DIRECTIONS

A quarterly publication of CLS Investments FALL 2018

In this quarter's "Directions" newsletter, CLS's Chief Investment Officer, Rusty Vanneman, CFA, CMT covers recent market activity, potential impacts of the upcoming midterm election, and why it's a good time to invest. In addition, client portfolio managers Case Eichenberger, CIMA, and Jeovany Zelaya break down three reasons to remain globally invested, and why some investors might be worrying too much about the next bear market.

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Learn more about Rusty here.

CLS INVESTMENTS

It was 10 years ago that Lehman Brothers failed. You may have noticed, as there have been countless articles marking this milestone in the press for good reason, it was a historic time. It was also a scary time for investors. Many pulled their investments out of the market, and some never returned.

Yet, if investors had held tight and not sold a single share 10 years ago, they would have done all right. In fact, as of late September, the annualized 10-year return for the U.S. market was 11%. That's well above the oft-mentioned long-term averages of 8-10% return for the U.S. stock market.

These 10-year returns will likely surge higher in the months ahead. It's not unreasonable to expect the annualized 10-year return to approach 25% – well above the prior records for highest 10-year returns. A big driver of this is the fact that returns from 10 years ago will be scrolling off the 10-year calculations. Remember, the market was down nearly 50% in the six months before it bottomed in early March 2009.

The table on the following page shows the current annualized return and the annualized return since the bull market began on March 10, 2009. Imagine what the returns will do as the bad, bad, bad numbers from late 2008 scroll off and are replaced. And that's not even considering the possibility that the market takes off late this year (more on that in a moment) and into next year.

There are more takeaways from the data:

- International stocks have lagged the U.S. by a lot, but their returns since the bull market began are still up by double-digits. That's probably better than most investors would have guessed.

Returns as of 9/7/18			
Asset Class	**Benchmark**	**Annualized 10-Year Return**	**Annualized Return Since 3/10/09**
Overall U.S. Stock Market	Russell 3000	11.1%	19.1%
U.S. Large Companies	S&P 500	11.1%	18.9%
U.S. Small Companies	Russell 2000	10.6%	20.1%
International Stocks	MSCI ACWI ex-U.S.	4.0%	11.0%
Emerging Market Stocks	MSCI EM	4.1%	10.8%
Bonds	Bloomberg U.S. Agg Bond	3.6%	3.6%
Commodities	Bloomberg Commodity	-7.1%	-2.2%
Real Estate	MSCI REIT	7.7%	20.5%

- Bonds have been up 4% per year over the last 10 years. For an asset class that investors typically expect to generate negative returns, that's not bad.
- Commodities – now, that return is bad. But it is also crazily exceptional. It is rare that an asset class return is negative over a 10-year time span. Contrarians surely salivate when they see past returns like this. (Note: CLS is a buyer of commodities.)
- Real estate, which many investors have sort of forgotten about lately, has the best annualized return since the bull market began. This was the asset class that took us into the abyss 10 years ago. Who would have guessed it would be the best performer?

Midterm Elections: Market Impact

Aside from our concerns that valuations are a bit high for the U.S. market and returns are expected to be below average (albeit positive) in the years ahead, one of the top questions we are addressing lately is, "How will the midterm elections impact the stock market?"

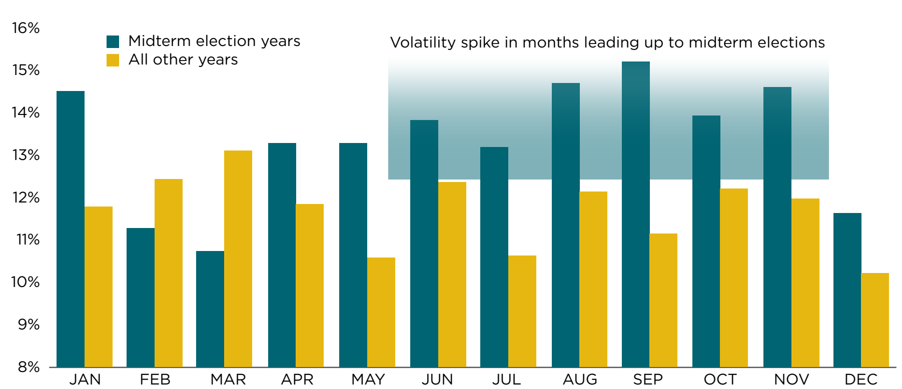
Let's approach this from two perspectives. First, what is likely to happen in the upcoming months? Second, how will the election impact the markets over time?

