CLS's WEEKLY 3

What You Need To Know About the Markets

FEBRUARY 7, 2018

1. Long overdue losses were mostly blamed on concerns about higher inflation leading to rising interest rates - a step back was due.
2. Flows into ETFs last year were the highest ever, but January's performance hints this year could blow away 2017's incredible record.
3. Updates from the latest CLS Forum - smart beta is still attractive and commodities are increasingly so.

CLS INVESTMENTS

Market Performance

Equities	JANUARY	YTD '18	12-MONTH
Total U.S. Market[1]	+5.27%	+5.27%	+25.16%
Domestic Large-Cap Equity[2]	+5.73%	+5.73%	+26.41%
Domestic Small-Cap Equity[3]	+2.61%	+2.61%	+17.18%
International Equity[4]	+5.57%	+5.57%	+29.68%
Developed International Equity[5]	+5.02%	+5.02%	+27.60%
Emerging Market Equity[6]	+8.33%	+8.33%	+41.01%
Fixed Income	**JANUARY**	**YTD '18**	**12-MONTH**
U.S. Investment Grade Bonds[7]	-1.15%	-1.15%	+2.15%
Cash Equivalent[8]	+0.11%	+0.11%	+0.89%
Commodities	**JANUARY**	**YTD '18**	**12-MONTH**
Commodity[9]	+1.99%	+1.99%	+3.58%

[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 1/31/2018

January Market and Portfolio Review

Last week was a step backward for the global markets. It should be noted, however, the stock market was up for four consecutive weeks beforehand, and it is still sporting a nice gain to start the year. The overall U.S. stock market (Russell 3000 Index) lost 4% last week, but is still up 3% on the year. Larger companies (S&P 500 Index) also lost 4%, but are up 3% on the year. Smaller companies (Russell 2000 Index) lost 4%, but are holding onto gains around 1% for the year.

Overseas markets also lost ground last week, but their relative performance was slightly better. Overall, international markets (MSCI ACWI ex-U.S. Index) were down 3%, but are up 4% for the year, with developed markets (MSCI EAFE Index) down 3% for the week, but up 4% for the year. Emerging markets (MSCI Emerging Markets Index) continue to lead, down 3 % last week, but still higher by 6% on the year.

The bond market (Bloomberg BarCap Aggregate Bond Index) lost 1% last month and is now down 2% for 2017. The 10-year Treasury yield ended the month at 2.84%.

Commodities (Bloomberg Commodity Index) lost 2% last week but are up 1% on the year.

In general, CLS portfolios are off to a strong start, in both absolute and relative performance, for the year. The leading driver for returns has been our unhedged international exposure. That has clearly helped relative performance both during January's gains and last week's losses. Our exposure to fixed income, especially longer-maturity bonds, has not helped performance. But all in all, it's been a good start to 2018.

What to Make of Last Week's Slide

Markets fall for many reasons. Potential catalysts of market movement in one time period may have no impact or influence in other time periods. As for last week's sell-off, the leading narrative is that interest rates are rising due to inflation concerns. There is truth to that, but interest rates and inflation expectations have been rising for weeks. I would argue that the leading reason for last week's sell-off is that is was simply just *due*.

Markets have a natural ebb and flow, and it's been highly extraordinary to go without the "ebb" for some time. Since the 1920s, the stock market has seen an average of seven 3% corrections per year.

Market volatility is normal. The low volatility in recent years was not normal.

Volatility is the risk involved in markets. It's the nature of markets to jostle around, sometimes significantly, shaking out weak hands (investors without the education and/or nerve to withstand short-term volatility) and moving money into strong hands. Investors should remember that the markets sometimes need to take one step back before taking the next two steps forward. It's natural and normal. If investors are unsettled by frequent short-term losses of 5-10% and the occasional bear market of 20% or more short-term losses, they should limit their exposure to the stock market, if not be involved at all.

Market Downturns Happen Frequently and They Don't Last Forever

Dow Jones Industrial Average 1900-2015

	-5% OR MORE	-10% OR MORE	-15% OR MORE	-20% OR MORE
Average Frequency[1]	About 3 times a year	About once a year	About once every 2 years	About once every 3.5 years
Average Length[2]	46 days	115 days	216 days	338 days

[1] Assumes 50% recovery of lost value
[2] Measures market high to market low

The Dow Jones Industrial Average is unmanaged, price-weighted average of 30 actively traded industrial and service-oriented blue chip stocks.

