DIRECTIONS

A quarterly publication of CLS Investments

SPRING 2019

This quarter, we are highlighting what we believe are the most insightful, inspirational, and overall beneficial articles from the CLS Weekly 3, our weekly market commentary. You'll read eye-opening stats about the market and the economic cycle. Plus, you'll discover the true value of financial advice as well as how to avoid a common investing pitfall.

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Learn more about Rusty here.

CLS INVESTMENTS

This year has seen an incredible start for the U.S. stock market.

For a frame of reference, the long-term average return for the stock market is 8-10% per year (the average depends on how far back one looks at the historical record), and we've already seen that in the first few months of 2019. The one-year total return number is still below the long-term average, but it's still positive and improving. The 3-year, 5-year, and 10-year numbers for the U.S. stock market are all well above the long-term average.

Given this strong start, we believe it would be reasonable to expect the stock market to temporarily pause or even to take a step back. The markets are cyclical, so just as it would be reasonable to expect the markets to move higher after a rough stretch of performance (like they did at the end of 2018), it would also be reasonable to see the rate of positive gains slow after a strong start.

But there is a key difference between periods in the market after prices moved sharply higher and when they have moved lower. After they have moved higher, we believe it's still smart to expect them to keep moving higher! It's important to remember that the markets have an overwhelming tendency to go up over time, especially over long time periods. For instance, since 1926, the U.S. stock market is positive approximately 75% of the time when looking at trailing 12-month returns. That percentage only goes higher as the investment holding period gets longer.

Even if we get a temporary setback (or two), it would still seem that investors may expect positive performance from the U.S. stock market. There are so many reasons. First, the market generally does well in the third year of a presidential election cycle as fiscal and monetary conditions are market-friendly, which we are already seeing given the recent actions from the Federal Reserve (Fed) and the White House. The second reason is that the Fed has become much more stock market friendly. As the old saying goes, "Don't Fight the Fed." Third, the stock market has historically seen strong years after a down year (like 2018). Finally, though economic growth appears to be slowing, it is still growing, and there does not appear to be a recession in the near term. Those are all positives.

Looking at the longer term, let's say over the next ten years or so, we may expect returns in the U.S. stock market to be below average, albeit still positive and still better than the "bank" (i.e., cash). The simple reason is that the stock market is not on sale, which again is reasonable since valuations (i.e., how much one pays for a dollar of revenues or earnings) are now above average. Valuations tend to be the leading indicator of future long-term returns.

Fun Bear Market Stats

from Senior Portfolio Manager, Kostya Etus, CFA

"I know you want this to be over. I'm right here. I will be right here. But you don't give up. You hear me? As long as you can still grab a breath, you fight. You breathe. Keep breathing."

-Hugh Glass, The Revenant (2015)

Let's face it, bear markets are not fun. But stats are! Well, they are for some people. I will do my best to make them fun for everyone! We took a look at daily S&P 500 returns going back to 1927 and identified every period with a drop of more than 20% from peak to trough (bear market) separated by increases of more than 20% (bull markets). Here are some of our findings:

1. How many bear markets have there been?

There have been 12. This would suggest that over the 90-year evaluation period, a bear market happens about every 7.5 years on average. Obviously, since each bear market is followed by a bull, we are currently in the midst of our thirteenth bull market. Since we are about 10 years into the current bull market, we may be due for a bear market sooner than later. With that said, the longest we have gone without a bear market is 12 years, between 1988 and 2000.

2. How long does the average bear market last?

The average bear market lasts just over 22 months. But the average bull market lasts over five years, more than double the length. Trying to time the market may be difficult, and given the market's tendency to favor bull runs, it is better to stay invested long term while staying balanced and diversified to prepare yourself for the eventual bear market.

