

CLS's WEEKLY 3

What You Need To Know About the Markets

AUGUST 7, 2018



1. Stocks that seem unstoppable don't stay that way forever
2. What could drive the recovery of two key commodities
3. Investors who obsess over management fees may be focused on the wrong costs

Market Performance

Equities	LAST WEEK	QTD	YTD '18
Total U.S. Market ¹	+0.81%	+4.21%	+7.57%
Domestic Large-Cap Equity ²	+0.80%	+4.63%	+7.40%
Domestic Small-Cap Equity ³	+0.63%	+1.92%	+9.73%
International Equity ⁴	-1.36%	+1.24%	-2.57%
Developed International Equity ⁵	-1.45%	+1.24%	-1.54%
Emerging Market Equity ⁶	-1.68%	+0.92%	-5.80%
Fixed Income	LAST WEEK	QTD	YTD '18
U.S. Investment Grade Bonds ⁷	+0.14%	+0.12%	-1.50%
Cash Equivalent ⁸	+0.04%	+0.18%	+0.95%
Commodities	LAST WEEK	QTD	YTD '18
Commodity ⁹	+0.11%	-2.68%	-2.69%

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

As of 8/3/2018

Week in Review

Global stocks closed slightly lower last week, as domestic shares rose and a rising dollar hurt overseas returns. U.S. bond prices rose slightly (therefore yields fell). The Federal Reserve (Fed) kept interest rates unchanged on Wednesday, as expected, and cited a strong economy that will likely lead to an interest rate increase at their next meeting. Highlighting this was Friday's payroll report, which actually came in below expectations at 157,000 but with a lower unemployment rate (3.9%) and revisions to the previous two months' numbers (+59,000 jobs).

Corporate news was a major market focus last week. Apple became the first company to reach a \$1 trillion market-cap (more on this shortly). One of Apple's largest shareholders, Berkshire Hathaway, reported blowout earnings over the weekend. Just over 80% of S&P 500 Index components have reported earnings; 80% have beat EPS estimates and 74% have beat revenues (according to FactSet). Both beat rates are at cycle highs and are a big reason stocks are heading back toward all-time highs.

Commodities managed to squeeze out a small gain last week despite the stronger dollar (the two tend to move in opposite directions). Oil was flat to slightly lower, while metals fell. Agricultural commodities gained more than 1.5%. More on commodities and where we see opportunity later.