Source: Capital Ideas, 6/29/2016

For perspective on how often the market falls 5% or more per year, let's look at a study of the markets going back to 2015, from the Capital Group, which is the investment firm behind American Funds. In short, the market falls often, and sometimes by a fair amount.

I recognize that saying the market was due for a fall may not be fully satisfying. There must be more to it, right? Market commentators like to focus on economic growth or corporate earnings growth (highest frequency data and growth stories are always the most attractive). But, that's not it. The economy is doing great. Some estimates for first quarter GDP growth top 5%. That would make it one of the best quarters in nearly 15 years. Corporate earnings growth, which is even more important to stock investors, is also going gangbusters this quarter. Beat rates (numbers of companies beating expectations) and future earnings guidance are the best they've been in years.

Instead, the most commonly cited reason for lower stock prices is that interest rates have been rising, and there is truth to that idea. Let's break it down.

"Interest rates" is a general term. It could reference short-term, long-term, corporate, or mortgage rates. All are important to monitor, and each deserves its own commentary due to its economic impact and market signaling. But in my opinion, the 10-year Treasury yield packs in the most messaging.

The 10-year Treasury yield is important because it is determined by market forces. The 10-year yield often precipitates changes in the economy, while short-term rates, which are mostly controlled by central banks, generally react to older data and political sentiment.

What to Make of Last Week's Slide (Continued)

Currently, investors and traders in longer-term interest rates are getting a bit spooked, and for good reason. We haven't seen inflation in years, and a variety of inflation measures, including wage growth (recently hit highest levels since 2009), are perking up. The U.S. dollar is also coming off of its worst year in a long time and is already under pressure this year. A falling dollar is inflationary because imported goods become more expensive. In addition, and perhaps most importantly, there are concerns about the pro-cyclical tax reform that was introduced when the economy is already doing well and the labor pool is tight. In other words, the budding flames of reflation just got another dose of lighter fluid.

This matters because the recent period of low and well-behaved inflation is a significant reason for the stock and bond markets' strong performance in recent years. It's also why real assets, such as commodities and real estate, and emerging markets have trailed U.S. markets by so much since the bull market began in March 2009. In technical terms, traditional stock and bond markets typically have a negative correlation with increased inflation expectations and actual inflation — in other words, when inflation drops, stock and bond markets usually move higher. The opposite is true for real assets. They have a positive correlation with inflation. When inflation rises, real asset prices typically rise.

That's why our exposure to real assets has been increasing in recent weeks. It's another way to diversify portfolios and potentially partially hedge inflation risks. We also favor real assets because other investors don't. The contrarian in us likes the fact that while money has been flowing into names, such as high-profile technology companies, that pushed markets higher last year, it's been leaving real assets. For example, the most over-owned sector by portfolio managers is technology and the most underweight sector is real estate. On the margin, CLS has been selling technology and buying real assets, such as real estate.

Finally, what about stocks and bonds? Our long-term view really hasn't changed with the price action in recent days. We still expect lower, albeit positive returns, for the U.S. stock and bond markets. We expect higher returns from overseas markets. That's our longer-term view. Shorter-term, we are taking action by looking for harvesting possible tax credits in certain situations. We are also looking for clues for short-term bottoms in stocks and bonds. Bonds, for instance, are coming off some bearish sentiment extremes — that suggest **above**-average returns in the near term. As for stocks, it's important to note that corrections move and bounce fast. We'll be watching closely.

Surf's Up

The move into exchange traded funds (ETFs) is the wave that keeps on getting bigger. Last year, ETFs raised more assets in one year than ever before. In fact, they raised more assets in one year than even traditional open-ended mutual funds ever have.

And in January, ETFs raised more in one month than they ever have before (they passed the bar well before month-end). If the pace continues this year, ETF inflows would be more than $800 billion, or more than 70% above 2017's record of $476 billion for the year. That's a scorching hot pace. ETF innovation also remains hot, with more new ETFs being introduced to start the new year than in past years. This wave has a long way to go before it hits the shore.

This interest and creativity was on display at the Inside ETFs Conference, held in Hollywood, Florida, at the end of January. This year's conference broke an attendance record and made it clear that several big players have entered the game of manufacturing ETFs. For instance, multiple well-known mutual fund firms are now launching ETFs. That's a lot of new talent and resources entering the ETF industry. For ETF investors, this is good news.

