

CLS's WEEKLY 3

What You Need To Know About the Markets

SEPTEMBER 25, 2018



1. We found one particular household that has had awful performance this year
2. The classification of sectors is undergoing a major change
3. We are entering a particularly strong season for global stock returns

Market Performance

Equities	LAST WEEK	QTD	YTD '18
Total U.S. Market ¹	+0.60%	+7.70%	+11.16%
Domestic Large-Cap Equity ²	+0.86%	+8.26%	+11.13%
Domestic Small-Cap Equity ³	-0.53%	+4.47%	+12.48%
International Equity ⁴	+2.72%	+1.45%	-2.37%
Developed International Equity ⁵	+2.90%	+2.26%	-0.55%
Emerging Market Equity ⁶	+2.27%	-0.84%	-7.44%
Fixed Income	LAST WEEK	QTD	YTD '18
U.S. Investment Grade Bonds ⁷	-0.26%	-0.15%	-1.76%
Cash Equivalent ⁸	+0.04%	+0.43%	+1.21%
Commodities	LAST WEEK	QTD	YTD '18
Commodity ⁹	+2.40%	-2.98%	-2.98%

¹Russell 3000 ²S&P 500 Index ³Russell 2000 Index ⁴MSCI ACWI ex-U.S. Index ⁵MSCI EAFE Index ⁶MSCI Emerging Markets Index ⁷Bloomberg Barclays Capital U.S. Aggregate Bond Index ⁸Bloomberg Barclays Capital 1-3 Month U.S. Treasury Bill Index ⁹Bloomberg Commodity Index

As of 9/21/2018

Week in Review

Global stocks climbed higher again last week, led by overseas companies, which outperformed domestic shares by more than 2%. Another round of U.S.-China tariff announcements failed to derail the rally. Many emerging economies, including China, rallied strongly (5%-7%). Recently, struggling markets, such as Russia, Turkey, and Argentina, rebounded sharply.

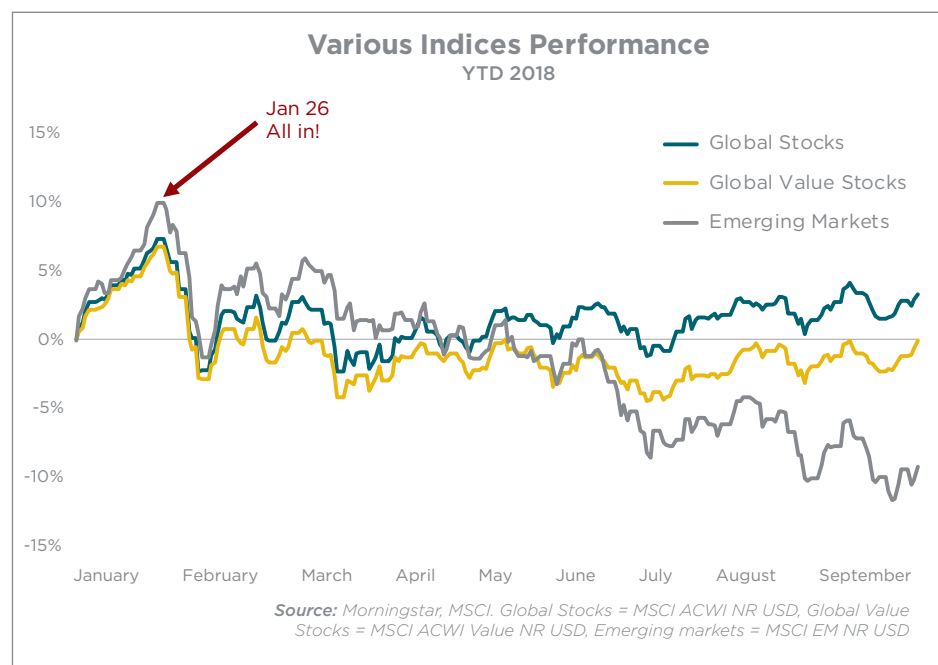
Economic data was limited but strong. U.S. jobless claims hit the lowest level since the late 1960s, prompting questions about future inflation prospects given the tight labor market. The yield on the closely followed 10-year Treasury rose to as high as 3.10% last week, the highest level in four months. The Federal Reserve is widely expected to raise short-term interest rates when it meets later this week.

The U.S. dollar fell on the week, helping commodity prices to perform well (the two markets tend to move in opposite directions). Speculation that Iranian sanctions would reduce global supply also supported energy markets.

Our Worst Performing Household

I normally would never single out individual investor performance, but in this case I believe it's necessary.

Earlier this year, on the same day, two accounts in the same household were invested in two different CLS strategies with a 100 Risk Budget Score. We received the proper paperwork and cash to invest on January 26, 2018. While not intentional, January 26 marked the peak for global stocks in 2018 (so far), after an incredible run from January 2017.



