CLS's WEEKLY 3

What You Need To Know About the Markets

MAY 7, 2019

1. Berkshire Hathaway shareholders meeting, a whirlwind weekend
2. Wisdom from Warren Buffett on building a competitive advantage
3. What to consider when investing in an IPO

Market Performance (as of 5/3/2019)

Fixed Income	10-YEAR	5-YEAR	3-YEAR	1-YEAR	YTD	QTD	LAST WEEK
Cash Equivalent[1]	+0.42%	+0.77%	+1.24%	+2.17%	+0.82%	+0.23%	+0.05%
U.S. Investment Grade Bonds[2]	+3.73%	+2.50%	+1.86%	+5.33%	+2.90%	-0.04%	-0.06%
Equities	**10-YEAR**	**5-YEAR**	**3-YEAR**	**1-YEAR**	**YTD**	**QTD**	**LAST WEEK**
Global Equity Market[3]	+11.30%	+6.97%	+11.65%	+5.77%	+15.85%	+3.35%	+0.27%
Total U.S. Market[4]	+15.34%	+11.37%	+14.95%	+13.82%	+18.83%	+4.15%	+0.32%
Domestic Large-Cap Equity[5]	+15.13%	+11.92%	+15.41%	+14.85%	+17.90%	+4.17%	+0.22%
Domestic Small-Cap Equity[6]	+14.93%	+8.46%	+12.86%	+7.26%	+20.94%	+4.71%	+1.05%
International Equity[7]	+8.10%	+2.98%	+8.70%	-2.13%	+13.01%	+2.55%	+0.28%
Developed International Equity[8]	+8.08%	+2.53%	+7.72%	-2.31%	+13.36%	+2.62%	+0.21%
Emerging Market Equity[9]	+8.26%	+4.49%	+12.22%	-1.52%	+11.97%	+2.34%	+0.49%
Diversifiers	**10-YEAR**	**5-YEAR**	**3-YEAR**	**1-YEAR**	**YTD**	**QTD**	**LAST WEEK**
Diversified Alternatives[10]	+4.18%	+0.52%	+1.58%	+1.33%	+3.63%	+0.65%	+0.07%
Commodity[11]	-3.06%	-9.44%	-0.20%	-8.94%	+4.93%	-1.31%	-1.10%

[1]Morningstar Cash Index [2]Bloomberg Barclays Capital U.S. Aggregate Bond Index [3]Morningstar GblMkt Large-Mid Index [4]Morningstar U.S. Market Index [5]Morningstar U.S. Large Cap Index [6]Morningstar U.S. Small Cap Index [7]Morningstar Gbl xU.S. Large-Mid Index [8]Morningstar DM xUS Large-Mid Index [9]Morningstar EM Large-Mid Index [10]Morningstar Diversd Alt Index [11]Bloomberg Commodity Index

Week in Review

It was a pretty quiet week in the markets with both U.S. and international markets up less than half a percent. Small-cap stocks led for the week, up just over 1%, and value stocks outperformed growth stocks.

Real estate also had a decent week. The sector outperformed equity markets but was still up less than 1%. Bonds were slightly negative as rates rose marginally after the U.S. Federal Reserve's (Fed) press conference included no hint of a rate cut later this year.

The big laggard for the week was commodities as oil prices fell by more than 1%. Grains also continued their slide as prices declined by more than 1%, too.

All Aboard for Omaha

By Michael Hadden, Investment Research Analyst

This past weekend, an estimated 30,000 investors descended on Omaha for the annual Berkshire Hathaway shareholder meeting. One of the neat things about being located in Omaha is the amount of industry professionals that we get the chance to meet with during the week leading up to this international event.

Our meetings kicked off with Morningstar. We spoke with analyst Greg Warren, who covers Berkshire Hathaway and a group of several asset managers. Mr. Warren is also one of the few people who is allowed to directly ask Warren Buffett questions at the annual meeting. It was very interesting getting to discuss the asset management industry and Mr. Warren's experience with Berkshire. He noted that the asset management industry in general is under pressure due to fee compression. At the same time, firms are trading at some of the most attractive valuations we have seen in the space. Firms that can differentiate themselves and expand their business offerings could set up for favorable forward outlooks.

