CLS's WEEKLY 3

What You Need To Know About the Markets

AUGUST 15, 2017

In This Edition

1. Last week saw a surge in volatility, but it wasn't as unusual as it may seem.
2. The ETF world has been hypnotized by low costs, but there are other considerations.
3. In today's market, there are still places to go to reduce risk and enhance returns.

CLS INVESTMENTS

Market Performance

Equities	LAST WEEK	QTD	YTD '17
Total U.S. Market[1]	-1.52%	+0.52%	+9.50%
Domestic Large-Cap Equity[2]	-1.37%	+0.97%	+10.40%
Domestic Small-Cap Equity[3]	-2.67%	-2.81%	+2.04%
International Equity[4]	-1.69%	+2.37%	+16.81%
Developed International Equity[5]	-1.48%	+1.97%	+16.05%
Emerging Market Equity[6]	-2.24%	+3.72%	+22.84%
Fixed Income	**LAST WEEK**	**QTD**	**YTD '17**
U.S. Investment Grade Bonds[7]	+0.24%	+0.84%	+3.14%
Cash Equivalent[8]	+0.02%	+0.11%	+0.41%
Commodities	**LAST WEEK**	**QTD**	**YTD '17**
Commodity[9]	+0.52%	+1.45%	-3.88%

[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 Index

As of 8/11/2017

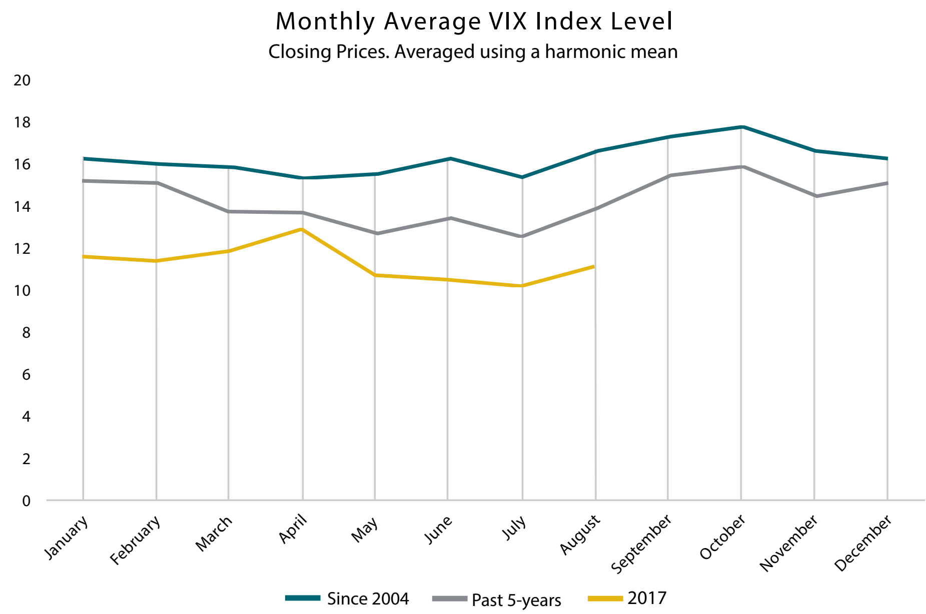
Week in Review

Volatility returned to global markets last week as investors digested earnings reports and rhetoric between the U.S. and North Korea sent a few jitters across asset classes. In equities, domestic large-cap companies and developed market equities fared decently, while risk-on markets, such as domestic small-caps and emerging markets, led declines. All in, the global stock market (as measured by the MSCI ACWI Index) fell 1.6%. Hardly a nose dive, but this was the only week this year that global equities fell more than 1%! To put that in context, the MSCI ACWI was down more than 1% 11 different times in 2016. More on volatility, or the lack thereof, shortly.

In other asset classes, fixed income and commodities shared strength. The yield on the closely followed 10-year Treasury bond closed at 2.19%. Gold prices moved higher by more than 2% on the week, outpacing the S&P 500's gains in 2017. Earnings season is in the later innings, a period typically dominated by retail names, many of which have rock-bottom expectations.

Volatility Is Back! Or Is It?

The Chicago Board Options Exchange Volatility Index (VIX) (which cannot be invested in) shot up a whopping 55% last week. While this seems like an extreme move, there are a number of important things to know before coming to an ill-advised conclusion. The VIX is an often-misunderstood index that is typically akin to measuring volatility (some say fear) in the market place. In fact, it actually measures anticipated volatility over the next 30 days, which is priced into S&P 500 Index options, not specifically realized volatility. Either way, volatility itself is quite volatile – so large moves shouldn't be surprising.



Source: Bloomberg. Harmonic mean helps to smooth the impact of large outliers that can be influenced by using a simple arithmetic mean.

Volatility is coming off an extremely low base. In late July, the index broke through 10 and closed at 9.36 – the lowest level since the VIX methodology was changed in late 2003. Not only has the VIX been exceptionally low this year, the past five years have also been below longer-term levels. Looking back at the events of the past year or even five years, it is probably a bit of a surprise that volatility has averaged at such low levels. Central bank accommodation, a less-volatile global economy, trends in investment strategies, or robust corporate earnings could all be contributing factors.

