Weekly 3

WHAT YOU NEED TO KNOW ABOUT THE MARKETS

October 9, 2019

CLS INVESTMENTS

Week in Review

Global equity markets were generally lower last week. U.S. large-cap companies were down slightly but were still the top performers within equities, while small-caps were down close to 1%. Growth stocks outperformed value stocks. International stocks were down close to 2%, underperforming domestic, with international developed markets being the laggards, down just over 2%. International stocks, on the other hand, had negative returns, dragged down particularly by emerging markets.

Aggregate bonds were up close to 1%, outperforming cash, as the 10-year Treasury yield dropped throughout the week to 1.53%. Broad commodities and diversified alternatives had a slightly negative week, while real estate finished in mildly positive territory, continuing its strong returns this year.

In economic news, there was an unexpected decline in the Institute for Supply Management's (ISM) manufacturing index, which fell for the sixth consecutive month and reached its lowest level since 2009. Additionally, the ISM reported weakness in the much larger services sector, which fell to its lowest level in three years. But a bright spot that calmed worries was the payroll data, which showed 136,000 jobs created in September, with previous months revised higher, and the national unemployment rate hit a 50-year low.

1 *There is a new game in town for lowering investing expenses and yet another barrier removed for investors.*

2 *U.S. outperformance may seem like the standard, but it is important to remember that markets are cyclical.*

3 *Expectations from various asset managers may differ, but they generally point in the same direction for key asset classes.*

Market Performance

as of 10/05/2019

FIXED INCOME	10-YEAR	5-YEAR	3-YEAR	1-YEAR	YTD	QTD	LAST WEEK
Cash Equivalent[1]	+0.51%	+0.95%	+1.52%	+2.31%	+1.75%	+0.03%	+0.04%
U.S. Investment Grade Bonds[2]	+3.80%	+3.46%	+3.30%	+12.00%	+9.35%	+0.77%	+0.81%
EQUITIES	**10-YEAR**	**5-YEAR**	**3-YEAR**	**1-YEAR**	**YTD**	**QTD**	**LAST WEEK**
Global Equity Market[3]	+8.77%	+6.77%	+9.41%	+1.44%	+14.86%	-1.07%	-0.91%
Total U.S. Market[4]	+13.47%	+10.44%	+13.03%	+3.29%	+19.42%	-0.81%	-0.30%
Domestic Large-Cap Equity[5]	+13.45%	+10.94%	+13.94%	+3.80%	+19.43%	-0.66%	-0.14%
Domestic Small-Cap Equity[6]	+12.01%	+7.37%	+7.69%	-5.61%	+14.26%	-1.43%	-0.98%
International Equity[7]	+5.00%	+3.37%	+5.83%	-0.65%	+10.05%	-1.40%	-1.66%
Developed International Equity[8]	+5.26%	+3.48%	+5.90%	-1.48%	+11.55%	-1.74%	-2.07%
Emerging Market Equity[9]	+4.12%	+2.98%	+5.75%	+2.60%	+5.68%	-0.39%	-0.42%
DIVERSIFIERS	**10-YEAR**	**5-YEAR**	**3-YEAR**	**1-YEAR**	**YTD**	**QTD**	**LAST WEEK**
Diversified Alternatives[10]	+3.03%	+0.64%	+1.47%	+0.22%	+4.31%	-0.44%	-0.32%
Commodity[11]	-4.03%	-7.03%	-1.36%	-8.12%	+3.36%	+0.22%	-0.48%

[1]Morningstar Cash Index [2]Bloomberg Barclay's Capital U.S. Aggregate Bond Index [3]Morningstar Global Market 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 Diversified Alternatives Index [11]Bloomberg Commodity Index.

KOSTYA ETUS, CFA

Co-director of Research & Senior Portfolio Manager

Konstantin "Kostya" Etus specializes in international investments. He is a co-manager on two mutual funds (aggressive allocation and international) and manager on various separate account strategies, including Core Plus ETF and ESG. In addition, he manages 529 plans.