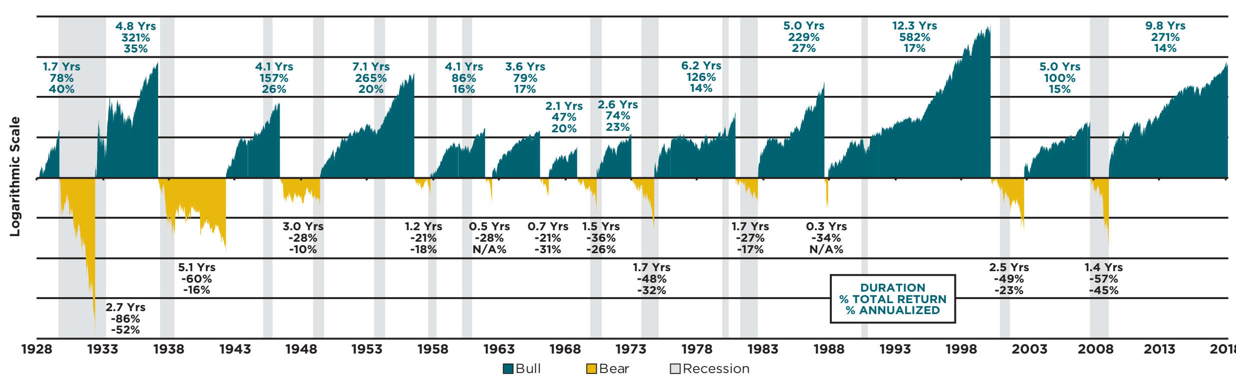
3. What is the average loss during a bear market?

The average loss is 41% cumulative (-27% annualized). On the other hand, the average bull market results in a 188% cumulative return (22% annualized). The reason the annualized number for bull markets is lower is that markets generally move up more slowly than they drop. But the cumulative return differences show that the up periods are overwhelmingly longer and stronger than the down periods. Lastly, the current bull market return of 271% seems a bit long in the tooth compared to historic averages.

4. How many years has the S&P 500 Index spent in a bear market?

Bear markets have consumed about 22 years of the S&P 500's history. That means that 68 years (roughly

S&P 500 Index Bull and Bear Markets



Source: S&P 500 price data is from Morningstar, Recession data is from nber.org, 1/3/1928 – 12/31/2018

75% of the time) have been spent in a bull market. This goes to show, yet again, that the market is more than just a coin flip, but you need to be invested for the long run to realize that benefit.

5. Have bear markets changed over time?

They have become shorter since the World War II era. The average length of a bear market post-1950 is only 15 months. However, average performance per bear market has not meaningfully changed. Meanwhile, the average bull market has increased in length by about six months during this more recent period.

6. Does a bear market always happen with an economic recession?

There have been 14 recessions over this time period, so off the bat we know that they don't always go hand in hand. Nine of the recessions happened in conjunction with a bear market (about 65% of the time). Sometimes a recession occurs at the beginning of a bear market and sometimes at the end, so we get a chicken-or-egg situation, wondering which one caused the other. But that means five recessions happened in the middle of bull markets, and three bear markets did not accompany a recession. Thus, just because we have one doesn't mean we will get the other.

The chart on the previous page shows all of the bull and bear markets and recessions since 1927. The main takeaway is that while bear markets and recessions do happen regularly, they are not as scary as they sound when you look at the big picture. They are relatively short-lived compared to bull markets and are, in fact, largely overshadowed. Staying out of the markets because of fear may lead you to miss out on those long and strong bulls at a detriment to your retirement savings. Our advice, as always, is to stay balanced, diversified, and invested for the long term.

The Value of Financial Advice

from Jeovany Zelaya, Client Portfolio Manager

The times have changed. We live in a world where anyone can access anything with the push of a button.

Check the stock price of Berkshire Hathaway. Done.

Open a brokerage account. Check.

You can even browse the internet for financial advice.

So, you might be asking yourself, does a financial advisor bring any value to the table? Is he or she worth the cost?

The multiple research reports I highlight below show the answer is an emphatic "Yes!"

