DIRECTIONS
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Keys to Investing Success:

Plus, How to Prepare for Falling Interest Rates.

*Rusty Vanneman, CFA, CMT, 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.*

CLS INVESTMENTS

In this quarter's Directions, CLS's Chief Investment Officer, Rusty Vanneman, explains the best practices investors can use to be successful with their long-term goals. Mr. Vanneman begins by explaining common mistakes investors make and how to control behavioral investing. He then will discuss six tips investors should use when preparing for falling interest rates.

In the investing world, the concept of behavioral finance is red hot these days — and for good reason. Many, if not most, investors struggle with investing, and it's not due to lack of information or intelligence; rather, it is due to temperamental or behavioral factors.

Think about it. The average investor is smart, college-educated, and tech-savvy . He or she has advantages when it comes to successful investing. Yet, investing is hard, especially when markets are volatile. Uncertainty associated with prices zigging higher and zagging lower can be unsettling, especially when it involves hard-earned savings dedicated to goals such as retirement.

This is a completely natural response, of course. We are simply human. We're emotional, and because the markets are composed of people, they can get messy, and so can our responses. The economic textbooks may say we're rationale actors, but it's not really our mental processing capabilities that determine success. Temperamental factors, such as cautious optimism, patience, and discipline, are far more influential. Since staying calm in turbulent times is easier said than done, it's often useful, if not outright necessary, to seek the proper counsel to protect us from ourselves.

To stress the importance of temperament, we quoted Warren Buffett's mentor and famed value investor Benjamin Graham in last quarter's *Directions*: "Individuals who cannot master their emotions are ill-suited to profit from the investment process." And, as Buffett said, "The most important quality for an investor is temperament, not intellect. You need a temperament that neither derives great pleasure from being with the crowd or against the crowd."

The list of behavioral biases is long, but arguably one of the most detrimental is "recency bias." This refers to an investor's tendency to weigh recent information as more important than longer-term data. In other words, instead of seeing markets as cyclical (with an upward, long-term bias) as they truly are, investors often believe a recent trend will continue indefinitely. It's why so many investors buy after prices have gone up, and sell after prices have gone down.

What Investors Can Control

Emotions are hard to control, but through education, counsel, or both, they can be partially managed. The markets also can't be controlled, particularly over shorter time periods. But, again, through education and properly managed expectations about market behavior, the markets' long-term growth can be harnessed.

What can be controlled? For long-term financial security, the most important variable is consistently spending less than what's earned — and to save that difference. Consistent saving is crucial to short-term and long-term financial peace. Once savings are adequate, a safety net has been established (including insurance), and consumer debt is being properly managed, then a saver can be an investor.

Another important factor to control (again, this is easier said than done) is our thoughts. We get bombarded by messaging that creates a sense of urgency and pushes us to act. But, the best thing to do is avoid frequently looking at our portfolios, financial news, or both. Studies have shown the more that investors review their portfolios, the worse they feel about them. And the worse they feel, the more likely they will behave in ways that are detrimental to long-term success.

What *can* also be controlled? If necessary, finding an advisor — somebody who can be trusted because they do what they say they will do. An advisor is someone with whom an investor can have a conversation with and build a relationship. Making sure the counsel is appropriate and reasonably priced are also decisions within an investor's control.

In sum, to rephrase Reinhold Niebuhr's famous Serenity Prayer:

Grant me the serenity and humility

To accept the market vagaries and volatility that I cannot control,

The strength to spend less than my income and to save the difference,

And the wisdom to seek out advice if necessary.

Stock Market Building Blocks

To help manage expectations, investors should consider the building blocks of an investment's return. This applies not only to the stock market, but to all investments. To explain the building blocks, let's look at an excerpt from my recently published book titled, "Higher Calling: A Guide to Helping Investors Achieve Their Goals."

"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, start with the basics."

Stock Market Building Blocks

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 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:

1. The dividend yield has averaged 4.4%.
2. Growth of earnings has averaged 3.9%.

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 1.8%. The change in valuation has added about 0.3% per year as valuations have expanded since 1871.

Six Tips to Prepare for Falling Interest Rates

The Federal Reserve (Fed) is predicting two more rate hikes in 2017, and that has many investors weighing the potential pros and cons of a rising rate environment. But, there are many reasons to believe interest rates could *fall*. The stock market is overvalued, and currently in a mature bull market, so it could easily correct. Uncertainty over fiscal policy in the Trump administration could sink inflation expectations, and the economy could certainly slow. Global rates remain lower than domestic rates, and investor sentiment is so one-sidedly negative right now, it might not take much for rates to start falling.

