CLS's

WEEKLY 3

What You Need to Know About the Markets

JULY 23, 2019

1 Smaller stocks could present an attractive opportunity right now

2 It's easy to lose focus as an investor, but we believe in sticking with value long term

3 The good and the not-so-good of ETFs in 2019

Week in Review

Stocks closed lower last week, led by U.S. equities. Emerging market stocks actually ended the week on a positive note. Smaller-cap stocks led the declines, but as I will discuss, there's some potential for that to change going forward. Bonds rallied as the U.S. Federal Reserve (Fed) continued to signal the likelihood of an interest rate cut at its meeting next week; now it's just a debate over how much to cut.

Earnings season continued last week. So far, so good (with nearly 80% beating expectations), but only 16% of companies have reported thus far. Economic data last week continued to show improvement. Retail sales had a blowout month in June, and consumer sentiment was in line with (high) expectations. We'll see if the recent string of solid data weighs on the Fed's decision next week.

Commodities fell last week, led by a large drop in oil prices after stockpiles fell less than expected and reports indicated that Iran is willing to work with the U.S. on its nuclear program in exchange for lifted export sanctions. Metal prices continue their upward momentum.

Grant Engelbart, CFA, CAIA

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.

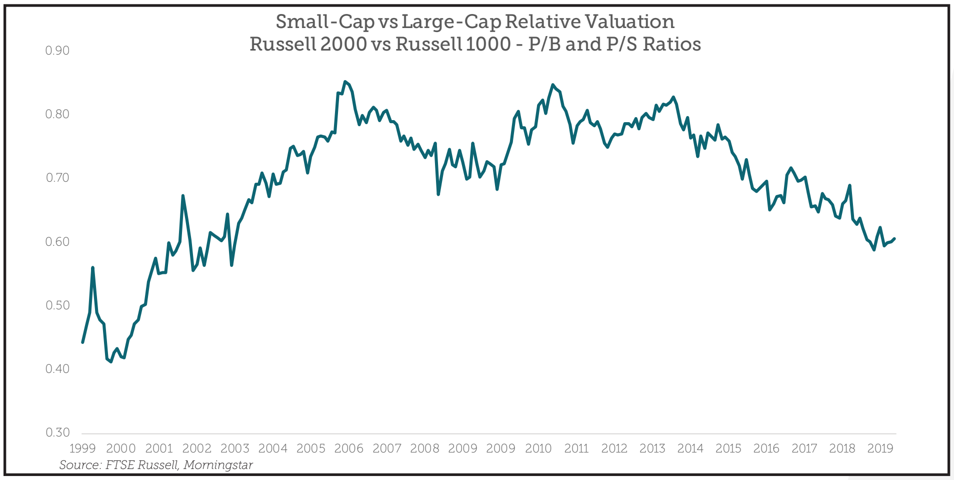
Market Performance *(as of 7/19/2019)*

Fixed Income	10-YEAR	5-YEAR	3-YEAR	1-YEAR	YTD	QTD	LAST WEEK
Cash Equivalent[1]	+0.47%	+0.87%	+1.39%	+2.28%	+1.32%	+0.12%	+0.04%
U.S. Investment Grade Bonds[2]	+3.86%	+2.95%	+2.25%	+7.46%	+6.13%	+0.01%	+0.38%
Equities	**10-YEAR**	**5-YEAR**	**3-YEAR**	**1-YEAR**	**YTD**	**QTD**	**LAST WEEK**
Global Equity Market[3]	+10.20%	+6.32%	+10.80%	+4.50%	+16.98%	+0.76%	-0.61%
Total U.S. Market[4]	+14.64%	+10.50%	+13.39%	+7.30%	+20.35%	+1.24%	-1.18%
Domestic Large-Cap Equity[5]	+14.41%	+11.03%	+14.04%	+8.79%	+19.84%	+1.48%	-1.21%
Domestic Small-Cap Equity[6]	+13.82%	+7.29%	+9.59%	-4.95%	+17.75%	-0.26%	-0.96%
International Equity[7]	+6.68%	+2.48%	+8.43%	+1.13%	+13.50%	+0.12%	+0.07%
Developed International Equity[8]	+6.82%	+2.35%	+8.16%	+0.24%	+14.33%	-0.03%	-0.14%
Emerging Market Equity[9]	+6.24%	+2.85%	+9.41%	+4.31%	+11.06%	+0.56%	+0.69%
Diversifiers	**10-YEAR**	**5-YEAR**	**3-YEAR**	**1-YEAR**	**YTD**	**QTD**	**LAST WEEK**
Diversified Alternatives[10]	+3.94%	+0.27%	+1.48%	+0.28%	+4.02%	+0.20%	-0.38%
Commodity[11]	-3.59%	-8.45%	-1.10%	-2.20%	+4.83%	-0.22%	-1.99%

[1]Morningstar Cash Index [2]Barclays 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 Global ex-U.S. Large-Mid Index [8]Morningstar DM ex-US Large-Mid Index [9]Morningstar EM Large-Mid Index [10]Morningstar Diversd Alt Index [11]Bloomberg Commodity Index.

