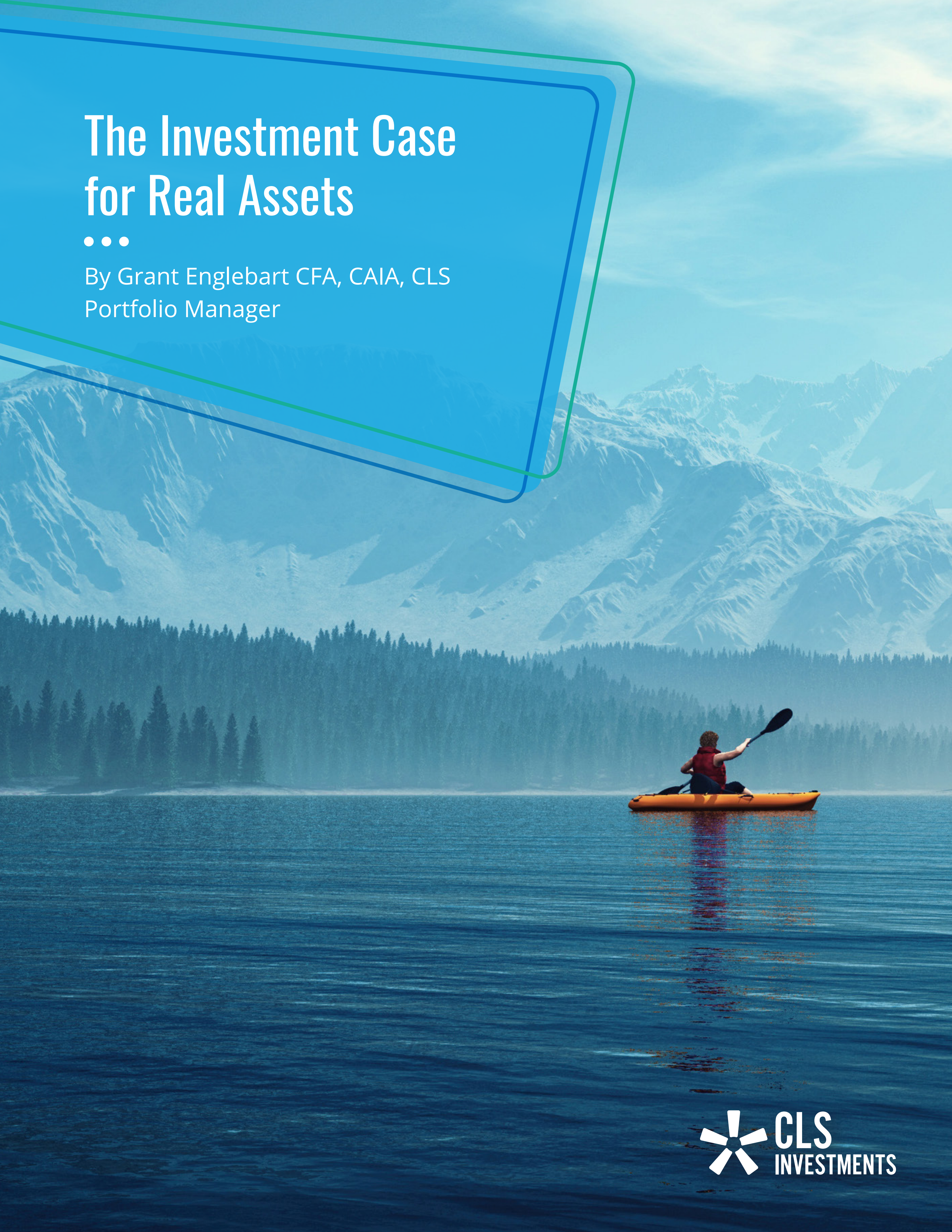

The Investment Case for Real Assets

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CLS INVESTMENTS

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Executive Summary

Stock and bond valuations continue to be expensive, so investors should brace themselves for below average market returns in the years ahead. This is why it is imperative to incorporate additional asset classes into long-term strategic portfolios. Real assets (defined as real estate, infrastructure, natural resource companies, and commodities) are taking on a more crucial role within strategic portfolio allocations due to their innate ability to hedge against inflation, enhance diversification to stocks and bonds, provide reliable and stable income streams, and potentially provide superior risk-adjusted returns over time.

