CLS's WEEKLY 3

What You Need To Know About the Markets

JANUARY 29, 2019

1. Avoiding the market drama through Risk Budgeting
2. The true diversification benefits of liquid alternatives
3. Where are we in the current economic cycle, and what does history tell us comes next?

Market Performance

Equities	LAST WEEK	QTD	YTD '19	3-YEAR	10-YEAR
Global Equity Market[1]	+0.26%	+6.41%	+6.41%	+12.16%	+11.57%
Total U.S. Market[2]	-0.13%	+6.93%	+6.93%	+14.91%	+14.93%
Domestic Large-Cap Equity[3]	-0.30%	+6.00%	+6.00%	+14.87%	+14.52%
Domestic Small-Cap Equity[4]	+0.08%	+10.69%	+10.69%	+15.19%	+15.39%
International Equity[5]	+0.71%	+6.17%	+6.17%	+9.99%	+9.02%
Developed International Equity[6]	+0.49%	+6.05%	+6.05%	+8.44%	+8.65%
Emerging Market Equity[7]	+1.35%	+6.51%	+6.51%	+15.66%	+10.71%
Diversifiers	**LAST WEEK**	**QTD**	**YTD '19**	**3-YEAR**	**10-YEAR**
U.S. Investment Grade Bonds[8]	+0.32%	+0.31%	+0.31%	+1.86%	+3.50%
Cash Equivalent[9]	+0.04%	+0.17%	+0.17%	+1.05%	+0.36%
Commodity[10]	-0.06%	+8.31%	+8.31%	+7.42%	-1.21%
Diversified Alternatives[11]	+0.14%	+1.40%	+1.40%	+1.96%	+4.56%

[1]Morningstar GblMkt Large-Mid Index [2]Morningstar U.S. Market Index [3]Morningstar U.S. Large Cap Index [4]Morningstar U.S. Small Cap Index [5]Morningstar Gbl xU.S. Large-Mid Index [6]Morningstar DM xUS Large-Mid Index [7]Morningstar EM Large-Mid Index [8]Morningstar U.S. Core Bd Index [9]Morningstar Cash Index [10]Morningstar Gbl Lng-Only Cmdty Index [11]Morningstar Diversd Alt Index As of 1/25/2019

Week in Review

Global equity markets were mostly flat for the week, taking a break following the post-Christmas rally. The S&P 500 Index is up more than 13% since December 24. Technology was a key area of strength in the U.S., while consumer staples and communication services lagged. Within domestic equities, mid-cap stocks shined, besting both large-caps and small-caps, and value stocks outperformed their growth counterparts.

International markets outperformed domestic, with emerging markets leading the way. European stocks struggled with some specific regions bucking the trend. Finland, Germany, and the Netherlands were particularly strong.

There wasn't much to report in the fixed income markets, as economic data releases have been sparse due to the government shutdown. Corporate bonds outperformed Treasuries on the margin, particularly those with longer maturities. High yield and Treasury Inflation-Protected Securities (TIPS) were relative underperformers. Commodities were slightly lower on the week, but following a difficult 2018, the Bloomberg Commodity Index is higher by 6% so far this year.

Last week ended on a positive note following a temporary agreement to reopen the U.S. government.

