CLS's WEEKLY 3

What You Need To Know About the Markets

OCTOBER 9, 2018

1. Navigating investments amid rising interest rates
2. The value of diversifying with emerging markets
3. Active vs. passive fixed income investing

Market Performance

Equities	LAST WEEK	QTD	YTD '18
Total U.S. Market[1]	-1.33%	-1.33%	+9.10%
Domestic Large-Cap Equity[2]	-0.95%	-0.95%	+9.52%
Domestic Small-Cap Equity[3]	-3.78%	-3.78%	+7.29%
International Equity[4]	-2.75%	-2.75%	-5.76%
Developed International Equity[5]	-2.34%	-2.34%	-3.74%
Emerging Market Equity[6]	-4.49%	-4.49%	-11.82%
Diversified Alternatives[7]	-0.33%	-0.33%	+0.34%
Fixed Income	**LAST WEEK**	**QTD**	**YTD '18**
U.S. Investment Grade Bonds[8]	-0.94%	-0.94%	-2.53%
Cash Equivalent[9]	+0.03%	+0.03%	+1.29%
Commodities	**LAST WEEK**	**QTD**	**YTD '18**
Commodity[10]	+2.04%	+2.04%	-0.03%

[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]Morningstar Diversified Alternatives Index [8]Bloomberg Barclays Capital U.S. Aggregate Bond Index [9]Bloomberg Barclays Capital 1-3 Month U.S. Treasury Bill Index [10]Bloomberg Commodity Index As of 10/5/2018

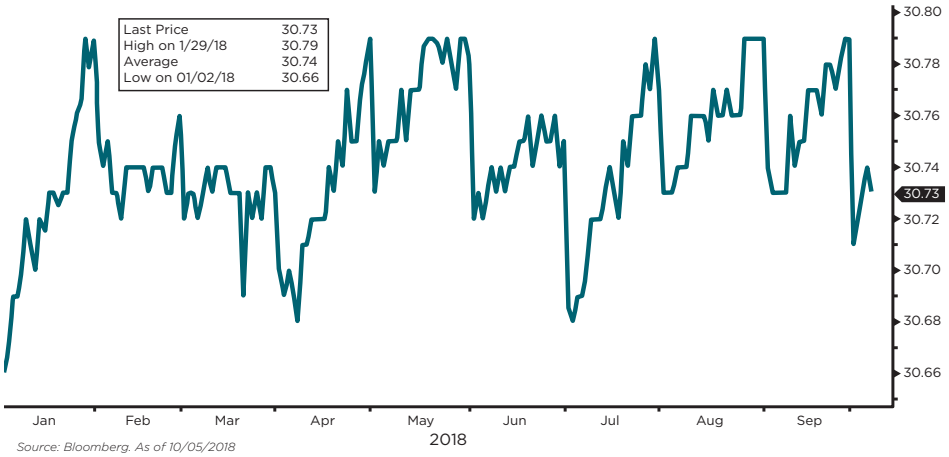
Week in Review

Stocks around the world were lower as long-term bond yields in the U.S. moved higher in response to stronger U.S. economic and labor market data. U.S. stocks, as defined by the Russell 3000 Index, finished down by about 1%, with small-caps trailing large-caps by nearly 3%. International stocks were lower with developed markets down 2% and emerging markets lower by over 4%. Bonds sold off as the 10-year Treasury yield moved higher by 18 basis points to yield 3.23%.

We have seen this before, haven't we? The taper tantrum of 2013. The debt ceiling crisis in 2011. Heck, even earlier this year! The Federal Reserve (Fed) has repeatedly made clear that it intends to raise short-term interest rates. Chairman Jerome Powell stated last week that the economy is in great shape and rates remain accommodative. For savers, this is good news. Yields on instruments such as CDs and Treasury bills are now more than 2%. Is it exciting? No. But it's better than the 0% it had been yielding for years, and buying safe investments and holding them to maturity helps investors sleep at night.

As I have mentioned in my commentaries before, we manage separate account municipal portfolios within our Master Manager program. CLS also runs many income strategies, and we have been keeping the duration on portfolios shorter than their benchmarks. What have we been buying lately? Here are a few examples:

FLRN U.S. Equity (SPDR Bloomberg Barclays Investment Grade Floating Rate ETF)