Vanguard, the second largest asset management firm with $5.3 trillion in assets under management, wrote a paper titled, "Putting a Value on Your Value[1]," which showed that a competent financial advisor can add about 3% in net returns. The paper's authors write that they don't expect a potential 3% improvement on an annual basis; instead, the benefits of working with a financial advisor will be "lumpy." Here are the authors:

> *"The most significant opportunities to add value do not present themselves consistently, but intermittently over the years, and often during periods of either market duress or euphoria. These opportunities can pique an investor's fear or greed, tempting him or her to abandon a well-thought-out investment plan. In such circumstances, the advisor may have the opportunity to add tens of percentage points of value add, rather than mere basis points, and may more than offset years of advisory fees."*

The chart below shows the breakdown of this 3% value-add:

Morningstar also wrote a white paper quantifying the value of a financial advisor. The paper is titled, "Alpha, Beta and Now… Gamma[2]." The authors of the article define gamma as "the measurement of additional expected retirement income achieved by an individual investor making intelligent financial-planning decisions." These intelligent financial planning decisions are actions

Advisor Behavior	Potential Value Added
Helping investors stay disciplined and providing guidance to do so	1.50%
Placing assets in tax-efficient or tax-managed investments	up to 0.75%
Providing guidance on asset withdrawal order	up to 0.70%
Utilizing low-cost funds	0.45%
Rebalancing the portfolio	0.35%
Allocating assets among broadly diversified investments	Potential slight value add, depending on investor's time horizon, risk tolerance, and financial goals
Providing guidance on total return versus income-only investing	Potential slight value add, depending on investor's desired level of spending and portfolio composition

Source: Vanguard - Putting a Value on your Value: Quantifying Vanguard Advisor's Alpha and services provided by the financial advisor, which can add up to 1.82% per year.

AON Hewitt and Financial Engines conducted a study between 2006 and 2008 and found that participants in 401(k) plans who received advice and guidance about target-date funds or the use of managed accounts outperformed their peers who didn't receive advice by 1.86% per year, net of fees. They conducted a similar study between 2009 and 2010 and found that during times of uncertainty, those participants who received help outperformed their peers who did not by 2.92% per year, net of fees[3].

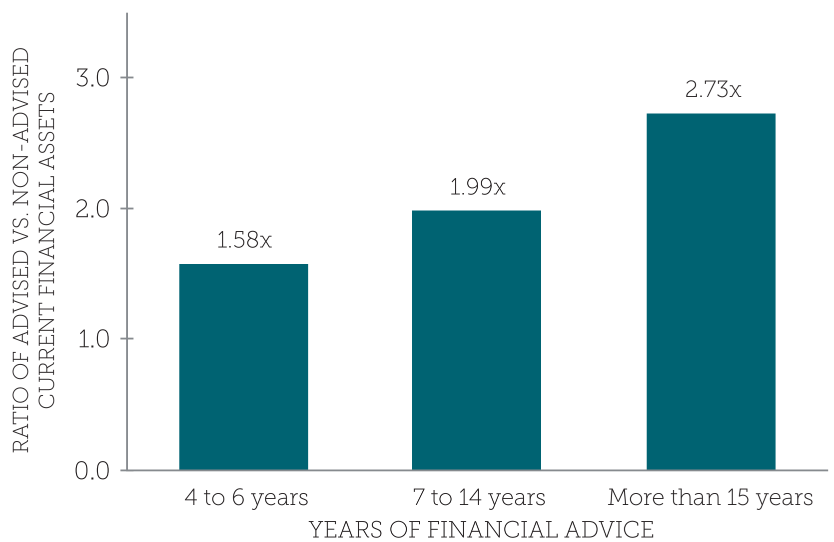
These studies suggest that one of the most important and valuable actions a financial advisor can take is to help an investor stay disciplined and focused on their long-term goals, especially during times of extreme market fear and greed.

The Investment Funds Institute of Canada explained in its "Value of Advice Report[4]" that partnering with a financial advisor, "for periods of four to six years, seven to 14 years, and 15 or more years, contributes positively and significantly to the level of assets... The impact on the level of assets is more pronounced the longer the tenure of the advice relationship." This means that the value-add provided by a financial advisor is compounded over time.

The chart below shows financial assets for households that received financial advice over different time frames, as a multiple of the financial assets of households that did not receive advice.

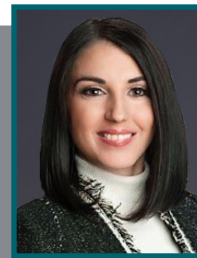
Does the financial advisor bring value to an investor relationship? Absolutely!

Prudent financial advice is like working out. You might not notice an improvement after your first day; but over time, the results can add up.



