Innealta CAPITAL

COMMENTARY: NOVEMBER 4, 2013

SEARCHING FOR EVIDENCE OF SUSTAINABLE, ORGANIC ECONOMIC GROWTH

That our investment committee continues to have negative views on equities as an investment exposure, particularly in the United States, is not surprising to our readers. We frequently receive questions about this view, and those questions come with increasing frequency following periods in which equity market returns have been positive.

In response, we are taking this opportunity to continue the discussion that we began last month on important macroeconomic variables. In this monthly commentary, we present several important variables and illustrate their time-series behaviors. We carefully describe the economic importance of these variables and focus on the general relation between these variables and equity returns.

Although the investment committee examines a wide array of data and uses sophisticated techniques to model the important properties of those data series, our focus here is on the top-level, "30,000 foot" view. These variables comprise some of the most foundational macroeconomic characteristics to which virtually every financial economist pays attention. Thus, although our presentation here focuses on more basic economic relations and statistical techniques, the importance of the emerging message is not diminished. In fact, the clarity of the message that emerges from the most basic view provides great comfort to the identical conclusions drawn from our more sophisticated analyses. Specifically, the conclusion is that current valuation levels are severely over-extended and that there is virtually no evidence of underlying, fundamental support for such lofty valuations as we see presently in the U.S. equity market as well as most equity markets around the world.

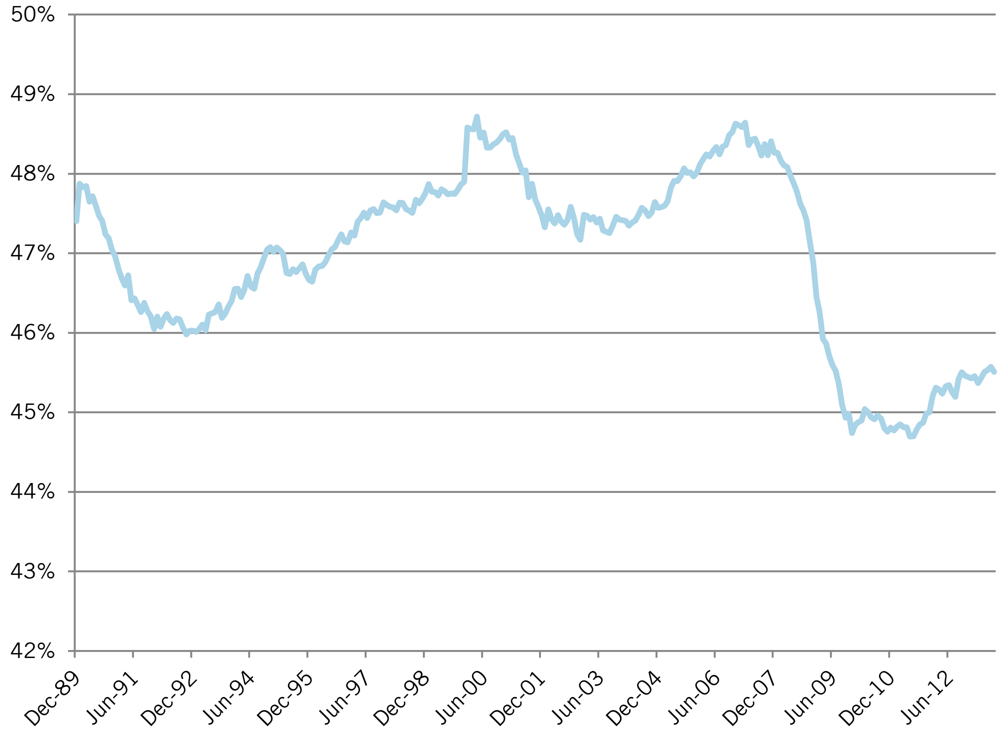
This month, we focus on several economic relations, including personal consumption expenditures and labor market participation, in addition to several measures of fundamental equity valuations. The analyses of each result in the same conclusion: by any metric that identifies sustainable, organic economic growth, equity markets have become disjointed from the underlying fundamentals required to support valuations.

LABOR MARKET PARTICIPATION

Last month, we presented evidence that changes to the methodology used to compute the unemployment rate mask (under-estimate) the true level of unemployment, since many workers have left the work force for a variety of reasons. We begin by highlighting the severity of this demographic shift, which results in a labor market participation rate that remains at levels below those seen in recent history.

