CLS's WEEKLY 3

What You Need To Know About the Markets

MAY 1, 2018

1. The rowing versus sailing debate — which is the better investment management analogy?
2. Is the old adage, "Sell in May, and go away," still true?
3. The Berkshire Hathaway meeting is quickly approaching.

Market Performance

Equities	APRIL	YTD '18	12-MONTH
Total U.S. Market[1]	+0.38	-0.27	+13.05
Domestic Large-Cap Equity[2]	+0.38	-0.38	+13.27
Domestic Small-Cap Equity[3]	+0.86	+0.78	+11.54
International Equity[4]	+1.60	+0.40	+15.91
Developed International Equity[5]	+2.28	+0.72	+14.51
Emerging Market Equity[6]	-0.44	+0.97	+21.71
Fixed Income	**APRIL**	**YTD '18**	**12-MONTH**
U.S. Investment Grade Bonds[7]	-0.74	-2.19	-0.32
Cash Equivalent[8]	+0.14	+0.47	+1.12
Commodities	**APRIL**	**YTD '18**	**12-MONTH**
Commodity[9]	+2.58	+2.17	+8.02

[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 3/30/2018

April Market and Portfolio Review

After a few months of lower returns, the stock market was able to post positive returns in April. Leading the way were developed international stocks and real assets such as commodities.

Last month, the overall U.S. stock market (Russell 3000 Index) gained less than 1% for the month, with larger companies (S&P 500 Index) and smaller companies (Russell 2000 Index) both up less than 1%. That said, smaller companies did slightly outperform, though they relinquished their fairly nice performance advantage late in the month.

Overseas markets were up less than 2% last month (MSCI ACWI ex-U.S. Index), but interestingly developed markets (MSCI EAFE Index) were up by more than 2% while emerging markets (MSCI Emerging Markets Index) were down by less than 1%. Emerging markets have been the market leaders and still hold a nice relative performance advantage over other major asset classes over the last 12 months.

The bond market (Bloomberg BarCap Aggregate Bond Index) also lost less than 1% last month and is down 2% for 2017. The 10-year Treasury yield did increase by nearly a quarter point last month and ended April at 2.95% after briefly spending time above 3%.

Commodities (Bloomberg Commodity Index) gained nearly 3% last month and is now the top performing major asset class year-to-date.

CLS portfolios, in terms of relative performance, performed well again in April despite our largest portfolio tilt in recent years (emerging markets) underperforming. Helping performance was our strong value tilt (which has been helping the last three months) and our increased emphasis on real assets such as real estate (REITs) and commodities.

Investors Might Need to Start Rowing

I love rowboats. I have plenty of paintings hung up around my home as proof. In fact, I have now owned a wooden catspaw dinghy for more than 25 years. She was named the "Bugeater" since there was already a boat in Marblehead Harbor, Mass. called the "Cornhusker." Technically, the Bugeater is a sailboat, but I always preferred taking the removable mast out and rowing along the rocky shoreline with my kids or my Newfoundland, Abby, who loved the water even more than they did. Regretfully, the Bugeater has been in storage for too many years now. But she will be rowed — and sailed — again.

What I like about rowing is it makes me feel in charge and able to handle my course in nearly every direction, regardless of which way the wind and tides move. I also feel rowing is an apt analogy for managing money. An investment manager can make active decisions in all market conditions. No matter the market tides and winds, an investment manager can still make moves to generate attractive returns.

I used to feel strongly, and often argued, that rowing is a better analogy for active investment management than sailing, where one goes with the prevailing winds. It's hard to believe how many investment firms have sailing pictures in their office lobbies (and horses, which I can't figure out), and use sailing terms when talking about investment management. Then again, I don't hear that quite as much living in Nebraska as I did in Boston.

Now, however, I have softened my stance on the rowing/sailing analogy debate. And, as much as it pains me because I do love my rowboats, I would reverse the emphasis. For long-term investors, when the winds have overwhelmingly blown in the direction of positive returns during most time periods (and increasingly so the longer the time horizon), why do all the extra work of rowing? Go with the winds. It's easier and faster. With sailing, you can go farther and longer. Besides, nearly all the great sea voyages of old were taken under sail, not by oarsmen (Vikings, Polynesians, and others aside).

