CLS's WEEKLY 3

What You Need To Know About the Markets

NOVEMBER 7, 2017

1. Education and managing expectations/emotions are as equally important, if not more so, as generating returns for investors.
2. Why do we have investment themes, and what do they say about our current thinking?
3. What is smart beta, and why do we like it?

Market Performance

Equities	OCTOBER	YTD '17	12-MONTH
Total U.S. Market[1]	+2.18%	+16.40%	+23.98%
Domestic Large-Cap Equity[2]	+2.33%	+16.91%	+23.63%
Domestic Small-Cap Equity[3]	+0.85%	+11.89%	+27.85%
International Equity[4]	+1.88%	+23.41%	+23.64%
Developed International Equity[5]	+1.52%	+21.78%	+23.44%
Emerging Market Equity[6]	+3.51%	+32.26%	+26.45%
Fixed Income	**OCTOBER**	**YTD '17**	**12-MONTH**
U.S. Investment Grade Bonds[7]	+0.06%	+3.20%	+0.90%
Cash Equivalent[8]	+0.08%	+0.64%	+0.69%
Commodities	**OCTOBER**	**YTD '17**	**12-MONTH**
Commodity[9]	+2.14%	-0.79%	+2.35%

[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 10/31/2017

Week in Review

Despite its bad reputation, October was another good month for the stock market. October is usually one of the worst months of the year for stocks, but in this bull market, below-average seasonals or bad news just isn't enough to slow stocks down.

Last week, however, saw plenty of market-friendly news. Earnings growth continued to be strong, a new Federal Reserve Chairman, Jerome Powell, who is generally considered to be market-friendly, was nominated, and a pro-business tax plan was proposed. However, it could be argued that the market should have done even better given these events. Then again, most of this good news had already been priced in. Earnings growth was expected to be strong, Jerome Powell was widely considered to be the chair pick, and the tax plan was anticipated (though it appears doubtful it will pass in its current form).

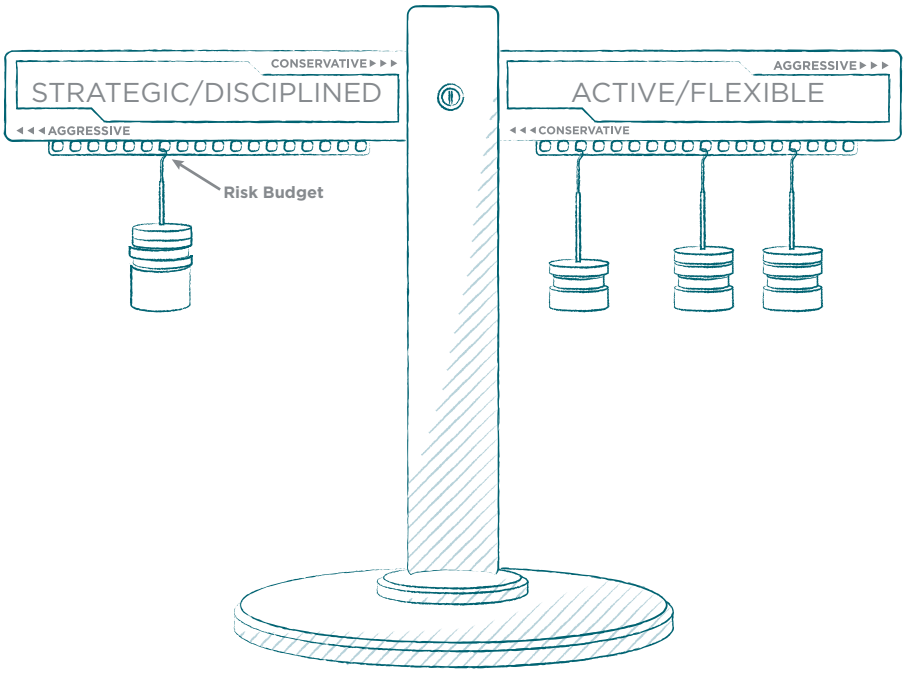
Last month, the overall U.S. stock market (Russell 3000 Index) was up 2%, with larger companies (S&P 500 Index) up 2% and smaller companies (Russell 2000 Index) higher by 1%. Overseas markets also performed well. Overall, international markets (MSCI ACWI ex-U.S. Index) were up 2%, with developed markets (MSCI EAFE Index) higher by 2%. Emerging markets continue to lead (MSCI Emerging Markets Index) and were up approximately 4% in October. The bond market (Bloomberg BarCap Aggregate Bond Index) was up slightly last month. The 10-year Treasury yield closed at 2.38%. Commodities (Bloomberg Commodity Index) were also up 2%.

