DIRECTIONS
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The Case for Investing in Real Assets

Plus, A Look into Bitcoin

In this quarter's Directions *newsletter, CLS's Chief Investment Officer, Rusty Vanneman, CFA, CMT shares a brief review of 2017 and outlook for 2018. Mr. Vanneman then goes on to explain the importance of investing in real assets to maintain a diversified portfolio. He finishes up with a breakdown on Bitcoin and CLS's thoughts on cryptocurrencies.*

*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.*

Learn more about Rusty here.

CLS INVESTMENTS

It has been a fantastic year to be an investor in the U.S. and global markets. The U.S. stock market stacked yet another strong year onto what is currently the second longest and second strongest bull market (defined as a gain of 20%, or more, from market lows) in market history. International stock markets did even better. Diversifying asset classes, such as bonds and real assets (such as commodities and real estate) also had gains, though not nearly as strong as the stock market.

It should be noted that thanks to the strong market gains in recent years, valuations (how much one pays for a dollar of fundamental value, such as revenue or earnings) are at high levels compared to historical averages and ranges. In turn, it should be expected that returns should be lower in the years ahead. If the average stock market return is 8-10% (it depends, of course, on the time frame), then investors should expect less – such as an average of 6% or lower over the next 10 years for the U.S. stock market.

The outlook does improve a bit for international stock markets. While their absolute valuations are also elevated, they are not nearly as much so as they are in the U.S. Thus, there is potential for higher returns from overseas markets, particularly emerging markets (such as China, India, Latin American, etc.) in the years ahead given their superior valuations, expected higher growth rates, and younger demographics.

The bond market, meanwhile, is currently offering much lower interest rates than the long-term historical averages. That also suggests below average returns, and the expected return for a bond is

typically the current yield. That said, for corporate bonds, the expected return is the current yield MINUS some adjustment for possible credit default. Nonetheless, like the stock market, returns are likely to be positive in the bond market, even if interest rates rise, as has been the historical experience.

Later in this commentary we will touch upon some non-traditional asset classes. First, what are real assets? This is a pocket of the market that has clearly underperformed in recent years and may even have a strong change to outperform conventional stocks and bonds in the years ahead.

Another asset class, cryptocurrencies, have burst onto the scene in recent years, with explosive returns this past year. It can be argued that this is indeed a new and important asset class, but not appropriate for most portfolios yet due to extremely high and erratic market behavior. More on both of these asset classes below.

The Case for Investing in Real Assets

Content in this "Reall Assets" section was provided by Portfolio Managers Paula Wieck, CFA, and Grant Engelbart, CFA, CAIA.

As stock and bond valuations continue to be expensive, investors should brace themselves for below-average market returns in the years ahead. This is why it is imperative to incorporate additional asset classes into long-term strategic portfolios. Real assets, defined as real estate, infrastructure, natural resource companies, and commodities, are taking on a more crucial role within strategic portfolio allocations due to their innate abilities to hedge against inflation, enhance diversification to stocks and bonds, provide reliable and stable income streams, and potentially provide superior risk-adjusted returns over time. Real assets can also be invested in through funds, both mutual funds and exchange traded funds (ETFs), which offers investors diversified portfolios, professional management, lower investment minimums, daily liquidity, and reasonable, if not flat-out low costs.

What Are Real Assets?

Much like the name implies, real assets provide exposure to physical assets, such as buildings, railroads, electricity, water, industrial metals, precious metals, and agriculture. Real assets can be beneficial due to their sensitivity to macroeconomic drivers, such as inflation and GDP growth trends, and their defensive qualities. These qualities are created by the relatively inelastic demand of a growing consumer population (demand stays constant for many real assets despite how the economic environment behaves), and relatively stable income streams throughout various market cycles.

Real Assets Can Benefit Strategic Portfolio Positioning

Real assets provide low correlations to stocks and bonds, may provide superior risk-adjusted returns, are powerful inflation hedges, and provide stable and reliable income streams.

- *Low Correlations Lead to Enhanced Diversification*: When securities have lower correlations to stocks and bonds that means they tend to behave differently through varying market cycles, which provides better diversification and lower portfolio volatility. Not only do real estate, infrastructure, natural resources, and commodities diversify stocks and bonds, but they diversify each other too, amplifying the diversification impact.