1 Go Small or Go Home!

Small-cap stocks seem almost forgotten nowadays in the top-heavy, growth-led market we've seen over the years (what seems like forever). But forgetting about small-caps would be a mistake, especially now. Valuations (as shown below) for small versus large stocks are at lows not seen for 15 years. Performance differentials are to a point where small-caps have historically "caught up" to large-caps. Trade war escalations may actually favor small-caps, which are domestically focused, and liquidity is increasing due to an expected Fed rate cut (or two). All of these factors could lead to small-caps rebounding.



Source: FTSE Russell, Morningstar

CLS is tilted toward the "Smid" (small and mid) continuum, and we want to increase that exposure for the aforementioned reasons and more. But we have a lot of continuums, positions, and ideas — so, just how do small-cap stocks fit into our investment themes?

Be Active

Small-caps are a diverse asset class. By index design, there are at least twice as many smaller companies as large. These companies range from older, slow-growing businesses to hyper-growth, new-age technologies. There is also less analyst coverage in small-caps. This leads to greater opportunities for smart beta and active management to add value. Small-cap value is also at extremes versus small-cap growth (similar to the situation in large-caps), which leads to value-led markets where active managers tend to shine (as this article states and then some).

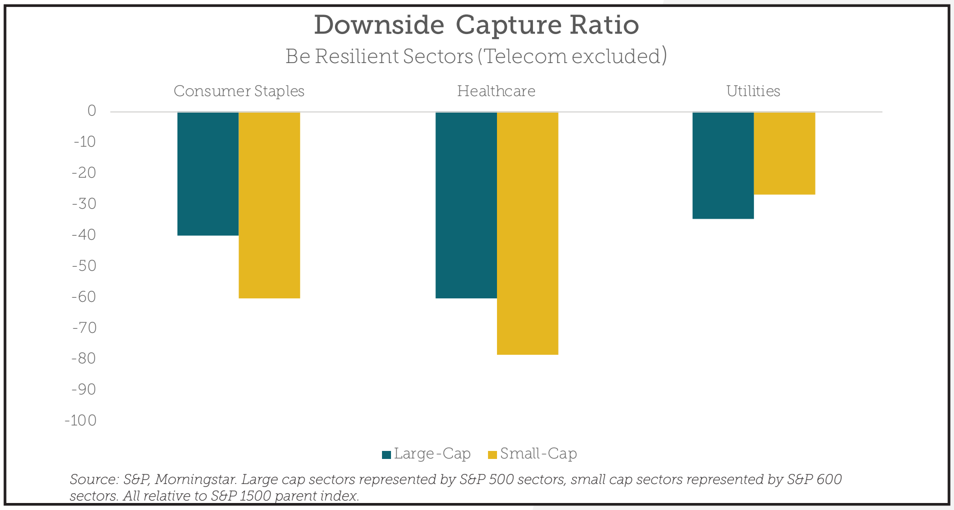
Be Innovative

While the FAANG (Facebook, Apple, Amazon, Netflix, and Google) stocks get a lot of credit for innovation, there are many smaller-cap stocks that are on the forefront of innovation (and frequently get bought out by a bigger name!). Nearly all of the innovation ETFs we look at are in the small/mid space.

Be Resilient

Small-caps are risky; how could they be resilient? Well it turns out that the smaller-cap versions of the same large-cap sectors that have historically been beneficial in uncertain markets (what are known as non-cyclical sectors) show an advantage versus the broad market, too. The chart below shows that yes, small-caps are a bit riskier than large-caps, but they still provide better protection in down markets versus the overall market (-100 implies the downside capture of the broad market). Healthcare performing worse on the downside in small-caps (but still better than the market) may make the most intuitive sense, as smaller healthcare companies tend to be early-stage biotech firms that are quite risky. We generally don't invest directly in small-cap sectors, but we will use smart beta and equally weighted sector allocations heavily, both of which tend to favor smaller stocks. Due to index methodology changes, telecom (the fourth non-cyclical sector) is excluded here.

