WEEKLY MARKET REVIEW

JULY 18, 2017

In This Edition

- *Will emerging markets finally hit a new all-time high?*
- *Timing the market, did it work well for you this year?*
- *How to improve performance by managing taxes.*

Market Performance

Equities	LAST WEEK	QTD	YTD '17
Total U.S. Market[1]	+1.38%	+1.46%	+10.52%
Domestic Large-Cap Equity[2]	+1.42%	+1.56%	+11.05%
Domestic Small-Cap Equity[3]	+0.93%	+0.98%	+6.02%
International Equity[4]	+2.93%	+2.45%	+16.89%
Developed International Equity[5]	+2.38%	+1.90%	+15.97%
Emerging Market Equity[6]	+4.58%	+3.94%	+23.10%
Fixed Income	**LAST WEEK**	**QTD**	**YTD '17**
U.S. Investment Grade Bonds[7]	+0.45%	+0.09%	+2.36%
Cash Equivalent[8]	+0.02%	+0.04%	+0.34%
Commodities	**LAST WEEK**	**QTD**	**YTD '17**
Commodity[9]	+1.12%	+0.16%	-5.10%

[1]Russell 3000 [2]S&P 500 Index [3]Russell 2000 Index [4]MSCI ACWI ex-U.S. Index [5]MSCI EAFE Index [6]MSCI Emerging Markets Index [7]Bloomberg Barclays Capital U.S. Aggregate Bond Index [8]Bloomberg Barclays Capital 1-3 Month U.S. Treasury Bill Index[9]Bloomberg Commodity

As of 7/14/2017

Week in Review

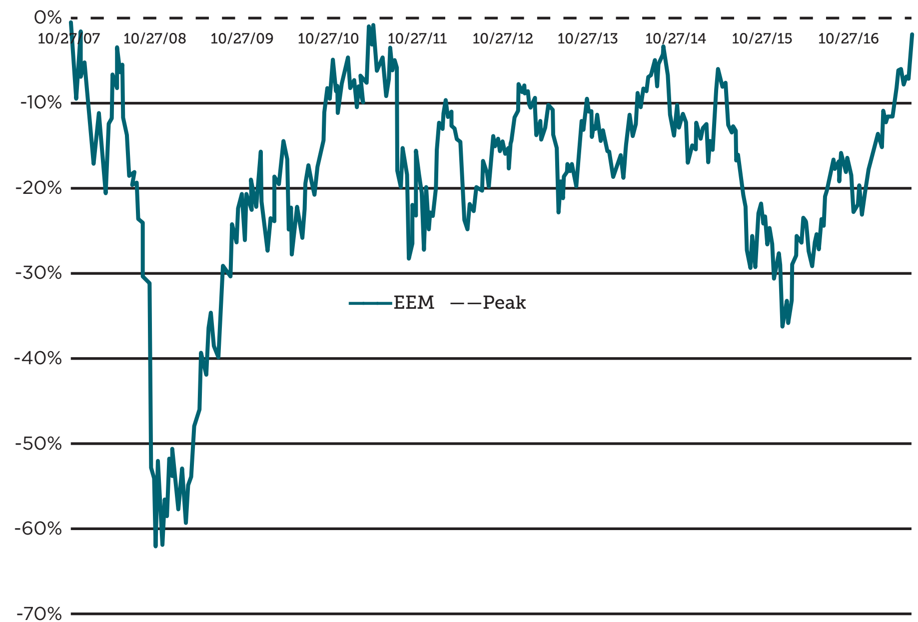
U.S. stocks continued their push higher as the S&P 500 and the Dow closed on a record high for the 24th time this year, and were up nearly 1.4%. International stocks were up almost twice the U.S. markets, at about 3%. One of our largest tilts in portfolios, emerging markets, were up over 4.5% on the week. Diversifying assets such as bonds and commodities were up about 0.5% and 1% respectively. A major headline for the week was Federal Reserve (Fed) Chairwoman Janet Yellen's talk on the economy. Major points were targeted around wage growth pressure and lower than expected inflation – although they conceded inflation is due to pick up. Also, to note was the conversation on the Fed's balance sheet and substantially reducing the $4.5 trillion position over time. Details around the reduction were not given and will be something to watch the rest of the year.

