CLS's WEEKLY 3

What You Need To Know About the Markets

JULY 3, 2018

1. Trade rhetoric in recent months has stirred the markets
2. A market we like: the U.K.
3. An example of long-term excellence and a winning combination

Market Performance

Equities	JUNE	YTD '18	12-MONTH
Total U.S. Market[1]	+0.65	+3.22	+14.78
Domestic Large-Cap Equity[2]	+0.62	+2.65	+14.37
Domestic Small-Cap Equity[3]	+0.72	+7.66	+17.57
International Equity[4]	-1.88	-3.77	+7.28
Developed International Equity[5]	-1.22	-2.75	+6.84
Emerging Market Equity[6]	-4.15	-6.66	+8.20
Fixed Income	**JUNE**	**YTD '18**	**12-MONTH**
U.S. Investment Grade Bonds[7]	-0.12	-1.62	-0.40
Cash Equivalent[8]	+0.15	+0.77	+1.29
Commodities	**JUNE**	**YTD '18**	**12-MONTH**
Commodity[9]	-3.50	+0.00	+7.35

[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 6/30/2018

June Market and Portfolio Review

Last month, the overall U.S. stock market (Russell 3000 Index) gained just 1%, with larger companies (S&P 500 Index) and smaller companies (Russell 2000 Index) recording similar returns, both just under 1%. For the quarter, however, all three indices recorded generous absolute gains, particularly smaller-cap companies.

It was rougher overseas, however, as international markets lost nearly 2% (MSCI ACWI ex-U.S. Index). Developed international markets (MSCI EAFE Index) were down about 1%, and emerging markets (MSCI Emerging Markets Index) were down more than 4%. For the quarter, all three international indices recorded losses, again led lower by emerging markets. In the first quarter of the year, emerging markets were easily the market leaders, but they went from first to worst in a few months due to the trade rhetoric between the U.S. and other countries, notably China.

The bond market (Bloomberg BarCap Aggregate Bond Index) gained less than 1% last month but still has a slight loss for the quarter and the year so far. The 10-year Treasury yield ended June at 2.84%.

Commodities (Bloomberg Commodity Index), meanwhile, which had taken the lead from emerging markets as the top-performing asset class for a while this year, also lost that distinction with a tough June. The index lost nearly 4% for the month and is now essentially unchanged for the quarter and year.

CLS portfolios, given their globally diversified mandate and approach to investing, gave back more relative performance after a strong first quarter as international equities and diversifying assets, such as bonds and commodities, lagged. Our portfolios benefitted from an emphasis on small-caps (including REITS – real estate investment trusts) and security selection (picking outperforming securities within an asset class segment or strategy). Moving forward, we are retaining our outlook and basic positioning but also finding some fresh opportunities, including one featured in this commentary.

What Should Long-Term Investors Do About Tariffs?

International markets were enjoying a streak of outperformance until the trade rhetoric began, and over the last three months, they have clearly underperformed. As long-term investors, our assessment of the current trade situation is as follows. (We recognize the situation is fluid and this information could get stale quickly).

An Overview

- The tariffs announced thus far are small and unlikely to have a significant impact on global growth.
- A global trade war benefits no one, as history has proven (tariffs were one of the major causes of the Great Depression in the 1930s).
- Tariffs may not achieve their aim, even if it's a commendable one.
- We do not expect a recession, but we do expect continued market volatility.

What Happened?

- President Donald Trump officially imposed 25% tariffs on steel imports and 10% on aluminum from everywhere in the world (pending some exemptions). Trump says the tariffs were imposed because other countries' trade practices threaten national security, and the tariffs will save U.S. jobs. Several countries impacted have suggested they will impose retaliatory tariffs on the U.S.
- More recently, President Trump imposed a 25% tariff (targeting $50 billion worth) on Chinese technology-focused goods based on an investigation into China's efforts to steal U.S. technologies and intellectual property. China has declared retaliatory tariffs of equivalent value primarily on agricultural imports from the U.S.

How Do Tariffs Work?

Import tariffs theoretically incentivize U.S. companies and consumers to buy products from U.S. producers (thus, it is known as a protectionist strategy).