On Thursday night, several members of our team attended the Value Investing Dinner put on by the Nebraska CFA society. The keynote speakers were Beini Zhou and Robert Hagstrom, whose topic was "What Would Warren Buy in Asia?" Both investors took a different approach to gaining exposure to Asian countries. Zhou directly invests in China and believes many of the large growth companies are very attractive valuations. Hagstrom takes another approach by investing in large multinationals that have business exposure to Asia. Both were highly bullish on the region due to demographics and economic growth. Of course, as heavy international and emerging market investors, it was encouraging to hear others see the same trends that we do.

Friday brought another day of meetings, beginning with Royce Funds. As a specialist in small-caps, Royce's perspective on this less-talked-about space is always extremely interesting. Royce made the point that now may be the time for small-caps as they often outperform other areas of the market in low-return environments. As we have often noted, we expect below-average forward returns in the equity market, and Royce believes that environment is favorable for small-cap outperformance.

Our final meeting was with Davis Funds, one of the few active managers that has issued

Michael Hadden
Investment Research Analyst

Michael Hadden is involved in all aspects of investment research, including performance reporting and Global Investment Performance Standards (GIPS) reporting.

Prior to joining CLS in 2017, Mr. Hadden held internships with Ameritas and Platte Valley Bank, while pursuing his degree. He graduated with honors and high distinction from the University of Nebraska at Lincoln, with a Bachelor of Science degree in Finance and Accounting. He is currently working toward his Chartered Financial Analyst (CFA) designation.

Did you know? Michael started investing in middle school.

ETFs on the equity side. Getting to meet with portfolio manager Danton Goei was incredibly insightful, as he serves as the manager on the international funds. He, much like Zhou, does boots-on-the-ground research and sees many tremendous opportunities for international companies to grow at substantial rates in the future. All in all, it was a great few days meeting with industry professionals, discussing current markets, and attractive opportunities. The Berkshire weekend may be an anomaly in that so many people are in town at once, but we regularly meet with industry greats to gather new ideas and challenge our own house views. CLS has built a reputation in the ETF strategist space even with its rather unusual Midwestern U.S. headquarters. People often think of New York City or other large financial hubs as the mecca of investing, but for one weekend a year, many of the industry's best make Omaha home.

Protecting Your Investment Castle

By Dustin Dorhout, Junior Investment Analyst

"We think of every business as an economic castle. And castles are subject to marauders. And in capitalism, with any castle . . . you have to expect . . . that millions of people out there . . . are thinking about ways to take your castle away. Then the question is, 'What kind of moat do you have around that castle that protects it?'"

–Warren Buffett, "Outstanding Investor Digest," 2000.

For decades, as illustrated by the timeless Berkshire Hathaway shareholder letters, annual conference Q&A, and interviews, Warren Buffett has asserted that the single most important factor in identifying a great investment with the potential to outperform over the long term is to ensure it has a "durable moat" or competitive advantage. This idea is held by many of the most prominent value investors.

So, what exactly makes a competitive advantage? Is there a model framework that exists to execute on the concept? Luckily for us, there is.

Michael Porter, a world-renowned Harvard professor known for his theories in economics and business strategy, wrote a book titled, "Competitive Strategy: Techniques for Analyzing Industries and Competitors," in which he models out how to analyze a company's industry structure and corporate strategy. Porter defines competitive advantage as "a function of either providing comparable buyer value more efficiently than competitors, which is low cost, or performing activities at comparable costs, but in unique ways that create more buyer value than competitors; and hence, command a premium price, which is differentiation." Either strategy can help a company maintain an advantage over its competitors, allowing a wider potential profit margin.

Porter illustrates five forces that are key to assessing competitiveness:

Competition in the industry:

- How many competitors exist in the industry, and what is their ability to undercut and take share from a company? If competition is fierce, and competitors can offer equivalently valued products, then the company has a lower competitive advantage because customers will simply seek out a competitor.

