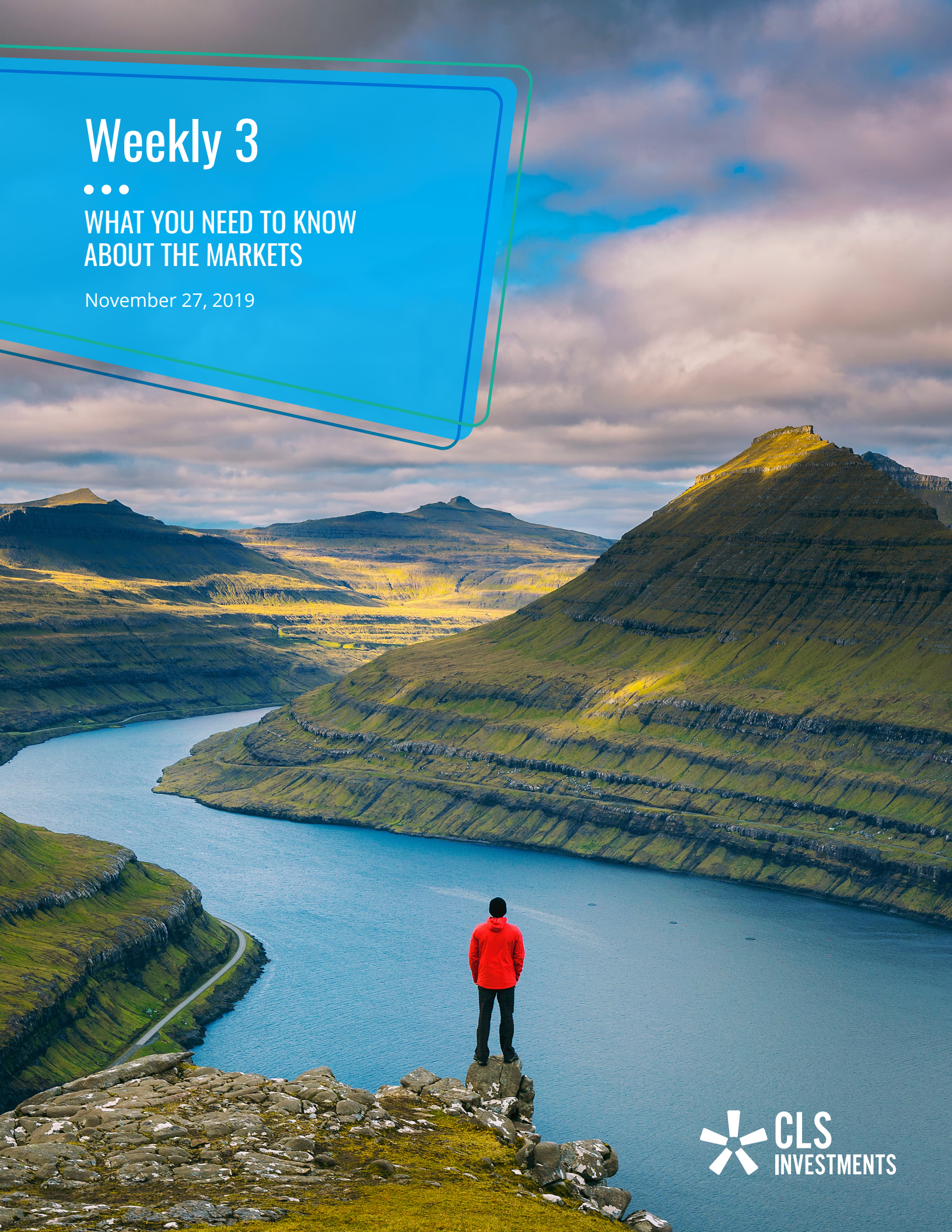
Weekly 3

WHAT YOU NEED TO KNOW ABOUT THE MARKETS

November 27, 2019



CLS INVESTMENTS

Week in Review

Global equity markets were generally lower last week amid China-U.S. trade concerns. Emerging markets lost the least within equities, down just slightly, while international developed markets were the weak link with over a half percent drop. In aggregate, international slightly underperformed domestic. And within domestic, large-caps beat small-caps. This marks the first negative week after six consecutive positive weeks for the U.S. market.

