CLS's WEEKLY 3

What You Need To Know About the Markets

NOVEMBER 6, 2018

1. Lessons from the October correction
2. Can Bitcoin reduce portfolio volatility?
3. U.S. earnings update

Market Performance

Equities	LAST WEEK	QTD	YTD '18
Total U.S. Market[1]	+2.74%	-6.73%	+3.13%
Domestic Large-Cap Equity[2]	+2.45%	-6.44%	+3.45%
Domestic Small-Cap Equity[3]	+4.35%	-8.69%	+1.82%
International Equity[4]	+3.93%	-6.35%	-9.24%
Developed International Equity[5]	+3.36%	-6.84%	-8.17%
Emerging Market Equity[6]	+6.09%	-4.81%	-12.12%
Diversified Alternatives[7]	+0.60%	-2.13%	-1.47%
Fixed Income	**LAST WEEK**	**QTD**	**YTD '18**
U.S. Investment Grade Bonds[8]	-0.73%	-1.07%	-2.65%
Cash Equivalent[9]	+0.04%	+0.19%	+1.46%
Commodities	**LAST WEEK**	**QTD**	**YTD '18**
Commodity[10]	-1.26%	-1.33%	-3.33%

[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 11/02/2018

Week in Review

Equity markets around the globe bounced back, as economic releases were mainly positive for the week. The U.S. unemployment report for October was much better than expected, and there was optimism over positive trade talks between the U.S. and China. Last week, overseas markets led the way higher, with emerging markets up over 6% and international developed markets up over 3%. In the U.S., small-cap companies were up over 4% and large-cap companies up over 2%. The commodity and bond markets had losses for the week.

This coming week will be a busy one with midterm elections taking place on Tuesday, November 6. The U.S. Federal Reserve (Fed) will hold a meeting mid-week, and earnings continue to be released.

In this week's commentary, I take another look at the volatile month of October, how cryptocurrencies may be able to enhance portfolios, and a look at Wall Street's reaction to earnings so far.

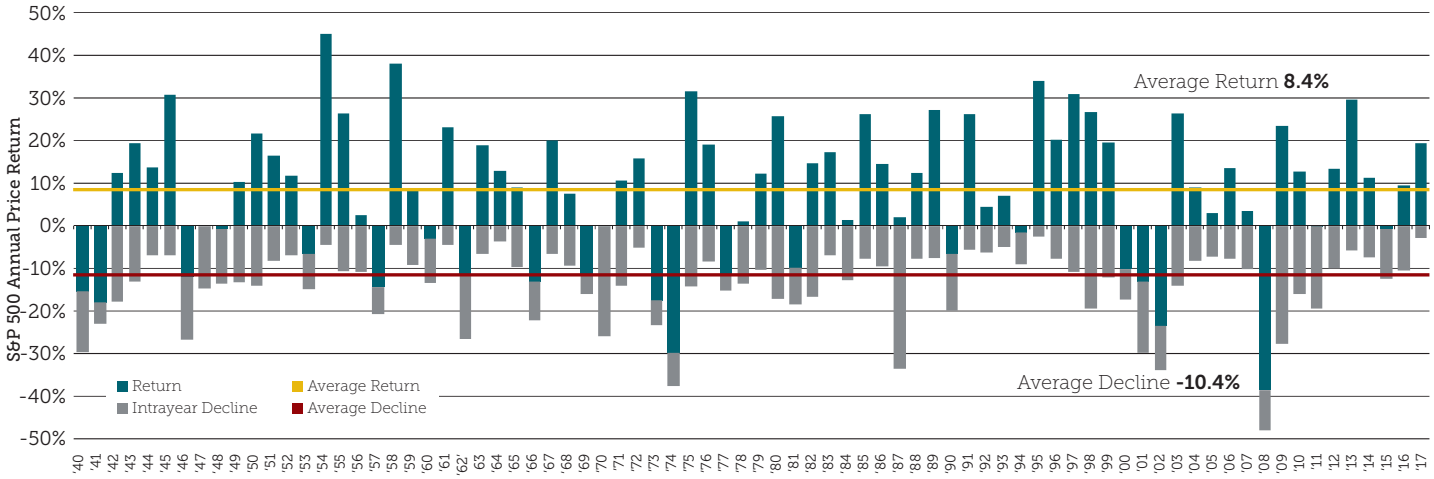
Let me begin by making a correction to the title of this article. Most major markets ended the month above the technical definition of a "correction," which is a 10% drawdown from peak to trough. But parsing definitions doesn't make it any easier to be an investor in 2018, a year that has experienced two separate 10% drawdowns. Statistically, we expect these once per year, but two is a little abnormal. So, what happened? What surprised us? And, what should we expect going forward?

