CLS's WEEKLY 3

What You Need To Know About the Markets

NOVEMBER 13, 2018

1. Election or not, the fourth quarter is not to be missed
2. Savers rejoice, higher contribution limits coming in 2019
3. Risk Budgeting has shined during 2018 drawdowns

Market Performance

Equities	LAST WEEK	QTD	YTD '18
Global Equity Market[1]	+0.96%	-5.55%	-1.94%
Total U.S. Market[2]	+1.86%	-4.99%	+5.05%
Domestic Large-Cap Equity[3]	+2.21%	-4.37%	+5.74%
Domestic Small-Cap Equity[4]	+0.12%	-8.58%	+1.95%
International Equity[5]	-0.33%	-6.66%	-9.54%
Developed International Equity[6]	+0.23%	-6.62%	-7.96%
Emerging Market Equity[7]	-2.04%	-6.75%	-13.91%
Diversified Alternatives[8]	+0.80%	-1.35%	-0.08%
Fixed Income	**LAST WEEK**	**QTD**	**YTD '18**
U.S. Investment Grade Bonds[9]	+0.25%	-0.82%	-2.41%
Cash Equivalent[10]	+0.04%	+0.23%	+1.50%
Commodities	**LAST WEEK**	**QTD**	**YTD '18**
Commodity[11]	-1.14%	-2.45%	-4.43%

[1]MSCI ACWI Index [2]Russell 3000 Index [3]S&P 500 Index [4]Russell 2000 Index [5]MSCI ACWI ex-U.S. Index [6]MSCI EAFE Index [7]MSCI Emerging Markets Index [8]Morningstar Diversified Alternatives Index [9]Bloomberg Barclays Capital U.S. Aggregate Bond Index [10]Bloomberg Barclays Capital 1-3 Month U.S. Treasury Bill Index [11]Bloomberg Commodity Index As of 11/9/2018

Week in Review

Global stocks finished last week higher for the second week in a row, despite a poor session on Friday. Value stocks outperformed growth, and larger companies outperformed smaller ones. International stocks gave back some of their recent outperformance, while bonds ended the week slightly higher. The yield on the closely followed 10-year U.S. Treasury ended the week at 3.18%

Midterm elections on Tuesday overshadowed many other events of the week. As expected, Republicans remained in control of the Senate while the house was taken by Democrats. The majority of economic data came in better than expected, including job openings, retail sales (Redbook), and Producer Price Index (PPI). The U.S. Federal Reserve's (Fed) interest rate decision came unusually on Thursday and was the final announcement that will not include a press conference. As a result, it received little fanfare and the Fed's released statement had limited changes.

Commodities ended the week lower, led by oil prices which are now down 20% from their peak. The U.S. dollar index ended the week higher.

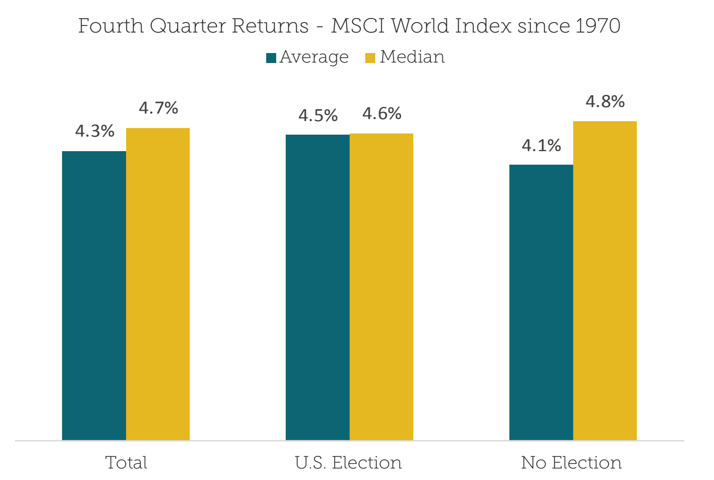
Midterm Mania

The most expensive midterm elections in history are now over, and the results fell in line with general expectations. Keep in mind that, statistically, just about anything that happens in 2018 will be the most expensive in history (public net worth is 12% higher, or about $11 trillion more than it was during the last midterm). The media has been filled with potential scenarios and historical outcomes, many of which we covered in a recent blog post (definitely give it a read if you haven't). One interesting outcome is that we have now returned to split-party "gridlock" in Washington, as we have a Republican White House and Senate and a Democratic House. Interestingly, this gridlock scenario has historically led to strong stock returns going forward in the few times it has occurred.

