DIRECTIONS

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THINK BEYOND STOCKS: *DIVERSIFICATION WITH DIFFERENT ASSETS*

In this edition of Directions, CLS Portfolio Manager Matthew Santini explains the benefits of diversifying investment portfolios through bonds and alternative investments.

Introduction

Portfolio diversification is more than just global, multi-cap, equity exposure. It has become obvious that market risk affects all portfolio holdings during global volatility. Portfolio success is as much about mitigating risk as it is about making money. In this quarter's *Directions,* I will highlight integral asset classes in a properly diversified portfolio.

A properly diversified portfolio allows the "efficient frontier," to expand. In short, an efficient frontier is a widely accepted metric in modern portfolio theory that plots the most efficient combination of risk and return. As shown in these graphs, increasing the number of asset classes can decrease risk while increasing return potential. An optimal portfolio will be comprised of multiple asset classes, including global stocks, fixed income, and alternative investments.

International Securities

There are countless studies about the merits of owning international securities. Most of them hinge on the general premise that global markets do not rise and fall in unison. Asia, in 2013, is a perfect example: China's index was down around 5 percent, while Japan's was up over 40 percent. Regardless, even with a global and far-reaching equity portfolio, you are not always insulated from dramatic losses and, more importantly, it might not be the most efficient use of risk.

Bonds

Correlation is the measure of asset classes' propensity to move together. The only true way to diversify a portfolio is to integrate asset classes that are not correlated. There are two uncorrelated asset classes that have proven to be long-term diversifiers: bonds and alternative investments. During the last major correction in 2008, a global equity-only portfolio did not fare well. Value was added by diversifying away from an all stock portfolio. The chart below shows that adding 30 percent in various domestic investment-grade fixed income securities to an all equity portfolio added significant value

Diversification helped limit losses and capture gains after the market bottomed out

	From the beginning of the crisis to the bottom, January 2008–February 2009	From the bottom up, March 2009–April 2013	Five years after the start of the crisis, January 2008–April 2013
All-Cash Portfolio	1.6%	0.3%	1.9%
Diversified Portfolio	-32.4	94.2%	17.8%
All-Stock Portfolio	-50.1%	127.5%	13.9%

Source: Strategic Advisers, Inc. Source: Strategic Advisers, Inc. Hypothetical value of assets held in untaxed accounts of $100,000 invested in a portfolio of 100% cash, 49% domestic stocks, 21% international, 25% bonds, and 5% short-term investments; and 70% domestic, 30% international stocks, respectively. This chart's hypothetical illustration uses historical monthly performance from January 2008 through March 2012 from Morningstar/Ibbotson Associates; stocks, bonds, and short-term investments are represented by the S&P 500 Index, MSCI EAFE Index, Intermediate Government Treasury Bond Index, and U.S. 30-day T-bills, respectively during volatile times. That value is still apparent five years later.

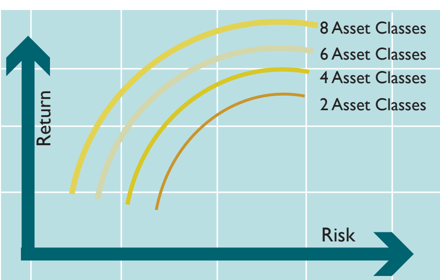
Alternative Investments

Alternative investments offer different styles of investing while seeking absolute risk-adjusted returns. Some of the most common alternative investment ETFs utilize derivatives, long and short positions, privately listed securities, and hedging. They seek to offer absolute risk-adjusted returns. The wide scope of the alternative investment landscape allows for a broader opportunity set. That broader set, when combined with a balanced portfolio, over time, has been shown to lower a portfolio's standard deviation while increasing return. The less correlated the asset classes, the better the relationship between risk and return.

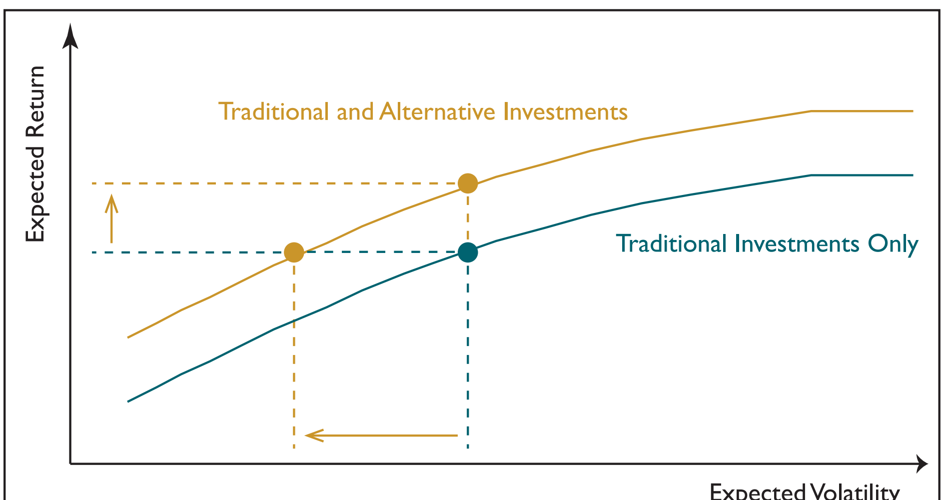
With the development of alternative ETFs, traditional investors can now partake in this wide spectrum of offerings, formerly reserved for institutional investors only. Alternative ETF's offer a liquid, transparent, and cost effective way for a portfolio to target an asset class.

