MONTHLY MARKET REVIEW

JANUARY 2016

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- *Recap the Inside ETFs conference.*
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CLS INVESTMENTS

Market Performance

Stock Market	LAST MONTH	YTD '16	12-MONTH
Total U.S. Market[1]	-5.64%	-5.64%	-2.48%
Domestic Large Cap Equity[2]	-4.96%	-4.96%	-0.67%
Domestic Small Cap Equity[3]	-8.79%	-8.79%	-9.92%
International Equity[4]	-6.80%	-6.80%	-11.95%
Developed International Equity[5]	-7.23%	-7.23%	-8.43%
Emerging Market Equity[6]	-6.49%	-6.49%	-20.91%
Fixed Income	**LAST MONTH**	**YTD '16**	**12-MONTH**
U.S. Bonds[7]	1.38%	1.38%	-0.16%
Cash Equivalent[8]	0.00%	0.00%	0.03%

[1]Russell 3000 [2]S&P 500 Index [3]Russell 2000 Index [4]MSCI ACWI ex-U.S. Index [5]MSCI EAFE Index [6]iShares MSCI Emerging Markets Index [7]Barclays Capital U.S. Aggregate Bond Index [8]Barclays Capital 1-3 Month U.S. Treasury Bill Index

January Market Review

It was a tough start to the year for the global financial markets. CLS portfolios held up relatively well, with risk budgeting doing what it was supposed to do, but it was still difficult to see portfolio values fall. We are cautiously optimistic that the remainder of the year will be better than the last four weeks.

As for the numbers, the overall U.S. stock market lost 6% in January, with larger companies losing substantially less than smaller companies. That is typically the case in most market setbacks, though of course not necessarily in all. International stocks were also down over 6% last month, with some markets outperforming. Some investors think international stocks lose more than domestic stocks in down markets, but that is a poor assumption. Relative performance is a function of many factors, including relative valuations and current market narratives.

Bonds were the winners among major asset classes last month. And again, it's interesting to see how fixed income continues to defy most market experts. Yes, yields are low, but bonds remain the ultimate diversifier for equity-dominated portfolios. The overall bond market gained over 1% in January. The 10-year Treasury bond closed the month at 1.92%.

Current CLS Outlook and Positioning

It was an extraordinary month for the markets, which saw notable price volatility, sharp losses in some segments, and big changes in investor sentiment. Notably, Japan joined the "club" with negative interest rates.

So, what happened? How does it change our outlook (if at all), and how are we positioning portfolios moving forward?

As always, the reasons for market movement seem obvious in hindsight, but they aren't necessarily so in real time. Was it the latest round of angst generated by swings in presidential election polls? Was it a few data points that suggested weaker economic growth (although, as almost always, the data was conflicting)? Was it really lower commodity prices, such as crude oil, or slower Chinese economic growth (which we've seen for a few years now anyway)? Was it earnings season results (which, quite frankly, is pretty normal in the aggregate)? The high valuations? The increase short-term interest rates? Was it the skittish investors trigger-happy to sell on the sensational headlines, such as the "The worst start to the year since X"?

In reality, each of the above contributed to some degree, but given that the market is mostly driven in the short term by emotions rather than fundamentals, there's probably more truth to the "negativity generated from election" rhetoric (i.e., "our country is broken...things must change!"), and investors' reactions to the breathless media.

Given the market movement last month, did our outlook change? In broad strokes, not really. For starters, our *CLS Investment Themes* remain intact. In fact, on a relative basis, CLS portfolios are behaving as expected, if not better, this year so far. But there are some modest outlook changes and potential portfolio shifts ahead. In short, as one might guess, CLS likes to buy stuff on sale. Prices are lower than they were a month ago, and we like to buy when others are selling. Near the end of the month, investor sentiment for the U.S. stock market dropped to its lowest levels since late 2011 – right after the market corrected and was about to surge higher in the months that followed. It might seem counter-intuitive, but when investor sentiment is this negative, stock markets tend to generate above-average returns moving forward.

What did we do in the portfolios in recent weeks? In some portfolios, we added a touch of risk on January 20, which at least heading into month-end is the current price bottom to the correction. Will that bottom stick? I think it stands a decent chance, at least for now. Crude oil prices, which have been trading in the same direction as the stock market recently, are vastly oversold and appear to be finally bouncing. Is it a "dead-cat bounce" (i.e., a temporary bounce before the market drops to new lows)? Could be, but the crude oil market has rarely been this oversold (i.e., rate of loss is well above average) and, historically, it bounces when it is oversold.

