CLS's WEEKLY 3

What You Need To Know About the Markets

JUNE 26, 2018

1. Weathering Trade Tensions with Small-Caps
2. The Dollar's True Impact on Emerging Markets
3. The Benefits of Smart Beta ETFs on Your (Tax) Alpha

Market Performance

Equities	LAST WEEK	QTD	YTD '18
Total U.S. Market[1]	-0.75	+5.42	+4.74
Domestic Large-Cap Equity[2]	-0.87	+4.80	+4.01
Domestic Small-Cap Equity[3]	+0.11	+10.47	+10.38
International Equity[4]	-1.25	-1.59	-2.75
Developed International Equity[5]	-0.96	-0.20	-1.73
Emerging Market Equity[6]	-2.27	-6.59	-5.27
Fixed Income	**LAST WEEK**	**QTD**	**YTD '18**
U.S. Investment Grade Bonds[7]	-0.01	-0.50	-1.95
Cash Equivalent[8]	+0.04	+0.40	+0.73
Commodities	**LAST WEEK**	**QTD**	**YTD '18**
Commodity[9]	-0.40	+0.26	-0.14

[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 6/22/2018

Week in Review

The markets were largely in risk-off mode last week as trade tensions between the U.S. and China resulted in a wave of new tariffs being announced on each country's exported goods. U.S. stocks, as defined by the Russell 3000 Index, finished down 0.8% with small-caps outperforming large-caps by 0.9%. International stocks were lower with developed markets down 0.9% and emerging markets lower by 2.3%. Global minimum-volatility stocks were the best performing smart beta strategy, finishing down just 0.6%, while global momentum stocks fell more than 1.4%. Bonds rallied slightly as the 10-year Treasury yield moved lower by 3 basis points to yield 2.90%.

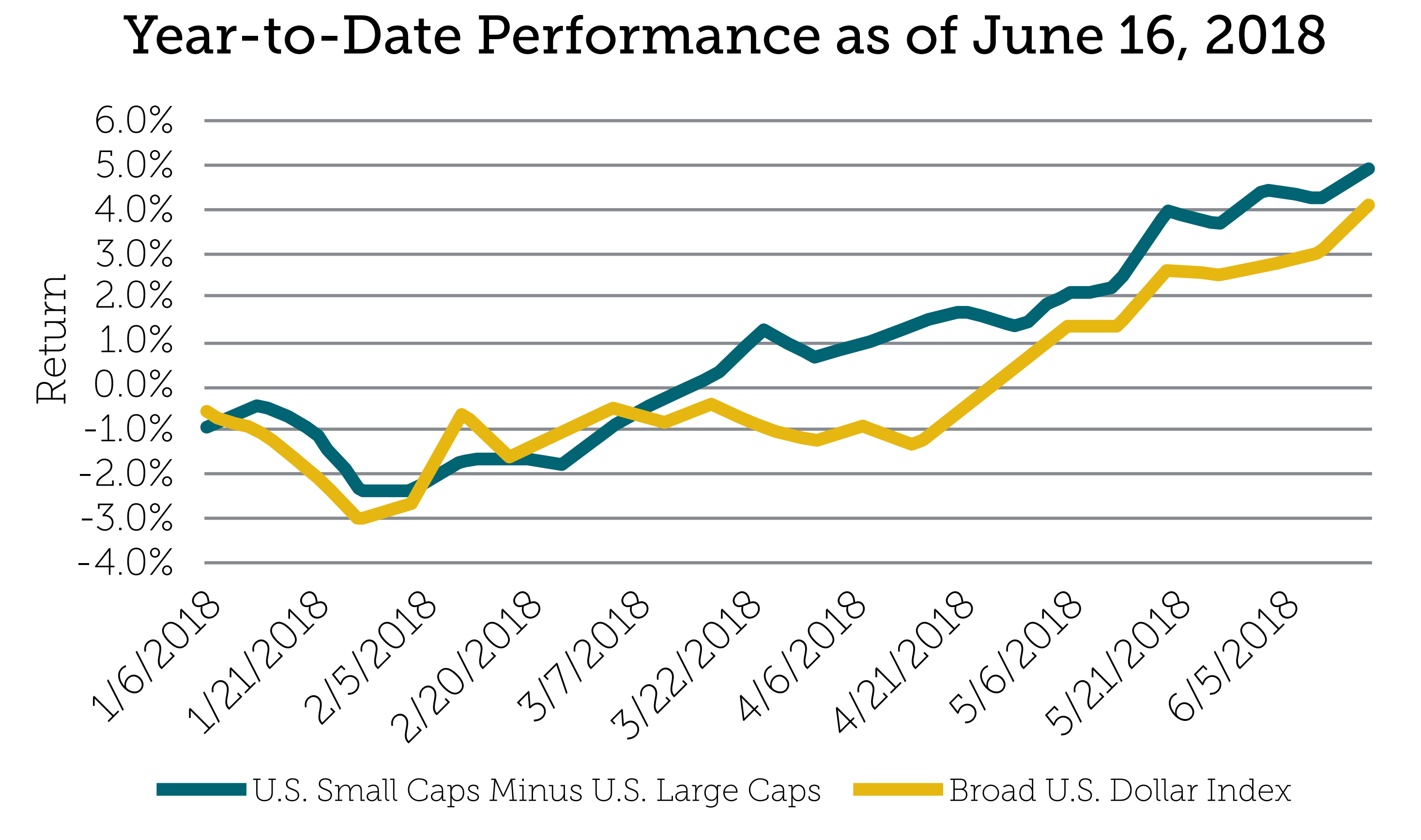
Weathering Trade Tensions with Small-Caps

