

# CLS's WEEKLY 3

What You Need To Know About the Markets

FEBRUARY 5, 2019



Last month was the best January in more than three decades

1. The markets witnessed major inflection points in market leadership beginning last September
2. An update on CLS's "Be Smart" Investment Theme
3. Key changes to how we show performance

## Market Performance (as of 1/31/2019)

Fixed Income	10-YEAR	5-YEAR	3-YEAR	1-YEAR	YTD	QTD	JANUARY
Cash Equivalent <sup>1</sup>	+0.36%	+0.63%	+1.03%	+1.92%	+0.20%	+0.20%	+0.20%
U.S. Investment Grade Bonds <sup>2</sup>	+3.68%	+2.44%	+1.95%	+2.25%	+1.06%	+1.06%	+1.06%
Equities	10-YEAR	5-YEAR	3-YEAR	1-YEAR	YTD	QTD	JANUARY
Global Equity Market <sup>3</sup>	+11.28%	+6.72%	+11.62%	-7.48%	+7.90%	+7.90%	+7.90%
Total U.S. Market <sup>4</sup>	+15.12%	+10.41%	+14.19%	-2.26%	+8.58%	+8.58%	+8.58%
Domestic Large-Cap Equity <sup>5</sup>	+15.00%	+10.96%	+14.02%	-2.31%	+8.01%	+8.01%	+8.01%
Domestic Small-Cap Equity <sup>6</sup>	+14.52%	+7.26%	+14.71%	-3.52%	+11.25%	+11.25%	+11.25%
International Equity <sup>7</sup>	+8.35%	+3.11%	+9.59%	-12.58%	+7.56%	+7.56%	+7.56%
Developed International Equity <sup>8</sup>	+8.11%	+2.66%	+7.74%	-12.51%	+6.57%	+6.57%	+6.57%
Emerging Market Equity <sup>9</sup>	+9.66%	+4.77%	+14.89%	-14.24%	+8.77%	+8.77%	+8.77%
Diversifiers	10-YEAR	5-YEAR	3-YEAR	1-YEAR	YTD	QTD	JANUARY
Diversified Alternatives <sup>10</sup>	+4.64%	+0.84%	+1.91%	-2.12%	+2.18%	+2.18%	+2.18%
Commodity <sup>11</sup>	-2.74%	-7.88%	+2.66%	-8.23%	+5.45%	+5.45%	+5.45%

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

## January Market and Portfolio Review

What a nice way to start the year. January ended up being the best January since the 1980s. It was a great month for globally diversified portfolios.

My expectation was for 2019 to be a good year for stocks (partly due to the historic tendency for the stock market to bounce back after weak quarters), and I continue to expect that 2019 will be above average for the U.S. stock market and even better for international stock markets.

Reasons for the strong performance include the Federal Reserve (Fed) softening its stance on raising interest rates and positive developments regarding U.S.-China trade talks. The end to the holidays

also meant market participants were back in full force, providing liquidity and taking advantage of sale prices created by the December losses.

Last month, the overall global stock market was up nearly 8%. The U.S. stock market gained almost 9%, with smaller companies gaining more than 11% and larger companies gaining over 8%.

International equity markets were up nearly 8% in January, with emerging markets leading the way with a gain of almost 9%. Developed international markets, meanwhile, increased nearly 7%.

Despite the stock market gains, the bond market also had a total return of more

than 1% as the 10-year U.S. Treasury yield ended January at 2.63%. The three-month U.S. Treasury yield ended the month at 2.41%.

Real assets were also strong performers. Commodities gained more than 5%, while global real estate investment trusts (REITs) gained more than 10% in January.

In general, CLS portfolios performed well again last month given the positive performance of bonds combined with the continued outperformance of emerging markets. Detracting from performance in January was our tilt toward value stocks.

## Inflection Point

After looking at year-end performance statements, and focusing on 2018 returns, many advisors and investors are wondering when the market will begin to reward its most attractive segments, including international stocks (especially emerging market stocks) and certain styles of investing (such as value investing).