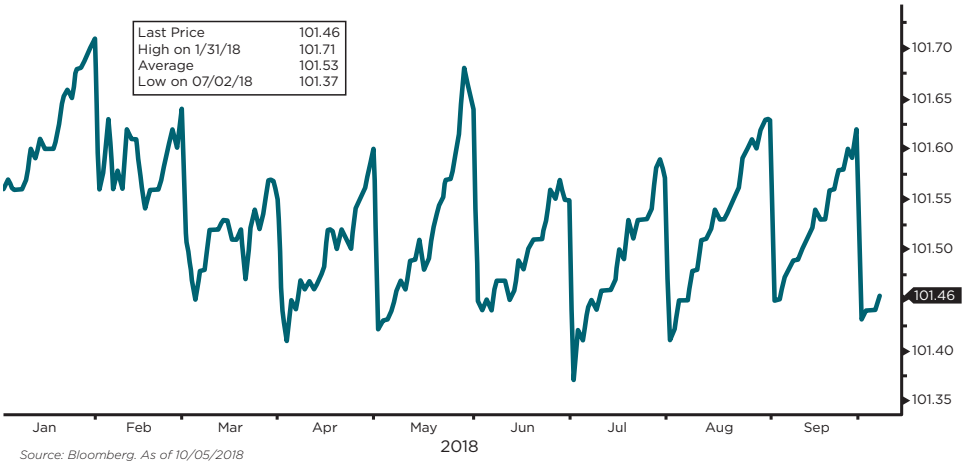
Source: Bloomberg. As of 10/05/2018

FLRN: This is a $4 billion SPDR Bloomberg Barclays Investment Grade Floating Rate ETF. It yields more than 2% and has a fairly stable price. Many securities reset higher monthly or quarterly based on LIBOR (London Interbank Offered Rate).

MINT: This is a PIMCO Enhanced Short Maturity actively managed ETF. The fund's objective is to provide maximum income while preserving capital.

I, for one, am excited that rates are moving higher, even though it can be daunting to decide where to invest as they do. It's like going out to eat at a familiar spot only to find many more items on the menu to choose from. But for many of these securities, the price is lower and the yield is higher. Now what is so bad about that?

MINT U.S. Equity (PIMCO Enhanced Short Maturity Active Exchange-Traded Fund)



Source: Bloomberg. As of 10/05/2018

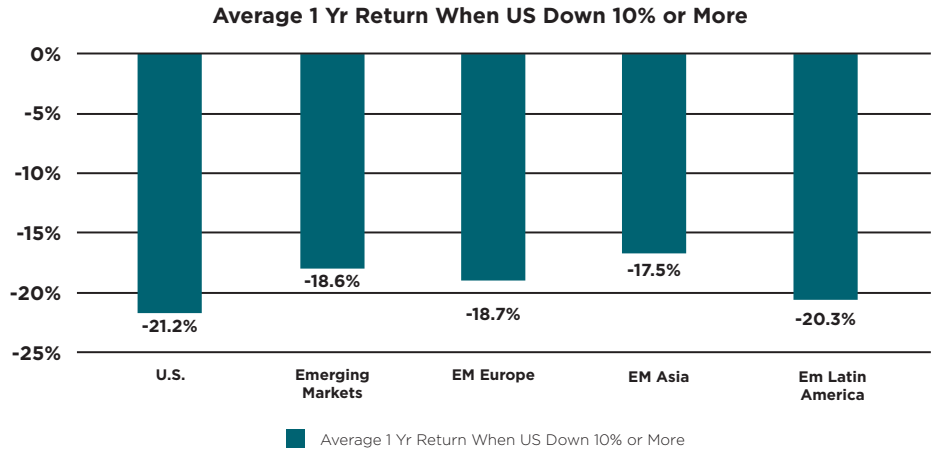
Are EM Stocks Worth Their Benefits in Diversification?

By Joe Smith, CFA, Senior Market Strategist

Emerging markets (EM) have been a point of contention for investors lately. EM stocks are now down nearly 12% on the year, while U.S. stocks have posted another gain of more than 9%. Clearly, this seems bad for global investors. But let me let you in on a secret – it's not as bad as you think if you believe in the value of diversification.

One benefit of holding EM in a portfolio is that stocks in emerging countries don't always move to the same drumbeat as stocks in the U.S. In some cases, they may even move in the opposite direction.

Let's illustrate with the data and answer two simple, but important, questions.