Small-cap versus large-cap is another continuum that is at or near an extreme level of valuation or performance difference (like value vs. growth, domestic vs. international, etc). Mean reversion will come, with a vengeance.



Source: S&P, Morningstar. Large cap sectors represented by S&P 500 sectors, small cap sectors represented by S&P 600 sectors. All relative to S&P 1500 parent index.

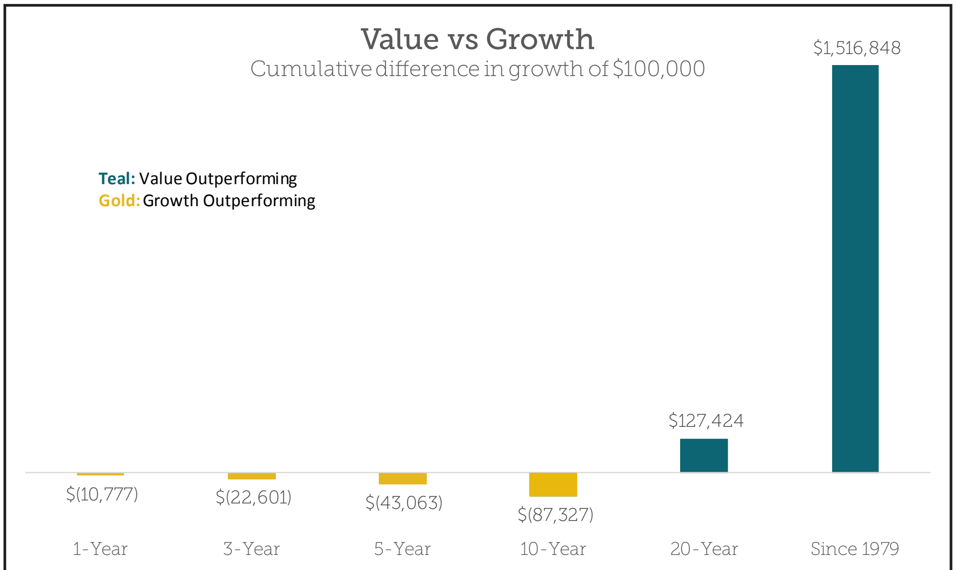
2 Value: Wife Approved

Well, this is embarrassing.

Regular readers know that I have [no problem](#) with self-deprecation. But this time, purely out of intellectual curiosity, I thought that it would be a cool idea to see how the stocks of companies that my wife likes (either they make things that she likes or they are places she shops) would do. So I pretty much randomly put together a portfolio of six stocks, equally weighted, and checked out how it has performed.

Wow.

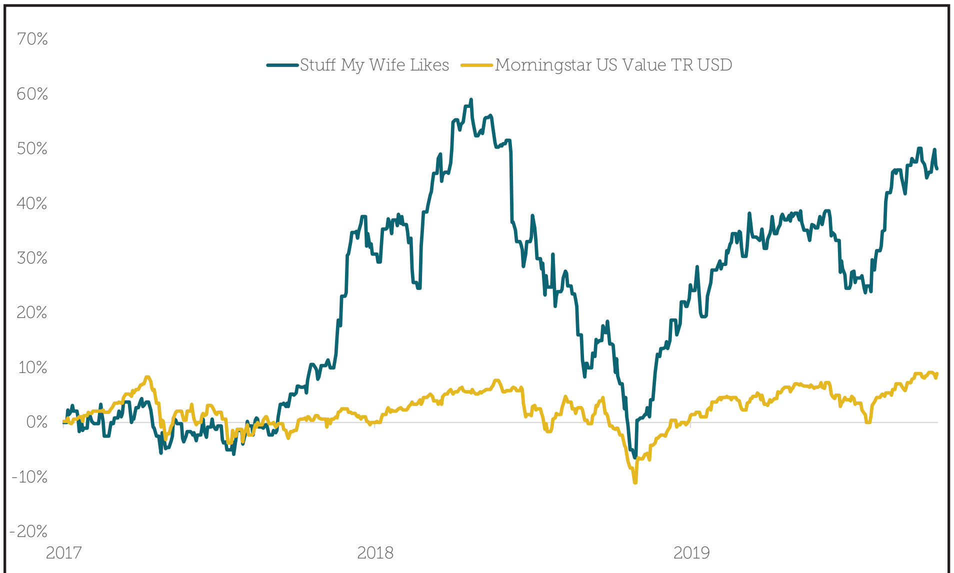
What have I been doing with my life? In less than two years, since the common inception of the six stocks (Dec. 1, 2017), this random portfolio has returned nearly 50% cumulatively — absolutely crushing any value index you choose from (our investing belief and current overweight). As I thought through how to justify explaining to my wife why we aren't invested in all of these stocks, some important lessons came to mind.