Whatever the reason, the low level of volatility isn't likely to remain forever (as we've written about numerous times). Spouts of volatility will come and go because stock markets are volatile, and they will reward participants for taking advantage. In recent years, volatility spikes have been quickly met with declines in volatility and rising markets, much to the chagrin of the fearful. Flare-ups like last week may start to wake a few sleepy investors, but if your portfolio is diversified, balanced, and positioned at the proper risk level, you should be able to sleep through the storms just fine.

Grant Engelbart, CFA, CAIA
Portfolio Manager

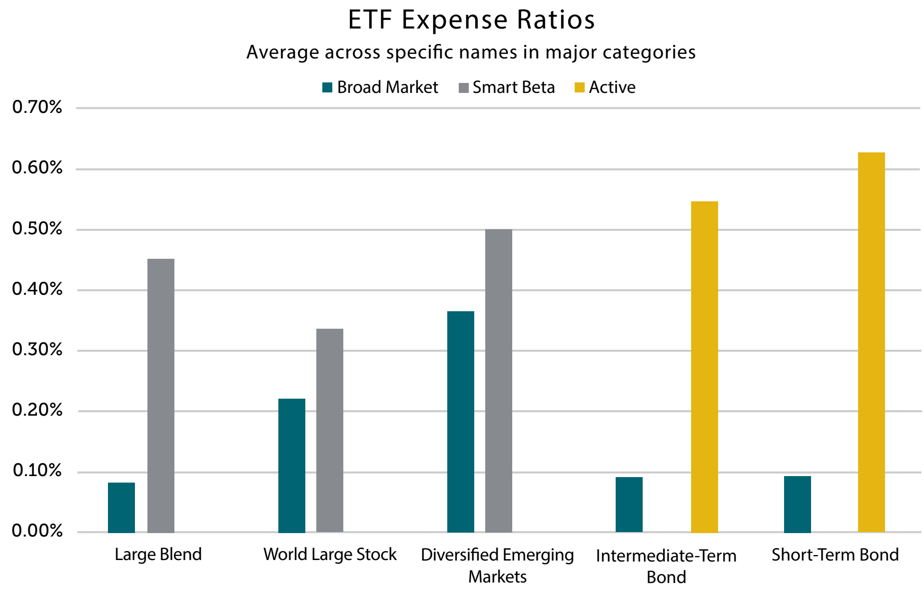
Grant Engelbart manages CLS's aggressive mutual funds and several ETF and mutual fund separate account strategies, including CLS's American Funds portfolios. He also leads the alternative broad asset class team and serves on several committees across CLS's parent company, NorthStar.

Mr. Engelbart first joined CLS as an intern in 2007. He returned in 2009 and held several roles in trading and investment research prior to accepting the role of Portfolio Manager in 2013. He previously held positions at TD Ameritrade and State Street Corporation.

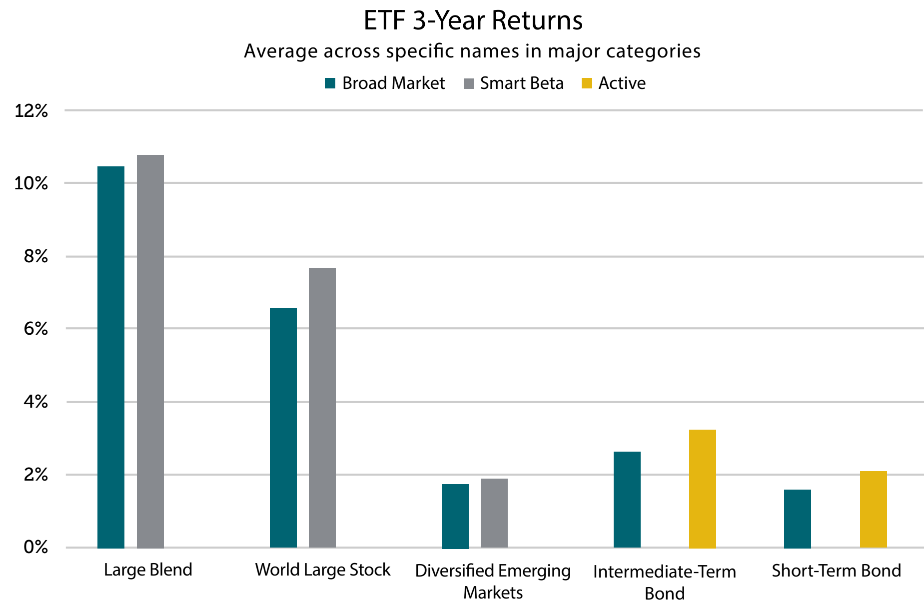
Mr. Engelbart received his Bachelor of Science degree in Finance from the University of Nebraska–Lincoln. He holds the Chartered Financial Analyst® (CFA) designation, Chartered Alternative Investment Analyst (CAIA) designation, and FINRA Series 65 license. He is a member of the CFA Society of Nebraska and the CAIA Chicago Chapter.

