

DIRECTIONS

A quarterly publication of CLS Investments

SUMMER 2019

This quarter, we break down factors that may potentially lead to increased market volatility and what investors need to do (and not do) to be ready. We also unveil two new CLS Investment Themes that represent a common thread between all of our portfolios. Plus, we provide some of our best insights on everything from the power of direct indexing, whether we think value investing is dead, possible impacts of self-driving vehicles, and more.



Rusty Vanneman serves as CLS's President and 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.

Learn more about Rusty [here](#).



All major stock markets are sporting gains for 2019, many in the double digits. Despite the gains, we anticipate the typical summer volatility that markets often experience will occur. We believe that volatility is likely to be amplified due to the ongoing trade rhetoric between the U.S. and China. We also expect the stock market to eventually move higher near year-end, and we also expect longer-term interest rates to rise.

What should investors make of the trade rhetoric coming out of Washington? The storylines seem to change almost daily. First, we need to keep in mind that much of the rhetoric is, of course, related to negotiation tactics. The rhetoric is extreme and it's an attempt to get a reaction. It's also noise that we believe 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 that it has been in years.

If the economy and market do start to deteriorate, consumer and voter

sentiment will be the interesting data to watch. Considering President Trump cares a lot about how the stock market is behaving, that position of strength may fade. Everything may fall apart, of course, but we believe it most likely won't.

There's even a chance that the trade situation will improve significantly. The president may be creating a tariff fight to end the use of tariffs entirely, as some believe. If that's the outcome, global trade could surge higher. Given each of these various scenarios, investors should simply expect more volatility, hold steady, and stay the course.

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 news broke that President Trump blacklisted Chinese telecommunications giant Huawei and that China considered retaliating by banning exports of rare earth materials to the U.S.

Contrary to current thinking, inflation and interest rates may even 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 EM economies have developed substantially in recent decades, EM 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, we believe U.S. stocks (at least the stocks leading the market) have priced in too much good news.

Be Resilient

At CLS, we tend to be optimistic investors, as the markets tend to go up over time. But we are also paid to worry and be aware of risks that could impact the investment portfolios we manage. It's a commonly held belief that the most successful people in all walks of life are those who are "cautiously optimistic," and we like to think that also applies to great investment managers.

One key to being a good investor is resilience. When it comes to investing, being resilient has to do with more than ensuring a well-built portfolio; mindset also plays a role. Resilience is about the ability to cope with an unexpected event or crisis and not lose stride with how we conduct ourselves. This can be accomplished not only through a disciplined investment process, but through effective habits and behaviors.

A successful investor is aware of the historical record and market relationships. He or she knows the markets have their ups and downs but, ultimately, tend to go up over time. A successful, resilient investor also acknowledges the noise and junk information that impact temporary short-term movement but appreciates that long-term fundamentals and valuations (how much you pay for fundamentals) eventually win out.

At CLS, we often write about building resilient portfolios. Since most of our portfolios are constructed with our Risk Budgeting approach, which targets a specific risk level, we measure, monitor, and manage changes in the global markets' risk characteristics at all times.

Portfolio resilience is also emphasized in our CLS Investment Themes. In our new "Be Resilient" theme, we acknowledge that while traditional fixed income still serves an important function in

balanced, multi-asset portfolios, investors should be creative and look at other asset classes and strategies to help diversify stock market risk. This may include using alternative strategies, such as merger arbitrage, managed futures, multi-asset hedge fund strategies, and more. It also may include real assets, such as commodities and real estate, for example: real estate investment trusts (REITs).

While not an official CLS Investment Theme, "Be Diversified" is another investment approach emphasized across portfolios. We are strong believers in global diversification, and that belief is reflected in our investment portfolios. Through our internal risk reports, we measure how diversified our portfolios are, and our goal is to be more diversified than our benchmarks.

Given the maturity of the current bull market, which is one of the longest and strongest in U.S. history, and the economic expansion (could this be the first decade ever without a recession?), we believe portfolios should be well-fortified and resilient for the years ahead. Whether the current cycle is in the bottom of the ninth inning, or has far more innings to go, portfolio management needs to be creative to ensure portfolios are well-diversified and resilient enough to meet whatever unexpected market behaviors occur in the future.

Country Ranks: A 10-Year View

from Kostya Etus, CFA, Senior Portfolio Manager



"Yesterday we were an army with no country, tomorrow, we have to decide which country we want to buy!"