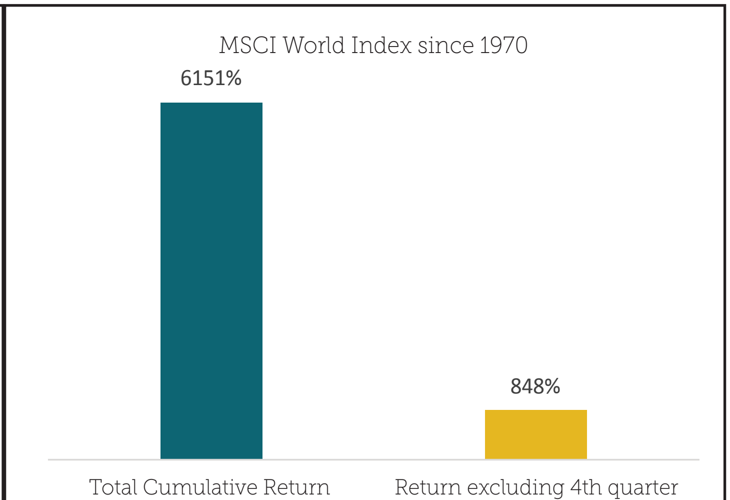
How should investors react to the elections or any elections really? If you have read CLS material before, you already know the answer — keep calm and stay invested! But I want to look at this from a slightly different angle – the perspective of a global investor in the modern political era (what happened in the markets following Teddy Roosevelt's reelection may not be as relevant). At CLS, we have talked and written numerous times about the typical stock returns in the fourth quarter. It's a period of undeniable seasonal strength. Since 1970, as the chart below shows, fourth quarter returns on the MSCI World Index have been strong in both election years and non-election years.

On average, there appears to be a slight edge during election years, but that's not true for median returns (stats again). No matter how you slice it, the fourth quarter is a strong period (nearly 80% positive regardless of whether an election is held). It does not pay to sit out this period, whether your party won or lost. Just take a look at returns over time if investors sit on the sidelines during the fourth quarter.

Besides my not-so-subtle questioning of various statistics used out there, the point is that avoiding markets altogether because of the outcome or expected outcome of political events can be just as damaging as trying to time the market. Sure, some sectors and industries could feel different impacts due to expected legislative changes, but overall we have to rely on statistically (there's that word again) proven methodologies, such as valuations, to position portfolios.