So, if they do fall, are your portfolios prepared? Below are six tips to help you prepare for whatever direction rates may go.

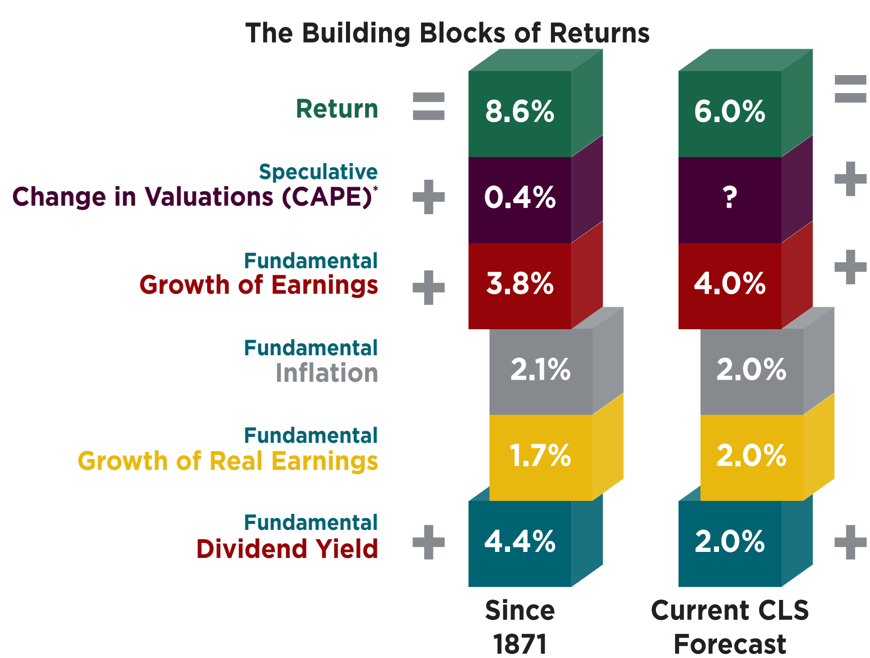
1. **First, define the terms.** What is the definition of an "interest rate environment?" Does it mean short-term rates the government/Fed controls? Does it mean long-term rates that market forces determine? Does it mean Treasury bonds? Corporate bonds?

   The bond market is *way more* complex than overnight rates, 3-month bills, or even 10-year Treasury yields. Like the stock market, the bond market comprises a lot of levers for active managers to pull when making investment decisions, trying to enhance portfolio returns, and managing portfolio risks.

   Defining "interest rate environment" by the Fed's controlled federal funds rate is arguably the best method (but yes, that's debatable). In this case, the definition is simple: What move did the Fed make last? The Fed is increasing short-term rates. Thus, by this definition, we are in a "rising rate environment."

   Defining it by longer-term rates is trickier, and it depends on the time frame. Some investors prefer three months, and in that case, 10-year Treasury yields are in a "falling rate environment." If we look at the 1-year time frame though, rates are rising.

2. **Get your rates straight.** Short-term rates are rising, but that doesn't mean all interest rates are moving higher. In fact, since the last Fed rate increase, 10-year Treasury yields have fallen. Interest rates — depending on maturities, credit risks, and more — can move in different directions.



Source: Yale School of Management, Shiller, Robert

3. **Think about possible market returns in terms of probabilities.** That's how we view longer-term rates at CLS. Asking "What is possible?" and "What is probable?" is far more effective than trying to forecast a single return expectation, which can be a dangerous and unhealthy practice for a few reasons. Thinking in terms of probabilities and possibilities is also consistent with building balanced portfolios.

4. **Be optimistic, but mildly.** At CLS, our current expectation is the bond market will generate a positive return over the next 12 months. We currently assign that a 60% chance. That compares to the long-term average of 85% for positive 12-month returns since 1926. So, we are less optimistic — but still optimistic — than the long-term averages.

5. **Watch the stock market.** Investors own bonds for a number of reasons. They may own them for a dedicated income stream, or they may own them to pay off future liabilities. But typically, investors own bonds to *diversify equity risk.* Not only do bonds dampen portfolio volatility over time, creating a smoother ride for investors, they generally have positive returns when the stock market sinks.

   Also, equity opportunity drives long-term investors' portfolio returns — and risks. So, for many asset allocators, how they feel about the overall stock market will drive bond allocations. In other words, own more bonds (regardless of interest rates) when stocks are expensive; own fewer bonds when stocks are on sale.

6. **Go against the grain.** Investment managers can't beat their competition if they are doing the same thing everybody else is doing. With this is mind, isn't it concerning that *everybody* is talking about a rising rate environment?