– Simon, *Die Hard* (1995)

The U.S. is often thought of as having the strongest returns post-2008 (post financial crisis). That is actually not true. Between 2009 and 2018, Thailand, the Philippines, and Indonesia had stronger returns. But what is even more interesting is that the U.S. was not the top performing country in any year within that period – yet another reminder of the benefits of global diversification.

The chart on the following page ranks 47 countries (which are investable through ETFs) by performance each year since 2009. The horizontal black

line in the middle marks the halfway point. There are a few key observations:

1. Diversification typically works. Not only was the U.S. never number one, it was in the top half for only six of the 10 years recorded. The MSCI All Country World Index (ACWI) and an equal-weighted average of all the countries were also in the top half for six years, but their rankings were more consistent and stable across time.

2. Performance chasing can be dangerous. Typically, the countries at the extremes tend to have a reversal the following year. Notice the downward arrows. The country that was the top performer in a given year

tends to be toward the bottom of the list the following year. This relationship generally holds true on the other end; last year's dogs tend to be this year's winners.

3. It's a large world out there.

There are a lot of countries in the world, and through the power of ETFs we can now invest in almost 50 of them. But home and familiarity biases tend to drive U.S. investors to U.S. investments because they are more comfortable with what they know and understand. But an investment manager who can sift through the media noise and evaluate the economic, fundamental, and valuation situations of various countries can have the upper hand due to the vast opportunity set available to them.