In fact, this has been happening since mid-September. It may be hidden in the 2018 numbers as it's easy to assume international markets underperformed in a steady, linear fashion. That's a common problem when looking at a shorter-term, calendar-based time frame. The period in question may capture various key inflection points within the markets. Market moves don't begin on January 1 and end on December 31.

There were major inflection points that began in September. U.S. companies began to slow down on returning overseas profits, which were overwhelmingly used for stock buybacks (companies use cash to buy back shares of their own

company's stock). The drop-off is evident in the data below, compiled by Bloomberg (hat tip to CLS Associate Quantitative Portfolio Manager Jackson Lee for finding this).

In short – wow. The financial media has cited various possible reasons for market gains and losses since September, but this is a big deal. Buybacks totaled more than \$60 billion every month for a solid eight months (and likely into early September) but absolutely plummeted in the last quarter of the year. Significant marginal buying power just disappeared.

That had a powerful impact on market returns. Here are the numbers since September 18:

- International stocks outperformed U.S. stocks (-3% vs. -6%).
- U.S. value stocks beat U.S. growth stocks (less than 5% loss vs. more than 6% loss).
- Emerging markets had a positive gain of more than 4%, despite the 6% loss in U.S. stocks.

Index	9/18/2018-1/31/2019
MSCI ACWI	-4.54%
Russell 3000	-6.27%
Russell 3000 Growth	-7.18%
Russell 3000 Value	-5.38%
S&P 500	-5.74%
Russell 2000	-11.53%
MSCI ACWI ex-U.S.	-2.81%
MSCI EAFE	-5.15%
MSCI Emerging Markets	+3.87%
BBgBarc US Agg Bond	+2.64%
BBgBarc US Treasury Bill 1-3 Mon	+0.83%
Bloomberg Commodity	-0.85%
Morningstar Diversd Alt	-1.77%
MSCI US REIT	+2.15%

- Real estate had a positive gain of nearly 3%.
- Bonds were also up nearly 3%.

Bottom line: It was a period of good, relative performance for globally diversified portfolios, and we believe it's reasonable to expect that should continue since relative valuations still support emphasizing just about anything but U.S. growth stocks; now momentum does, too.

Index/Portfolio Buyback & Dividend Analysis															
Period	2018 M12	2018 M11	2018 M10	2018 M9	2018 M8	2018 M7	2018 M6	2018 M5	2018 M4	2018 M3	2018 M2	2018 M1	2017 M12	2017 M11	2017 M10
Buyback (Billions)	0.39	7.65	12.77	65.71	67.64	67.69	66.80	62.93	65.03	62.39	61.02	56.50	46.55	45.83	46.11
Buyback Yield	2.66%	2.87%	3.04%	2.75%	2.66%	2.58%	2.65%	2.55%	2.45%	2.42%	2.33%	2.26%	2.17%	2.16%	2.16%
Dividend (Billions)	0.37	2.65	4.83	39.24	38.94	38.94	38.73	39.08	39.12	38.32	38.04	35.89	38.22	37.62	38.26
Dividend Yield	1.58%	1.75%	1.90%	1.76%	1.76%	1.76%	1.87%	1.86%	1.85%	1.89%	1.88%	1.87%	1.84%	1.83%	1.83%

Source: Bloomberg

## Spotlight on CLS's "Be Smart" Investment Theme

At CLS, we have many strategies and portfolios that we manage. We also have a team of 14 individuals, each with their own personalities, biases, and preferences. Given all the different views, we created the CLS Investment Themes to help us communicate the consistencies across CLS's various ETF portfolios.

The Investment Themes are officially vetted and approved by the CLS Investment Committee, which meets formally each quarter. At our last meeting, which took place at the end of January, we discussed one current investment theme and considered two possible new themes. Stay tuned regarding the latter as they are still being debated by the Portfolio Management team.

Our three current CLS Investment Themes:

### 1. Be Active

This had two parts. First, we believe active management and its ability to beat market

benchmarks is cyclical. Due to a combination of reasons, we think it's time for active management to do well again. Second, we like to use actively managed ETFs. Nearly 20% of our ETF assets are invested in actively managed ETFs, well above the 1-2% industry average.