Aggregate bonds were up slightly last week, outperforming cash, as the 10-year Treasury yield fell, ending the week at 1.77%. Broad commodities, diversified alternatives, and real estate all had a slightly negative week.

In economic news, there was a generally positive tone as existing home sales rose more than expected, the University of Michigan measurement of consumer sentiment increased to period highs, and the IHS Markit composite of both manufacturing and service activity hit a four-month high. Lastly, the Federal Open Market Committee (FOMC) minutes indicated there would be a pause for the rate-cutting cycles unless there is clear weakness in the economy.

1 *While bull markets don't die of old age, they do die eventually.*

2 *We look past regional borders to search for undervalued companies that create attractive opportunities.*

3 *CLS is focused on helping minimize the tax burden on investors.*

Market Performance

as of 11/25/2019

FIXED INCOME	10-YEAR	5-YEAR	3-YEAR	1-YEAR	YTD	QTD	LAST WEEK
Cash Equivalent[1]	+0.53%	+1.00%	+1.58%	+2.24%	+1.99%	+0.26%	+0.03%
U.S. Investment Grade Bonds[2]	+3.64%	+3.16%	+4.02%	+10.81%	+8.63%	+0.10%	+0.29%
EQUITIES	**10-YEAR**	**5-YEAR**	**3-YEAR**	**1-YEAR**	**YTD**	**QTD**	**LAST WEEK**
Global Equity Market[3]	+8.78%	+7.21%	+11.76%	+16.09%	+21.43%	+4.59%	-0.33%
Total U.S. Market[4]	+13.41%	+10.53%	+13.99%	+19.32%	+26.21%	+4.82%	-0.23%
Domestic Large-Cap Equity[5]	+13.32%	+11.14%	+15.20%	+20.48%	+26.47%	+5.20%	-0.25%
Domestic Small-Cap Equity[6]	+12.39%	+7.33%	+7.55%	+10.51%	+21.14%	+4.50%	-0.46%
International Equity[7]	+5.09%	+4.16%	+9.51%	+12.61%	+16.52%	+4.39%	-0.44%
Developed International Equity[8]	+5.42%	+4.22%	+9.43%	+13.12%	+18.26%	+4.17%	-0.57%
Emerging Market Equity[9]	+3.97%	+3.92%	+9.95%	+11.37%	+11.47%	+5.06%	-0.07%
DIVERSIFIERS	**10-YEAR**	**5-YEAR**	**3-YEAR**	**1-YEAR**	**YTD**	**QTD**	**LAST WEEK**
Diversified Alternatives[10]	+3.04%	+0.67%	+1.79%	+2.88%	+5.03%	+0.25%	-0.38%
Commodity[11]	-4.71%	-6.82%	-0.96%	-3.45%	+4.64%	+1.46%	-0.43%

[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 xU.S. Large-Mid Index [9]Morningstar EM Large-Mid Index [10]Morningstar Diversified Alternatives Index [11]Bloomberg Commodity Index.

What Causes a Bear Market?

1

> 105 years old, he hung in there, didn't he?" —Peter Venkman
> "He didn't die of old age, either. He was poisoned, stabbed, shot, hung, stretched, disemboweled, drawn and quartered." —Ray
> "Ouch." —Venkman
> *-Ghostbusters II (1989)*

The chart I've included in this article, familiar to those who have read CLS's Reference Guide, shows that markets generally move up slower than they drop, but the "up" periods are longer and stronger than the "down" periods – more evidence for the benefits of staying invested long-term. But bear markets do happen; what is often unclear is what causes them. There are many great quotes that start with "Bull markets don't die of old age..." but they all end differently:

"...they are killed by higher interest rates."