| 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 |
|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|
| Brazil | Argentina | Ireland | Turkey | UAE | Egypt | Denmark | Brazil | Argentina | Qatar |
| Indonesia | Thailand | Qatar | Nigeria | Argentina | Indonesia | Ireland | Peru | Vietnam | Peru |
| Russia | Peru | Indonesia | Egypt | Greece | Philippines | Belgium | Russia | Austria | Brazil |
| India | Chile | New Zealand | Philippines | Finland | India | Israel | Thailand | Poland | Russia |
| Turkey | Colombia | USA | Belgium | Ireland | Israel | Japan | Colombia | China | Finland |
| Norway | Malaysia | Malaysia | Poland | USA | Argentina | Russia | Canada | Korea | New Zealand |
| Chile | South Africa | Philippines | Colombia | Germany | Turkey | Austria | Taiwan | Chile | USA |
| Colombia | Indonesia | United Kingdom | Thailand | Spain | Qatar | Italy | New Zealand | India | Israel |
| Taiwan | Philippines | Thailand | Denmark | Netherlands | Thailand | Finland | South Africa | Peru | Thailand |
| Thailand | Qatar | Colombia | Singapore | Qatar | USA | Netherlands | Indonesia | Turkey | Malaysia |
| Australia | Sweden | Switzerland | Germany | Nigeria | Peru | Portugal | Chile | Nigeria | India |
| Singapore | Denmark | ACWI | UAE | Belgium | Taiwan | USA | Norway | Hong Kong | Hong Kong |
| Peru | Mexico | Norway | New Zealand | Japan | China | Switzerland | UAE | South Africa | Norway |
| Korea | Korea | Belgium | Mexico | Switzerland | New Zealand | France | Australia | Singapore | Taiwan |
| Philippines | Nigeria | Australia | Hong Kong | France | UAE | Argentina | Austria | Denmark | Switzerland |
| Sweden | Hong Kong | Korea | India | Denmark | Denmark | Hong Kong | USA | Thailand | Indonesia |
| Argentina | Singapore | Mexico | Austria | Sweden | Vietnam | Germany | Korea | Netherlands | Singapore |
| China | Taiwan | Netherlands | China | ACWI | South Africa | ACWI | ACWI | France | ACWI |
| Hong Kong | India | Spain | Australia | United Kingdom | Hong Kong | Sweden | Qatar | Greece | Portugal |
| South Africa | Turkey | Canada | Sweden | Italy | ACWI | Vietnam | All Country Ave | Italy | Colombia |
| Belgium | Canada | ACWI Ex USA | France | ACWI Ex USA | Belgium | ACWI Ex USA | Argentina | All Country Ave | Australia |
| Mexico | Russia | Japan | Korea | All Country Ave | Singapore | India | France | Norway | UAE |
| Canada | All Country Ave | South Africa | Netherlands | Austria | Ireland | New Zealand | Netherlands | Germany | Vietnam |
| All Country Ave | Japan | Nigeria | All Country Ave | New Zealand | Canada | Korea | ACWI Ex USA | Taiwan | France |
| Israel | Poland | Sweden | Switzerland | Hong Kong | Switzerland | Philippines | Portugal | ACWI Ex USA | Poland |
| Malaysia | USA | Denmark | Peru | Portugal | Finland | United Kingdom | Germany | Spain | Japan |
| New Zealand | Australia | Hong Kong | Vietnam | Israel | All Country Ave | China | Japan | Malaysia | Netherlands |
| Spain | ACWI | France | South Africa | Norway | Australia | Australia | Hong Kong | Philippines | All Country Ave |
| United Kingdom | Egypt | All Country Ave | Norway | Taiwan | Netherlands | All Country Ave | Singapore | Indonesia | Sweden |
| Austria | Switzerland | Singapore | ACWI Ex USA | Egypt | ACWI Ex USA | Taiwan | China | Brazil | Egypt |
| Netherlands | ACWI Ex USA | Germany | Taiwan | Malaysia | Japan | Mexico | Sweden | Japan | United Kingdom |
| Poland | Norway | China | ACWI | Vietnam | Spain | UAE | Poland | ACWI | ACWI Ex USA |
| ACWI Ex USA | Vietnam | UAE | USA | Canada | United Kingdom | Norway | United Kingdom | Portugal | Nigeria |
| Portugal | Finland | Russia | United Kingdom | Australia | Sweden | Spain | Spain | Switzerland | Denmark |
| Egypt | Austria | Chile | Finland | Korea | Mexico | Chile | India | Finland | Mexico |
| Denmark | United Kingdom | Taiwan | Malaysia | China | Italy | Singapore | Malaysia | United Kingdom | Spain |
| ACWI | Germany | Peru | Russia | Poland | France | Indonesia | Finland | USA | Philippines |
| France | New Zealand | Brazil | Italy | Singapore | Germany | Qatar | Switzerland | Sweden | Canada |
| Vietnam | Brazil | Portugal | Canada | Russia | Malaysia | Malaysia | Philippines | Australia | Italy |
| UAE | China | Italy | Japan | Mexico | Korea | Nigeria | Ireland | Belgium | China |
| Italy | Israel | Israel | Chile | Philippines | Chile | Thailand | Belgium | Ireland | Chile |
| USA | Netherlands | Poland | Ireland | India | Brazil | Egypt | Vietnam | Colombia | Korea |
| Switzerland | Belgium | Finland | Indonesia | South Africa | Poland | Canada | Turkey | Canada | Germany |
| Germany | France | Turkey | Greece | Thailand | Colombia | Poland | Mexico | Mexico | South Africa |
| Greece | UAE | Austria | Portugal | Brazil | Norway | South Africa | Italy | New Zealand | Ireland |
| Ireland | Portugal | India | Spain | Colombia | Nigeria | Peru | Egypt | Russia | Belgium |
| Finland | Italy | Vietnam | Brazil | Chile | Austria | Turkey | Greece | Egypt | Austria |
| Qatar | Ireland | Argentina | Qatar | Indonesia | Portugal | Brazil | Denmark | UAE | Greece |
| Japan | Spain | Egypt | Israel | Turkey | Greece | Colombia | Israel | Israel | Turkey |
| Nigeria | Greece | Greece | Argentina | Peru | Russia | Greece | Nigeria | Qatar | Argentina |

Source: Morningstar using MSCI indices, 1/1/2009 - 12/31/2018

This information is prepared for general information only. Past performance is not a guide to future performance.

Direct Disruption

from Shana Sissel, CAIA, Portfolio Manager



Change is coming to the ETF marketplace. ETFs once seemed unstoppable as industry trends evolved from closed-end products to mutual funds to ETFs. But the evolution isn't over yet. Now, while the industry continues to rake in an impressive \$1 billion each day, some ETF players have become complacent, and their products are ripe for disruption.

Given their low costs (zero-fee ETFs hit the market in February) and tax-efficiency, ETFs may appear to be the perfect investment vehicles for investors. But they still have vulnerabilities. Namely: ETFs are not tax-maximized. In other words, trade activity isn't always done in the best interest of tax-sensitive investors.

Enter direct indexing! Matt Hougan, CEO of Inside ETFs, calls it the "Great Unwrapping" – a solution for investors who are looking for their own personal index within a certain band of tolerance, using a customized approach to maximize tax-efficiency.

The Advantages of Direct Indexing

So, what makes direct indexing a strong option for constructing

portfolios? We believe there are three main advantages to implementing direct indexing:

1. **Tax-Efficiency:** ETFs are tax-efficient, but direct indexes may be even more tax efficient. Tax-loss harvesting, gain deferrals, and transition management are all benefits offered by direct indexes that are not available through a typical one-size-fits-all ETF.