  The table below shows the correlation between major classes over the last 15 years. The lower the correlation, the more powerful the diversification benefit. For example, the correlation between the MSCI ACWI indices (which is the

Real Assets Benefit Strategic Portfolio Positioning

		1	2	3	4	5	6
1	MSCI ACWI NR USD						
2	BBgBarc U.S. Agg Bond TR USD	0.06					
3	Bloomberg Commodity TR USD	0.54	0.07				
4	S&P Global Natural Resources TR USD	0.81	0.02	0.74			
5	S&P Global Infrastructure NR USD	0.89	0.28	0.56	0.77		
6	DJ Global World Real Estate TR USD	0.87	0.27	0.46	0.64	0.86	

■ 1.00 to 0.60 ■ 0.60 to 0.20 ■ 0.20 to -0.20 ■ -0.20 to -0.60 □ -0.60 to -1.00

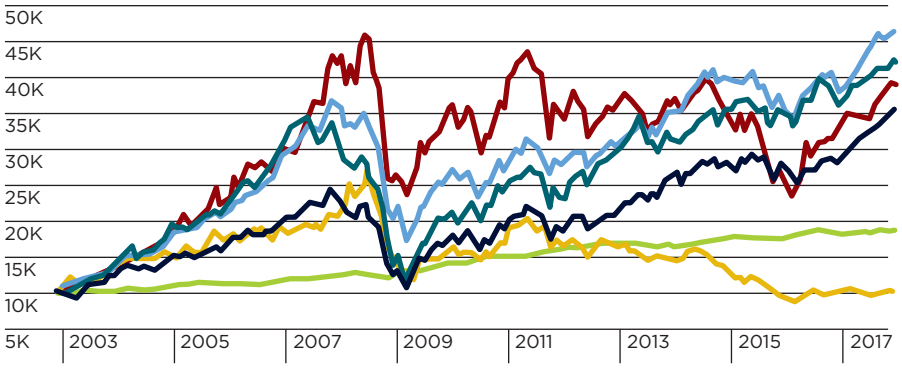
Time Period: 12/1/02 to 11/30/17.

Source: Morningstar Direct

global stock market) has a correlation to the Bloomberg Commodity Index of 0.54. While that is a positive correlation, it is fairly low. To re-state, commodities have historically been a powerful diversifier for stock market investors. Perhaps not as powerful as bonds (Bloomberg Barclays Aggregate Bond Index has a 0.06 correlation), but still effective nonetheless.

- *Better Risk-Adjusted Returns:* Because of lower correlations, adding real assets to a traditional stock and bond portfolio can improve risk-adjusted returns. For instance, when the broad market is not performing well, the defensive nature of real assets could provide some downside protection for strategic portfolios. They may also benefit when the markets are appreciating or inflation is increasing due to their high sensitivity to GDP growth and inflation changes over time.
- *Provide an Inflation Hedge:* As the U.S. economy nears full employment, the potential for inflationary pressures increases. Real assets may provide greater sensitivity to inflation than stocks and bonds, meaning real assets could deliver enhanced protection in the face of rising inflation.
- *Provide Stable and Reliable Income:* As global investors continue to search for income in an environment where most fixed income and dividend-paying stocks appear expensive, they can add real assets to their allocations. Many real assets, such as real estate and infrastructure, have longer-term lease agreements in place that can provide predictable and stable income streams in any economic environment. In addition, many infrastructure assets are regulated by the government, which allows for incremental price-increase mechanisms that are either tied to inflation or throughput volumes.

Better Risk-Adjusted Returns



Investment Name	Value	Investment Name	Value
MSCI ACWI NR USD	35.08K	S&P Global Infrastructure	46.2K
S&P Global Natural Resource	38.6K	Bloomberg Comodity TR U.S.	9.98K
BBgBarc U.S. Agg Bond Tr	18.73K	DJ Global World Real Estate	41.93K

Source: Morningstar Direct

As market valuations in traditional assets appear stretched, inflation potentially hovers on the horizon, and the search for yield continues, there has never been a better time to consider adding real assets to a balanced portfolio.

What About Bitcoin?

What about Bitcoin, which has arguably been one of the hottest story in the markets in 2017. What could it do in 2018? It would surprise me if Bitcoin reached $100,000 — if not more — or, if it fell to $0.

The skyrocketing cryptocurrency has indeed become a hot topic among many major investors, including Katy Perry and Warren Buffett, who were supposedly recently discussing Bitcoin in Omaha!

A $100,000 target in 2018 (as of this writing, the price is $16,000) is not our official CLS house view or outlook. But, the prospect of substantially more gains raises several key points.

