DIRECTIONS

A quarterly publication of CLS Investments SUMMER 2018

In this quarter's "Directions" newsletter, CLS's Chief Investment Officer, Rusty Vanneman, CFA, CMT covers recent market activity, how to interpret tariffs, why it's a good time to buy, and the reality of Social Security benefits. In addition, Senior Market Strategist, Joe Smith, CFA, responds to some of the most frequent questions CLS receives from investors.

*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.*

Learn more about Rusty here.

CLS INVESTMENTS

It is still a great time to be an investor. This is true for many reasons, which are illustrated in the table on the following page. Let's review.

Returns for the previous quarter ended well above average. Despite ongoing rhetoric regarding a possible trade war, the U.S. market rose nearly 4%. However, trade talks did have an impact. Small-caps stocks, which are somewhat insulated from global trade, were up nearly 8%, while international stocks lost ground. That included emerging markets, which were clearly outperforming earlier this year.

Over the last year, returns have been strong in all asset classes, except bonds. But bonds have fared relatively well considering the sensational headlines regarding rising rates and the "scary" bond market. A short-term loss is not that significant given the diversification and income benefits that bonds continue to provide.

The last two columns of the returns table on page two, which show 10-year returns and those since the March 2009 bear market, are something to watch in the months ahead. These numbers will converge sharply over the next nine months as the highly negative returns of the 2008 financial crisis continue to scroll off the 10-year return. In fact, if returns continue to be above average this year, we could see a 10-year period of 20% annualized returns, the first in stock market history (at least since 1871). There's a good chance this will happen, and it will generate significant attention if it does.

The international markets have also posted generous double-digit returns since the bull market began in March 2009, but they have

Equities	QTD	YTD '18	1 YEAR	3 YEAR	5 YEAR	10 YEAR	SINCE 3/10/09
Total U.S. Market[1]	+3.89	+3.22	+14.78	+11.58	+13.29	+10.23	+18.86
Domestic Large-Cap Equity[2]	+3.43	+2.65	+14.37	+11.93	+13.42	+10.17	+18.59
Domestic Small-Cap Equity[3]	+7.75	+7.66	+17.57	+10.96	+12.46	+10.60	+19.96
International Equity[4]	-2.61	-3.77	+7.28	+5.07	+5.99	+2.54	+11.59
Developed Int'l Equity[5]	-1.24	-2.75	+6.84	+4.90	+6.44	+2.84	+11.76
Emerging Market Equity[6]	-7.96	-6.66	+8.20	+5.60	+5.01	+2.26	+11.50
Fixed Income	**QTD**	**YTD '18**	**1 YEAR**	**3 YEAR**	**5 YEAR**	**10 YEAR**	**SINCE 3/10/09**
U.S. Investment Grade Bonds[7]	-0.16	-1.62	-0.40	+1.72	+2.27	+3.72	+3.69
Cash Equivalent[8]	+0.44	+0.77	+1.29	+0.62	+0.38	+0.31	+0.25
Commodities	**QTD**	**YTD '18**	**1 YEAR**	**3 YEAR**	**5 YEAR**	**10 YEAR**	**SINCE 3/10/09**
Commodity[9]	+0.40	+0.00	+7.35	-4.54	-6.40	-9.04	-1.65

[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

significantly lagged domestic markets. Moving forward, we strongly expect international markets to outperform since relative performance is cyclical and valuations are currently more favorable in international markets. Diversifying abroad always makes sense, but it is arguably even more prudent to do so in the current environment.

What Should Long-Term Investors Think About Tariffs?

International markets were enjoying an outperformance streak earlier this year 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. It is important to note, we recognize the situation is fluid and this information could become 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, 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 who 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 also likely go up. These increases will be partly passed on to consumers who may then buy fewer of these expensive 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.