For example, imagine a consumer is interested in a pair of Chinese-made shoes that cost $100. After a 25% tariff is imposed, the price to the consumer goes up to $125. This could encourage the consumer to purchase cheaper, U.S.-made shoes, thus boosting U.S. shoe manufacturing, creating more jobs, growing the U.S. economy, etc. But, there are three big problems with this seemingly simple story:

1. China will most likely retaliate, as it has already, by imposing tariffs on imports of U.S. products (hurting U.S. exporters), creating a back-and-forth trade war.
2. Many U.S.-made products (such as iPhones) utilize components made in China. Thus, input costs increase for these U.S. manufacturers.
3. If a tariff is only set on China, other countries that have struggled to compete with China's scale efficiency will now get their chance to be major exporters to the U.S. – problem not solved.

Possible Market and Economic Impact

- For now, the steel and aluminum tariffs may have the most impact. Manufacturing input costs are likely to go up. Thus, the prices of steel- and aluminum-heavy products, such as cars and soda, will likely go up, too. These increases will partly be passed on to consumers who may then buy fewer of these products.
- Countries that send the most steel and aluminum to the U.S. (thus, the most heavily affected) include Canada, Brazil, South Korea, Mexico, Russia, and China (as of this writing, South Korea, Australia, Brazil, and Argentina are exempted). The expectation is these countries will raise tariffs on imports from the U.S, including agriculture products and airplanes, potentially hurting these industries.

- A trade war, even a small one let alone a global feud, could be a headwind for economic growth as consumers spend less and costs for manufacturers go up, negating some of the benefits achieved from the recent tax reform. Likewise, jobs saved in some industries may be offset by jobs lost in others.

Outlook

We do not believe these tariffs risk a global recession as the currently affected imports make up a small portion of the global economy, which has been on an upward trajectory. Inflation, however, may be pressured higher with rising prices. But this could benefit real assets, such as commodities and real estate. We also foresee market volatility persisting.

Our advice for long-term investors is, as always, to avoid knee-jerk reactions to news headlines and focus on staying globally diversified, balanced, and invested.

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.*

United Kingdom: Five Reasons We're Buying

One international market has become very interesting to us, and we have started buying in some portfolios: the United Kingdom. The U.K. is currently attractive to us for several reasons. CLS Portfolio Manager Grant Engelbart recently outlined five points we are paying particular attention to.