2. **Risk Customization:** Unlike traditional ETFs, direct indexes may offer investors a better fit for their risk tolerance. We believe that direct indexes can manage around concentrated stock positions, avoid making outsized sector bets, and generally better control the risk associated with the portfolio by setting parameters to meet a specific investor's needs.

3. **ESG/Social Criteria Customization:** As with any rules-based approach, direct-indexed portfolios may meet client-specific desires to avoid certain industries or to seek out companies that meet a preferred ESG (environmental, social, governance) framework.

Direct indexing isn't new. Firms such as Wealthfront, Privé, Optimal Asset Management,

Parametric, and Aperio have been doing it for years. With almost \$100 billion in direct-indexed assets, if Parametric were an ETF issuer it would be the sixth largest and fourth fastest growing. But improvements in technology have made it possible for new entrants that offer direct-indexed solutions at lower minimums and lower fees than the legacy firms.

Using Direct Indexing

As this disruptive technology shakes up the industry, it is essential to stay ahead of the curve. In January 2019, Orion Advisor Services launched its proprietary optimization solution, ASTRO. This technology has changed the game for financial advisors who want to harness the power of direct indexing in their portfolios.

The initial launch of ASTRO gave advisors access to the software tool that helps them create an in-house, direct-index solution for their clients. The advantage was obvious; advisors could now offer high-net-worth clients an institutional-quality service without having to pay a big investment firm to do it for them.

However, it soon became clear there remained a strong desire by many advisors to outsource the solution if the fee was reasonable enough. Recently, CLS launched a suite of Tax Managed Direct Index SMA Beta strategies available exclusively on the FTJ FundChoice platform. Utilizing Orion's ASTRO technology, CLS has created five new models, each of which replicates a different broad-market index to create tax-efficiencies. The models represent a separate portfolio for each client, not a commingled vehicle. These

models are designed for clients seeking tax-efficient rebalancing and direct ownership of securities. With an initial minimum account size of just \$50,000 and a fee of 25 basis points, these portfolios provide advisors an option unavailable through some established competitors.

At CLS, we empower financial advisors to help their investors succeed. Using a high-tech portfolio customization tool, these five tax-managed portfolios will utilize direct indexing to deliver what we

believe will be a better after-tax experience for investors and empower advisors to stay ahead of the direct-indexing curve. The ETF industry brought innovation and transparency to our industry, and it enabled advisors to better serve investors. We believe as the next evolution, direct indexing will only make us better.

Stay tuned to find out more about the next phase of direct-indexing solutions CLS will be launching in the coming months.

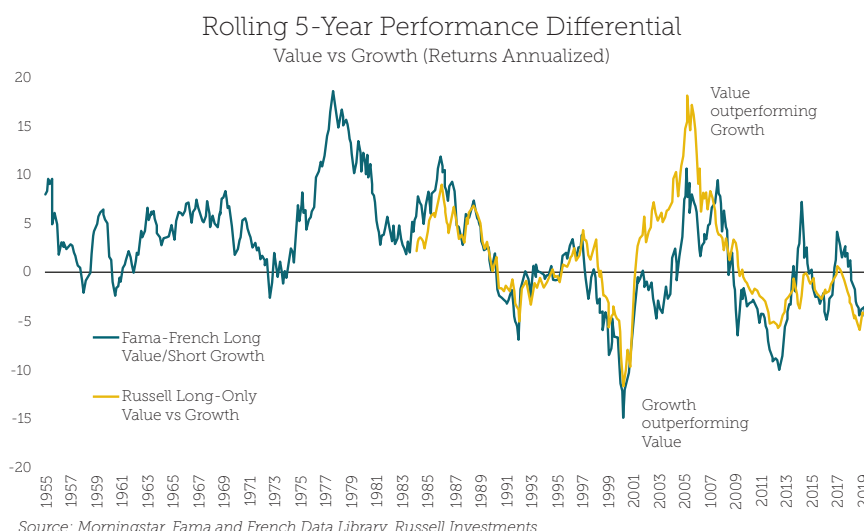
Value Investing: Time for a Eulogy?

from Grant Engelbart, CFA, CAIA, Director of Research & Senior Portfolio Manager



There are nearly 30 million Google search results for the words "value investing is dead." Berkshire Hathaway buying Amazon stock earlier this year may confirm what critics of value investing have been saying. Realistically, critics have had good reason to be skeptical of value's return.