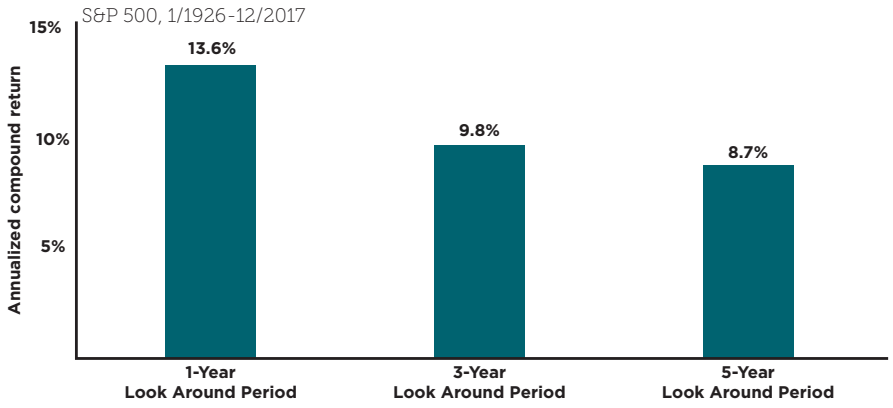
Our advice, as always, is to avoid knee-jerk reactions to news headlines and focus on staying globally diversified, balanced, and invested.

It's Always a Good Time To Buy

Despite the trade rhetoric and weak price performance at the end of the quarter, the stock market is still relatively close to its all-time highs. Some parts of the market, including small-caps and technology, are frequently extending into new all-time highs. Yet, despite the tremendous wealth generated in investor equity portfolios in recent years, investor sentiment remains orderly and controlled.

When talking to investors, either in person or otherwise, it is apparent that greed is not a problem yet. In fact, fear continues to be present in the back of most minds. Many investors believe the floor could still fall out under the stock market, and it's not difficult to come up with realistic scenarios for this

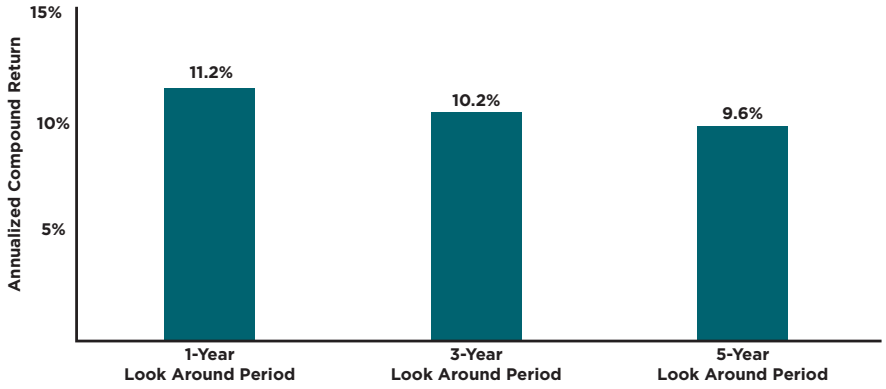
Average Annualized Returns after New Market Highs



Source: Dimensional Fund Advisors

Average Annualized Returns after Market Decline of More than 10%

S&P 500, 1/1926-12/2017



Source: Dimensional Fund Advisors

to occur: overvaluation (e.g., the top tech stocks in the U.S. trade at price/earnings multiples 4x long-term market averages), higher interest rates, tight credit spreads (overvaluation in the corporate bond market), a possible trade war, higher energy prices, and European problems (Italy, Brexit, and more). The list goes on.

These conditions remind me of the old truism: a market that doesn't fall on bad news is inherently strong and more likely to rise than fall in its next major move. In other words, given all the reasons prices should go down, the market remains unchanged on the year and near all-time highs. This resilience suggests the prospect of more gains in the immediate term is still greater than the prospect of losses.

Another concern making many investors hesitant to invest in the market, or more likely to trim or exit positions, is that it is a seemingly unattractive time to invest new money when the market is near, or at, new highs. History suggests this concern may also be overblown. As data from Dimensional Fund Advisors (DFA) shows, market performance after reaching new highs is typically positive. The average market return over the year following a new market high is, astoundingly, almost 14%. The average annualized three-year return is almost 10%, and the five-year is almost 9%. Thus, despite the market reaching all-time highs, it is still a good time to invest.

Other investors are concerned the correction (loss of 10% or more) earlier this year marked an interruption of the long-running bull market (the nine-year stretch since the stock market last recorded a loss of 20% or more) and therefore, the end is near. While that is a fair point, and the correction may indeed have been a crack, the historical odds suggest it's not wise to bet against the stock market.