WHAT ARE REAL ASSETS?

Much like the name implies, real assets provide exposure to physical assets, such as buildings, railroads, electricity, water, industrial metals, precious metals, and agriculture. Real assets can be beneficial due to their sensitivity to macroeconomic drivers, such as inflation and GDP growth trends, and their defensive qualities. These qualities are created by the relatively inelastic demand of a growing consumer population (demand stays constant for many real assets despite the behavior of the economic environment), and relatively stable income streams throughout various market cycles.

Real Assets May Benefit Strategic Portfolio Positioning by:

- Exhibiting low correlations with stocks and bonds, a feature that can lead to enhanced diversification benefits.
- Potentially improving risk-adjusted returns in traditional stock and bond portfolios.
- Providing greater sensitivity to inflation than stocks and bonds, allowing them to deliver enhanced protection in the face of rising inflation.
- Offering predictable and stable income streams in any economic environment.

Real Assets Defined

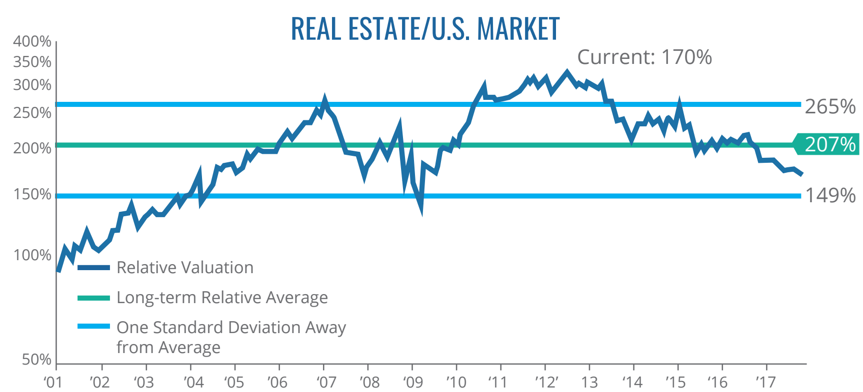
We define real assets as physical assets classified within four categories: real estate, infrastructure, natural resources, and commodities.

REAL ESTATE

Real estate can incorporate many different types of structures, such as single-family housing, apartment complexes, retail shopping centers, hotels, and industrial/storage buildings. However, in our discussions of real estate, we are referring to liquid, indirect investment in equity, Real Estate Investment Trusts (REITs). REITs are investment vehicles that resemble mutual funds (i.e., REITs can own many types of real estate but typically trade on major exchanges).

Population and job growth drive real estate demand, so when the economy is accelerating, this segment of the market can benefit. However, due to the long-term nature of office and industrial building leases and mortgages, REITs can provide stable and reliable income during times of economic stress, exhibiting a defensive-like quality at times. While these long-term leases and mortgages create stability, the shorter-term leases are able to incorporate regular increases in rent obligations tied to inflation. By utilizing the broad array of real estate exchange traded funds (ETFs) in the space, investors have access to multiple REITs, which adds another layer of diversification to portfolios.

REITs typically offer high dividend yields, which grow along with inflation, making the market segment attractive for income seekers who also want an inflation hedge as part of their portfolios. The correlation of global real estate to global stocks is less than one, while the correlation of real estate to bonds is a mere 0.27. This makes real estate an attractive alternative to an expensive bond market. The relative valuation of real estate compared to the broad U.S. market is currently quite attractive, trading at a 37% discount as of November 30, 2017, which makes this segment the cheapest it has been since the 2008 financial crisis (on a relative basis).



Source: Morningstar, as of 11/30/2017

INFRASTRUCTURE

Infrastructure includes diverse segments of the market, such as transportation, renewable power, energy, and utilities. Infrastructure assets can benefit from relatively inelastic demand, as McKinsey & Company, a global management consulting firm, projects $3.3 trillion in annual spending will be needed from 2016-2030 to keep pace with anticipated GDP and population growth.

The transportation segment includes companies that own or operate railroads, toll roads, seaports, bridges, tunnels, and airports. Typically, these operations are regulated by a government body that grants them the ability to increase prices tied to inflation or throughput volumes, making these assets a viable inflation hedge. In addition, the concession period is relatively long (anywhere from 10-99 years or more in some cases), which produces reliable and stable income streams over time.