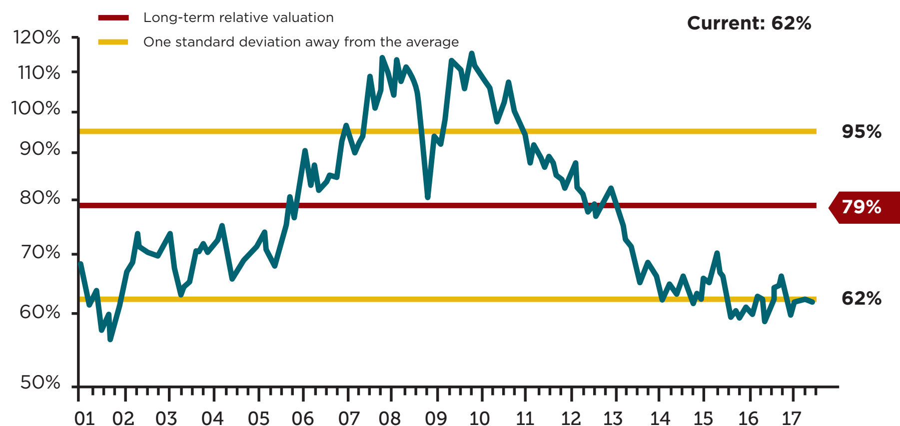
New All-Time High? Close, But Not Quite

- Emerging market stocks approach a new all-time high.
- With current valuations in mind, these markets are still relatively attractive.

We are often asked about investing at all-time highs (we believe it is always a good time to invest) and managing around market peaks. While it's true the U.S. market has been at, or slightly below, all-time highs plenty of times this year, there are still attractively priced areas.

For example: emerging markets. Those up-and-coming countries, such as Hong Kong, Taiwan, India, China, and Brazil, and many of the large companies headquartered there, including Samsung, Tencent, Alibaba, and Baidu, were recently the darlings of the global market. They supplied market investors with great returns in the 2000s until they reached their all-time high on October 29, 2007. Since then, there has not been as much to smile about (see the chart below). These markets have not peaked since, prompting investors to wonder if they are worth it. And since the S&P 500 has reached 154 new all-time highs since emerging markets peaked, it's been hard to make the case that they are. It's worth noting, iShares MSCI Emerging Markets ETF (EEM) is the ETF that tracks the MSCI Emerging Market Index.





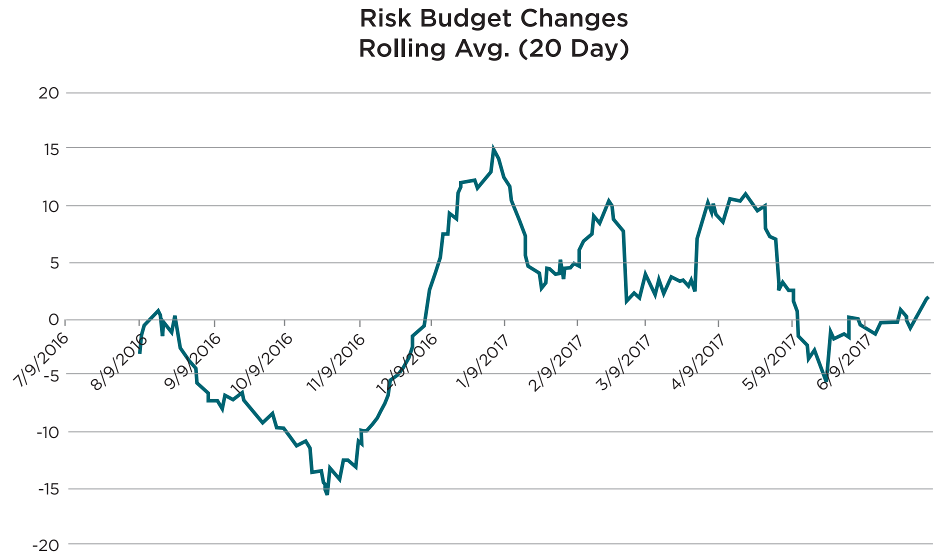
Source: Morningstar, as of 6/30/17

However, so far this year, emerging market companies have been on a tear, doubling U.S. market returns and finally adding that diversification and performance boost we often talk so fondly about. As they inch closer to a new all-time high, the next question we may be asked is whether it is time to sell. We would vote a resounding no. Even though they are very close and may ultimately surpass their previous high, emerging markets are still cheap compared to the U.S. (see second chart below) and still warrant a strong part of future allocations. We dive deeper into this in our most recent Quarterly Market Outlook.

I would like to thank Gene Frerichs, CLS Senior Performance Analyst, for helping with this article.

Feeling Lucky? Enough to Time the Market?