Value investing is simple, really. It's just a matter of buying securities that are trading for less than their intrinsic value. Determining that intrinsic value, however, can be astronomically difficult, in large part because there is no right answer. Simplifying this intrinsic value has been done over the years, perhaps most traditionally with book value (accounting value). Securities trading at low price-to-book (P/B) are considered value; those trading at high P/B are growth. Eugene Fama and Kenneth French created indices that went long on the cheap stuff and short (betting on the inverse) on the expensive stuff. It earned them a Nobel prize. Now, book value is widely [criticized](#) as less relevant, if not completely so. Warren Buffett



himself even noted in his most recent [shareholder letter](#) that investors should stop looking at Berkshire's book value.

Let's sort through some fact and fiction on value performance and see what we can surmise for the future.

- **Fiction: You are measuring value wrong!** There could be some truth to this one, but just about any way you slice it, value has underperformed growth. Look below for the

cumulative returns over recent periods for emphasis.

- **Fact: Combining value with other factors may help smooth out underperformance.** This is true and makes intuitive sense. If factor investing captures the essence of active management, there are other factors that active managers consider when investing in undervalued stocks. The quality of the

| Cumulative Returns Value vs. Growth | 3 Years | 5 Years | 10 Years |
|--|---------|---------|----------|
| Traditional Value (Long/Short) | -7.1% | -30.3% | -37.9% |
| Value (P/B) | -15.0% | -30.5% | -126.3% |
| Value (P/B, P/E, Dividend) | -10.9% | -25.8% | -129.1% |
| Value (Sector Neutral, P/B, P/E, EV/CFO) | -9.8% | -23.9% | -62.4% |

Source: Morningstar, MSCI, Fama-French Data Library, Russell Investments

company (quality) and the recent trends in stock price (momentum) are two big ones. At CLS, we combine [quality and value](#) in our Target Stock Portfolio (TSP) strategies available in either a 30-stock select portfolio or full-fledged [direct index](#).

- **Fiction: Value hasn't worked since the fallout of the tech bubble.** As you can see in the first graph, value versus growth has ebbed and flowed over time. More recently, it has ebbed toward underperformance. There have been some periods since the tech bubble when value did outperform growth fairly handily. About this time in 2012, value had underperformed growth by more than 5% annualized for the prior five years and then went on to outperform by more than 10% in the year following. Using that same 5% underperformance threshold, forward-looking one-year returns for value are impressive. Median returns for value outperformed growth by nearly 9% (and outperformed a whopping 80% of the time). As of April 30, 2019, value has underperformed growth 6%

over the past five years. This is a level that was only observed in the tech bubble (for the Russell long-only index).

- **Fact: Relative valuation is definitely not dead.** At CLS, we believe strongly in value investing, but we also maintain a consistent risk profile through time. Meaning, we need to stay invested. If everything is expensive or everything is cheap, we look at asset classes on a relative basis to determine what is attractive. It is the essence of our CLS Relative Value Chart Pack (please ask us for a copy). Looking at the last 10 years, across the asset classes we include in the pack (sectors, market-cap and style, regions), we can look at the returns on a forward basis for securities trading at undervalued extremes a standard deviation or more below their average. Spoiler alert – we think they look great. Below are the one- and two-year forward returns

when these asset classes hit their relative value lows and exceed their parent index. So, on average, securities have outperformed by more than 4% in the year after hitting an attractive valuation. That's big.

Maybe even more importantly, there are a number of asset classes currently at these levels – international securities, both developed and emerging, several sectors including energy and financials, and of course value stocks!

Given the nature of many investors, it's natural to question value at this juncture. Times change. Some may ask whether value just can't be the same in today's tech-driven economy. But if the past relationships hold true as I've shown here, we believe abandoning a value orientation now could be a grave mistake. But hey, maybe this time is different.

| | 1 Year Fwd | 2 Years* Fwd |
|-----------------------|------------|--------------|
| Avg Outperformance | 4.1% | 1.8% |
| Median Outperformance | 5.0% | 2.3% |
| % Outperforming Index | 75.9% | 67.9% |

**Annualized. Sources: CLS Investments, Morningstar, Factset, MSCI Data using CLS Relative Value Chart pack from 2010-2019*

