CLS's

WEEKLY 3

What You Need to Know About the Markets

JUNE 4, 2019

CLS INVESTMENTS

1 How should investors react to recent trade developments?

2 CLS is overweight emerging markets and value stocks.

3 How to measure portfolio performance?

Month in Review

May was a tough month for the stock market. Each week, it went backward in price. With that said; it was a good month for bonds and a particularly strong month for long-term Treasuries.

Keep in mind that May is typically a relatively soft month, and it should have been somewhat expected to see a market pullback after the year's particularly strong first four months. It's normal to see market pullbacks of 5-10%. In fact, since 1928, the stock market has averaged three to four dips of 5% or more per year.

Even after May's dismal performance, all major stock markets are sporting gains for 2019, many in the double digits.

Of course, there were other catalysts for the losses besides the market's need for a breather. The leading reason was the increased concern over tariffs and their impact on global economic growth. (We'll discuss this subject in more detail later in this report, but the condensed takeaway is that investors should expect more market volatility in the months ahead.)

CLS portfolios also lost ground last month. Sector positioning generally helped, while regional international exposure did not. Fixed income exposure limited losses. For the year, however, our tilts toward value stocks and emerging market equities have hindered performance, at least versus the over-all market whose performance has been driven by large cap U.S. tech stocks. The average CLS portfolio has nearly 20% more in value stocks than growth stocks. (More on this topic later, too.)

We continue to expect typical summer volatility in the markets, although that's likely to be amplified due to the aforementioned trade rhetoric. We do expect the stock market to eventually move higher near year-end, and we also expect longer-term interest rates to rise.

For the month of May, the overall global stock market lost nearly 6%, but it is still up over 9% for the year. The U.S. stock market lost more than 6% in May, but it is higher by more than 11% for the year. Smaller companies lost nearly 8% (up more than 10% year-to-date), and larger companies lost a bit more than 6% (also up over 10% year-to-date).

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.*

Did you know? Rusty had a brief stint as a cowboy near the town of Valentine in Cherry County, Nebraska.

Developed international equity markets lost nearly 5% in May but remain up over 8% so far this year. Emerging markets lagged (there was a dispersion of returns from China's 10% loss to actual gains in various countries), falling less than 7%. For the month, emerging markets lost over 6%. For the year, emerging markets are up over 4%.

The bond market was up nearly 2% in May and is now higher by almost 5% for the year. The 10-year U.S. Treasury yield ended May at 2.14%, which is 0.6% off its 2019 high. The three-month U.S. Treasury yield ended the month at 2.38%. It is not common to see short-term interest rates higher than longer-term rates, which is what we're seeing now. This is deemed an "inverted" yield curve, and it typically suggests lower economic growth is ahead but not necessarily immediate.

Real assets also had losses last month. Commodities lost almost 6% in May (still up by nearly 7% year-to-date), while global real estate investment trusts (REITs) lost just less than 1% in May and are now higher by over 12% year-to-date.

Market Performance *(as of 5/31/2019)*

Fixed Income	10-YEAR	5-YEAR	3-YEAR	1-YEAR	YTD	QTD	LAST WEEK
Cash Equivalent[1]	+0.44%	+0.81%	+1.31%	+2.23%	+1.01%	+0.42%	+0.04%
U.S. Investment Grade Bonds[2]	+3.83%	+2.70%	+2.50%	+6.40%	+4.80%	+1.80%	+0.92%
Equities	**10-YEAR**	**5-YEAR**	**3-YEAR**	**1-YEAR**	**YTD**	**QTD**	**LAST WEEK**
Global Equity Market[3]	+9.60%	+5.30%	+9.07%	-1.33%	+9.09%	-2.68%	-1.85%
Total U.S. Market[4]	+14.02%	+9.38%	+11.66%	+3.01%	+11.10%	-2.62%	-2.56%
Domestic Large-Cap Equity[5]	+13.80%	+9.90%	+12.22%	+4.16%	+10.44%	-2.43%	-2.62%
Domestic Small-Cap Equity[6]	+13.49%	+6.30%	+8.48%	-7.25%	+10.21%	-4.58%	-2.82%
International Equity[7]	+6.16%	+1.58%	+6.76%	-6.04%	+7.13%	-2.79%	-1.05%
Developed International Equity[8]	+6.30%	+1.32%	+5.83%	-5.78%	+8.10%	-2.15%	-1.82%
Emerging Market Equity[9]	+5.74%	+2.47%	+10.23%	-6.72%	+4.28%	-4.69%	+1.36%
Diversifiers	**10-YEAR**	**5-YEAR**	**3-YEAR**	**1-YEAR**	**YTD**	**QTD**	**LAST WEEK**
Diversified Alternatives[10]	+3.76%	+0.25%	+1.17%	+0.28%	+2.76%	-0.19%	-0.26%
Commodity[11]	-4.18%	-9.52%	-1.73%	-12.37%	+2.31%	-3.77%	-1.23%

[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.