Broadly defined as the number of employed workers divided by the size of the general population, the labor market participation rate is important, since it is a proxy for the fraction of the population actively employed and thus contributing to economic production and generating income. Sizeable decreases in the labor market participation rate imply there have been increases in the number of individuals requiring support through public programs or that there are sizeable increases in the number of individuals living off their savings. Given the timing and dramatic rate of decline in the participation rate, the latter explanation seems unlikely to describe a significant fraction of the change in labor market participation. As Exhibit 1 illustrates, the dramatic drop in labor market participation is consistent with the large number of workers who left the work force permanently after the Financial Crisis of 2008-9. During this time period, we have seen dramatic increases in the number of filers for a number of social welfare programs, including unemployment benefits, early social security enrollments and disability programs. This picture suggests not only that a much smaller fraction of the U.S. population is participating in the labor market, but that the burden falling on their shoulders to provide support for the increasingly large demographic requiring social support has increased, too. This trend in the labor market participation rate is just one of many indicators that paint a picture of an economy lacking sources of organic growth capable of supporting the expanding valuations we have seen of late.

Exhibit 1: U.S. Labor Market Participation Rate



SOURCE: U.S. Bureau of Labor Statistics

PERSONAL CONSUMPTION EXPENDITURES

Next, we turn to personal consumption expenditures. Not surprisingly, consumer spending is related significantly to employment. When jobs are more plentiful, the average worker has more disposable income to spend on goods and services. Additionally, consumer spending is an important component of growth. In fact, consumer spending accounts for approximately 40% of U.S. GDP. Clearly, growth in GDP is influenced heavily by consumer spending. In fact, during the previous decade, consumer spending accounted for the primary driver of U.S. GDP growth. Further, the U.S. consumer supported global economic growth as export-oriented economies such as China benefited mightily from rising exports driven by U.S. consumer spending.

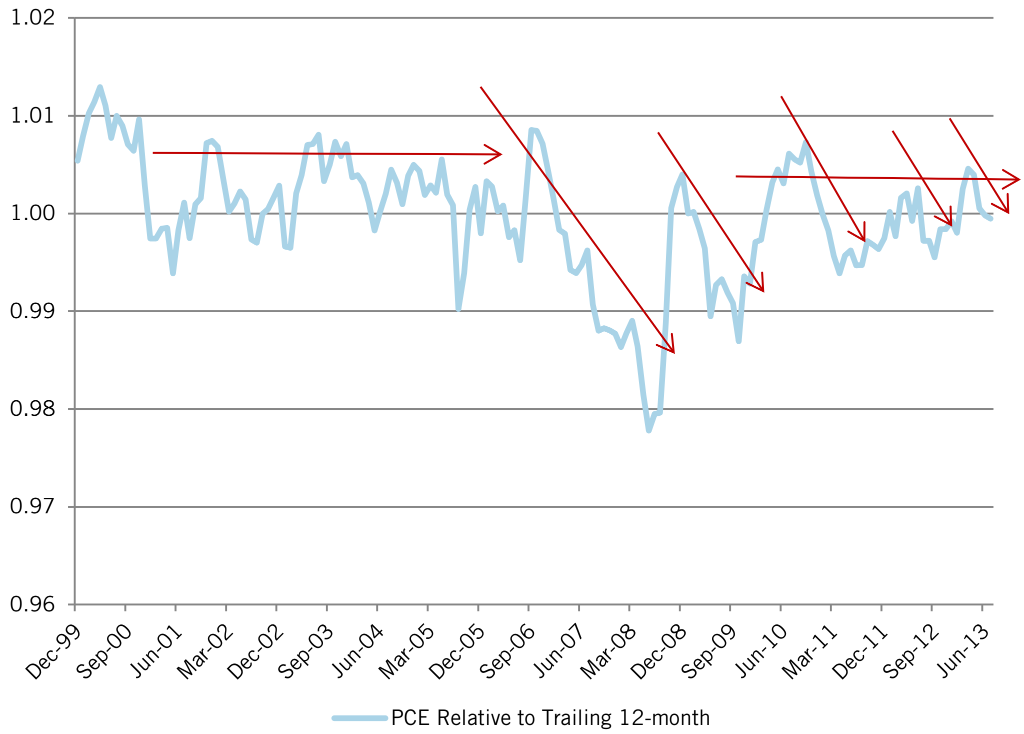
For these reasons, we next turn to the patterns in real U.S. consumer spending. Since the time-series is fairly noisy, we present the data normalized by the trailing 12-month weighted average level of consumer spending. As a result of this normalization, values greater than 1 indicate an increase in real consumer spending, while values below 1 indicate declines.

Exhibit 2 presents the time-series of U.S. personal consumption expenditures. Visual inspection of the figure indicates the overall series appears generally to be in positive territory during the first part of the past decade, until the early stages of the financial crisis emerged. This indicates that consumer spending on a real basis, which means adjusted for inflation, generally expanded during that period.