For the immediate term, we can do no better than to cite Capital Group's excellent summary that can be found *here*.

The article listed five key points to remember:

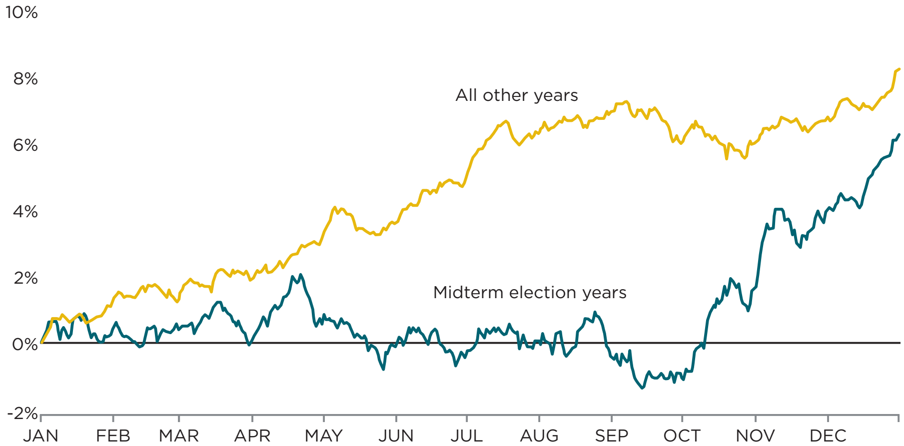
1. Volatility is elevated in midterm election years.
   - We haven't necessarily seen a big bump in volatility yet, but it would not be unlikely to see an uptick before the election.
2. Market returns tend to be muted until later in midterm years.
   - Historically, that is indeed the case, but not so far this year. Then again, October tends to be a weak month.
3. Markets usually bounce back strongly after elections.
   - Knowing nothing else, this is a reason to be very bullish for the fourth quarter and 2019.
4. The President's party typically loses seats in Congress.
   - Current projections indicate this will be the case.
5. Even when the House flips control, markets experience similar patterns.

S&P 500 Index Annualized Monthly Volatility Since 1970



Sources: Capital Group, RIMES, Standard & Poor's. As of 8/31/18. Volatility is calculated using the standard deviation of daily returns for each individual month. The median volatility for each month is then displayed in the chart on an annualized basis. Standard deviation is a measure of how returns over time have varied from the mean. A lower number signifies lower volatility.

S&P 500 Index Average Year-to-Date Return (1931-Present)



Sources: Capital Group, RIMES, Standard & Poor's. As of 8/31/18.

- As usual, control in the various government branches tends to be an overrated factor for long-term market returns.

Regarding long-term trends around election cycles, the chart below follows a trend in the Dow Jones Industrials over a four-year presidential cycle based on daily data starting in 1900. The y-axis shows % return and the x-axis shows the current presidential cycle. In this graph, the trend is more important than the actual level of the Dow.

As we are currently in the second presidential year, the presidential cycle suggests the first half of the year will generally be flat with a slight drag on returns. The back half of the year starts out weak but has a rebound in the fourth quarter. Is the current market environment sticking to this pattern? Overall, performance has been stronger than historic cycles would suggest.

Here are some key points to keep in mind:

- There aren't many data points to review when analyzing elections. And even when there are, it's not as simple as looking at a single variable, such as who is running for office. Underlying economic conditions, interest rate environments, valuations, etc. differ in every election.
- But I would argue that some conclusions can be made about the presidential election cycle on stock market returns, and they do make intuitive sense. For example, the year after the election is usually the most difficult as the monetary/fiscal backdrop tends to be less accommodative when votes don't need to be won. Conversely, the market typically does best in the year before the election as the monetary/fiscal backdrop is more accommodative when the incumbent tries to favorably influence the electorate.

