CLS's WEEKLY 3

What You Need To Know About the Markets

SEPTEMBER 11, 2018

1. CLS's evolution as an ETF strategist
2. Three reasons to continue to invest globally
3. How you can prepare for the start of the next bear market

Market Performance

Equities	LAST WEEK	QTD	YTD '18
Total U.S. Market[1]	-1.06%	+5.81%	+9.22%
Domestic Large-Cap Equity[2]	-0.98%	+6.05%	+8.86%
Domestic Small-Cap Equity[3]	-1.57%	+4.47%	+12.47%
International Equity[4]	-2.83%	-2.59%	-6.26%
Developed International Equity[5]	-2.83%	-2.37%	-5.05%
Emerging Market Equity[6]	-3.06%	-3.61%	-10.03%
Fixed Income	**LAST WEEK**	**QTD**	**YTD '18**
U.S. Investment Grade Bonds[7]	-0.45%	+0.22%	-1.40%
Cash Equivalent[8]	+0.04%	+0.36%	+1.13%
Commodities	**LAST WEEK**	**QTD**	**YTD '18**
Commodity[9]	-1.33%	-5.15%	-5.15%

[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 9/7/2018

Week in Review

Markets were broadly lower last week with not many positive areas to be found. Cash and Italian stocks were higher, but most others were in the red. Growth stocks underperformed value stocks in the U.S.

Major headlines included the monthly U.S. jobs and wages report, which both held surprises to the upside: 210,000 jobs created and wages up by 2.9% — the largest spike since 2009! The strong data could signal a possibility for more rate hikes this year.

The U.S. trade deficit expanded in July with imports rising by 0.9% and exports falling by 1%. The news makes us wonder: Are trade wars good and easy to win? Time will tell.

Turning Back the Clock - How CLS has Evolved as an ETF Strategist

CLS is one of the longest-tenured managers of ETF-only portfolios. We started to construct diversified, Risk Budgeted models of ETFs back in 2001. In fact, after a quick search of ETF-only portfolios and managers in the Morningstar database, only about 3% of portfolios were offered in 2001 or earlier.

ETFs have seen explosive growth since launching in 1998 – 34% annually through 2017.

ETFs have evolved significantly since they first launched. New styles, including bond ETFs, commodity and alternative asset class ETFs, and new niche, active, and smart beta products, have been added to the ETF universe. Likewise, CLS's portfolios have also evolved. I always find it interesting to look back at early models and see how the ETFs we use have changed and our outlook has been updated, but our methodology has stayed constant.

Above is an allocation I pulled from a client in our 70 Risk Budget model from early 2003. (Quick note of appreciation to those clients who have been with us for more than 15 years. Thank you.)

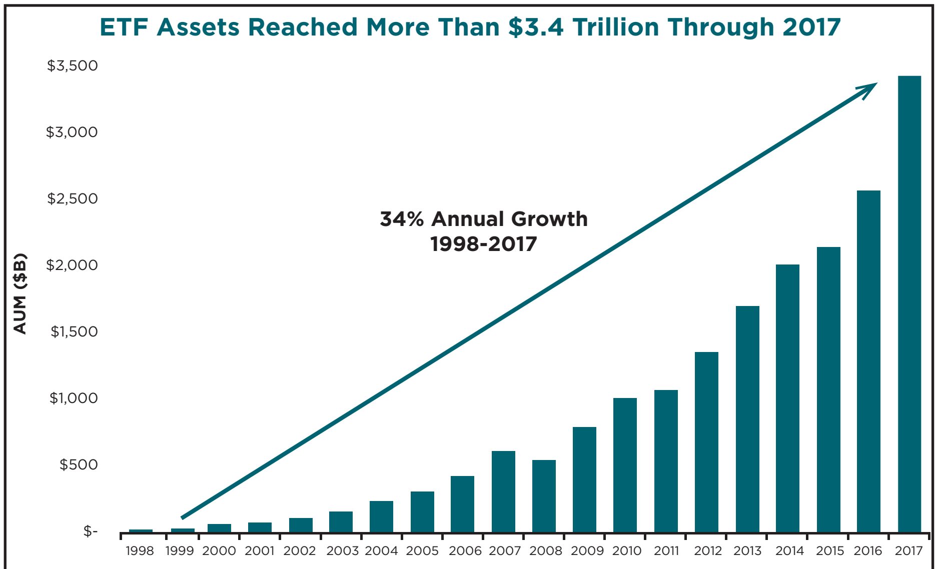
iShares S&P 500 Growth ETF	21%	IVW	Equity
iShares MSCI EAFE ETF	6%	EFA	Equity
iShares iBoxx $ Invmt Grade Corp Bd ETF	22%	LQD	Fixed Income
iShares 1-3 Year Treasury Bond ETF	9%	SHY	Fixed Income
iShares Russell 1000 Value ETF	16%	IWD	Equity
SPDR® S&P MidCap 400 ETF	11%	MDY	Equity
iShares Russell 1000 Growth ETF	8%	IWF	Equity
iShares U.S. Real Estate ETF	4%	IYR	Fixed Income
Cash	3%	Cash	Cash
% of Total:	100%		