What's Normal:

Markets are unpredictable, but we must remember that in order to go up in the long term, they must go down occasionally in the short term.

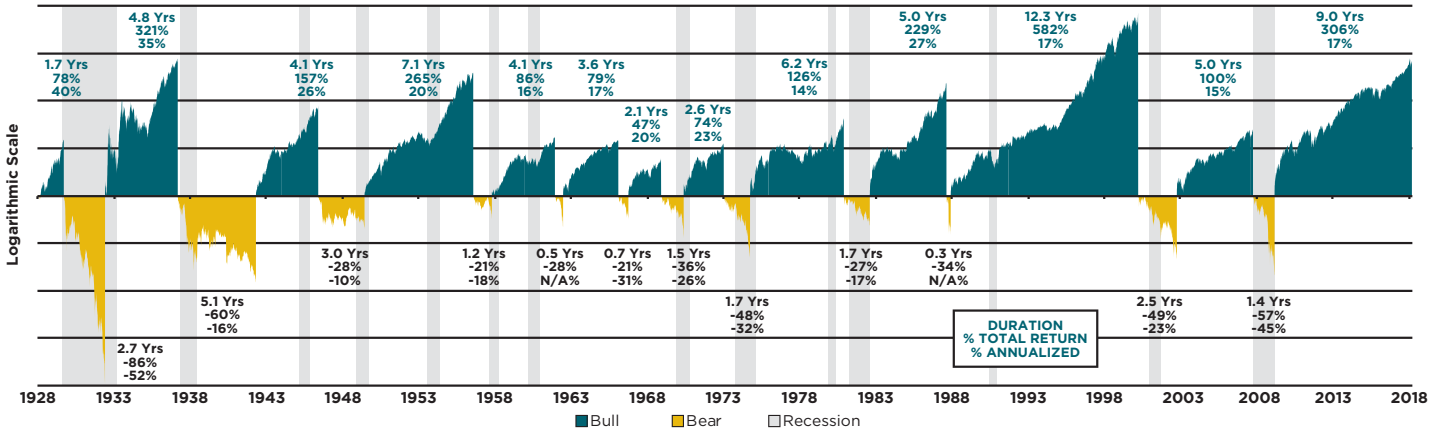
- As CLS Chief Investment Officer Rusty Vanneman wrote last week, this is the price to pay to invest in our capital markets.
- The two charts below help put this into perspective and remind us of the importance of taking a breath and remembering our goals.
  - Drawdowns are normal and natural, but the news headlines will sound scary.
  - Drawdowns happen infrequently and typically don't last long. They are necessary to move higher in the future.

S&P 500 Annual Return, with Market Low During Year



Source: Morningstar Direct 12/31/17. Returns are based on price index only and do not include dividends. Grey bars represent intra-year drops which refers to the largest market drops from a peak to a trough during the year. Returns are calendar year returns from 1940 to 2017.

S&P 500 Index Bull and Bear Markets



Source: S&P 500 price data is from Bloomberg, Recession data is from nber.org, 01/03/1928 – 3/15/2018

What Caught Our Attention:

- Bonds were also negative during this (and 2018's previous) sell-off.
  - We believe that high-quality bonds are typically the best hedge against falling equity prices, but in October they also fell! They still helped lessen the impact of the drawdown, but they didn't generate positive total returns, which most fixed income investors would expect.
- Did emerging market stocks act as a hedge?
  - Emerging markets saw mixed results. Market-cap-weighted emerging markets fell in line, but Brazilian equities were a lone bright spot.
  - The chart below shows global stocks (VT), government bonds (GOVT), and Brazilian stocks (EWZ). Brazilian stocks hedged all of our clients' risk, but do not expect that to happen often. This instance offered further evidence that diversifying globally is still a great idea.
- Smart beta (specifically multifactor ETFs) helped performance.
  - Smart beta has been a significant theme for CLS over the last few years, and we often tout how they hold up in bear markets. In October, the multifactor ETFs we emphasize in the CLS Smart ETF Models outperformed their respective index by an average of about 0.8% and ranked in the top quartile of their peer group.
  - Result: They added value above pure market cap.