1 CLS's Response to Tariff Concerns

The trade rhetoric coming out of Washington is not getting any better, especially considering the latest developments regarding a variety of topics including Mexico, 5G technology, and rare earth materials. The storyline seems to change almost daily. How should investors respond?

First, we need to keep in mind that much of the rhetoric is, of course, negotiation tactics. The rhetoric is extreme and an attempt to get a reaction. It's also noise that investors should ignore (easier said than done!). Second, it's in the economic interests of the majority to ensure a positive conclusion. Most likely, that's what we'll get.

President Trump is working from a position of strength, at least for now. The economy, global trade, and the stock market are at or near all-time highs; consumer confidence is extremely positive, and the labor market is the best it has been in years. The interesting data to watch, however, is consumer and voter sentiment if the economy and market start to deteriorate. Considering the President cares a lot about how the stock market is behaving, that position of strength may fade.

Investors can expect more volatility, hold steady, and stay the course. Everything may fall apart, of course, but it most likely won't. There's even a chance the trade situation will improve significantly. The President may be creating a tariff fight to end the use of tariffs entirely, as some believe, and if that's the outcome, global trade could surge higher.

One sector that could be negatively impacted by the trade battle is technology, especially with the recent developments over 5G and rare earth materials. Tech was hit hard when those news stories broke.

Contrary to current thinking, inflation and interest rates may pick up moderately. All else being equal, tariffs are inflationary. Since wage growth is nearly double the current inflation rate (as is housing) and moving higher, more inflation would suggest higher interest rates, at least for longer-term bonds. Higher inflation, interest rates, or both could boost value stocks, which tend to do better in rising rate environments.

The tariff dispute is also impacting emerging markets (EM). While their domestic economies have developed substantially in recent decades, emerging markets still rely significantly on global trade, and they have suffered more than other major stock market indices this year. But the full story of EM's performance is more nuanced. Individual EM performance has been all over the place. China had a great start to the year before it got hit last month, and multiple EM countries posted gains in May.

Either way, we believe emerging markets have priced in a lot of negative news based on their current valuations. Perhaps more importantly, U.S. stocks (at least the stocks leading the market) have priced in too much good news.

2 Emerging Market Value

At CLS, we have often written about how we favor emerging markets and value stocks. Currently, our proprietary in-house expected return for emerging markets is that they will fare better than the U.S. market by approximately 2% per year over the next 10 years. Meanwhile, emerging market value stocks are expected to return another 2% above and beyond broad emerging market returns. That 2% per year may not sound like a lot, but over time, that really adds up.

Therefore, it shouldn't be a surprise that one of the top ETF holdings at CLS is PXH (Invesco FTSE RAFI Emerging Markets Index ETF). PXH is like a Reese's Peanut Butter Cup to CLS portfolio managers — it's both EM and value, two of our favorite market exposures.

Comparing PXH valuation and growth statistics to the S&P 500 produces some interesting results. Using Morningstar data, the S&P has a price-to-earnings (P/E) ratio of 17.8, while PXH has a P/E of 8.9. That means the S&P is twice as expensive. In fact, for all four major valuation metrics, which we use in the CLS Chart Pack "Starting Points Matter," the S&P is 2-3x more expensive than emerging market value stocks! The S&P's yield is also only 40% of PXH's.

Given those valuation differences, you might expect far superior growth for the S&P 500, right? Well, not so fast. Top-line (sales) and bottom-line (earnings) growth was basically the same, and the growth in assets (book value) was superior for PXH! No matter how you slice it, we believe EM value stocks are simply more attractive for long-term return potential than the S&P.

	SPY	PXH	SPY/PXH
Price/Forward Earnings Ratio	17.8	8.9	2.0
Price/Book	3.1	1.1	2.8
Price/Sales	2.1	0.9	2.5
Price/Cash Flow	9.2	3.1	2.9
Dividend Yield	2.0	4.8	0.4
Long-Term Earnings	10.8	10.6	1.0
Book Value Growth	4.3	5.7	0.8
Sales Growth	7.1	7.1	1.0
Book Value Growth	4.3	5.7	0.8

Source: Morningstar, as of 12/31/18

	Median FANG	PXH	FANG/ PXH
Price/Forward Earnings Ratio	51.5	8.9	5.8
Price/Book	22.6	1.1	20.6
Price/Sales	7.4	0.9	8.7
Price/Cash Flow	21.9	3.1	7.0
Dividend Yield	0.0	4.8	0.0
Long-Term Earnings	30.7	10.6	2.9
Book Value Growth	30.8	5.7	5.4
Sales Growth	33.1	7.1	4.7

Source: Morningstar, as of 12/31/18

Let's take this analysis one step further. One large "bet" that CLS has in portfolios is our underweight to the FANG stocks (Facebook, Amazon, Netflix, Google). We invest in these companies but not to the extent the benchmark averages own them. Given their strong returns this year, this position has negatively impacted our year-to-date performance.