Mr. Etus began his career at CLS in 2011 as a Trading Specialist and became a Research/Portfolio Analyst in early 2013. In 2016, he was promoted to Portfolio Manager. Prior to working at CLS, Mr. Etus worked as an Associate Financial Analyst at ConAgra Foods, Inc., managing the company's global cash network.

He graduated from the University of Nebraska at Omaha with a Bachelor of Science degree in Business Administration and obtained Master of Investment Management and Financial Analysis and Master of Business Administration degrees from Creighton University. He holds the Series 65 securities registration and the Chartered Financial Analyst® (CFA) designation.

Did you know? Kostya grew up in Soviet Russia.

The Race to Zero: Version 2.0

1

> Sir, anything you order is free of charge, sir." —Waiter
> "Why is it free of charge?" —Marla
> "Don't ask." —Narrator (Ed Norton)
>
> *–Fight Club (1999)*

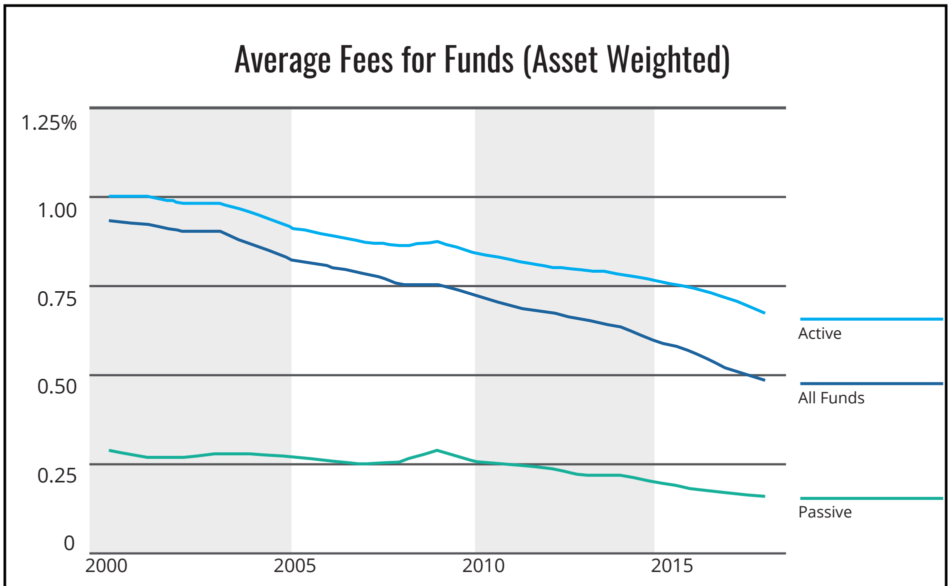
The biggest news from last week was not about recession or impeachment fears, nor was it about trade wars, although it did have to do with a different kind of war: a fee war. The headline heard round the world was that Schwab and TD Ameritrade eliminated commissions for stock, exchange-traded fund (ETF), and option trades.

But let's take a step back and figure out how this all started. The "race to zero," as it has come to be known, deals with reducing costs for investors in an attempt to garner assets from competitors. This has been particularly prevalent in the ETF industry where similar index-based investments have little to compete on aside from cost. But the meteoric growth in the ETF market eventually started turning heads in the mutual fund world, and focus began shifting toward launching lower-cost passive products as well as lowering fees on existing active funds. This really came to a climax with the release of the zero-fee Fidelity index funds. You can clearly see this trend in the chart below from Morningstar's annual fund fee study. So, if fund fees can go to zero, why can't trading commissions?

On the brokerage side, commissions for trades have also been reduced over the years at the major institutions such as Schwab, TD Ameritrade (TD), E*Trade, and Fidelity, primarily pressured by the rise of Silicon Valley start-up Robinhood, which began offering commission-free trades back in 2013. Since then, Vanguard Group and J.P. Morgan Chase have offered up free trading applications; and just two weeks ago, Interactive Brokers began offering a commission-free product called IBKR Lite. It was just a matter of time before one of the big brokers pulled off the Band-Aid, and it was not much surprise that it was Schwab to go first.

