Directions

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CLS INVESTMENTS

Investing Mindset for the Future

We often hear that these are unprecedented times. And while that is true for most of us individually, the current crisis is not entirely new in terms of world history.

The world has lived through pandemics before, and they haven't changed the fundamental nature of the markets. In the broadest terms, the markets will likely continue to act as they always have. They will likely be cyclical. They will also likely trend upward, not downward, especially over longer time horizons. Markets are driven by human beings. They are volatile and messy, but historically they have always bounced back — despite pandemics, wars, and economic recessions.

With this said, I think there are important items to keep in mind for investment success in the years ahead.

- The U.S. stock market is likely priced for below-average returns going forward, but these returns will still most likely be positive and better than bonds and cash.
- Investors invest to "beat the bank." In other words, the goal is not to beat the overall market, but to beat the return you could get by just putting your money in a savings account. The key is to figure out how much you can participate in the markets. Whether it's 20% in the stock market, or 50%, or 100%, the "right" answer depends on your personal goals and capacity for risk.
- Bonds, especially with interest rates near 0%, will very likely have below-average returns moving forward. While bonds will still be part of the toolkit to diversify equity risk, return expectations should be muted, and investors will need to be more creative when diversifying portfolios.
- With lower expected returns for stocks and bonds, investors will need to save more to achieve their goals.
- Because investors are living longer, combined with lower expected returns in the markets, many investors will likely need to raise, not lower, their exposure to the stock market, in addition to saving more.
- Although returns are expected to be lower for the overall U.S. market, there should be opportunities to enhance returns by diversifying into less expensive asset classes with higher expected returns. Now is one of those times. Small-caps, value stocks, such as financials, and emerging markets all have higher expected returns than the overall market.

RUSTY VANNEMAN, CFA, CMT
Chief Investment Officer

Rusty Vanneman serves as Chief Investment Officer (CIO) for Orion Advisor Solutions, where he is responsible for overseeing the investment processes across Orion and its subsidiaries, including CLS Investments.

*Mr. Vanneman joined CLS in September 2012 as CIO. Previously, he served as CIO 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. In 2018, Mr. Vanneman took on the role of President of CLS, in addition to his position as CIO. He became CIO of Orion in 2019.*

*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® designation since 1994, and is a member of the CFA Institute. He has also been a Chartered Market Technician® 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.**

**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.*

- Volatility will likely remain high. This has always been the price of investing, but it will be more of an issue moving forward. Returns aren't likely to be as robust, but volatility will likely be more so. Risk-adjusted performance probably won't be as efficient as it was. There are a few ways to handle this.
    - Build portfolios with broad diversification, as this is even more crucial now to help control portfolio risk.
    - Have a disciplined plan to regularly rebalance portfolios, which should help to enhance returns in addition to controlling risk.
    - If possible, view your portfolio less often. Investors who more frequently examine their portfolios tend to see and feel more volatility and, in turn, have lower allocations to equities, trade a lot more (more performance slippage to transactions costs and timing costs), and ultimately tend to experience lower returns.
    - Look at the bottom-line portfolio returns, not just the "underperforming" individual securities. In a diversified portfolio, there is always something "underperforming."
- Please remember that "expert" forecasts (including this one) should be treated with more than a grain of salt. For example, did you know that Wall Street strategists had their most optimistic view on future stock market returns at the beginning of this year — just in time for the most epic sell-off in generations? Even more interesting is the Federal Reserve's own forecasts. The Fed is arguably composed of some of the best, the brightest, and the most credentialed experts with the best training, resources, and most importantly, the most current information, and yet their forecasts have historically been notoriously inaccurate.

What's the best antidote to a world filled with opinion and forecasts? You guessed it, diversification. Diversified portfolios may still participate in the upward slope of long-term growth, but they're humble enough to better endure various market cycles.

Market Outlook: Prices Climb Wall of Worry

RUSTY VANNEMAN, CFA, CMT
Chief Investment Officer

The current market environment includes many supportive factors that suggest continued gains for investors, while there are others that point to potential losses.