The Future is Here

from Joe Smith, CFA, Deputy Chief Investment Officer



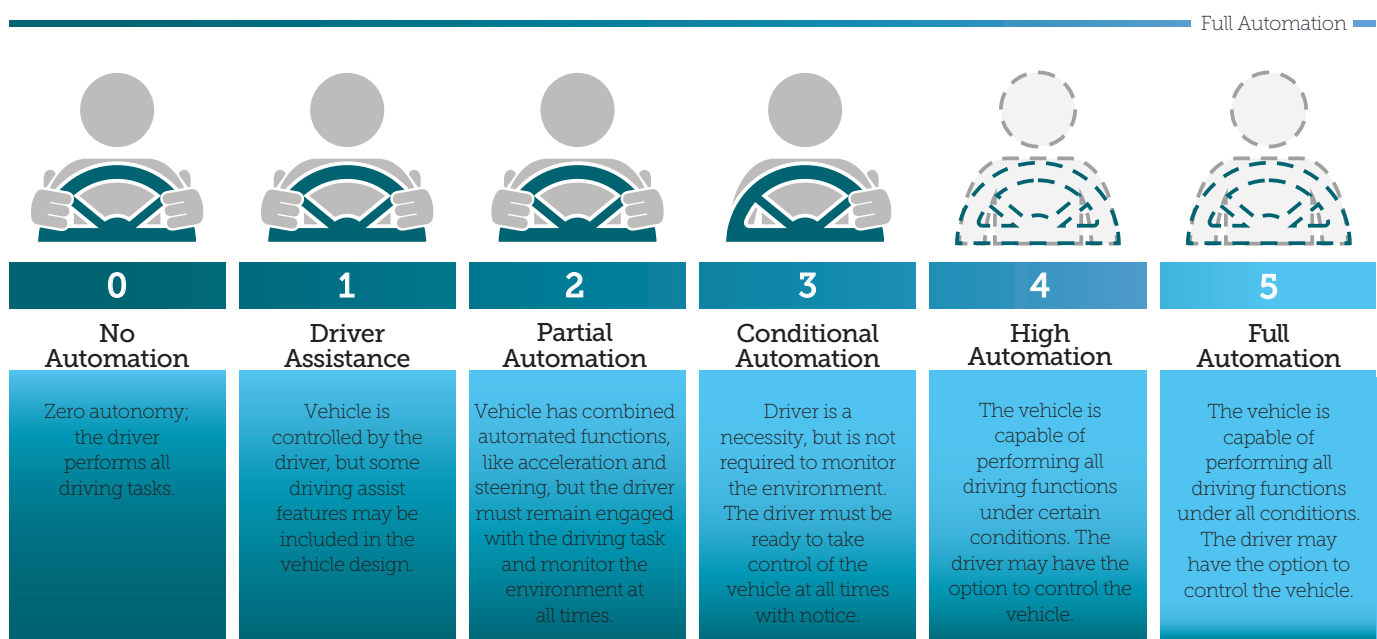
My fiancé and I traveled to Pittsburgh recently for her five-year MBA class reunion at Carnegie Mellon University (CMU). We are both alumni of the Tepper School of Business at CMU and enjoyed the opportunity to see former professors and classmates as well as receive updates on the latest research and projects being pursued on campus. One of those ongoing efforts is around robotics and its application in autonomous vehicles.

Pittsburgh, not Silicon Valley, is home to some of the country's leading names in autonomous vehicle technology. Companies such as Aurora, Argo, and Uber's Advanced Technology Group (ATG) are at the forefront of new technologies that aim to allow vehicles to become more autonomous and require less human intervention in everyday decisions on the road.

Autonomous vehicle technology has the potential to reshape the way we think about getting

from point A to point B. Much of this technology isn't just about vehicles requiring less assistance from drivers. Rather, it's about improving safety on our roads. Safety in the autonomous vehicle world means using artificial intelligence (AI) to analyze a situation in real time and react with the right course of action. The primary objective of using AI, ultimately, is to reduce the number of traffic accidents and vehicle fatalities that occur on the road. What is most interesting to me is that this

SAE Automation Levels



Source: "Automated Driving Systems: A Vision of Safety." U.S. Department of Transportation. NHTSA.gov.

technology is getting closer to what industry experts refer to as Level Five – or full automation.

Lyft and Uber's recent initial public offerings (IPOs) both represent opportunities for investors to take advantage of the potential of autonomous vehicle technology. Each

firm has dedicated efforts to increase the use of self-driving cars for passenger ridesharing and pickup. I believe that as autonomous vehicle technology continues to get smarter, it will disrupt the entire transportation industry and prompt consumers to reimagine how they get

around. Although it is too early to tell how companies like Lyft and Uber will work out in the long term for investors, I think the future of transportation is going to impact each of us sooner rather than later.

