Innealta
CAPITAL

COMMENTARY: APRIL 3, 2014

OVERVIEW OF THE CURRENT CAPITAL MARKET ENVIRONMENT

Based on the team's review of our quantitative investment framework, the Investment Committee continues to view the majority of equity markets globally as overvalued. Given the currently elevated levels of geopolitical risks and ongoing concerns of an economic slowdown, especially in China, we maintain the belief that downside risk is generally not accurately reflected in current valuation multiples.

DOMESTIC

Domestically, most fundamental metrics continue to exhibit signs of overvaluations. Important metrics such as Shiller PE ratios and corporate profit margins are at or near all-time highs. These levels will be unsustainable. To return to more normal valuation levels, one of two possible scenarios must take place. (1) Prices retreat, contracting valuations to more reasonable levels. Avoiding equity exposures at the times when the risk of large valuations declines is most elevated is a cornerstone of our investment approach. (2) Earnings “catch up” to higher valuation levels. This scenario is also undesirable since, absent capital gains, dividend yields are far too low to compensate investors for equity market risks. Thus, whether or not a significant compression of equity market valuations transpires, current lofty valuations imply that equity market investors are doomed to suffer low returns for the foreseeable future.

EUROPE

In Europe, developments mostly have focused on the impact of economic sanctions on Russia and Europe after Russia annexed Crimea. In our view, the initial sanctions imposed on Russia by the U.S. and other western nations are more of a formality, mostly targeting a handful of individuals within or close to the Russian government. In addition to restricting travel for these individuals, a small number of asset freezes on Russian foreign investments have been put in place. In theory, these actions could trigger outflows of other Russian investments from abroad. However, in our assessment, any impact stemming from investment outflows is likely to have happened already. Moreover, it seems unlikely, absent further provocation, that western leaders will levy any additional sanctions with potentially broader economic implications, as most discussions on this topic have been extremely vague. No country has an interest in disrupting the relatively weak and fragile world economy by being particularly aggressive against Russia through sanctions or otherwise. Among the best examples of conflicting pressures, Europe is the region that is most heavily reliant on good economic relationships with Russia, which supplies about 30% of the continent’s energy needs.

Feasible alternatives for Europe to reduce its reliance on Russian energy include higher domestic energy production or energy imports from other countries (such as the U.S). These changes take a long time to implement. European politicians are painfully aware of this reality, and have tempered their reaction to circumvent the threat that Russia may constrain, or even cut off, its energy supply to Europe in retaliation. Moreover, the Eurozone already is mired in internal economic and financial problems, leaving it unable to afford the luxury of maintaining a tough stance against Russia. In our view, the annexation of Crimea will not be reversed, and may lead to long-term escalation of geopolitical risks, as Putin’s move against Crimea may have created a precedent for further Russian actions. The leaders of other rogue states are likely to be emboldened by this precedent, further increasing geopolitical risks.

ASIA

Turning to Asia, recent economic data out of China are consistent with a slowing economy as reflected in a contraction in manufacturing and weaker-than-expected trade numbers. The much-discussed cyclical rotation from infrastructure building and investment to sustainable, domestic consumer demand continues to be lacking. The conjunction of slowing economic growth, currency manipulation by the PBOC, and default fears from rising credit strains have resulted in investors reassessing the risk premium required for investing in China. These concerns have spilled over to other regional economies, in some cases presenting attractive opportunities for adding beta exposure at attractive levels.

Indications continue to emerge that China's leaders will increase government spending to create economic stimulus that will provide a short-term offset to the decline in economic growth. Thus far, stimulus efforts have been ad hoc and focused on new infrastructure spending. For example, the most notable recent spending project is the construction of five new railway lines. This has led some analysts to label it a "tweak as you go" stimulus policy aimed at preserving the targeted 7.5% GDP growth in a somewhat artificial manner. As we monitor our investment framework, we continue to consider outside factors, such as additional government stimulus spending and the ability of heavily indebted entities to service and roll over their debts.

In Japan, a sales tax increase in April will be widely followed by policymakers and market participants as its impact on economic activity remains uncertain. The tax increase is widely expected to lower domestic consumption spending. A reduction in personal consumption expenditures is counter to the radical policies directed by Prime Minister Abe to ignite economic growth and likely will hinder the extension of recent gains in domestic demand. As a result, we expect that additional stimulus measures will be required to offset the impact of the tax increase. Bank of Japan Governors have pledged their support to achieving the 2% inflation target and it seems indeed likely that additional efforts will be required to achieve the target.