Positive Factors:

On the positive side, at least for now, there is the reopening of the economy. This helps to create undeniably positive social and economic momentum. This currently isn't difficult to do, however, since recently the economy has arguably been the poorest it's ever been in U.S. history. Socially, fear remains high, but it is also dissipating.

Markets tend to move on trends, not levels. In other words, when things get "less bad," prices usually improve. It's all about investors adapting to changing expectations. If people expect the worst, but things marginally improve, prices will typically reverse, and vice versa (something to keep in mind for FANG (Facebook, Amazon, Netflix, and Alphabet), stock fans)

Despite being a common refrain, the idea that "we have never been here before" isn't true from a societal standpoint. We have been here before. We have written about various pandemics before, including what I believe is the most relevant template for our current situation: the 1957 flu. At this point, the 1957 flu was arguably worse than COVID-19, and the economy and markets moved in a similar fashion as they have recently. Markets, which anticipate what may happen in the economy, typically lead the official economic data, which is based upon collected data from the past.

For a quick refresher on the 1957 flu, it hit the U.S. in the summer. The stock market sold off immediately and didn't stabilize until the fourth quarter. Economic growth remained positive during the second and third quarters of 1957, but was down sharply in the fourth quarter and down 10% in the first quarter of 1958 (the worst quarter for economic growth since WWII — until perhaps when this current quarter ends, of course). Prices bottomed in the fourth quarter of 1957 and then proceeded to gain more than 40% in 1958 and didn't have a losing year until 1962.

What's different with this pandemic? Again, everything is moving faster. For better or worse, it's been said that this was the first "social media panic." Information moved faster. Fear and caution were elevated more quickly. This surely saved lives and also activated unprecedented global collaboration for the development of treatments and vaccines. It should provide some reassurance to investors given the talent, resources, and urgency devoted to the cause. As a betting man, I'm taking the under on treatments and potential vaccines being developed faster than they have in the past.

Perhaps the biggest reason to be positive remains the investing principle: “Don’t fight the Fed.” We have seen unprecedented monetary support from the Federal Reserve, including pinning short-term interest rates at 0% for the foreseeable future, injecting massive amounts of liquidity into the system, buying ETFs (including corporate bond ETFs), and moving markets with the sheer power of its symbolic words and actions. The Fed is doing more than just protecting the financial system; it’s also providing massive, unprecedented support to help ensure the markets don’t crumble. Though the wisdom of this support may be debatable, and there will likely be a price to be paid; for now, it’s serving as a positive for the markets and generates a tidal wave of liquidity that investors should respect.

For the economy, at least in the short-term, the fiscal support has also been the strongest since WWII. Federal spending as a percentage of GDP has averaged 20-25% for decades. Investors can likely expect that number to double this year. Europe and Japan have also provided massive fiscal support. That’s a lot of ‘juice’ in the system.

“Don’t fight the tape” is also a powerful principle. Currently, there is a lot of technical support (based on the study of prices) for more gains, including good market breadth, which indicates that most stocks are participating in gains, not just a handful of glamour stocks. Healthy markets typically have broad participation, which this market now has.

It should be noted that sectors which were hit hard, have now also bounced hard. For example, energy prices as measured by OK Crude Oil Future Contracts were up over 80% during May (best month ever), and energy stocks were up nearly 53%, as measured by the Energy Sector SPDR ETF. Again, an example of how prices typically lead economic activity.

Lastly, investor sentiment, both individual and professional, remains extremely negative, which is simply remarkable given the gains off the lows already. The ‘Wall of Worry’ is still firmly in place. Typically, when sentiment is this negative, the stock market produces above-average gains for the next one-, three-, six-, and 12-month periods. Sentiment is cyclical and typically works as a contrarian signal because markets are always adapting to changes in expectations.

Negative Factors:

Granted, there are also plenty of not-so-good factors to consider.