### 2. Be Creative

We believe we need to be creative in diversifying portfolios. While bonds still make sense to manage overall risk and yield, we think the use of alternatives and real assets, such as commodities, also makes sense moving forward. The typical multi-asset CLS portfolio has 10% or more invested in alternatives, real assets, or both.

### 3. Be Smart

This theme captures our heavy use of smart beta ETFs. These are ETFs built on "factors", such as value (buying companies with the lowest valuations) and quality (buying companies with the strongest balance sheets and

solid profitability). CLS portfolios, on average, are nearing 50% in smart beta ETFs. This is double the industry average.

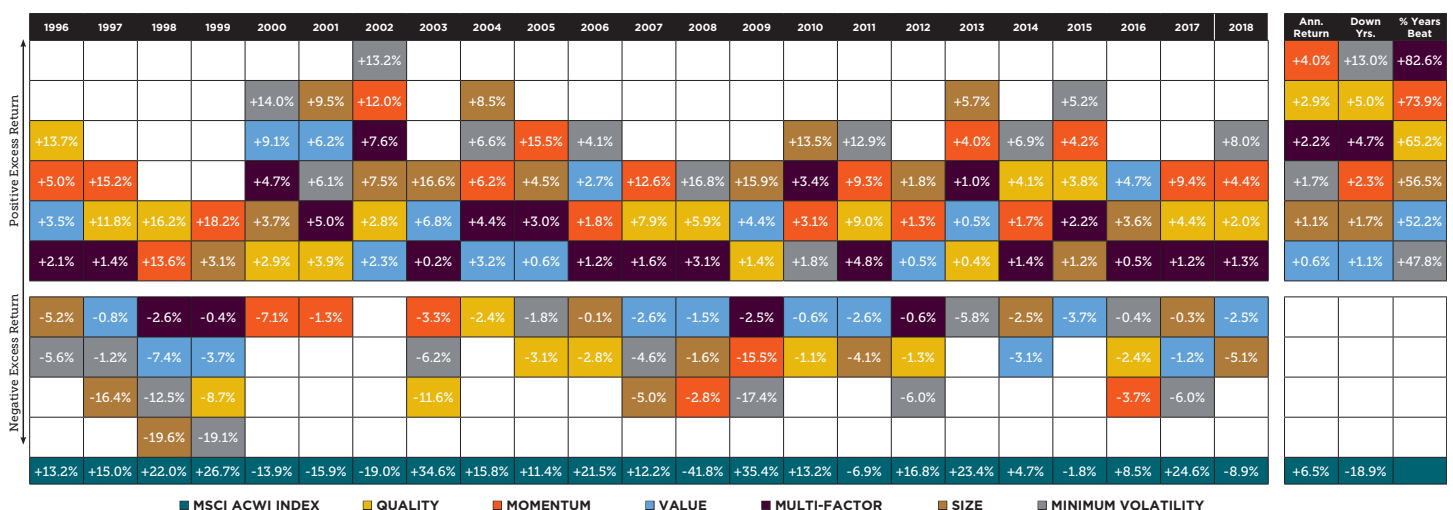
### How did the Smart Beta theme do last year?

There are two ways to look at this. First, we review the performance of five factors. The table below, from the CLS Reference Guide (link), shows the performance of the five factors we follow, plus the average of the five, since 1996. The chart shows each factor in relative terms, displaying whether they outperformed or underperformed the broad global equity benchmarks.

In short, 2018 was another winning year for factor investing. Three out of the five factors outperformed, and the average bested the broad market by more than 1%. Small-cap and value stocks were the two factors that did not work last year.

It's important to note that factor investing has historically done

## Excess Returns vs. MSCI ACWI



Source: Morningstar Direct as of 12/31/2018. MSCI All Country World Factor Indexes relative to the MSCI All Country World Index (Gross Returns).