"...they get murdered by the Fed."

"...they die of excess."

"...they die of exhaustion."

"...they are killed by recessions." (Note: you can see in the chart below that a recession is not a requirement for a bear market.)

"...they die of fright." This is my favorite one, and the one I think holds the most merit.

Often, this "fright" is caused by an extreme event that may not have much to do with investments, such as war. I evaluated some interesting bear markets that have occurred post World War II to get a better idea of what caused them. After all, history is a great teacher.

1946-1947

Geopolitics. As WWII came to an end, industrial production plummeted and investors feared a second Great Depression.

1961-1962

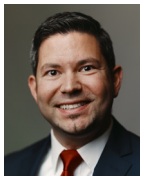
Geopolitics. A failed Bay of Pigs invasion in Cuba sparked Cold War fears while unions demanded salary increases, angering President John F. Kennedy and creating fears of an anti-business administration.

1966

Geopolitics. As the Vietnam War was heating up after the U.S. bombing of Hanoi, the Federal Reserve signaled the economy was overheating, sending interest rates and inflation higher.

1968-1970

Geopolitics. The murder of Martin Luther King, Jr., the murder of President Kennedy, and massive anti-war demonstrations led to widespread riots, kicked off by the Detroit race riots in 1967.



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.

1973-1974

Geopolitics. An Arab Oil Embargo in 1973 led to price spikes and endless lines at the gas pump. The Watergate scandal and resignation of President Richard Nixon pushed stocks down even further.

1980-1982

High Rates/Inflation. Paul Volcker became chairman of the Federal Reserve in 1979; he believed that raising rates to unprecedented heights was the best way to calm soaring inflation. By the end of 1979, interest rates were at 21.5%, and by 1982, unemployment rose to 10.5%.

1987

High Rates/Inflation. More inflation-related fears sent the 10-year Treasury yield from 7% at the start of 1987 to more than 10% by October, leading to a flight to safety.

2000-2002

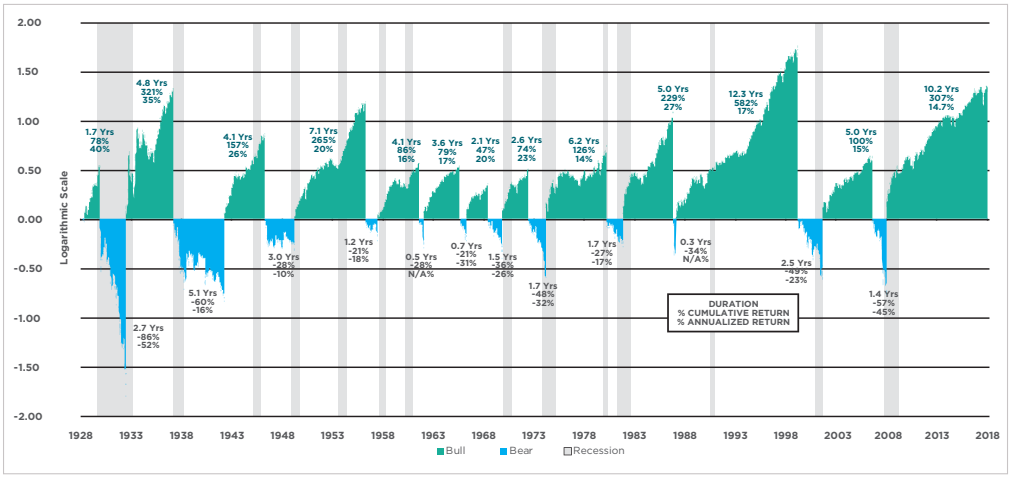
Market Panic. This is about the only bull market that did actually die of investment-related concerns. Stock prices reached astonishing heights, and some of the highest fliers didn't have any actual earnings to speak of. Selling led to more selling led to more selling.

