DIRECTIONS
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Look Beyond Simply Maximizing Returns

A lesson on personal budgets and understanding the markets.

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CLS INVESTMENTS

In this quarter's "Directions," CLS's Chief Investment Officer, Rusty Vanneman, and freelance writer, Robyn Murray explain why investment success is not the maximized rate of return on a portfolio, even though most investors believe it is. Mr. Vanneman begins with the basics of individual budgeting and preparing for your financial future, breaking down what really should be important to investors. He then dives into the markets, how to understand them and how they can help achieve long-term financial goals.

When it comes to planning for retirement, most investors think the key to eventual success is to maximize the rate of return on a portfolio. While that surely helps, and is obviously something everyone desires, it is usually not the **most important** element to long-term success.

First, we believe it is more important to have a proper financial plan than it is to focus on a maximum return. While many investors can invest on their own, many more need to work with an investment advisor to figure out how to create an appropriate financial plan and to properly execute it. That is what advisors do. They handle questions that run the gamut of financial life, from basic savings and debt management to retirement and estate planning, and they are prepared to help educate their clients and lead them to financial security. It's no use generating returns for investors just to see them disappear into debt.

Second, when it comes to actually investing, an important key to success is understanding the simple basics of how financial markets work. This helps create proper expectations – which are crucial to have when it comes to remaining disciplined to a financial plan and investment portfolio.

The Basics

Track Spending

It's an unfortunate truth that many people, from all walks of life, have no idea what they spend their money on. For those who routinely overspend or underestimate their income needs, they should try this simple exercise. First, make a list of what they expect they'll spend their money on each month; then, track what they actually spend. Have them keep a notebook on hand for one month and write down each purchase. It's a very basic exercise, but the results are usually surprising.

The first step to managing any unwanted behavior in spending is to understand the problem, and identify habits that lead to greater control. If someone still can't rein it in after this exercise, they should focus on understanding what their motivations are. It's important they realize that digging themselves into a hole each month puts their long-term financial goals out of reach.

Get Out of (Bad) Debt

We live in a debt-heavy society, and investors may find themselves on one side of two extremes. They may react to our consumption-fueled world by considering all debt to be abhorrent, or they may embrace it and consider steep credit card debt to be an expected part of life. What's important for both types of investors to understand is that not all debt is created equal. A mortgage debt is held against an asset that appreciates in value, and interest paid on it is partially regained through tax deductions. Paying off a mortgage in full, if an investor has the means, might feel good, but it doesn't make much financial sense. Investing that money instead will likely earn returns at a higher rate than what's being paid on the mortgage. Student loans also have long-term financial payoffs, and the interest rates are typically manageable. But the cost of tuition is skyrocketing, and more and more young people are assuming unmanageable debt burdens that will dampen their income for decades. The value of an educational degree must be weighed against the cost. Sinking into $100,000 worth of debt for a degree in a low-income profession will never make fiscal sense.

Bad debt is consumer debt. Credit cards and car loans are beneficial for only one reason: building credit. The interest rates are high, and the items loaned against are depreciating. For every investor, getting out of this type of debt should be a top priority. Avisors should encourage investors to cut expenses, sell things they don't need, and raise extra income — whatever must be done to get out of debt fast.

A basic rule of thumb is that consumer debt should not consume more than 15% to 20% of net income. If someone is paying more, doesn't know how much debt they have, or is only paying monthly minimums, they are in over their heads.

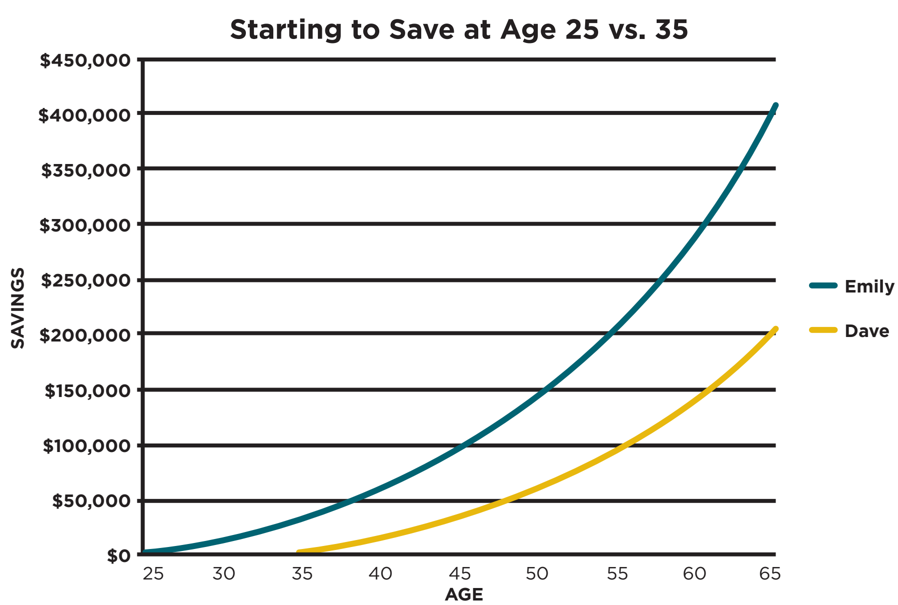
Build Savings

A cash reserve is critical and should cover at least three to six months of expenses. A healthy reserve will prevent dipping into retirement funds or getting back into credit card debt if there's a job loss or unexpected expense.

