CLS's WEEKLY 3

What You Need To Know About the Markets

APRIL 17, 2018

1. Stock-to-bond ratios have a fatal flaw: they don't account for risk.
2. Odds of timing a DCA correctly are not great, but psychology may determine whether or not to do it.
3. Alternative ETFs are starting to show the benefits of lower costs.

CLS INVESTMENTS

Market Performance

Equities	LAST WEEK	QTD	YTD '18
Total U.S. Market[1]	+2.01%	+0.65	0.00%
Domestic Large-Cap Equity[2]	+2.04%	+0.66%	-0.10%
Domestic Small-Cap Equity[3]	+2.41%	+1.34%	+1.26%
International Equity[4]	+1.31%	+1.44%	+0.24%
Developed International Equity[5]	+1.48%	+1.96%	+0.40%
Emerging Market Equity[6]	+0.73%	0.00%	+1.41%
Fixed Income	**LAST WEEK**	**QTD**	**YTD '18**
U.S. Investment Grade Bonds[7]	-0.18%	-0.23%	-1.69%
Cash Equivalent[8]	+0.03%	+0.06%	+0.40%
Commodities	**LAST WEEK**	**QTD**	**YTD '18**
Commodity[9]	+2.72%	2.14%	+1.73%

[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 4/9/2018

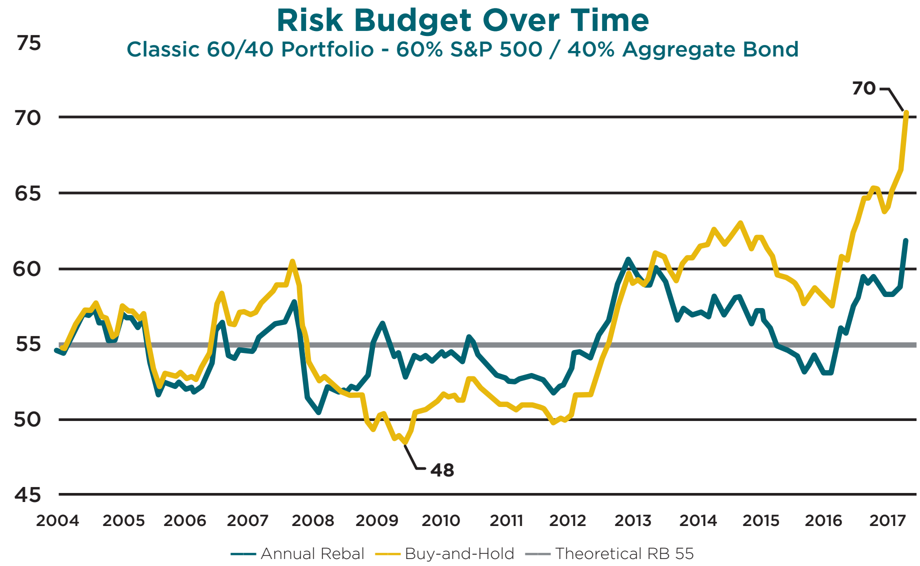
Week in Review

Global stocks managed modest gains last week despite a constant barrage of geopolitical headlines. Earnings season began with three of the largest U.S. banks reporting strong results on Friday. Economic reports focused on inflation measures (Consumer Price Index and Producer Price Index) showed mixed results. Despite this, crude oil led commodities higher. Commodities were the best performer on the week and are year-to-date. Emerging markets lagged on Russian sanctions but have still bested all other major stock indices this year. Bonds finished slightly negative as the yield on the closely followed 10-year Treasury closed up five basis points to 2.83%.

The 60/40 Portfolio — Not What it Seems?

The classic 60/40 portfolio composed of 60% equities and 40% bonds has been around for decades, and many consider it a potential starting point for investors. It's been declared dead numerous times and dissected by financial practitioners and researchers over and over.

For us at CLS, due to our Risk Budgeting Methodology, the 60/40 has long been irrelevant because, of course, the 60/40 is by design a stock-to-bond ratio. Not all stocks are the same, not all bonds are the same, and the risk of both changes over time. Don't believe me? Check out the graphic on the right. This shows the Risk Budget of a classic 60/40 portfolio composed of 60% S&P 500 and 40% Bloomberg Barclays U.S. Aggregate Bond. I show it for two different rebalancing frequencies, annually and never (buy-and-hold). While never rebalancing seems strange to us, many investor portfolios (outside of CLS) at this point in the market cycle have not been rebalanced for years, if not longer. As you can see in the chart, risk changes a lot, especially in the buy-and-hold portfolio. Risk dropped below a 50 in 2009 as equities became a smaller part of the portfolio — one of the worst times ever to be underweight risk. More recently, risk has crept higher to a 70. And this is just for very broad asset classes; the risk changes are only amplified for more granular and specific exposures.