   There's an old market chestnut: "The markets like to move in the direction that causes the most pain." The pain trade is for lower interest rates. Bottom line, it is not a sure thing we are in a rising rate environment, so be prepared for whatever may come.

Conclusion

Accepting what is not in our control, and being willing to stand alone against a tide of popular opinion requires a certain amount of humility and strength. That's something I try to keep in mind every day. As I wrote in my book, "Higher Calling:"

"My son and I started a club a few years ago: The Vanneman Boys Club. It has a bunch of cool stuff: secret handshakes, codes, mottos. It's all quite top secret, of course, but I think I can share one story from several years back.

One of our mottos at VBC is: "Always be grateful. Always be humble. Always be strong." When my son Ethan was 11, he asked me, "What about when you go to work?"
"That's still my motto," I told him. "Those rules guide me every day — at home and at work."

For instance, I try to be grateful that we live in a world of opportunities, growth, and innovation, I told him. I'm grateful we can take advantage of these opportunities through the financial markets.

I try to be humble because I don't know how the future will unfold. I may have an informed view, but I don't really know. There will always be volatility and surprises. There will always be rollercoaster rides and black swans. That's why I diversify. Balanced portfolios are humble.

I try to be strong because I work to reach my goals and stay the course. There is strength in purpose. Strength in planning, in taking action, in discipline. And there is strength in patience.

Ethan seemed to be satisfied with the answer. I was too."

Thanks for reading. Stay balanced.

2017 Investment Themes

from CLS Chief Investment Officer, Rusty Vanneman, CFA

GLOBAL VALUE

This theme refers to an emphasis on value stocks around the globe that have lower valuations than the overall market. In other words, they might have a lower stock price to some fundamental unit of value ratio, such as sales or earnings. Not only do relative valuations support increasing positions in value stocks, but an improving economy also supports this theme. We are currently overweight value stocks, and will likely to increase that positioning even more in 2017.

Value stocks sectors CLS will be emphasizing: financials, natural resources, and emerging markets.

SMART BETA

This theme is essentially a re- branding of our previous theme, X-Factor. 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. Over the past year, this investment theme has positively contributed to our performance. Moving forward, while recognizing that all investment styles are cyclical, we believe this theme will provide a durable edge over the long haul.

Equity Factors: Value, Quality, Size, Minimum Volatility, and Momentum
Fixed Income Factors: Credit and Duration

CREATIVE DIVERSIFICATION

This theme remains the same as last year. 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 the ways we actively manage our fixed income exposures, our continued use of alternative asset class segments and strategies, and through buying commodity-based ETFs.

Three Biases Investors Should Avoid in 2017

Senior Market Strategist, Joe Smith, 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.

Investors with these characteristics can also tend to be prone to falling into systematic biases that can result in disaster if they are not careful. Why? Because the human mind plays tricks on all of us when faced with complex decisions in the face of events that are not entirely known today. Investor biases can lead to less than optimal decisions made by advisors and their clients that can impact the ability to meet their long-term goals. Here are three biases that have been identified in academic literature over the years that advisors and their clients should be mindful of when making investment decisions.

1. Overconfidence bias: Overconfidence involves the allusion of having well-calibrated expectations about what is likely to happen going forward in the markets. Many market pundits tend to give examples of their expectations for the Dow Jones or the S&P 500 prediction over the course of the year. Unfortunately, overconfidence can lead to much larger surprises versus their expectations (on both the upside and the downside).

Recommendations:

- Manage you and your client's expectations and avoid making overconfident statements.
- Make clients aware of the uncertainty associated with their investment decisions.

2. Optimism bias: As human beings we tend to be wired to focus on the positives in life and less so on the negative ones. This tends to result in people's beliefs being skewed in the direction of optimism. Optimism can be harmful because it can result in someone underestimating the likelihood of bad outcomes that are not in their control – specifically the movement in the markets. Optimism can also result in people believing events of chance can be thought of as games of skill that can be fully controlled.

Recommendations:

- Communicate realistic odds of success to your clients.
- Keep a list of past recommendations that were not successful.
- Don't focus exclusively on the upside associated with past performance.

3. Overreaction to events of chance: Have you ever found yourself looking for a pattern in what appears to be a random sequence of information? Human beings often look to determine the relationships in outcomes that in many cases are actually random. Investors are guilty of this when they translate a short-term set of outcomes into a long-term trend without any other evidence to support their claim.

Recommendations:

- Make a list articulating your reasoning or rationale behind making an investment decision.
- Ask yourself if your decision is based on long-term objectives or in response to short term trends that may in fact be random.

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