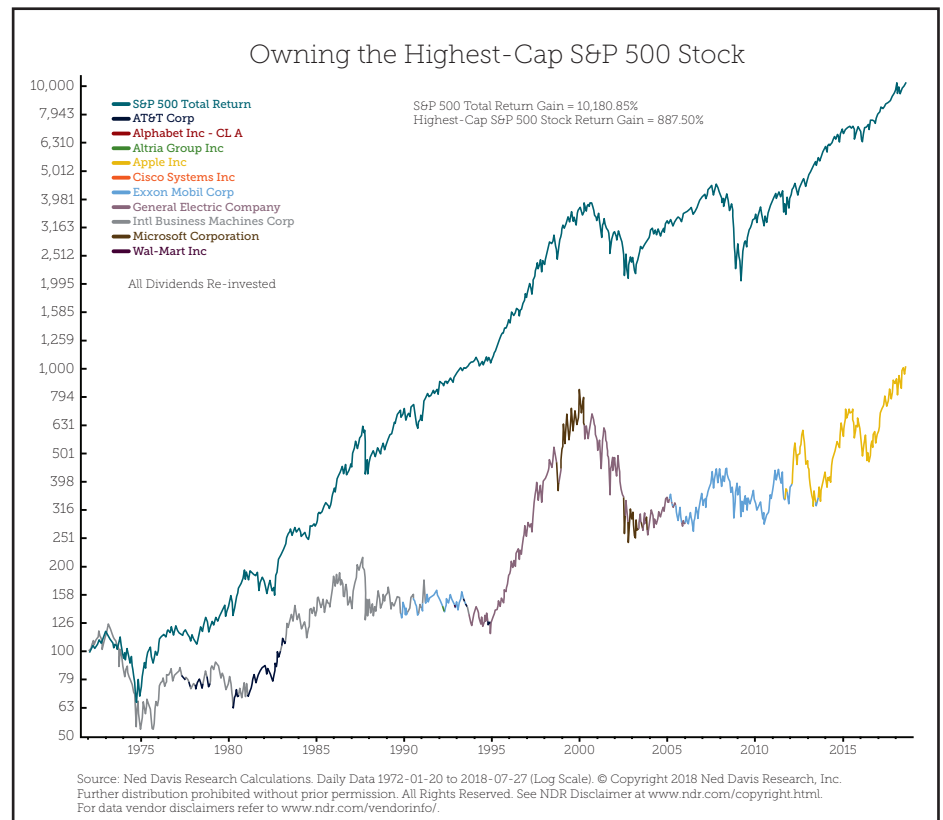
No Stock is Invincible

Facebook made bold [headlines](#) a couple weeks ago following its disappointing earnings report and guidance, which pushed the stock down 19% in one day. A stock falling 19% in one day may seem extraordinary, but in fact 180 U.S. stocks have fallen more than 19% in one day just this year. The fact that the fourth largest stock by market-cap (if we separate both Alphabet share classes) fell that amount is bound to create the largest daily dollar loss in history, so it shouldn't have been as shocking as it was made out to be. Besides, Facebook was flat on the year following that 19% loss!

Facebook's fall does bring up an interesting point that I have [been exploring lately](#): Investing in individual stocks is hard, even for the largest and most experienced institutions. Additionally, even a fortress of a stock is subject to competition and decline (see GE). The chart to the right shows the performance of the S&P 500 since 1972 versus the performance of the largest stock in the index

over the same time period. The underperformance of owning the largest stock in the index is incredible. It brings up a number of important points: Even if it seems Apple is invincible (it just hit \$1 trillion market-cap!), history shows the likelihood of it continuing to outperform the

index is slim. And in a similar light, why own a market-cap index if it will have this bias toward large, overvalued names? It all comes back to the simplest rule in investing: diversification. Nowadays, there are plenty of ways to [Be Smart](#) in how investors diversify their portfolios.



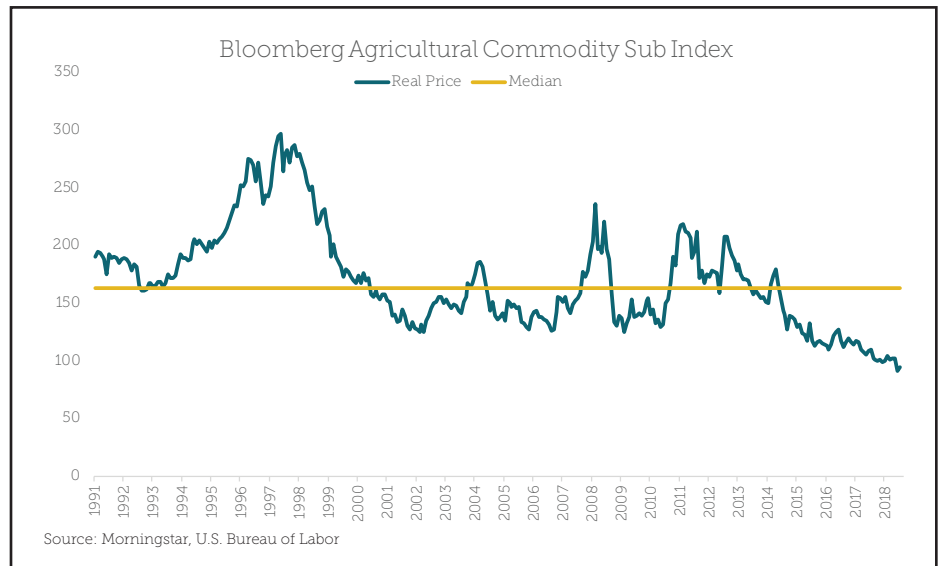
Commodities: More Than Just Oil

After years of stagnation following the collapse of oil in late 2014, commodities have slowly but surely worked their way to recovery, mainly on the back of a climb in oil prices from under \$30 to near \$75 in June (for U.S. West Texas Intermediate). Industrial metals have also contributed to the recovery as global growth has picked up. However, commodities are a deep and complex asset class that almost always holds opportunities. Two areas we are increasingly interested in are agricultural commodities and gold, which also happen to be two of the best diversifiers.