Last week, the U.S. and China upped the ante on ongoing trade tensions with a series of tariffs on U.S. and Chinese goods. Trade wars, historically, have not been good for global growth as illustrated by the Great Depression of the 1930s. Although the sizes of the tariffs so far have been small, a trade war could be a headwind for growth globally as consumers may be less willing to purchase goods from abroad.

In the midst of recent trade tensions, U.S. small-caps have been reasonably shielded from the negative impacts of possible tariffs and the resulting market volatility. Why is that the case?

Investors should remember that small-caps tend to include stocks whose revenues are largely generated through domestic consumption rather than selling to overseas customers. This means that moves in the currency market will have less impact on their bottom lines, unlike larger-cap stocks that tend to operate as multinational firms.

At CLS, we are currently overweight small-caps, and we favor them for good reason beyond simply where they derive their revenues. Historically, small-caps have been rewarded in the market over longer periods of time. They are also attractively priced relative to U.S. markets and thus should have greater potential for return enhancement going forward.



Source: Morningstar Direct. Cumulative year-to-date performance for the Russell 2000 Index compared to the Russell 1000 Index. Nominal U.S. Dollar Index used to proxy a basket of currencies relative to the U.S. dollar. Data based on weekly returns from December 31, 2017 through June 16, 2018.

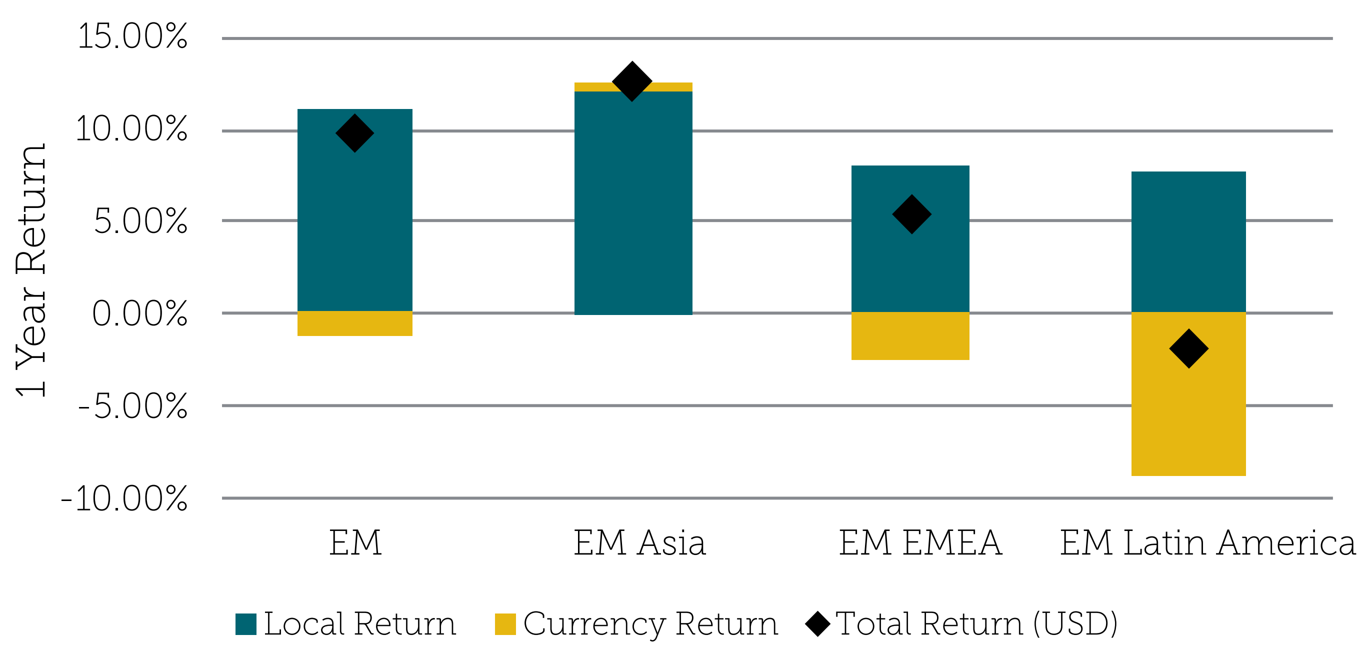
Recent trade news has also generated volatility for emerging market (EM) stocks as the dollar has rallied against other EM currencies. That has many investors believing that ongoing trade tensions could be bad for EM across the board if the dollar continues its rally.

Determining the true impact of the dollar on emerging markets requires breaking down EM as an asset class into its constituent parts to determine which areas are taking the brunt of currency fluctuations. Based on our own analysis at CLS, we find that the story is not as impactful as investors may believe, as illustrated by the chart below.

