# CLS's WEEKLY 3

*What You Need To Know About the Markets*

OCTOBER 2, 2018

1. Bond market myths
2. A look at anticipated expected returns
3. Fire round on recent advisor and investor questions

## Market Performance

| Equities | SEPTEMBER | YTD '18 | 12-MONTH |
|---|---|---|---|
| Total U.S. Market[1] | +0.17% | +10.57% | +17.58% |
| Domestic Large-Cap Equity[2] | +0.57% | +10.56% | +17.91% |
| Domestic Small-Cap Equity[3] | -2.41% | +11.51% | +15.24% |
| International Equity[4] | +0.46% | -3.09% | +1.76% |
| Developed International Equity[5] | +0.87% | -1.43% | +2.74% |
| Emerging Market Equity[6] | -0.53% | -7.68% | -0.81% |
| **Fixed Income** | **SEPTEMBER** | **YTD '18** | **12-MONTH** |
| U.S. Investment Grade Bonds[7] | -0.64% | -1.60% | -1.22% |
| Cash Equivalent[8] | +0.16% | +1.26% | +1.52% |
| **Commodities** | **SEPTEMBER** | **YTD '18** | **12-MONTH** |
| Commodity[9] | +1.92% | -2.03% | +2.59% |

*[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 9/30/2018*

## September Market and Portfolio Review

Despite its history as one of the weaker months of the year, September was another positive month for globally diversified equity portfolios. Domestic and international stocks both finished with gains.

Last month, the overall U.S. stock market (Russell 3000 Index) gained less than 1%, with larger companies (S&P 500 Index) up nearly 1% and smaller companies (Russell 2000 Index) down more than 2%. Growth stocks (Russell 3000 Growth) slightly outperformed value stocks (Russell 3000 Value), but both were up less than 1%.

International equity markets were also up by less than 1% in September (MSCI ACWI ex-U.S. Index) as developed international markets (MSCI EAFE Index) were up less than 1% and emerging markets (MSCI Emerging Markets Index) were down by less than 1%.

The bond market (Bloomberg BarCap Aggregate Bond Index) lost less than 1% as the 10-year U.S. Treasury yield ended September at 3.05% (from 2.86% at the end of August). The three-month U.S. Treasury Bill yield ended the month at 2.19% (up by 8 basis points).

Real assets were mixed. Commodities (Bloomberg Commodity Index) gained nearly 2%, while real estate investment trusts (REITs) lost nearly 3% in September.

In general, CLS portfolios performed well last month. While top-down allocations, such as an emphasis on emerging markets, detracted, bottom-up security selection helped. For example, our typical emerging market position has now outperformed emerging market benchmarks by 2%-3% this year.

# *Bond Market Myths*

The bond market's loss in September now places the overall index down just over 1% for the last 12 months. The bond market only loses ground on a 12-month trailing basis about 15% of the time (per historical data over the last 100 years). It is not a common occurrence, and it is certainly not as common as many (including the financial press and many investment professionals) believe. Interest rates (of all sorts) have indeed risen of late, and the Federal Reserve (Fed) is likely to continue raising short-term rates. But that does not mean bonds should be abandoned in balanced portfolios.

Late last month, CLS Senior Portfolio Manager and Director of Research Grant Engelbart and I traveled to Los Angeles to meet with the Capital Group, which manages the American Funds. We met with various investment professionals, including some from the fixed income team. It was very useful to hear their thoughts on American Funds' portfolios, including their recent research paper titled "Realities, Myths and Actionable Ideas," which outlined several myths about fixed income investing.