2007-2009

Housing Crisis. In 2006, all you needed to buy a $1 million home was a bright smile and a fast-talking mortgage broker. By 2008, it was determined that bundles of bad loans were just as bad as individual bad loans – obscured by the power of financial engineering, that apparently was not common sense at the time. As mortgage defaults started, they crippled some of the biggest institutions on Wall Street.

Upon evaluation of these bear markets, what we find is that geopolitics is generally the culprit and is generally unpredictable. Additionally, high rates, high inflation, and housing could be a cause, none of which are an issue right now. Our advice, as always, is to stay balanced, diversified, and invested for the long term to improve the chances of reaching your financial goals.

S&P 500 Index Bull and Bear Markets



Source: S&P 500 price data is from Morningstar, Recession data is from nber.org, 1/3/1928 – 12/31/2018

Finding Diamonds in the Rough

2

> Mr. Ford, Ferrari has a message for you, sir." —Lee Iacocca
> "What did he say?" —Henry Ford II
> "He said Ford makes ugly little cars in ugly factories. And, uh, he called you fat, sir." —Lee Iacocca
> *-Ford v Ferrari (2019)*

Two key investment philosophies at CLS are investing in relatively undervalued stocks and allocating on a global scale. Additionally, we added a new investment theme this year focused on innovative and disruptive technologies. Let's take a dive into some of the recent developments in these areas.

Black Friday Deals and Investing in Undervalued Companies

The top-selling products and typical "doorbusters" on Black Friday tend to be tech-related: TVs, computers, cameras, gaming consoles, cell phones, smart watches, headphones, and various other products related to connectivity and convenience. One thing all of these products have in common is that they all use microprocessor chips to power their inner workings. And at the heart of each microprocessor are semiconductors.

Semiconductors are made of silicon, and that is where the California technology hub "Silicon Valley" gets its name. But did you know where the largest semiconductor company in the world is located (measured by market capitalization)? Hint: it's not in the U.S.

It is in Taiwan, and it is cleverly called Taiwan Semiconductor Manufacturing Company (TSMC). Estimates suggest that TSMC accounts for about 50% of the world's semiconductor revenues and about 80-90% of the profits. Apple is actually its top customer (that's right, you are carrying a piece of TSMC in your pocket), and it has designed a revolutionary chip that rivals have not been able to match.

Despite the U.S.-China trade war and the geopolitical turmoil in Hong Kong, TSMC has had outstanding returns this year, although it has underperformed its competitor, NVIDIA. That said, TSMC trades at about half the valuation, similar return-on-assets, higher margins, and much lower debt. We believe these factors set it up for stronger expected returns for the future. Its lower valuation is due to the fact that it's headquartered in an emerging market, which U.S. investors may avoid due to home bias.

NAME	TICKER	TOTAL RETURN (YTD)	PRICE-TO-EARNINGS RATIO	RETURN ON ASSETS %	NET MARGIN %	DEBT TO CAPITAL %
Taiwan Semiconductor Manufacturing Co Ltd ADSR	TSM	47.86	24.59	15.33	32.59	3.16
NVIDIA Corp	NVDA	57.80	45.38	19.84	26.93	19.30

Source: Morningstar Direct as of November 22, 2019.

We are always on the lookout for international companies that operate like U.S. counterparts but trade at significantly lower valuations. We love this type of undervalued company, and we scour the world looking for them as they can potentially present very attractive opportunities for future outperformance.

Finding Diamonds in the Rough (cont.)