Schwab has been at the forefront of the low-cost movement by consistently undercutting the competition for ETF and mutual fund expense ratios. It seems reasonable that Schwab was the first to pull the trigger in announcing the reduction of commissions to zero. TD and E*Trade stock prices had an immediate negative reaction, falling nearly 26% and 16% respectively on announcement day. But these price drops may have been justified because the market expectation was that both brokerage firms would follow suit and lose their commission revenues. It just so happens that commissions account for an estimated 28% of revenues for TD and 17% for E*Trade. They rely significantly more on commission revenues than Schwab, for which commissions account for closer to 4% of total revenue.

Sure enough, TD and E*Trade quickly eliminated their commissions, too. We expect that Fidelity will be the next to react to this news, finishing the race to zero on the brokerage side. Ultimately, this is a benefit to investors, freeing up the markets and eliminating another barrier to investing for all.



Source: Morningstar Direct. Data as of 12/31/2018.

U.S. Outperformance is NOT the Norm

2

Excuse me, sir. Another ice warning, this one is from the Noordam." -Operator "Oh, not to worry. Quite normal for this time of year. In fact, we're speeding up. I've just ordered the last boilers lit." -Captain Smith

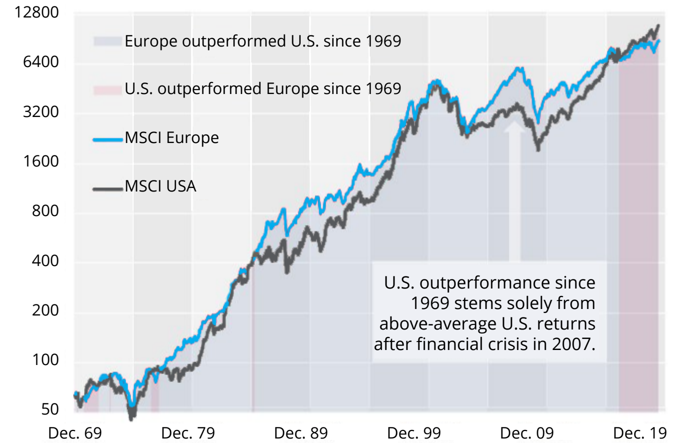
—Titanic (1997)

Did you know that European markets have outperformed the U.S. consistently since 1969 all the way up to the financial crisis in 2008? It wasn't until after the crisis that the U.S. rebounded with a vengeance and has had excessive returns, catching up to Europe and making U.S. stocks overvalued.

Over the last decade, investors have become used to this U.S. outperformance and naively consider it the norm. This is caused by a human behavior pattern called "recency bias" — when a person most easily remembers something that has happened recently, compared to remembering something that occurred a long time ago.

The U.S. market is now expensive due to biased strong flows into the U.S. and out of international over the past decade.

Europe Outperformed U.S. Until Financial Crisis



Source: Thomson Reuters Datastream and own calculations during 1999-2019 for global stock markets based on MSCI REGION INDICES (RI in EUR) as of 4/30/2019.

So, what do you think the next decade will bring?

It is important to understand that markets are cyclical in nature, and no one market outperforms for too long.

Investor emotions are hard to predict, which is why it's tough to time the market, but the human brain cannot be changed — so you know you tend to get the same result eventually. You cannot teach someone to ignore their instincts. Therefore, the markets tend to be cyclical.

The table to the right shows the last few decades of regional performance. Prior to 2009, emerging markets (MSCI EM) were huge performers, outpacing the U.S. by a wide margin. But after 2009, the U.S. has been on a tear, beating EM handily. In such a scenario, relative value investors are chomping at the bit to sell U.S. and buy EM; we believe it's a bargain shopper's dream.

So, once again, what do you think the next decade will bring?