DFA data shows the market typically performs well after a decline of 10% or more. Over the following year after a decline, average market returns have rebounded to double digits at 11%, and three- and five-year annualized returns have rebounded to about 10%. This suggests it pays to invest in the market, not abandon it, after a sharp decline.

In conclusion, whether the market has just reached all-time highs or suffered a pull-back, it is typically better to invest than not.

Why Do Financial Advisors Make Investors "Eat Their Vegetables?"

A study of market history reveals certain truisms that stand out. First, the markets have a powerful tendency to go up over time. This makes sense because the global economy expands over time. Second, market returns are "lumpy," meaning they don't rise in a straight line. They are messy because prices are volatile, and sometimes they drop, at least temporarily. Third, more volatile markets, such as the stock market, tend to record higher returns over time. That's why stocks return more than assets such as cash savings or money markets, which have no volatility. And it's why investors invest in the stock market. They don't invest to beat the market; they invest to beat the bank.

This is also why good financial advisors tend to say the same things. Good advisors don't call the market's every turn; they advise the financial equivalent of eating our vegetables:

- Expect volatility
- Expect short-term losses, even large ones
- Control what you can, such as your savings rate (more is better) and how much financial media you consume (less is better)
- Stay balanced
- Stay the course

Ultimately, investor behavior determines long-term success. And success is usually more about discipline than unique insights. If investors struggle with financial discipline, a financial advisor can help.

Can We Count On Social Security?

Good financial advisors should always encourage their clients to save more. If there is one path to financial wealth, it is spending less than is earned and saving the difference. Savings is one variable investors can control. They can't control the markets and what happens in the economy, but they can manage their savings rates. But saving is difficult for most investors. According to the U.S. Bureau of Economic Analysis, the personal savings rate in the U.S. was 12% in 1968. In 2018 that rate fell to 3%. In summary, Americans are saving less.

Many investors who have fallen behind in their retirement savings might try a more aggressive approach. That could be the right answer, but it depends on how their current portfolios have been established. Working with a financial advisor can help investors determine what is appropriate. Either way, it's always safe to save more.

It's also important to remember what is likely the largest asset in a retirement portfolio – Social Security benefits. Many believe Social Security is in serious trouble, but its challenges may be overstated. According to *Franklin Templeton*:

In its recent report, the Social Security Trustees stated that to ensure both trust funds remain solvent over the next 75 years, the payroll tax would need to immediately go up by 2.84%. Translation: If the current Social Security tax rate of 12.4% were increased by 2.84% to 15.2%, everyone would get their benefits for the next 75 years. Keep in mind that employees and their employers would each pay half of the increase—1.4%. In other words, if we all chip in $14 more for every $1,000 we earn up to the maximum taxable earnings (currently $128,400), Social Security would remain solvent for the next 75 years.

In other words, Social Security is probably more reliable than many investors believe. Again, it's always safe to save more!

Thank You

Thanks for reading. If you have any questions on this material, or anything outside this article, please let me know. Thank you for your time and trust.

Why the Destination is Highly Dependent on the Journey

from Senior Market Strategist, Joe Smith, CFA

"Life is a school of probability." — Walter Bagehot

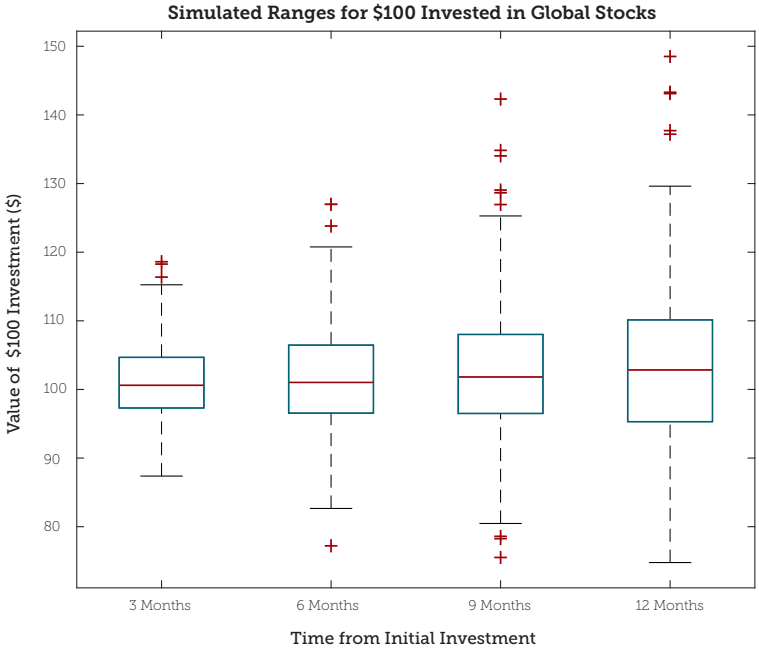
What will the markets return in the next 12 months? Should I expect 20% gains per year in the future? Will the markets correct by more than 10% in the next six months?