Potential of new entrants into the industry:

- What are the costs and rates of entry to the industry, and how will the existing firm react to an incoming threat? If the costs to entry are low for a competitor, then the moat narrows for the existing firm.

Power of suppliers:

- How much leverage does a supplier hold to increase the price of inputs for the firm? The main factors to identify here are the quantity of suppliers, uniqueness of the input, and the cost the company would experience if it needed to switch.

Power of customers:

- What is the customer's ability to drive down current or future prices of a company's products? Key points to analyze are the quantity of customers, the significance of each customer, and the cost for obtaining new customers. Low customer quantity and high significance of each to the bottom line gives them the power to reduce prices.

Threat of substitute products:

- Does the marketplace currently or potentially have goods or services that could replace the firm's product mix? If a company has a differentiated product that is difficult or illegal to mimic, it will have more power and thus an increased competitive and sustainable advantage.

If companies can answer positively to the questions above, they will have a sustainable competitive advantage and may therefore earn more profits. For companies, this analysis offers a means to consistently generate returns in excess of the cost of capital. For investors, it provides a forecasting tool to determine if what you're buying today has the ability to produce positive results for years to come.

At CLS, we conduct fundamental analyses at the industry and company level in order to determine the potential value creation. We believe that having a thorough understanding of an industry, including how the various firms interact with one another and the stability and potential of growth into the future, is key to the investment and risk-mitigation process.

CLS conducts further valuation analyses on the investments we make to ensure the market has not priced in the competitive advantages of the investments that we find attractive at the fundamental, industry level.

As an investment firm focused on risk, understanding an investment's competitive advantage is of utmost importance. We strive to continually improve and execute on the best processes to ensure the best outcome for our clients.

Dustin Dorhout

Junior Investment Research Analyst

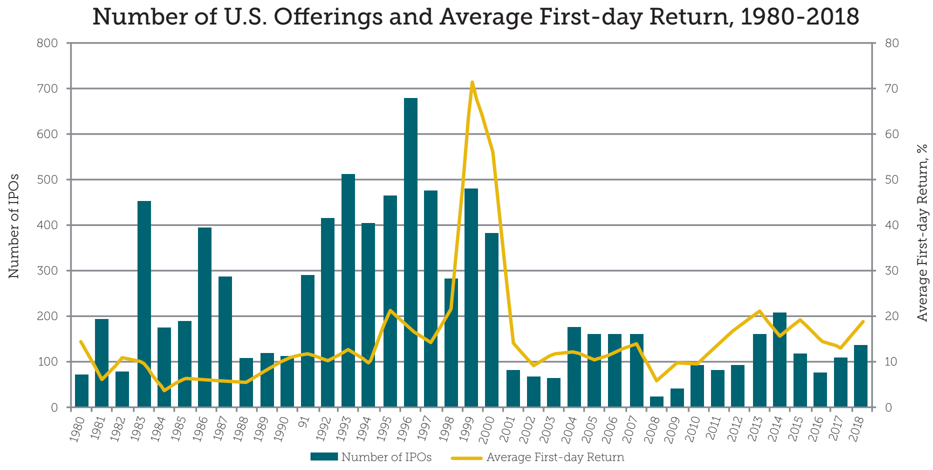
Dustin Dorhout joined CLS's Portfolio Management Team in 2018 as a Junior Investment Research Analyst. His research focuses primarily on domestic equity.

Prior to starting his career with CLS, Mr. Dorhout developed a strong background in the financial industry, holding internships at Orion, First Data Corporation, and Spectrum Financial Services. In these roles, he assisted in product management, data analysis, and evaluating investment opportunities.

Mr. Dorhout attended Creighton University's Heider College of Business where he double-majored in Finance-Analysis & Economics. He graduated with a Bachelor of Science degree in Business Administration. Mr. Dorhout is currently working toward his Chartered Financial Analyst (CFA) designation.