- **COVID-19:** We will undoubtedly get a second (and perhaps a third) wave of infections. How manageable will that be? While it doesn’t seem likely now, a second national lockdown would be devasting in many ways.
- **Tension with China:** This is a big deal, but the most probable result in the near-term will be more volatility. This issue also has the potential to negatively impact corporate profitability. Less globalization may also lead to higher inflation.
- **Inflation:** While the official numbers are currently low and falling due to demand shock, consumer expectations of inflation are not (grocery items costing substantially more will do that). There are plenty of reasons inflation may move higher later this year, including supply disruptions, higher wages, exploding federal deficits, and more.
- **Political season:** Politics typically create market volatility, and it’s reasonable to expect that the societal pressures occurring now will negatively impact the markets more than ever.

- **Social media:** Social media giants Facebook and Twitter also face political risk. The market has been led by these types of high-profile, large companies in recent years. When the dot.com bubble burst two decades ago, the glamor stocks' fall led the market down. It should be noted, however, that broadly diversified global portfolios held up much better during that time.
- **Summer doldrums:** The summer is typically the weakest time of year for the market, without much direction. It's hard to imagine that this summer will be quiet though.
- **Overbuying:** The market is "overbought" from a technical standpoint, which would suggest a pause to refresh. That said, when market prices look overextended, investor sentiment is typically giddy. That is not the case now.
- **Valuations:** The market is expensive. High valuations suggest lower expected long-term returns and a higher probability of short-term losses. The offset to this concern is that the market typically handles higher valuations better when interest rates are low. In this case, the risk may not be the high valuations themselves, but rather the potential for climbing long-term interest rates.

The Time is Now for International Investing

Renowned investors routinely recommend that we invest in what we know, but that hardly covers the full list of easily investable companies across this vast globe. When an investor routinely invests in just their home country, a bias is exhibited and an unknown 'bet' is being made on future performance.

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CLS Director of Research/Sr. Portfolio Manager

Another bias that investors often demonstrate is recency bias. The fact that international stocks have lagged U.S. stocks in the last 10 years will likely cause more investors to place their bets on the areas in the market which have recently gone up, which is typically not a good strategy for future returns.

We find there are at least 4 reasons to invest with a global mindset.

1. **Increased exposure: to higher GDP production, more listed stocks, and faster-growing populations.**

Vast Opportunities Exist Outside U.S. Borders

Share of Global Market Capitalization	
U.S.	**Countries Outside the U.S.**
53%	47%

Share of Global GDP	
U.S.	**Countries Outside the U.S.**
24%	76%

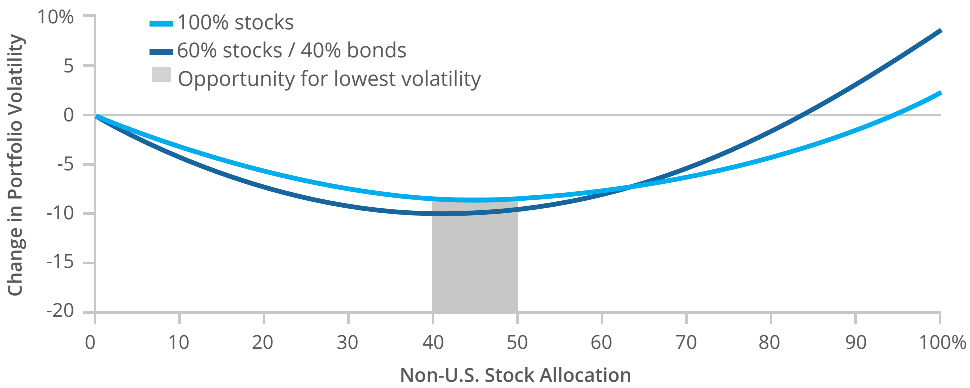
Share of Listed Stocks	
U.S.	**Countries Outside the U.S.**
10%	90%

Share of Global Population	
U.S.	**Countries Outside the U.S.**
41%	96%

Source: World Bank as of 12/31/2018

2. **Volatility reduction:** **By having a mix of assets within countries that do not move perfectly together, a benefit of risk reduction may be created. Lowered risk or volatility is beneficial for portfolios when they are properly constructed.**

