DIRECTIONS
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A Good Place to Start

An introduction to balanced portfolios, assets, and funds.

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CLS INVESTMENTS

In this quarter's Directions, CLS's Chief Investment Officer, Rusty Vanneman, writes an introduction to understanding the elements of an investment portfolio. Mr. Vanneman explains how securities are defined and what role they each play in a balanced portfolio, creating an excellent resource for investors at any level. Below is an explanation of asset classes, what balanced portfolios are, the importance of advisors, and the differences in types of funds.

Reviewing one's investment portfolio can be confusing. For good reason, balanced investment portfolios hold an array of securities, and the variety can be overwhelming. At CLS, for instance, we cover more than 100 asset class segments and strategies. In a well-balanced portfolio, however, each security serves a purpose. But how exactly are these securities defined? What role does each serve, and which ones are the "best to own?" To be a good investor, it's critical to have a thorough understanding of the securities in a portfolio, and definitions are a good place to start.

Asset Classes

Securities are usually first grouped into asset classes. Using basic definitions found on Investopedia (a great resource, even for experienced investors), "an asset class is a group of securities that exhibit similar characteristics, behave similarly in the marketplace, and are subject to the same laws and regulations. The three main asset classes are equities (stocks), fixed-income (bonds) and cash equivalents (money market instruments)." These are the basics when it comes to asset classes, but each can be broken down more granularly.

Stocks are often called risk assets or growth assets. Both are apt terms, and it's good to understand why. First, they are growth assets because they participate in long-term economic growth and have therefore provided more attractive total returns historically than other asset classes. To achieve long-term financial success, investors should own growth assets. But that can be easier said than done, which is why stocks are also called risk assets. Stock prices are volatile, can have sharp losses, and at times haven't produced a positive return over multi-year stretches.

That's where bonds and cash come into play for many investors. Bonds and cash are typically considered income securities, but I would argue that they generally serve the more important role of providing stability in multi-asset portfolios.

What are Balanced Portfolios?

So, how do investors strike the right balance between stocks, bonds, and cash in their portfolios? Or, to say it another way, what is the proper balance of risk or stability? I believe the latter is a more helpful way of looking at it. Each investor is a little different in terms of his or her appetite and ability to take risk. That's why determining financial and emotional capacities for risk is so important. Doing so will help an investor determine an appropriate Risk Budget for his or her balanced portfolio and decide how much risk to have in each asset class. Risk Budgets, both for investors and asset classes, evolve over time and need to be monitored.

The Role of Advice and Active Management

Because risk tolerances change over time, many investors need a financial advisor to help determine their proper risk tolerances and therefore their appropriate Risk Budgets. Various studies have shown advisors add value for many investors. Vanguard Investments conducted one of the most quoted studies on the value of advice, which places it at approximately 3% per year.

Because risk levels of asset classes change, and since CLS believes portfolios should adapt to those changes, we advocate active management. In its simplest definition, active management means asset allocations can change. Active management is more about managing risks than it is about enhancing returns.

What are Funds?

While the media is mostly focused on individual stocks — for some good reasons and some not so good reasons — many investors are invested in funds. In short, funds are an investment vehicle comprised of many securities.

Most investors are invested in two primary fund types: mutual funds and exchange traded funds (ETFs). (We will leave hedge funds and closed-end funds for another commentary. If you want to read more on them now, check out Investopedia!)

Mutual funds came first, and they are some of the finest financial innovations ever created for investors. They are regulated, professionally managed, diversified portfolios offered at reasonable prices. Mutual funds brought investing to the general public.

ETFs, meanwhile, were created nearly 30 years ago. They are the new technology. And like most new technologies, they are generally better than old technologies for many, if not most, long-term investors. But that is admittedly an over-simplification. First, ETFs are generally better because they have lower average annual expenses than mutual funds. Second, they are more tax-friendly. The catch, however, is that they must be traded on an exchange and that often means additional transaction costs. If an investor wants to trade frequently, these costs will add up and could offset the annual expense ratio advantage. For investors who take into account dollar-cost averages, mutual funds may be a superior option as they can be bought in precise dollar amounts (as they can be bought in fractional shares, but ETFs cannot). While these benefits for mutual funds are real, they are also vulnerable. Expect ETFs to be available in more retirement plans in the years ahead.

If you would like to learn more about ETFs, please visit our ETF Education Center.

Summary

Being a good investor means having a plan and staying disciplined to that plan (easier said than done, which is why a financial advisor is necessary for many investors). To do so, investors need to know what they own and how portfolios behave over time.

Thanks for reading. Stay balanced.