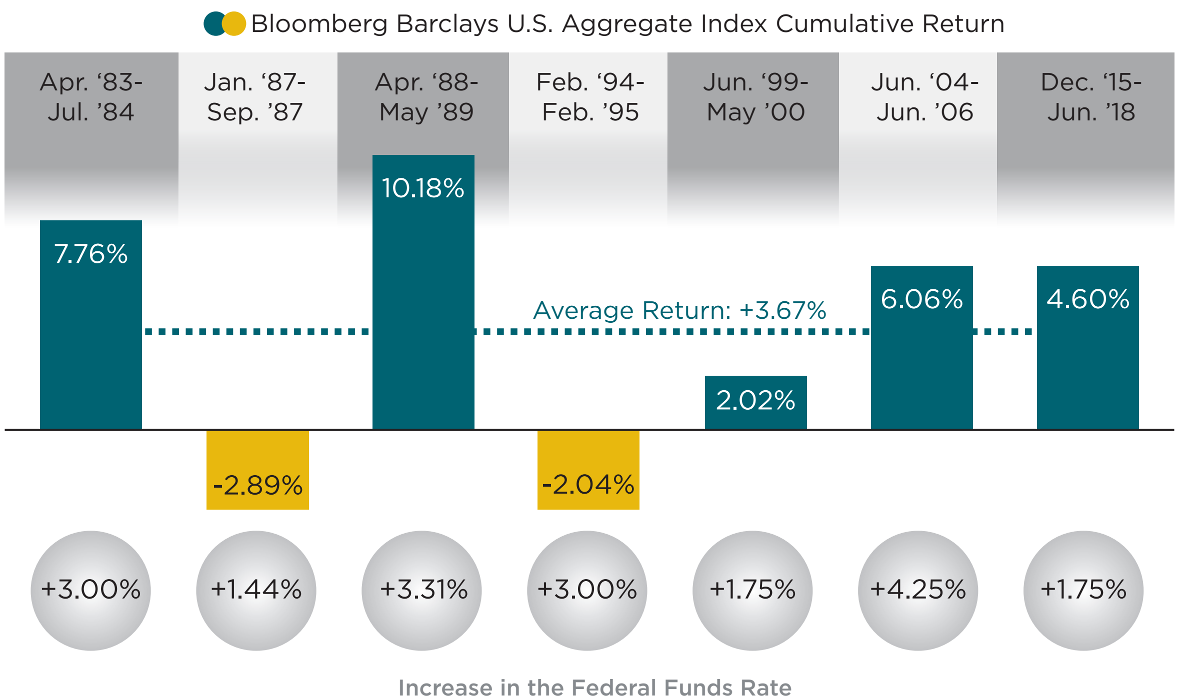
One myth the research highlights is that higher federal funds rates mean negative bond returns. As the chart below shows, over the last seven Fed hiking cycles, the overall bond market moved higher, not lower, five out of seven times. The average gain for the bond market was nearly 4% during those hiking cycles.

Another myth is that it always pays to be overweight high-yield credit (otherwise known as "junk bonds" or non-investment-grade credit). The reality is that Treasury bond market returns have historically been better when high-yield bonds are richly valued. In fact, since 1996, whenever high-yield bonds were expensive, they trailed the Treasury market by nearly 4% per year for the next two years. In other words, when high-yield bonds are expensive, it's usually not worth the risk.

For more on fixed income, and a summary of CLS's latest view on the bond market, click here.

## Myth: Higher Fed Funds = Negative Bond Returns

### *Reality: High Quality Bonds Have Generally Produced Positive Results During Recent Fed-Hiking Cycles*




*Sources: Bloomberg Index Servicez Ltd., Federal Reserve, Data through 6/30/2018*
*Periods represented above include: 4/1/83-7/31/84, 1/1/87-9/30/87, 4/1/88-5/31/89, 2/4/94-2/1/95, 6/30/99-5/16/00, 6/30/04-6/29/06, 12/16/15-6/30/18.*
*Note: Daily results for the index are not available prior to 1994. For those earlier periods, returns were calculated from the closest month end to the end of the first hike through the closext month end to the day of the final hike.*