I know the preceding paragraphs could stir up a good philosophical discussion in a few watering holes in Boston (possibly the highest concentration of money managers and boaters in the U.S.), but I think the truth is the current environment requires sailing and rowing to succeed.

We are currently in the midst of one of the longest and strongest bull markets in history, and there's a decent probability it will end up being the longest and strongest. In an environment such as this, sailing with the favorable winds and passively investing in the market has indeed been the best course to take.

The environment, however, will change, as it always does. When it does, the ability to row by actively managing portfolios against the winds and tides will be essential to remain on course. We may be nearing that time. The winds are changing for active management.

Market Outlooks: Long- and Short-Term

Long-term: What to expect from balanced portfolios

In the long term (five years or more), expect lower returns from U.S. stock and bond markets. Given the maturity of the bull market, valuations (how much to pay for a dollar of revenues or earnings) are higher than average. That means expected returns need to be adjusted lower. In the bond market, where interest rates are low (10-year Treasury bond rates, for instance, are about 3%), return expectations are also lower than average.

Thus, our expectation is a passively managed (buying the broad market), balanced portfolio of U.S. stocks and bonds will generate returns of 3-4% before fees in the years ahead. Positive, but below-average, returns are expected, especially lower than those seen in recent years. We also expect the market environment to be far more volatile — not as smooth and enjoyable a ride as it has been the last several years.

Short-Term: Sell in May, and go away?

A reasonable short-term (approximately six months) expectation is a choppy, volatile market for a combination of reasons.

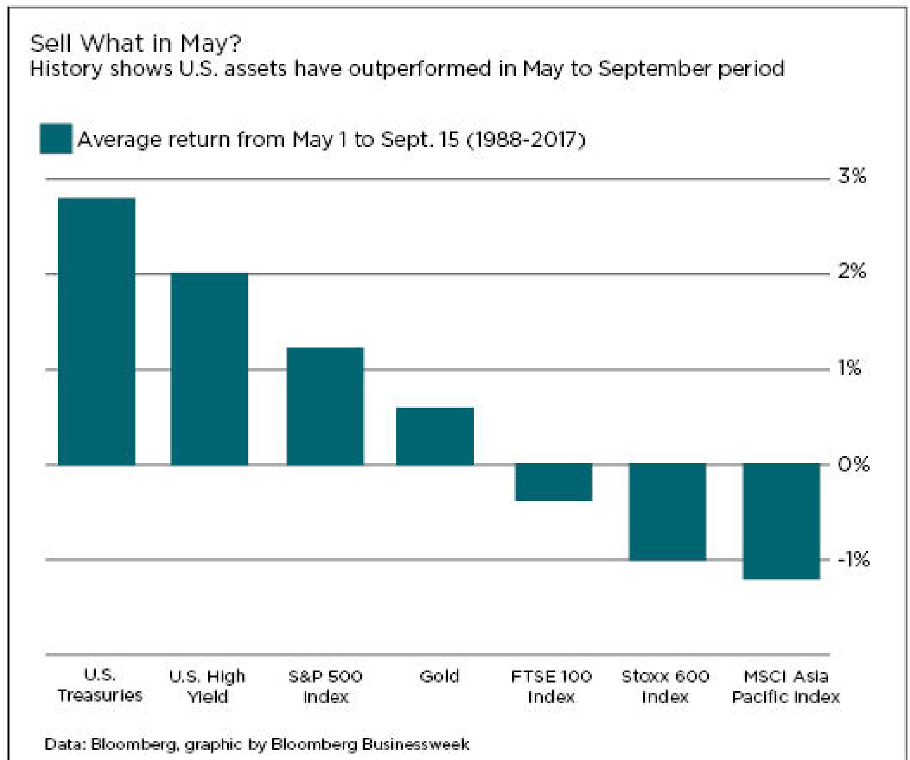
First, volatility has already picked up from the abnormally low levels experienced in recent years. Volatility, like nearly everything in the markets, is cyclical, and it appears the cycle has reverted toward more normal levels.