- Over the last year, markets have run up significantly.
- We have seen a significant increase in Risk Budget scores over one year.



Over the last year, global stock markets have given investors a lot to smile about. While calling it "irrational exuberance" may be excessive, valuation metrics are reaching highs rarely seen in the U.S. So, the term first coined by legendary Fed Chair Alan Greenspan may not be far off. Let's just say, things have been very good for stock investors. How good? Over the last year, we have seen double-digit stock returns, near record lows in volatility, global participation, a global economic recovery, strong global earnings growth, and accommodative central banks across the world. What could go wrong?

We often try to set proper expectations and would rather under promise and over deliver. My colleagues recently wrote about tempering return expectations for the stock market, most notably here and here. But, what do investors have to say about it? Often, changes to risk in an account are based on the client's willingness (emotional) to take risk and not necessarily his or her ability (time horizon) or need (goals). We put together a quick study of Risk Budget changes over the last year to determine whether there have been more increases than decreases and chart when they took place as well as the average increase or decrease in the number. Below are the results. (Thanks to Grant Engelbart, CFA, for his help with this data.)

The chart above shows the average Risk Budget change over the past 20 days. It measures both magnitude and frequency. On average, Risk Budgets moved down leading up to the last presidential election, when political emotion may have fueled changes. In December and January, as the market moved higher, we

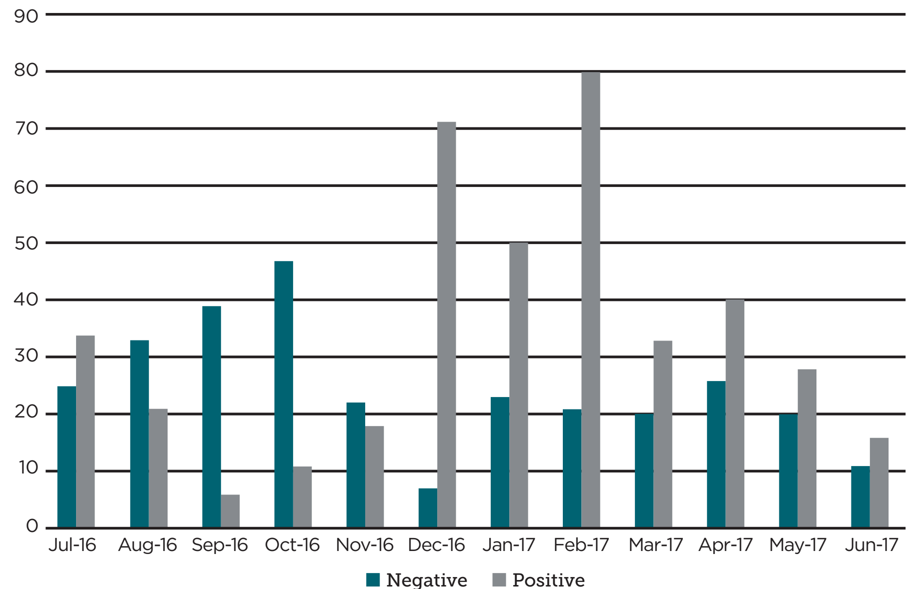
Case Eichenberger, CIMA®
Client Portfolio Manager

Case Eichenberger has been with CLS since 2007. Mr. Eichenberger has held various roles while at the company, including Relationship Representative and Internal Wholesaler. In 2015, he accepted the role of Client Portfolio Manager. In his current role, Mr. Eichenberger co-manages CLS's American Funds strategies, works closely with CLS's separate account strategies (Master Manager), and communicates very closely with advisors and their clients both remotely and in-person.

Mr. Eichenberger holds the Series 6, 63, and 65 licenses. He also holds his Certified Investment Management Analyst (CIMA®) designation. During the accreditation process, Mr. Eichenberger attended the Wharton School of Business at the University of Pennsylvania.

noticed a significant uptick in Risk Budget scores.

The chart to the right shows both negative and positive increases in Risk Budget scores by month over the last year. Negative increases outpaced positive ones in late summer and early fall, leading up to the election (look at October). December, January, and February skewed largely positive, perhaps signaling an increase in risk appetite due to strong market performance.



So, what does all this mean and how do we view it? While we can't conclude anything with certainty, more than 700 changes in the last year, with the average at about 20 points, suggest emotion-driven investing. In a perfectly rational world, the Risk Budget score of investors would almost never change unless a life event happens, such as retirement. In theory, investors maintain their Risk Budget scores no matter what the markets do around them. While we know changes will happen, we hope to become a little better over time at coaching against emotional decisions and chasing returns.