Source: Morningstar, MSCI, CLS Investments



Source: Morningstar, MSCI, CLS Investments

Exciting (?) Retirement Changes

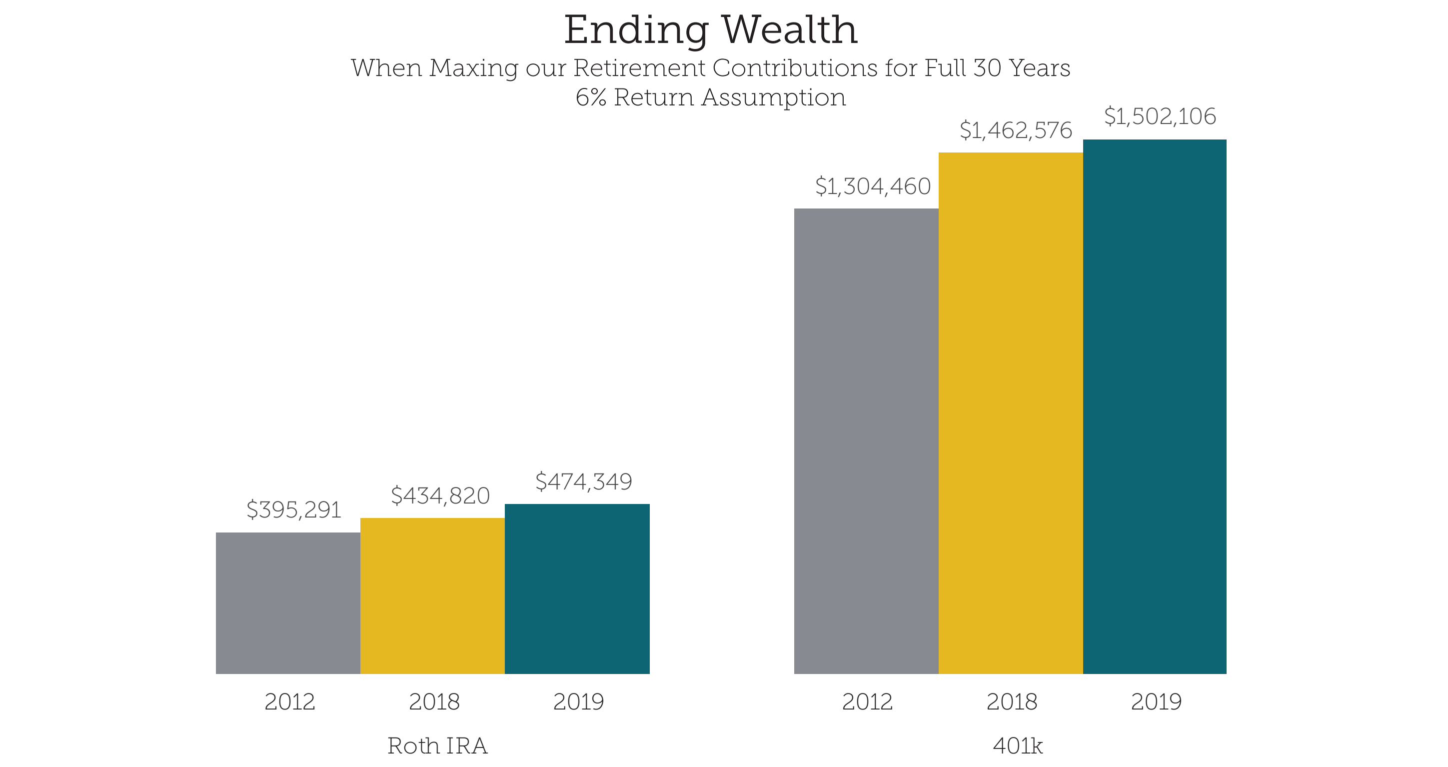
On November 1, the IRS announced increases in contribution and income limits for a variety of retirement vehicles. The IRS generally isn't known for exciting announcements, but any time contribution limits are adjusted upward, it's cause for celebration. A summary of the major changes:

- Elective deferrals for 401(k) participants will be increased from $18,500 to $19,000 per year. This also applies to most other defined contribution plans, such as 403(b) and 457 plans, etc.
- IRA contribution limits are increased from $5,500 to $6,000. This applies to both Roth and traditional IRAs.
- Income phase-out ranges for those eligible to contribute to a Roth IRA are increased somewhat.
- Income limits for traditional IRA tax deductions are also marginally increased.
- Contribution limits for a SIMPLE account are increased from $12,500 to $13,000.
- Catch-up contribution limits did not change for those over 50 and remain at $1,000 for IRAs and $6,000 for 401(k)s.

Unfortunately, these changes aren't that exciting to everyone. Many people do not contribute, or are not in a position to contribute, anywhere near these maximums. But what if they did?