During the financial crisis, consumer spending exhibits a dramatic decline, as the values fall far below parity, indicating spending levels below the trailing 12-month average. Most importantly, in the wake of the financial crisis, consumer expenditures have stabilized, but the values remain close to parity, indicating at best there is no growth in real consumer spending. This is important when viewed in the context of consumer spending's strong influence on GDP, and that historically this has been a critical driver of GDP growth. Based on this chart, it is reasonable to conclude that there exists no underlying economic support for the type of rapidly expanding valuations we see in the equity market, given that such support must be coming from some source other than consumer spending, which has been historically one of the most critical drivers of growth. Going back to Economics 101, this means growth will come from government spending, investment spending or exports. For a variety of equally supported reasons, it is not reasonable to expect growth from those other sources under the current economic conditions.

It is important to mention that with consumer spending stuck in neutral, and in many cases actually in reverse, equity market valuations seem completely disjointed from this reality. It is even more sobering to view the patterns in consumer spending since 2010, when the Federal Reserve began quantitative easing efforts. Since then, there have been three periods (illustrated with the downward sloped arrows) of strong decreases in the consumer spending level relative to the trailing average. Additionally, the exhibit shows clearly that there are very few times when real consumer spending has actually expanded, despite the Fed’s tremendous stimulus efforts. Thus, we again are left searching for the sources of sustainable, organic economic growth able to support current equity valuations.

Exhibit 2: Personal Consumption Expenditures Relative to Trailing 12-months



SOURCE: U.S. Bureau of Economic Analysis

FUNDAMENTAL VALUATION METRICS

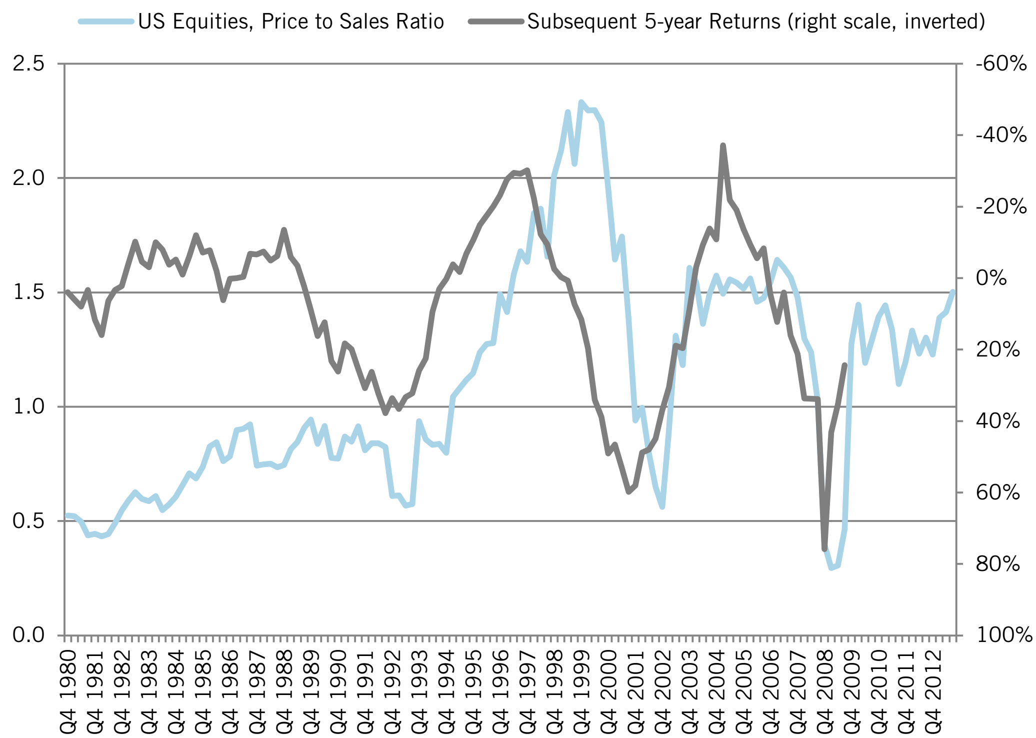
To directly gauge the reasonableness of current equity market valuations, we next turn to several fundamental valuation metrics. We begin by examining the current price-to-sales ratio among U.S. equities. The level of corporate sales corresponds directly to economic growth. Top-line growth is a reasonable proxy for organic economic growth as it is not influenced by the forces that can obfuscate the information contained in earnings (specifically, that earnings may be influenced in the short-term by managers' discretion over certain accounting choices and cost-cutting measures that may improve earnings over short horizons). We will return to this topic later.

In general, the price-to-sales ratio is informative as higher numbers reflect richer valuations per dollar of sales generated, while lower numbers would be consistent with lower valuations, and likely better entry points. Financial economists have identified important links between fundamental valuation metrics and subsequent equity market returns. Specifically, high valuation multiples tend to be followed by poor equity market returns, and low multiples tend to be followed by relatively high returns.

