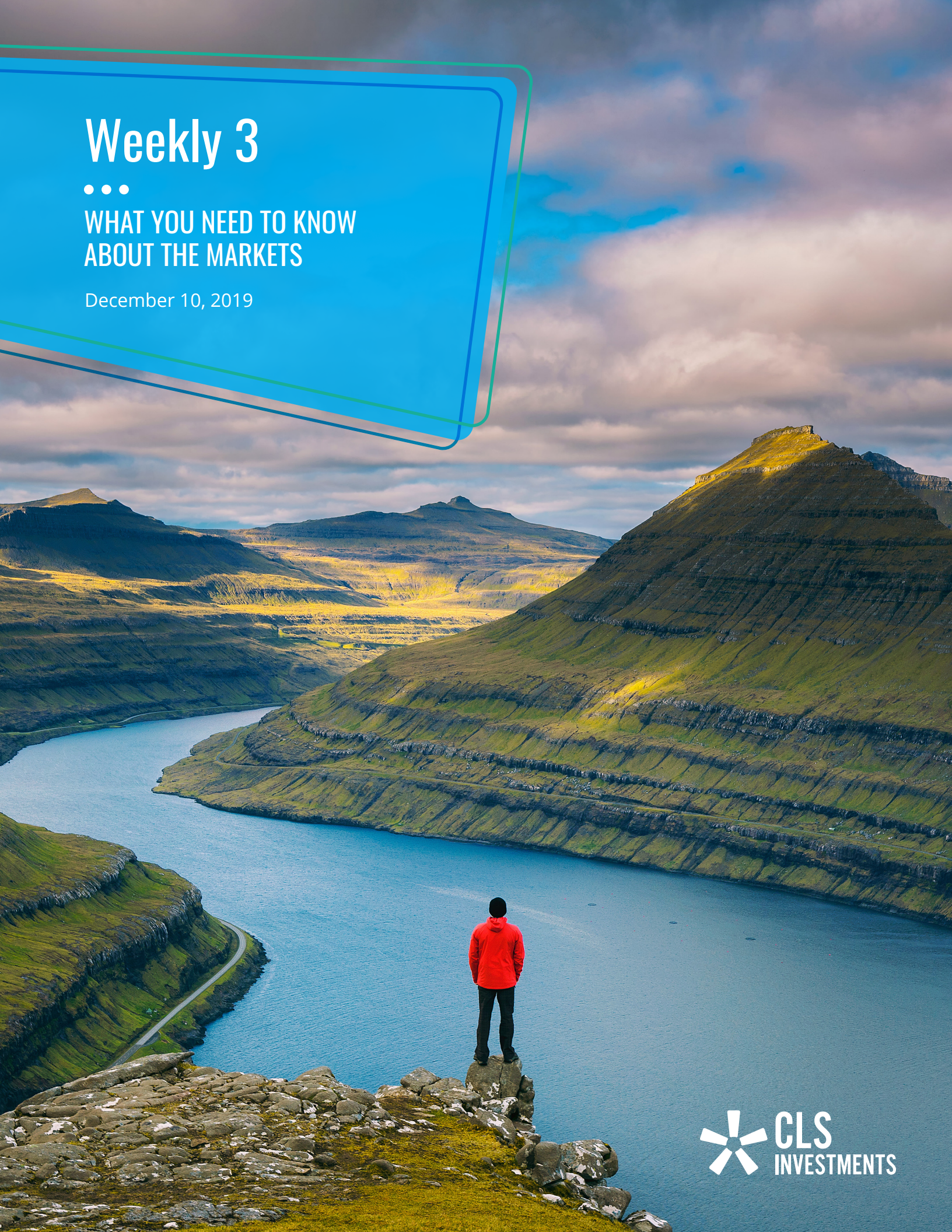


# Weekly 3

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## WHAT YOU NEED TO KNOW ABOUT THE MARKETS

December 10, 2019





# Week in Review

Global stocks edged higher last week. Back-and-forth trade deal discussion and poor manufacturing data was overshadowed by a much stronger than expected non-farm payroll report on Friday. International stocks led the way, in particular emerging markets. The U.S. dollar index traded lower on the week, helping to boost commodity prices which were the best performing asset class on the week. Fixed income closed lower, as the yield on the closely followed 10-year Treasury edged up to 1.84%.