Prepare for Retirement

Everyone's needs are different, but a general rule is 80% to 100% of present income is needed to maintain a lifestyle in retirement. Housing costs may go down in retirement, but other expenses, such as health care and travel, will go up. Here are a few basic rules to remember:

- **Pay yourself first.** No matter the circumstances, saving for retirement must always be a top priority. There are always bills to pay and college educations to fund, but retirement savings should be treated like a mandatory monthly bill. Set a fixed amount (a good starting point is 10% of annual income), and save regularly.
- **Start saving now!** It's easy to put off a plan when the benefits are only enjoyed in the future. But the power of compounding interest must be illustrated clearly, especially for young investors.



Business Insider / Andy Kiersz

- **Maximize contributions to employer-sponsored retirement plans.** This should be a no-brainer. Some employers match 100% up to 5% or 8% of the employee's contributions. That is free money! But, nearly a quarter of eligible employees don't participate.
- **Choose benefits carefully.** Payouts from employer-sponsored retirement plans can be distributed as monthly payments (taxes are paid based on a ratio), or a lump sum (all taxes are paid), or they can be rolled over into an IRA (taxes are deferred).
- **Don't stop investing.** We're all living longer these days, so don't think the investing game is over at 65.
- **Don't touch retirement funds.** Withdrawing retirement funds early has significant tax penalties, and of course it places retirement plans in jeopardy. People routinely tap retirement funds for expenses such as home renovations, college funds, or — cringe — an immediately depreciating new car.
- **Make a smart decision on Social Security**. The longer individuals wait to receive Social Security benefits, the higher they will be. Receiving benefits at age 62 versus 70 can reduce payments by as much as 75%.

Plan Your Estate

Having proper estate documents in place can make a tremendous impact on people's lives at particularly vulnerable points. People should set up a Power of Attorney (POA) to help ensure a designated representative will help manage their affairs if they are no longer able of body and/or mind, they should also create living wills to ensure their personal wishes are carried out in the event of a terminal illness or accident. Medical durable POAs can combine these documents, and revocable trusts or payable-on-death accounts can be simple, flexible ways to keep funds out of probate and ensure beneficiaries receives their full due.

The Markets

Understanding the Fundamentals

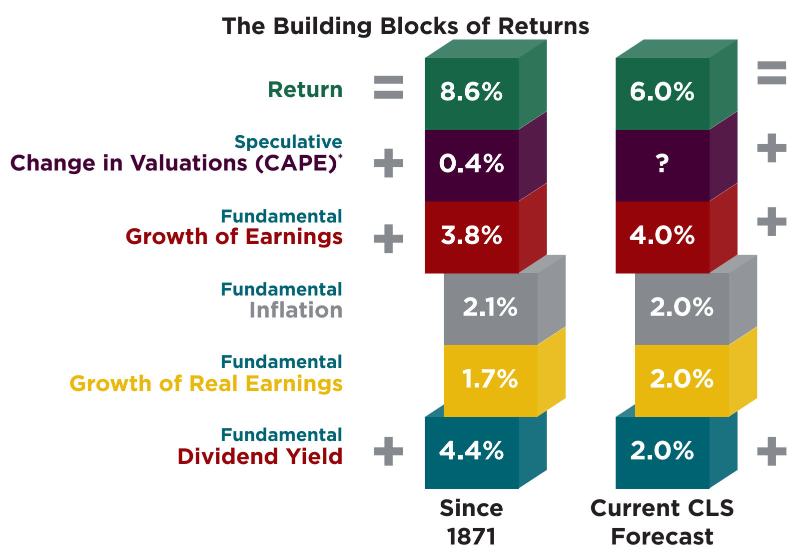
It's hard not to think of the ever-capricious markets in real time, especially when stock tickers and financial pundits create incessant buzz; but, the true nature of the markets can only be understood by studying historical returns and the drivers of those returns. Investors need this historical context to understand how markets work. To illustrate, let's start with the basics.

