CLS's WEEKLY 3

What You Need To Know About the Markets

JUNE 5, 2018

1. May was the best month for the U.S. market since January.
2. The mindset required for successful investing is different from other endeavors.
3. The future is bright, thanks to technology.

Market Performance

Equities	MAY	YTD '18	12-MONTH
Total U.S. Market[1]	+2.82	+2.55	+15.06
Domestic Large-Cap Equity[2]	+2.41	+2.02	+14.38
Domestic Small-Cap Equity[3]	+6.07	+6.90	+20.76
International Equity[4]	-2.31	-1.92	+9.67
Developed International Equity[5]	-2.25	-1.55	+7.97
Emerging Market Equity[6]	-3.54	-2.61	+14.03
Fixed Income	**MAY**	**YTD '18**	**12-MONTH**
U.S. Investment Grade Bonds[7]	+0.71	-1.50	-0.37
Cash Equivalent[8]	+0.15	+0.62	+1.21
Commodities	**MAY**	**YTD '18**	**12-MONTH**
Commodity[9]	+1.42	+3.62	+11.02

[1]Russell 3000 [2]S&P 500 Index [3]Russell 2000 Index [4]MSCI ACWI ex-U.S. Index [5]MSCI EAFE Index [6]MSCI Emerging Markets Index [7]Bloomberg Barclays Capital U.S. Aggregate Bond Index [8]Bloomberg Barclays Capital 1-3 Month U.S. Treasury Bill Index[9]Bloomberg Commodity Index

As of 5/31/2018

May Market and Portfolio Review

Last month, the overall U.S. stock market (Russell 3000 Index) was up nearly 3% for the month – the U.S. market's best month since January. Larger companies (S&P 500 Index) gained more than 2% while smaller companies (Russell 2000 Index) gained an impressive 6%. Small caps are now up nearly 21% over the last year – showing clear leadership over all other major equity indices.

Overseas markets meanwhile lost 2% last month (MSCI ACWI ex-U.S. Index), with developed markets (MSCI EAFE Index) down 2% and emerging markets (MSCI Emerging Markets Index) down 4%. For the year, international markets now have slight losses. Contributing factors to the weakness in recent months have been the rise in the dollar (about 3% year-to-date) and concerns about European politics. More on these topics shortly.

The bond market (Bloomberg BarCap Aggregate Bond Index) gained 1% again last month. The 10-year Treasury yield ended the month at 2.83%.

Commodities (Bloomberg Commodity Index) also gained over 1% last month. Commodities have outperformed the overall stock market this year and the asset class now has an 11% return over the last 12 months.

CLS portfolios, in terms of relative performance, did give back some of their strong performance earlier in the year due to our continued and high conviction overweight to international stocks and our underweight to domestic large-cap growth stocks such as the Big Four (Apple, Amazon, Google & Facebook). CLS portfolios continue to favor international equities and value stocks (i.e., securities with lower valuations, such as lower price/earnings ratios) due to a combination of reasons, including relative valuations.

"In the short run, the market is a voting machine, but in the long run, it is a weighing machine."
—Benjamin Graham

Benjamin Graham, who is generally considered the father of value investing, described the market well. He said that over the short-term, the stock market is a voting machine, determining what is popular and unpopular based on investor sentiment. Over the long-term, however, company fundamentals, such as revenues and earnings and how much an investor pays for them, determine returns. That's why he considered the market a weighing machine over time.

Currently, short-term investor sentiment is not extreme one way or the other. Some investors are optimistic, while others are negative on the market's prospects citing a few concerns. Here's my take on those worries of those who are pessimistic:

1. Europe is vulnerable.

Europe certainly has its challenges. The continent has an older population, which is highly indebted and anti-market in many circles. The European Union (EU) and currency are vulnerable to fracturing.

This is not really a new story, but the latest development is a potential referendum on EU membership in Italy, which has disrupted the markets. But even prior to that recent drama, economic activity slowed slightly in Europe. Nonetheless, CLS believes Europe continues to be cheap relative to the rest of the world, and there are still pockets of value, for example the U.K., which interest us. If prices fall sharply, especially relative to other stock markets, we will likely buy European equities. But we also believe there are more attractive areas within developed markets, such as parts of Asia and Canada, in which to invest new dollars.

2. Rising interest rates will generate lower returns.

Interest rates have indeed risen this year. Yields on 10-year Treasury bonds, which are controlled by market forces, have risen from 2.40% at the end of 2016 to a high of 3.11% earlier this year. (Yields have since fallen more than a quarter-point.) As for short-term rates, the effective federal funds rate, which is controlled by the Federal Reserve, has risen from 1.30% at the end of last year to its current 1.70%.