Exhibit 3 presents the time series of the U.S. equity market price-to-sales ratio (blue line). The peak takes place during 1999 when the ratio expanded to roughly 2.25 times. The ratio exhibits strong cyclical variation, with sharp declines evident during the market crashes of 2000 and 2008-9. Superimposed in the Exhibit is the subsequent 5-year U.S. equity market return (red-line). Note, the equity returns are plotted on the right-hand axis and have been inverted to better illustrate the relation. The clear pattern emerging is that higher multiples tend to be followed by low returns, while low multiples tend to come before large, positive returns. Turning to the current valuation levels, we see that the multiples, while not quite as extreme as the levels seen in the late 1990s, are quite elevated and are certainly well above historical norms. Most importantly, these levels generally precede very low, and frequently negative, equity market returns. Clearly, this measure of fundamental value is consistent with other historical periods when valuations have proven to be over-extended and have subsequently reversed.

Here, we need to insert an important qualifying statement. In this presentation, we are not suggesting there exists a causal relation between variables. In reality, the relation is more complicated than that which can be captured by simple bivariate estimates. We are simply presenting commonly used metrics of fundamental valuations and showing that historically, these levels have been associated with subsequent returns. Note that this minimally offers a reality check for those arguing that equities are inexpensive, even though, by our standards, the evidence provided is not econometrically rigorous.

Exhibit 3: U.S. Equities Price-to-Sales Ratio and Subsequent Equity Returns



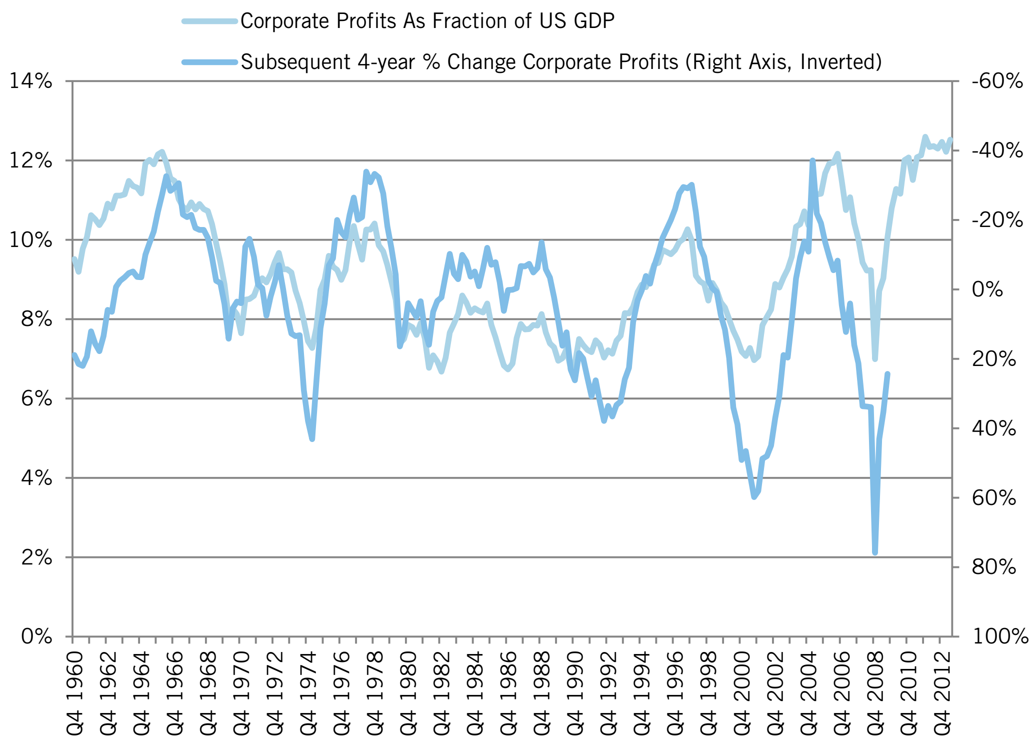
SOURCE: Thomson Reuters Datastream

Given the recent stock market run-up, we would expect companies to have sustainable earnings growth in support of these extending valuations. For this reason, Exhibit 3 presents top-line (revenue) relative to equity valuations. To further explore the fundamental support for current valuations, we next we turn to corporate profits.

Exhibit 4 presents U.S. corporate profits as a fraction of GDP (blue line). Visual inspection of the exhibit reveals the highly cyclical nature of corporate profits. Additionally, it is clear that current earnings as a fraction of GDP are alarmingly high when compared to the levels seen historically. This observation leads to the important question as to whether or not these elevated levels are sustainable. Certainly the historical record suggests that these levels have never been sustainable previously, so we are hard pressed to find convincing evidence that this time will be any different. Unfortunately, many prognosticators extrapolate these recent levels forward, concluding that valuations are attractive under the assumption the trend does not reverse.

