%
2016	7%	7%	12%	10%
2017	15%	2%	22%	4%
Average Total Ret	6%		7%	
Average Std Dev	8%		13%	
Annualized Total Ret	6%		5%	
Cumulative Total Ret	174%		158%	
Total Period Std Dev	9%		15%	
Ending Value	\$27,419		\$25,788	

Source: Morningstar data. Non-diversified portfolio represented by 100% S&P 500 Index. Diversified portfolio represented by a 60% equity / 40% fixed income portfolio with 60% of the equity in U.S. stocks and 40% in international. U.S. stocks represented by the Russell 3000 Index, international stocks by the MSCI ACWI ex-USA Index, and fixed income by the Bloomberg Barclays U.S. Aggregate Bond Index.

WHAT INVESTORS CAN CONTROL



RISK
COST
TIME
EMOTION
TAXES
VALUATION

WHAT INVESTORS CAN'T CONTROL



RETURN

the annualized/cumulative returns favor the diversified portfolio. How can this be?

- It is because the risk of the diversified portfolio is so much lower; for the entire period it is 9% versus 15% – a 40% relative reduction in risk.

- For every down day that the diversified portfolio outperforms, it is able to compound returns and grow faster on the rebound.

The result is a 16% higher cumulative return for the diversified portfolio. Translated

into dollars, if you started the period with \$10,000, the diversified approach results in an additional \$2,000 in your pocket.

As a reminder, CLS builds Risk Budgeted, global, balanced portfolios to help investors succeed over time.

Win by Losing Less

from Director of Research & Senior Portfolio Manager Grant Engelbart, CFA, CAIA



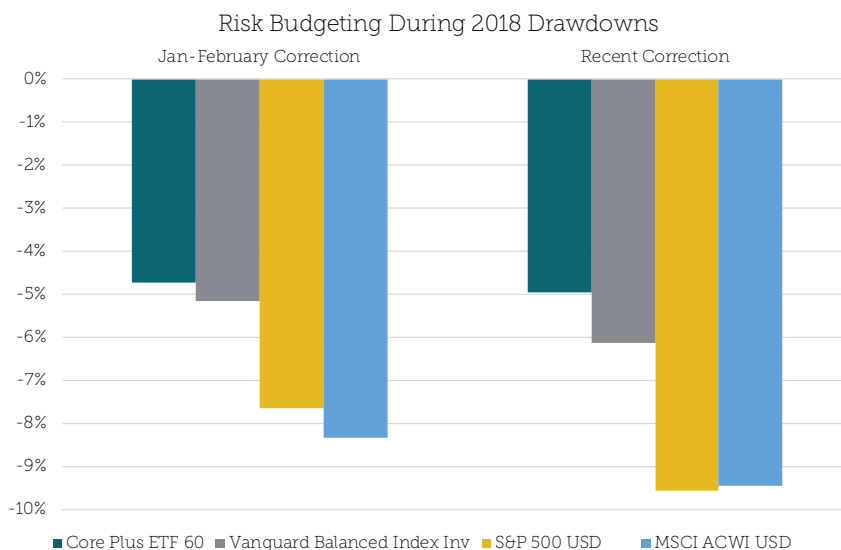
Risk Budgeting focuses on the management of volatility in client portfolios. This manifests itself in the most apparent form for clients during market corrections, where "risk" and "volatility" move from being vague statistical measures to "Wait, how much money did I lose??" As strategic risk managers, CLS strives to keep risk consistent on a relative basis through thick and thin. What can this mean for clients? A smoother ride, a more dependable portfolio, and realistic expectation-setting for both up and down markets.

As we seek to outperform over time, we look at a number of metrics to determine how we should position ourselves (with value being very important). These are intermediate-to-long-term decisions. Risk management, however, is a consistent and frequent endeavor, utilizing statistics with various time frames and signal frequencies. Risk changes every day, and the proper measurement and management of that risk prepares us for any expected or unexpected (usually

the case) turbulence. "The pilot has turned off the seat belt sign, but please keep your seat belt buckled in case of unexpected turbulence." (Try telling that to a two year old...)