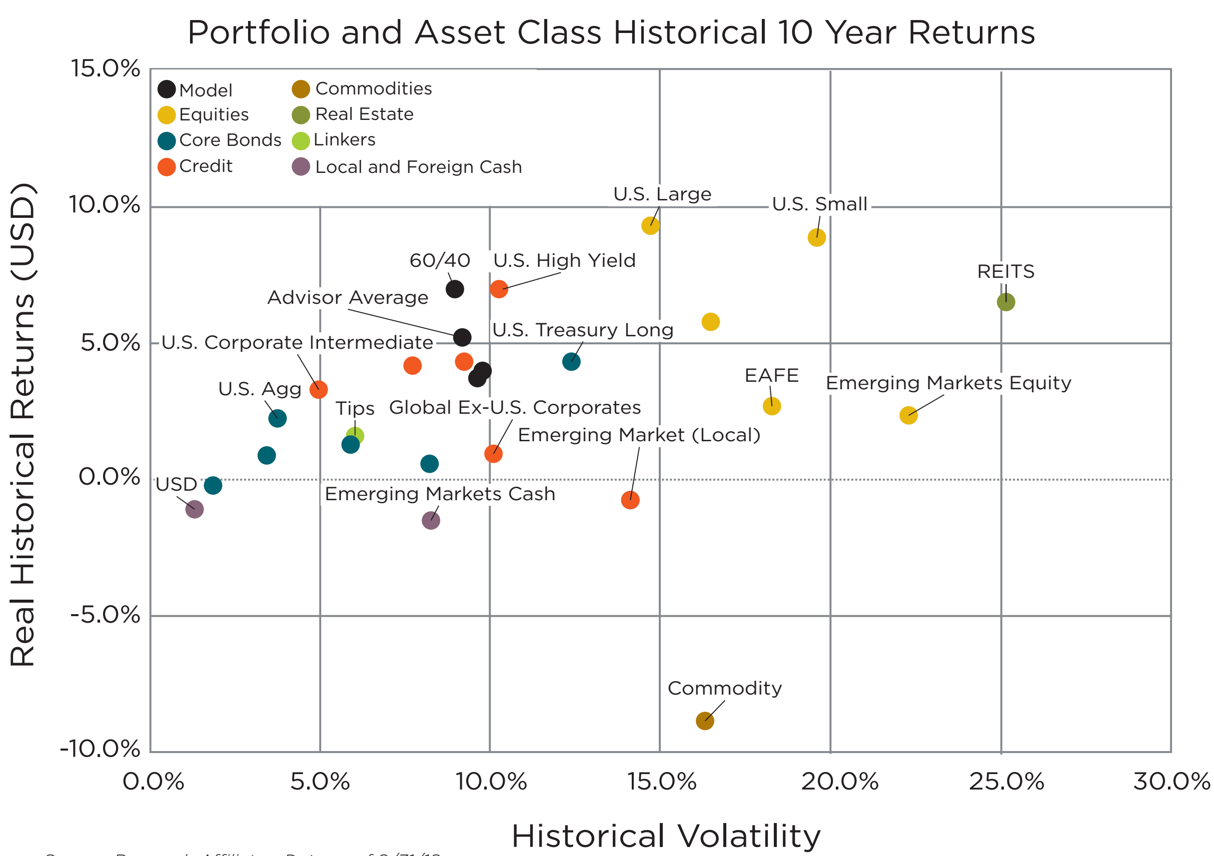
## *Where is the Market Headed?*

In our most recent quarterly outlook, we discussed our return expectations for the major asset classes and our expectation that emerging markets will outperform the U.S. market by nearly 5% per year for the next 10 years. We're not the only relative valuation firm that thinks so. Some firms believe the performance gap will be even wider.