Given the cyclical nature of earnings, we also plot the subsequent percentage earnings change over the next four years (red line). Note the subsequent percentage change is plotted on the right axis and the scale is inverted for ease of comparison. Visual inspection of the exhibit reveals that earnings growth tends to be very low, and frequently negative, when earnings are a large fraction of GDP. The mean-reverting nature of earnings as a fraction of GDP is quite strong in the historical data. Given the current high levels of earnings as a fraction of GDP, the historical record suggests significant declines in corporate earnings are likely on the horizon. Again, we must emphasize that we are not arguing there exists a causal relation between these variables, but we are merely demonstrating that historically earnings have exhibited strong mean-reversion, which is bad news during times when the level is high (as it is presently). This evidence also raises the question as to the attractiveness of current valuations, where support for those valuations requires the extrapolation of these high levels into the future, despite the fact that these levels have never been sustainable historically.

Exhibit 4: Corporate Profits as Percentage of GDP and Subsequent Changes in Profits



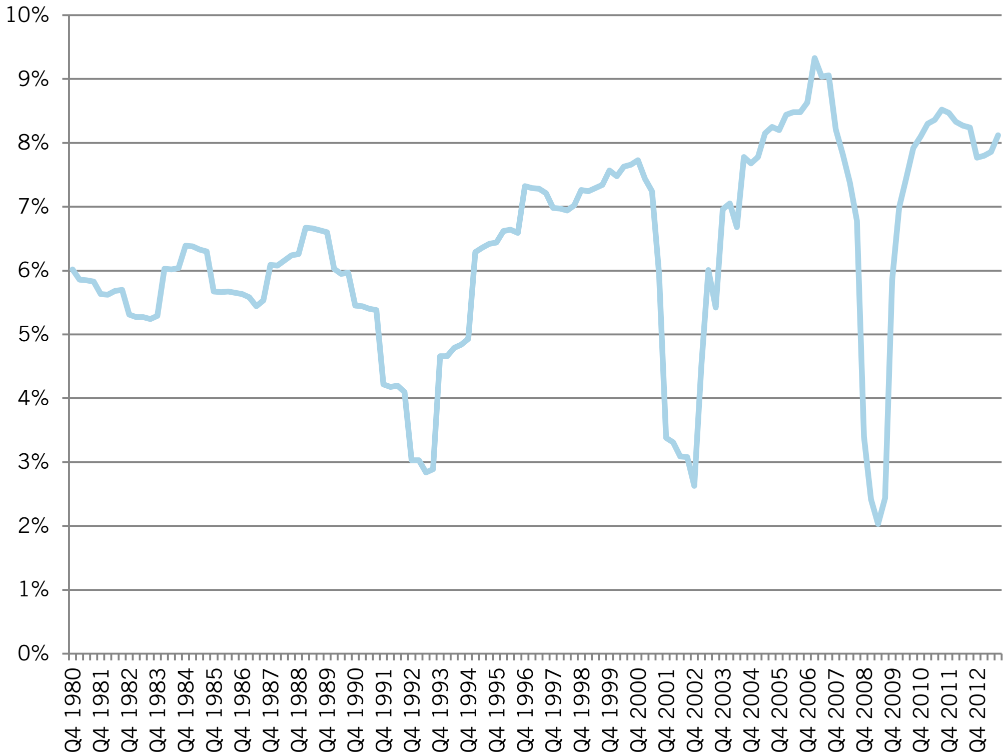
SOURCE: U.S. Bureau of Economic Analysis

While Exhibit 4 presents earnings growth, it does not distinguish what are the sources of earnings growth. We began this section by considering the price-to-sales multiple, followed by analysis of growth in corporate earnings and the two pictures are not entirely consistent. This is due to the fact that earnings changes may come from either top-line growth or from changes in profit margins. The more sustainable and organic source of earnings growth is top-line revenue growth. In the current environment, however, top-line growth has been virtually non-existent, while much of earnings growth has been driven by cost-cutting measures, or in the financial sector by the strategic release of loss reserves, that in turn result in improved profit margins. Given the clear limits to the extent to which cost-cutting measures are able to provide sustainable earnings growth, this source of earnings growth is less desirable than top-line growth.

Exhibit 5 presents the historical profit margins, defined as net earnings divided by gross sales, for U.S. corporations. The cyclical nature of the profit margin is striking. Immediately, several peaks are evident, and it is not a coincidence that these peaks immediately precede market crashes! The current levels indicate profit margins have surpassed those seen in the late 1990s, and, at over 8%, are close to the highest levels seen in recent history. Of course it is important to note that the margins seen during the late 1990s and early 2000s have been proved ex-post to have been skewed by crafty, and often times fraudulent, accounting practices (e.g. Enron, MCI-WorldCom, Global Crossing, and Fannie Mae & Freddie Mac). This is particularly concerning due to the suspension of marking to market accounting which took place at the same time the Fed embarked on its unorthodox policy efforts.