First, anything is possible in the markets. Bitcoin really could reach $100,000 next year or in the years ahead. It could even reach $1,000,000 or more! It could also reach $0 and never recover.

At CLS, we believe anything is possible in the markets. That's why we diversify our portfolios. We diversify because we don't know with 100% certainty what the markets will do, especially in the short term. We may have the tools, time, and talent to develop and maintain our edges in information, analysis, and behavior, but we don't know for certain where the markets are going and when - nobody does; nor does any algorithm or computer program.

Because we don't know,

we constantly try to prepare emotionally and mentally for a variety of possibilities. Ideally, nothing should surprise us. That is easier said than done as the markets are always moving in some way that is unexpected to most observers.

So, what exactly is Bitcoin? Officially, it's considered a cryptocurrency. The Oxford dictionary defines "cryptocurrency" as a "digital currency in which encryption techniques are used to regulate the generation of units of currency and verify the transfer of funds, operating independently of a central bank." Bitcoin is not the only cryptocurrency, but it is surely the most well known. Basically, cryptocurrencies are a subset of currencies. These are indeed investable, and therefore, qualify as asset class segments with their own distinctive return and risk characteristics. Therefore, multi-asset investors should consider them.

How is CLS investing in Bitcoin or other cryptocurrencies? Currently, we are not. But, investors could expect CLS to invest in cryptocurrencies as some point. In fact, in anticipation of some possible new Bitcoin ETFs, we have started early due diligence. We even formally discussed these new ETFs at 2017's first quarter CLS Investment Committee Meeting. Alas, no ETF was launched earlier this year, so we didn't invest. However, even if the ETFs had been launched, it's not certain we would have invested, and if we had, it would not have been any material position weight. We prefer to buy asset class segments when they are on sale and prices are down.

We are not alone in thinking cryptocurrencies qualify as asset class segments. For example, well-known money manager Bill Miller (longtime Legg Mason value fund manager who beat the market 15 years in a row until the 2008 financial crisis), has been interested in Bitcoin for three years. He has invested and made considerable money in one of his hedge funds. His view, which I respect: "I consider (Bitcoin) an experiment, and it is an experiment that might or might not work . . . there is a nontrivial chance it goes to zero." Miller sees Bitcoin as a store of value rather than a currency. "(Bitcoin) doesn't have any intrinsic value, and it is not backed by anybody, but what's the intrinsic value of the painting "The Scream" that Leon Black bought for $120 million? It is just paint and canvas."

Yes, investing in Bitcoin could be like investing in any esoteric asset class segment, including wine, antiques, art, baseball cards, or even tulips.

So, are Bitcoin and other cryptocurrencies good investments? At this point, given the absolutely massive volatility — prices sometimes moving a lot more in one day than some asset classes do in years — my view is cryptocurrencies are simply too wild at present to have any significant role in investment portfolios.

Extreme volatility is dangerous, and most investors should avoid it. However, like bugs fatally attracted to porch lights, many investors are drawn to high-volatility stocks in the hopes of getting rich quick. Sure, there are stories of winners, as there are in Vegas, but study after study shows that price volatility, especially high volatility, has a destructive influence on investor behavior and portfolio returns. Currently, cryptocurrency (including Bitcoin) volatilities are too high to make this asset class attractive in multi-asset portfolios.

In sum, the meteoric rise of Bitcoin, along with all cryptocurrencies, has been the market story of 2017, a year loaded with exceptional stories. As investors, we all need to pay attention to this budding asset class and make sure neither fear nor greed impacts our decision-making. We also need to remember anything is possible in the markets, and thus, we should diversify.

Since we need to diversify, cryptocurrencies deserve our consideration as they become more investable. Currently, however, even if an ETF was introduced today, we think a wait-and-see approach is more prudent given the extreme level of volatility. However, once risk characteristics become a bit more stable, this asset class could possibly find its way into CLS portfolios.

Thank You

Thanks for reading. If you have any questions on this material, or anything outside this article, please let me know. Thank you for your time and trust.

Stay balanced.

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2018 Investment Themes

from CLS Chief Investment Officer, Rusty Vanneman, CFA, CMT

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

SMART BETA

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. 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

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.

