MONTHLY MARKET REVIEW

JULY 2017

In This Edition

- *Yet another positive month for the global financial markets.*
- *Risk - What is it? Why do we manage it? Are you prepared?*
- *Why factor investing truly works.*

CLS INVESTMENTS

Market Performance

Stock Market	JULY	YTD '17	12-MONTH
Total U.S. Market[1]	+1.89%	+10.99%	+16.14%
Domestic Large-Cap Equity[2]	+2.06%	+11.59%	+16.04%
Domestic Small-Cap Equity[3]	+0.74%	+5.77%	+18.45%
International Equity[4]	+3.69%	+18.30%	+19.01%
Developed International Equity[5]	+2.88%	+17.09%	+17.77%
Emerging Market Equity[6]	+5.96%	+25.49%	+24.84%
Fixed Income	**JULY**	**YTD '17**	**12-MONTH**
U.S. Investment Grade Bonds[7]	+0.43%	+2.71%	-0.51%
Cash Equivalent[8]	+0.08%	+0.38%	+0.50%
Commodities	**JULY**	**YTD '17**	**12-MONTH**
Commodity[9]	+2.26%	-3.11%	+0.77%

[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]Barclays Capital U.S. Aggregate Bond Index [8]Barclays Capital 1-3 Month U.S. Treasury Bill Index[9]Bloomberg Commodity

As of 7/31/2017

July Market Review

July was yet another good month for the global markets. In fact, it's been a great year and 1-, 3-and 5-years for investors.

In July, the over-all U.S. stock market (Russell 3000) was up nearly 2%, with larger companies (S&P 500) up just over 2% and smaller companies (Russell 2000) up just less than 1%. Each of these indices are up over 16% the last 12 months – about twice the average 12-month trailing return.

Overseas markets are doing even better. Last month, international markets (MSCI ACWI ex-US) were up just under 4%, with developed market (MSCI EAFE) higher by less than 3%. Emerging markets continue to be leaders this year though, (MSCI Emerging Markets) up nearly 6%. Over the last year, international markets are up over 19%, with emerging markets up nearly 25%!

The bond market (Bloomberg Barclays Capital U.S. Aggregate Bond Index) had another decent month last month too, and despite the persistent negativity on the asset class, it is still up nearly 3% year-to-date.

Lastly, the only asset class that is getting beat up this year – commodities (Bloomberg Commodity Index) – had a solid month, as it was up over 2%. It is, however, still down over 3% this year – and down by nearly 13% over the last 3 years.

All-Time Lows

The global stock markets are at, or near, all-time highs. One market, however, hit an all-time low this past month: the Chicago Board Options Exhange (CBOE) Volatility Index (VIX).

The VIX Index is considered by many financial professionals, CLS included, as a key measure of market expectations for near-term volatility in the S&P 500 (U.S. large-cap stocks). More specifically, the VIX estimates volatility in S&P 500 stock index option prices. According to the CBOE, *"Since its introduction in 1993, the VIX Index has been considered by many to be the world's premier barometer of investor sentiment and market volatility."*

Many refer to the VIX as the "fear index" because if the VIX moves significantly higher, it indicates investors expect increased volatility in the markets. Higher volatility is indeed nerve-wracking for many investors.

A key thing to remember about the VIX is that it is determined by market prices of options. It's a real money indicator. It's not just asking what people are thinking. It's capturing what people are doing.

Currently, the VIX is near all-time lows (which it set recently). This clearly does not signal fear, and it may even signal complacency.

During my nearly 30 years in investment management and counseling, I have seen lower market volatility as a win-win for advisors and investors. Not everybody on Wall Street likes lower volatility though. Traders, for instance, prefer prices to jostle around a bit more. The financial media, all else being equal, also prefers more volatility. When the markets are relatively stable, investors get more comfortable. And, when investors are more comfortable, it becomes easier to stick to investment plans. In turn, this helps improve the odds of better investor experiences and eventual investment success.