Please note the year-to-date and one-year numbers listed above. They are very strong. The last two months of last year also saw very strong relative performance by the domestic markets over international. For instance, the Russell 3000 was up 16% for the year as of October 31, but it was up 24% over last year. Emerging markets, meanwhile, were up 32% as of October 31, but they were up 26% over last year. These numbers show the strength of recent market performance and that of domestic stocks at the end of 2016. So, what does this all mean? By year-end, we can hope to expect international returns to assert their dominance even in the one-year time frame.

The Why Behind the CLS Weekly 3

Several months ago, we rebranded our "CLS Weekly Market Review" and named it the "CLS Weekly 3." While the content didn't change greatly, the new name encouraged our portfolio managers to narrow the market news down to the most significant three messages of the previous week, and it lets our readers know these three points were not to be missed.

The three items are generally related to questions we have received from advisors or investors, or to our current thinking and portfolio positioning. We believe regularly communicating these thoughts in language that is accessible, honest, and educational (plain talk) is essential to creating positive long-term investor experiences.



Much like a scale keeps weight balanced, Risk Budgeting ensures that the amount of risk in your portfolio is equal to the level of risk you are comfortable taking.

Investment management isn't just about generating a rate of return. It's more than that. It's about the overall investor experience. A thoughtfully constructed portfolio that takes appropriate risks and generates satisfactory returns at a reasonable cost is indeed important to the investor experience, but so are the communication, education, and client service that go with it.

Investors need to feel comfortable and confident within their portfolios. Not being surprised by a portfolio's behavior is crucial to staying balanced and staying the course. Building and managing portfolios exactly as explained and providing the necessary support through all market conditions are key to maintaining that comfort and confidence.

Several years ago, I read a book about the restaurant Commander's Palace in New Orleans (perhaps one of my favorite restaurants anywhere). A chapter related to the business of owning restaurants and why anyone would want to take that on was particularly interesting. Its message was: A successful restaurant, or any successful business, needs to create an overall experience that satisfies customers, if not thrills them, and keeps them coming back. It isn't just about great food — and investing isn't just about creating strong portfolios.

At CLS, we communicate with much more than our Weekly 3. Besides traveling to see advisors and clients and speaking with them by phone, we also regularly produce essential materials, such as the Quarterly Market Outlook, the Quarterly Reference Guide, our Monthly Perspectives (which highlight our latest thinking and positioning), and our Monthly Chart Packs. We also write internal commentary, white papers, blogs, and contribute content to outside publications, and we create a lot of videos. Our audiences include

investors, advisors, and our fellow teammates at CLS.

We also recently reformatted our bi-weekly podcast (please check it out and subscribe — links are below) and have renamed it "CLS's The Weighing Machine." The podcast's new title is a play on three things:

1. This quote by the father of value investing, Benjamin Graham: "In the short run, the market is a voting machine, but in the long run, it is a weighing machine." Essentially, Graham was referencing the fact that short-term market movement is often caused by investor emotion and sentiment, but fundamentals and valuations win out over longer periods.

2. At CLS Investments, we use Risk Budgeting to build portfolios. We work to balance an investor's Risk Budget with the appropriate blend of asset classes depending on his or her shifting risk characteristics and return expectations. To illustrate this concept, we use a scale.

3. In my commentary, I often close with the phrase, "stay balanced," again referring to the importance of keeping a stoic mindset when it comes to staying invested in the markets. Investors should never get too high (greedy) or too low (fearful).

"CLS's The Weighing Machine" can be found in various places:

- Apple: here and here
- Android: here

RustyVanneman, CFA, CMT

Chief Investment Officer

Rusty Vanneman is responsible for all investment operations at CLS, including investment philosophy, process, people, positioning, and performance. Mr. Vanneman is also responsible for internal and external communications regarding market environment and current investment strategies. He is part of the management team on two mutual funds (one aggressive and one balanced).