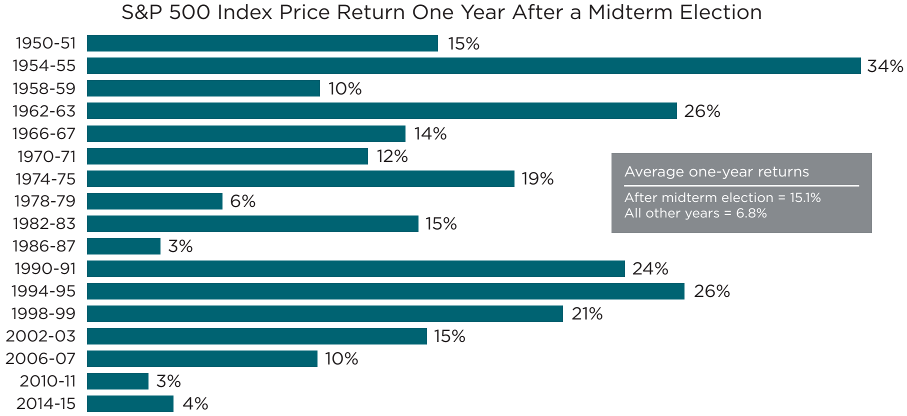
Bottom line: Political uncertainty often causes increased stock market price volatility. The first three quarters of a midterm election year typically do not generate stock market gains. But once there is more clarity on political platforms, the stock market generally does much better.

Is It A Good Time To Invest?

One of the most popular questions from investors is: "When is a good time to invest?"

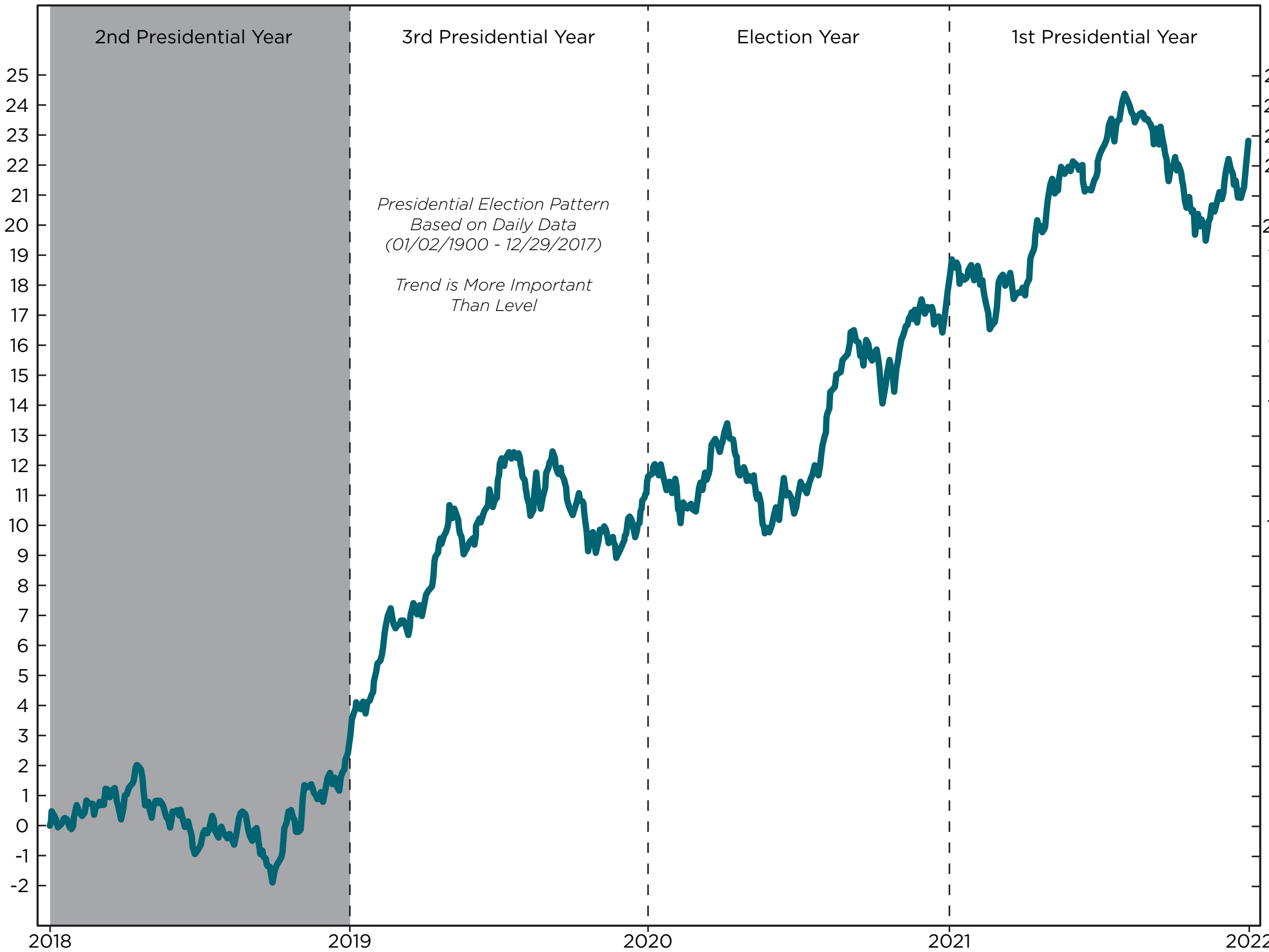
The best answer is this: If you have money to invest, you should invest immediately. Each day, the market has a positive expected return. Most days are higher than lower, and stocks are typically more likely than not to beat cash and bonds. These probabilities and expected returns only improve in favor of