However, even though expected volatility is currently low, I think it's just a good practice for investors to always prepare for higher volatility, perhaps even more so now given how exceptionally low it is. What we have seen this year is not normal.

An expectation of higher volatility in the near-term doesn't mean investors should become alarmed, but it would be prudent to expect the road to get bumpier. Besides, it should also be noted that August and September have been two of the worst months for stock market performance over the last 20 years and over the last 50 years.

Some Worthwhile Reads From the Past Month:

Rusty Vanneman, CFA, CMT: "Higher Calling: A Guide to Helping Investors Achieve their Goals"
https://www.amazon.com/Higher-Calling-Helping-Investors-Achieve/dp/0692838627

Jeremy Grantham: "Don't Expect P/E Ratios to Collapse"
http://www.barrons.com/articles/grantham-dont-expect-p-e-ratios-to-collapse-1493745553

Howard Marks: "There They Go Again…"
https://www.oaktreecapital.com/docs/default-source/memos/there-they-go-again-again.pdf

Morgan Housel: "Short Investing Rules"
http://www.collaborativefund.com/blog/short-investing-rules/

What is Risk?

What exactly does "risk" mean for investors? The truest and best definition is the risk of not reaching their goals.

At CLS though, when we refer to risk, we are generally referring to price volatility. In my experience working with investors, the most disruptive factor - even if they can't articulate it precisely - is price volatility. In other words, the more prices move up and down - yes, even when prices move higher - the more emotional many investors start to behave. Volatility causes many investors to rush to buy assets after they have already gone up in price and sell after they have gone down.

Everyone likes stability (not only in the markets), and while the best investors see volatility as opportunity - to take advantage of emotion-driven pricing - most see unstable prices as a threat. To manage this volatility or risk, the catalyst that knocks investors off course, we stick to three important beliefs that guide us in building portfolios:

1. Over the long term, investors are rewarded for bearing risk; having too little risk may endanger the attainment of investment goals.
2. All investors have a capacity to bear some investment risk. The capacity to bear risk is a function of an investor's emotional and financial capacity to take risk.
3. The best way to manage risk is to measure it, rather than relying on a traditional stock-to-bond ratio.

Since we believe it is important to manage risk, we use a Risk Budgeting approach to building and managing portfolios. We believe doing so helps investors have better experiences and are more likely to reach their investment goals.

RustyVanneman, CFA, CMT

Chief Investment Officer

*Rusty Vanneman 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.*

Mr. Vanneman received a Bachelor of Science in Management from Babson College, where he graduated with high distinction. He holds the Chartered Financial Analyst (CFA) designation and is a member of the CFA Institute. He is also a Chartered Market Technician (CMT) and a member of the Market Technician's Association (MTA). In addition, Mr. Vanneman has authored a book "Higher Calling: A Guide to Helping Investors Achieve Their Goals."

Now, here's a curveball. Is your portfolio prepared for a market *melt-up*? What if prices move sharply higher heading into year-end? Again, volatility doesn't just mean lower prices.

While investor sentiment is indeed net bullish and valuations are above-average, both of which suggest *below*-average returns moving forward, it seems nearly every advisor and investor I talk to is more concerned about the market falling, and falling hard, than prices moving higher. Bull markets move higher on a *"wall of worry"* and many advisors and investors still seem plenty worried.

The odds are, despite the expectation that stock market returns will be below-average over the next 5-10 years (at least in the U.S.), prices will still likely move higher. Even when the market has above-average valuations, it's still more likely to post gains than losses. And, it's still more likely to post *strong* gains than losses.