2018 has provided two of the quickest and sharpest downturns we've seen in recent years, something that should not be unexpected while the U.S. market is at its current levels. Below, the Core Plus 60 RB portfolio (60% of the risk of the global equity

market) is shown against two major indices during this year's corrections. Performance has been exactly what you'd expect, if not better. This can be applied to any Risk Budgeted strategy – the measurement is the same. The \$40 billion Vanguard Balanced Index fund, which has a similar risk profile to a 60 RB CLS portfolio, has seen more downside risk this year, mainly due to lower diversification versus how we build portfolios.



Source: Morningstar. January-February peak to trough from January 26, 2018 to February 9, 2018. Recent correction from October 3, 2018 to October 29, 2018. Core Plus 60 portfolio net of fees.

Keep Calm and Stay Invested

from Deputy Chief Investment Officer Joe Smith, CFA



As human beings, we are driven by emotions and often compelled to take action to address them. Investing is no different, and times like these can make each of us feel we ought to “do something.” However, those emotions can drive us to do the one thing that we all know to be damaging in the long term: sell low, buy high.

When the markets are volatile, it is important to remind ourselves of our intended goals and investment timelines and to consider whether or not anything has changed. For investors, this doesn't necessarily mean considering a change

in your Risk Budget score, but rather a conversation with your advisor on why those scores are appropriate for your current situation and stated goals.

Another important consideration is to avoid checking account balances on a day-to-day basis if we don't have the stomach for it. Keep in mind that “unrealized” losses in any situation are just that — unrealized — until we choose to sell that security down the road. If we remain invested for the long haul, there can be a much lower chance that will be our final result when we choose to sell our investments.

Finally, many of our investment horizons are quite long, which means that all we should really do is put even more dollars to work. When markets head lower, they can present some of the best opportunities to pick up assets. Why? Simply put, investors are usually willing to sell them at meaningful discounts.

Some of the most important aspects to investing are patience and staying invested. We believe these are both key ingredients to longer-term investment success.

2019 Investment Themes

from CLS President & Chief Investment Officer, Rusty Vanneman, CFP®



BE ACTIVE

There has been much ado about the move from “active investment management to passive investment management.” The real story, however, is the move from mutual funds to exchange traded funds (ETFs). This secular trend has a long ways to go, and in large part due to lower costs for investors. A bigger reason regrettably, is that many investors are chasing recent performance. In general, passive strategies have indeed outperformed active strategies in recent years net of fees, but that relative performance should dissipate as the market environment changes. While higher costs and cash levels will still negatively impact active managers (though not as much as in years past), active management will benefit when value stocks, small-cap stocks, and international stocks start to outperform domestic large-cap growth stocks.



BE SMART (BETA)

Smart Beta ETFs are rules-based ETFs whose holdings aim to intentionally diverge from a broad, market-cap-weighted index. At CLS, we emphasize five equity factors and two fixed income factors when we analyze portfolios and select ETFs. Moving forward, while recognizing that all investment styles are cyclical, we believe this theme will provide a durable edge over the long haul. Historically speaking, the average equity factor has added 2% of value over the market per year, and 4% per year when the stock market is down.

Equity Factors: Value, Quality, Size, Minimum Volatility, and Momentum

Fixed Income Factors: Credit and Duration



BE CREATIVE (WHEN DIVERSIFYING)

With interest rates at low levels compared to historical averages, this theme refers to the need to continue diversifying equity volatility to manage overall portfolio risk. CLS achieves this by being creative in using other asset classes to diversify risk, including the judicious use of alternative asset class strategies and commodities. Alternatives may enhance risk-adjusted performance in a variety of ways, depending on the strategy, while real assets such as commodities may help performance particularly when inflation or inflation expectations are rising.

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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 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. 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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