Renewable energy is becoming more prominent as countries across the globe seek to reduce carbon emissions. Renewable energy companies typically focus on energy generation via water (hydroelectric power), solar, wind, or other organic materials. Due to technological advances, costs have declined, increasing the potential for higher profit margins. This renewable power is becoming an attractive investment opportunity as demand for environmentally friendly power generation continues to grow, technological advances reduce costs, and environmental regulation increases.

The energy sector includes pipelines for oil and natural gas, processing facilities, and energy transportation networks. Long-term contracts often exist between energy infrastructure companies and those which consume the various energy resources provided or transported. Because the income streams of energy infrastructure assets are typically based on the commodity's throughput level instead of price, they provide relatively stable and reliable income streams.

Utilities are typically regulated by governments, and these infrastructures provide consumers with products and services, such as communication towers, electricity, and water. This segment generates highly inelastic demand when consumption growth skyrockets, particularly within emerging markets, thus also creating relatively stable and predictable cash flows.

Due to the urbanization trend within emerging economies and relatively high barriers to entry, the ability to reduce costs through technical innovations while incorporating price increases via higher inflation or throughput volumes, infrastructure assets can be an attractive alternative in traditional portfolios.

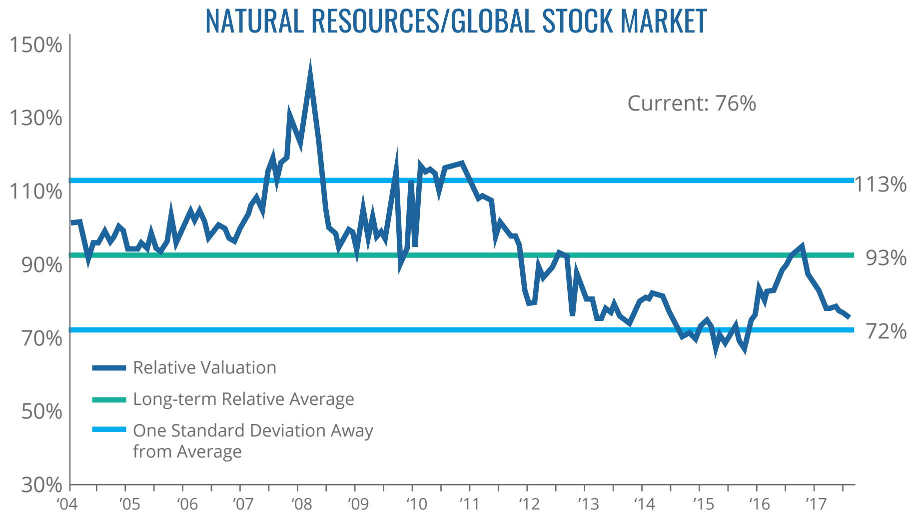
NATURAL RESOURCES

Natural resource companies are involved in the production, distribution, and storage of commodities and natural resources. Oil and gas, metals, agricultural goods, and lumber are some examples of resources that are extracted and then refined in some way by natural resource companies. Natural resource companies are typically publicly traded stocks, but they can also include REITS that own the land from which resources are being extracted.

The earnings generated by these companies are sensitive to the prices of the underlying commodities they interact with. Because natural resources tend to be publicly traded equities and can be large parts of major indices, these companies are also sensitive to the overall stock market. Natural resource companies have historically paid out larger portions of their earnings in the form of dividends, resulting in a higher yield than the overall stock market.

Resource companies can vary widely. Some smaller companies are focused on exploration and the search for the next big oil or gold deposit, and they leave the extraction work to their larger counterparts. Still, other players in the space sit in the middle of the supply chain and process the commodities for future usage. Large conglomerates will often be vertically integrated with divisions up and down the supply chain. This differentiation amongst the segment provides stability and the opportunity for outsized returns from smaller exploration companies.