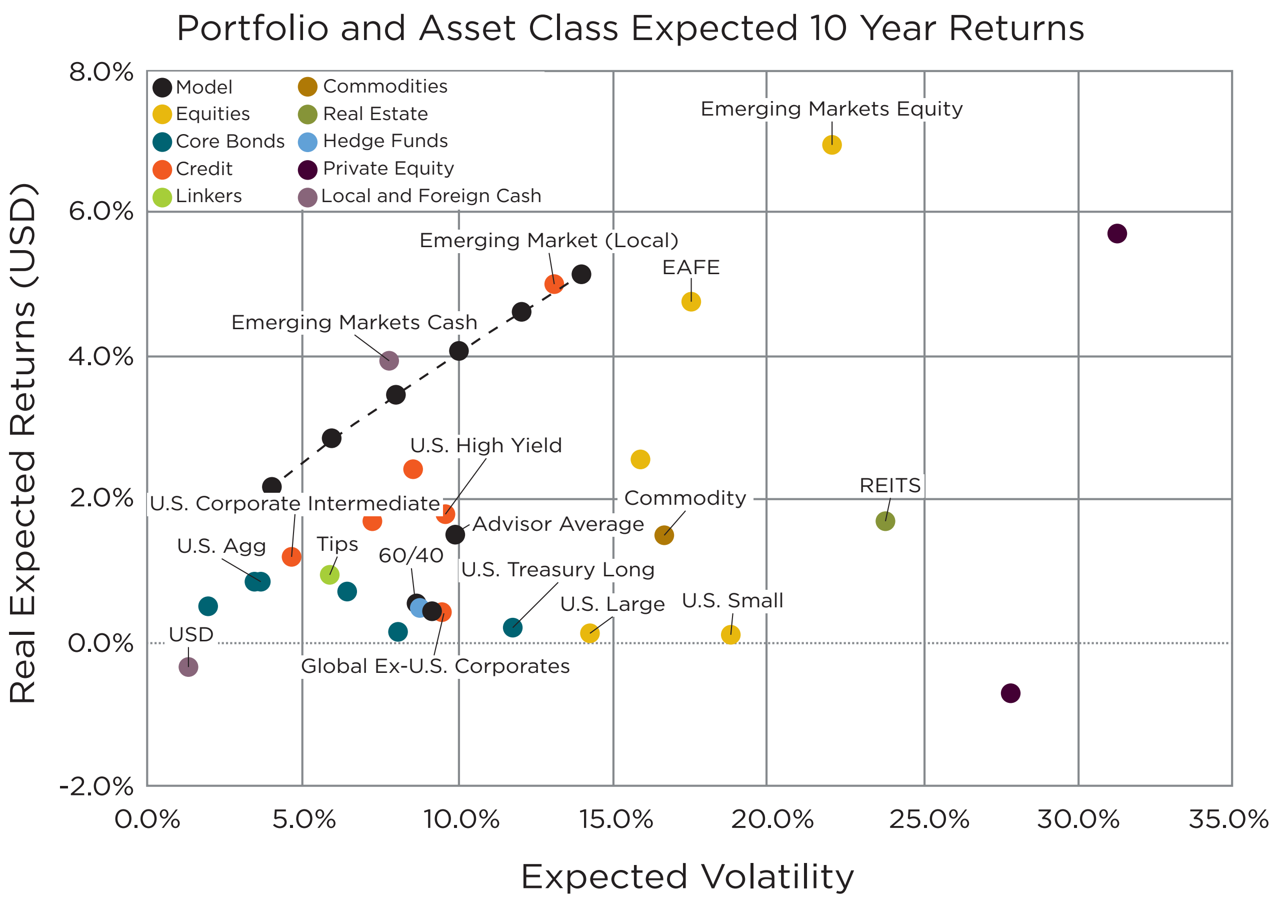
Last month, I visited the offices of one of the thought leaders and top investment managers in asset allocation and smart beta, Research Affiliates (RA). Based in Newport Beach, California, this firm is led by the investment icon Rob Arnott. Since CLS's expertise and resources are also dedicated to asset allocation and smart beta (in addition to risk management), it was good to see what a firm with nearly $200 billion in assets under management is doing.

The meeting was fascinating in many ways. Also fascinating are some of the cool (and free) offerings that RA has available on its website, like interactive asset allocation and smart beta tools. The asset allocation tool offers some interesting insight. For example, one chart you can create looks at historical 10-year **real** (after inflation) returns. Below are some quick conclusions from that chart.

- U.S. large- and small-caps returned 10% above inflation. Very impressive.
- International equities (EAFE and EM) also posted healthy positive returns, but they clearly lagged the U.S. markets.
- Cash (purple dots) experienced negative returns after inflation. Just think of all that cash sitting on the sidelines for the last 10 years.
- The dark green dot represents REITS (real estate investment trusts), which is easily the most volatile asset class.
- The black dots are fascinating.
- The 60/40 is the standard U.S. balanced portfolio. It generated about 75% of the S&P's return with about 60% of the risk. That's the "free lunch" of diversification in action. That's why we build diversified, balanced portfolios.
- Another black dot, labelled "Advisor Average," compiles the typical financial advisor's results. In short, returns are nearly 2% **below** the 60/40 average but with **higher** volatility.




*Source: Research Affiliates. Data as of 8/31/18*




*Source: Research Affiliates. Data as of 8/31/18*

Now, that was looking backwards, but we invest for the future. Given current valuations, how do the same plots look now for expected 10-year returns after inflation?

There are some significant takeaways.

