DIVERSIFYING ABROAD

For many investors, the expansion of the ETF marketplace has for the first time enabled truly low-cost exposures to non-U.S. equity markets. These exposures can be utilized to enhance portfolio risk-relative return via the additional diversification they may provide and the potential to capture relative outperformance. Our quantitatively driven approaches to utilizing these non-U.S. equity exposures seek to improve upon a more generic application of these beneficial characteristics within our portfolios.

DISAGGREGATING THE AGGREGATES

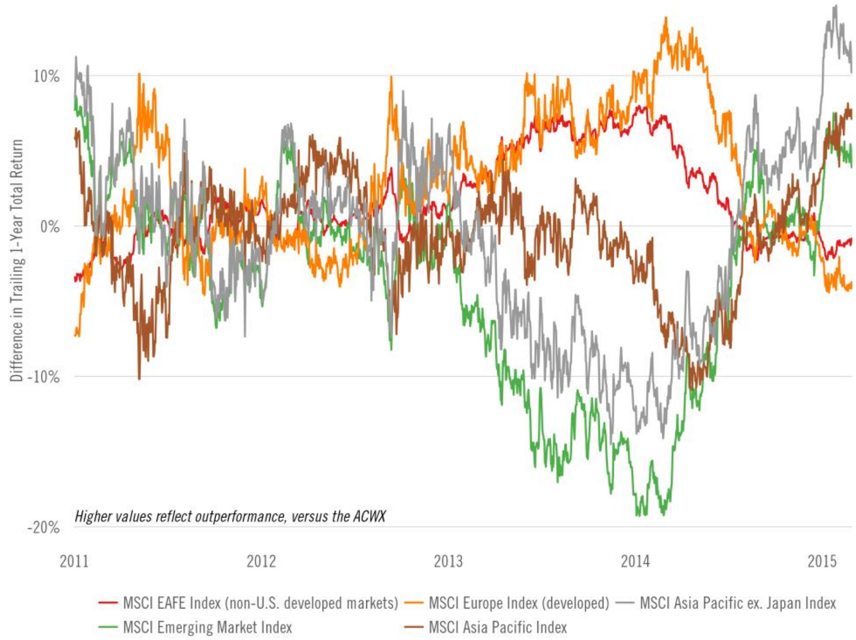
The MSCI All-Country World Index ex. U.S. (ACWX), which reflects the performance of 45 individual non-U.S. country equity markets, is an exposure to which one may turn to diversify a portfolio around U.S. equities. With some technical modifications, the weights of individual countries within the ACWX reflect their relative total capitalization.

Not a critique of the methodology, that composition nonetheless has the effect of skewing the index exposures to the very largest international equity markets. As of the end of January 2015, the top 5 markets (Japan, United Kingdom, France, Canada and Switzerland) constituted greater than 50% of the weight in the ACWX, while the top 10 composed just under three-quarters of the capitalization of the index. The upshot, not surprisingly, is that the largest markets are the primary contributors to index-level performance. Regional and economic-development-based indices can be used to redistribute weights among incrementally more narrow sub-indices. As we show in Figure 1 (a bit messy, but that's the point…), the potential to alter total return, versus a higher-level index, by redistributing funds among constituent indices is considerable. It is for this reason that the Investment Committee continues—as the expansion of the ETF marketplace provides—to "disaggregate the aggregates" in our Global All Asset portfolios, both among the equity and the fixed income allocations. This process allows the Committee to express more targeted views based on the team's interpretations of our quantitative frameworks.

FIGURE 1

Difference in Trailing 1-Year Returns, Versus MSCI All-Country World Index ex. U.S.