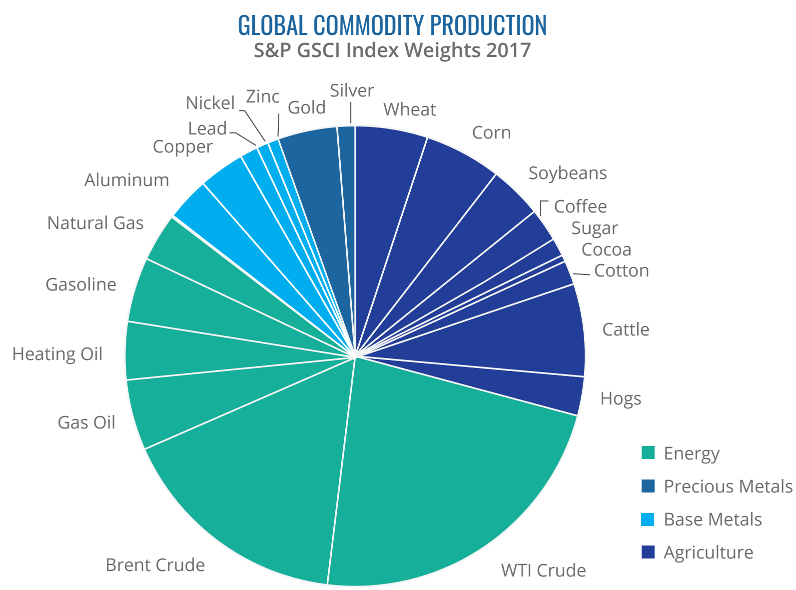
Lower overall equity correlation, higher levels of income, and the ability to participate in stock market returns with the prospect for above-average returns make natural resource companies particularly attractive additions to portfolios. As of November 30, 2017, the chart below shows, global natural resource companies were trading at attractive levels as were many real assets.



Source: Morningstar, as of 11/30/2017

COMMODITIES

Commodities are physical assets that many of us use and touch every day. There are nearly 50 widely traded commodities, ranging from milk to palladium. We generally look at commodities in four broad segments: energy (i.e., oil), precious metals (i.e, gold), base metals (i.e., copper), and agriculture, which is often divided into grains (i.e., wheat and corn) and softs (i.e., cotton).



Source: S&P, as 10/4/2017

Like many real assets, commodities are not necessarily affected by the same macro-economic forces that move traditional stocks and bonds, such as interest rates, economic growth, and inflation. While these have an effect, secondary factors, such as weather or geopolitical risk, can have a stronger impact on certain commodities. This contributes to the lower historical correlation between commodities and traditional stocks and bonds.

Individual commodities are also generally quite volatile but, this is actually helpful for diversifying portfolios. Since 1970, there has been a whopping 63% rolling annual difference between the best and worst performing commodities. For investors in commodity indices and funds, this allows for rebalancing effects to increase expected returns. For instance, selling the best performing commodity each year and buying the worst (rebalancing a fund or ETF) contributes to a positive additional return estimated at more than 3% annually.

Despite higher volatility, the lack of correlation can reduce risk in portfolios that include commodities. Historically, commodities are positive (on a monthly basis) around 40% of the time when the global stock market is negative.

Of all the real asset segments, commodities may be the most apparent inflation hedge. Many commodities serve as inputs for a variety of companies, and higher prices will typically start at the commodity level and be passed through the value chain to the end consumer. Energy has long been a large component of consumer prices, and energy-related commodities, such as oil, gasoline, heating oil, and natural gas, all have direct effects on the prices we pay to drive our vehicles or power and heat our homes.

Real Assets Benefit Strategic Portfolio Positioning

Real assets provide low correlations to stocks and bonds, may provide superior risk-adjusted returns, are powerful inflation hedges, and provide stable and reliable income streams.

- ***Low Correlations Lead to Enhanced Diversification***: When securities have lower correlations to stocks and bonds, they tend to behave differently through varying market cycles, which provides better diversification over time. Real estate, infrastructure, natural resources, and commodities not only diversify stocks and bonds, but also diversify each other, amplifying the diversification impact.

CORRELATIONS

15-Year, Measured Monthly

MSCI ACWI NR USD					
BBgBarc US Agg Bond TR USD	0.06				
Bloomberg Commodity TR USD	0.54	0.07			
S&P Global Natural Resources TR USD	0.81	0.02	0.74		
S&P Global Infrastructure NR USD	0.89	0.28	0.56	0.77	
DJ Global World Real Estate TR USD	0.87	0.27	0.46	0.64	0.86

