CLS's

WEEKLY 3

What You Need to Know About the Markets

AUGUST 6, 2019

CLS INVESTMENTS

1 What does the Fed's rate cut mean for investors?

2 Thoughts on market opportunities from two important guests of CLS

3 It's our higher calling to counsel investors and help them stay balanced and invested

Month in Review

Despite volatility to end the month, the global stock market posted another gain in July, with U.S. stocks leading the way.

For the year, the global stock market is now up by more than 16%, while the U.S. stock market is up just shy of 21%. It has been a good year for investors, and we expect that there is a good chance the markets will move even higher.

At the end of July, however, a few catalysts for price weakness made a showing. In fact, last week was the worst week of 2019 for the stock market. First, the Federal Reserve (Fed) cut short-term rates by 25 basis points (one quarter of 1%), and, evidently, the markets were hoping for more. I'll have more on the Fed later in this report. Second, President Trump issued new tariffs on China. While long-term investors should consider the day-to-day news about trade talks as mostly noise, the latest news and data around trade are definitely not positive and will likely stiffen the headwinds for global growth.

Given these developments, combined with the market's seasonal tendencies for middling to below-average returns in August and September, it's hard to imagine the market exploding to the upside in the weeks ahead. The silver lining is that this is a great time to buy, as the last three months of the year have historically been quite strong for the stock market (last year was one clear exception).

CLS portfolios have participated in the year's strong gains, although our high-conviction views have lagged the overall market. We continue to favor international stocks over U.S. stocks, as U.S. stocks are the most expensive that they have been relative to international stocks in decades. We have also tilted portfolios toward value-oriented sectors, such as financials, and away from growth sectors, such as technology and consumer discretionary. Similarly to U.S. stocks, growth stocks are the most expensive they have been relative to value stocks in decades.

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.

At CLS, our long-term investing approach continues to be characterized by discipline and patience. As one market sage told me decades ago, "The trick to successful investing is to broadly diversify and don't buy expensive (stuff)." At CLS, that's exactly how we try to do it.

The overall global stock market gained less than 1% in July. This was led by the U.S. stock market, which was up nearly 2%. Smaller U.S. companies gained more than 2%. Developed international equity markets had slight losses on the month, and emerging markets lost nearly 1%.

The bond market also had a slight loss for the month. The 10-year U.S. Treasury yield ended July at 2.02%. The three-month U.S. Treasury yield ended at 2.08%. It is uncommon to see short-term interest rates higher than long-term rates, which is what we're seeing now. This is deemed an "inverted" yield curve, and it typically suggests that lower economic growth is ahead but not necessarily imminent.

Real assets also had losses last month, and commodities lost nearly 1%.

Market Performance *(as of 7/31/2019)*

Fixed Income	10-YEAR	5-YEAR	3-YEAR	1-YEAR	YTD	QTD	JULY
Cash Equivalent[1]	+0.47%	+0.88%	+1.41%	+2.28%	+1.38%	+0.18%	+0.18%
U.S. Investment Grade Bonds[2]	+3.75%	+3.05%	+2.17%	+8.08%	+6.35%	+0.22%	+0.22%
Equities	**10-YEAR**	**5-YEAR**	**3-YEAR**	**1-YEAR**	**YTD**	**QTD**	**JULY**
Global Equity Market[3]	+9.45%	+6.53%	+10.11%	+2.88%	+16.39%	+0.25%	+0.25%
Total U.S. Market[4]	+14.08%	+11.09%	+13.24%	+7.50%	+20.68%	+1.52%	+1.52%
Domestic Large-Cap Equity[5]	+13.91%	+11.58%	+13.90%	+8.39%	+19.93%	+1.57%	+1.57%
Domestic Small-Cap Equity[6]	+13.18%	+8.17%	+9.45%	-1.84%	+19.48%	+1.21%	+1.21%
International Equity[7]	+5.77%	+2.35%	+7.17%	-2.13%	+12.04%	-1.17%	-1.17%
Developed International Equity[8]	+5.94%	+2.32%	+6.83%	-2.52%	+13.11%	-1.10%	-1.10%
Emerging Market Equity[9]	+5.25%	+2.38%	+8.43%	-0.65%	+8.90%	-1.39%	-1.39%
Diversifiers	**10-YEAR**	**5-YEAR**	**3-YEAR**	**1-YEAR**	**YTD**	**QTD**	**JULY**
Diversified Alternatives[10]	+3.61%	+0.37%	+1.36%	-0.27%	+3.85%	+0.04%	+0.04%
Commodity[11]	-4.11%	-8.34%	-0.68%	-5.36%	+4.35%	-0.67%	-0.67%