Did you know? Grant invested in his first fund at age 13.

Is Cheaper Always Better?



Source: Morningstar



Source: Morningstar

Nearly every week it seems an ETF or index fund issuer is cutting expense ratios to get just one more basis point ahead of the competition. I've written before about some of the issues with only looking at expense ratios and forgetting other costs, so I won't rehash much here. Don't get me wrong, lower expenses are terrific for investors and should definitely be a very important consideration. However, what often gets forgotten is the age-old adage: "You get what you pay for."

One area of ETFs that might be growing faster than issuers cutting expenses is smart beta. We are so passionate about the use of smart beta products that it has been one of our investment themes for two years in a row, and it has become cemented in our philosophy. While smart beta ETFs are getting cheaper and cheaper, they are still more expensive than their dirt-cheap, broad market brethren, as seen in the first chart. *(In fixed income, smart beta is quite new, but active funds have been more prevalent so we will use active instead. At some point soon, we'll be able to compare broad market versus smart beta versus active in equity and fixed income ETFs.)*

But, do you get what you pay for? Turns out you do. Just using average returns across these same categories for multi-factor smart beta ETFs and available active fixed income ETFs, returns over the past three years are better (net of expenses). And, that's just the average ETF - doing due diligence on what drives risk and return in these products can lead to even better outperformance. Not to mention, the risk-management benefits of smart beta products are also crucial to portfolio construction.

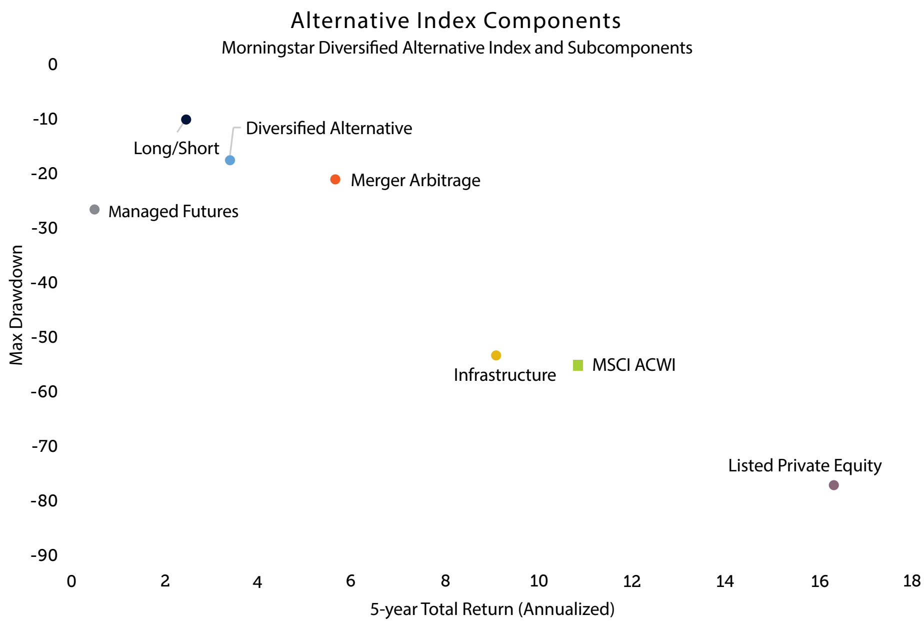
As the universe of products expands and longer time periods emerge, we'll get a better answer to the question. There will surely be products launched that just can't contend with (basically free) index funds, but there will also be (and already have been) terrific multi-factor, and even actively managed equity and fixed income ETFs, that are more than worth their expense ratios. Next time you are choosing between a fund that charges 10 bps or 15 bps, make sure and ask yourself if cheaper is *always* better.

Don't Forget Alternatives

Nearly every day there is a new bull or bear argument out there for stocks and bonds. Investors are becoming more polarized in their views, with many either taking too much risk and others not taking enough. With valuations in some major asset classes stretched relative to history, where is one to look?

Including a diversified basket of alternative asset classes in a portfolio can be a way to avoid the feeling of buying something overvalued, and also help defend your portfolio against tumultuous markets that will come someday. Many of these alternatives are hedged by design, typically shorting out some type of market exposure to limit risk. They are becoming easier to access and less expensive thanks to ETFs.

At CLS, we like to look at a diversified benchmark that exposes us to asset classes that we can actually invest in (unlike hedge funds, venture capital, etc). The components of this benchmark, and the benchmark itself are broken out above. As you can see, by design there are risk-reducing alternatives, such as long/short, managed futures, and merger arbitrage, and there are return-seeking alternatives, such as publicly listed global infrastructure and private equity. All of these asset classes should be diversifying (i.e. less correlated) with traditional asset classes. The combination of risk-reducing and return-seeking provides a smooth ride over a market cycle and gives us plenty of options as to what alternatives we think make the most sense in specific portfolios.



Source: Morningstar

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.

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