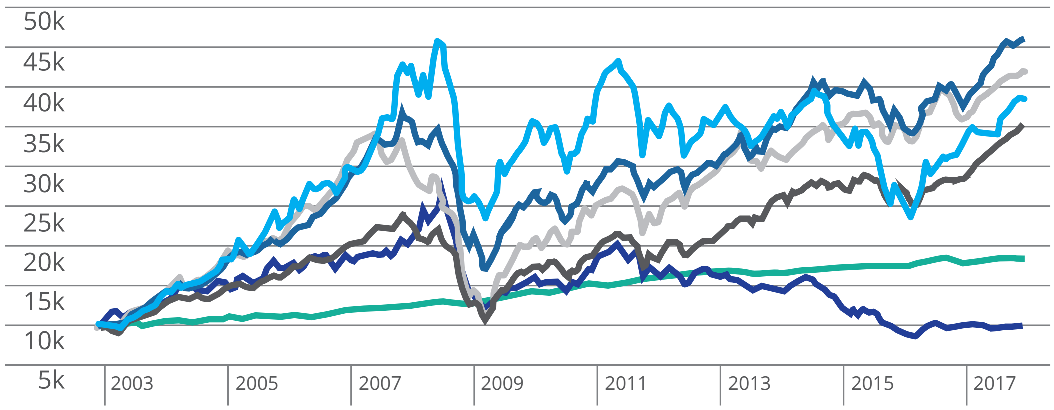
1.00 to 0.60 | 0.60 to 0.20 | 0.20 to -0.20 | -0.20 to -0.60 | -0.60 to -1.00

Source: Morningstar, from 12/1/02 to 11/30/17

**Note: A perfect positive correlation is exactly 1. This implies that as one security moves, either up or down, the other security moves in the same direction. A perfect negative correlation means that two assets move in opposite directions. A correlation of zero implies no relationship at all.*

• ***Better Risk-Adjusted Returns:*** Because of lower correlations, adding real assets to a traditional stock and bond portfolio can improve risk-adjusted returns. For instance, when the broad market is not performing well, the defensive nature of real assets could provide some downside protection for strategic portfolios. They may also benefit when the markets are appreciating or inflation is increasing due to their high sensitivity to GDP growth and inflation changes over time.

GROWTH OF $10K FOR REAL ASSETS



Investment Name	Value	Investment Name	Value
MSCI ACWI NR USD	35.08k	S&P Global Infrastructure NR USD	46.2k
S&P Global Natural Resouces TR USD	38.6k	Bloomberg Commodity TR USD	9.98k
BBgBarc U.S. Agg Bond TR USD	18.73k	DJ Global World Real Estate TR USD	41.93k

Source: Morningstar, as of 12/6/2017

• ***An Inflation Hedge:*** As the U.S. economy nears full employment, the potential for inflationary pressures increases. Real assets may provide greater sensitivity to inflation than stocks and bonds, meaning real assets could deliver enhanced protection in the face of rising inflation.

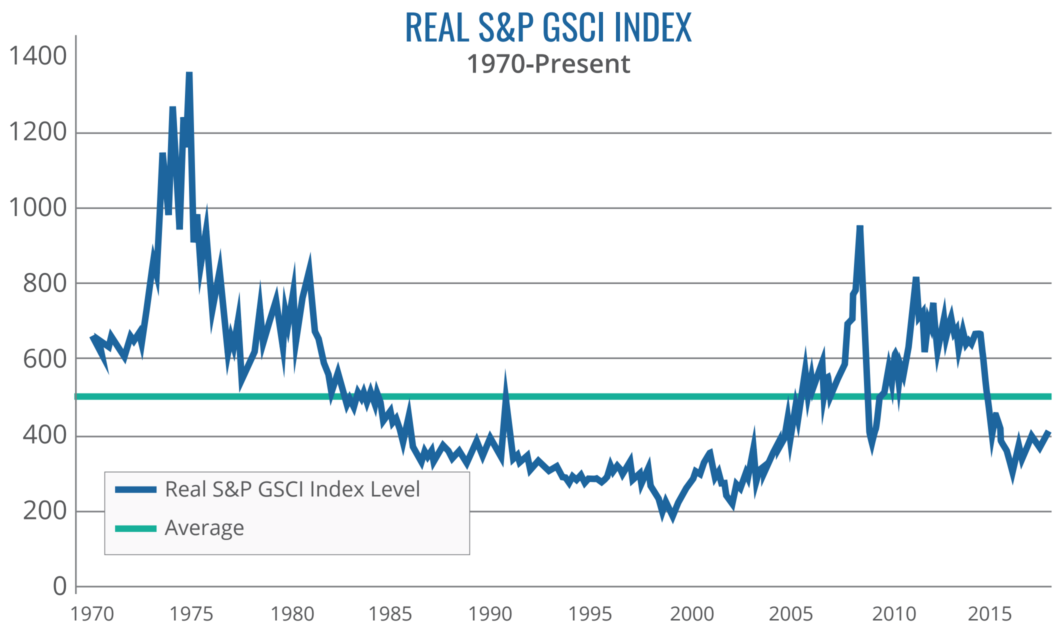
• ***Stable and Reliable Income***: As global investors continue to search for income in an environment where most fixed income and dividend-paying stocks appear expensive, they can add real assets to their allocations. Many real assets, such as real estate and infrastructure, have longer-term lease agreements in place that can provide predictable and stable income streams in any economic environment. In addition, many infrastructure assets are regulated by the government, which allows for incremental price-increase mechanisms that are either tied to inflation or throughput volumes.