The exhibit is consistent with the view that current earnings growth comes from improvements to margins, which is not a source of sustainable earnings growth. Absent top-line growth, it is impossible to sustain earnings growth that comes largely from cost-cutting. Again, we are left searching for a source of sustainable growth to support current valuations. However, what has emerged is a set of very basic, fundamental illustrations that are consistent in their suggestions that current valuations are over-extended and that the underlying support for those valuations is faltering.

Exhibit 5: U.S. Corporate Profit Margins



SOURCE: Thomson Reuters Datastream

CONCLUDING REMARKS

We have summarized several economic variables that are directly related to the health of the overall economy and indicative of a lack of fundamental support for current domestic equity market valuation levels. The clear picture emerging from each is the same: that there appears to be no sustainable source of organic economic growth to provide support for the current equity market valuation levels. This view is consistent with the more detailed signals from our quantitative framework.

Clearly, this leaves us searching for the driver of extending valuations. By the process of elimination, in our opinion, the only factor driving current valuations is the extraordinary monetary policy. The impact of monetary policy on equity valuations has extended to very dangerous levels. In fact, extended valuations of this magnitude rarely have been seen in recent history, except for the time period immediately preceding the end of the bull market in 2000. Note, however, that using these same valuation metrics for the *median* stocks in the various universes it can be shown that current valuations are actually considerably *higher* than even the 1999-2000 period!

The Investment Committee understands well the gravity of the current predicament. However, investing in equities purely for fear of missing out on the potential upside resulting from further monetary distortions is imprudent and unwise, and irresponsibly ignores the risk of pursuing such prospects. The real costs to reckless monetary policy, coupled with failed fiscal policies, accrue continuously. While difficult to predict exactly when, eventually global capital markets will reflect the reality of the underlying economics. Absent sustainable sources of real economic growth, there is no driver capable of supporting current valuations. Thus, we have no choice but to remain patient and adhere to our discipline, knowing that there are opportunities on the horizon. In the meantime, our focus is on remaining grounded so we are able to identify and capitalize on those opportunities.

CURRENT STATE OF OUR SOLUTIONS—MONTHLY UPDATE

United States

Equity markets rose further over October after the continued rally briefly stalled due to the deadlock in the U.S. debt ceiling discussions. Once those discussions had been resolved, at least temporarily, just before the October 17th deadline, equity markets around the world and particularly in the U.S. continued to rise further. Part of the reason for continued gains most likely has been a decision by the Federal Reserve not to start tapering their monetary stimuli yet, a decision that was most likely due to the government shutdown and the associated uncertainty that it created for the overall economy. Moreover, the government shutdown prevented the release of several economic indicators that the Fed has been using in its decision-making process regarding its tapering decision.

Unfortunately, the perverse tale of investor myopia continues as the market seemingly interprets any news, including bad news, as great news. More bad news makes it less likely that the Fed starts tapering. Apparently, market participants cannot get enough of the bad news coming out! That seems to be the simple and sad truth these days. In our opinion this is further evidence that an asset price bubble of historic proportions continues unabated. It seems that the fate of the U.S. stock market (and to some extent global equity markets for that matter) is almost entirely in the hands of the U.S. Federal Reserve.

Fundamentals have become largely irrelevant. Properly measured P/E ratios are at extreme levels of around 25, meaning that the earnings yield is at a low of around 4%. This issue has been masked by the fact that analysts—at least the ones we hear from on TV—have switched to a more convenient definition of earnings, called forward operating earnings, a notion that isn't even defined under generally accepted accounting principles (GAAP). Forward operating earnings are based on Wall Street estimates of future earnings that have been "adjusted" for extraordinary items and a number of other factors. The problem with this type of earnings measure is that it is invariably much higher than actual subsequent net earnings simply due to its construction.

In our view (and in the view of a growing number of the more knowledgeable market participants), the market is completely overvalued and overbought, much more so than at the end of the Tech Bubble. Any further market increases only push valuations further up the proverbial cliff, towards the eventual and dramatic fall. Still, equity markets could reach even loftier heights, given our view that Fed accommodation has been the primary driver of equity gains over the past year or more, and considering the expectation, confirmed by statements of some Federal Reserve board members, that these unprecedented efforts will continue at least through the early part of 2014. But that assessment does not lead us to be more bullish given the very dangerous terrain markets now scale. Any piece of news that could prompt market participants to expect the Fed to start tapering earlier than previously expected could cause equity valuations to contract violently.