*Mr. Vanneman joined CLS in September 2012 as Chief Investment Officer. Previously, he served as 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 and he served as 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 degree in Management from Babson College where he graduated with high distinction. He has held the Chartered Financial Analyst (CFA) designation since 1994, and is a member of the CFA Institute. He has also been a Chartered Market Technician (CMT) since 1999, and a member of the Market Technician's Association (MTA). In addition, Mr. Vanneman authored the book "Higher Calling: A Guide to Helping Investors Achieve Their Goals." He was named one of the Top 10 Portfolio Managers to Watch by Money Management Executive in 2017.**

Did you know? Rusty had a brief stint as a cowboy near Valentine in Cherry County, Nebraska.

**CLS Investments, LLC ("CLS") Chief Investment Officer, Rusty Vanneman, CFA, CMT, was selected as a "Top 10 Fund Managers to Watch" in 2017 by Money Management Executive. Money Management Executive is an unbiased, third-party publication covering the asset management industry. Money Management Executive chose the list of managers to watch by screening Morningstar data from funds with a single manager, ranked as having the best three-year annualized returns in their respective categories. The list of managers was published March 27, 2017. Money Management Executive is not affiliated with CLS. Ratings and awards may not be representative of any one client's experience and are not indicative of CLS's future performance.*

CLS Investment Themes

It's the time of year when clients start to ask if we are changing the CLS Investment Themes for the New Year. Meanwhile, others might be asking, "What are the CLS Investment Themes?"

First, here's some background. At CLS, we run several strategies. We have a team of 13 high-achieving and competitive individuals, who have different training, biases, and opinions on the markets. Despite these differences and the potential for mixed messaging (for instance, one portfolio manager could be buying a sector while others are selling it), there are three characteristics that unify the various CLS portfolios and strategies.

1. We all share the same basic philosophy and methodology for managing portfolios: Risk Budgeting. More than 90% of CLS assets are formally Risk-Budgeted, and the remaining are risk-managed, but not officially managed to a specific Risk Budget target. These include our protection-focused strategies and our Active Income X Strategy.

2. Each portfolio shares the same basic investment process, which utilizes both in-house tools, such as Risk Budgeting and the CLS Edge Score (our proprietary expected return tool), and third-party tools, such as Factset, Morningstar Direct, Bloomberg, and Ned Davis Research. We share office space, hold regular meetings, and have plenty of hallway discussions. All of these factors tend to nudge portfolios in similar ways.

3. The CLS Investment Themes, approved by the CLS Investment Committee, which formally meets each quarter, but interacts regularly, are expressed in every portfolio at CLS. It is up to the Portfolio Management Team to articulate the themes within the portfolios and strategies.

These themes are usually held for some duration. It is important to note they are not swapped out each year (coincidentally, the last few changes occurred around the beginning of the year). Currently, there is debate (there is always debate!) about how the themes might change in the quarter(s) ahead, but at this point, no changes are imminent. That said, this could change.

Our current CLS Investment Themes:

Global Value

- We are emphasizing value stocks, ranging from emerging markets to financials, around the world.

Smart Beta

- We are using smart beta ETFs heavily in CLS portfolios. Smart beta ETFs emphasize equity factors, such as quality, value, low volatility, momentum, and small-caps, in addition to fixed income factors, such as credit and duration. We believe emphasizing smart beta ETFs will help enhance returns and manage risk better than traditional market-cap-weighted ETFs.

Creative Diversification

- Since interest rates are low, we use fixed income to diversify equity-dominated portfolios by actively managing our fixed income exposures, including the maturities, credit qualities, and sectors of our bond holdings. We also use alternatives, including commodities.

For more on our current investment themes, please refer to our Quarterly Market Outlook.

Let's focus on smart beta, as this theme will surely be in place in the years ahead.

Smart Beta Investment Theme: Update on Performance

Our smart beta theme is very important to understanding CLS portfolios. While smart beta ETFs have become increasingly popular, they are still not always easy to explain. Adoption rates are quickly increasing, but surveys show the leading reason adoption rates are not higher is that investors are still trying to understand what they are and what they are used for. With that said, let's review why we like using smart beta ETFs so much.

Smart beta (factor-based) ETFs are, technically, any ETF that is:

1. Passively managed, i.e., managed to match the performance of its underlying benchmark. (Conversely, actively managed funds work to outperform their underlying benchmarks).