Modern Monetary Theory

from Rusty Vanneman, President & Chief Investment Officer



Perhaps the most popular question I have received from investors in recent weeks is about Modern Monetary Theory (MMT). This topic will be important to understand in the years ahead, as it will surely be a major talking point in the 2020 election. Its impact could become notable if it attains more proponents, especially if they are major economic decision makers.

MMT is controversial. It is also likely to become very political as it gains more notice and will surely be oversimplified and misrepresented. While it has some well-credentialed advocates, it also has notable critics from both the left and right. Some have dubbed it "Modern Magical Thinking" or even "Magical Monetary Tree."

While MMT has many principles and potential policy impacts, here are its most significant arguments:

1. Federal deficits usually don't matter, since the government has a monopoly over its currency.
2. Unlike households, governments don't have budget constraints, since they can just print as much money as needed.
3. The only real limit to a government's spending power is excessive inflation.

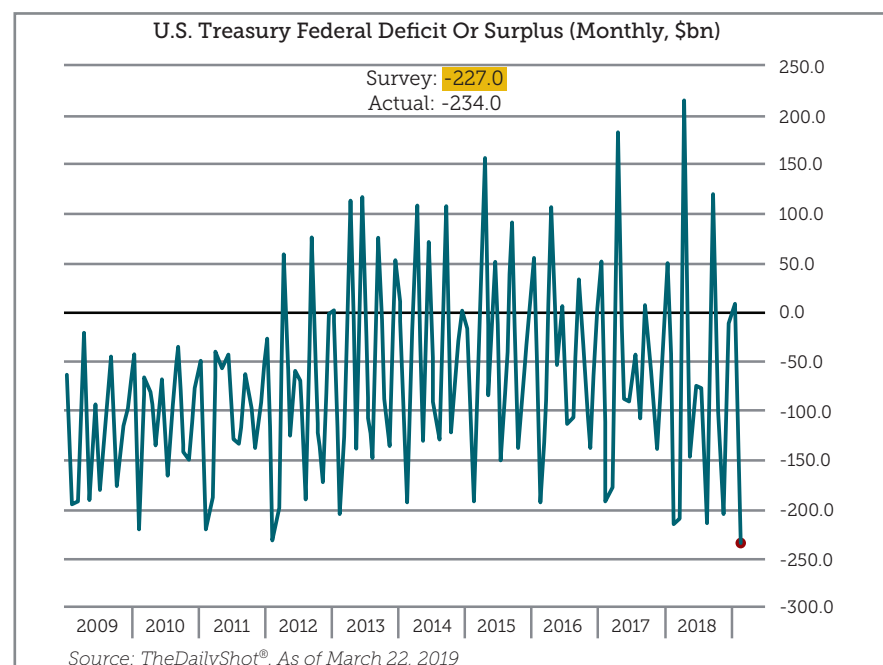
Essentially, MMT proponents argue that deficits don't matter as long as they don't stoke inflation.

The topic of deficits is important. The federal deficit continues to grow, and the monthly deficit has grown to the widest levels seen in many years. So, are deficits bad or not?

Proponents of MMT argue that deficits don't negatively impact the economy if inflation doesn't take hold, and there are plenty of examples to support that. The U.S.

has had huge deficits in recent years, but this decade could be the first in U.S. history without a recession or inflation! Another example is Japan, as it has been able to sustain its economy despite massive government debt for decades now. Sure, growth in Japan has been below average, but it has been stable.

However, I believe there is more powerful evidence about deficits than these two cases. When reviewing both the absolute level of debt and the trend of that debt, it's evident that a higher level of debt (typically measured as debt/GDP) and an increasing debt



load both suggest below-average economic growth.

Ned Davis Research (NDR) published a study called "Deficits Do Matter" on March 22, 2019. In this study, NDR attempted to determine whether overall debt levels are improving or worsening. It found that since 1964, worsening (increasing) debt levels meant lower economic growth and lower job growth. It should be noted that growth was still positive in both cases, but it was clearly lower than when the debt level was improving.

Some have argued that there is a certain chicken-and-egg relationship between deficits and economic growth. There is some truth to that, too. But again, there is more evidence, never mind intuitive sense, that supports the notion that more debt eventually translates into less growth.