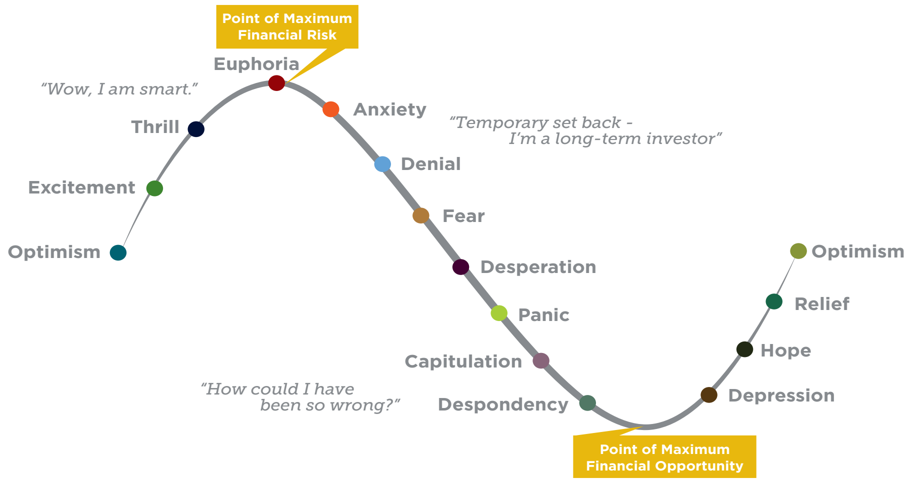
No More Market Drama

Sometimes watching CNBC is like watching a soap opera: so much drama! It seems like only yesterday everyone was convinced that the market was crashing. Just a few weeks ago, some of the highest-profile credit strategists in the industry were urging investors to reduce risk in their fixed income portfolios. Only a week later, Bloomberg News reported that those same strategists had completely reversed course. By now, the average investor has whiplash. If the so-called professionals can't decide what to do, who can?

The focus for the CLS Portfolio Management Team is to ignore the noise and remain committed to our process. The cornerstone of that process is our proprietary Risk Budgeting Methodology. We start by evaluating each investor's specific time horizon and investment goals. We then establish a budget, which represents the amount of risk the investor is comfortable taking. We seek to build a portfolio that carefully balances the risk of each underlying asset with the ability of the portfolio to grow and achieve the investor's goals. The fact is that all investors have some capacity to take on risk, and some element of risk is necessary when striving for financial rewards. Not taking on enough risk can seriously hinder an investor's ability to reach their financial goals. CLS's Portfolio Management team helps investors build a globally diversified portfolio that offers the right balance of risk and reward. We constantly monitor the portfolio's underlying risk to ensure it remains in line with its designated risk budget. By remaining true to our investment process, we can stay focused through all the drama that surrounds the market and keep investors on track.

For more information on CLS's Risk Budgeting Methodology, visit the dedicated [Risk Budget resource page] on our website.

The Cycle of Investor Emotions



Shana Sissel, CAIA

Portfolio Manager

Shana Sissel joined the CLS Portfolio Management Team in 2018. She is responsible for actively supporting the Portfolio Management Team's efforts within a variety of special projects and investment management strategies, as well as writing and speaking on behalf of CLS.

Ms. Sissel has more than two decades of industry experience at leading investment firms, primarily in Boston and Chicago. Most recently, she was a Client Portfolio Manager at Ariel Investments where she represented Ariel's Domestic Research Team. Ms. Sissel also brings a vast background in market research and analysis through various roles held at Fidelity Investments' Strategic Advisor Inc., Mercer Investments, Peak Financial Management, and Russell Investments.

Ms. Sissel earned a Bachelor of Science Degree in Sport Management from the University of Massachusetts at Amherst before receiving her Master of Business Administration Degree from Bentley University's McCallum School of Business. She also holds the Chartered Alternative Investment Analyst (CAIA) designation.

As a frequent media contributor, Ms. Sissel has appeared on CNBC and other regional news outlets. She has also been quoted extensively in the Wall Street Journal, Smart Money, and Investment News.

The Truth About Liquid Alternatives

The world of alternative investments was flipped on its head over a decade ago when hedge fund inspired Investment Act of 1940 (40 Act) funds began appearing on the scene. While diversification benefits can be achieved through liquid alternatives, it's important to keep our expectations in check. Unlike traditional hedge funds, liquid alternatives have significant limitations in how and what they can invest in that curb their alpha-generating potential compared to their hedge fund counterparts. Let's take a look at the three biggest structural limitations that liquid alternatives face under the 40 Act.