While U.S. manufacturing showed continued weakness, data from China indicated improving manufacturing readings. The U.S. labor market continues to flourish, as jobless claims hit near a 50-year low on Thursday, and payrolls jumped by 266,000 workers (nearly 100,000 more than expectations). Many retailers are among the few corporations left to report earnings, and in general pointed towards continued consumer strength. 75% of companies reporting earnings for the third quarter have exceeded expectations.

Attention this week turns towards the Federal Reserve's interest rate decision Wednesday and general elections in the U.K. on Thursday.

## Market Performance

as of 12/7/2019

FIXED INCOME	10-YEAR	5-YEAR	3-YEAR	1-YEAR	YTD	QTD	LAST WEEK
Cash Equivalent <sup>1</sup>	+0.53%	+1.01%	+1.60%	+2.22%	+2.05%	+0.33%	+0.04%
U.S. Investment Grade Bonds <sup>2</sup>	+3.66%	+3.15%	+4.06%	+9.82%	+8.55%	+0.03%	-0.22%
EQUITIES	10-YEAR	5-YEAR	3-YEAR	1-YEAR	YTD	QTD	LAST WEEK
Global Equity Market <sup>3</sup>	+8.66%	+7.44%	+11.80%	+16.88%	+22.63%	+5.62%	+0.31%
Total U.S. Market <sup>4</sup>	+13.37%	+10.68%	+14.24%	+18.76%	+27.81%	+6.15%	+0.14%
Domestic Large-Cap Equity <sup>5</sup>	+13.32%	+11.25%	+15.53%	+19.48%	+28.04%	+6.51%	+0.19%
Domestic Small-Cap Equity <sup>6</sup>	+12.30%	+7.69%	+7.67%	+12.69%	+23.76%	+6.76%	+0.26%
International Equity <sup>7</sup>	+4.90%	+4.47%	+9.31%	+15.12%	+17.42%	+5.20%	+0.53%
Developed International Equity <sup>8</sup>	+5.24%	+4.53%	+9.24%	+16.46%	+19.42%	+5.19%	+0.45%
Emerging Market Equity <sup>9</sup>	+3.79%	+4.28%	+9.74%	+11.33%	+11.62%	+5.21%	+0.78%
DIVERSIFIERS	10-YEAR	5-YEAR	3-YEAR	1-YEAR	YTD	QTD	LAST WEEK
Diversified Alternatives <sup>10</sup>	+2.97%	+0.74%	+1.73%	+3.24%	+5.49%	+0.68%	+0.19%
Commodity <sup>11</sup>	-4.75%	-5.96%	-2.25%	-2.81%	+4.05%	+0.90%	+1.49%

<sup>1</sup>Morningstar Cash Index <sup>2</sup>Bloomberg Barclay's Capital U.S. Aggregate Bond Index <sup>3</sup>Morningstar Global Market Large-Mid Index <sup>4</sup>Morningstar U.S. Market Index <sup>5</sup>Morningstar U.S. Large Cap Index <sup>6</sup>Morningstar U.S. Small Cap Index <sup>7</sup>Morningstar Gbl ex U.S. Large-Mid Index <sup>8</sup>Morningstar DM ex U.S. Large-Mid Index <sup>9</sup>Morningstar EM Large-Mid Index <sup>10</sup>Morningstar Diversified Alternatives Index <sup>11</sup>Bloomberg Commodity Index.

**1** *Benefits of outsourcing investment management*

**2** *Five crucial steps for investment due diligence*

**3** *Overcoming fear in investing*

# To Outsource or Not to Outsource? That is the Question.

# 1

Many advisors are still reluctant to outsource portfolio management. But a recent study by Cerulli Associates suggests that they could benefit from doing so. The study found that 55% of all advisory practices rely on their own research and portfolio construction. However, only 7% of those currently handling these activities themselves are doing so optimally.

It's easy to understand why advisors are so reluctant to outsource portfolio management, as they often believe their primary value-add to clients is managing their investments and being viewed as an investment expert by those same clients. However, that isn't exactly true. Advisors can add value to clients by providing them access to resources and experts they would not otherwise have. In fact, we believe the most successful firms are those that provide comprehensive wealth management, focusing less on underlying investment performance and more on helping clients plan for and meet their financial goals.