Currently, the median valuations for the FANG stocks are 6-21x higher than they are for PXH. Wow! To be fair, the FANG stocks have far better growth, but the growth is only 3-5x better. For example, earnings growth is 3x (2.9) better for the FANG stocks than for PXH, but investors are paying 6x (5.8).

This does not seem like a good deal. It could be argued that high-growth stocks can grow into those valuations, and there is some truth to that. But these are getting to be very large companies — it's just simple math that they won't be able to maintain these growth rates. If they did, they would take over the entire economy! We believe once growth rates fade, so will those valuation premiums. Those companies will still be great companies, but they may be lousy investments.

3 How to Analyze Money Manager Performance

For several decades, I built portfolios of actively managed mutual funds. Over the years, I met portfolio managers from nearly every major investment management firm, and many boutiques, to understand how they built portfolios, bought and sold securities, and managed risk.

From this experience, I determined that investment management comes down to five "Ps": people, philosophy, process, positioning, and performance.

The first three Ps, in my opinion, are the most important to understand: philosophy and process and the people who execute them. Many expect performance to be first, but performance is more of a check on what should have been learned from the first three Ps.

Assessing performance is not simply about whether the portfolio beats its benchmark over time, although that is part of it. The most useful questions to ask when assessing performance are: first and foremost, did the portfolio behave like I expected? Did it exhibit the risk characteristics I expected? Did it make changes to the portfolio as expected as market conditions changed? Are the market exposures, or securities held, expected?

An investment manager should be able to manage a portfolio's behavior in line with expectations. That does not go out of style, nor is it cyclical.

Beating a benchmark, however, is cyclical. Investing styles don't work in every market condition. Disciplined investment styles work over time, just not every time — as former CLS President and CEO Todd Clarke used to say.

Once we understand an investment philosophy and process, and believe it will be successful over time, the due diligence goal is to determine the management of that fund is disciplined. This is especially important when the manager's style of investing is not currently working, and they might be feeling short-term business pressures to change their approach. Making short-term changes might appease some people, but I would never employ a manager who works to appease.

With that said, how are CLS portfolios performing this year? The answer depends on how the advisors and investors using the portfolios answer these questions: Did the portfolios behave as they expected? Second, are they beating benchmarks?

Regarding the second question, CLS portfolios have generally not beaten their benchmarks in recent time frames. While we believe in our relative valuation approach to security selection, which CLS Director of Research and Senior Portfolio Manager Grant Engelbart wrote about two weeks ago, it hasn't been working lately as we have favored emerging market equities and value stocks over growth stocks, especially the FANG stocks.

Our positioning due to relative valuations has been consistent for years, and it can be examined using the "CLS Starting Points Matter: Chart Pack" that we publish each month. Reviewing these charts should make it clear what we favor and disfavor; what we're buying and selling; and what we are overweight and underweight. There should be no surprises on what market exposures CLS is favoring after looking at this report.

More importantly, in answer to the first key question, CLS portfolios should have behaved as investors expected. The risk characteristics should be in line with expectations as all reports we review would suggest. The portfolios should also be actively managed to investor expectations, based on number of trades, portfolio turnover, tracking error, and how holdings have changed over the last year.

A portfolio's performance and behavior shouldn't surprise its investors. It may underperform at times due to its style being out of favor, such as CLS being a global investor in an environment where international stocks have lagged domestic, but it's important to know that the investment philosophy and process is disciplined and designed to outperform the markets over time. That's how we manage CLS portfolios.

Thank You

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

Stay balanced.

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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.

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 CFA® is a globally respected, graduate-level investment credential established in 1962 and awarded by CFA Institute — the largest global association of investment professionals. To learn more about the CFA charter, visit www.cfainstitute.org.

The CMT Program demonstrates mastery of a core body of knowledge of investment risk in portfolio management. The Chartered Market Technician® (CMT) designation marks the highest education within the discipline and is the preeminent designation for practitioners of technical analysis worldwide. To learn more about the CMT, visit ttps://cmtassociation.org/.

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The price-to-earnings ratio is a valuation method obtained by dividing the market value per share by the earnings per share. The price-to-book ratio is used to compare a stocks' market value to its book value by dividing the current closing price of the stock by the latest quarter's book value per share. The price-to-sales ratio is a valuation metric for stocks calculated by dividing the company's market cap by the revenue in the most recent year; or, equivalently, divide the per-share stock price by the per-share revenue. The price/cash flow ratio (also called price-to-cash flow ratio or P/CF), is a ratio used to compare a company's market value to its cash flow. Dividend yield is a ratio which shows the amount a company produces in dividends on an annual basis relative to sales price. It is calculated by dividing the annual dividends per share by the price per share.

**CLS Investment, 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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