Source: Morningstar, MSCI, Russell. MSCI USA Enhanced Value and MSCI Growth used for all time periods except since 1979. Russell 1000 Value and Growth used for since 1979 time period.

First, charts can be deceiving. This just happened to be one start date, shortly after the IPO of one of the included components. The prior three years was full-on retail apocalypse, as this portfolio (ex. the unlisted stock) underperformed value by more than 5% annually!

Second, who has the stomach for this? The Risk Budget of this concentrated, six-stock portfolio is more than 200. Check out that big dip in the middle – just a quick 41% drawdown. If you stuck with this (again, pretty much random) portfolio of just six stocks, then good for you. Most people likely couldn't.



Source: Morningstar "Stuff my Wife Likes" is an equally-weighted index of Instagram/Facebook (FB), RH (RH), Stitch Fix (SFIX), Target (TGT), The Container Store (TCS), and Williams Sonoma (WSM).

Picking stocks, especially huge winners, is [really hard](#). Most underperform, many end up bankrupt, delisted, or bought out. Without the disciplined process that value investors typically have, finding winners in the long term has proven to be a tough task.

[Value works](#), but it takes time. Not that we need another reminder, but it has been a while since value really shined through, with fits and starts along the way. You have to go back a couple of decades and catch the tech bubble to see the outperformance we are accustomed to. Long term, however, the difference versus growth is striking. Fads, shiny new asset classes, and random six-stock portfolios have to face the all-powerful mean reversion someday. We think value's time is near.

3 Two Sides of ETFs in 2019

ETFs continue their rapid ascent, taking market share from mutual funds and cash on the sidelines. Trends in ETFs are always of interest to us, and there are a couple in particular this year that are worth noting. Let's look at the good and not so good.

The Good: $4 Trillion!

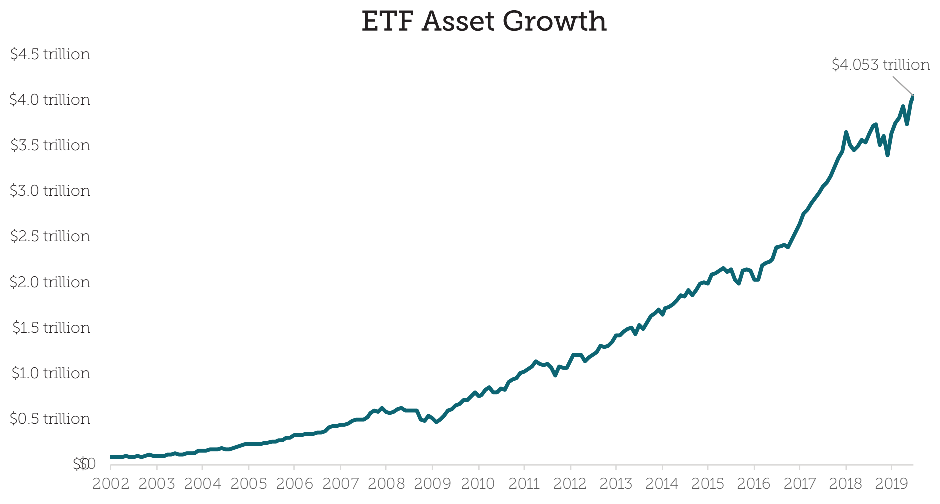
The ETF asset growth chart to the right is one of the most beautiful charts there is — moving up and to the right and nearly going parabolic. Just this month, total ETF assets hit the $4 trillion milestone. Fewer than five years ago, assets were at $2 trillion!