Over the past year, currency impacts have detracted from gains in EM stocks by just over 1.1% as of June 22, 2018. However, reviewing the three major regions shows that currency impacts have been fairly unequal across the EM complex. Emerging Latin American stocks have been hit hardest with currency impacts, reducing gains in those markets by 8.8%. Emerging Europe/Middle East/Africa(EMEA) stocks have seen returns reduced by only 2.4%. Surprisingly, emerging Asian stocks have seen a slight benefit from currency impacts of 0.4%. Just to put things into further perspective, emerging Asia represents more than 75% of the MSCI Emerging Markets Index, while emerging EMEA and emerging Latin America each make up just 14% and 11% of the remaining index respectively.

CLS continues to be overweight EM with emerging Asia representing our largest overweight within EM across CLS portfolios. We are also finding attractive opportunities within other areas of EM, such as Latin America and emerging Europe, as we continue to believe recent weakness means stocks are trading at very attractive discounts. Emerging markets will continue to be an important allocation decision for investors as much of the world's future growth is tied to companies doing business in this part of the world.

Components of One Year Total Return for Emerging Markets by Region



Source: MSCI. Based on MSCI Emerging Markets NR Indexes. Broad market and regional breakouts measure returns using both local return and USD return indexes. Daily returns for the 252 days evaluated from July 6, 2017 through June 22, 2018.

Smart Beta ETFs Are Good for Your (Tax) Alpha, Too

"...in this world nothing can be said to be certain, except death and taxes."
— Benjamin Franklin

Since the late 1970s, our industry has been determined to find the best opportunities likely to outperform the market. But many of us know that from the moment we buy an asset to the moment we sell it, there is still one more hurdle to overcome — taxes.