As we have stated previously, the reestablishment of nuclear power is critical for the Japanese economy, which has been forced to import fuel in the wake of the Fukushima nuclear disaster. A positive development in recent days is that the energy regulator has agreed to expedite safety checks, which will be a significant step in resuming nuclear power production.

Innealta's investment methodology prefers the relative stability of fixed income, for both income and potential capital gain, while seeking to take advantage of the greater variability of equity to add incremental return. These basic principles influence all our strategies, which in turn are implemented across a range of portfolios.

In regard to beta exposures, the firm's quantitative framework facilitates the discovery and analysis of prospective risk-relative returns for individual equity markets. Aided by that framework in its review of global investment opportunities, the Investment Committee remains highly selective in choosing and maintaining exposures, as the pervasive, distortive impact on valuations from central bank actions presents a challenge to the identification of attractive beta opportunities in the current market environment.

Even so, select opportunities remain. In some regions, such as Central and South America, equity markets have been impacted negatively by the spillover effects of geopolitical risks and concerns regarding emerging market growth. In some specific markets within those regions, the Committee believes such reactions have been overdone, presenting sufficient potential reward for the assumption of relevant risk.

Year-to-date, this caution has proved warranted. We saw little in the way of equity market volatility last year. And the Committee remains convinced that global risks of most sorts, broadly speaking, are not accurately reflected in equity market valuations. And, yet, it would seem investors have tempered the ebullience we experienced last year...at least a bit. As we move into the second quarter, the Committee believes the relatively cautious stance in the Portfolios not only far better reflects the risk factors discussed earlier, but also presents a strong foundation from which to take advantage of any additional opportunities that stem from further appreciation of global risk that remains mostly unacknowledged by the average equity investor.

HIGHLIGHTS OF RECENT PORTFOLIO CHANGES

Sector Rotation Portfolio (Core and Total Return)

- Basic Materials (Sold)
- Consumer Staples (Purchased)
- Utilities (Purchased)

We maintain exposure in the portfolios to the Financials and Industrials sectors.

Our quantitative framework views two additional sectors (Consumer Staples and Utilities) favorably. Most notably, among these sectors, fundamental valuation metrics and the dynamics of those metrics have emerged as attractive. We have established small, initial beta exposures to these sectors and continue to monitor both the framework and other exogenous factors as we consider increasing these exposures. We began the month with a beta exposure to the Basic Materials sector, but the framework's scoring of this sector weakened sufficiently such that the team decided to eliminate the exposure, realizing a considerable gain.

Net of any adjustments made to accommodate equity trades, the Sector Rotation Portfolio also reflects changes the Investment Committee made to the Fixed Income Portfolio that we describe below.

Country Rotation Portfolio

- Singapore (Increased)

Our quantitative framework continues to favorably view the Singapore equity market, where solid fundamentals support current valuation levels. The Investment Committee has increased the allocation to this beta exposure after initially establishing the position earlier this year. This exposure has withstood the recent market volatility nicely and continues to offer attractive risk-adjusted returns. Singapore's impeccable sovereign credit rating and enviable positioning to benefit from, but not be grossly dependent upon, growth throughout other Asian economies adds to the Investment Committee's favorable view of the equity market.

We maintain beta exposure to Japan, Peru, Russia and South Korea, each of which is viewed favorably through our quantitative framework. In each case, we continually monitor the exogenous events ranging from unpredictable geopolitical risks to economic data releases and their impact on underlying fundamentals.

Net of any adjustments made to accommodate equity trades, the Country Rotation Portfolio also reflects changes the Investment Committee made to the Fixed Income Portfolio that we describe below.

Fixed Income Portfolio

- Short-Term Fixed Rate U.S. Corporate Bonds (Reduced)
- U.S. Mortgage Backed Bonds (Reduced)
- Short-Term High Yield U.S. Corporate Bonds (Increased)
- High-Yield Emerging Market Bonds (Increased)

The Investment Committee evaluates all sectors of the fixed income market continuously. The Committee adjusts the portfolio positions over time to reflect evolving market conditions and to take advantage of newly available exposures as the ETF product space expands. We recently made several changes to the portfolios which increase the yield and maintain a limited duration exposure relative to our benchmark index.