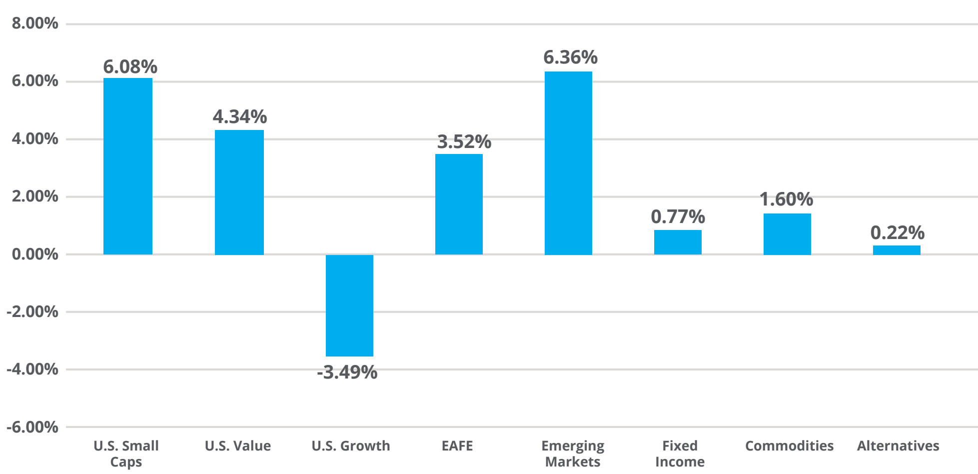
Average Annualized Change in Portfolio Volatility When Adding Non-U.S. Stocks to a U.S. Portfolio



Source: Vanguard and MSCI 3/31/2020

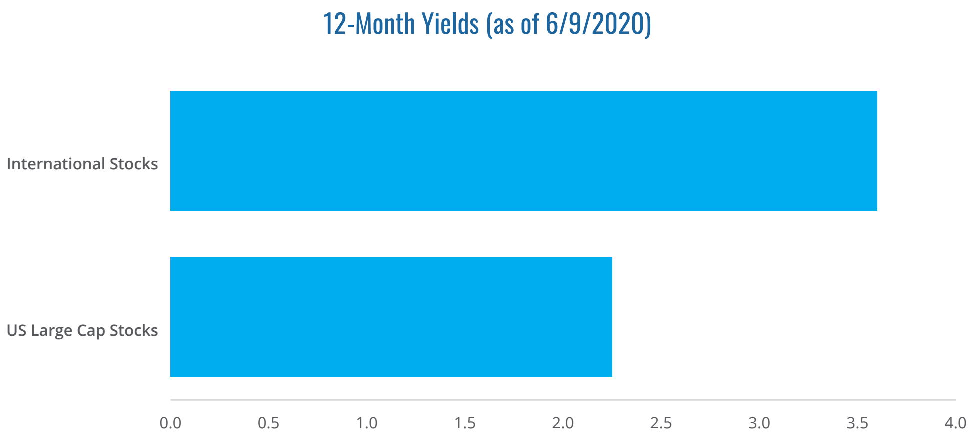
3. **Positive outlook:** **Below we share our expectations for Developed International (EAFE) and Emerging Market stocks. Based on valuations of current markets, we expect international stocks to start a new cycle of outperformance.**

Our 10 Year Expected Returns for Broad Asset Classes Relative to the U.S. Market



Source: Morningstar, Bloomberg, Ned Davis Research, Research Affiliates, and MSCI, as of 3/31/20. Past performance is not a guide to future results.

4. **Higher dividend yields:** **Owning overseas stocks may provide opportunities for increased yield.**



Source: Morningstar, 6/9/2020

We believe there is great value to be found in overseas markets, which may help to reduce risk when complementing a diversified portfolio, while helping to increase investors' shares of strong companies they may not even know about.

The time is now for international investing.

Disclosures:

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