1. **Yield**
   Yield is the income generated by the investment. For stocks, this would be the dividend. For fixed income investments, this would be the interest paid.
2. **Growth in Yield**
   Will the yield grow over time? Dividends tend to grow over time, while the interest from fixed income does not. Many investors, especially equity investors, like to look at growth in earnings instead of yield because to grow dividends, earnings must grow.
3. **Changes in Valuation**
   Will investors pay more or less for a dollar of earnings or dividends, or coupon interest for a bond, over time?

These building blocks provide investors with a frame of reference for historical returns and the drivers behind them. For instance, since 1871, the U.S. stock market has experienced a return of nearly 9% per year, while:

- The dividend yield has averaged 4.4%.
- Growth of earnings has averaged 3.8%.

Growth is composed of two elements: inflation and real growth. Since 1871, inflation has averaged 2.1% per year. That means real growth (i.e., growth adjusted for inflation) has averaged 1.7%. The change in valuation has added about



Source: Yale School of Management, Shiller, Robert

0.4% per year as valuations have expanded since 1871.

Distribution of Returns Over Time

Explaining the distribution of returns over time, which many overlook, is critical. It demonstrates that investing is not gambling and that one must be invested for the long-haul to realize the power of stock market returns.

The table below displays a lot of information, and it typically surprises investors. While I like to say it's always good practice to expect a short-term loss over the course of any year, the stock market has actually generated a positive rolling 12-month return more than 70% of the time going back to 1871. This is a great point to show investors. Despite how they might feel, the stock market is not a coin flip. Though there is uncertainty and volatility in prices, it is not the same as gambling. Gambling has a negative expectation (i.e., expect to lose over time), but investing has a positive expectation (i.e., expect to make money over time). Over time, the story gets even better. The longer the holding period, the higher the probability of positive returns.

One more point about this table that surprises many investors: how often the stock market has a return of 5% to 10%. This return bucket contains the historical average and, quite frankly, the range most forecasters predict, year after year, for the following year's return. But returns only fall at that point 10% of the time! That's a wow to many investors. Instead, the market experiences losses or double-digit returns more than 80% of the time.

The market is emotional and volatile. Returns like these are destabilizing, and they activate fear and greed. Any loss creates angst, which is natural because it represents hard-earned money, but temporary losses are completely healthy and normal market behavior. Big gains create a different kind of angst — that of missing out. The fear of missing out prompts many investors to abandon plans and chase performance, but that's as destructive as being scared out of the market.

As the primary driver of returns and volatility, the stock market deserves most of the attention, but bonds deserve some too. Bonds help diversify equity positions, which reduce overall portfolio volatility. Bonds also provide income, which many investors require or desire.

Summary

The key to long-term success often boils down to two things. First, proper financial planning, which includes saving enough money to properly invest. Second, understanding of how the financial markets work and having proper expectations. Doing these two things will help many, if not most, investors successfully build and achieve long-term investment objectives.

Thanks for reading. Stay balanced.

Stocks: Distribution of Returns Over Time

Since 1871	1 Year	3 Year	5 Year	10 Year
Returns > 20%	30%	14%	6%	0%
Returns between 10 and 20%	22%	32%	35%	31%
Returns between 5 and 10%	10%	20%	23%	39%
Returns between 0 and 5%	10%	18%	25%	26%
Returns between 0 and -5%	9%	10%	8%	4%
Returns between -5% and -10%	7%	3%	2%	0%
Returns <-10%	12%	3%	1%	0%

As of 6/30/16
Source: Yale School of Management, Shiller, Robert

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 fixed income 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.

A Treacherous Question:
How Do Risks Compare to Potential Rewards?

CLS Chief Strategist, Scott Kubie, CFA

Advisors have a lot on their minds. In addition to worrying about regulators and a tendency to watch too much politically-slanted news, advisors seem extra concerned about markets lately. While most questions I receive from advisors focus on a narrow market segment, a recent question captured the essence underlying a wide range of inquiries.

The advisor asked: "How do risks compare to potential rewards?"

While the question is well stated and thoughtful, its underlying assumptions invite investors to emphasize factors likely to undercut their portfolios. Taken to its logical conclusion, it tempts investors to become market timers. This article will discuss three dangerous assumptions that lurk behind this question:

- Risks are known.
- Investors can understand how markets will react to events.
- Predicting risky events is a fruitful form of research.

Assumption 1: Risks are Known

During the Gulf War, Secretary of Defense Donald Rumsfeld uttered one of the wisest things about risk ever said:

"There are known knowns. These are things we know that we know. There are known unknowns. That is to say, there are things that we know we don't know. But there are also unknown unknowns. There are things we don't know we don't know."

Many risk models focus on quantifying the known unknowns and turning them into probability estimates. But these models assume the factors examined are the risks of greatest concern. While this analysis is important and valuable, our risk systems must allow for the unknowns that can surprise us at any time.

