CLS's WEEKLY 3

What You Need To Know About the Markets

DECEMBER 4, 2018

1. It was a tough year for investors, but our beliefs stand firm.
2. How do we define active management? We review five common definitions.
3. Correction have silver linings, it's a good time to be an investor and a counselor.

Market Performance

Equities	NOVEMBER	YTD '18	12-MONTH
Global Equity Market[1]	+1.46%	-2.55%	-0.98%
Total U.S. Market[2]	+2.00%	+4.48%	+5.53%
Domestic Large-Cap Equity[3]	+2.04%	+5.11%	+6.27%
Domestic Small-Cap Equity[4]	+1.59%	+0.98%	+0.57%
International Equity[5]	+0.95%	-10.13%	-8.12%
Developed International Equity[6]	-0.13%	-9.39%	-7.94%
Emerging Market Equity[7]	+4.12%	-12.24%	-9.09%
Diversified Alternatives[8]	+0.84%	-0.77%	-0.40%
Fixed Income	**NOVEMBER**	**YTD '18**	**12-MONTH**
U.S. Investment Grade Bonds[9]	+0.60%	-1.79%	-1.34%
Cash Equivalent[10]	+0.18%	+1.63%	+1.72%
Commodities	**NOVEMBER**	**YTD '18**	**12-MONTH**
Commodity[11]	-0.56%	-4.68%	-1.83%

[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 11/30/2018

November Market and Portfolio Review

With a fantastic closing week to finish the month, it appears that the market is ready to shake off its second correction of the year and resume its long-running bull market.

Helping the stock market this past week were two shifts. The Federal Reserve (Fed) appeared to soften its stance on raising interest rates, and yet another possibility of a positive resolution to the China-U.S. trade talks unfolded. On December 1, President Trump and Chinese President Xi Jinping agreed to a ceasefire on trade while negotiations continue. The U.S. will leave tariffs at 10% into the new year, and China agreed to purchase more U.S. goods.

While the status of the trade negotiations seems to change every few days, the Fed's comment does seem significant, especially since the Fed chair's comment in early October about rates being "well below normal" can easily be singled out as the primary catalyst behind the latest market swoon.

Last month, the overall global market (MSCI All-Country World Index) was up over 1%. The U.S. stock market (Russell 3000 Index) gained about 2%, as both larger and smaller companies gained about 2%. The real performance difference was between growth and value stocks. Growth stocks (Russell 3000 Growth Index) were up about 1% and value stocks gained 3%.

International equity markets were up 1% in November (MSCI ACWI ex-U.S. Index), but emerging markets led the way with a gain of 4%. Developed international markets (MSCI EAFE Index), meanwhile, lost less than 1%.

The bond market (Bloomberg Bar Cap Aggregate Bond Index) gained nearly 1% as the 10-year U.S. Treasury yield ended September at 3.01%. The three-month U.S. Treasury Bill yield ended the month at 2.37%.

Real assets were mixed. Commodities (Bloomberg Commodity Index) had a small loss while real estate investment trusts (REITs) gained nearly 5% in November.

In general, CLS portfolios performed well last month given the positive performance of bonds combined with the outperformance of emerging markets and value stocks.

It Has Been a Tough Year for Three Reasons — But We're Still Believers

It has been a tough year for all investors, including global managers such as CLS.

Challenge #1:

Most markets and asset classes at the end of November had losses on the year, which would qualify 2018 as the worst year for such broad-based asset class performance in more than 100 years. Daily price swings have also been much larger this year, though not necessarily much different from long-term averages. We've seen two 10%+ corrections in one year, which is also rare. Many segments of the markets, including several international markets and even the FANG (Facebook-Amazon-Netflix-Google) stocks, have lost even more, officially reaching bear market (20% loss or more) status.

Our belief:

Despite this dismal showing, we still believe in the ability of financial markets to grow wealth over time. The markets allow investors to participate in the economy's relentless long-term growth. Over time, the global economy grows and stock markets have historically risen. Historically, the U.S. stock market has a positive 12-month return 75% of the time, and the chance of a positive return increases the longer the time horizon. We do not have any reason to believe that will not continue.

Challenge #2:

Global investors have had a difficult year as international markets have underperformed U.S. markets. International markets took an especially big punch in terms of relative performance during the second quarter. For the year, through the first 11 months, international has lagged the U.S. market by a wide margin.

Our belief:

Nonetheless, we still believe in global investing. As our white paper "Why International: The Case for International Investing" shows, adding international equity lowers overall portfolio volatility. It also helps risk-adjusted performance over time. As noted last month in CLS Senior Portfolio Manager Kostya Etus's Weekly 3, globally diversified portfolios have outperformed the S&P 500 Index in terms of total return since 2000 with much lower volatility. That has happened despite an epic, never-seen-before, nine-year losing streak. Besides, while the U.S. makes up more than 50% of the global stock market, expect that number to fall in the years ahead as the U.S. only makes up about 25% of the global economy and less than 5% of the global population.

Challenge #3:

It has been a difficult year for the performance of CLS portfolios versus our own benchmarks. Most of the damage was concentrated in the second quarter when international markets moved lower on trade concerns, the dollar strengthened, and U.S. growth technology stocks moved higher. Since mid-September, however, CLS portfolios in the aggregate have outperformed.