Source: The Investment Funds Institute of Canada as of July 2012

[1] *Source: Vanguard – "Putting a Value on Your Value: Quantifying Vanguard Advisor's Alpha"*
[2] *Source: Morningstar – "Alpha, Beta, and Now...Gamma"*
[3] *Source: The Laws of Wealth: Psychology and The Secret to Investing Success by Dr. Daniel Crosby*
[4] *Source: The Investment Funds Institute of Canada, The Value of Advice Report 2012*



It's All About the Economic Cycle

from Portfolio Manager Shana Sissel, CAIA

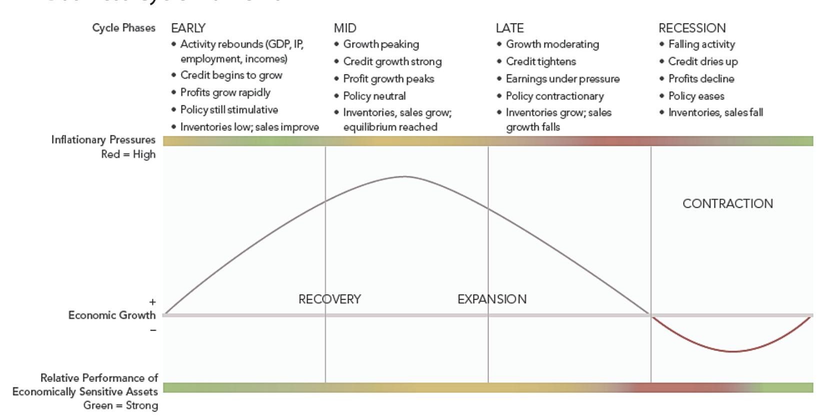
We spend a lot of time and energy as investors trying to understand what is going on in the stock and bond markets from day to day. Sometimes we forget to take a step back and look at the big picture. The big picture, of course, is the economic cycle, which turns out to be a reliable and predictable 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

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.

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 on the previous page.

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.

A Day Late and $2,000 Short

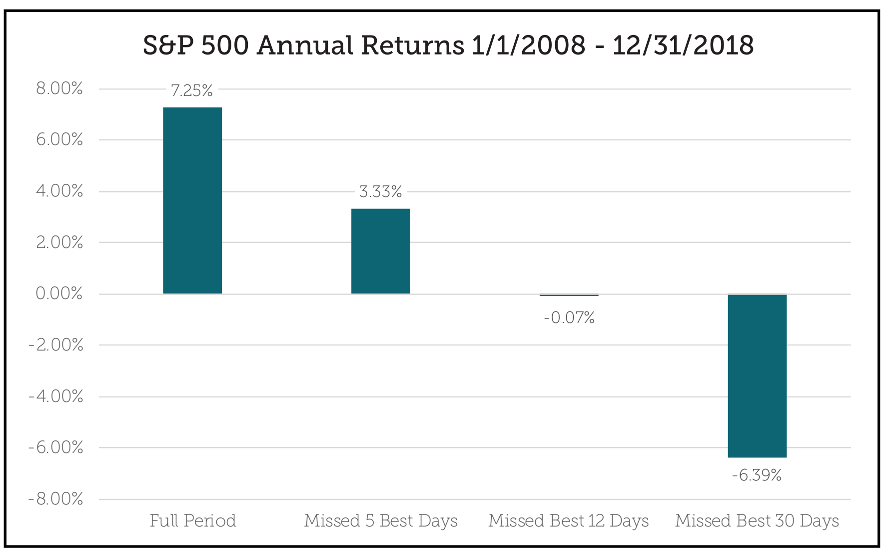
from Michael Hadden, Investment Research Analyst

If you were out of the market for any length of time between 2008 and 2018, you would have missed significant returns. In fact, if you missed the best performing day over that 11-year period, your annualized return would have dropped from 7.25% to only 6.19%. In percentage terms, this may not seem like a dramatic difference, but if you had invested $10,000 on January 1, 2008, and didn't touch it, you would have had $21,600 by December 31, 2018. Alternatively, if you got market jitters and pulled out your money in October 2008, and had not been invested for one day – October 13, 2008 – even if you reinvested the very next day, holding it through the end of 2018, you would have ended with $19,360. One day sitting out of the market would have cost you more than $2,200.