Stocks fell fairly dramatically in early February and have been slowly working on their recovery. Some of our major positions in global value stocks and emerging markets have lagged.

As a result, the performance of this household has been abysmal.

Percentage of Positive Returns, MSCI World Index							
	Quarterly	6-Mo	Yearly	3-Yr	5-Yr	10-Yr	20-Yr
% Positive	68.6%	71.3%	77.1%	81.6%	98.8%	97%	100%
Avg Rtn*	2.5%	5.1%	10.6%	10.3%	12.5%	10.4%	10.6%

Source: Morningstar, MSCI Returns over one year are annualized. As of 8/31/2018.

Obviously, this investor didn't have the investing prowess to time the market appropriately. However, there are many reasons they should still have confidence going forward. Let's look at a few:

typically at least 20 more years — a significant amount of time to continue growing your money even while taking distributions. Using the MSCI World Index back to 1970, returns, even over short periods such as three to five years, are positive, and typically very positive, an overwhelming majority of the time. (If you need your money in less than three years, the stock market may not be the best place.)

Value

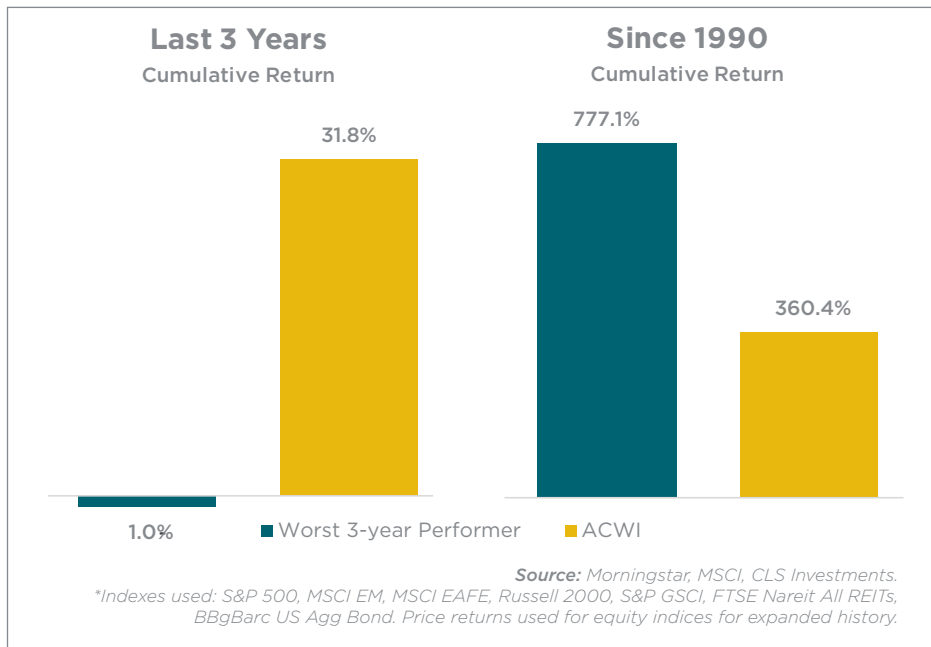
I recently wrote about [Warren Buffett's 88th birthday](#) and how value investing requires a bit of a strong stomach at times — especially when growth stocks are soaring. However, the results over time are compelling; otherwise, no one would invest that way. There is plenty of academic support and long-term results from many value-oriented funds and managers that support value, but a simple simulation can also shed some light.

For this example, I took seven major asset classes with adequate history back to the late 1980s and looked at the returns of owning the worst performing asset class the three years prior, updated every January. This isn't how we

Time

This investor is a bit younger, so they have a long investing horizon. A lot of our investors don't have the same amount of time, but I believe most investors have more than they think. At retirement, life expectancy is

Our Worst Performing Household (Cont.)



invest, of course, but interesting nonetheless. What do returns look like for this portfolio? Over the last three years, returns have been pretty abysmal (the strategy has owned commodities). However,

since 1990, returns have been outstanding, more than doubling the ACWI. Again, not how we manage money but consistent with our contrarian, value-oriented mindset.

Contributions

This doesn't apply to everyone, but this particular investor is contributing monthly to his or her portfolio, as many investors are in qualified accounts. This may provide the investor with some solace in knowing that not all assets were invested at the same time and that he or she is continuing to invest either at lower points over time or riding the upward momentum (however you want to spin it!).

These are just three of the big reasons that this investor has fewer reasons to be concerned about their investment. Which is great, because these two accounts happen to be my own! Yes, this novice investor with terrible timing is none other than yours truly. And they say portfolio managers are overconfident...