There is value in assessing known risks. There is greater value in humbly admitting that a placid market can be quickly disturbed by something we never imagined.

Assumption 2: Investors Can Understand How Markets Will React to Events

George Osborne, until recently the British equivalent of the Treasury Secretary, predicted turbulent financial markets, low labor productivity, and a weak global economy would make for "a dangerous cocktail of risks" should Britain vote to leave the European Union.

Voters ignored warnings by Osborne (who did a very good job helping Britain recover from the financial crisis) and others and voted to leave anyway. While markets sold off sharply on the news, they have since recovered, and global markets are up 2.23% since the vote in late June.

News is often shaped by how policy makers react to it, and this complicates the process. Predicting the event is only half the battle.

Ben Inker of GMO, summarizes the challenge of the first two assumptions this way:

"To a very significant degree, markets, in the short term, are driven by "news" — events that would have to be predicted ahead of time to properly guess what the markets will do in the future. This task is complicated by the fact that even given an accurate prediction of news or surprises, which for this purpose are synonymous, predicting the actual response of the market is surprisingly tricky, because the connections between data and events and stock market performance are often unintuitive."

Assumption 3: Predicting Risky Events is a Fruitful Form of Research

Even if investors can overcome the challenges of predicting events and market reaction, it still may not be worthwhile to pursue estimating the risk in markets. Investors possess limited time for research. Sifting through websites and gluing yourself to cable news needs to be more profitable than putting greater emphasis on areas of greater importance. What markets offer low valuations? What corporations and countries are experiencing healthy growth?

Investors I know, who watch a lot of news, tend to experience more stress than success. Short-term focus leads investors to miss key rallies and take on too little risk most of the time.

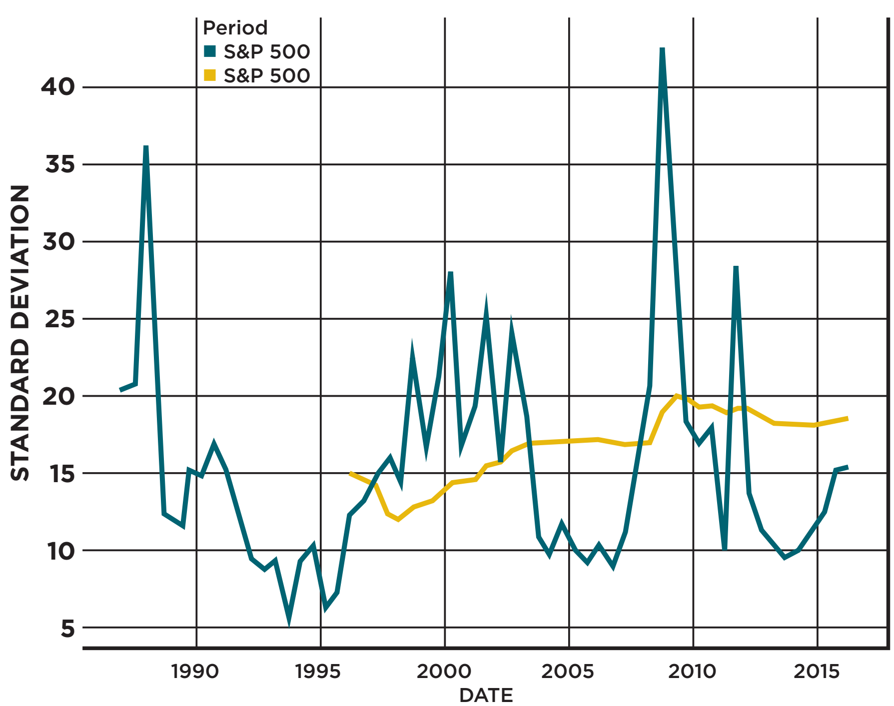
Risk Budgeting's Response

Instead of trying to read the risk levels of our time, Risk Budgeting tacitly assumes risk remains equal. At first, this idea seems difficult to accept. But risk outcomes narrow significantly as time frames expand. The chart below shows the standard deviation of the S&P 500 measured weekly since 1986. The first line measures the standard deviation every six months. The second measures it every 10 years. While the short-term risk spikes and troughs frequently, the 10-year risk stays in a narrow range around 14-16.

The graph also points out an important aspect of risk. Elroy Dimson of the London Business School, defines risk as more things could happen than did. In some years the risks came to be and volatility spiked. In other years they didn't, and markets were excessively calm.

Over the longer term, these events tended to average out. So stay away from market timing, under any guise, and don't spend your days watching the news for the next big risk. Instead, focus on taking the long-term risk you can handle in pursuit of a more meaningful life than staying glued to CNN.

Standard Deviation of the S&P 500 Since 1986



Source: Morningstar

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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