Agriculture

Agricultural commodities have been in decline since the massive Midwestern U.S. drought in 2012-2013. Prices of corn, wheat, soybeans, and other crops are driven by weather more so than many other commodities. This year, many parts of the upper Midwest have seen above-average rainfall for this time of year. As a result, according to some farmers, the local corn crops are looking great (hopefully also true for the Cornhuskers this season). Despite healthy crops and ample supplies globally, demand continues to build. Agricultural commodities are used in a wide variety of places beyond the dinner table, such as biofuels and livestock feed, where the outlook

is positive. Couple the demand with low correlations, defensive characteristics, an inflation-adjusted price more than 40% below the long-term median, and the fact that we are entering a seasonally strong period for many of these commodities, we like our prospects in this more nuanced area.



Gold

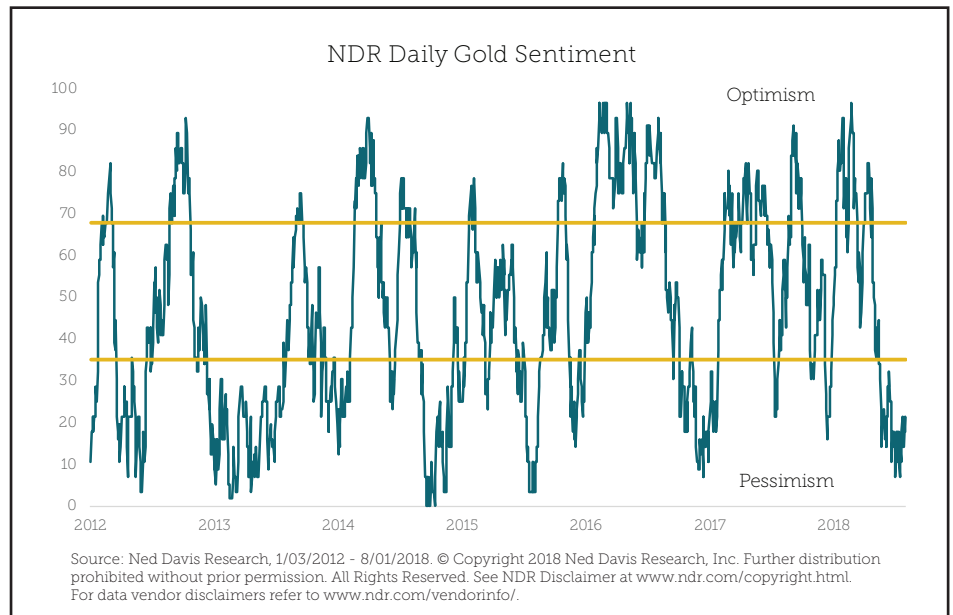
Gold is one of the more emotional metals. Opinions on the metal tend to range widely. However, over time gold has been able to provide some hedging characteristics against both bear markets and inflation. Recently, gold has struggled despite some factors starting to appear that have historically provided a tailwind. Gold is sensitive to a number of different macroeconomic drivers, such as real interest rates, the money supply, the U.S. dollar, inflation,

and stock prices. Of course, many of these are interrelated. A slowing in the rise of real interest rates (gold trades in the opposite direction of real rates), the U.S. dollar appearing topy based on sentiment measures (gold also trades inverse to the U.S. dollar), and the fact that gold is also

trading at one of the lowest levels relative to the money supply in recent memory seem supportive of the metal going forward. At CLS, we also frequently review trading sentiment. Currently, as shown in the chart on the next page, the view toward gold is quite pessimistic, and this is typically a time for gold to shine (pun intended). As we near a historically more difficult period for stocks, perhaps having a little gold could provide the hedge that Bitcoin hasn't!

Commodities: More Than Just Oil (Cont.)

We continue to believe commodities deserve a strategic place in investor portfolios. The growing number of commodity-focused ETFs provides us the tools to tilt our allocation toward some of these areas of the asset class that have provided investor portfolios with a number of important benefits.



Grant Engelbart, CFA, CAIA Co-Director of Research/Senior Portfolio Manager

Grant Engelbart manages CLS's aggressive mutual funds and several ETF and mutual fund separate account strategies, including CLS's American Funds portfolios. He also leads the alternative broad asset class team and serves on several committees across CLS's parent company, NorthStar Financial Services Group, LLC.

Mr. Engelbart first joined CLS as an intern in 2007. He returned in 2009 and held several roles in trading and investment research prior to accepting the role of Portfolio Manager in 2013. He previously held positions at TD Ameritrade and State Street Corporation.