Have a Nice Day at Work, Son! Millennials at Home: Part 1

from CLS Chief Investment Strategist, Scott Kubie, CFA

The 1955 Academy Award for Best Picture went to "Marty," a film about a 34-year old, socially awkward butcher who lives with his mother. Unlike in 1955, Marty living with his parents wouldn't seem very strange today. According to analysis released by the Pew Research Center, "In 2014 … adults ages 18 to 34 were slightly more likely to be living in their parent(s)' home than they were to be living with a spouse or partner in their own household."

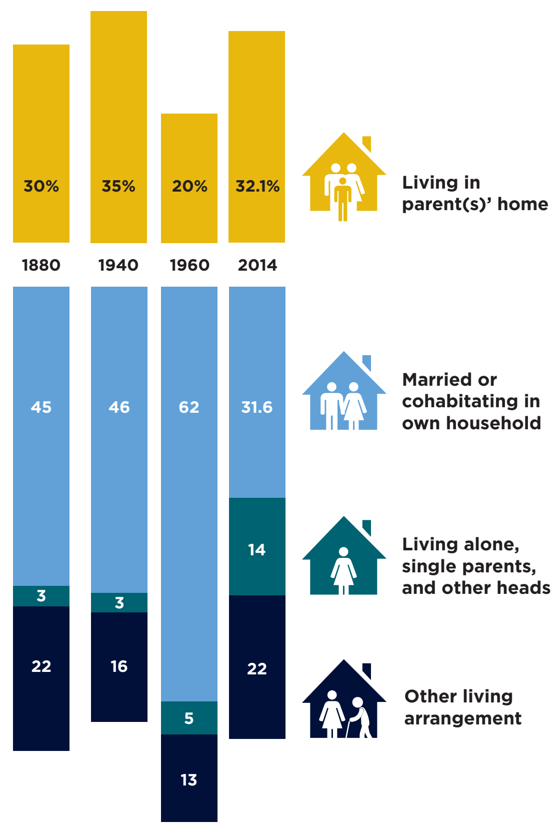
Pew attributed the turn of events to the declining share of young Americans choosing to settle down romantically before age 35. Digging deeper into the data, particular groups show a greater probability of living with their parents than the broader sample. First, men are more likely than women to live with their parents. Second, college-educated young adults are 70% more likely to live with a spouse or partner than those without a college education.

While the numbers seem extraordinary, the data is not far removed from data in the early 1940s. During that period, America was still suffering with the economic damage from the Great Depression. Economic conditions had pushed the risk appetite of young people lower. Shortly thereafter, many of the young men and some of the young women were called out of their homes to serve our country and the world. (Especially just following Memorial Day weekend, we express our deep thanks.)

The war changed circumstances and attitudes. By 1950, marriage was on the rise and peaked around 1960. Since then, reversion to the mean, cultural changes, and changing economic circumstances have driven the rates lower. It isn't surprising to see men without a college education leading the charts of those living at home. High school educated males bore the brunt of the Great Recession. Many manufacturing jobs were outsourced and automated, and the service economy rebounded more quickly.

Living with a parent is the most common young adult living arrangement for the first time on record

% of 18- to 34-year-olds by living arrangement



Note: "Living in parent(s)' home" means residing in a household headed by a parent regardless of the young adult's partnership status. "Other heads" include young adults who are the household head and living with roommates or boarders. "Other living arrangements" include living in the home of a grandparent, an aunt/uncle or a sibling or residing in a group quarters living arrangement (college dormitory or correctional facility).

Source: Pew Research Center tabulations of the 1880, 1940 and 1960 U.S. decennial censuses and 2014 American Community Survey (IPUMS)

Will Someone Remake "Marty?" Millennials at Home: Part 2

from CLS Chief Investment Strategist, Scott Kubie, CFA

As discussed in Part 1, economic concerns have swung the number of young adults choosing to remain at home to high levels. While the charts in the previous section show the peak in 1960 was abnormal, so are today's low levels. The low percentage of young adults married or cohabitating is likely to reverse.

Recent economic data also indicates the trend will slow or reverse in the near future. For one, the unemployment rate has been steadily creeping lower and jobs are more plentiful. Like we see from the 1940s data, it takes time for economic confidence to be rebuilt. We are now years removed from the Great Recession and expect those groups most affected to benefit from the lengthy recovery.

Data from the JPMorgan Chase Institute shows young spenders make up the biggest demographic segment supporting consumer spending growth. A second chart shows the bottom fifth (quintile), based on income, are contributing a larger share to consumer spending growth in recent months.

These trends are providing healthy support for the housing market. The number of homes that went under contract to be sold climbed to the highest level in over a decade. Pending sales of previously owned homes rose 5.1% last month from March, exceeding expectations of a 0.7% rise. Young adults are becoming more willing to spend.