For many reasons, including the evidence we have presented above, we make long-term investment decisions based on fundamentals, rather than trying to guess how long the market and the Fed will continue their unprecedented behavior. Periods of irrational exuberance such as the current one exist in financial markets and they can at times be humbling. However, in the long run, we are absolutely confident that a rational, cool-headed investment approach will prevail as it has done over the entire history of financial markets. Eventually, the notion of "this time being different" always has been a recipe for disaster when it comes to investment decision making.

Europe

Europe is still in deadlock as German coalition talks to form a government have been taking longer than many of us had expected. It is likely a so-called grand coalition between the two strongest parties will emerge. This would unfortunately mean that Chancellor Merkel would have to share power with a party that is less free-market-oriented and more socialist than her previous coalition partner. The consequence of that could be that painful but necessary measures to ease Eurozone fiscal and structure problems might be postponed even further.

Given the recent lack of news in regard to the Eurozone crisis, one could be forgiven for believing that the worst is over in the Eurozone. In fact, a deceptive tranquility has been the state of affairs, particularly in Eurozone bond markets. Yield spreads of individual country government bonds over German government bonds have decreased substantially, even among those of most badly affected countries in the Eurozone periphery. For example, Spanish 10-year government bond yields are only about two percent higher than German 10-year government bond yields. The yield spread is down from a high of more than 6% in 2012. The pattern is similar for other Eurozone periphery countries, such as Portugal, Italy and Ireland. This seems to indicate that credit risk (or sovereign default risk) has become negligible in these countries. The question is whether this situation is sustainable or simply the calm before the next storm once the Eurozone drama unfolds again. Credit markets there seem to be pricing in an European Central Bank (ECB) support system that most likely does not or will not exist. Current spreads are ignoring economics completely.

We foresee potential problems along several dimensions with this seemingly positive development. First, the financing costs and debt sustainability of the Eurozone periphery is almost entirely dependent on the ECB, which has pledged "to do whatever it takes" to save the Eurozone in its current form. As a result, whatever happens to the weaker countries within the region, investors seem to be reassured that the ECB will bail them out. Taking this argument to an extreme, the implication is that the solvency of any debtor nation within the Eurozone is completely irrelevant and the only important issue is the ability and willingness of the ECB to pay if things go wrong. Clearly, this situation is not sustainable: countries on the Eurozone periphery are issuing long-term debt with maturities of ten years or more. Can the ECB really be expected to be the lender of last resort for these countries for the indefinite future? Doesn't this create a severe moral hazard problem potentially even worse than what we have experienced already? We believe that Eurozone bond markets are currently feeling a false sense of security as the expectation that the ECB is going to bail out everyone for the indefinite future is unrealistic. Currently, the risk of a country defaulting or exiting the Eurozone is being ignored. This situation looks remarkably similar to the pattern that caused the Eurozone crisis to erupt in the first place.

A further concern is that the investment pattern in Eurozone bond markets has changed substantially in the sense that foreign investors have retreated from the region. For example, in Italy and Spain domestic investors have accounted for almost 100% of new government debt issuances. This is a direct result of investor sentiment on the one hand and of the financial measures that have been put in place in the Eurozone on the other. However, a grave concern with this development is that in the Eurozone periphery governments and banks have become increasingly dependent on each other, which could exacerbate financial instability in the (high probability) event of a new crisis. In other words, Eurozone periphery banks are going to be in trouble if their governments have liquidity problems and vice-versa. If the weakest element in the chain fails, the entire system may break down. This would then require the ECB to bail out both banks and governments in the affected countries. The ECB has acknowledged this problem and is attempting to put measures in place to address it.

As before, the Eurozone will have to make painful decisions as few of the real problems have been resolved. Although the euro has gained some ground over the last few months against most major currencies, the picture may change once the Eurozone debt problems come to the forefront again. Some of the euro's gains over the dollar are probably more related to dollar weakness rather than euro strength. Moreover, European equity valuations are heavily influenced by U.S. monetary policy as well.

We believe investment opportunities will arise in Europe over time. Our main focus is currently on the European countries that are not part of the Eurozone and therefore not as badly affected by deleterious policy choices. Once valuation levels return to more realistic levels there, we are ready to add select investment exposures as opportunities arise.

Asia-Pacific

We continue to maintain a somewhat more favorable view towards Asia-Pacific compared to most other regions, the U.S. and Europe in particular. However, U.S. monetary policy has a strong impact on equity market valuations in this region as well, which we have seen time and again over the last few months. Moreover, many of the economies in this region are heavily reliant on exports rather than domestic consumption, which is often still as weak as only parts of the individual economies are economically developed. For the reasons we outlined above, it is hard to believe the U.S. consumer is capable of supporting economic growth abroad, since there is no evidence of their ability or willingness to do so. In addition, many equities in this region are currently overvalued as well and a correction is needed before we see any immediate investment opportunities.