A fascinating study called "Growth in a Time of Debt" by Reinhart and Rogoff, published in 2010, became highly politicized and, thus, controversial. It was a comprehensive review of the impact of debt on economies. While it had a few initial data errors that trashed its reputation, its strong conclusions were significant and appear to be correct. The most significant was that economic growth slips about 1% from long-term averages to below-average growth until debt is sufficiently lowered. We've clearly seen that in the U.S.

The study cites the following conditions in a high-debt economy:

- High-debt levels signify lower, but still positive, economic growth.
- Interest rates stay low, and bond market returns are below average.
- The record on inflation is mixed, but it is generally below average in developed economies.
- The currency generally weakens.
- The domestic stock market typically has below-average returns.

Over the last 10 years, has this study been correct regarding the U.S. experience? For the most part, yes.

- We may not have had a recession, but economic growth has been below average by about 1%. Spot on.
- Interest rates have remained low. When the government spends more, that means more money gets put back in the banking system. If the private sector demand doesn't increase, in our opinion, the additional supply of money will likely push interest rates lower. That has happened. Ten-year U.S. Treasury yields are lower than they were 10 years ago and have been lower for most of the decade.
- While the U.S. dollar (U.S. Dollar Index) is currently higher than it

was 10 years ago, it has mostly been lower over this time frame.

Now here are the big differences – but perhaps not: Inflation has remained low, but stock prices have moved much, much higher than long-term averages. Corporate profits have improved much more than GDP growth (for a combination of reasons), and that has clearly helped the stock market. However, valuations have also greatly expanded. In other words, inflation may not have shown up in typical consumer prices, but it has been seen in asset prices. It could be reasonably argued that we have seen significant asset inflation over the last 10 years.

What does this mean for CLS portfolios?

1. We expect lower growth from the U.S. (and other developed economies) in the years ahead; thus, we continue to favor emerging markets.
2. We do not think the bond market will get crushed. Sure, absolute return potential appears below average, but we believe traditional fixed income will still be functional in multi-asset portfolios.
3. Since currency weakness and inflation could still be threats, we continue to favor some alternatives exposure, such as commodities and real estate (REITs).

For a helpful summary of MMT, check out this article from [Bloomberg](#).

2019 Investment Themes

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



At CLS, we manage various investment strategies which differ depending on investors' 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 of our portfolios. They are specific enough to articulate what makes CLS portfolios different, but they are broad enough for each portfolio manager at CLS to express her or his views. These themes, which are approved by the CLS Investment Committee, may be held for years or for months depending on market conditions.



BE ACTIVE

We believe investors need to be active, not passive, when building investment portfolios due to continuous changes in the expected risks and returns of various global stock and bond markets. For example, CLS portfolios are different from the broad market as some markets are more expensive and carry more risk than others. Examples include emphasizing value-oriented stocks (companies that can be bought for a lower multiple of sales or earnings) and international stocks (as U.S. stocks are the most expensive they have been versus international stocks in decades). In addition, when building portfolios of exchange-traded funds (ETFs), CLS will emphasize smart beta ETFs (rules-based funds, such as those that only buy securities with the lowest price-to-sales ratios) and actively managed ETFs (funds that try to be different from their underlying benchmarks).



BE RESILIENT

This theme essentially has two parts. First, the bull market in stocks (now a 10-year increase in price without a 20% pullback) and the economic expansion are mature. It doesn't mean that the demise of either is necessarily imminent, but CLS is nonetheless making the portfolios more resilient in anticipation of late-cycle market behavior. This means that CLS portfolios will be putting more emphasis on non-cyclical sectors that should perform better in this anticipated environment. These sectors would include consumer staples and healthcare. The second part of this theme is that fixed income (i.e. bonds) remains vital to helping stabilize and manage portfolio risk. Nonetheless, interest rates are low by historical standards. Thus, investors need to be creative in diversifying equity risk. CLS will do this by putting more emphasis on alternative investment strategies, such as merger arbitrage which has low volatility like the bond market, and real assets such as commodities and real estate investment trust (REITs). Real assets tend to be more volatile like the stock market, but since they often have a different rhythm to price movement, they help reduce overall portfolio volatility. They also provide some insurance against changes in inflation and inflation expectations.



BE INNOVATIVE

Despite what we anticipate to be slower growth in the immediate year(s) ahead, we believe that the future remains especially bright for the global economy and markets. Due to innovative technologies, the economy is being reshaped and new opportunities are being presented in a variety of industries, including cybersecurity, clean energy, healthcare, FinTech, artificial intelligence, robotics, biotech, and much more.

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