A few observations:

- The ETF universe was only composed of about 120-130 funds in 2003
- The CLS-managed investor portfolio was fairly simplistic and held only eight ETFs.
- Only two fixed income ETFs were used because only six were available!
  - CLS was still able to manage duration by using short-term Treasuries in combination with longer-term corporate bonds.
- All these ETFs are still around today.

On the following page is our allocation for the same investor today.

- The ETP (ETFs, ETNs, etc.) universe includes more than 2,000 choices now.
- The CLS-managed investor portfolio has grown to 12 as options to become more granular in our selection process expanded.
- Four fixed income ETFs and two alternative ETFs are being used.
  - There are more than 300 fixed income ETPs to choose from and about 500 alternative ETPs.
- New ETFs include smart beta equity and actively managed fixed income.
- There is one overlapping name highlighted in each portfolio.
  - Large-cap value was used 15 years ago and remains as we continue to focus



Source: Morningstar, as of 12/31/2017

iShares Core S&P Small-Cap ETF	6%	IJR	Equity
iShares Russell 1000 Value ETF	9%	IWD	Equity
Xtrackers Russell 100 U.S. QARP ETF	6%	QARP	Equity
iShares MSCI EAFE Value ETF	17%	EFV	Equity
iShares MSCI Europe Financials ETF	2%	EUFN	Equity
Invesco FTSE RAFI Emerging Markets ETF	8%	PXH	Equity
SPDR® S&P China ETF	7%	GXC	Equity
Vanguard Information Technology ETF	5%	VGT	Equity
First Trust Global Tact Cmdty Strat ETF	6%	FTGC	Alternative
IQ Merger Arbitrage ETF	5%	MNA	Alternative
Invesco Senior Loan ETF	4%	BKLN	Fixed Income
SPDR® DoubleLine Total Return Tact ETF	10%	TOTL	Fixed Income
Invesco Variable Rate Investment Grd ETF	9%	VRIG	Fixed Income
PIMCO 1-5 Year U.S. TIPS ETF	4%	STPZ	Fixed Income
Cash	2%	Cash	Cash
% of Total:	100%		

on stocks trading at lower price-to-earnings ratios.

A side-by-side comparison illustrates how our outlooks have evolved as markets changed.

- U.S. stocks were fairly valued in 2003, but they have since become expensive, and CLS has shifted toward a global approach.
- CLS shifted away from growth stocks as they became expensive relative to value stocks.

All in all, CLS's portfolios have evolved to use more funds that enable us to get more granular, more asset classes that improve diversification, and newer ETFs that help us add value above the market. But one thing has not changed – the Risk Budget. Each portfolio is taking on 70% of the risk of a globally diversified stock market, and that will never change.

Case Eichenberger, CIMA

Client Portfolio Manager

Case Eichenberger co-manages CLS's American Funds strategies, works closely with CLS's separate account strategies (Master Manager), and communicates with advisors and their clients both remotely and in-person.

Since joining CLS in 2007, Mr. Eichenberger has held various roles, including Relationship Representative and Internal Wholesaler. In 2015, he accepted the role of Client Portfolio Manager.

Mr. Eichenberger received his Bachelor of Science degree in Business Administration from Midland University. He holds the FINRA Series 6, 63, and 65 licenses and Certified Investment Management Analyst (CIMA®) designation. During the accreditation process, he attended the Wharton School of Business at the University of Pennsylvania.