In Japan, benchmark 10-year Japanese government bond yields have now dropped below 0.6%, the lowest of any country in the world. The Bank of Japan has engaged in massive purchases of longer-term government bonds in an effort to lower nominal bond yields and increase inflation in order to encourage investors to shift out of bonds into riskier assets such equities. Sound familiar? However, Japanese equities already have risen by about 60% from last year, even as the economy has remained sluggish. Similarities with the U.S. are apparent as financial market valuations have become very dependent on central bank actions and more and more disconnected from the real economy. Market volatility in Japan remains low, but if investors start selling, the volatility is likely to increase strongly.

In China, significant problems remain, including weak domestic consumption, heavy dependence on exports, overheated (to say the least) real estate markets and reliance on investment spending to fuel growth. Inflation and wages continue to increase at a faster pace than economic growth, which will force policy makers to curb inflation and real estate price rises, in particular, and therefore sacrifice economic growth. At the same time the Chinese government has voiced its intention to boost domestic consumption, although it has not yet announced concrete measures to achieve this objective.

Our quantitative framework has been relatively bullish on Hong Kong for quite some time as the business environment in the former city state continues to be favorable. Still, we recently liquidated our position in that equity market. We had enjoyed a very good run, and despite the continuing positive business environment, our quantitative framework suggests that that market's prospective risk-relative returns could no longer be viewed as more favorable than that available in fixed income.

The Indian equity market has rebounded strongly since the end-of-August lows, as has the country's currency. The new arrival of a credible Reserve Bank of India governor, Raghuram Rajan, who started in his position at the beginning of September and enjoys rock-star status domestically, has helped market sentiment improve. However, market sentiment in India has also been very reliant on the U.S. Federal Reserve's decision to delay tapering, which helped to bring a strong inflow of foreign capital into the country. Our framework indicates that there has been little meaningful improvement in other economic factors. India's economy is still struggling with growth at a decade-low of around 4% and the central bank has raised rates to combat high inflation. The renewed stability of the rupee may also prove ephemeral as it is largely due to Reserve Bank of India interventions that will not be sustainable over the longer term. Moreover, India's political leadership continues to be dysfunctional and political uncertainty will prevail at least until the country's national elections next May.

Latin America

We still are invested in the Peruvian equity market. Since our initial investment in June this year, Peru's equity market has moved sideways and we experienced some relatively modest losses. With recent increases in that market we are now approximately breaking even on our investment. We continue to believe that the country's equity market is much more realistically valued than most other markets and we therefore plan to retain our investment. The political leadership in Peru also continues to implement pro-growth fiscal policies.

We also continue to be relatively positive on Brazil, though Brazilian equities have followed trends elsewhere and are currently overvalued. While most of the news on Brazil is currently dominated by the collapsing empire of Brazil's formerly richest resident Eike Batista, the economy is still in reasonable shape, though slow economic growth and inflationary pressures remain.

We are less positive about other Latin American countries, such as Mexico and Colombia. Mexico has relatively poor fundamentals and therefore our quantitative framework is very bearish on the country. Although business confidence in Mexico has been rising to some degree, there are few signs of an economic recovery in sight. In fact, Mexican banks' bad debts just reached their highest levels in a decade, mostly as a result of problems in the construction sector and consumer credit.

SUMMARY

The prolonged U.S. debt ceiling deadlock and its associated consequences seem to have caused the Fed to postpone tapering even further. The delay was a relief to market participants and has caused equity valuations to increase further, not just in the U.S. but across the globe. The disconnect between equity valuations and the underlying real economy therefore has been exacerbated even further. Equity markets around the world have continued to move far away from fair valuations based on underlying fundamentals. This is particularly true of the U.S. While Asia Pacific and Latin America continue to look more attractive than Europe and the U.S. on a relative basis, even these markets now appear overvalued. Due to the further postponement of the tapering decision in the U.S. we expect a further depreciation in the U.S. dollar against other major currencies over the coming months.

Given our economic and geopolitical concerns we continue to increase our allocation to short-duration fixed income securities and to equity positions on a very selective basis only. We have also reduced our high-yield emerging market debt allocation, particularly the higher-duration securities, and reallocated the proceeds to U.S. domestic shorter-term fixed income securities. These very liquid vehicles also allow us to move funds very quickly should any opportunities arise over the coming weeks and months.

IMPORTANT INFORMATION

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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.

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For more information, contact Scott Silverman at 949.540.7307 or your financial advisor.

AFAM Capital, Inc.
12117 FM 2244 Bldg. 3 -#170
Austin, TX 78738
P: 512.354.7041 F: 512.402.1014