To the right is a table of 12-month rolling returns for the U.S. stock market going back to 1871. A few takeaways:

Frequency of Historical Rolling 12-Month Annualized U.S. Stock Market Returns

12-Month Rolling Returns	According to Historical Averages: Frequency of Returns Since 1871*
Returns > 20%	30%
Returns between 10 and 20%	22%
Returns between 5 and 10%	10%
Returns between 0 and 5%	10%
Returns between 0 and -5%	9%
Returns between -5 and -10%	7%
Returns <-10%	12%

Numbers as of 6/30/17
Past performance is not a guide to future performance. Individual client accounts may vary. Probabilities are based on calculations from CLS portfolio managers and research analysts. The CLS outlook is comprised of equal-weighted portfolio manager forecasts in five different return categories. The analyst team is equal weighted to count as a single portfolio manager vote. Historical probabilities for the five categories are also researched. Overall views which are presented have been adjusted based on perceived value by each portfolio manager and analyst.
**Source: Robert Shiller*

1. The market historically has produced more 12-month trailing returns of 20% or more (30% of the time) than losses (28% of the time). I think that's simply a remarkable stat - and one that many investors wouldn't guess.
2. The market has produced a 12-month return that matches the long-term average (the 5-10% bucket) only about 10% of the time! The stock market produces lumpy returns.
3. The market has produced a double-digit gain or a loss 80% of the time. That's another illustration that the markets are not inherently stable. Thus, investors need advice and mechanisms (such as using investment advisors, investment plans, or both) or portfolios (such as Risk-Budgeted ones) to help them navigate that sort of market movement.

So, if prices move sharply higher, how will you react? Will the "fear of missing out" (FOMO) disrupt your investment plans? Again, risk doesn't just refer to downside volatility when prices fall; upside volatility also destabilizes and affects investor behavior.

While we might be in a mature bull market with above-average valuations (at least in the U.S.), which again suggest below-average returns over the coming 5-10 years, that doesn't mean the market can't post strong returns in the months, quarters, and years ahead. In short, there is plenty of kindling piling up (such as earnings, improving economic data, and more) that suggests we could have an interesting back half of the year. Given the market's historical tendencies, including strong seasonal patterns for the *last quarter* of the year, we could see an explosive finish to a great year.

To me, it feels a lot like the late 1990s. Back then, U.S. large-cap growth companies, particularly some flashy names in the technology sector, had moved sharply higher, caught the fancy of investors, and pushed the market into overvalued status. Nonetheless, the market ran higher for a few more years. Eventually though, those gains ultimately wrecked many investors who abandoned sound investment plans and chased the performance of high-flying stocks. They feared missing out and couldn't resist the temptation. Once they jumped in though - and to be fair some investors posted solid gains for a few years - they were in a higher-risk position than they should have been when the market eventually cracked. Many ended up behind where they would have been if they had stayed put.

How should an investor prepare? A regular reader will know my answer. Do nothing, at least not until you talk to your advisor. If your personal situation has indeed changed - your objectives, financial or emotional capacity to take risk, or you've experienced a major life event - a change in your Risk Budget might be warranted. If not, your portfolio is already appropriate. Just know that the market is inherently volatile, but thankfully it should ultimately move higher over time.

Factor Investing - Why We Like It

In addition to Risk Budgeting, there are a variety of ways we work to manage risk in portfolios. One way is through the use of smart beta ETFs.

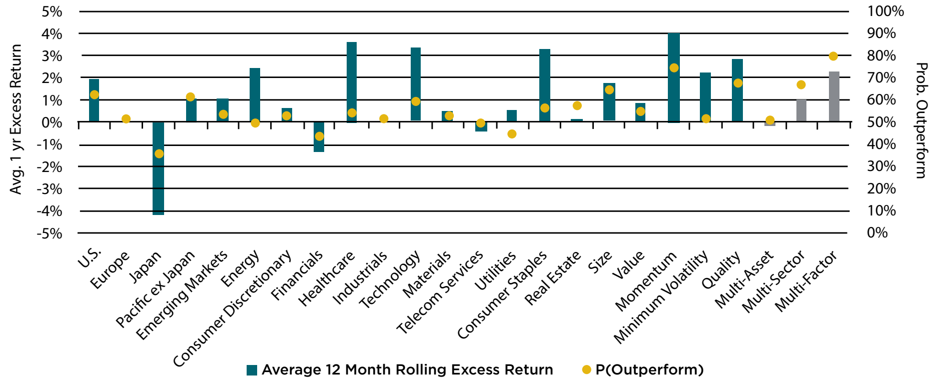
CLS is a leading user of smart beta ETFs. Smart beta is built on factors, such as momentum, value, or quality. Instead of building portfolios the traditional way around economic sectors and industries, many investors also utilize factor investing to enhance their odds of success.