- Emerging market equities easily have the highest expected real return at 7%.
- U.S. returns are expected to be 0%. In other words, if you want to beat inflation over the next 10 years, U.S. stocks aren't going to get you where you need to go.
- That said, it's nice to see most asset classes have higher expected returns than U.S. stocks.
- If this expectation is right, and we believe it's likely as we think valuations tend to be the best predictors of five to 10-year returns, the next decade should be a great time to be a globally diversified investment manager, like we are at CLS.

## *Quick Answers to Recent Questions*

Below is a brief review of a few questions recently received from advisors. For the sake of time and space, I'll try to keep my answers succinct. Please let me know if you want me to go into more detail on any of the questions below.

***"What do we think about the news regarding Tesla and Elon Musk?"***

Despite the apparent resolution on the last weekend of the month, it's hard to imagine this is positive for the stock in the long term, nor a positive factor for glamour stocks in general. The market tends to move on narrative and emotion in the short term, and Musk is a favorite among many investors. As always though, this is only one factor among many. The stock market is resilient with a strong tendency to move higher, not lower.

***"Isn't investor sentiment too bullish? Don't households have too much in equities?"***

Valuations are very high, and the average household does have more in equities than usual. This would suggest we're late in the stock market cycle. That said, I meet and speak with many investors, and greed is not a problem yet. The "wall of worry" is still firmly in place. When it comes to broad market participation, while the average household has more in equities, they tend to be concentrated in higher net worth investor portfolios. In other words, many investors are not involved in the market yet. Regretfully, they will likely get involved near the end of the bull market – whether that happens years from now or next month.

***"Stock market volatility in the market is low by historical measures. Can that continue?"***

Of course it can. But investors should always expect more volatility. The long-term average for volatility is nearly double what the recent experience has been. Hope for the best but expect the worst is good practice, and it's why we invest in balanced portfolios.

***"What is the impact of higher energy prices?"***

Higher energy prices are generally negative for the economy as they create more inflationary pressures, which we have already been seeing. They could also contribute to slowing the economy on the margin. But energy prices are volatile, so we will monitor them. Again, they are only one factor among many impacting the economy and markets.

***"Is CLS investing in pot stocks?"***

No, we are not. We may at some point, if the valuations are right. Like other glamour stocks that catch the fancy of investors, valuations are high for this industry (sorry, couldn't resist).

***"Is CLS more of a top-down or bottom-up investment firm?"***

Good question. CLS is both. "Top-down" means we make portfolio decisions based on overall market or economic conditions. The continuums outlook in our Monthly Perspectives captures these outlooks. "Bottom-up" means we spend considerable time picking the best ETFs for desired market exposures. For instance, we like emerging market (EM) equities, but we don't simply buy the broadest EM ETF. We emphasize smart beta or actively managed ETFs that best capture the targeted exposure we are looking for.

***"Why do we express our stock market outlook in terms of probabilities for U.S. stock market returns?"***

We produce return probabilities instead of single return forecasts because it's a better way to think about the markets and building portfolios.

We show long-term numbers because it's important to understand the historical experience and use the base rate as a starting point for forecasts.

We use the U.S. market primarily because we have historical data going back to 1871. Secondarily, it's the index that most investors focus on foremost.

It's a fair point that we should also look at international, but obviously we don't have data going back to 1871 for overseas markets.

***"What is the impact of the recent major sector reclassifications on CLS portfolios?"***

The sector reclassifications (summarized here) saw some of the more notable technology names reclassified as communications services.

This has little impact on CLS portfolios. While the portfolio analytics will show different sector loadings, it didn't require a single trade in our portfolios. These sector reclassifications, however, must be destabilizing for investment firms that use sector rotation strategies as part of their investment disciplines.

*"What are we reading?"*

I love this question, and I used to include links to recent articles in my monthly reviews. I should consider doing that again. One good read, and always welcome, is Howard Marks' most recent newsletter. He preaches caution in the current environment.

**Thank You**

As always, a sincere thank you for reading. If you have any questions or feedback, please let me know.

For those attending our Advisor Insight conference in Omaha later this month, we will see you soon!

Stay balanced.

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## Rusty Vanneman, 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.*

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Beta is a measure of the volatility, or systematic risk of a security or a portfolio in comparison to the market as a whole.

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.

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