The IPO Soap Opera

By Jeovany Zelaya, Client Portfolio Manager



Source: Jay R. Ritter, Cordell Professor of Finance, University of Florida

Growing up in a Spanish household, I saw my fair share of Telenovelas. Telenovelas are Spanish soap operas. They're full of moments of joy, excitement, despair, and tons of drama. Today, in my position as a client portfolio manager watching the financial markets, I'm often reminded of these television melodramas – particularly when the markets are worked up about the launch of an IPO!

IPO stands for initial public offering. This type of offering happens when a formerly private company issues common stock to the public for the first time. According to Nasdaq, as of March 31, 2019, there have been 50 individual company IPOs so far this year. Some, including Pinterest, Zoom Video Communications, and Lyft, have garnered a lot of media attention.

The rare story of investing in an IPO and becoming an instant millionaire is exciting. When it happens, it attracts our attention and makes us ponder if investing in an IPO is right for us. But is it? The answer fully depends on your personal financial situation, but there are a few things to keep in mind if you're thinking about it.

Jay Ritter, professor of finance at the University of Florida, has done extensive research on IPOs. Below are some of his findings:

- From 1980 to 2018, there have been 8,497 IPOs.
- The average one-day return is about 18%.
- About 70% of companies have had a positive return on their IPO.
- 40% of the companies that have done an IPO have had negative earnings.
- The average three-year, buy-and-hold return is 22%.

An important item to address is that a large portion of an IPO's three-year return comes from its initial, one-day pop.

The chart above shows the number of IPOs and first-day returns from 1980 to 2018. The years 1999 and 2000 were anomalies for one-day returns. We all remember (or have heard of) the dot-com bubble. Companies such as AskJeeves.com had an IPO on July 1, 1999, and gained 364% its first day. Where's the company now? Google it.

If you do buy an IPO, how long are you going to hold the stock? IPOs have underperformed other firms of the same size (market-cap) by an average of more than 3% per year during the five years after issuing, not including the first day's return.

Percentage Returns on IPOs from 1980-2017 During the First Five Years After Issuing

	First six months	Second six months	First year	Second year	Third year	Fourth year	Fifth year	Geometric mean years 1-5
IPO firms	6.6%	0.8%	7.9%	6.6%	12.1%	19.3%	10.8%	11.2%
Size-matched	5.7%	6.0%	12.1%	14.5%	15.4%	16.5%	13.2%	14.3%
Difference	0.9%	-5.2%	-4.2%	-7.9%	-3.3%	2.8%	-2.4%	-3.1%

Source: Jay R. Ritter, Cordell Professor of Finance, University of Florida

Of course, investing in an IPO means that you're investing in one company. A huge question you need to ask yourself is how much pain are you willing to tolerate? Individual companies can suffer drawdowns that exceed 70% (e.g., Amazon and Apple), or worse, they can go bankrupt. I believe it would be wise to have the majority of one's money in a diversified portfolio in order to mitigate this concentration risk of investing in just one company.

If this is too much drama for you, then I recommend you focus on increasing and maxing out your retirement accounts. You can watch the next season of IPOs from the comfort of your living room.

Jeovany Zelaya
Client Portfolio Manager

Jeovany Zelaya is a Client Portfolio Manager at CLS Investments. He is responsible for communicating CLS's investment philosophy, process, strategies, and performance to external clients and prospects.

Prior to beginning his current role, Mr. Zelaya served as an Internal Wholesaler of Qualified Plans starting in 2016. His background in sales gives him an edge in providing ongoing updates, analysis, and support to CLS's Sales Team.

Mr. Zelaya holds a Master of Business Administration degree from the University of Nebraska at Omaha. He received his Bachelor of Business Administration degree from the University of Houston and is currently pursuing a Bachelor of Science in Accounting degree from Auburn University. Mr. Zelaya holds his FINRA Series 65 license and is currently a Level III candidate in the Chartered Financial Analyst (CFA) Program.

Did you know? Jeovany grew up in El Salvador.

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 Barclay's Capital U.S. Aggregate Bond® Index measures the performance of the total United States investment-grade bond market. 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 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. 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 volatility of the indexes may be materially different from the individual performance attained by a specific investor. In addition, portfolio holdings of investors may differ significantly from the securities that comprise the indexes. You cannot invest directly in an index.

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