Mr. Eichenberger is a member of Greater Omaha Young Professionals and a volunteer for Habitat for Humanity.

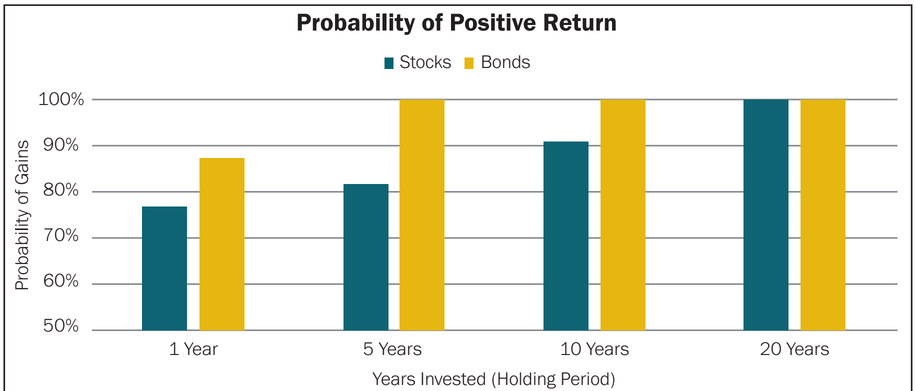
Did you know? Case comes from a long line of educators.

Three Reasons to Stay Global

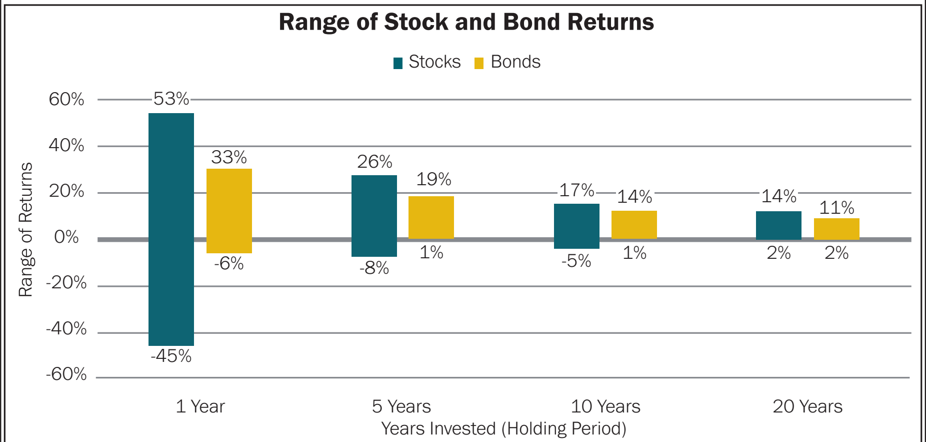
By Jeovany Zelaya and Case Eichenberger, Client Portfolio Managers

Global market returns in 2018 have been choppy and desynchronized since mid-April. Bonds are down, global stocks are barely positive, and U.S. small-caps have been a strong, bright spot: diversification in action. But we realize there are tough conversations to be had when markets diverge, and investors may want to chase a hot trend into an expensive asset class.

To the right are a few charts and points that may help keep clients invested in their global portfolios.



Source: Monthly data from 1950 - Aug 2018; S&P 500 data from Bloomberg, IA SBBI US IT; Goft TR data from Morningstar



Monthly data from 1950 – Aug 2018 S&P 500 data from Bloomberg, IA SBBI US IT Govt TR data from Morningstar Direct

1. Short-term performance will fluctuate (having the right expectations helps).

Question: Why is my portfolio showing a low return?

Answer: Frequency of checking the portfolio and news headlines.

- The frequency with which investors check their accounts will determine how they feel their accounts are doing.
  - On any given day, returns can be positive or negative; however, the longer a person invests, the higher the chance they will see positive returns.
- Sensational headlines cause investors to overreact and make unnecessary changes to their portfolios. This will make returns volatile in the short-run.

2. Markets are cyclical (diversification helps).

Question: Why should I diversify?

Answer: It's hard to buy the right stock, sector, or region and sell that investment at the right time.