The Cerulli Associates study suggested that most advisors would benefit from outsourcing. In fact, the study found that advisors with less than \$1 billion in assets under management were unable to maintain the required staff to bring portfolio management in-house.

At CLS Investments and Orion Advisor Solutions (CLS's parent company), we offer smaller advisors the necessary resources to outsource portfolio management effectively. The marketplace is ripe with opportunities for us to continue to grow our businesses.



**SHANA SISSEL, CAIA**

*Director of  
Investment Due  
Diligence, Senior  
Portfolio Manager*

*Shana Sissel joined the CLS Portfolio Management Team in 2018. She is responsible for actively supporting the Portfolio Management Team's efforts within a variety of special projects and investment management strategies, as well as writing and speaking on behalf of CLS.*

*Ms. Sissel has more than two decades of industry experience at leading investment firms, primarily in Boston and Chicago. Most recently, she was a Client Portfolio Manager at Ariel Investments where she represented Ariel's Domestic Research Team. Ms. Sissel also brings a vast background in market research and analysis through various roles held at Fidelity Investments' Strategic Advisor Inc., Mercer Investments, Peak Financial Management, and Russell Investments.*

*Ms. Sissel earned a Bachelor of Science Degree in Sport Management from the University of Massachusetts at Amherst before receiving her Master of Business Administration Degree from Bentley University's McCallum School of Business. She also holds the Chartered Alternative Investment Analyst® (CAIA) designation.*

*As a frequent media contributor, Ms. Sissel has appeared on CNBC and other regional news outlets. She has also been quoted extensively in the Wall Street Journal, Smart Money, and Investment News.*

# The Art and Science of Manager Due Diligence

## 2

For more than a decade, I have been focused on investment manager due diligence of some variety. I've worked with outsourced CIO platforms, hedge fund of funds, and large, institutional, long-only fund of funds over that time. Due diligence seems like a routine process, but it's not. The truth is that it is very easy to differentiate who does it well and who doesn't. So, what makes for a strong due diligence process? Here are my five tips.

### 1. Preparation is key.

In all my years doing investment manager due diligence, I worked with only one firm that really focused on being well prepared for manager meetings. At first, I found the process tedious and painful, but as time went on I realized that being well prepared helped me get the most out of the meetings I had. Here are the keys to good prep:

- Review all manager pitch book and marketing materials prior to the meeting.
- Create and distribute a prep pack of relevant analysis to all attendees two to three days ahead of time.
- Provide the manager with the key topics you'd like to focus on prior to the meeting.
- Compose a well-thought-out agenda with input from all key stakeholders.

### 2. Avoid bringing personal biases to the table.

I believe this is a far-too-common problem in manager due diligence. I've worked at firms that refused to give high marks to managers at large firms, particularly if they were retail-oriented, because they felt that environment did not provide any real edge. I've seen managers eliminated because they didn't have the right pedigree, followed an investment strategy that had complexity, managed portfolios that were too big, held too many names, etc. Biases can either eliminate good choices, or they can be preferential. Friendships, revenue sharing, bias toward boutique structure, or gender/race preference can also lead to issues in due diligence. Personally, if I felt biased toward a manager, I placed greater scrutiny on my work and asked for additional input from a neutral colleague. I tried hard to avoid using elimination bias by accepting meetings with firms or managers that I might typically have preferred to decline. In the end, many investors that I took a chance on proved to be solid choices.

### 3. There are no hard rules in due diligence.

Due diligence is all about guidelines, not rules. Eliminating a manager because they don't meet a specific asset requirement, have too much turnover, or have high cash allocations are common in the due diligence process. Ultimately, I believe the only eliminators should be operational or legal problems – issues that could pose real risk to the investor. As an analyst, my job is to determine if the strategy will outperform over a full market cycle. Does it have an edge? Clear source of alpha? I once evaluated a manager whose turnover seemed excessive, but, upon further review, I could determine the manager had real skill in trading and had consistently added value through their approach.