Recent Worthwhile Reads

"Long-Term Returns Have a Cost, and It's Well Worth the Price"
https://www.betterment.com/resources/investment-strategy/behavioral-finance-investing-strategy/long-term-returns-cost/

"Contradicting Warren Buffett: When Volatility is Risk"
http://blog.cordantwealth.com/contradicting-warren-buffet-when-volatility-is-risk?utm_content=56914911&utm_medium=social&utm_source=twitter

"It's the Little Things That Can Color an Investor's Outlook"
https://blogs.wsj.com/moneybeat/2017/07/07/its-the-little-things-that-can-color-an-investors-outlook/

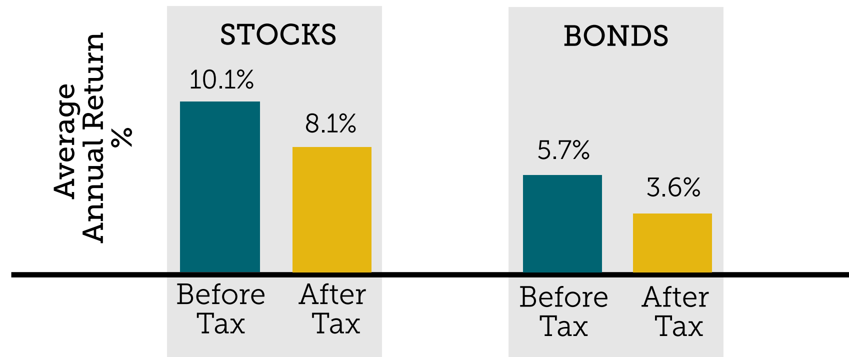
"Time for Investors to Rethink Dollar's Impact on International Equities"
https://thecapitalideas.com/weakening-dollar-impact-international-equities/?cid=sm_tw_11885

"Investors Fight Strange Winds"
https://www.bloomberg.com/gadfly/articles/2017-07-05/investors-find-it-hard-to-stay-course-in-strange-winds

"Every Great Investment Hurts"
http://www.collaborativefund.com/blog/every-great-investment-hurts/

- Taxes have an adverse impact on take-home performance.
- By using newer technologies, investors can improve bottom-line performance.

Impact of Taxes on Investment Returns 1926-2014



56.49%

17,527 out of 31,027 Mutual Funds paid out some capital gains in 2014

6.84%

122 out of 1,794 ETFs paid out some capital gains in 2014

**Source: Morningstar*

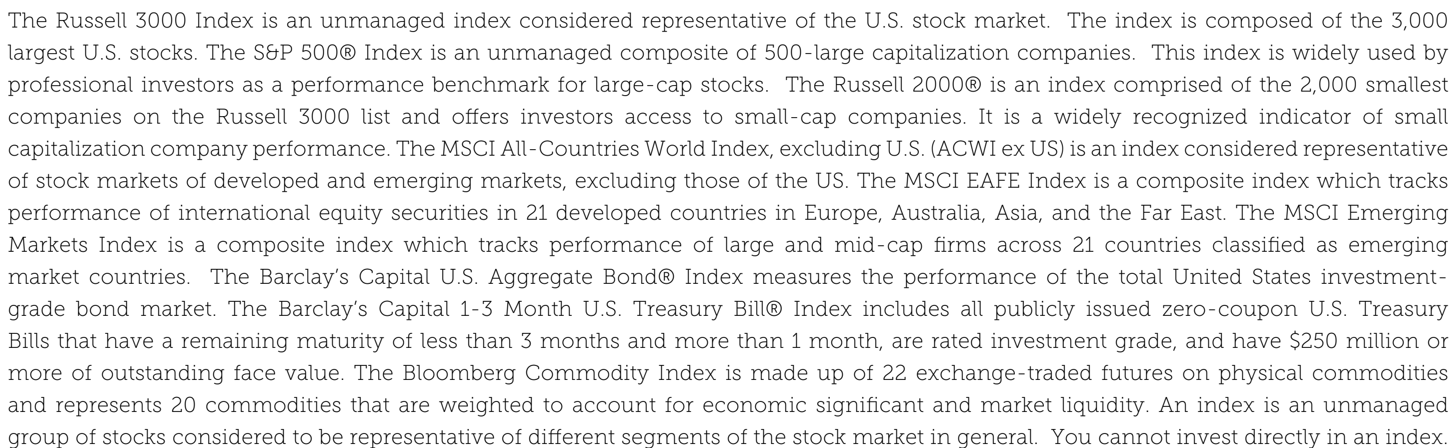
We believe every basis point matters to help improve bottom-line performance for our clients. This is true in the way we manage, trade, and research positions regarding costs, expected returns, etc. But after that is done, there are still plenty of ways to maximize returns for the given Risk Budget. One effective way is through managing taxes and using more tax-efficient vehicles.