- Markets ebb and flow; what's hot now might not persist into the future.
- This is why it's important to diversify among several markets (e.g., international and domestic) and asset classes (e.g., stocks, bonds, cash, and alternative investments).
- The chart at the top of the next page illustrates how different asset classes move up and down through time.

3. Valuations drive long-term future performance.

Question: Why do valuations matter?

Answer: Because they're the best predicators of future returns. We're investing for the future, not the past.

2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Cumulative	Annual	Std. Dev
55.8%	25.6%	34.0%	32.1%			78.5%	26.9%						21.3%	37.3%			32.5%
47.3%	20.2%	21.4%	26.3%	39.4%		31.8%	18.9%		18.2%				12.0%	25.0%	470.7%	12.3%	20.5%
38.6%	18.3%	13.5%	18.4%	16.2%		27.2%	16.8%		17.3%				11.8%	21.8%	389.3%	11.2%	19.8%
28.7%	11.6%	7.8%	15.8%	11.2%		26.5%	15.1%		16.3%	38.8%	13.7%		11.2%	15.6%	313.3%	9.9%	18.1%
23.9%	10.9%	4.9%	13.7%	9.1%		25.4%	12.0%		16.0%	32.4%	6.0%		8.2%	14.6%	222.1%	8.1%	16.3%
2.38%	9.1%	4.6%	4.8%	7.0%		18.9%	7.8%	7.8%	12.0%	22.8%	4.9%	1.4%	2.6%	3.5%	212.8%	7.9%	12.1%
4.1%	4.3%	3.0%	4.3%	5.5%	5.2%	5.9%	6.5%	2.1%	4.2%	13.9%	4.4%	0.5%	1.0%	1.7%	83.9%	4.1%	2.6%
1.0%	1.2%	2.4%	2.1%	4.8%	1.8%	0.1%	0.1%	0.1%	0.1%	0.0%	0.0%	0.0%	0.3%	0.8%	19.6%	1.2%	1.7%
				-1.6%	-25.9%			-0.3%	-1.1%	-2.0%	-2.2%	-0.8%			-4.0%	-0.3%	
					-33.8%			-4.2%		-2.6%	-4.9%	-2.0%					
					-35.6%			-12.1%		-9.5%	-17.0%	-4.4%					
					-37.0%			-13.3%				-14.9%					
					-43.4%			-18.4%				-24.7%					
					-53.3%												

CASH · COMMODITIES · BONDS · EMERGING MARKETS · GLOBAL BALANCED · INTL. STOCKS · SM.-CAP STOCKS · LG.-CAP

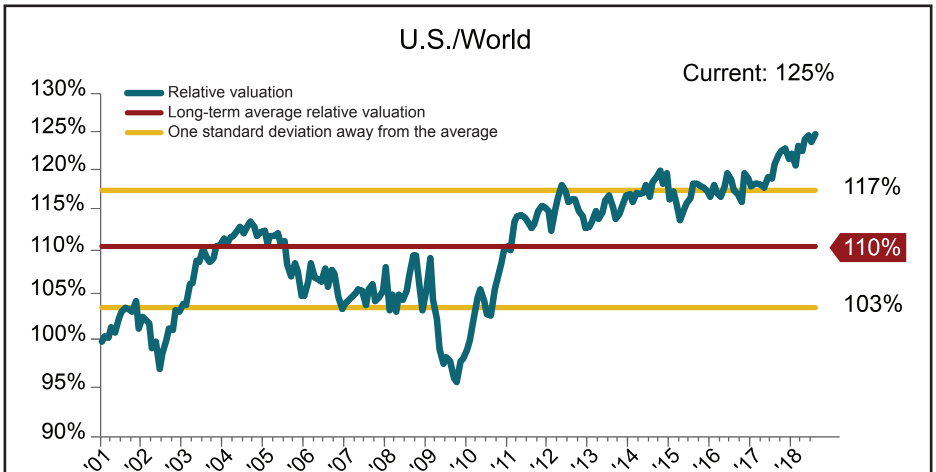
Global Balanced is represented by 60% stock and 40% bond with the stock portion being 60% domestic and 40% international. Domestic equities are represented by Russell 3000 Index, international equities represented by MSCI ACWI ex U.S. Index, and bonds represented by the Barclays Aggregate Index. Source: Morningstar Direct as of 12/31/2017.