Now, you may say that it's unlikely that you would have missed out, specifically, on the best market return day in 11 years. This may be true, but during the eight days before October 13, 2008, the S&P 500 was down more than 22%. It's not far-fetched to assume that investors pulled their money out of the markets at that time.

This is a specific example of a much broader problem: trying to time the markets. Countless famous investors have said that they have never met someone who could do it successfully over the long term. It doesn't take long to see returns diminish. The chart above shows annualized returns over the 11-year period with examples of missed returns on a few of the best days. It only takes missing out on the five best days to cut returns by more than 50%. Missing the best 12 days reduces returns from more than 7% per year to 0%. That means you could have been invested 99.6% of the time and yet, with some poor timing, finished the period right where you started.

It certainly would take some horribly bad luck (or judgement) to miss out on only the best days, but the results are still astonishing. The example isn't extraordinary either. Often, the best market return days closely follow the worst, increasing the likelihood that investors will try moving out of the market at the worst possible time.



We believe there is no bad time to be invested in the market when you're investing for the long term. The table below from the CLS Reference Guide depicts this well. During more than 80 years of market history, investors have had a better chance for positive returns every day. This only gets more and more likely the longer an investor is in the market.

This can often be forgotten in times of volatility and extended periods of negative returns. These periods can make it hard not to fear the negative returns will continue. However, the next time you find yourself (or a client) wanting to get out of the market, just remember how only a little time out can make all the difference.

S&P 500 Percent of Positive Return (Since 1927)											
Frequency Return	Daily	Weekly	Monthly	Quarterly	6-Mo	Yearly	3-Year	5-Year	10-Year	20-Year	30-Year
% Positive	52%	56%	59%	63%	66%	68%	77%	78%	88%	96%	100%

Source: Bloomberg data from 12/30/1927 to 11/30/2018

2019 Investment Themes

from CLS President & Chief Investment Officer, Rusty Vanneman, CFA

At CLS, we manage various investment strategies which differ depending on investor Risk Budgets, investment objectives, and other considerations. What connects each of the strategies, however, are the CLS Investment Themes. These themes are the common threads between all the portfolios. They are specific enough to articulate what makes CLS portfolios different than others, but they are broad enough for each portfolio manager at CLS to express her or his particular views. These themes, which are determined by the CLS Investment Committee, may be held for years or for months depending on market conditions.

BE ACTIVE

There has been much ado about the move from "active investment management to passive investment management." The real story, however, is the move from mutual funds to exchange traded funds (ETFs). This secular trend has a long way to go, and in large part due to lower costs for investors. A bigger reason regretfully, is that many investors are chasing recent performance. In general, passive strategies have indeed outperformed active strategies in recent years net of fees, but that relative performance should dissipate as the market environment changes. While higher costs and cash levels will still negatively impact active managers (though not as much as in years past), we believe active management will benefit when value stocks, small-cap stocks, and international stocks start to outperform domestic large-cap growth stocks.

BE SMART (BETA)

Smart Beta ETFs are rules-based ETFs whose holdings aim to intentionally diverge from a broad, market-cap-weighted index. At CLS, we emphasize five equity factors and two fixed income factors when we analyze portfolios and select ETFs. Moving forward, while recognizing that all investment styles are cyclical, we believe this theme will provide a durable edge over the long haul. Historically speaking, the average equity factor has added 2% of value over the market per year, and 4% per year when the stock market is down.

Equity Factors: Value, Quality, Size, Minimum Volatility, and Momentum

Fixed Income Factors: Credit and Duration

BE CREATIVE (WHEN DIVERSIFYING)

With interest rates at low levels compared to historical averages, this theme refers to the need to continue diversifying equity volatility to manage overall portfolio risk. CLS achieves this by being creative in using other asset classes to diversify risk, including the judicious use of alternative asset class strategies and commodities. Alternatives may enhance risk-adjusted performance in a variety of ways, depending on the strategy, while real assets such as commodities may help performance particularly when inflation or inflation expectations are rising.

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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. 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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