# The Art and Science of Manager Due Diligence (cont.)

## 2

One of my all-time favorite strategies was one that often held a substantial cash position, upward of 30% of the portfolio at times. Most firms wouldn't take the time to really analyze how that cash impacted the portfolio; it's easier just to eliminate and move on. I'm not one of those analysts. The strategy had a 30-year track record. Reviewing how it raised and deployed cash showed a manager who only invested when they could find opportunities that met their investment criteria. Often, they were raising and deploying cash at the right moment in the investment cycle. That firm proved to be a consistently strong performer over the last decade.

### 4. Test and challenge the investment thesis.

This comes down to preparing and remaining skeptical throughout the process. In preparing for a meeting, I'd often spend time reviewing the underlying portfolio looking for positions that didn't seem to align with what the manager said they did. For example, a manager who focuses on quality likely avoids companies with excessive leverage; so, if I found one with excessive leverage, I'd be sure to ask about it.

What they don't own can be just as insightful as what they do. Years ago, I was searching for small-mid-cap deep-value managers during a period when J.C. Penney was struggling and brought in a new CEO to help facilitate a turnaround. At that time, the retail darlings of deep-value managers were RadioShack, Staples, and J.C. Penney. After several meetings, one firm bucked the trend and didn't own two of the three darlings. This stood out to me and became a key discussion point during our meeting.

Other times, it's about testing the process. For example, I once met with a manager who touted a real edge in their stock picking, but to me it sounded like they chased momentum, even if they didn't realize it. Sure enough, a quick test of the portfolio showed momentum, not skill, to be the primary driver of excess returns.

### 5. You aren't the enemy.

The best due diligence analysts want their manager meetings to be productive for everyone. Allowing the manager to prepare for you as thoroughly as you prepare for them is the key. I always tried to provide a manager with the primary discussion points prior to a meeting so they could prepare accordingly. No one benefits if the answer to an important question is "We'll have to get back to you on that."

### BONUS TIP: Avoid hubris at all costs.

While this might seem contradictory to No. 2, it is one rule that has proven to be important time and time again. Hubris can destroy even the best manager. I believe it should be avoided like the plague.

# The Science and Politics of Fear

3

Throughout 2019, news headlines have driven market returns. We've spent a lot of time talking about the recent rise in market volatility, the brief yield curve inversion, trade wars, and recessions. Now, I'm going to talk about why these headlines have such an impact on investor psychology.

One of my all-time favorite books, "The Science of Fear," was written by a Canadian sociologist named Dan Gardner in 2008. Morgan Housel of Collaborative Funds lists it No. 1 on his list of "[23 Books That Changed My Life](#)," and I wholeheartedly agree. The book truly is life-changing. It builds upon the work of Nobel Prize-winning economist Daniel Kahneman, the father of behavioral economics.

Kahneman's research into human judgement focused on two systems of human decision-making: feeling and reason. Reason works slowly and examines evidence in coming to a decision. Feeling is more primal; it makes a decision in an instant. Often called the "lizard brain," this method of decision-making is how almost all people assess risk, and it's hard to overcome. Gardner describes this more basically: All human beings assess risk by how quickly we can recall an event happening, and in this 24-hour, instant-news world, extremely rare events happen every day, and rare events make great headlines. This easy recall has created a warped sense of risk and heightened our fears that bad things will happen. It also matters how information is presented to us, and the media has mastered the art of presenting information in a way to have maximum impact. Let's look at an example from recent market headlines.

**"Trump's Trade War Tanks Market Nearly 800 Points"** *Boston Herald Front Page*  
December 5, 2018

For many, the mere mention of an 800-point market decline brings back nightmares of the financial crisis, but let's add some perspective. The Dow Jones Industrial Average opened the day on December 4 at 25,752.56. It dropped just over 725 points for the day, which in percentage terms is 2.8%. The market declining 2.8% hardly has the same impact as "nearly 800 points." The truth is that much of the information we receive through the media is presented this way. Simply stopping and thinking about that would help us better understand the real risks around us. That is the point of "The Science of Fear." It helps the reader better understand risk and raises awareness for how information is presented.

So, the next time you find yourself terrified by the latest headline, take a deep breath and think a little bit about the information behind it. Are you a victim of your lizard brain? Maybe, but I believe you'll be far less likely to take the bait if you read "The Science of Fear."

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Contact Us Today



17605 Wright Street | Omaha, NE 68130

888.455.4244 | [CLSinvest.com](https://CLSinvest.com)