The Investment Case for Real Assets

Real assets are taking on a more crucial role within strategic portfolio allocations due to their innate ability to hedge against inflation, enhance diversification to stocks and bonds, provide reliable and stable income streams, and potentially provide superior risk-adjusted returns over time.

The demand for real estate, infrastructure, natural resources, and commodities will only continue to grow. The global management consulting firm, McKinsey & Company, projects that 60% of new urban consumers will reside within emerging markets. The firm estimates new and existing cities across the globe will need to build out floor space that is equivalent to 85% of today's building stock. There will also be an increase of nearly 80 billion cubic meters in municipal water demand by 2025, and today's level of port infrastructure will need to increase more than 2.5 times to meet the rising container shipping demand. The firm projects that from 2016-2030, an average of $3.3 trillion a year will be needed to build economic infrastructure to support the expected rates of growth.

Valuations for real assets are near historically low levels, producing an attractive entry point for investors.



Source: Bloomberg, as of 11/30/2017

As market valuations in traditional assets appear stretched, inflation hovers on the horizon, and the search for yield continues, making it a good time to consider adding real assets to a balanced portfolio.

Any graphs and charts contained in this work are for informational purposes only. No graph or chart should be regarded as a guide to investing. CLS calculates the relative valuations consisting of a composite of the price-to-earnings ratio (P/E), price-to-book ratio (P/B), price-to-sales ratio (P/S), price to cash flow ratio (P/CF), and the price-to-dividend ratio (P/D). The price-to-earnings ratio is a valuation method obtained by dividing the market value per share by the earnings per share. The price-to-book ratio is used to compare a stocks' market value to its book value by dividing the current closing price of the stock by the latest quarter's book value per share. The price-to-sales ratio is a valuation metric for stocks calculated by dividing the company's market cap by the revenue in the most recent year; or, equivalently, divide the per-share stock price by the per-share revenue. The price/cash flow ratio (also called price-to-cash flow ratio or P/CF), is a ratio used to compare a company's market value to its cash flow. The price-to-dividend ratio shows how much a company pays out in dividends each year relative to its share price by dividing the annual dividends per share by the price per share.

The S&P GSCI is recognized as a leading measure of general price movements and inflation in the world economy. The index representing market beta is world-production weighted. The MSCI ACWI captures large and mid cap stocks across developed markets and emerging markets countries. The index covers approximately 85% of the global investable equity opportunity set. The Bloomberg Barclays Capital U.S. Aggregate Bond Index measures performance of the U.S. investment-grade bond market. 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. The S&P Global Natural Resources Index includes 90 of the largest publicly-traded companies in natural resources and commodities businesses that meet specific investability requirements, offering investors diversified and investable equity exposure across 3 primary commodity-related sectors: agribusiness, energy, and metals & mining. The S&P Global Infrastructure Index is designed to track 75 companies from around the world chosen to represent the listed infrastructure industry while maintaining liquidity and tradability. To create diversified exposure, the index includes three distinct infrastructure clusters: energy, transportation, and utilities. The Dow Jones Global Select Real Estate Securities Index tracks the performance of equity real estate investment trusts (REITs) and real estate operating companies (REOCs) traded globally. The index is designed to serve as a proxy for direct real estate investment, in part by excluding companies whose performance may be driven by factors other than the value of real estate.

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