S&P 500 Index Price Return One Year After a Midterm Election



Sources: Capital Group, RIMES, Standard & Poor's. Calculations use Election Day as the starting date in all election years, and November 5th as a proxy for the starting date in other years. Only midterm election years are shown in the chart.

Dow Industrials Four-Year Presidential Cycle



Source: Ned Davis Research, Inc.

the stock market every day the time horizon is stretched out.

But we're all human. If we buy right before the stock market falters, it's inevitable that we will feel regret and wish we had bought later.

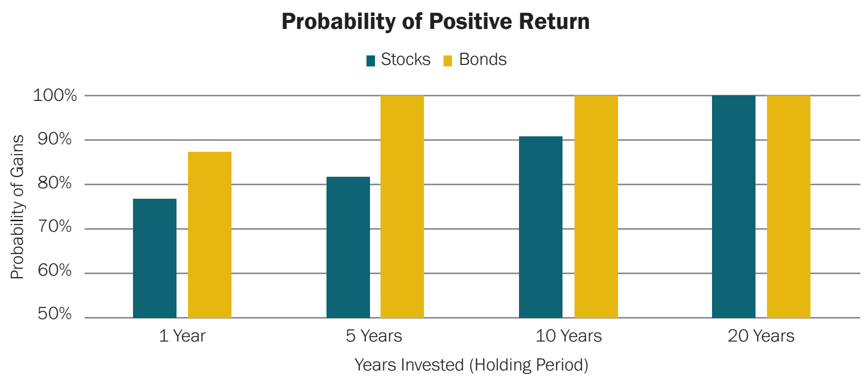
The second-best answer to this common question, however, helps solve this problem: Systematically spread purchases out over time. This can be done in different ways, but the key is to determine the plan and execute it exactly as such. One common method, for example, is to invest one-third immediately, another third exactly a month later, and the last third another month after that. It's a disciplined approach that takes the emotion out of deciding when to invest. Plan your work and work your plan. While the expected return of this disciplined approach usually has a lower return than investing all at once, it is much more palatable to most investors. In fact, this approach is undoubtedly effective in getting investors into the market. Bottom line: It works.