- See the U.S./World chart to the right. When the teal line is above the top gold line, stocks are very expensive. When the teal line is below the bottom gold line, stocks are very inexpensive.
- The chart shows that the U.S. market is currently expensive.

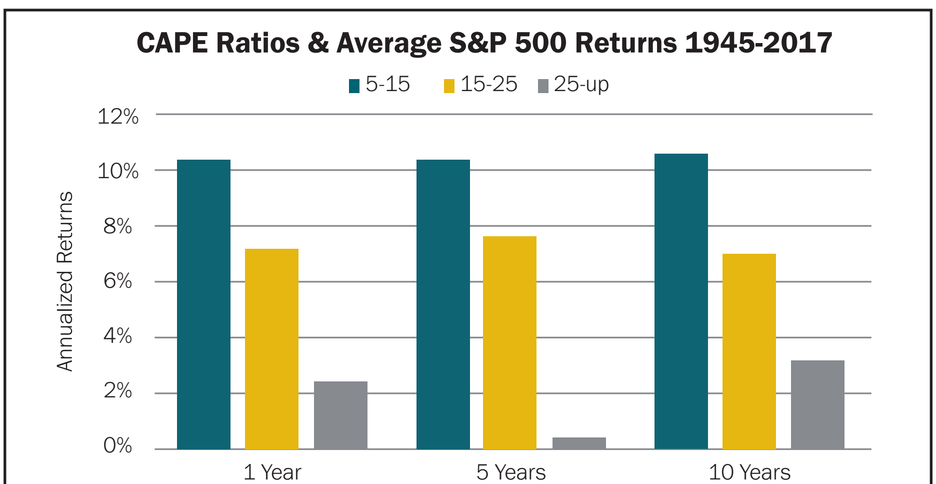
Question: What does this mean?

Answer: Future returns from the U.S. market should be lower than the recent past.

- History shows the higher the valuation of an investment, the higher the chance that investment will produce lower future returns.
- The chart directly to the right shows how U.S. returns have performed given the level of CAPE (cyclically adjusted price-to-earnings) ratio (a valuation metric).



Factset, as of 8/31/2018



Source: Robert Shiller, as of 8/2018

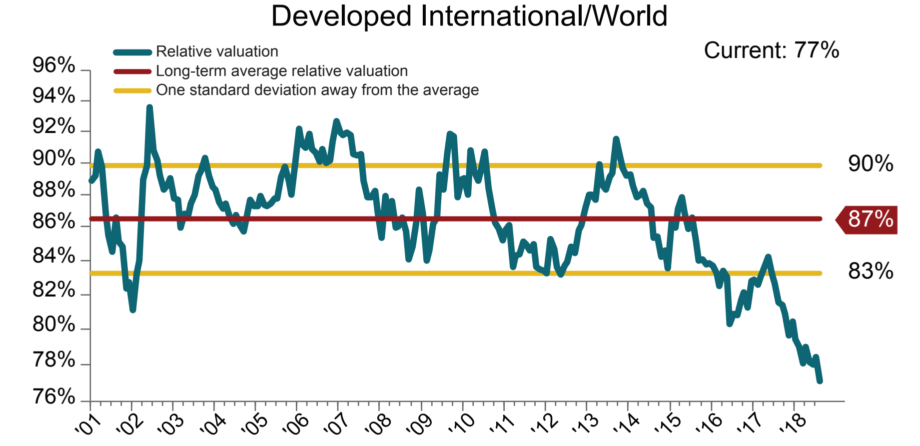
- The lower the CAPE ratio, the higher the returns, and vice versa. As of August 2018, the CAPE ratio for the U.S. market is 32.29.

Question: Where do we go from here?

Answer: Invest in markets where valuations are attractive.

- International markets appear to be a great place to invest.
- Value stocks also look very attractive against growth stocks.

To summarize, short-term performance will vary and can appear to swing wildly. Diversified portfolios act as hedges against one single asset class. U.S. stocks are expensive; tilting toward undervalued areas will help returns in the long run. Valuations should not be used as timing tools to jump in or out of one area of the market, but they have proven to be helpful guides for investors to slowly tilt toward undervalued areas and away from overvalued ones.