2

Ford vs. Ferrari and Investing Internationally

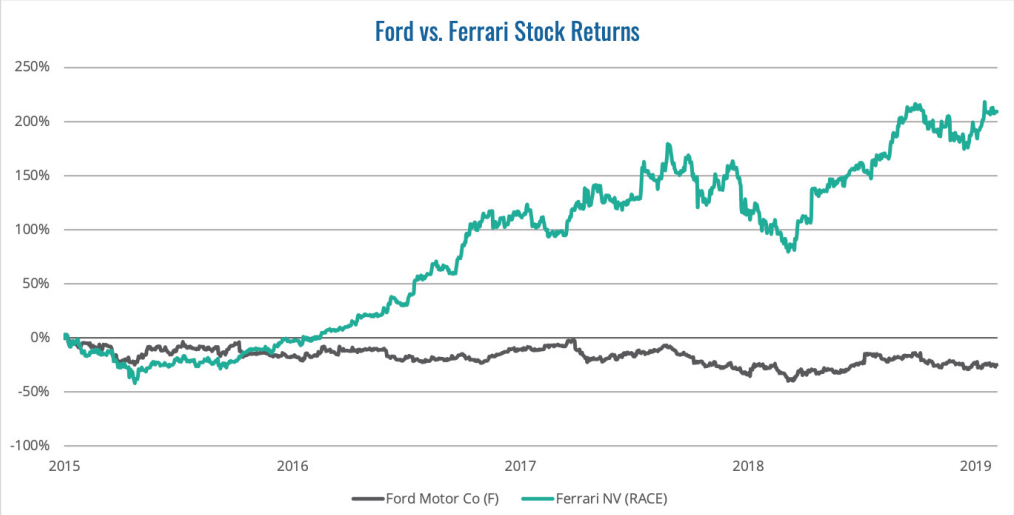
The "Ford v Ferrari" movie came out a couple weeks ago and has been a box office hit, not to mention it has received great reviews and has generated Oscar buzz for outstanding performances from Matt Damon and Christian Bale. (This may be the first movie where Bale uses his actual voice – count me in!)

The movie is about visionaries and innovators who defied convention and created a revolutionary race car for Ford to take on the undisputed world champion, Ferrari. But has this innovation continued through time as Ford evolved as a dominant industry leader?

Like many other large companies with wide margins, Ford has become complacent and has not kept up with innovations, while the relatively small Ferrari continues to be a leader within its niche market of high-end sports cars. Take a look at the stock prices of Ford vs. Ferrari since Ferrari went public in October of 2015. You can clearly see where the growth has happened, seems like Ferrari has won that race!

With Ferrari being based in Italy, it may have been overlooked by investors who only focus on domestic allocations. It is important to look all over the world for companies that are growing and innovating and are reasonably valued, which is often a recipe for attractive opportunities.

Ford vs. Ferrari Stock Returns



Investment Name	Cumulative Return	Annualized Return	Initial Value	Ending Value
Ford Motor Co	-24.57%	-6.65%	10,000	7,543
Ferrari NV	209.36%	31.77%	10,000	30,936

Finding Diamonds in the Rough (cont.)

2

The Cybertruck and Investing in Innovation

Tesla unveiled the much-anticipated "Cybertruck" last week, inspired by a futuristic design from "Blade Runner," which was, interestingly, made in 1982. They will be available in 2022 at a starting price of just under $40,000. There will be stiff competition from leading truck makers Ford and General Motors (GM), which jointly control 92% of the U.S. truck segment. But the disruption and technological evolution that Tesla has created in the automotive industry has not gone unnoticed as both Ford and GM (as well as Amazon, if you can believe it) have begun developing electric trucks of their own.

The adoption of electric vehicles by the legacy car manufacturers is refreshing to see. There have been so many examples of industry leaders stuck in their ways and not able to adapt to the future. Think about the phone maker Nokia. In mid-2008, Nokia was the largest phone maker in the world, but in hindsight we can see that Nokia was only able to make "dumb phones." A relatively new entrant into the phone business, named Apple, with its iPhone 3G, was a small blip in the overall cell phone market then, but it was the largest "smartphone" maker! Who knew that smartphones would rule the future?

Sales of electric vehicles currently account for a tiny fraction of total car production, but knowing how technology has evolved in the past can be a good tool for evaluating the future. That said, the average life of a cell phone is about 2 years while it's closer to 12 years for a car, so the transition to electric will appear in slow motion compared to smart phone adoption.