[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 Fed Cuts Rates

The Fed completed its much-anticipated July meeting with the announcement of a 25 basis point (bp) cut to the federal funds rate. The move was highly expected, as the market has had a 100% probability of a rate cut priced in for more than a month. In fact, the market anticipated a 50 bp cut and responded to the lower-than-expected cut with some disappointment. Equity markets sold off, bonds rallied, and the dollar moved higher. These moves seem counterintuitive to a rate cut.

The Fed's decision to cut rates really was exceptional. Not only was it the first rate cut since 2008, and it wasn't that long ago that everybody thought the Fed would raise rates, but it is rare to cut rates when the stock market is at all-time highs. It is also unprecedented to cut rates when the unemployment rate is as low as it currently is.

So, why did the Fed cut rates?

- The most common view is that this was an insurance cut to get ahead of things before the economy moves into recession. Economic data in the U.S. remains positive, but it is slowing, and trade tensions continue to weigh on the global economy.
- The bond market is also concerned about a potential recession. The aforementioned inverted yield curve (long-term rates lower than short-term rates) suggests a recession could be on the horizon. An inverted yield curve isn't just symbolic. All else being equal, it's a negative for financial institutions whose profitability is still impacted by its basic business model of borrowing short-term and lending long-term. An inverted yield curve shuts down that profit opportunity, discourages lending, and negatively impacts future economic growth. A lower short-term interest rate helps alleviate that situation.
- Inflation remains below the Fed's targeted 2% rate. Although low inflation isn't necessarily negative, the Fed does not want to risk deflation. Cutting rates can help ignite inflation.
- The Fed is surely thinking global, too. Global growth is slow and slowing. Interest rates around the world are much lower than they are in the U.S., if not flat-out negative. This generally makes the U.S. dollar stronger. While the Fed is not directly concerned by a stronger dollar, it may be an indirect concern because of its negative effects on the U.S. economy (as a stronger dollar hurts exports). We often hear that the president wants a weaker dollar. These cuts may help him get his wish.

What does this mean for markets?

- Expect more volatility. There will surely be more emphasis on key economic data and what it may mean for the next moves from the Fed. This includes growth and inflation data, not just in the U.S., but also abroad.
- By cutting rates while the U.S. economy is still in decent shape, the Fed is being proactive in keeping the current expansion intact. Although we are now in the longest economic expansion on record, expansions do not have to die of old age. Current economic data suggests that a recession this year is still unlikely. However, it seems that odds are increasing for a recession in the year(s) ahead. This depends on a variety of factors, including the development of trade talks.

What is CLS watching for now?

- We believe that the economy is treading water comfortably, and in the current environment, we don't expect the Fed to enter a prolonged easing cycle. As previously mentioned, we see this as an insurance cut.
- We will continue to monitor economic data and future moves by the Fed to get a sense of the economic environment and potentially attractive opportunities that may become available as the cycle continues.
- We believe that the U.S. is in late stages of the economic cycle, which has prompted one of our new investment themes: "Be Resilient." This theme reflects our current emphasis on building portfolios with an overweight to defensive sectors that have historically outperformed the market as economic data weakens and expansions end.

In summary, the move by the Fed should encourage market participants. It should benefit globally diversified portfolios and help international equities on the margin (due to a potentially weaker dollar) and value stocks, assuming the lower short-term rates push the inflation rate higher.

2 The Forum and "The Weighing Machine"

In the last week of the month, CLS Investments held its quarterly CLS Forum and Investment Committee (IC) meeting. The IC is composed of senior investment team members, compliance staff, and former CLS President and CEO Todd Clarke. The IC reviews CLS performance and market risk, among other metrics. The IC is officially in charge of any changes to our core investment philosophy and Risk Budgeting Methodology. In addition, the IC is responsible for the CLS Investment Themes, which are intertwined with all CLS investment strategies.