Grant Engelbart, CFA, CAIA Director of Research & Senior Portfolio Manager

Grant Engelbart manages CLS's aggressive mutual funds and several ETF and mutual fund separate account strategies, including CLS's American Funds portfolios. He also leads the alternative broad asset class team and serves on several committees across CLS's parent company, NorthStar Financial Services Group, LLC.

Mr. Engelbart first joined CLS as an intern in 2007. He returned in 2009 and held several roles in trading and investment research prior to accepting the role of Portfolio Manager in 2013. He previously held positions at TD Ameritrade and State Street Corporation.

Mr. Engelbart received his Bachelor of Science degree in Finance from the University of Nebraska at Lincoln. He holds the Chartered Financial Analyst (CFA) designation, Chartered Alternative Investment Analyst (CAIA) designation, and FINRA Series 65 license. He is a member of the CFA Society of Nebraska and the CAIA Chicago Chapter.

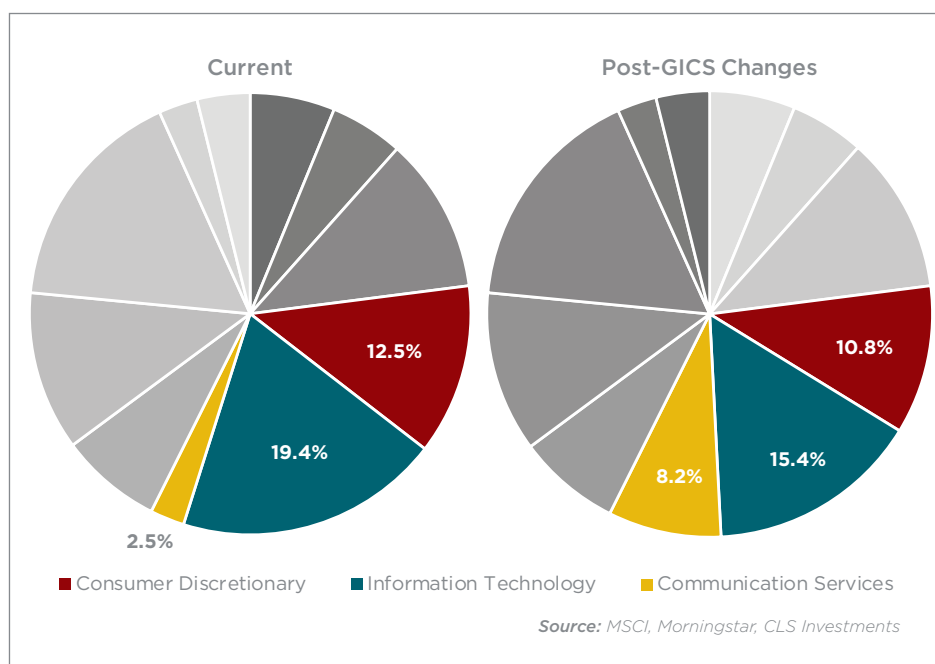
Mr. Engelbart was named one of the Top Ten Money Managers to Watch by Money Management Executive in 2018.

Did you know? [Grant invested in his first fund at age 13.](#)

Sector Shuffle

A major change to financial market classification has been happening over the summer, possibly unbeknownst to many investors. The Global Industry Classification Standards (GICS) will see the largest change in its history, as a new sector is essentially being added. Telecommunications, which due to large-scale consolidation is dominated by just two firms (AT&T and Verizon), is being expanded to include media, entertainment, and communications companies and renamed the “communication services” sector. This shuffle will affect the technology and consumer discretionary sectors (in addition to the aforementioned communication services sector).

Large and well-known companies in technology and discretionary are being reclassified as communication services. For example, Google parent Alphabet and Facebook will move out of technology, and Disney, Comcast, and Netflix will move out of discretionary. These moves increase the size of the communication services sector from a measly 2.5% of the global stock market to more than 8%.



We welcome the balancing of sector weights particularly in a changing global economy. Technology’s run in recent years has made it the largest global and domestic sector, which makes controlling allocations to the sector difficult. Telecom, traditionally a defensive and income-oriented sector, is now a high-beta sector with most of the FAANGs (Facebook, Netflix, and Google parent Alphabet). Historical valuation evaluation will be affected for each of these sectors fairly dramatically. Several ETFs have been implementing these changes slowly over the

summer, with others trading Friday, September 21, to make the change. The official date for the GICS change is September 28, 2018. We continue to assess the impact on CLS portfolios and market structure. Look for more from us on this topic in coming weeks. If you have questions, please let us know.