Recent changes include increased exposure to short-term U.S. corporate high-yield bonds and emerging market bonds. In both cases, we introduced new ETFs to the portfolios, further improving diversification across providers and enhancing the portfolio expected return per unit of duration exposure. These additions were funded by equivalent reductions in short-term fixed-rate U.S. Corporate bonds and U.S. mortgage backed securities. The net impact of the changes is to improve significantly the portfolio yield while maintaining portfolio duration below that of our fixed income benchmark.

These changes, and the overall portfolio positioning, reflect the Committee's view that benchmark rates, and particularly key rates on the longer end of the term structure, will be increasingly volatile over the course of this year. Such a view is consistent with the reduced demand for longer-term bonds as the Fed tapers its asset purchases even as the Federal government's funding needs remain substantial.

Taking advantage of opportunities when they arise requires the ability to liquidate portions of our fixed income allocations in a flexible manner. As a result, we need to maintain reasonable liquidity levels in the Fixed Income Portfolio. We achieve this objective by including highly liquid fixed income positions, which generally trade easily and can provide desired liquidity in virtually all market conditions. Two such exposures include short-term corporate bonds and short-term floating rate bonds.

Risk-Based Core Portfolios

- Short-term U.S. Government and Credit Bonds (Sold)
- Short-Term Floating Rate Bonds (Increased)
- Short-Term High Yield U.S. Corporate Bonds (Increased)

The Investment Committee enacted several changes to the portfolios' fixed income allocations, including the addition of short-term high-yield U.S. corporate bonds an increase in short-term floating rate bonds along with a corresponding removal of the short-term U.S. Government and Credit exposure. These changes enhance the yield with virtually no increase in the duration risk profile of the fixed income holdings.

We maintain our previous tactical equity allocations. The portfolios maintain an overweight, relative to our long-run strategic target exposures, to emerging market equities and developed Asia-Pacific equities. We continue to underweight U.S. and European equities.

Risk-Based Total Return Portfolios

- Short-term U.S. Government and Credit Bonds (Sold)
- Short-Term Floating Rate Bonds (Decreased)
- Short-Term High Yield U.S. Corporate Bonds (Increased)
- High-Yield Emerging Market Bonds (Purchased)

The Investment Committee enacted several changes to the portfolios' fixed income allocations, including the addition of a short-term high-yield U.S. corporate exposure and an expansion in the portfolios' overall emerging market bond exposure. Funds for these purchases came from a reduction in the short-term U.S. Government and Credit exposure and the short-term floating rate exposure.

We maintain our previous tactical equity allocations. The portfolios maintain an overweight, relative to our long-run strategic target exposures, to emerging market equities. We continue to underweight U.S. and European equities.

IMPORTANT INFORMATION

The information provided comes from independent sources believed reliable, but accuracy is not guaranteed and has not been independently verified. The security information, portfolio management and tactical decision process are opinions of Innealta Capital (Innealta), a division of AFAM Capital, Inc. and the performance results of such recommendations are subject to risks and uncertainties. For more information about AFAM Capital, Inc. please visit afamcapital.com. Past performance is not a guarantee of future results.

Any investment is subject to risk. Exchange traded funds (ETFs) are subject to risks similar to those of stocks, such as market risk, and investors that have their funds invested in accordance with the portfolios may experience losses. Additionally, fixed income (bond) ETFs are subject to interest rate risk which is the risk that debt securities in a portfolio will decline in value because of increases in market interest rates. The value of an investment and the return on invested capital will fluctuate over time and, when sold or redeemed, may be worth less than its original cost. This material is not intended as and should not be used to provide investment advice and is not an offer to sell a security or a solicitation or an offer, or a recommendation, to buy a security. Investors should consult with an investment advisor to determine the appropriate investment vehicle. Investment decisions should be made based on the investor's specific financial needs and objectives, goals, time horizon and risk tolerance. All opinions and views constitute our judgments as of the date of writing and are subject to change at any time without notice.

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 exchange-traded fund 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.

Diversification does not protect against loss in declining markets.

Registration of an investment adviser does not imply any certain level of skill or training.

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Innealta's competitive advantage is its quantitative investment strategy driven by a proprietary econometric model created by Dr. Gerald Buetow, Innealta's Chief Investment Officer. The firm's products include Tactical ETF Portfolios, a U.S. Sector Rotation Portfolio and a Country Rotation Portfolio. Innealta aims to beat appropriate benchmark performance by tactically managing portfolios utilizing a proprietary econometric model. By harnessing the benefits of ETFs, Innealta is able to provide investors with exposure to multiple asset classes and investment styles in highly liquid, low cost portfolios.

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