Mr. Engelbart received his Bachelor of Science degree in Finance from the University of Nebraska at Lincoln. He holds the Chartered Financial Analyst (CFA) designation, Chartered Alternative Investment Analyst (CAIA) designation, and FINRA Series 65 license. He is a member of the CFA Society of Nebraska and the CAIA Chicago Chapter.

Mr. Engelbart was named one of the Top Ten Money Managers to Watch by Money Management Executive in 2018.

Did you know? [Grant invested in his first fund at age 13.](#)

*CLS Investment, LLC ("CLS") Portfolio Manager, Grant Engelbart, CFA, CAIA, was selected as a "Top 10 Fund Managers to Watch" in 2018 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 12, 2018. 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.

Are You Focused on the Wrong Costs?

Content provided by: Josh Jenkins, CFA, Co-Director of Research/Senior Portfolio Manager

The asset management industry hit a milestone last week when Fidelity Investments announced two core equity funds with no management fees. Competition for market share has been fierce between fund providers, and this move undercuts some large players, such as iShares, Vanguard, State Street, and Schwab, each of whom offers large-cap domestic stock exposure at four basis points or less. For investors, this is a definite win. Lower costs simply lead to better outcomes.

Market watchers often obsess over expense ratios because doing so requires very little work. The data is easy to find, there is no calculation required, and it's simple to conceptualize. However, management fees and expenses are not the only costs that eat away at investor returns. They may not even be the largest. For taxable investors, particularly those in high brackets, there is a good chance that Uncle Sam is making more off you than your fund provider.

The most commonly cited advantage of ETFs is lower fees, and it is easy to see why. The top table to the right shows the ETF universe charges just over one-third of the fees traditional mutual funds do on an asset-weighted basis.

A knowledgeable respondent might identify tax efficiency as another advantage of ETFs, though it's frequently listed near the bottom of the list. This benefit is not as easy as

the expense ratio to quantify. Luckily, our good friends at Morningstar offer a solution via their tax-cost ratio. The tax-cost ratio calculates the annual drag on performance from taxes paid on interest, dividend, and capital gains distributions from a fund. The tax-cost ratio can be interpreted similarly to the expense ratio, it's just a different organization taking a cut of the returns.

The data over the last three years clearly justifies the assertion that ETFs are more tax efficient, as illustrated in the table on the bottom right. What's surprising is for taxable investors in high brackets, the tax efficiency can be a much larger benefit to investors than fee savings: about 30% larger when comparing ETFs to traditional mutual funds.

The point of all of this is not to bash mutual funds. Even among ETFs, the tax benefits can vary. For example, investors looking to tilt their portfolios toward value have options that include a traditional value exposure or a dividend-

oriented strategy. Both options would achieve the desired effect, but the dividend-oriented approach comes with higher tax impact. The average value-tilted ETF has a 10 basis point lower annual performance drag over dividend ETFs. For some perspective, that's two and a half times the cost savings investors would get by switching to the new Fidelity zero-cost ETFs from the previous lowest-cost options. Unfortunately, this cost is much less obvious to many, and it is therefore ignored.

The trend toward lower fees is definitely a positive for investors, but they don't need to wait around for a fund provider to act to reduce the cost drag on their portfolios. There is low-hanging fruit available to many investors in the form of controlling tax impact. Focusing on the more tax-efficient vehicles and strategies for taxable accounts could be even more impactful than the gradual fee declines for many investors, particularly those in higher brackets.

Fund Type	Asset Weighted Avg Expense Ratio	Asset Weighted Avg 3 Year Tax Cost Ratio
Mutual Funds	0.59	1.20
ETFs	0.22	0.72
Difference	0.37	0.48

Data from Morningstar Direct as of July 31, 2018. The ETF category excludes ETNs and leveraged/inverse trading vehicles.

3 Year Tax Cost Ratio	
Fund Type	Asset Weighted Average
Mutual Funds – All	1.20
Mutual Funds – Large Value Category	1.72
ETFs – All	0.72
ETFs – Large Value Category	0.83
ETFs – Dividend Oriented	0.93

Data from Morningstar Direct as of July 31, 2018. The ETF category excludes ETNs and leveraged/inverse trading vehicles. Value categories are based on the Morningstar category. The dividend oriented grouping is based on ETFs with dividend in the name



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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