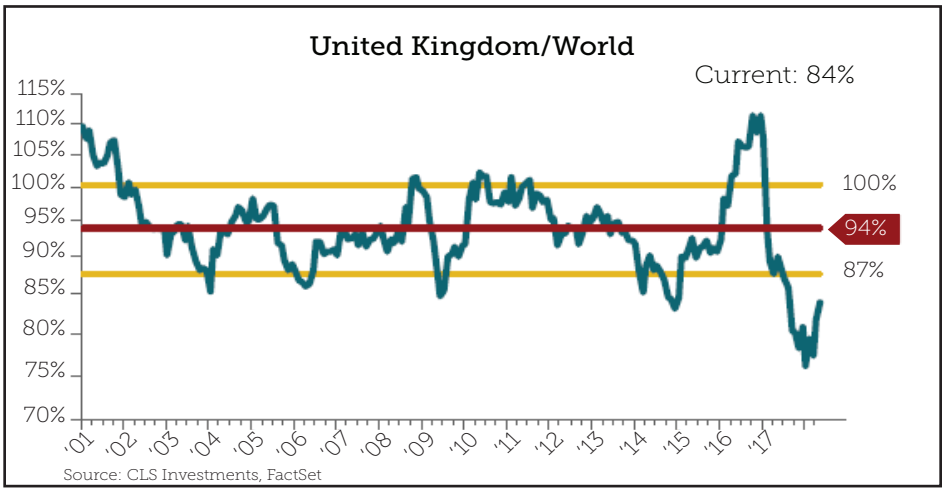
1. Valuations

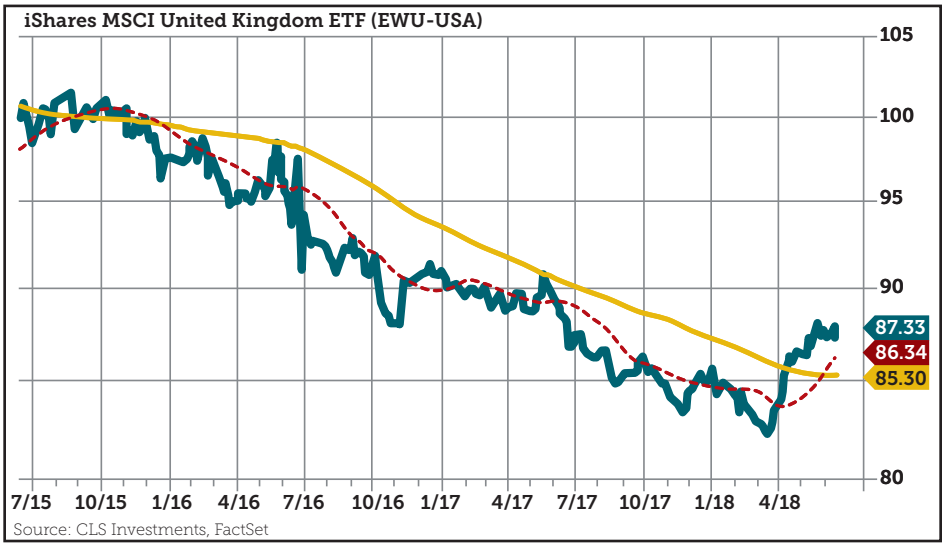
The U.K. is currently valued as cheaply as we've seen since we began tracking the data. The red line in the chart to the right shows the U.K. has traded at a 6% discount relative to the rest of the world since 2001, but it is now trading at a 16% discount. In addition, the current relative valuation is well below the yellow line, which represents one standard deviation below the average. In fact, it is now nearly two standard deviations from the average, something that should only happen 5% of the time. The U.K. is on sale.

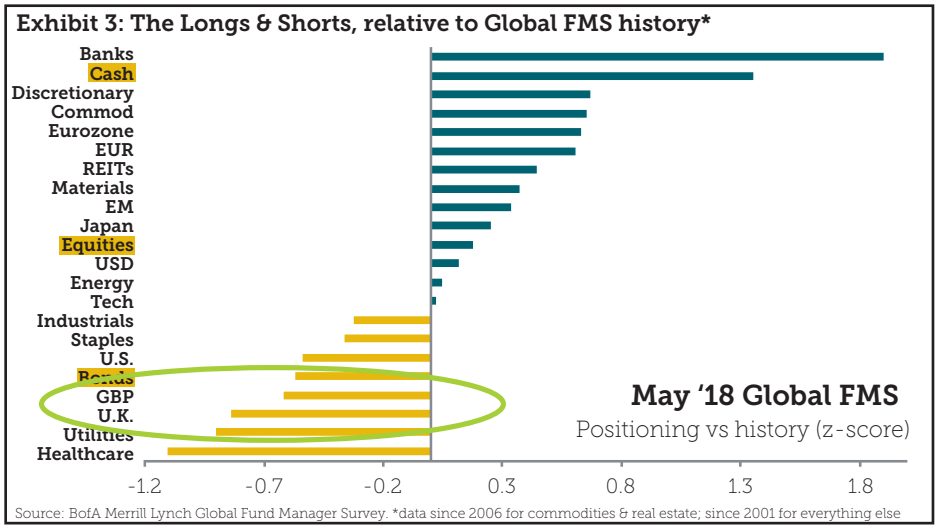
2. Behavioral — Technicals

Behavioral analysis covers both technicals and sentiment. As the chart to the rigth shows, the U.K. has recently "broken out" among international markets. The chart compares U.K. returns to those of the global market, illustrating relative performance. Where the line goes down, as it has over the last three years, the U.K. is underperforming. Note, the line has now turned upward. It is also above the quarterly moving average (red line) and annual moving average (green line). This data is very positive and suggests momentum has shifted back in favor of the U.K.

At the same time, fund managers are generally underweight both U.K. stocks and the pound due to uncertainty about the country's future after Brexit. But sentiment tends to revert. There are many crowded trades out there; this isn't one of them. The chart on the following page, from the BoFA Merrill Lynch Global Fund Manager Survey, shows how money managers are currently positioned. Bottom line: while valuations and technicals appear positive, most portfolio managers aren't biting yet. But we are.