Taxes can represent a meaningful drag on an investor's performance if his or her tax situation is not carefully monitored and managed. The ability to defer tax payments can be thought of as taking out a loan from the government that doesn't come due until you choose to realize the gains from your investment. The longer that payment is pushed off, the better the chances to increase your gains by remaining invested in the markets. If an investor chooses to take money out in a shorter time frame, those gains can come at a substantial cost in the form of higher taxes on those realized gains.

At CLS, we value ETFs because they help investors defer their tax bills by minimizing unwanted capital gains. Since most ETFs manage capital gains within the fund to keep capital gains distributions near zero, each investor's capital gains can be anticipated based on when they choose to sell their shares back into the market.

What about ETFs that attempt to beat the market instead of tracking it such as smart beta ETFs? Smart beta ETFs represent the essence of active management by managing to a series of rules that mimic the actions of a typical active manager. Can smart beta ETFs strive to be tax-efficient, too?

Based on our own analysis, which was inspired by recent research published by Rob Arnott at Research Affiliates, we find that smart beta ETFs can deliver on tax efficiency even better than most other fund types. Reviewing a mix of three-year annualized gross-of-fee, net-of-fee, and after-tax returns (pre-liquidity and post-liquidation), we find smart beta ETFs have generated positive excess returns over their market-cap benchmarks, while delivering superior tax alpha to their active mutual fund counterparts. This has translated to a tax alpha improvement of more than 2.8% annualized on a pre-liquidation basis and more than 1.7% annualized on a post-liquidation basis.

Smart beta ETFs as a segment will continue to grow, and we are firm believers in incorporating them into our Risk Budgeting Methodology because of their ability to outperform using a rules-based framework. But it's nice to know they have another purpose — delivering greater tax savings for clients.

Average Excess Returns by Fund Type, Annualized Three Years Ending May 31, 2018

Fund Type	Gross Return	Net Return	After-Tax (Pre-Liquidation)	After-Tax (Post-Liquidation)
All Mutual Funds	-0.12%	-1.10%	-2.97%	-3.54%
Active Mutual Funds	-0.16%	-1.18%	-3.10%	-3.62%
All ETFs	0.32%	-0.05%	-0.58%	-2.20%
Smart Beta ETFs	0.65%	0.30%	-0.26%	-1.91%

Source: Morningstar Direct. Annualized three-year performance as of May 31, 2018 for U.S. equity mutual funds and ETFs. Oldest share class used for mutual funds. All funds evaluated with at least a three-year track record. Excess returns compared against the appropriate Russell 1000, Mid-Cap, and 2000 style index within each Morningstar category.

Joseph Smith, CFA
Senior Market Strategist

Joe Smith specializes in quantitative research, risk management, and ETF due diligence. He serves as Senior Market Strategist for the CLS AdvisorOne International Equity Fund, CLS's Thematic Growth Strategy, and CLS's Core Plus ETF Strategy.

Prior to joining CLS in 2015, Mr. Smith worked at Russell Investments where he served as an Analyst responsible for asset allocation research, portfolio construction, optimization design, and risk management research. He later joined Russell ETFs as Manager of ETF Product Development and Research, a role in which he developed quantitative indexing strategies implemented as ETFs. Mr. Smith also worked for Charles Schwab Investment Management as a Senior Product Specialist supporting product management activities for the Schwab ETFs fund family. In addition, he worked for CLS during the summer of 2014 as an Investment Analyst.

Mr. Smith received his Bachelor of Science degree in Economics from the University of Washington. He later received his Master of Business Administration from the Tepper School of Business at Carnegie Mellon University.

Mr. Smith holds the Chartered Financial Analyst (CFA) designation and is a member of the CFA Society of San Francisco, Pittsburgh, and Nebraska. He is also a member of the Society of Quantitative Analysts and the Quantitative Work Alliance for Applied Finance, Education, and Wisdom.

Did you know? In grad school, Joe spent 40 days in nine countries.

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.

Alpha, also called the risk-adjusted return, is the difference between an asset's expected return and its actual return. Beta is a measure of the volatility, or systematic risk of a security or a portfolio in comparison to the market as a whole.