The future is bright for ETFs — and it should be. Mutual funds may still rank as one of the greatest financial innovations of all time, offering professionally managed, diversified portfolios at a reasonable cost. But, ETFs are simply the better technology due to their lower costs and transparency.

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.*

Content by Grant Engelbart, CFA, CAIA - Portfolio Manager

The quarterly CLS Investment Committee (IC) Meeting took place last week. Each meeting is divided into two parts. The first is a thorough review of our performance, process, Risk Budgeting Methodology, governance documents, and other topics. The second is the CLS Forum, which typically features outside speakers related to our current and potential future CLS Investment Themes. This quarter's CLS Forum featured two speakers, who covered commodities (specifically agricultural commodities, such as corn, wheat, soybeans, and sugar), and smart beta.

Sal Gilbertie, President at Teucrium Trading, LLC

Gilbertie is the founder of Teucrium Trading, LLC, a small trading firm that has five ETFs focused on individual agricultural commodities. He has been in the industry for nearly four decades, and his stories and experience were fascinating to listen to. Gilbertie spoke about some of the supply-and-demand drivers behind agricultural commodities and their outlook.

Gilbertie also talked about what could be one of the better investment opportunities available in today's market environment. Currently, there are few bargains in the investment world. Nearly every total return index is at, or near, all-time highs. Commodities, however, are approximately 60% off from their all-time highs. Agricultural commodities may be some of the only true bargains left as most are still trading at or near multi-year lows. They are also trading around their cost of production, a level that would imply supply and demand is in approximate balance. It also suggests that prices are not likely to fall much from current levels, indicating limited downside.

The trick, of course, is determining what will make agricultural prices move higher. If prices don't go anywhere, it could be argued that investing in agricultural commodities is just dead money. Gilbertie even suggested prices will likely hover at these levels until a supply disruption moves them higher, but when it does, prices typically substantially higher (2-3x). As Gilbertie said, the timing is impossible to predict, but a disruption will eventually happen (they always do), which makes the current potential risk/reward opportunity seems very attractive.

In addition, as we have often written, agricultural commodities have been used in some CLS strategies as they are excellent diversifiers with very little correlation and defensive characteristics when traditional stock and bond markets stumble.

Look for an interview with Gilbertie in an upcoming edition of CLS's The Weighing Machine podcast.

Brent Leadbetter, Senior Vice President at Research Affiliates

Research Affiliates is a firm that licenses strategies and indices to other firms (PIMCO, Schwab, PowerShares, etc.) for use. It was one of the original pioneers of the smart beta ETF space and continues to be a large part of our allocations. They are led by arguably one of the best, if not the best, tactical global asset allocators, Rob Arnott.

Leadbetter spoke about multiple topics, including how common performance chasing even is in factor and smart beta investing, amoung academics and product developers. In short, Brent confirmed much of what we like to examine, including the effectiveness of relative valuation in assessing factors and why they are important to monitor in anticipateing future returns. One reason we own the factors we do is because of their current relative valuation levels.

One big takeaway from Leadbetter's talk is that the value factor in emerging markets (EM) is currently at its lowest relative valuation in the history of Research Affiliate's data. While emerging markets have had an incredible run of late (up 37% in 2017), EM indices are top heavy and led by growth names, so there is plenty of room to run for many emerging market investments. We continue to look at value in EM as a great opportunity going forward.

CLS's Investment Committee is an important part of our team and process, and it serves as a formal double-check to much of the work we do every day. Look for more upcoming commentary stemming from our CLS Forum guests.

Thank You

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
LinkedIn* | *Twitter

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 index of 500-large capitalization companies. This index is widely used by professional investors as a performance benchmark for large-cap stocks. The Russell 2000 Index is an index comprised of the 2,000 smallest companies on the Russell 3000 Index and offers investors a benchmark for small-cap stocks. The MSCI ACWI ex U.S. Index (MSCI All-Countries World Index, excluding U.S.) is an index considered representative of stock markets of developed and emerging markets, excluding those of the U.S. The MSCI EAFE Index is an index which tracks performance of international equity securities in developed countries in Europe, Australia, Asia, and the Far East, excluding the U.S. and Canada. The MSCI Emerging Markets Index is an index which tracks performance of large and mid-cap firms across countries classified as emerging market countries. The Bloomberg Barclays Capital U.S. Aggregate Bond Index measures performance of the U.S. investment-grade bond market. The Bloomberg Barclays 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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