10-Year Performance Ranks

Region	Rank	1999-2009		Rank	2009-2019
MSCI USA	10	-20%		1	282%
MSCI ACWI	9	-2%		2	181%
MSCI Emerging Asia Index	4	100%		3	163%
MSCI Emerging Markets	2	137%		4	125%
MSCI ACWI ex USA	5	21%		5	106%
MSCI EAFE	7	8%		6	102%
MSCI Europe	8	4%		7	101%
MSCI Pacific	6	20%		8	92%
MSCI Emerging Europe	3	123%		9	77%
MSCI Emerging Latin America	1	288%		10	68%

Source: Bloomberg using MSCI indices from 12/31/2008 to 8/31/2019.

Performance Expectations for Various Asset Classes

3

> *Since when can weathermen predict the weather, let alone the future?"*
> *—Marty McFly, Back to the Future (1985)*

At CLS, we produce our own capital market assumptions (CMAs), or expectations for future returns, for various asset classes. They are complements to our refined Risk Budgeting framework. The expectations start with the historic risk premium associated with risky assets and further overlays current relative valuations, as well as adjustments for quality, changes in risk, and technical signals.

More recently, we have been comparing our expectations to those of other asset management firms. In the table below, for simplicity purposes, we have taken an average of eight notable asset managers' forecasts for four key asset classes. Here are the findings:

U.S. Stocks

The U.S. market has had one of the longest and strongest bull markets on record in the current period starting post-financial crisis. Thus, it is no surprise that valuations are on the expensive side. Given that long-term historic market returns are generally between 8% and 10% in the U.S., an expectation of just more than 2% from CLS is certainly a bearish outlook, but note that it is still positive. The asset manager average is not quite as bad, but it is still less than half of the historic average at more than 3%.

International Stocks

Developed international markets outside of the U.S. have had trouble growing their economies despite incredibly accommodative monetary policies, such as having negative interest rates. Additionally, Brexit and trade disputes in Europe and demographic trends in Japan have caused additional pressure on growth. This has resulted in weak technicals and quality metrics, as well as heightened risk, resulting in weaker expectations from CLS, although they are still higher than the U.S. The asset manager average is about double the CLS average, so other managers are more optimistic on the region but directionally similar.

Long-Term Expected Returns

	CLS	Asset Manager Average
U.S. Stocks	2.10%	3.48%
International Stocks	2.75%	6.25%
Emerging Markets	5.40%	8.20%
Bonds	2.03%	2.38%

As of 8/31/2019. Information contained herein is derived from sources we believe to be reliable, however, we do not represent that this information is complete or accurate and it should not be relied upon as such. This information is prepared for general information only. Past performance is not a guide to future performance. Future expectations may not be realized.

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Emerging Markets

Emerging markets have attractive valuations, growing economies, and higher interest rates, which gives their governments ammo to boost economic growth, if needed. These metrics lead to us to expect more than double the returns of the U.S., at 5.4%. This aligns well with the asset manager average, which is almost more than double their U.S. expectation, at 8.2%.

Bonds

Historically low rates and a flat yield curve may give pause to some investors, believing bonds to be overvalued. But, remember, the best predictor of bond returns is the current yield, and bonds are typically in favor in a more volatile and uncertain environment as a safe-haven investment. Thus, a 2% forecast from CLS is relatively close to the asset manager average.

While CLS tends to be more conservative in our assumptions, it seems that directionally we are in line with the asset manager average. Based on these expectations, among other factors, CLS has been positioned toward higher allocations in international stocks, particularly within emerging markets. Additionally, it is important to remember bonds are an important diversification tool, a source of income, and have potential for returns similar to U.S. stocks with lower risk going forward.

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 Morningstar Diversified Alternatives Index allocates among a comprehensive set of alternative underlying ETFs that employ alternative and non-traditional strategies such as long/short, market neutral, managed futures, hedge fund replication, private equity, infrastructure or inflation-related investments. The Russell 3000 Index is an unmanaged index considered representative of the U.S. stock market. The index is composed of the 3,000 largest U.S. stocks. 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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