The CLS Forum is split into two segments in which outside speakers present on topics related to our Investment Themes. The speakers argue either for or against the current themes and may help introduce and articulate new themes.

Our first forum guest for the July meeting was John van Moyland from Kensho via State Street Global Advisors (SSGA). During his presentation, John provided a basic overview of Kensho and his background. As a thought leader on the New Economy, John expanded on what he thinks that means for investors. He focused on five key areas of potentially significant investment opportunity:

- Future security
- Smart mobility
- Intelligent structures
- Clean energy
- Final frontiers

Our second guest was from PIMCO, which has arguably been the top fixed income shop of the last 25 to 30 years. PIMCO Portfolio Manager Dave Braun runs the BOND ETF, which has been one of CLS's top ETF holdings for years and was initially launched as the ETF equivalent of the once-largest mutual fund, PIMCO Total Return. (There are notable differences between the mutual fund and ETF now.)

Dave spoke on our Be Resilient theme and provided insights from PIMCO on the economy and global financials with special emphasis on the fixed income markets. With interest rates as low as they are, Dave reaffirmed the value of the fixed income asset class. He also reminded us why investors need to be active and make changes to their fixed income allocations when conditions warrant, and he provided various examples of current opportunities.

Each speaker was interviewed on CLS's The Weighing Machine, a bi-weekly podcast hosted by Robyn Murray and myself. Our guests provided highlights of their full presentations, which you will be able to hear in our next two episodes.

Speaking of podcasts, the tables were recently turned on me! I was interviewed on Money Matters with Adam Torres.

3 Higher Calling

As an investor, I'm grateful to live in a world of opportunities, growth, and innovation. As an investment advisor, I'm grateful to live in an inspiring world full of hope and opportunities to make a positive difference in many people's lives. I may not be able to control the markets or know what will happen next, but I can help provide the discipline and patience needed by the investors who depend on me. It's my responsibility, my life's work, and my higher calling.

I've heard these sentiments echoed by advisors from across the country and, most recently, in the White Mountains of New Hampshire.

For the last few years, I've been invited to participate in an annual hike by outdoor and hiking enthusiast Eric Clarke, the founder and CEO of CLS's sister company, Orion Advisor Services. The hike is organized by Tiburon Advisors and is called Chip and Skip's Excellent Adventure. Quite frankly, it often seems that the goal is to simply survive the day!

The participants of the hike are financial advisors and C-level executives from financial services firms around the country, along with some of their friends and families. This year, the Excellent Adventure was in New Hampshire, and we hiked the Presidential Range in one day (it's typically a two-day hike). It was about 25 miles, 9,000 vertical feet, and included several peaks. Not exactly a walk in the park!