1. **Liquidity:** One of the benefits offered by traditional alternatives, such as hedge funds and private equity, is the illiquidity alpha. Investors often understand and expect that by giving up daily liquidity they should be rewarded with better returns. This can come through many different avenues, whether it be allowing the manager to invest in less liquid investments or giving the manager time to trade more patiently. This illiquidity alpha is not available in liquid alternatives. The 40 Act limits the ability of liquid alternative funds to invest in illiquid securities (defined as instruments that take longer than seven days to liquidate in the public markets). A 40 Act fund is mandated to maintain 85% of its portfolio in liquid assets.

2. **Shorting:** The ability to go short as an investment strategy is what originally put the "hedge" in hedge fund. Strategies like equity market neutral and fixed income arbitrage count on shorting to be a significant aspect of their investment strategy. The rules of the 40 Act severely limit how much shorting can be done. As a result, many of the strategies that are most beneficial for diversification purposes cannot be effectively executed in a liquid-alternatives structure.

3. **Leverage:** Funds registered under the 40 Act cannot employ leverage as effectively as their non-40 Act peers. The 40 Act limits the use of leverage to 33% of the gross asset value of the fund, using either derivatives or securities as margin collateral. Leverage is a double-edged sword, of course, but a manager with real skill in executing their strategy can use leverage to potentially increase the rewards to shareholders. Leverage is often the key reason liquid alternatives underperform like-minded hedge fund peers.

Despite these structural limitations, the diversification benefits provided by liquid alternatives remain. At CLS, we allocate to alternatives through our Focused Alternatives portfolio. In the portfolio, we employ funds that utilize strategies such as merger arbitrage, buy-write options and long-short equity to help reduce the overall risk for our clients. You can build a strong alternative allocation using liquid alternatives, if you keep your expectations in check.

It's All About the Economic Cycle

We spend a lot of time and energy as investors trying to understand what is going on in the stock and bond markets from day to day. Sometimes we forget to take a step back and look at the big picture. The big picture, of course, is the economic cycle, which turns out to be a reliable and predictable measure of what is going on in the world, not just with the investment markets, but also politics, monetary policy, and consumer behavior. The cycle has four distinct phases, and there is no limit to how long each phase can, or will, last.

1. **Early Cycle:** This is often a recovery period following a contraction. During the early cycle, we typically observe a clear rebound in economic activity, such as employment, GDP, industrial production, and incomes. Credit markets begin to grow, and corporate profits experience rapid improvement. Government policy remains stimulative. Inventory levels remain low, and sales are sluggish but improving. Consumer sentiment also remains low during this period.

2. **Mid-Cycle:** This period is marked by economic expansion, which can continue for several years. The mid-cycle is arguably the longest phase in the economic cycle; the one we just experienced was the longest mid-cycle period in history. This phase is marked by steady, peaking growth, strong credit markets, strong corporate earnings and profits, stable political policy, rebounding inventory levels, strong sales growth, and improving consumer sentiment.

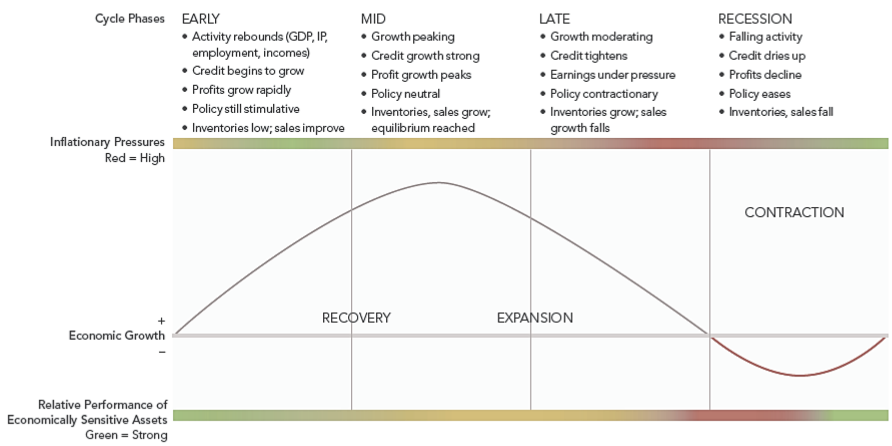
3. **Late Cycle:** While the late cycle is still considered an expansion period, the stock market is the least predictable and most volatile during this phase. Economic growth begins to moderate, employment markets remain strong, credit markets tighten, corporate earnings are under pressure, political and monetary policies shift toward contraction, inventory levels peak, sales growth slows, and consumer sentiment reaches peak levels. This period is often difficult for investors to navigate because market volatility doesn't always favor a "buy on dip" strategy, and the likelihood that any market decline will be the start of a bear market increases meaningfully. Most experts agree we have finally entered the late phase of the current economic cycle.

