CLS's WEEKLY 3

What You Need To Know About the Markets

DECEMBER 26, 2018

1. Cash is king once again
2. What to make of the Fed announcement
3. Capital gains season

Market Performance

Equities	LAST WEEK	QTD	YTD '18
Global Equity Market[1]	-5.05%	-14.90%	-11.64%
Total U.S. Market[2]	-7.20%	-17.50%	-8.78%
Domestic Large-Cap Equity[3]	-7.03%	-16.67%	-7.87%
Domestic Small-Cap Equity[4]	-8.39%	-23.61%	-14.81%
International Equity[5]	-2.56%	-12.35%	-15.06%
Developed International Equity[6]	-2.64%	-13.30%	-14.54%
Emerging Market Equity[7]	-1.46%	-8.46%	-15.49%
Diversified Alternatives[8]	-1.59%	-4.22%	-3.57%
Fixed Income	**LAST WEEK**	**QTD**	**YTD '18**
U.S. Investment Grade Bonds[9]	+0.45%	+1.17%	-0.45%
Cash Equivalent[10]	+0.04%	+0.49%	+1.76%
Commodities	**LAST WEEK**	**QTD**	**YTD '18**
Commodity[11]	-3.12%	-7.14%	-9.02%

[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 12/21/2018

Week in Review

Stock markets were significantly lower around the world last week as US stocks, as defined by the Russell 3000 were down over 7%. International stocks held up much better with developed markets down over 2% and emerging markets down just over 1%.

Bonds were positive on the week as interest rates continued to move lower with the 10-year Treasury ending the week at 2.78%, its lowest rate since the end of May.

Diversifying assets classes held up relatively well to the US market. Commodities finished the week down just over 3% and liquid alternatives finished down less than 2%.

What to Make of 2018 by Michael Hadden

It has been a tough year across most asset classes. Following 2017 when equities ripped higher, cash has returned as king. After years of getting paid essentially nothing to hold cash, as rates have risen this year, cash has become a competitive asset class. In fact, for just the 12th time since 1928 — and the first time since 1994! — cash is outperforming both equities and bonds year to date.

Cash is King

Most instances of outperformance by cash have occurred during a big stock market drawdown, but not all. On two occasions, cash outperformed in years when equities were positive. Market timers may say that after last year's equity boom and high market valuations it was obvious investors should be in cash. This argument may have some merit, but sitting on the sidelines in January would have made anyone impatient as markets were up nearly 10% before the first sell-off of the year.

Year	S&P 500 (includes dividends)	3-month T.Bill	Return on 10-year T.Bond
1930	-25.12%	4.55%	4.54%
1931	-43.84%	2.31%	-2.56%
1941	-12.77%	0.08%	-2.02%
1966	-9.97%	4.84%	2.91%
1969	-8.24%	6.56%	-5.01%
1973	-14.31%	6.73%	3.66%
1974	-25.90%	7.78%	1.99%
1977	-6.98%	5.13%	1.29%
1978	6.51%	6.93%	-0.78%
1981	-4.70%	14.30%	8.20%
1990	-3.06%	7.55%	6.24%
1994	1.33%	3.99%	-8.04%
2018*	-7.87%	1.88%	-0.70%

Source: http://people.stern.nyu.edu/adamodar/
**Returns through 12/21/2018*

What Now?

If we entertain market timers and say they correctly anticipated a down market year and moved their investments to cash, what does one do from here? The correction has brought valuations down to more sustainable levels. There are some extremely attractive opportunities in the international markets. Taking a look at historical trends following a year when cash was the strongest performer lends some interesting insight.

Year	S&P 500 (includes dividends)
1931	-43.84%
1932	-8.64%
1942	19.17%
1967	23.80%
1970	3.56%
1974	-25.90%
1975	37.00%
1978	6.51%
1979	18.52%
1982	20.42%
1991	30.23%
1995	37.20%
Average	**9.84%**
Median	**18.85%**
% of Time Positive	**75.00%**

Source: http://people.stern.nyu.edu/adamodar/

The S&P clearly has had a wide variation in performance the following year. Everything from down 43% to up 37.2%. But as with overall market trends, the average return is positive, and markets are positive more often than negative. This reiterates the struggle of being a market timer. What do you do now? If (and it's a big if) you correctly moved to cash during 2018, you made the right call. But there comes a point when you will need to reenter the market. Historically, we have seen years when the market continued to fall, significantly at times. Other times we have seen the market bounce back in a big way. It goes to show that making market calls is extremely difficult and few, if any, can do it successfully over a long time horizon.