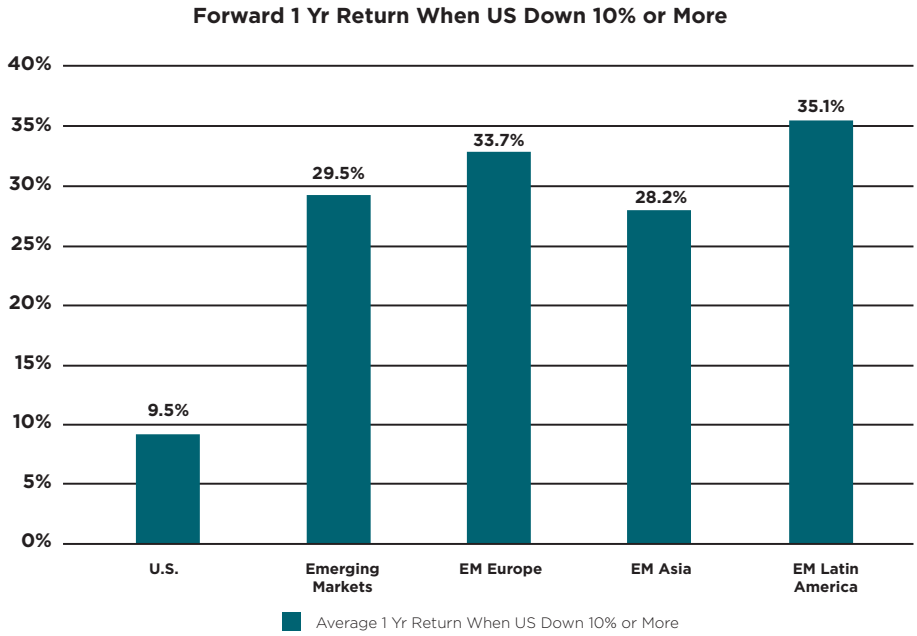
Source: Morningstar Direct. MSCI EM Gross Return Indexes and the Russell 3000 Total Return Index used to proxy returns for EM and U.S. stocks. Data from Jan. 1988 - Sept. 2018

1. **What is the average performance of EM stocks when U.S. stocks are down 10% or more in one year?**

- Contrary to popular belief, EM stocks historically hold up well relative to U.S. markets when the U.S. moves significantly lower.

2. **What is the typical forward one-year performance of EM stocks after U.S. markets have fallen 10% or more?**

- EM stocks have handily outperformed U.S. stocks after the U.S. has seen a meaningful decline.



Source: Morningstar Direct. MSCI EM Gross Return Indexes and the Russell 3000 Total Return Index used to proxy returns for EM and U.S. stocks. Data from Jan. 1988 - Sept. 2018

So what's the point? It's pretty simple. Diversification may not always feel great when it's not proving its worth, but its value is clear when it matters most. If you are a global investor and not just U.S.-centric, EM stocks are there to help you avoid the consequences of leaving all your eggs in one basket.

Active vs. Passive: Fixed Income Edition

By Jackson Lee, CFA, Quantitative Associate Portfolio Manager

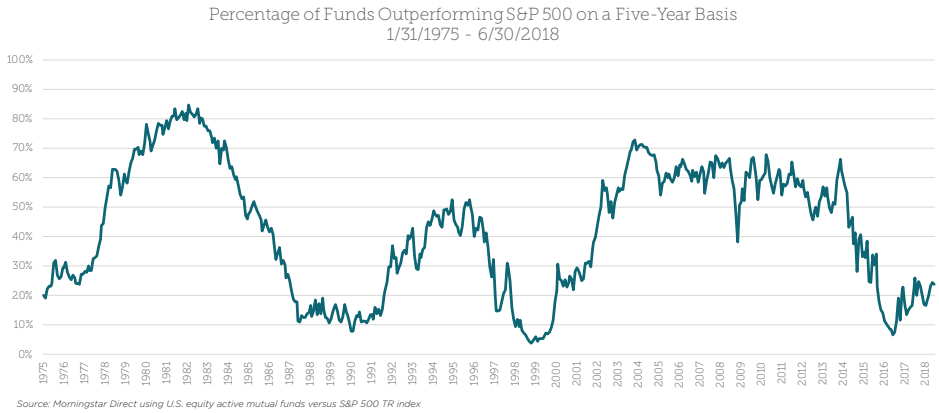
The merits of active management have long been debated by investors. For the past decade, passive management has won out as passive equity funds continued to grow at the expense of active counterparts. In many ways, this trend helped investors as the current bull market has led the market-capped indexes to outperform active managers while costing investors less.

However, at CLS we often remind our clients that the performance of active management is cyclical, as the chart on the upper right shows. In fact, some might argue that right now is the best time to use active management as markets have seen an uptick in volatility. Volatility provides opportunities for active managers as securities are more likely to be mispriced, especially in less efficient markets.

One area of market inefficiency is in the fixed income space. The opportunity for outperformance is even larger due to the flaws in the construction of the fixed income indexes. Using the Bloomberg Barclays U.S. Aggregate Bond Index as an example, areas of opportunity include:

1. A structural tilt toward Treasuries and mortgage-backed securities, which historically have relatively high correlations and dominate the index, while sectors with low correlations (high yield, emerging market bond, sovereign debt, etc.) are excluded.
2. The index is debt-weighted, which means a large portion of the holdings are exposed to companies with the most debt.