In the late 1940s and 1950s, economic stability promoted romantic and economic risk taking, which contributed to a sustained period of economic growth. As this recovery keeps chugging along, millennials moving out of the basement could provide a significant boost.

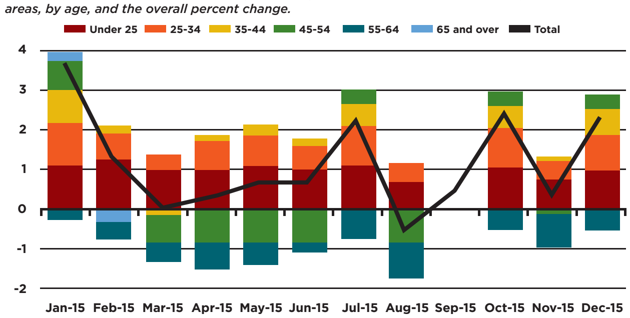
Back to Marty. After being harassed to go to a dance, he meets Clara, a plain schoolteacher who was abandoned by her blind date. Romantic feelings ensue but are choked off the next day by Marty's mother and friends.

At the end of the movie [spoiler alert], Marty realizes life with Clara offers more promise than where he is headed. He hops into a phone booth, calls Clara, and as the phone rings, tells his friends, *"Well, all I know is I had a good time last night! I'm gonna have a good time tonight! If we have enough good times together, I'm gonna get down on my knees and I'm gonna beg that girl to marry me!.... You don't like her? That's too bad!"*

If young adults adjust towards Marty's perspective, the economy will receive a significant boost.

Young Spenders

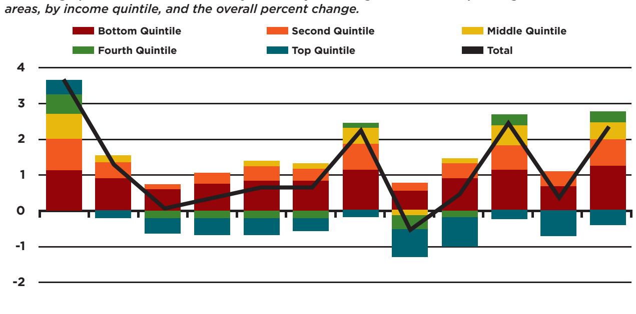
Percentage-point contributions to the year-over-year change in consumer spending for 15 metro areas, by age, and the overall percent change.



Source: JPMorgan Chase Institute

Middle-Class Moderation

Percentage-point contributions to the year-over-year change in consumer spending for 15 metro areas, by income quintile, and the overall percent change.



Source: JPMorgan Chase Institute

2016 Investment Themes

from CLS Chief Investment Officer, Rusty Vanneman, CFA

X-FACTOR

We expect lower U.S. stock market returns in the year(s) ahead and will therefore be emphasizing factor-based ETFs, otherwise known as "smart beta" ETFs. These ETFs have a rules-based approach to building a portfolio, which emphasizes a factor, such as value, growth, or high quality. Factor-based ETFs capture the essence of active management but at a fraction of the cost. We believe this emphasis will enhance returns in the year(s) ahead. CLS is already an industry leader in the usage of smart beta ETFs, and this emphasis is likely to grow.

In addition, we expect market volatility will increase in the year(s) ahead. Market volatility has been at historically low levels in recent years, and this usually sets the stage for increased volatility. If that is the case, additional risk management, via factor-based risk management, should fortify our Risk Budgeting approach.

INTERNATIONAL OPPORTUNITIES

In a low-growth world, valuations, yields, monetary policies, and reforms play greater roles, and international markets are more likely to benefit from these factors than U.S. markets going forward. Currently in international markets, valuations are lower, dividend yields are higher, reforms are taking hold, and central banks are providing greater support.

While these benefits are powerful, some international markets are facing certain headwinds. For example, some emerging market economies aren't growing as once expected. A diversified approach to international investing may be complemented by targeted allocations in particular countries, regions, and sectors. We expect wider performance dispersion between countries when reforms and policies have an outsized effect.

CREATIVE DIVERSIFICATION

Given the low level of interest rates, we continue to be creative in how we diversify our equity-dominated portfolios. We can do this in two ways. First, we can be tactical in our fixedincome exposures, which we have been. We have actively managed our duration (i.e., interest rate sensitivity), credit, and sector exposures. Currently, our portfolios are less interest-rate sensitive than the overall bond market, and our overall credit quality is higher than in years past. Second, we can use alternative asset class segments and strategies, which can include managed futures, hedge fund strategies, and currencies. This could also mean increased exposure to commodities, which have been beaten down over the last several years (many commodities are at multi-year price lows). Commodities are a diverse and broad asset class, and we can utilize the broad array of ETF offerings to tailor our exposure.

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