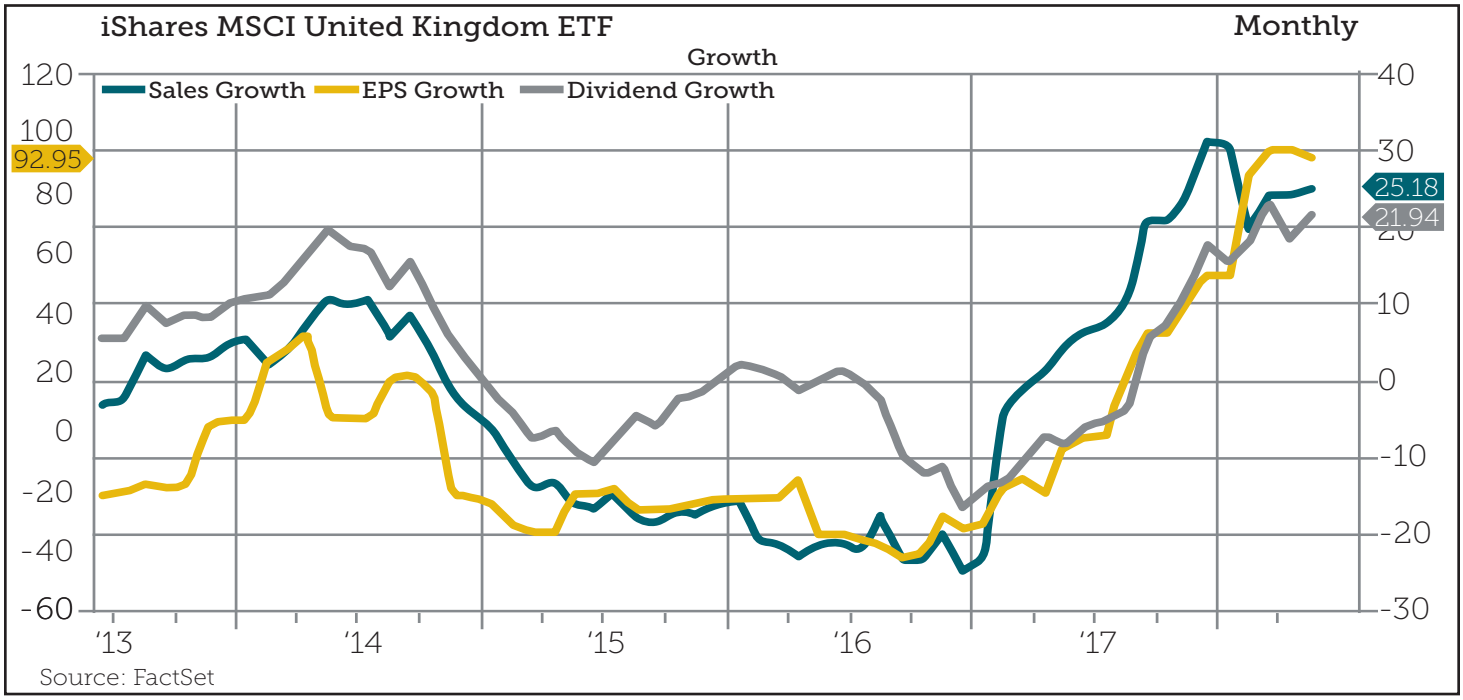


3.Economics

The U.K. economy is growing, albeit slowly, along with the rest of Europe. Retail sales have improved markedly, inflation is moderate and reasonable, and economic sentiment has improved from post-Brexit lows. Toward the end of last year, the British pound was the most undervalued it has been on a purchasing-power-parity (PPP) basis versus the U.S. dollar in 30 years (since the beginning of that data). At 85% of GDP, government debt isn't nonexistent, but it is at one of the lowest levels in the developed world, and interest rates are quite low. The economic backdrop is improving.