Nibbling on energy stocks is a hot topic among CLS portfolio managers. Related to this is the idea of buying back high-yield bonds. High-yield bonds took it on the chin last year, in large part due to energy companies leading the way lower. Some CLS portfolio managers are also considering dipping their toes back into broad commodity exposures. The common thread of these ideas? All of these asset class segments are on sale.

ETF.com Conference Grab-Bag of Takeaways

Last week was the annual Inside ETFs Conference. Over 2000 people were there, ranging from ETF providers, strategists and liquidity providers to media and investors. The days were jammed full with presentations and meetings. Benefits included meeting new people, fortifying relationships, and collecting new ideas ranging from portfolio construction and practice management to product innovation.

Here are some useful takeaways:

- First, it is possible to get cold in Florida! And for hotel rooms to not have heat. And for tornadoes to be within a few miles of your meeting place without you even knowing about it.
- Despite the market losses in January, there were strong, bullish arguments presented for the stock market to move higher, namely that the economy is not as weak as some are saying, nor as likely to move into a recession as some fear.
- Of course, there are bearish arguments too, but most of the circumstances behind them – potential weakness in commodities and slower Chinese growth – have already happened.
- ETF growth is going to remain explosive for lots of reasons. Lower costs remain a big driver for ETF growth, but more significantly the increased usage of smart beta and actively managed ETFs will continue to drive assets from mutual funds to ETFs. Expect this trend to continue for years to come.
- Smart beta ETFs were indeed the top topic at the conference. At CLS we see these, as many do, as ways to enhance returns and manage risk in portfolios. More on smart beta below.
- The audience at the conference voted on the ETF of the year. I don't necessarily agree with the selection, but it does show the power of getting a message across in the marketplace – and that products are sold, not bought.
- I was lucky to sit at lunch with the author of *Freakanomics*, Stephen Dubner. In his presentation, he had a lot of great anecdotes and points, but one that stuck out to me was that the smarter a person is, the more likely he or she is to seek out confirming evidence of his or her views instead of counter perspectives. Great investors, however, do the opposite. For instance, Charlie Munger (Warren Buffett's partner) likes to say, "Invest, always invert."

Rusty Vanneman, CFA, CMT

Chief Investment Officer

*Rusty Vanneman joined CLS in September 2012 as Chief Investment Officer. Previously, Mr. Vanneman was 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. During this time, Mr. Vanneman was 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 in Management from Babson College, where he graduated with high distinction. He holds the Chartered Financial Analyst (CFA) designation and is a member of the CFA Institute. He is also a Chartered Market Technician (CMT) and a member of the Market Technician's Association (MTA).

Smart Beta ETFs: Creative Destruction in Action

Speaking of ETF growth, ETFs are truly eating mutual funds' lunch. And their breakfasts and their dinners. In 2015 alone, for example, ETFs had net inflows of $242B. Mutual funds had net outflows of $125B. Expect the bleeding to continue.

There are many reasons for this trend – and many that indicate it will continue in the years ahead. The biggest reason, of course, is the new technology of ETFs is superior to the structure of mutual funds. While I truly believe mutual funds are one of the most important financial innovations ever – they brought diversified portfolios to the masses – ETFs are simply the next generation of diversified portfolios, and their primary benefit is lower overall costs.

One area of growth that will continue to erode mutual fund market share are the aforementioned smart beta ETFs. Also known as strategic beta or alternative beta, smart beta ETFs are rules-based portfolios built around factors instead of traditional, capitalization-weighted methods that guide most market benchmarks. In other words, instead of building portfolios around the most popular stocks, smart beta ETFs are built around fundamental factors, such as revenues, earnings, or technical factors like momentum or volatility.

There are a few reasons this is attractive. First and foremost, investors can now build portfolios that capture the essence of active management at a fraction of a cost – and they don't have to worry about their portfolio managers waking up on wrong side of the bed and not executing the strategy. The smart beta portfolio, since it is rules-based and transparent, is disciplined and consistent. It's a dependable building block for portfolio construction. In turn, portfolios should be more stable in their behavior, which, combined with lower costs, should enhance investor experiences.

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It is also noteworthy that mutual fund companies recognize the obvious intuitive appeal of smart beta ETFs and the clear competitive threat. Nearly all of the largest investment firms are now entering the ETF game.

Thanks for reading. Stay balanced.

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An ETF is a type of investment company whose investment objective is to achieve the same return as a particular index, sector, or basket. To achieve this, an ETF will primarily invest in all of the securities, or a representative sample of the securities, that are included in the selected index, sector, or basket. ETFs are subject to the same risks as an individual stock, as well as additional risks based on the sector the ETF invests in.

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