4. **Recession:** Historically, this is the shortest phase in the cycle and often the most painful. During this phase, most economic activity deteriorates rapidly, credit markets dry up, corporate profits decline, political and monetary policy turns stimulative, inventory levels fall, and sales contract. The severity of recessions varies, but it is almost certainly a period when equity markets struggle mightily.

The Fidelity Investments asset allocation team has developed a very helpful approach to economic cycle research. In its most recent update, the team indicated most major economies are firmly in the late cycle, as shown in the chart below.

While the late cycle can be difficult to navigate, it does not mean that equity markets cannot be fruitful to investors; it just means greater caution may be warranted. This is often the period in which financial advisors are needed the most. It can be a fantastic time to demonstrate the importance of working with a professional.

Business Cycle Framework



Note: The diagram above is a hypothetical illustration of the business cycle. There is not always a chronological, linear progression among the phases of the business cycle, and there have been cycles when the economy has skipped a phase or retraced an earlier one.
** A growth recession is a significant decline in activity relative to a country's long-term economic potential. We use the "growth cycle" definition for most developing economies, such as China, because they tend to exhibit strong trend performance driven by rapid factor accumulation and increases in productivity, and the deviation from the trend tends to matter most for asset returns. We use the classic definition of recession, involving an outright contraction in economic activity, for developed economies.*
Source: Fidelity Investments (AART), as of 12/31/18.

The Morningstar Global Market Large-Mid Index is an index that measures the performance of the global market's equity markets targeting the top 90% of stocks by market capitalization. The Morningstar U.S. Market Index is an index that measures the performance of U.S. securities and targets 97% market capitalization coverage of the investable universe. It is a diversified broad market index. The Morningstar U.S. Large Cap Index is an index that measures the performance of U.S. large-cap stocks. These stocks represent the largest 70% capitalization of the investable universe. The Morningstar U.S. Small Cap Index is an index that measures the performance of U.S. small-cap stocks. These stocks fall between the 90th and 97th percentile in market capitalization of the investable universe. In aggregate, the Small Cap Index represents 7% of the investable universe. Morningstar Global ex U.S. Large-Mid Index is an index that measures the performance of Global Markets (ex-U.S.) equity markets targeting the top 90% of stocks by market capitalization. The Morningstar DM ex U.S. Large-Mid Index is an index that measures the performance of developed markets ex-U.S. equity markets targeting the top 90% of stocks by market capitalization. The Morningstar EM Large-Mid Index is an index that measures the performance of emerging markets targeting the top 90% of stocks by market capitalization. The Morningstar U.S. Core Bond Index is an index that measures the performance of fixed-rate, investment-grade USD-dominated securities with maturities greater than one year. It is market-capitalization weighted. The Morningstar Cash Index is an index that measures the performance of a Treasury Bill with six to eight weeks until maturity in the U.S. market. The Morningstar Global Long-Only Commodity Index is an index is fully collateralized commodity futures index that is long all in equitable commodities. This index provides investors with a means of understanding the performance of commodity futures markets and serves as a benchmark for investment performance of commodities as an asset class. The Morningstar Diversified Alternatives Index is an index that provides diversified exposure to alternative asset classes in the ProShares ETF lineup. 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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