Second, it appears various inflection points have occurred in relative performance between several asset class segments, most notably the weakness in the technology sector, which had led the market in recent years. Value stocks are starting to perform relatively better. Small-caps stocks are also performing relatively better. Real assets, such as commodities and REITs (real estate investment trusts), are performing relatively better. Changes in market leadership often coincide with volatile markets.

Third, the stock market often follows a seasonal pattern of weaker performance during the middle of the year. The adage "Sell in May, and go away" (at least until the end of September) has some truth to it. The Bloomberg study below shows average returns over the last 30 years (and studies going back longer show the same), and they are indeed below average May through September.

However, seasonal weakness is not a sufficient reason for long-term investors to change their investment plans. Returns are still, on average, positive for each month through August, and September's average loss is still well below 1%.

Nonetheless, the next several months could be relatively volatile with little real progress in total returns.



The Berkshire Hathaway Annual Meeting

Content provided by: Mark Matthews, Investment Research Analyst

The Berkshire Hathaway annual meeting, or Buffett weekend as I like to call it, is the most anticipated event in finance. Some of the most intelligent minds in the industry converge in Omaha from around the world hoping to gain insights from The Oracle of Omaha, Warren Buffett, and his famously witty vice-chairman, Charlie Munger. The popularity of the event has earned it the moniker "Woodstock of Capitalism."

However, it wasn't always an exciting event. In 1981, only 12 people attended, and the meeting was held in the cafeteria of National Indemnity Co. It wasn't until Buffett mentioned the meeting in his 1984 letter to shareholders that it began to resonate with the investment community.

"Many annual meetings are a waste of time, but Berkshire's meetings are a different story," he wrote. Since then the event has taken off, with attendance compounding nearly as much as Berkshire's investment returns — perhaps even commensurately. So much so that it's no longer just a meeting but an entire weekend filled with events, vendors, and prize giveaways.

As attendance grew, the location for the meeting changed a number of times, too. The meeting transitioned from a cafeteria with a handful of people to the Orpheum Theater and Joslyn Art Museum with hundreds, to the Aksarben (Nebraska spelled backwards!) Holiday Inn with thousands, to the CenturyLink Center where it is held today with 30,000 to 40,000 in attendance.

Five things to expect:

1. Extremely Long Lines

The meeting starts at 8:30 AM, but doors open at 7:00. By 6:00 AM, thousands of people are typically waiting in lines wrapped around the building hoping to bull rush the door and get a seat as close as possible to the legendary investors.

2. A Movie

Every year, the meeting begins with a movie. The movie serves as a sort of cartoon caricature advertisement of Berkshire brands and holdings. While there's never any distinct plot or structure, it's typically filled with cheap laughs and cameos.

3. Wisdom from Buffett and Munger

Buffett and Munger sit on a stage for several hours sharing knowledge and experience gained from a combined 100-plus-year career. Fueled by Cherry Coke (the official drink of the weekend) and peanut brittle, the two answer questions from analysts, shareholders, and media professionals all day.

4. Discount Shopping

Holdings of Berkshire, such as Nebraska Furniture Mart, Brooks (running shoes), and Borsheims (considered the Tiffany of the Midwest) have deep discount sales throughout the weekend. The notoriously frugal Buffett strongly encourages shareholders to spend.

5. Fun

Attendees of the event have competed in newspaper tossing competitions and played ping pong with enormous paddles, and Buffett has been known to whip out his ukulele for a sing-along.

With all the fun and excitement surrounding this event, the biggest takeaway will be the invaluable tidbits gleaned from Buffett and Munger's answers to shareholder questions. Each year, their thoughts on Berkshire holdings, the economy, and the stock market provide key lessons to long-time Buffett followers, such as me. I'm sure this year won't be any different.

Hope to see you there!

Thank You

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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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.*

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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