After-tax returns on taxable assets to the investor are perhaps the most important planning considerations to keep in mind. This is what the investor keeps in performance and in dollars. Paying taxes is certain on earned income, and paying capital gains sometimes cannot be avoided. However, investors should not pay more taxes than necessary to participate in the market.

Since the 1920s, returns of both stocks and bonds have been reduced by about 200 basis points due to the impact of taxes. In the early days of the market, there may not have been many options for investors to lower that gap. But now, we believe there is plenty of opportunity to improve the net performance for the client through tax-efficiency and tax-management.

The bottom chart notes the tax efficiency of mutual funds and ETFs. Put simply, the "new" technology of ETFs (compared to when mutual funds first launched) allows investors to keep more of what they earn by typically distributing lower (and most of the times zero) capital gains to their shareholders than mutual funds. However, we still prefer mutual funds to other forms of investing, such as stock picking; but for taxable accounts, it may be time to look at buying a 'smartphone' rather than a 'flip phone.'

For more information on how CLS can help manage taxes for investors, please reach out to a sales individual at: 888-455-4244.



The Russell 3000 Index is an unmanaged index considered representative of the U.S. stock market. The index is composed of the 3,000 largest U.S. stocks. The S&P 500® Index is an unmanaged composite of 500-large capitalization companies. This index is widely used by professional investors as a performance benchmark for large-cap stocks. The Russell 2000® is an index comprised of the 2,000 smallest companies on the Russell 3000 list and offers investors access to small-cap companies. It is a widely recognized indicator of small capitalization company performance. The MSCI All-Countries World Index, excluding U.S. (ACWI ex US) is an index considered representative of stock markets of developed and emerging markets, excluding those of the US. The MSCI EAFE Index is a composite index which tracks performance of international equity securities in 21 developed countries in Europe, Australia, Asia, and the Far East. The MSCI Emerging Markets Index is a composite index which tracks performance of large and mid-cap firms across 21 countries classified as emerging market countries. The Barclay's Capital U.S. Aggregate Bond® Index measures the performance of the total United States investment-grade bond market. The Barclay's Capital 1-3 Month U.S. Treasury Bill® Index includes all publicly issued zero-coupon U.S. Treasury Bills that have a remaining maturity of less than 3 months and more than 1 month, are rated investment grade, and have $250 million or more of outstanding face value. The Bloomberg Commodity Index is made up of 22 exchange-traded futures on physical commodities and represents 20 commodities that are weighted to account for economic significant and market liquidity. An index is an unmanaged group of stocks considered to be representative of different segments of the stock market in general. You cannot invest directly in an index.

The graphs and charts contained in this work are for informational purposes only. No graph or chart should be regarded as a guide to investing. While some CLS portfolios may contain one or more of the specific funds mentioned, CLS is not making any comment as to the suitability of these, or any investment product for use in any portfolio. This material does not constitute any representation as to the suitability or appropriateness of any security, financial product or instrument. There is no guarantee that investment in any program or strategy discussed herein will be profitable or will not incur loss. This information is prepared for general information only. It does not have regard to the specific investment objectives, financial situation, and the particular needs of any specific person who may receive this report. Investors should seek financial advice regarding the appropriateness of investing in any security or investment strategy discussed or recommended in this report and should understand that statements regarding future prospects may not be realized. Investors should note that security values may fluctuate and that each security's price or value may rise or fall. Accordingly, investors may receive back less than originally invested. Past performance is not a guide to future performance. Individual client accounts may vary. Investing in any security involves certain non-diversifiable risks including, but not limited to, market risk, interest-rate risk, inflation risk, and event risk. These risks are in addition to any specific, or diversifiable, risks associated with particular investment styles or strategies.

Relative valuation is a method of evaluating the financial worth of a company by comparing its value to the value of its competitors. 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.

*Graph was compiled using data from the Morningstar Direct Database. Morningstar provides figures for assets and annual report expense ratios for all ETFs and mutual funds domiciled in the US. With this information, a dollar-weighted average of expense ratios was calculated for both mutual funds and ETFs. The results are displayed in the graph.

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