Yet, this is not a deep concern. Interest rates are still quite low given historical averages and the current economic environment. Higher rates would be normal, and they do not necessarily indicate the severe losses in the bond market that many pundits believe will occur due to higher rates. Historical data (since the 1920s) shows that the bond market has an even stronger bias toward positive rolling 12-month returns than the stock market, and that is true even during rising-rate environments.

Also note that bond market sentiment is very negative. A negative environment, such as this, is the only one in which the bond market generates *above-average* returns in the short term (see the tables below from Ned Davis Research).

T-Bond Futures Performance
Full History: 06/06/1984 to 05/29/2018

NDR Daily Bond Sentiment Composite is	% Gain/ Annum	% of Time
Above 62.0	-4.84	21.21
38.0 – 62.0	4.18	54.54
Below 38.0	8.23	24.25
Buy/Hold = 3.15% Gain/Annum		
Source: Ned Davis Research		

T-Bond Futures Performance
Chart View: 01/03/2006 to 05/29/2018

NDR Daily Bond Sentiment Composite is	% Gain/ Annum	% of Time
Above 62.0	-1.25	23.25
38.0 – 62.0	-0.38	51.49
Below 38.0	10.11	25.26
Buy/Hold = 1.96% Gain/Annum		
Source: Ned Davis Research		

3. The rising dollar will weaken gains.

The U.S. Dollar Index has risen about 3% this year. All else being equal, this has helped U.S. stocks versus international stocks, which have seen their U.S.-denominated gains diminished by their weaker currencies. It has also helped smaller companies versus larger companies, which generally attain most of their revenues overseas. This has been a mixed blessing for CLS portfolios. While we have a tilt toward smaller companies, which has helped performance, our emphasis on unhedged international exposure has not.

So, where to next? We still believe the dollar is overvalued, and if interest rates fall in the short-term, the dollar's rise will likely slow, if not stop. The caveat is that the dollar tends to trend longer than other markets, and since it has recently trended higher, it could still achieve more short-term gains.

4. Valuations of large-cap growth stocks are too high.

Over the last nine-plus years, the U.S. stock market has averaged an annual return of more than 19%. That is remarkable because the market has never seen a 20% annualized return over a 10-year period (at least going back to 1871). Large-cap growth stocks, led by such names as Google, Amazon, and Facebook, have performed extremely well and are up more than 20%. Valuations are now elevated for the overall stock market.

This has been a great experience for investors, but it is unlikely to continue. The future is more likely to be the opposite. For a frame of reference, there are a few eras in the stock market that might be appropriate parallels.

During the late 1990s, specifically the dot-com era, large-cap growth technology names were the dominant performers. Eventually, however, those companies faltered and initiated a sharp bear market in the U.S.. Despite the bear market, globally diversified portfolios, which were composed of international securities, value stocks, and real assets (such as commodities and real estate), held up much better in the bear market and the years that followed.

The second parallel might be a better example: the "Nifty Fifty" in the 1970s. During this time, there were several leading companies considered so superior for long-term investors that valuations were viewed to be irrelevant. In this case, the companies were superior, and most are household names even today. However, many generated negative returns over the following 10 or more years after their prices crested during the 1970s.

Bottom line: Valuations matter, and the valuations of the aforementioned Big Four are indeed well above industry averages. Long-term investors need to stay globally diversified.

5. The concern that seasonal factors will create weakness in the market.

We are entering the weakest time of the year historically. From May through September, the stock market has, on average, essentially gone nowhere. It is interesting how well this pattern has held up for so long. It's not infallible — nothing ever is in the markets — but it has held over a variety of time frames.

Some investors take this information as an invitation to exit the market. Don't! If anything, one should take advantage of the opportunity to invest more money when the market temporarily falters.

Why Successful Investing Differs From Other Endeavors

The skills and mindset required in successful investing are very different from other professional endeavors. One example is how most successful investors deal with geopolitical events, which could apply to the current situation in Europe. Many might believe investors should take action now in case the current issues create a catalyst for a bear market (loss of 20% or more). A temporary loss is unlikely — primarily because bear markets don't happen all that often and the market has an overwhelmingly powerful desire to move higher over time, even during difficult periods. But it could happen.

For example, being proactive is the right course of action in many endeavors — but not necessarily in investing. In our opinion, successful investing isn't about forecasting the impacts of potential changes in political policy. Instead, it's about having a disciplined approach to taking advantage of opportunities provided by the emotional reactions that drive market behavior over the short-term. We believe the market sometimes overreacts — both to the upside and downside, and when it does, we want to be ready to take advantage. In other words, we're not going to sell European equities now simply because there's a chance prices could falter. Instead, we might look to buy European equities if prices drop suddenly or sharply.

Another example is that in most areas of professional and personal success, the abilities to find common ground and connect with others are essential to good relationships and interactions. For investing, however, it is often the ability to find the differences — the desire to be different — that makes the better investors stand out.