We frequently encounter these types of questions at CLS for good reasons. Our investors have objectives and goals they strive for, and they want to know if they will arrive at their destinations as planned. It's important for them to know when they're working with long investment horizons, they generally can reach their destinations, but they will usually experience uncertainty along the way. The reality is although stock returns have historically been positive, the path they take can sometimes fill investors with either excitement or dread. In essence, the destination is dependent on the journey.

What exactly do I mean by this? Let's say, for example, an investor has $100 to invest in the market and would like a risk profile consistent with global stocks. Assuming CLS's 12-month return expectation for global stocks (as of this writing, about 3%), let's see what happens if we simulate 500 alternative paths of what that $100 could become in one year.

The chart below illustrates our experiment. On average, the investor would have about $103.13 or a return of 3% after 12 months. This is generally consistent with CLS's expected return for global stocks. However, the ranges of possible totals are wide. In some cases, the final value of the investment is much higher than $103. In other cases, the investor is worse off from where he or she started, ending with much less than the original $100. However, the comfort investors should take from the results is that the more extreme outcomes carry much lower probabilities of being realized than our general expectation for global stocks.

We believe investors should always think in terms of odds and probabilities of what could happen versus taking the most likely expectation as just given. This is important to help manage one's own expectations and emotions as the market hums along and takes unexpected twists and turns. A probability-based framework can also help investors stay on track toward their destinations without feeling as surprised by what their journeys may hold.



Source: CLS Investments. Based on CLS Edge Score as expected return and volatility assumption for CLS's global stock benchmark, the Equity Baseline Portfolio (EBP), as of April 30, 2018. Simulations based on daily returns on cumulative basis over 252 trading days using a geometric Brownian motion process in MATLAB.

2018 Investment Themes

from CLS Chief Investment Officer, Rusty Vanneman, CFA, CMT

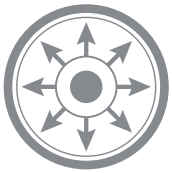
BE ACTIVE

There has been much ado about the move from "active investment management to passive investment management." The real story, however, is the move from mutual funds to exchange traded funds (ETFs). This secular trend has a long way to go, and in large part due to lower costs for investors. A bigger reason regretfully, is that many investors are chasing recent performance. In general, passive strategies have indeed outperformed active strategies in recent years net of fees, but that relative performance should dissipate as the market environment changes. While higher costs and cash levels will still negatively impact active managers (though not as much as in years past), active management will benefit when value stocks, small-cap stocks, and international stocks start to outperform domestic large-cap growth stocks.

BE SMART (BETA)

Smart beta ETFs are rules-based ETFs whose holdings aim to intentionally diverge from a broad, market-cap-weighted index. At CLS, we emphasize five equity factors and two fixed income factors when we analyze portfolios and select ETFs. Moving forward, while recognizing that all investment styles are cyclical, we believe this theme will provide a durable edge over the long haul. Historically speaking, the average equity factor has added 2% of value over the market per year, and 4% per year when the stock market is down.

Equity Factors: Value, Quality, Size, Minimum Volatility, and Momentum
Fixed Income Factors: Credit and Duration



BE CREATIVE (WHEN DIVERSIFYING)

With interest rates at low levels compared to historical averages, this theme refers to the need to continue diversifying equity volatility to manage overall portfolio risk. CLS achieves this by being creative in using other asset classes to diversify risk, including the judicious use of alternative asset class strategies and commodities. Alternatives may enhance risk-adjusted performance in a variety of ways depending on the strategy, while real assets, such as commodities may help performance, particularly when inflation or inflation expectations are rising.