Investing is about probabilities, and successful investors are always looking for an edge to maintain or improve risk-adjusted performance.

According to research by CLS Senior Market Strategist Joe Smith, CFA, factors improve the odds of beating the markets over time. According to Joe's work, individual factors tend to outperform the markets 62% of the time on average, while asset classes and sectors only do this roughly 53% and 52% of the time respectively. When combined into an equal-weighted mix, factors outperform almost 80% of the time, while equal-weighted mixes of asset classes and sectors only do so 51% and 67% of the time respectively.

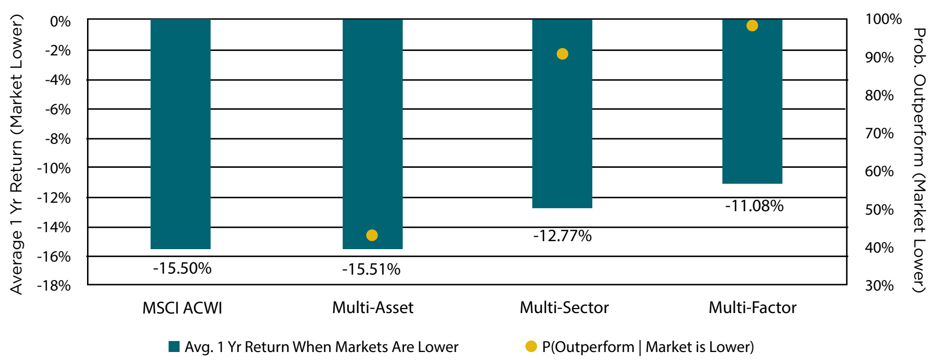
The top chart to the right, while it might take time to unpack, is beautiful. The data goes back to 1996 and shows 1-year rolling excess returns versus the global stock market. The teal lines show the average excess return and the gold dots show the probability of outperforming over the prior 12 months. The "Multi-Factor" bar on the far right has an average excess return of 2% per year and an 80% probability of outperforming the overall global market.

Avg. 1 Year Rolling Excess Return vs. Odds Outperforming Market: Asset Classes, Sectors, and Factors



Sources: FTSE/Russell, MSCI, Morningstar Direct, and CLS Investments. Performance versus MSCI All Country World Index for Russell 3000 Index and MSCI Indexes. Multi-asset, multi-sector, and multi-factor portfolios are equal-weighted mixes of asset class, sector, and factor index components. From January 1996-June 30, 2017.

Avg. 1 Year Return in Downside Market vs. Odds Outperforming in Downside Market



Sources: FTSE/Russell, MSCI, Morningstar Direct, and CLS Investments. Performance versus MSCI All Country World Index for Russell 3000 Index and MSCI Indexes. Multi-asset, multi-sector, and multi-factor portfolios are equal-weighted mixes of asset class, sector, and factor index components. From January 1996-June 30, 2017.

The factors we follow at CLS are: size, value, momentum, minimum volatility, and quality. Notice that all have positive historical excess returns and higher than 50% probabilities of success. Those are better odds than regions or sectors provide.

Of course, by isolating those years the market has negative returns, the odds of success by factors improves. Please see the bottom chart above. In down years, an equal-weighted mix of factors has outperformed the market by about 4.4% on average. An equal-weighted mix of sectors has typically outperformed the market, but only by 2.7%, while an equal-weighted mix of asset classes was on par with the market.

Bottom line: We believe factor investing improves the odds of improving our bottom lines.

As always, a sincere thank you for reading. If you have any questions or feedback, please let me know.

Stay balanced.

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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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