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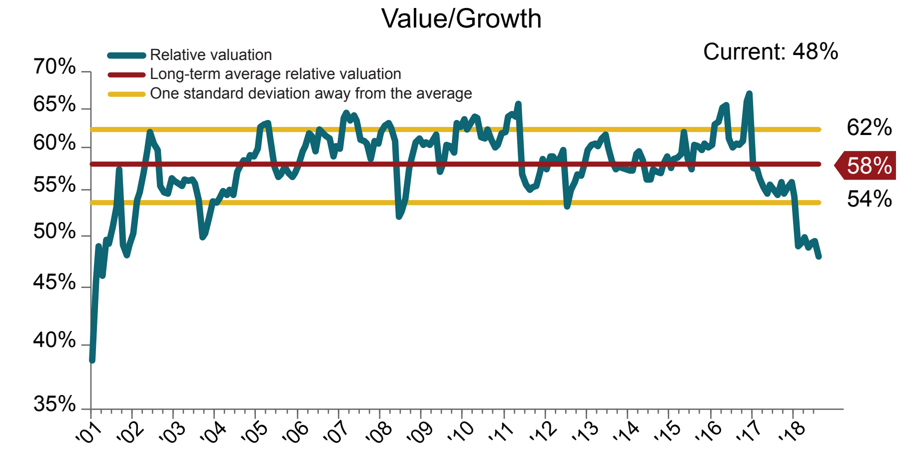


Factset, as of 8/31/2018

The U.S. stock market recently became the longest bull market on record and has again been hitting all-time highs. I'm not here to debate if this really is the longest bull market on record. (Did the pullback of 20% or more intraday in 2011 count? Did the 19.9% drop in 1990, which was counted as a bear, stop the run from 1987 to 2000? Does it really matter anyway?) But what I will say is the pain felt in 2008 is still fresh in the minds of investors, and some say this is the most hated bull market of all time.

We often talk to clients who are emotional and nervous and occasionally get sold poor tactical strategies to sidestep down markets. We also talk to clients who get sold some sort of portfolio insurance that delivers superior returns only when the much-awaited bear market happens.

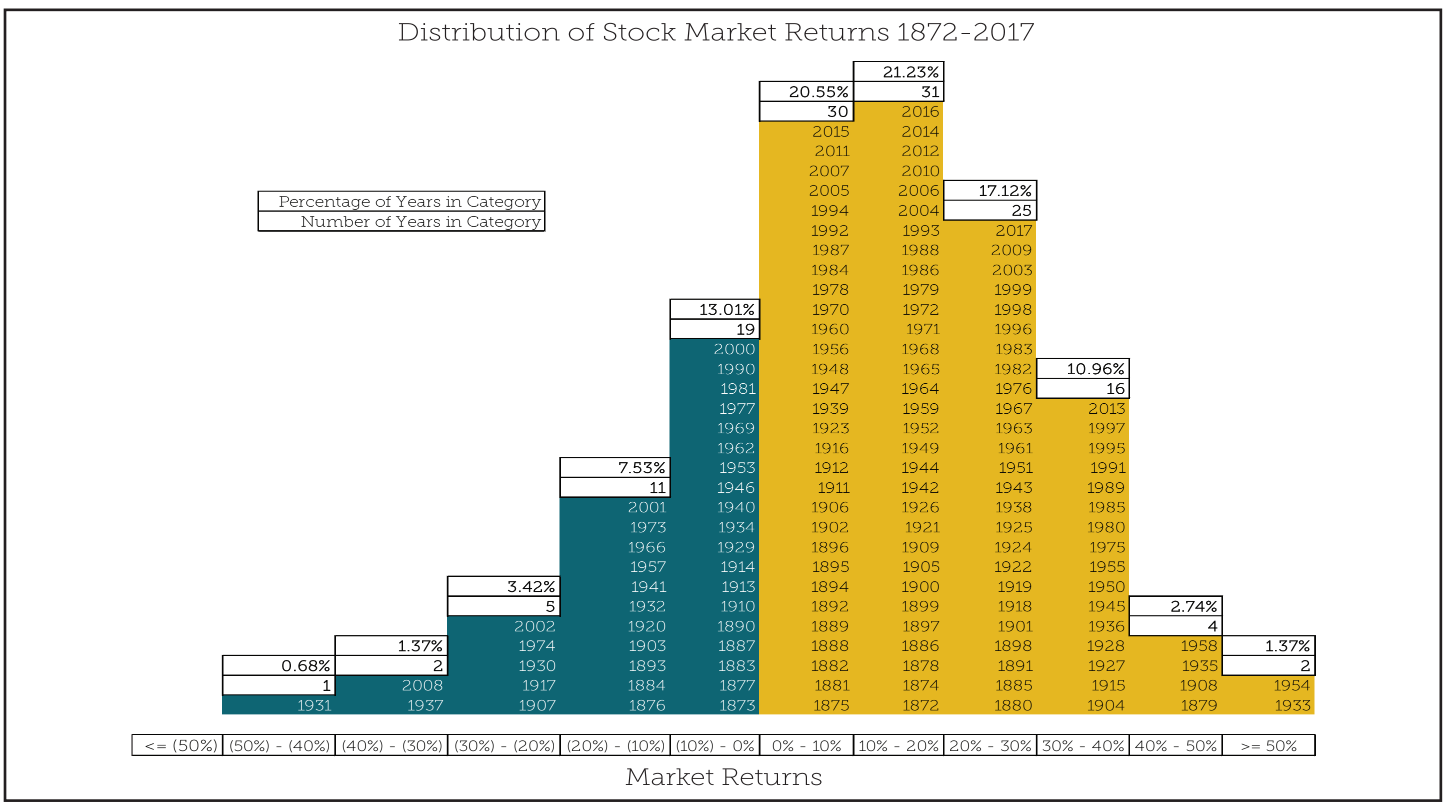
Clients may be worrying about crashes too much. Perhaps because they remember 2000 and 2008 so vividly, or perhaps because this bull market appears old. But we cannot forget the base rates of probabilities.