Three Reasons to Stay Global

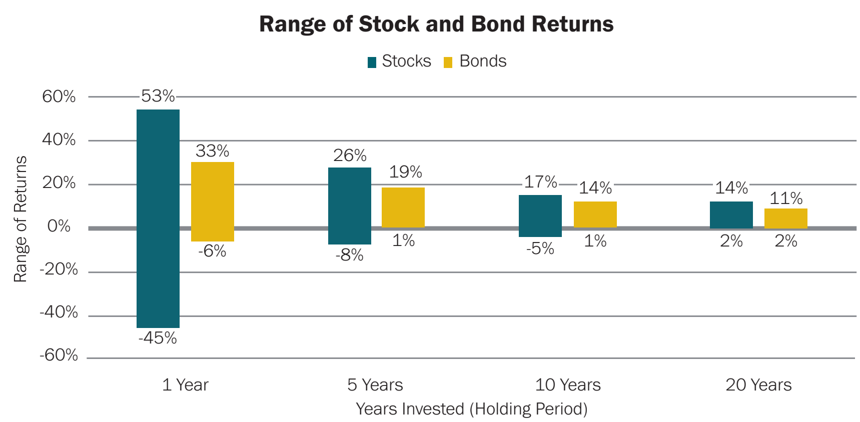
from Client Portfolio Managers, Case Eichenberger, CIMA and Jeovany Zelaya

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 Direct



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.

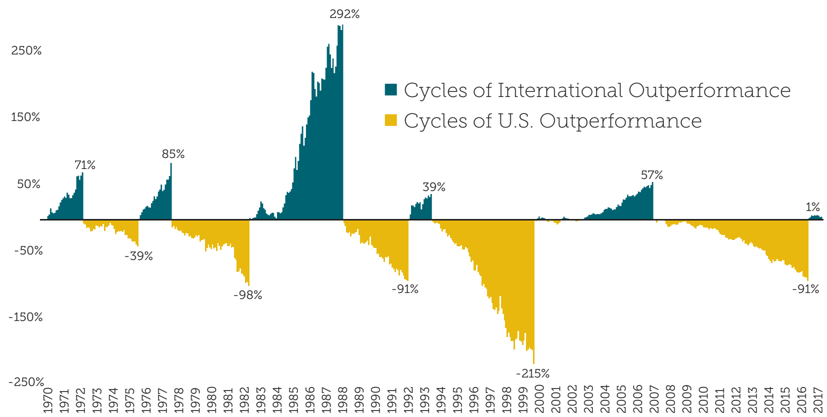
2. Markets are cyclical (diversification helps).

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 charts above illustrate how different asset classes

Cumulative Relative Performance of the MSCI EAFE Index Relative to the S&P 500 Index



Cycles of International Outperformance			
Start Date	End Date	# of Months	Performance
1971	1973	31	71%
1976	1978	24	85%
1983	1989	68	292%
1993	1994	17	39%
2000	2007	86	57%
2017	Current	15	1%
	Average	**45**	**109%**

Cycles of U.S. Outperformance			
Start Date	End Date	# of Months	Performance
1973	1976	40	39%
1978	1983	57	98%
1989	1993	47	91%
1994	2000	74	215%
2007	2017	112	91%
	Average	**66**	**107%**

Source: Morningstar Direct data from 01/01/1970 to 5/31/2018

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.

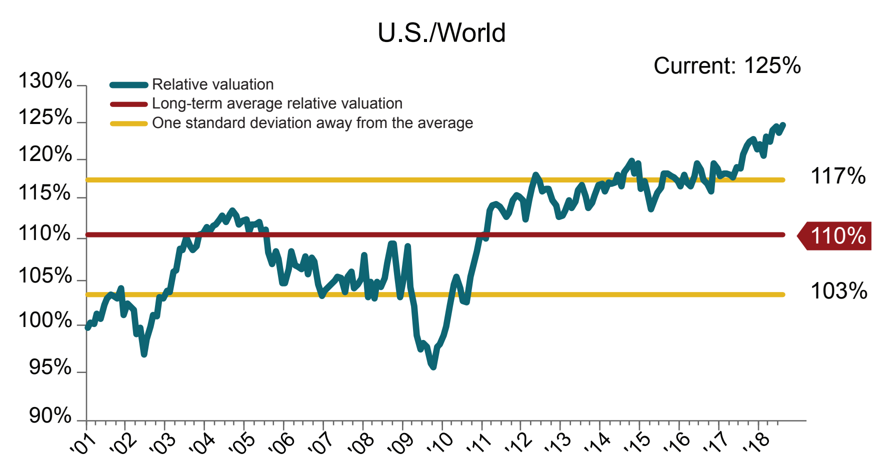
move up and down through time.