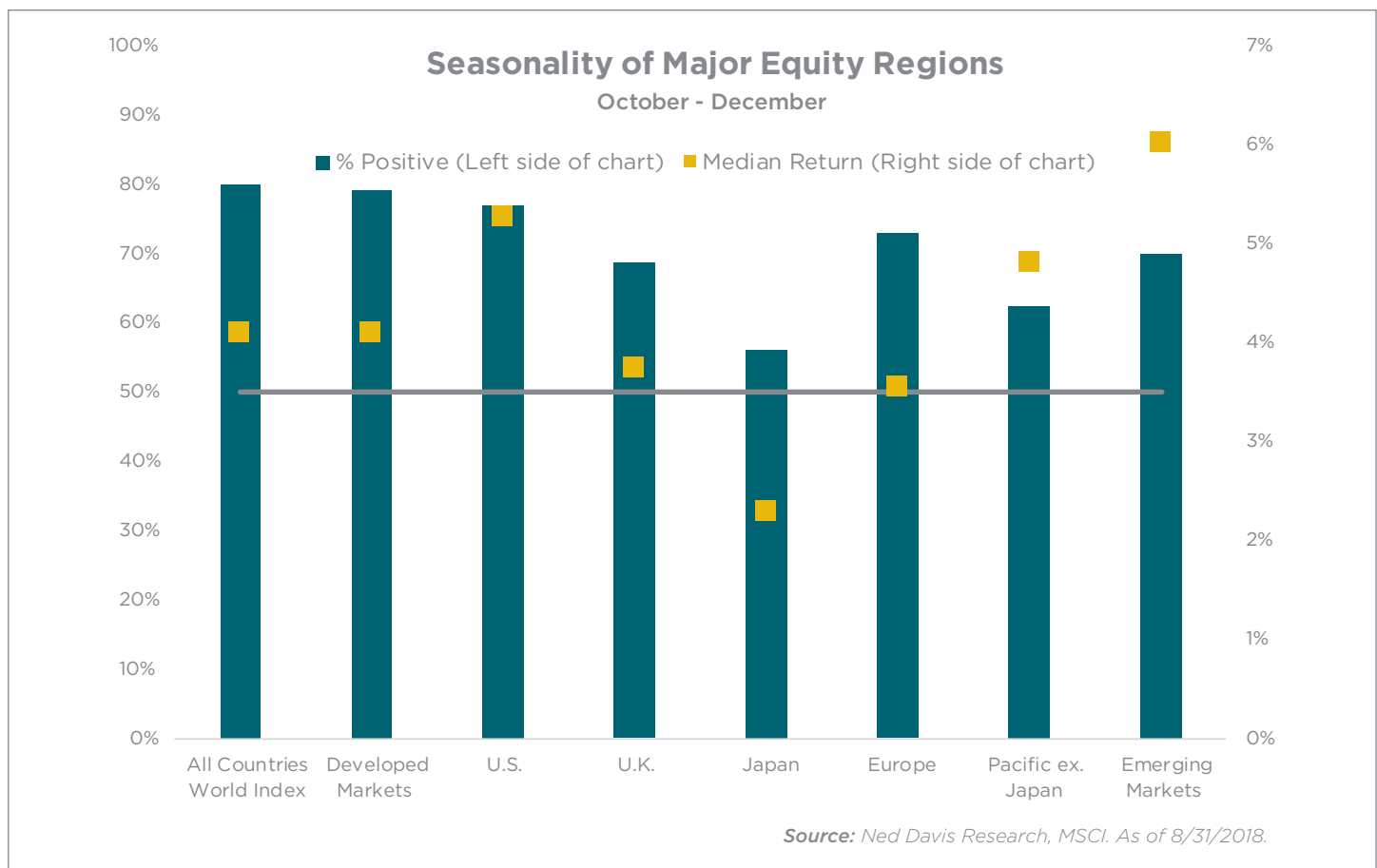
Changing Season(ality)

It's officially fall. The leaves are changing, the weather is getting cooler, and the sun is going down earlier. Different asset classes have seasons too, with tendencies to perform differently in some months versus others. This is perhaps most evident in commodity markets, where seasonal weather patterns affect supply and demand characteristics. Equities also tend to show some seasonality, and as we head to the fourth quarter,

there are a number of positives to take a look at.

As this section's chart shows, all major equity regions are positive more than half of the time in the fourth quarter, with returns averaging almost 4.5%. Emerging markets are positive 70% of the time, with returns exceeding that of any other major region at 6%. October is notorious for its major market declines (1987, 2008), but in fact, for these major equity regions, October returns

are positive more than 60% of the time, the third highest of any month! As we close out the year, the benefits of staying invested may be even more evident entering a seasonally strong period across the globe.



CLS Investment, LLC ("CLS") Portfolio Manager, Grant Engelbart, CFA, CAIA, was selected as a "Top 10 Fund Managers to Watch" in 2018 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 12, 2018. 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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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 stock's 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.

CLS Investment, LLC ("CLS") Senior Portfolio Manager & Co-Director of Research, Grant Engelbart, CFA, CAIA, was selected as a "Top 10 Fund Managers to Watch" in 2018 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 12, 2018. 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.

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