The Not-So-Good: Closures

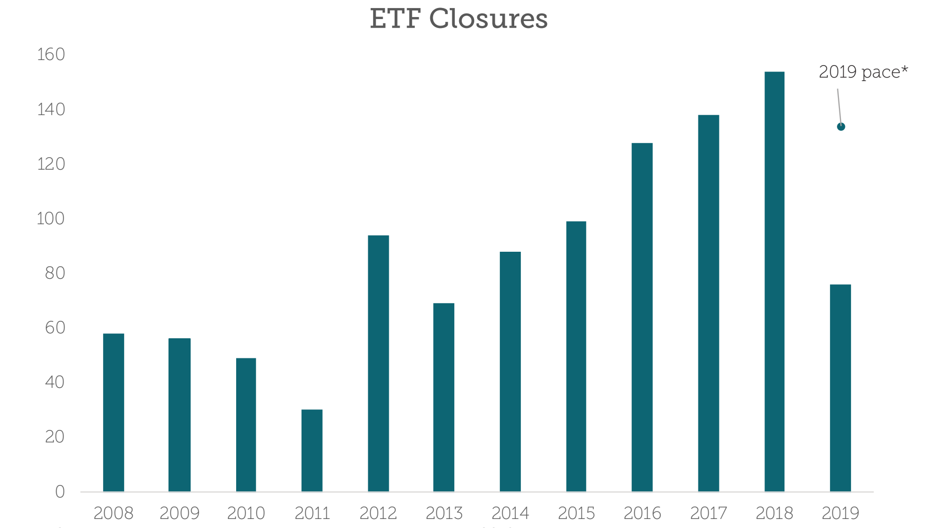
On the other side of the coin, ETFs are closing at an increasing pace, at least in absolute terms. 2018 saw the highest number of ETF closures on record (it also had the highest number of ETFs in existence, so take that as you will). This year is on pace to come in just below last year's number. While this may seem bad on the surface, we don't view this as all that troublesome. There are a number of "zombie" ETFs that sit out there with no assets and no trading volume. At a certain point, purging is a good idea before investors use or trade them inappropriately. The battle to gain assets in the ETF space also spurs innovation, as fund companies are looking at newer and better ways of developing products.

The Good: Fees

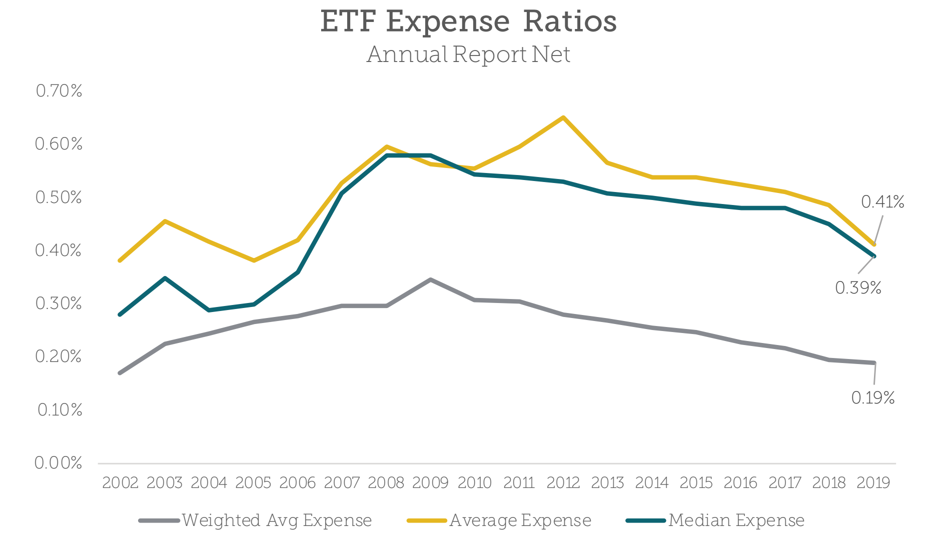
ETF expense ratios continue to fall, particularly in large index products. On an asset-weighted basis, the average ETF costs just 0.19%. The simple average across the thousands of ETFs out there is about twice as high. There are some ramifications in those products that are



Source: Morningstar



*Source: ETF.com. *Dot indicates the pace of closures in 2019 if the same number of ETFs close in the second half of the year as closed in the first 6 months of the year.*