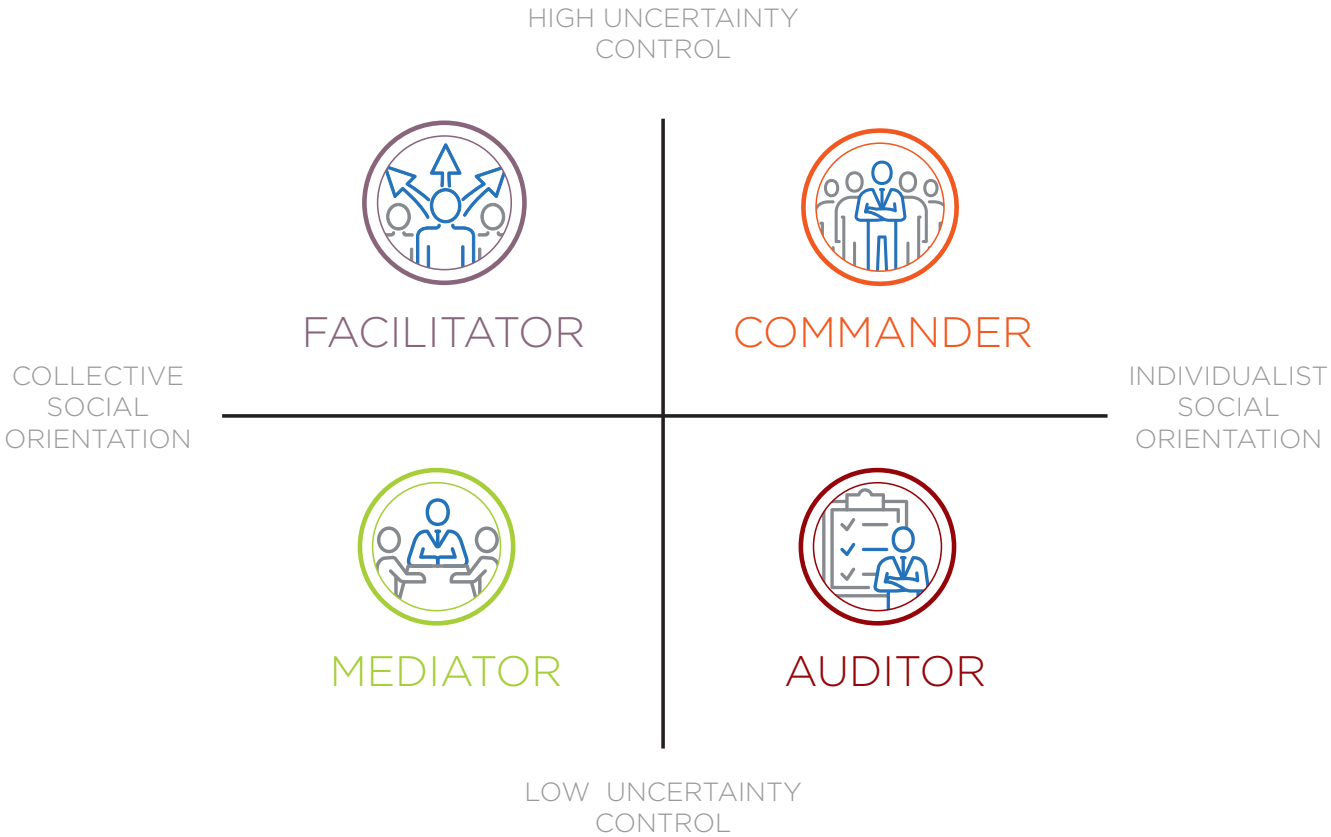
I invited my daughter to hike with us this year. She recently graduated from Bowdoin College, and since she is now starting her career in the financial industry, she enthusiastically agreed to join us on the hike. While there were a few times I wondered if I would survive her instead of the hike itself, she ultimately grinded it out and eventually led much of the way. And she had fun! She also said that she would do it again. The picture below is from the last peak – after hiking 22+ miles.

Besides the legit adventure, accomplishment, and comradery, there is something about hiking on the trails that prompts great conversations to flow. The topics range from family to, of course, our professions. There's a lot of pride in what advisors do and what they can accomplish for their clients. It's not just numbers. It's relationships and the ability to really understand an investor's expectations, emotions, and their desired outcomes. This is the stuff that ultimately drives long-term success, and each of the advisors on that hike live that calling.

At CLS Investments, we continue to think of and develop new ways to empower advisors and investors toward better investment outcomes. Specifically, over the last few years, we've been working on a new tool that will help advisors and investors better understand their investing behavior. It's called Investor BluePrint™, an in-depth psychological assessment that taps into client characteristics to uncover behavioral patterns that may impact financial decision-making. The development of this tool is being led by CLS Chief Behavioral Scientist and Analytics Officer Nick Arreola, PhD.

Investor BluePrint™ comprises four behavioral profiles based on a combination of Uncertainty Control and Social Orientation (see grid on the following page). Uncertainty Control captures attitudes and beliefs about future outcomes, while Social Orientation refers to whether someone leans toward conforming to the social norms and adopting the customs of a group (Collectivist) or toward forming and expressing their unique identity separate from others (Individualist). Neither of these traits is inherently good or bad;

3 Higher Calling (Cont.)



rather, each serves as a guide to better understand investors and help advisors communicate potential challenges that could interfere with achieving their financial goals.

For more about Investor Blueprint™ and to learn more about Nick and his work, listen to this episode of CLS's The Weighing Machine. It's a fun interview, and it's obvious that Nick enthusiastically believes that it's his calling to help advisors and investors achieve their goals.

For advisors interested in utilizing behavioral finance to help investors stay on track, the Investor Blueprint™ assessment is available online to take for free.

Thank You

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

Stay balanced, and stay the course.

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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.

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**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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