Our belief:

Despite the challenges from earlier in the year, we still believe in our approach to emphasizing value and international, especially emerging markets. It makes sense when considering future performance when factoring in variables such as valuations, profitability, and dividend yields.

The accompanying table lists capital market assumptions (CMAs), which are basically long-term expected returns. The first column shows the expectations for CLS, followed by two value-oriented investment firms, Research Affiliates

	CLS	RAFI	GMO	MFS	Rocaton
U.S. Stocks	1.8%	2.6%	-1.7%	2.3%	2.9%
Intl Stocks	3.2%	7.5%	3.0%	6.3%	6.4%
EM	7.6%	9.7%	6.9%	8.4%	9.5%
Bonds	2.5%	3.2%	2.3%	3.6%	3.6%
As of Date	11/27/2018	10/31/2018	10/31/2018	7/31/2018	6/30/2018
Outlook	10 year	10 year	7 year	10 year	10 year

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(Newport Beach, California) and GMO (Boston), growth-oriented firm MFS (Boston), and the highly regarded investment consultant, Rocaton (Greenwich, Connecticut).

Return expectations for the U.S. stock market are consistently expected to be below average. Returns for international markets are expected to be higher, especially for emerging markets. It is also interesting to note that the U.S. bond market is expected to have higher returns than the U.S. stock market over the next ten years.

As for value investing, which has historically been the premier style of investing, it has been rough sledding the last nine years. But, there are signs that we could be at an inflection point. The last time the largest U.S.-based growth stocks broke down in terms of performance was nearly 20 years ago, and we could be nearing a similar point again. If we are, value investing could significantly outperform in the years ahead. We'll be ready.

Source: Morningstar Direct as of 10/31/2018

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.

How is Active Money Management Measured?

CLS is an active money manager. But what does that mean exactly? There are various definitions. The short one: We will change the portfolio based on our expectations of future returns and risks. This means there will be more portfolio activity, and, more importantly, the portfolio will differ from the overall market.

There are five primary ways we consider a money manager to be active.

1. Portfolio turnover:

Portfolio turnover is an annualized measure of how much of the portfolio changes over time. At CLS, the turnover for a typical portfolio is 30-50% per year. This means that one third to one half of our portfolios change positions over the course of a year. In other words, we hold positions for 2 to 3 years on average. For a frame of reference, the average mutual fund has had a turnover rate of nearly 91% over the past 3 years, which suggests CLS has a longer investing horizon.

In 2018, at least through the end of October, the average CLS portfolio has had an annualized turnover of roughly 30%. Some CLS strategies are higher and some are lower. In recent years, turnover has been slightly lower than average, primarily because volatility has been lower than long-term averages, even in 2018, remarkably. We also have many large unrealized gains in portfolios, which slows activity until we can find compelling reasons to take those gains.

2. Numbers of trades per year:

Reviewing how many trades a portfolio manager makes per year is another way to measure their level of activity. This includes trades that involve movement regarding changes in return or risk expectations, but it could also be related to dealing with daily cash flows (such as a mutual funds), rebalancing, or tax-related trades.

At CLS, how we fare on this measurement depends on the strategy. In some strategies, such as AdvisorOne, underlying trades happen every day. It also depends on market conditions. The more volatile the market, the more relative performance inflection points occur, the more trades are visible. In general, while every strategy is continually monitored, it's reasonable to expect trades at least every six months, but that truly fluctuates based on market conditions.

3. Year-over-year change in allocations:

A visual way to examine an active manager is to chart how much the portfolio changes over time. A year-over-year review is a good place to start. Reviewing a performance report should show how much change has taken place within the portfolio over the last year.

4. Tracking error:

Tracking error is a statistical measure of how much an investment's return differs from a benchmark's. While many investors don't ask about tracking errors, I believe this is an important number to measure and manage.

At CLS, we try to have tracking errors at least above 2%. This means that most of the time returns will be 2% better or worse than a respective benchmark. A fund with a tracking error of less than 2% is often considered an "enhanced index fund," which we do not want our portfolios to be known as.

5. Active share:

Active share is another statistical measure that shows how much an investment's portfolio holdings differ from a benchmark's. This is important because you can't have superior risk-adjusted returns if your portfolio isn't different.

At CLS, we monitor this number primarily to ensure that we are considered sufficiently active by our clients and investors. There is no hard guideline for any CLS strategy to have a minimum active share level at this point because the academic literature is mixed on how effective this measure is. Nonetheless, we still measure and monitor.

The Silver Linings of Corrections

When the stock market has a correction, dropping 10% or more, it's an uncomfortable time for many investors. It's not fun to see how much money we can lose over a short period. It can also be scary as the news seems to get more provocative and sensational when the explanations for past losses seem likely to become predictors of more losses.

Investors, however, can look at corrections as excellent opportunities to invest more. Stocks are on sale! Temporary market losses might also mean market volatility has created a dispersion in returns within the market, which also creates investment opportunities. For taxable investors, market corrections provide an opportunity to harvest tax credits by realizing losses on positions that can be used to offset realized gains on other positions.

Corrections are also an important time for investment counselors. This is when advisors must keep investors balanced and on course toward their long-term financial objectives. Corrections are a time when "money is in motion," since many investors are nervous and looking for sound counsel. This is a time for financial advisors to shine.

Thank You and Happy Holidays

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

Stay balanced, and enjoy the holidays.

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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.

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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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