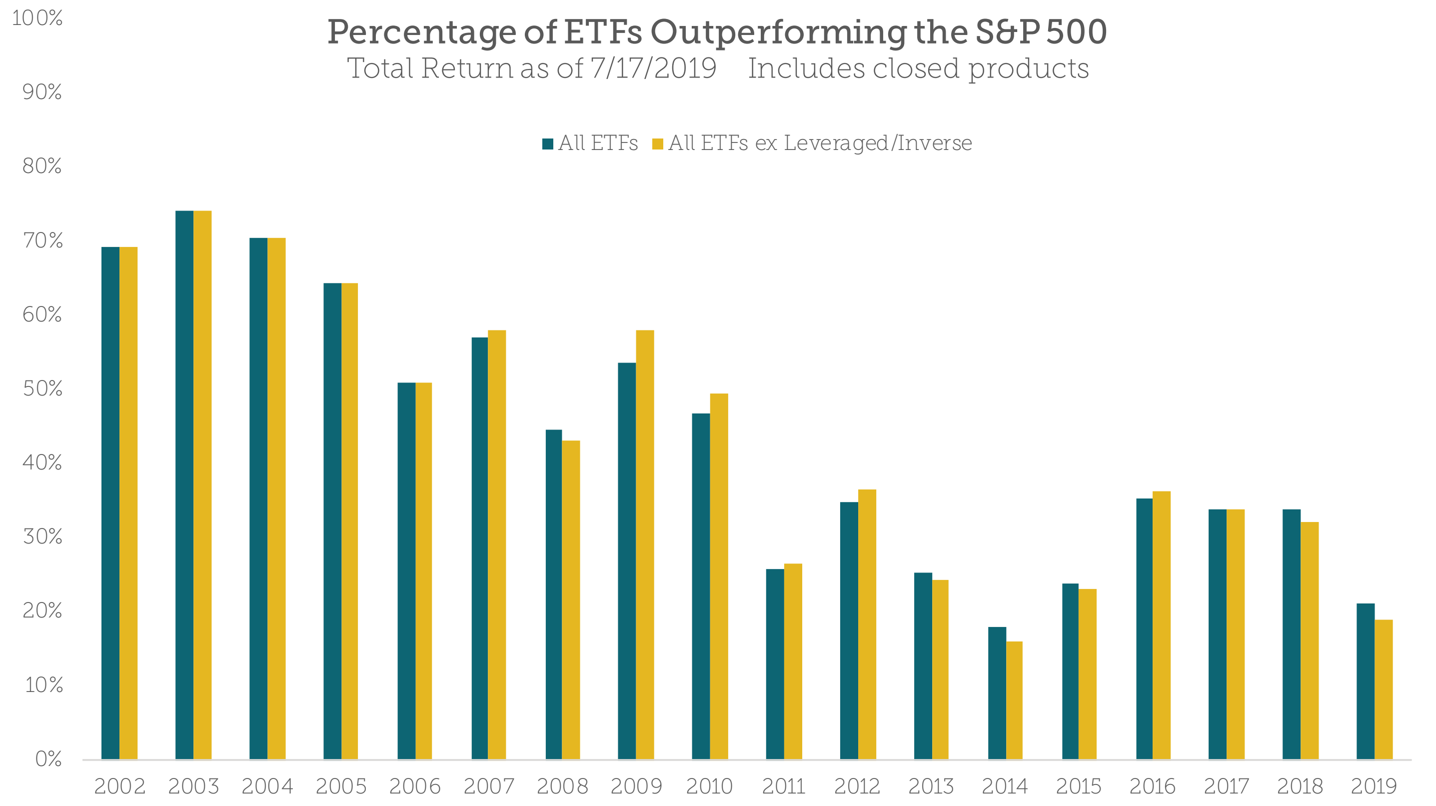
Source: Morningstar

3 Two Sides of ETFs in 2019 (Cont.)

alpha seeking and differentiated, and therefore generally higher cost, and the pure index names that continue to race toward zero.

The Not-So-Good: Performance?

Not all that unlike what is happening in active mutual funds, ETFs in aggregate are struggling to beat the S&P 500 Index. This is a bit of an unfair comparison, since there are only a few ETFs that seek to outperform the S&P 500 Index, but it illustrates several different issues going on in today's top-heavy market. Diversification in just about anything but large-cap U.S. exposure has been difficult in recent years. The structure of the ETF universe is also changing. Large-cap domestic exposure is saturated, and fees are near zero – not exactly a place for a new entrant to make a splash. Fixed income, even with pretty exceptional recent performance, hasn't outperformed equities for the most part in the lengthy bull market. But it has become a huge part of the ETF market.



Source: Morningstar

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 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.

The S&P 500 Index is an unmanaged composite of 500-large capitalization companies. This index is widely used by professional investors as a performance benchmark for large-cap stocks. 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.

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 Russell 1000 Index measures the performance of the large-cap segment of the U.S. equity universe. It is a subset of the Russell 3000 Index and includes approximately 1000 of the largest securities based on a combination of their market cap and current index membership. 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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**CLS Investment, LLC ("CLS") Senior Portfolio Manager & Co-Director of Research, 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.*

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