From 12.31.09 to 02.28.15.
SOURCE: Innealta Capital using data from Bloomberg



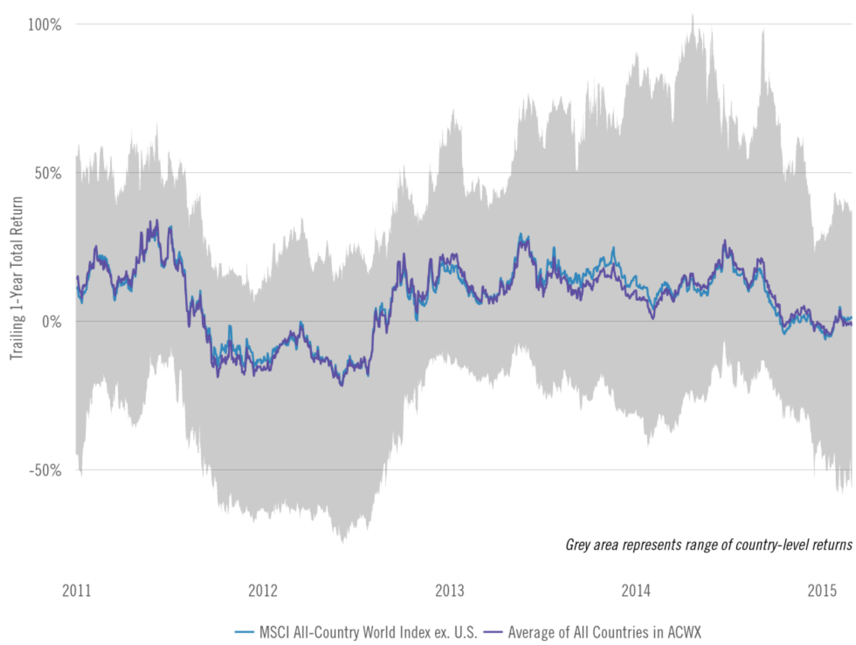
RANGE OF OPPORTUNITY

As noted, the opportunity to augment portfolio diversification via more granular equity exposures is substantial. Further disaggregation to the country level may provide additional benefit to diversification and risk-relative return, given the generally wide range in yearly performance among country equity markets. Shown in Figure 2, while the average trailing 1-year returns for all countries within the ACWX might approximate the trailing 1-year return for the index, the range of performance among those individual markets can be wide.

FIGURE 2

Trailing 1-Year Returns: MSCI All-Country World Index ex. U.S., Versus Average Country

From 12.31.09 to 02.28.15.
SOURCE: Innealta Capital using data from Bloomberg



GAUGING THE POTENTIAL BENEFIT

Understanding that there is opportunity to enhance portfolio diversification among global equity markets, Innealta employs two distinct approaches to take advantage of these possibilities. Both approaches are driven by the Investment Committee's review of the firm's quantitative frameworks. The first approach applies to our Global All Asset Portfolios. The process is two-stage: the Committee first utilizes a constrained optimization-based methodology to define our Secular Tactical Asset Allocation (STAA). The STAA serves as the foundation for second-stage decisions. These decisions express the Investment Committee's tactical under- and overweights relative to the STAA for each individual equity market. The result of this process is a series of allocations to regional-specific equity ETFs in these portfolios that may differ substantially from their weights in a broader index (in this case, the global cap-weighted equity market in its entirety), with the primary drivers of those differences being their relative contribution to overall portfolio risk-relative potential return and, in turn, their specific risk-relative return opportunities versus fixed income.

The second approach focuses more narrowly on the risk-relative return potential of specific country equity markets versus fixed income and is applicable to the Country Rotation Portfolio. Perhaps not surprisingly, the potential to enhance absolute return is even more substantial, though so is the potential to add risk. Our quantitative approach is designed to focus on the former, while limiting the potential impact of the latter. A few additional figures show what we mean.

In Figure 3 we have estimated the contribution of each country in the ACWX to the total return of the index and plotted the respective total return performance of each country (all in U.S. dollars) against its average weight. Total net returns in USD for the 62-month period range from a gain of 157.6% for the Philippines to a loss of 83.5% for Greece, with a reasonably broad spread in between. In hindsight, leaving aside the impact on volatility for the moment, that spread suggests there was opportunity to enhance return by adjusting the weights in favor of outperformers.

FIGURE 3

Estimated Country-Specific Contribution to MSCI All-Country World Index ex. U.S. Returns