## Spotlight on CLS's "Be Smart" Investment Theme (Cont.)

especially well in down market years. Even though the average gain wasn't as typically strong in 2018, factor investing did provide support in yet another difficult year.

So, if factor investing did well in general, did CLS pick the right smart beta ETFs?

The tables below show CLS's security selection last year (this time the hat tip goes to CLS analyst Michael Hadden).

The first shows how CLS did picking ETFs overall last year. The one-year, asset-weighted average peer group rank for our

ETF holdings was in the top 36%. That's good. That includes all the ETFs we own, whether they are conventionally market-cap weighted, actively managed, or smart beta.

The excess return (how much the ETF's return exceeded the peer group average) on an asset-weighted basis was +1.32%. A good year.

Next, Michael isolated just our smart beta holdings. The data for smart beta ETFs shows that the one-year, asset-weighted average peer group rank for our ETF holdings was in the top 31%.

The excess return for the smart beta ETFs that we owned on an asset-weighted basis was +2.44%. That's an excellent year.

For the sake of balance, it should be noted that the factor we liked most last year was value – which did not outperform the broad market. Also, one of our top value smart beta ETF holdings underperformed its peer group. Nonetheless, factor investing worked yet again in a down market, and in our opinion CLS, in general, picked the right smart beta funds.

CLS ETF Holdings Peer Group Percentile Ranks			
	3 Mo	1 Yr	3 Yr
Equal Weight	43.30	40.27	37.20
Asset Weight	41.40	36.16	33.84
Median	39.00	37.00	33.00

Source: Morningstar as of 12/31/2018

CLS ETF Smart Beta Holdings Peer Group Percentile Ranks			
	3 Mo	1 Yr	3 Yr
Equal Weight	42.96	40.31	35.48
Asset Weight	38.49	30.87	27.51
Median	39.00	38.00	32.50

Source: Morningstar as of 12/31/2018

CLS ETF Holdings Excess Returns			
	3 Mo	1 Yr	3 Yr
Equal Weight	0.55	1.22	1.10
Asset Weight	0.59	1.32	1.01
Median	0.40	0.89	1.00

Source: Morningstar as of 12/31/2018

CLS ETF Smart Beta Holdings Excess Returns			
	3 Mo	1 Yr	3 Yr
Equal Weight	0.62	1.36	1.24
Asset Weight	1.16	2.44	1.85
Median	0.52	1.16	1.19

Source: Morningstar as of 12/31/2018

## Changes to Performance Report

This month, we changed how the Weekly Three presents financial market performance in two notable ways.

First, instead of showing the shorter-term numbers in the first columns and the longer-term numbers in the latter columns, we have reversed that.

Since investors are investing for long-term goals, and since various studies show the more investors focus on shorter-term numbers the worse they do as investors, we believe this important change should help investors stay balanced and stay

the course given the placement of the longer-term returns.

I recently spent some time at UCLA completing the WisdomTree Behavioral Sciences Executive Education Program where I received a certificate in behavioral finance studies. One important takeaway from the program was regarding information design. In other words, how information is presented can have an important impact on investor behavior.

Second, instead of showing stock market returns in the first rows, followed by bonds and cash, we will also reverse that to emphasize that long-term investors are investing

for longer-term performance. The goal of investing isn't to "beat the market" but to "beat the bank" (i.e., have higher returns than cash) and to beat inflation over time. Presenting information in this fashion should help investors maintain the right perspective.

### Thank You

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

Stay balanced.

Rusty Vanneman, CFA, CMT  
CLS Investments  
President, Chief Investment Officer  
Rusty.Vanneman@CLSIInvest.com  
402-896-7641



### **Rusty Vanneman, CFA, CMT** *President, Chief Investment Officer*

*Rusty Vanneman is responsible for leading CLS's Portfolio Management Team and overseeing all investment operations at CLS, including investment philosophy, process, 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 for several of CLS's proprietary mutual funds. In 2018, Mr. Vanneman took on the role of President of CLS, in addition to his position as CIO.*

*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 is 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.\**

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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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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