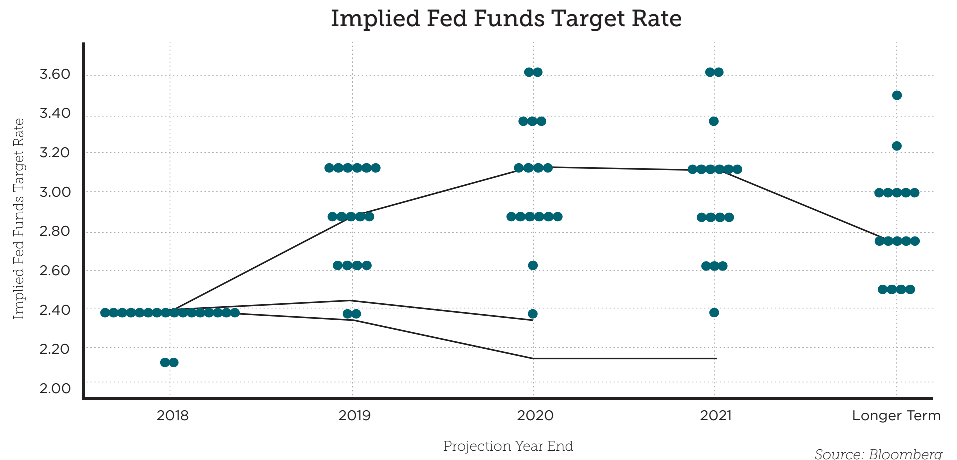
CLS in 2019

Given that CLS is not a market timer, what is in store for CLS portfolios in 2019? You won't see our portfolios moving to cash. We will continue to utilize Risk Budgeting, ensuring portfolios are taking on appropriate levels of risk. We see this market pullback as an opportunity as areas of the market seem ripe for outperformance. Among those are value and emerging market stocks. In fact, we have seen solid outperformance by both areas in this fourth quarter. We will continue to monitor the market environment and actively pursue the best opportunities that we see available.

Thank you for your trust in CLS, and happy holidays.

A Market Overreaction by Dustin Dorhout

Last Wednesday, the Federal Reserve held its most anticipated meeting, by both investors and the financial media, since Jerome Powell took office in February. Its decision to raise interest rates by 25 basis points was widely expected, but market watchers were paying close attention to the language of the Fed's statement and meeting minutes, looking for any dovish signals that would ease concerns of overly rapid rate hikes after a volatile quarter. Per the report:



"The Committee judges that risks to the economic outlook are roughly balanced, but will continue to monitor global economic and financial developments and assess their implications for the economic outlook. In view of realized and expected labor market conditions and inflation, the Committee decided to raise the target range for the federal funds rate to 2-1/4 to 2-1/2 percent."

The decision put the effective federal funds rate just shy of the 2.5-3.5% range that the Fed deems to be 'neutral monetary policy.' Overall, this meeting had a relatively moderate tone to it, with slight movement downward on the "dot plot" of forward rate expectations. Furthermore, out of the 17 members of the Fed's board, 11 expect two hikes or fewer in 2019 — which would bring the funds rate into neutral territory.

This was the ninth interest rate increase since 2015 and the 100th since 1970. Given the quantity and frequency with which the Fed raises rates, one would expect market participants to be much better at pricing in these decisions, but this was not the case. The S&P 500 dropped by more than 150 bps, and the Nasdaq dropped even more, roughly 210 bps. Moreover, we also saw the yield curve flatten, lower inflation expectations, wider credit spreads, and dollar strength. Market participants were clearly disappointed by the meeting.

As Dr. David Kelly of JP Morgan stated, "I just wish markets could react a little more calmly to a move that was both predictable and prudent." However, out of the 100 interest rate hikes since 1970, there was a seven-year gap of interest rate movements by the Fed from the global financial crisis to 2015, making Mr. Market rather rusty in his ability to get ahead of Fed decisions.

In conclusion, given the language used in the Fed's last meeting of 2018, it seems most prudent to expect a meaningful slowdown in interest rate increases and to be more attentive to key market and economic signals in the new year. And as always, we advise avoiding knee-jerk reactions to news headlines and instead emphasize a focus on staying globally diversified, balanced, and invested!

Capital Gains Distributions Q & A

What is a capital gains distribution?

As underlying investments in a mutual fund are bought and sold, gains may be generated, which legally have to be paid out to the end investor for tax purposes. Dividends and interest accrued throughout the year are also paid out at this time for most of our funds.

When do mutual funds typically distribute capital gains?

Generally, mutual funds distribute capital gains once per year at the end of the calendar year (December).

Is this a taxable event?

Yes, it is a taxable event but should not affect anyone in a qualified account.

What if I don't want the cash distribution, but I want to stay invested?

Most brokerage accounts are set up to automatically reinvest dividends and capital gains distributions, so the cash from the distribution will simply be used to buy more shares of the same fund making the distribution. You will now be holding more shares of a cheaper security, but the dollar amount owned of that fund remains the same.

Why does my mutual fund account appear to have a large negative return?

It is most likely from a capital gain and income distribution. When the distribution is paid out, the payment comes out of the value of the fund, which makes the price return appear negative. However, the total return (price plus capital gains/income) remains consistent with the market changes that day. See the charts on the following page for more details.

But why does the performance appear negative?

Due to the distribution, the price per share of the fund was lowered to reflect the payout. However, you get to keep the distribution so your overall account value doesn't change. Most of the time, this distribution is reinvested in the fund, keeping your fund value the same. Typical price reporting websites will display a large negative price return the day of the distribution (equal to the change in the fund's value that day, as well as the distribution paid out). These are typically corrected the next day to reflect the total return.

The MSCI ACWI Index captures large and mid cap stocks across developed markets and emerging markets countries. The index covers approximately 85% of the global investable equity opportunity set. 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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