One more example in how investing differs is that in most areas of life, professionally and personally, it makes sense to reward winners and punish losers — to allocate more resources to what's working and fewer to what's not. In the markets, however, relative performance is cyclical. So, successful long-term investing is generally about doing the opposite of what works elsewhere. Buy weakness and sell strength.

Many readers of this commentary may have experience serving on investment committees. Investment committees are loaded with talented, bright, and successful people — people who are proactive and action-oriented, who know how to allocate resources and how to cut "losers." These traits may have helped them succeed in their professions, but they often lead to poor decisions in asset allocation and manager selection in the portfolios they steward.

For those readers serving on investment committees, I have a couple great books to offer as potential resources. Ben Carlson's "Organizational Alpha: How to Add Alpha in Institutional Asset Management" is a slam dunk. It is short, sweet, and right on the money on nearly every point. For those who want more meat, I recommend two books authored by David Swensen, Chief Investment Officer of Yale's highly successful endowment: "Pioneering Portfolio Management: An Unconventional Approach to Institutional Investment" and "Unconventional Success: A Fundamental Approach to Personal Investment." Both are good reads for those who want to know more about the design and construction of sound and truly long-term investments for endowments, foundations, and the like.

Embrace Technology

In a recent episode of CLS's The Weighing Machine, CLS's Chief Technology Officer, Chad Boyer, encouraged investment advisors to embrace technology and be excited for how technology is going to improve our professional lives. I agree. At CLS, we are hoping to introduce new technology and tools later this year that will help empower advisors even more.

I'm not sure this excitement is shared among many advisors. For example, many have yet to embrace professional networking and prospecting tools, such as LinkedIn. To be fair, face-to-face and even telephone conversations are clearly superior to online communication in terms of building relationships. But there are many tools that can create efficiencies for advisors, freeing them to do what they do best: work directly with investors.

Kevin Kelly, the founding executive editor of Wired magazine, writes in his most recent book, "The Inevitable: Understanding the 12 Technological Forces That Will Shape Our Future," that "jobs are just bundles of different tasks. And any task that requires efficiency, or where efficiency matters most, those are tasks that go to the bots. That leaves humans the inefficient tasks, which are the things we really want to do: innovation, science, art and so on." I would add: relationships.

More from Kelly: "new technologies give us new desires we never knew we had. And in the beginning, those new desires are highly inefficient, because we don't know how to do them well yet. As we do them more and more, we realize efficiencies that we can give to the bots. That liberates us to take on a new desire, a new thing we didn't know we wanted before."

Changes in technology are unsettling at first — heck, I'll admit I hate it when Microsoft upgrades its Excel software — but technological advances improve our tools and enhance productivity. The key is to always be learning and adapting — learning new skills or hiring others who can teach or use new technologies.

Another great read and listen on the topics of technology and marketing, though not necessarily directly financial-related, is Scott Galloway, a professor of marketing at NYU Stern School of Business and the author of the highly readable and informative "The Four: Hidden DNA of Amazon, Apple, Facebook and Google." He also produces regular commentary and videos. I have found Galloway is either a love-or-hate sort of author and speaker, but he is able to shed light on a variety of topics that sometimes aren't necessarily the easiest to understand. He's good, and I hope you find him to be a resource when trying to understand trends in technology and the economy.

Thank You

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

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Chief Investment Officer

Rusty Vanneman is responsible for all investment operations at CLS, including investment philosophy, process, people, 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 on two mutual funds (one aggressive and one balanced).

*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 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 Valentine in Cherry County, Nebraska.

**CLS Investments, 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.*

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 S&P 500 Index is an unmanaged index of 500-large capitalization companies. This index is widely used by professional investors as a performance benchmark for large-cap stocks. The Russell 2000 Index is an index comprised of the 2,000 smallest companies on the Russell 3000 Index and offers investors a benchmark for small-cap stocks. The MSCI ACWI ex U.S. Index (MSCI All-Countries World Index, excluding U.S.) is an index considered representative of stock markets of developed and emerging markets, excluding those of the U.S. The MSCI EAFE Index is an index which tracks performance of international equity securities in developed countries in Europe, Australia, Asia, and the Far East, excluding the U.S. and Canada. The MSCI Emerging Markets Index is an index which tracks performance of large and mid-cap firms across countries classified as emerging market countries. The Bloomberg Barclays Capital U.S. Aggregate Bond Index measures performance of the U.S. investment-grade bond market. The Bloomberg Barclays Capital 1-3 Month U.S. Treasury Bill Index includes all publicly issued zero-coupon U.S. Treasury Bills that have a remaining maturity of less than 3 months and more than 1 month, are rated investment grade, and have $250 million or more of outstanding face value. 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. An index is an unmanaged group of stocks considered to be representative of different segments of the stock market in general. You cannot invest directly in an index.

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