Source: CLS Investments, Morningstar

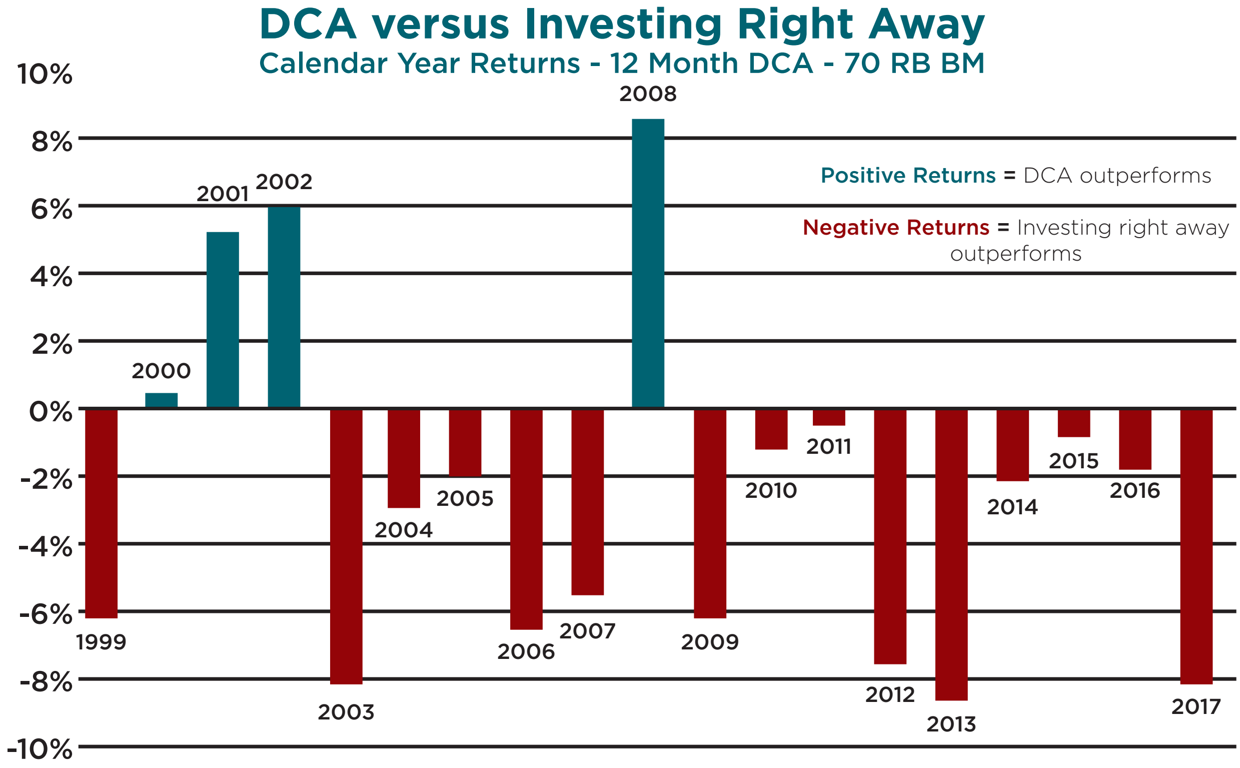
These changes in risk end up being felt in investors' portfolios, and their investing experience becomes more of a roller coaster than they expected. This leads to investors "quitting" at the worst times, and you know the rest of the story. Risk Budgeting is a powerful yet simple tool for CLS and our advisors to utilize, and it's always a great time to make sure investors are in the correct Risk Budget.

To DCA or Not to DCA?

There is a good chance nearly every investor is engaging in some sort of dollar-cost averaging (DCA), most likely in their retirement accounts. It is generally accepted that this is a good thing, as we can all feel a little better when the market is falling, knowing we are adding money. However, investors are often faced with the dilemma of whether or not to DCA when opening a new account. Should we invest our initial sum right away or DCA over time?

Deciding to DCA in this context is really no different than trying to time the market. Let's take a look back at the last 19 years, a period marked by tremendous bull and bear markets, for some insight. Despite those two large bear markets, annual rolling returns were positive a whopping 70% of the time for our 70 Risk Budget benchmark. That in and of itself would imply the chances of timing a DCA correctly are not great. Further, as shown in the graph, I calculated the year-by-year return difference if an investor did a 12-month DCA or invested right away. The benefits of doing the DCA are only evident four times — all periods when the market struggled. During the positive years for the market, doing a DCA would have cost an average of 4.5%.

So, with little chance of getting it right, why even consider doing a DCA? Psychology! Getting an investor to finally pull the trigger and invest — through a DCA or not — is much better than sitting on the sidelines while the market moves higher (70%+ of the time). If they are comforted knowing not all of their money is "at risk" at once, and that keeps them in the game, then the DCA is well worth it.