Electric cars are one of countless innovations happening around the world, and CLS has allocated to ETFs that attempt to benefit from these technological disruptors, which are driving change for the future. I leave you with a quote from the all-wise Oracle of Omaha:

"I've always said the easier thing to do is figure out who loses. And what you really should have done in 1905 or so, when you saw what was going to happen with the auto is you should have gone short horses. There were 20 million horses in 1900 and there's about 4 million horses now. So it's easy to figure out the losers, you know the loser is the horse. But the winner was the auto overall."

—Warren Buffett, speaking to University of Georgia students in 2001

Source: Tesla

A Time to be Thankful: The Capital Gains Edition

3

Thanksgiving is a time to research the best pumpkin pie recipes, coordinate with family members on what time works best for dinner, and check what estimated capital gains will be in 2019.

Estimated capital gains are fund earnings that have not yet been distributed to shareholders. They are relevant to investors using these funds to determine how much in taxes they will owe to Uncle Sam – applicable to taxable accounts only. They are also relevant to investors who are thinking about investing in a new fund. If a fund has a lot of embedded gains, a new investor could receive capital gains distributions – and pay taxes on them – for gains that happened before the investor purchased the fund, which is not fun to experience.

Investors are keeping a close eye on potential capital gains this year after the experience they went through last year. Data collected by Russell Investments showed that 91% of U.S. equity funds (active, index, and ETF funds) had a negative return in 2018. They also found that 86% of U.S. equity funds paid a capital gains distribution. The average taxable distribution last year was 11%. This means on top of the negative return investors received from their U.S. equity funds, they also had to pay taxes!

This year, the investment industry is estimated to pay out a slightly lower capital gains distribution compared to 2018. The bright side is that this year the stock market is up double digits compared to its negative return last year. The outrage by investors won't be as obvious.

These capital gains payouts have been especially high in recent years for two reasons:

1. U.S. equity funds have been the beneficiaries of the longest bull market in history. They have appreciated holdings that will need to be sold when investors withdraw money from their funds. This is more apparent in actively managed funds (e.g. the average capital gains distribution for large blend active funds in 2018 was almost 8%) versus passive funds (e.g. the average capital gains distribution for large blend passive funds was almost 4%).
2. A change in management could be the catalyst for above-average capital gains, too. For example, in January a new manager took over the well-known Fidelity Magellan fund, which was formerly managed by Peter Lynch, and that fund is expected to pay out 12% in capital gains in 2019. Also, a few Invesco funds are expected to pay out more than 20% in capital gains this year. This has to do with the reshuffling of managers when Invesco acquired Oppenheimer Funds late last year.

JEOVANY ZELAYA
Client Portfolio Manager

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

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

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

Did you know? Jeovany grew up in El Salvador.

A Time to be Thankful: The Capital Gains Edition (cont.)

3

It is well known that ETFs are more tax-efficient than mutual funds given their creation and redemption process. For example, actively managed, large blend ETFs on average paid out 0.8% capital gains versus mutual funds in the same category (7.9%).

Direct indexing is sort of like the new kid on the block when it comes to investment vehicles. These products are meant to replicate an index with fewer securities and can be tax-managed. (Shameless plug: CLS's Direct Indexing Tax Managed models are available exclusively on the Orion Portfolio Solutions platform.) The big value-add of these direct-indexed, tax-managed models is that they are designed to achieve 1% to 2% of tax alpha through tax management, meaning no capital gains taxes would be paid by investors using these vehicles.

I'll end with a few things I'm thankful for this year:

- I'm thankful that our direct-indexed, tax-managed models will likely provide tax alpha for our investors.
- I'm thankful our ETF strategies are estimated to pay little to no capital gains this year.
- Finally, I'm thankful CLS's proprietary mutual funds are estimated to pay out below-industry-average capital gains in 2019.

Happy Thanksgiving to you and your family!

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 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 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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