So far this year, active managers of fixed income have not disappointed.



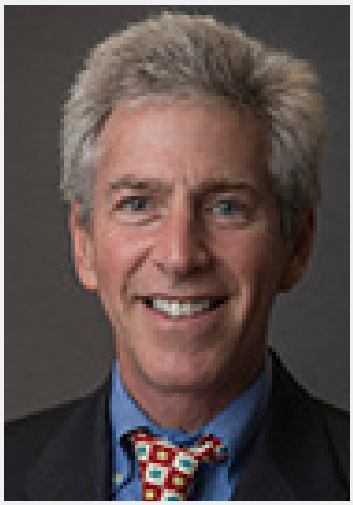
Source: Morningstar Direct using U.S. equity active mutual funds versus S&P 500 TR index

The table below compares the average performance of active versus passive funds in bond ETFs, and the numbers are striking. While the expense ratio of the active funds is sustainably higher, the 180 basis points (bps) outperformance far outweighs the cost.

At CLS, we are emphasizing active management as part of our investment theme, Be Active. We believe this kind of outperformance in fixed income will persist as long as there is market inefficiency. The conviction in this belief will grow even stronger as the market returns to a more normal level of volatility, which we have not seen for a few years.

	Active				Passive			
$-Weighted Average	AUM	# of ETFs	Expense Ratio	Return	AUM	# of ETFs	Expense Ratio	Return
US Fund Ultrashort Bond	$ 14,390,982,613.00	12	0.32	1.52	$ 19,742,971,255.00	7	0.16	1.43
US Fund Intermediate-Term Bond	$ 6,588,193,750.00	10	0.56	-0.85	$ 118,016,334,601.00	19	0.06	-1.69
US Fund Bank Loan	$ 3,733,355,662.00	4	0.77	3.21	$ 8,467,300,240.00	3	0.64	3.52
US Fund Preferred Stock	$ 3,344,583,743.00	3	0.85	-0.43	$ 28,366,989,042.00	11	0.48	0.85
US Fund High Yield Bond	$ 1,694,720,673.00	5	1.01	2.97	$ 47,047,459,825.00	28	0.43	2.44
US Fund Short-Term Bond	$ 1,516,843,954.00	7	0.64	0.64	$ 65,663,585,866.00	17	0.07	0.21
US Fund Multisector Bond	$ 453,448,246.00	4	0.84	-0.58	$ 55,695,996.00	1	0.28	-1.37
US Fund World Bond	$ 390,229,335.00	2	0.53	1.17	$ 13,314,984,621.00	12	0.18	-0.21
US Fund Emerging-Markets Local-Currency Bond	$ 268,548,052.00	3	0.60	-9.92	$ 5,545,524,966.00	6	0.31	-9.55
US Fund Corporate Bond	$ 216,975,900.00	4	0.30	-0.26	$ 79,933,422,606.00	42	0.11	-2.51
US Fund Short Government	$ 146,098,291.00	1	0.25	0.57	$ 16,212,148,521.00	8	0.13	0.13
US Fund Emerging Markets Bond	$ 112,945,563.00	4	0.61	-2.97	$ 19,410,883,758.00	8	0.43	-4.21
US Fund Nontraditional Bond	$ 48,018,675.00	3	0.85	4.33	$ 743,706,280.00	10	0.36	2.35
Total	**$32,904,944,457.00**	**62**	**0.53**	**0.92**	**$ 422,521,007,577.00**	**172**	**0.18**	**-0.95**

Source: Morningstar. Data represents period of 1/1/2013-9/30/2018.



Marc Pfeffer

Managing Directior, Institutional Fixed Income & Senior Portfolio Manager

Marc Pfeffer specializes in fixed income strategies. He is a Portfolio Manager on the CLS Flexible Income Fund team and manages the CLS Active Income X Strategy and CLS's ETF strategies. He also manages individual municipal bond portfolios for the CLS Master Manager Strategy and is a senior member of the CLS Investment Committee.

Mr. Pfeffer joined CLS in 2011, continuing as Senior Portfolio Manager for the Milestone Treasury Obligations Fund. The Fund was incorporated into CLS's fund family in January 2012. Mr. Pfeffer has more than 30 years of investment management experience, including time spent as the Chief Investment Officer at Milestone. He also worked previously at Goldman Sachs and Bear Stearns.

Mr. Pfeffer graduated from the State University of New York at Buffalo with a Bachelor of Science degree in finance. He received his Master of Business Administration degree, with a focus on finance, from Fordham University. Mr. Pfeffer holds his FINRA Series 7, 63, and 65 licenses.

Did you know? Marc is also an avid poker player.

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 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.

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