CLS's Junior Investment Research Analyst, Dustin Dorhout, and I stacked returns for the stock market from 1872-2017. What we found was not surprising, but investors, advisors, portfolio managers, and other market participants often need to be reminded of it: Markets typically move higher, and large crashes are statistically infrequent.

Key findings:

- Note the positive skew of the chart – more gold than teal and higher chances for positive returns on any given year.
  - About 75% of the years are positive and only about 25% are negative.
  - **Takeaway:** It's a good time to be in stocks if you have a long-term outlook.
- Note how infrequent bear markets (losses of 20% or more) have been.
  - They occurred only about 5.5% of the time!
  - **Takeaway:** Hire a good advisor or manager, and don't spend your waking hours worrying about something that has a low probability of happening.
  - **Takeaway No. 2:** Don't overpay for portfolio insurance that often expires as worthless or for a tactical strategy that costs you more in gains than losses saved.

Market drawdowns of 20% or more do happen; they are a feature of markets. They are signs of healthy market behavior and help drive prices to new highs. But keep in mind how infrequent they typically are, and instead focus on finding a Risk Budgeted portfolio than can keep you invested in all market environments with the help of a strong financial advisor.



Relative valuation is a method of evaluating the financial worth of a company by comparing its value to the value of its competitors. CLS calculates the relative valuations consisting of a composite of the price-to-earnings ratio (P/E), price-to-book ratio (P/B), price-to-sales ratio (P/S), price to cash flow ratio (P/CF), and the price-to-dividend ratio (P/D). The price-to-earnings ratio is a valuation method obtained by dividing the market value per share by the earnings per share. The price-to-book ratio is used to compare a stocks' market value to its book value by dividing the current closing price of the stock by the latest quarter's book value per share. The price-to-sales ratio is a valuation metric for stocks calculated by dividing the company's market cap by the revenue in the most recent year; or, equivalently, divide the per-share stock price by the per-share revenue. The price/cash flow ratio (also called price-to-cash flow ratio or P/CF), is a ratio used to compare a company's market value to its cash flow. The price-to-dividend ratio shows how much a company pays out in dividends each year relative to its share price by dividing the annual dividends per share by the price per share.

CIMA professionals integrate a complex body of investment knowledge, ethically contributing to prudent investment decisions by providing objective advice and guidance to individual investors and institutional investors. To learn more about the CIMA, visit https://www.imca.org/cima

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