2. Has underlying securities weighted by any weighting scheme or factor that is not capitalization (market capitalization = shares outstanding multiplied by stock price). For instance, smart beta ETF portfolios could be weighted by revenues or earnings.

A factor is a screen, or filter, that a portfolio manager might use to build a portfolio. A durable factor, one that works over time, must be based on both economic intuition and academic evidence.

Those are the technical elements, but why do we use them? In short, smart beta ETFs capture the essence of active management at a fraction of the cost.

Let's break that last sentence down. They capture the essence of active management because the factors that construct smart beta ETFs are typically the same fundamental screens many money managers use when building portfolios. These factors are usually significant drivers in the methodology used by a particular manager to manage her or his fund. Lower cost is obviously a plus. All else being equal, lower cost always wins. Thus, smart beta is attractive because many investors use active management in an attempt to achieve superior, risk-adjusted performance, but these allow them to do so at a far lower cost. To contrast, the average actively managed mutual fund has an expense ratio in excess of 1% per year. The average smart beta ETF, meanwhile, has an expense ratio of approximately 30-35 basis points, or one-third of 1%. That's a good head start for better performance.

Better yet, factor investing - particularly when using the five global equity factors we focus on at CLS: quality, value, low volatility, momentum, and small-caps - has provided an average annual excess return (above the overall market) of more than 2% a year for the last 20-plus years. The average factor excess return has also been positive in 81% of those years.

Best yet, these factors have performed even better in down years. Over the last 21 years, the MSCI All Country World Index has experienced a negative return in six of those years. In each, the average factor has been higher for the year. The average excess return in those years was +4.6%.

CLS Analyst, Michael Hadden, broke down each global factor that we utilize going back 21 years and compiled the table of data on the next page (a treasure trove of useful info). Using this table, we can see the strong positive skew to the factor's relative performance, which offers a convincing argument to favoring smart beta exposure.

For the year, at least through September 30, the average return for a factor was 0.7%, which is about on pace for typical performance. Momentum is leading the way this year (up nearly 7% relative to the overall market). Quality has also experienced positive excess return. Minimum volatility, meanwhile, is lagging, but that is to be expected considering the overall market's strong gains this year.

Given the numbers above, it should come as no surprise that about one-third of CLS portfolios, and about half of our equity exposure, are invested in smart beta ETFs. Those numbers are growing at CLS, and they are growing industry-wide. Adoption rates are quickly increasing as are overall allocations.

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

Stay balanced.

Rusty Vanneman, CFA, CMT
CLS Investments
Chief Investment Officer
Rusty.Vanneman@ CLSInvest.com
402-896-7641

Smart Beta Investment Theme: Update on Performance (Continued)

Multi-Factor	Average Return	Positive Excess Return	Negative Excess Return	Batting Average
All Years	2.3%	17	4	81%
Postitive ACWI Years	1.0%	11	4	73%
Negative ACWI Years	4.6%	6	0	100%
Quality	**Average Return**	**Positive Excess Return**	**Negative Excess Return**	**Batting Average**
All Years	2.7%	13	8	62%
Postitive ACWI Years	1.4%	13	8	62%
Negative ACWI Years	4.8%	6	0	100%
Momentum	**Average Return**	**Positive Excess Return**	**Negative Excess Return**	**Batting Average**
All Years	3.8%	15	6	71%
Postitive ACWI Years	4.9%	12	3	80%
Negative ACWI Years	1.7%	3	3	50%
Value	**Average Return**	**Positive Excess Return**	**Negative Excess Return**	**Batting Average**
All Years	0.8%	12	9	57%
Postitive ACWI Years	0.5%	9	6	60%
Negative ACWI Years	1.5%	3	3	50%
Size	**Average Return**	**Positive Excess Return**	**Negative Excess Return**	**Batting Average**
All Years	1.5%	13	8	62%
Postitive ACWI Years	1.0%	9	6	60%
Negative ACWI Years	2.5%	4	2	67%
Minimum Volatility	**Average Return**	**Positive Excess Return**	**Negative Excess Return**	**Batting Average**
All Years	1.5%	10	11	48%
Postitive ACWI Years	-4.0%	4	11	27%
Negative ACWI Years	11.9%	6	0	100%

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 Bloomberg Barclay's Capital U.S. Aggregate Bond® Index measures the performance of the total United States investment-grade bond market. The Bloomberg 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 exchange-traded futures on physical commodities and represents 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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