Source: CLS Investments, Morningstar

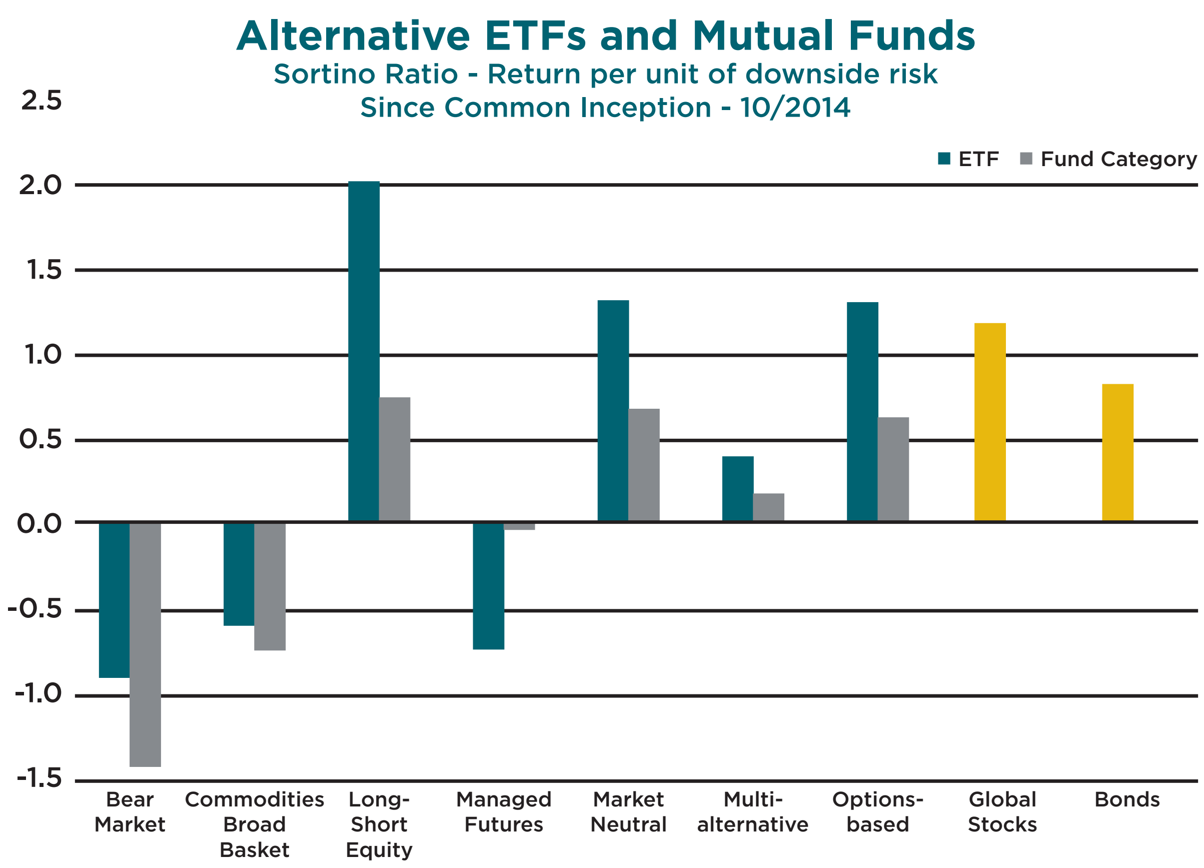
ETFs: A Better Alternative?

With lower-than-average expected returns across major asset classes, it is no surprise CLS is increasing allocations to (liquid) alternative investments. Alternatives are also a key part of our "Be Creative" investment theme. Common misconceptions in the liquid-alternative space is that mutual funds offer superior options for liquid-alternative investors than ETFs and alternative ETFs are new, untested, and even dangerous. Well, considering I am writing about them, that just doesn't seem to be true.

Due diligence on alternative ETFs can be a tricky science, especially given the limited return history for many products. We keep a close eye on the correlations of alternatives to the equity and bond markets, but one additional area that makes sense for many alternatives is downside risk metrics. Let's focus on a fairly simple but powerful metric that measures risk-adjusted returns.

The Sharpe Ratio, or return per unit of risk (measured by return minus the risk-free rate divided by standard deviation), is commonplace in financial literature. A close cousin, however, is more instructive for alternatives. The Sortino Ratio, or return per unit of downside risk, measures the same thing in the numerator (return minus the risk-free rate) but divides by the downside deviation in the denominator. Upside risk isn't the same as downside.

In the chart below, I show the largest ETF in each category compared to the full fund category average (which also includes ETFs). Over the past few years, for every alternative category but one, ETFs have shown a higher Sortino Ratio than their mutual fund peers (this is also true for the Sharpe Ratio). Three of the alternative categories also beat stocks and bonds in this measure. Alternative ETFs are showing the benefits of their lower costs, and they are only getting better.



Source: Morningstar

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 Financial Services Group, LLC.

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 at 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.

*Mr. Engelbart was named one of the Top Ten Money Managers to Watch by Money Management Executive in 2018.**

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