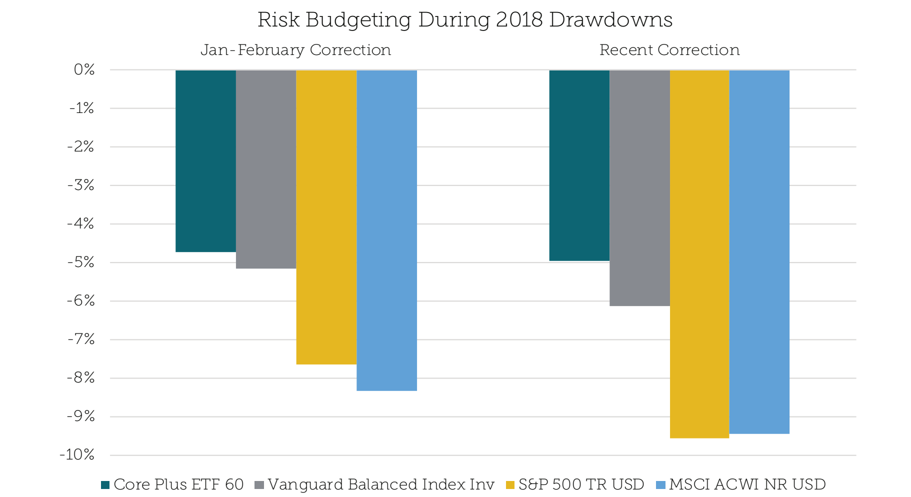
Under some basic assumptions, such as a 6% annualized return (well below historical equity returns), if an investor contributed the maximum amount annually to a 401(k) plan under the updated (2019) limits, he could reach $1 million in just 25 years. And that's not even including an employee match!

While the annual changes seem minor, they can, of course, add up over time. Just a few years ago, in 2012, contribution limits were $16,500 for 401(k)s and $5,000 for IRAs. Over 30 years (well below the normal contribution period), those revised maximums translate into a gain of nearly $80,000 for IRAs and $150,000 for 401(k)s. Taking advantage of these limits should be aspirational for investors of all shapes and sizes.



Source: CLS Investments

Win by Losing Less



Source: Morningstar. January-February peak to trough from January 26, 2018 to February 9, 2018. Recent correction from October 3, 2018 to October 29, 2018. Core Plus 60 portfolio net of fees.

Risk Budgeting focuses on the management of volatility in client portfolios. This manifests itself in the most apparent form for clients during market corrections, where "risk" and "volatility" move from being vague statistical measures to "Wait, how much money did I lose??" As strategic risk managers, CLS strives to keep risk consistent on a relative basis through thick and thin. What can this mean for clients? A smoother ride, a more dependable portfolio, and realistic expectation-setting for both up and down markets.

As we seek to outperform over time, we look at a number of metrics to determine how we should position ourselves (with value being very important). These are intermediate-to-long-term decisions. Risk management, however, is a consistent and frequent endeavor, utilizing statistics with various time frames and signal frequencies. Risk changes every day, and the proper measurement and management of that risk prepares us for any expected or unexpected (usually the case) turbulence. "The pilot has turned off the seat belt sign, but please keep your seat belt buckled in case of unexpected turbulence." (Try telling that to a two year old...)

2018 has provided two of the quickest and sharpest downturns we've seen in recent years, something that should not be unexpected while the U.S. market is at its current levels. Below, the Core Plus 60 RB portfolio (60% of the risk of the global equity market) is shown against two major indices during this year's corrections. Performance has been exactly what you'd expect, if not better. This can be applied to any Risk Budgeted strategy – the measurement is the same. The $40 billion Vanguard Balanced Index fund, which has a similar risk profile to a 60 RB CLS portfolio, has seen more downside risk this year, mainly due to lower diversification versus how we build portfolios.

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.

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. The Morningstar Diversified Alternatives Index is an index comprised of exchange traded funds (ETFs) in the ProShares lineup that use alternative and non-traditional strategies. 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.

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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