Five Reasons to Keep Expectations Low for Market Returns

Portfolio Manager, Kostya Etus, CFA

"The light that burns twice as bright burns half as long, and you have burned so very, very brightly, Roy." – Eldon Tyrell, Blade Runner (1982)

As regular readers of the CLS blog may know, I love watching movies. But, I am often disappointed with great movies because I hype them up in my mind to unreachable expectations. A recent example is "The Big Sick". It was a great movie, but the stellar reviews and high praise from trusted colleagues elevated my expectations, and I ended up disappointed.

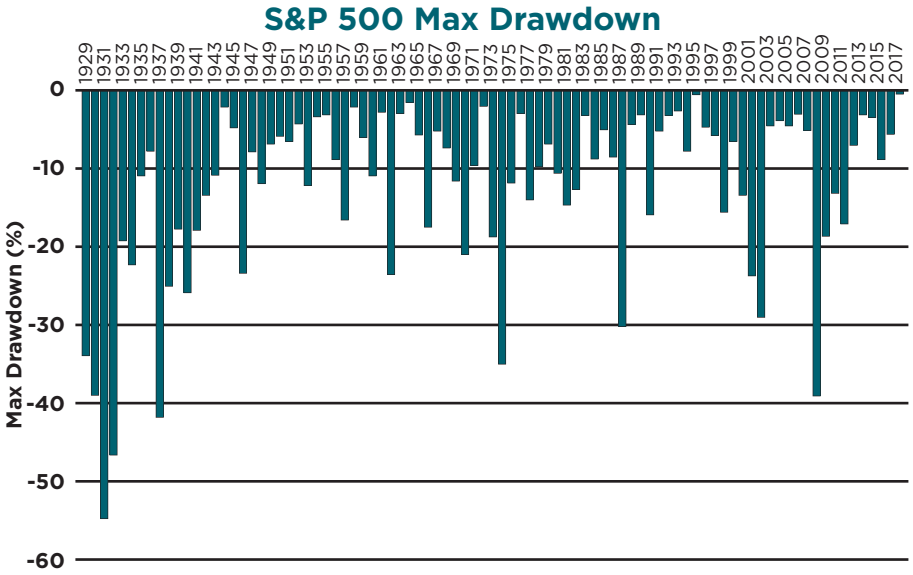
The markets are no different. Investors often have high expectations for market returns, which often lead to disappointment when the market doesn't deliver. These expectations are elevated by the same forces driving those of movies — colleagues discussing their successes, sensational media headlines, and analyst and economist forecasts (similar to critics' movie reviews). In addition, as bull markets heat up, expectations rise. Then, any type of negative market action may cause an unwarranted investor reaction — for example, selling investments in a panic as they hit bottom.

At CLS, we believe a bear market is unlikely because there are no signs of an economic recession. Global economic growth is stable and strengthening in many countries, and corporate earnings have rebounded in 2017 after several years of weakness. But, we do foresee below-average returns in the near future for the following reasons.

U.S. stock market valuations are at record highs, which suggest a higher probability of reversion to the mean and weaker performance ahead.

Since 1929, the U.S. market has never experienced a full year with such a small maximum drawdown as we have had in 2017 (see chart below).

This is the first year since 1970 that the U.S. market has not had a single monthly negative total return.



Morningstar Direct data as of 9/30/17

Five Reasons to Keep Expectations Low for Market Returns (Continued)

Portfolio Manager, Kostya Etus, CFA

The U.S. market hit its sixth consecutive high in September. That's the longest streak in 20 years. Meanwhile, the Chicago Board Options Exchange (CBOE) Volatility Index (VIX), which measures expected stock swings, fell to an all-time low, passing the last record set in 1993.

The Dow has set 69 new records for closing highs since the 2016 presidential election. And, it has reached four 1,000-point milestones in one year for the first time ever.

All of these statistics suggest this is not the time to get comfortable. Markets are cyclical in nature and a reversal of direction may come sooner than later. This is why it is important to stress a balanced and globally diversified approach to investing that focuses on targeting risk based on both ability and willingness to take it on. Such an approach will help moderate expectations and help investors stay invested for the long run.

I took my own advice for the recent premiere of the much-anticipated "Blade Runner 2049". I was excited about it, but I stayed away from trailers and reviews and kept my expectations reasonable. I thoroughly enjoyed it.

An ETF is a type of investment company whose investment objective is to achieve the same return as a particular index, sector, or basket. To achieve this, an ETF will primarily invest in all of the securities, or a representative sample of the securities, that are included in the selected index, sector, or basket. ETFs are subject to the same risks as an individual stock, as well as additional risks based on the sector the ETF invests in.

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