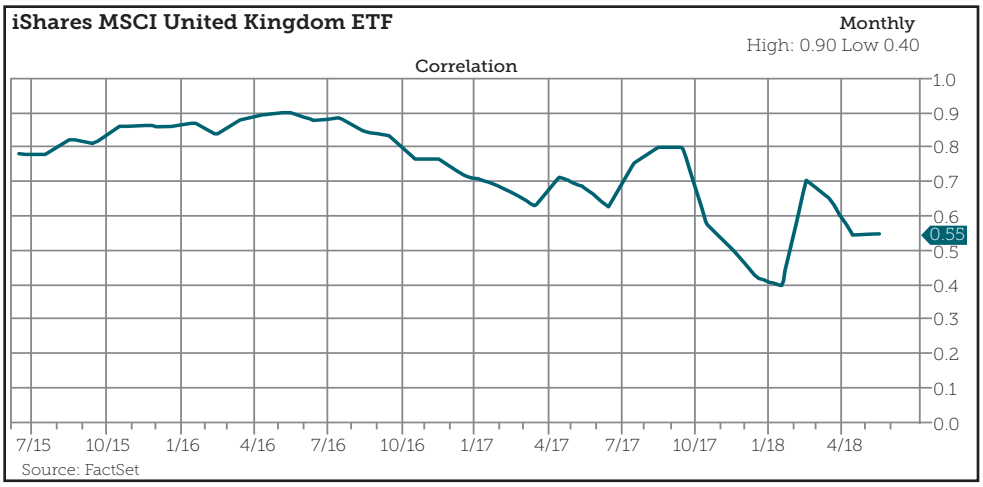
4. Fundamentals

Half of the U.K. stock market is in financials, energy, and consumer staples – classic value sectors. Low interest rates and the oil price collapse in 2015 and 2016 depressed earnings in many of these areas, but they are now accelerating off that lower base and growing at an impressive clip. Quality statistics, such as return on equity and corporate debt, have also improved lately. The fundamentals look good.



5. Quantitative

The correlation between the U.K. and the rest of the world has dropped to less than 0.6, implying that only about 30% of the price movement of U.K. stocks can be explained by movement in the rest of the world. What a great portfolio addition! Diversification can help control portfolio risk and is a major reason to invest internationally. This means investing in the U.K. can potentially enhance returns and reduce overall portfolio risk.



Story of Long-Term Excellence

CLS Investments is one of the largest ETF strategists in the industry, as we have been building ETF-only portfolios for more than 15 years. We take a lot of pride in our ETF security analysis, not only in the portfolios we build, but also in the thought leadership, education, and communication we produce.

We also spend significant time, talent, and resources on risk management and asset allocation, which extends to all the portfolios we manage, including our non-ETF portfolios. Some of our earliest strategies, which began when we were founded in 1989, are still around. Many are mutual fund portfolios. In fact, our largest non-ETF strategy deals with the American Funds, which we have been managing for more than 20 years.

CLS's American Funds strategy has been successful because CLS and American Funds are a strong combination. American Funds has recorded solid performance thanks to the excellence of its managing organization (Capital Group in Los Angeles) and its individual security selection capabilities. Combine that with CLS's Risk Budgeting, and historical returns have been reliable and very competitive.

Much of the credit goes to American Funds being solid ingredients in investor portfolios. As the company's website states, "Since 1931, Capital Group has been singularly focused on delivering superior, consistent results for long-term investors using high-conviction portfolios, rigorous research and individual accountability." Capital Group has proven active management (being different from a benchmark in an effort to outperform it over time) does work over time.

There are a variety of factors Capital Group cites that make a winning culture generate good performance, but the two variables most significant to helping relative performance versus the competition are (1) an emphasis on lower costs and (2) a management that "eats their own cooking" by investing in the funds they manage. We believe the same. (Hear more about why the people at American Funds, along with Davis Funds, think this is a good environment for active management at CLS's Advisor Insight Conference this October in Omaha. The conference will focus on ways advisors can grow their businesses, and I believe it will be the most impactful conference CLS Investments has ever had.)

There is an excellent book on the Capital Group titled "Capital: The Story of Long-Term Investment Excellence." It is by the highly regarded author Charlie Ellis and has many helpful takeaways for advisors and investors alike.

One item I found enlightening is similar to what I believe we try to do at, but with a few twists. In short, Capital Group believes major corporate decisions take into account three constituencies: clients, owners (partners), and employees. A good decision should be, on balance, a benefit for all three. We believe the same but with some important differences. First, we don't only consider general interests, but actual growth. With growth, other success metrics will follow, and growth is more fun!

First, we want to see our advisors grow. I think it's an important distinction to say "advisors" instead of "clients" because it's more than just a transaction; it's our calling as advisors to help investors reach their investment goals. If advisors are growing, then investors are succeeding.

Second, we want to see CLS grow. Growth for the firm doesn't just help ownership. A rising tide raises all boats within the firm.

Third, we want to see CLS teammates continuously grow professionally. We are always seeking ways to improve as investment professionals. We are in an amazing industry with so many rewards, especially the satisfaction of helping advisors and investors succeed. This is a win-win for our teammates and the firm, and again, it's more fun.

In summary, good investment firms spend a lot of time developing, enhancing, and maintaining strong corporate cultures. At CLS, we are always trying to grow and improve so we are better able to empower advisors to help investors succeed.

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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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.