3. Valuations drive long-term future performance.

Question: Why do valuations matter?

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

- See the U.S./World chart. 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.



Factset, as of 8/31/2018

Question: What does this mean?

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

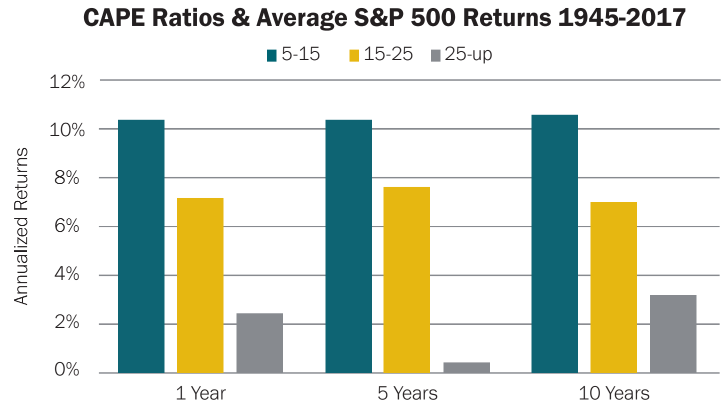
- History shows the higher the valuation of an investment, the higher the chance that investment will produce lower future returns.
- The bar chart to the right shows how U.S. returns have performed given the level of CAPE (cyclically adjusted price-to-earnings) ratio (a valuation metric).
- The lower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

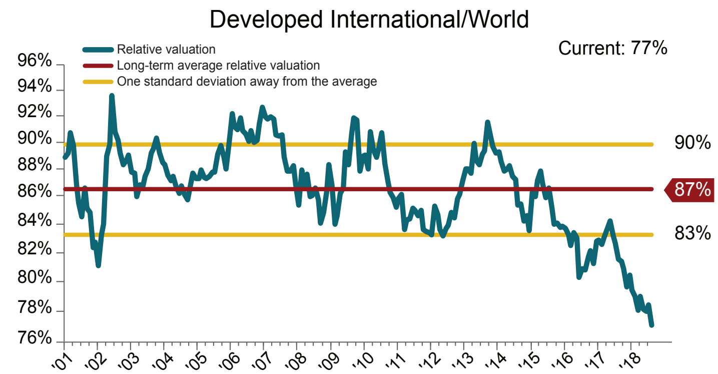
Answer: Invest in markets where valuations are attractive.

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

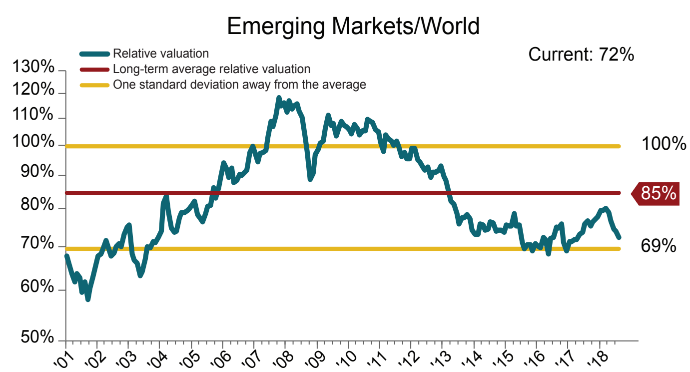
To summarize, short-term performance will vary and can appear to swing wildly. Diversified portfolios act as hedges against one single asset class. U.S. stocks are expensive; tilting toward undervalued areas will help returns in the long run. Valuations should not be used as timing tools to jump in or 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.