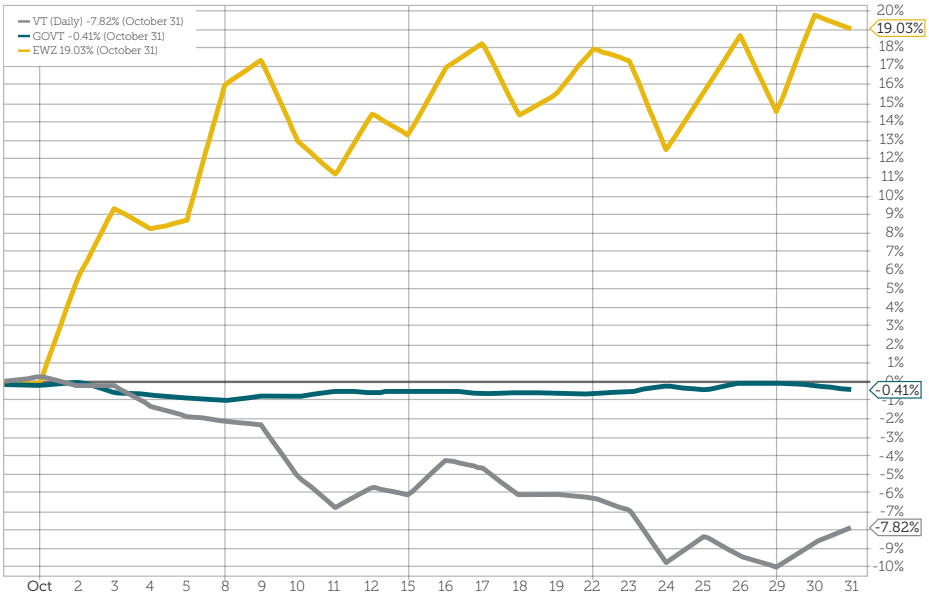
What Helped CLS Portfolios:

- Underweighting expensive U.S. growth stocks boosted performance.
  - At CLS, we believe that the most expensive asset classes have the furthest to fall in times of stress. This was true as growth led the way down in October, falling 9%, while value stocks held up better, falling less than 6%.
  - Value is a key CLS overweight.
- Alternatives, such as commodities and liquid alternatives, helped returns relative to broad stocks.
  - Commodity ETFs, which CLS favors, were down about 2-5%.
  - Yes, they were still negative, but much less so than their Risk Budget score may suggest. The correlation benefits of commodities are a key reason we favor these areas during times of stress.
  - Liquid alternatives fared similarly.

What to Expect:

- Expect more volatility. October, historically, is often a volatile month, and a midterm election year makes it even more so. Expect more volatility in November with a potential "Santa Claus" rally in December.
- Expect CLS to keep a steady hand. When markets fall quickly, investors often panic. So it's important, as professional managers, not to panic or sell like many do. We won't.
  - You may see a few trades as we look at our buy list, and if forced selling makes assets we favor cheaper, we may slowly buy and sell areas that have run up in our portfolios.

Brazilian Equities, a Bright Spot in October



Source: FactSet, 10/01/2018-10/31/2018

Bitcoin Turns 10!

Bitcoin, the cryptocurrency, turned 10 recently, and CLS continues to be intrigued by this up-and-coming asset class.

At the recent quarterly CLS Investment Committee meeting, we brought current crypto (and previous ETF) expert Matt Hougan into our Omaha headquarters. Matt serves as Global Head of Research for Bitwise Asset Management and provided a review of the asset class while explaining how it can be used in institutional portfolios.

We believe combining asset classes that are not perfectly correlated will help returns and lower volatility. Bitcoin and other cryptocurrencies are no exception. Consider the data below from Bitwise that shows even a measly 1% allocation to Bitcoin over the past four years could have helped risk adjusted returns, lowered drawdowns, and enhanced returns overall.

What does CLS think of Bitcoin? We believe the jury is still out. The investment case can be made to include Bitcoin in your portfolio, but there are a few reasons for hesitation.