Conclusion

The charts throughout this piece depict the merits of a diversified portfolio that incorporates both bonds and alternatives. CLS prides itself in active, diversified portfolios that take advantage of the highly evolved ETF universe, and encompass both bonds and alternative investments when the underlying mandate warrants. Therefore, we are able to offer efficient portfolios that incorporate asset classes that traditionally help lower volatility and increase expected returns.



Source: Frontier Investment Management



For illustration puposes only, not drawn to scale.

Source: Baird Private Wealth Management

About the Author

Matthew Santini joined CLS in August 2011, after the acquisition of the Milestone Treasury Obligations Fund, which he has continued to manage as well as the AdvisorOne Select Appreciation Fund. Mr. Santini began his career at Citigroup, where he helped clients evaluate proprietary offerings. Mr. Santini holds a B.A. in Economics from Rollins College. Mr. Santini currently holds his FINRA Series 7 and NASAA Series 63 Securities registrations.

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Q4 Market Highlights & 2014 Investment Themes Outlook
from CLS Chief Investment Officer, Rusty Vanneman

Last year, was outstanding for investors. The U.S. stock market was up significantly, and even though other asset classes notably lagged, balanced portfolios still generated strong absolute returns.

Where to next? In short, we don't expect a repeat of 2013, at least for the domestic stock market. While there are elements in place to suggest more positive returns, including a still accommodative Federal Reserve, combined with positive momentum in the economy and markets, it's not likely that U.S. stocks will dominate other asset classes to the extent they did this past year. Entering the New Year, we have updated the investment themes that we use to help construct our portfolios. Here are the 2014 themes:

- The Power of Innovation. With improving confidence by corporate decision-makers, we expect that capital expenditures will rise in 2014. In turn, we believe that growth-oriented companies, including those in the technology sector, will likely do better in the year(s) ahead.

- High Quality Focus. We continue to like companies with relatively stable profitability, stronger balance sheets, and higher dividend growth. Not only should they do better in a slower growth environment, but they also generally hold up better in choppy stock markets.

- Go Global. Over time, broadening one's investment universe by including international securities provides more opportunities to enhance returns, while reducing portfolio risks. And this is a good time to rebalance back into international as international equity markets currently have more attractive valuations than the U.S.

- Active Diversification is our final theme. The multi-decade bull market in bonds is likely over. While interest rates won't likely move far in 2014, we will look to diversify equity-dominated portfolios through a combination of active management in diversifying asset classes, including fixed income and alternatives.

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Investment grade refers to the credit rating of a particular security. Securities with ratings of AAA, AA, A, and BBB are considered investment grade. Investment grade is not a guarantee that the security will produce a return.

Hedging is making an investment to reduce the risk of adverse price movements in an asset. Normally, a hedge consists of taking an offsetting position in a related security, such as a futures contract.

An ETF is a type of investment company whose investment objective is to achieve the same return as a particular market index. An ETF is similar to an index fund in that it will primarily invest in the securities of companies that are included in a selected market index. An ETF will invest in either all of the securities or a representative sample of the securities included in the index.

A derivative is a contract which is also a security. The price is derived from, or dependent upon, underlying assets including, but not limited to, stocks, bonds, commodities, currencies, interest rates, and market indexes. Derivatives have numerous risks which include all risks associated with their underlying securities.

Standard Deviation is a statistical measure of the historical volatility of a mutual fund or portfolio, usually computed using 36 monthly returns. A measure of the extent to which numbers are spread around their average. The greater the standard deviation, the greater the fund's volatility.

Fixed Income is an investment style designed to return income on a periodic basis. While more conservative than many investment strategies, there are risks associated with fixed income investing, notably regarding interest rates, credit default, inflation, liquidity risks, and prepayment risks.

High quality investments are investments made in companies and/or products with outstanding characteristics. Although high quality investing attempts to eliminate as much risk as possible, risk is always inherent in any investment methodology.

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. The Barclay's Capital U.S. Aggregate Bond® Index measures the performance of the total United States investment-grade bond market. 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.

Foreign securities may be subject to unstable international political and economic conditions, currency fluctuations, foreign controls on investment and currency exchange, withholding taxes, a lack of adequate company information, less liquid and more volatile markets, and a lack of governmental regulation which subject foreign securities to risk. Investing in emerging markets involves greater risk and potential reward than investing in more established markets. Risks for emerging markets include, for instance, risks relating to the relatively smaller size and lesser liquidity of these markets, high inflation rates and adverse political developments.

Large Cap Investments typically invest in larger companies whose market capitalization is over $10 Billion. Mid Cap Investments typically invest in mid-sized companies whose market capitalization is between $2 Billion and $10 Billion. Small Cap Investments typically invest in smaller companies whose market capitalization is between $300 Million and $2 Billion.

There are risks associated with bonds. These risks include, but are not limited to, the same interest rate, inflation, and credit risks associated with the underlying bonds owned by the portfolio and your return of principal is not guaranteed.

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