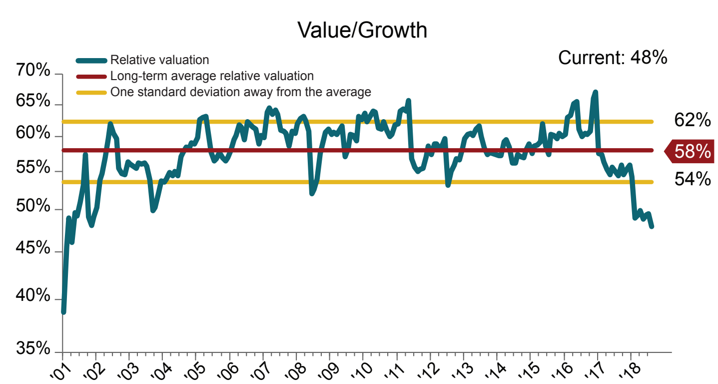
Source: Robert Shiller, as of 8/2018



Factset, as of 8/31/2018



Factset, as of 8/31/2018



Factset, as of 8/31/2018

Preparing for the Imminent Bear Market

from Client Portfolio Manager, Case Eichenberger, CIMA

The U.S. stock market recently set the record for longest bull market in history 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.

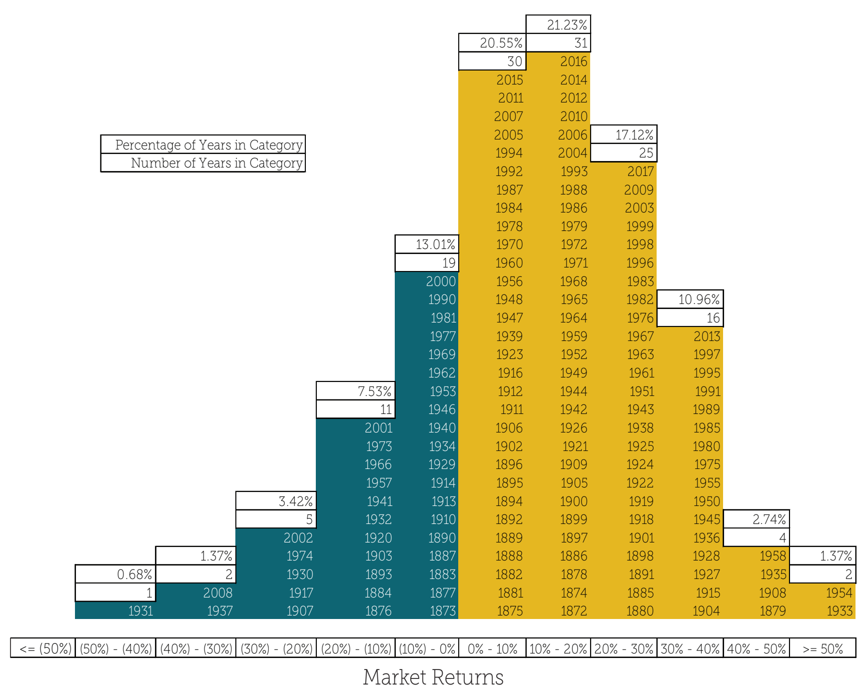
Clients may be worrying about crashes too much. Perhaps because they remember 2000 and 2008 so vividly, or perhaps because this bull market appears old. But we cannot forget the base rates of probabilities.

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.
- Notice that bear markets (losses of 20% or more) occurred only about 5.5% of the time!
  - Takeaways: Hire a good advisor or manager, and don't spend your waking hours worrying

Distribution of Stock Market Returns 1872-2017



Source: Stock market data from "Irrational Exuberance" Princeton University Press, by Robert J. Shiller in conjuction with new S&P 500 data that came following the publishing. As of 12/31/2017.

about something that has a low probability of happening. 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.

2018 Investment Themes

from CLS Chief Investment Officer, Rusty Vanneman, CFA

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 ways 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.

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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