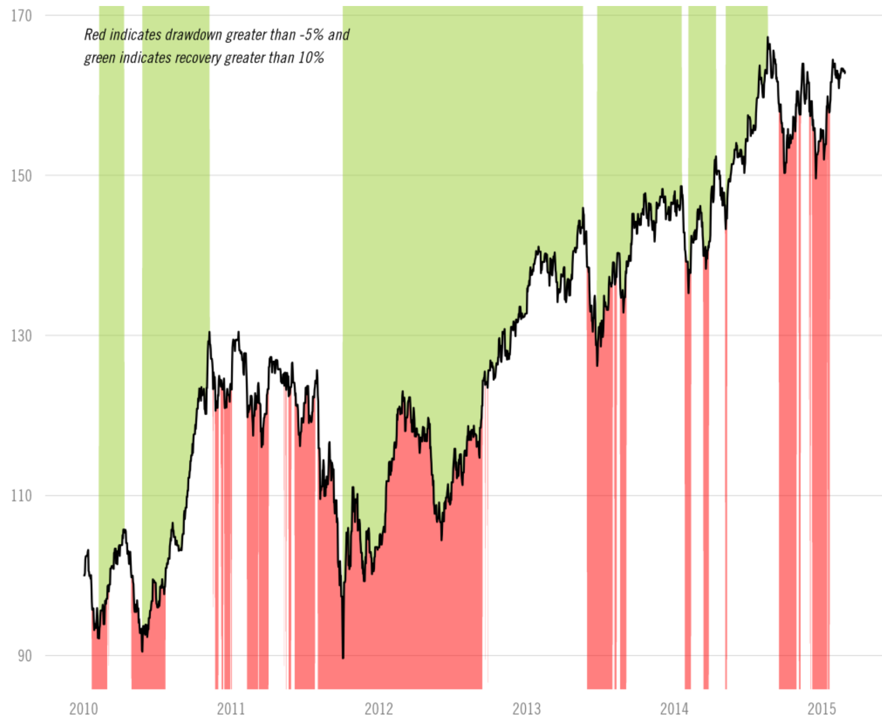
From 12.31.09 to 02.28.15. Contribution estimated using monthly country-level index constitutent weights provided by MSCI. SOURCE: Innealta Capital using data from Bloomberg and MSCI

Even more, there's a manner of virtue in the underlying volatility, an aspect of global equity market performance that we seek to target via our tactical decisions in our Country Rotation Portfolio. Consider the Hong Kong equity market. Gauging by its placement in Figure 3, it was a reasonably well-performing market that contributed more than 1 percentage point to the overall total return of the ACWX at an average weight of 2%. But the static view hides a significant amount of underlying volatility. In Figure 4, we detail six drawdowns in excess of 5% and the same number of recoveries from the troughs of those drawdowns in excess of 10% for that market over the past 5+ years. During these ebbs and flows, the Investment Committee has found six occasions (including the presently "on" position) to expose the Country Rotation Portfolio to the Hong Kong equity market, adding in excess of three percentage points to the portfolio's total return, even as the allocation in the portfolio averaged out to well under a percentage point over that time frame.

FIGURE 4

Drawdowns and Recoveries for the Hong Kong Equity Market

From 12.31.09 to 02.28.15.
SOURCE: Innealta Capital using data from Bloomberg



BANG FOR BUCK

More than a bit too crude, perhaps, but it's not altogether terrible short-hand for the thinking behind the investment approach. The intention is to maximize the contribution from beta allocations, while minimizing the additional volatility they impart to the portfolio, and otherwise fortifying portfolio risk-relative total return via dynamic allocations to fixed income. It's just one example, and we cannot always expect to see such success in specific countries, but with Hong Kong, we have managed to gather substantially more contribution even with less of an average exposure than its respective metrics within the ACWX.

The broader goal is that, over time, we manage to do so in the aggregate, and this has been the case since the strategy's inception in 2009. Our business development team is more than happy to discuss the impact tactical equity exposures have had on total return for the Country Rotation Portfolio. Readers should feel free to reach out to a member of the team, contact details for whom may be found at www.innealtacapital.com/contact-us.

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Sector ETFs, such as Real Estate Investment Trusts ("REITs") are subject to industry concentration risk, which is the chance that stocks comprising the sector ETF will decline due to adverse developments in the respective industry.

The use of leverage (borrowed capital) by an ETF increases the risk to the fund. The more a fund invests in leveraged instruments, the more the leverage will magnify gains or losses on those investments.

Country/Regional risk is the chance that world events such as political upheaval or natural disaster will adversely affect the value of securities issued by companies in foreign countries or regions. Country/Regional risk is especially high in emerging markets.

Emerging markets risk is that chance that stocks of companies located in emerging markets will be substantially more volatile, and substantially less liquid, than the stocks of companies located in more developed foreign markets.

Securities rated below investment grade, commonly referred to as "junk bonds", may involve greater risks than securities in higher rating categories. Junk bonds are regarded as speculative in nature, involve greater risk of default by the issuing entity, and may be subject to greater market fluctuations than higher rated fixed income securities.

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