1. It is not easily investable for CLS at this point. We prefer to have liquid vehicles, and there is yet to be an ETF based on this asset class. That said, most ETF experts believe something will be available by the end of 2019.
2. Investors tend to view each segment differently and fail to look at the portfolio as a whole. We like to pick and choose winners and losers, and when one asset is inclined to have drawdowns upward of 90%, it is hard to stick with the strategy to keep it in there. This can be a problem for most investors.
3. Bitcoin dominates the cryptocurrency landscape. Ideally, we could buy a fund of several crypto assets in one wrapper and rebalance between them to lower volatility even more! This is another aspect to keep in mind.

We believe there will eventually be a simpler and more liquid way to gain access to this new asset class, but that hasn't happened yet. CLS will continue to learn and take pulse of this landscape from key thought leaders in the industry.

Summary Statistics: How Much Bitcoin is Enough?

	Total Return	Volatility (Monthly)	Sharpe Ratio	Up Capture	Down Capture	Max Drawdown
Traditional Portfolio	26.53%	6.5%	0.80	0.61	0.71	-11.37%
1% Bitcoin	31.09%	6.70%	1.02	0.69	0.69	-10.95%

Source: Bitwise Asset Management, 1/1/2014-3/31/2018

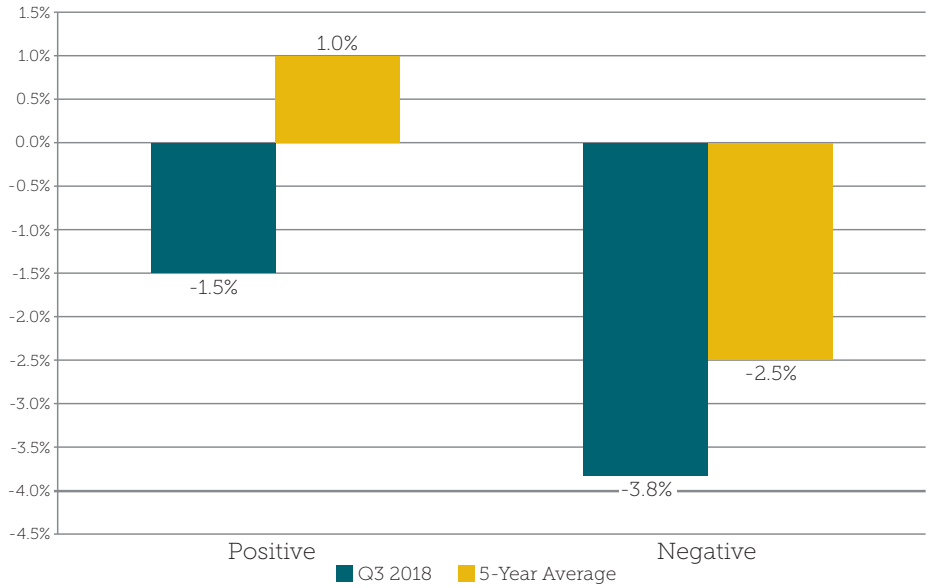
U.S. Earnings Update – Very Good, Which is Bad for Stocks

Earnings season is upon us once again. So far, about half of the S&P 500 companies have reported results for the third quarter. According to FactSet, close to 80% of the largest and most influential companies have reported earnings above expectations, which is higher than the five-year average! With all of these companies beating growing expectations, the market must be rewarding their stock prices and pushing them higher, right?

Not this quarter. Plus, this is not quite how the discounting mechanism of the stock market works. The stock market is forward looking. Often described as a discounting mechanism, it takes all current information and reflects it in the prices. The data to the right from FactSet shows that stocks are typically rewarded by 1% price changes when a company beats estimates. Recently, this has not been the case as most stocks have lost ground after beating estimates.

While expectations are being met and exceeded, optimism about the future appears to be slowing, and stocks are not being rewarded. The high dollar on future earnings, tariffs, rising wage growth, and rising rates may all be making market participants think hard about the future outlook for U.S. stocks. It's impossible to put a simple explanation on it, but it bears watching and reiterates the case for investing outside of the U.S. for diversification purposes.

S&P 500 EPS Surprise vs. Avg. Price Change %



Source: FactSet

Case Eichenberger, CIMA

Senior Client Portfolio Manager

Case Eichenberger co-manages CLS's American Funds strategies and the CLS Shelter Fund, 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 and was promoted to Senior Client Portfolio Manager in 2018.

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.

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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