Innealta CAPITAL

COMMENTARY: NOVEMBER 5, 2014

TREND WATCHING

In its work evaluating the relative investment attractiveness of individual equity markets, the Investment Committee reviews a range of perspectives on an array of fundamental series, placing present levels in various historical contexts, while emphasizing both short- and long-term trends. Fundamental analyses are one of the four primary components of our proprietary quantitative framework, the other three being: 1) Distributional Characteristics / Risk, 2) Macroeconomic and 3) Behavioral / Technical. All the metrics are incorporated into a composite that aids the Investment Committee in its characterization of the potential risk-relative returns of each equity market versus fixed income. Such analyses, thus, form the basis of our tactical trades.

Given the breadth of our quantitative framework, we hesitate to place a spotlight on an individual metric. Still, the focus can be illustrative of the process we use to gauge equity markets. In the following example, we will use a highly simplified comparison to give readers a sense of what we mean when reference the 'dynamics' evaluated in our models.

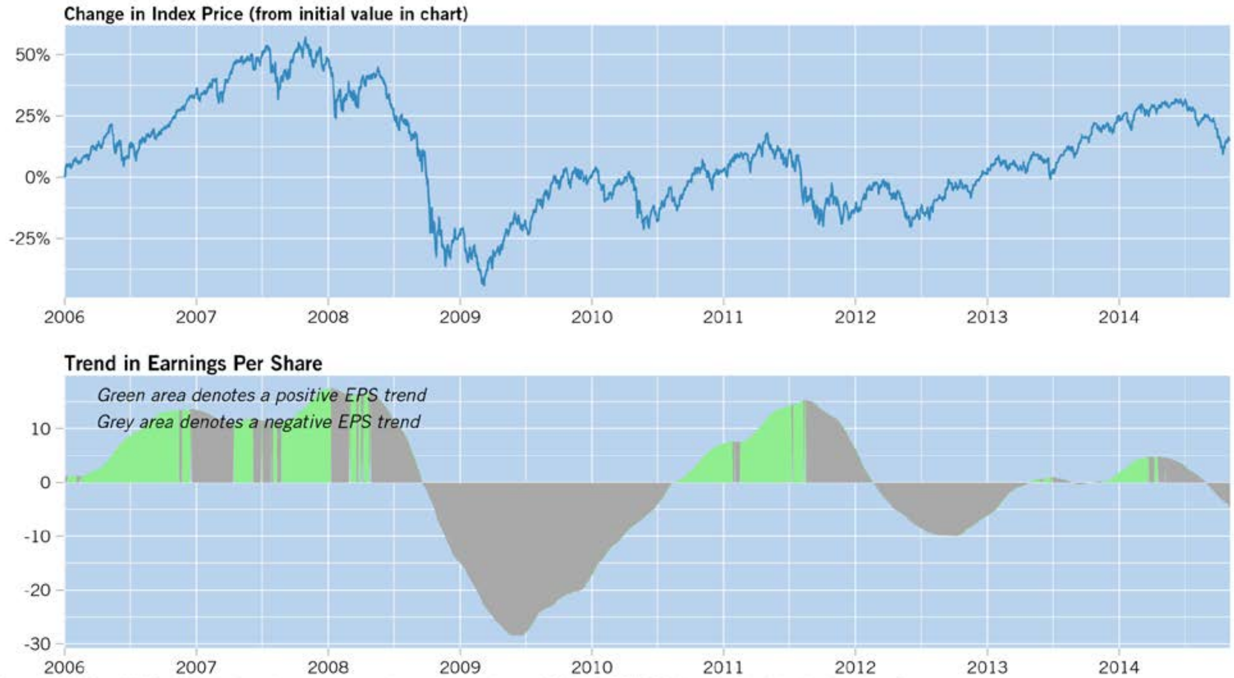
Among the many metrics we follow are the fundamental series (e.g. earnings per share) related to a specific equity market. The ratios of the index price to those fundamentals, of course, define that market's valuation (e.g. price-to-earnings ratio). We track and review the dynamics of all three (prices, fundamentals, valuations) within our framework. In doing so, we establish the basis for tactical investment decisions as a function of each individually, as well as the interplay of all three.

DETERIORATING DYNAMICS IN EUROPE

We have noted over the past few months the broader degradation in many of the fundamental metrics that we follow and, in many cases, the resulting deterioration in valuation metrics. With a generally unimpressive second quarter baked in and with third-quarter earnings season in full swing, the impact of a still very weak macroeconomic backdrop is showing up in corporate results.

This trend is evident in developed European equity markets. In Figure 1, we first show the index price since the end of 2005, displayed as its subsequent percentage change from the starting value in the chart. Readily apparent is the general strength in the index from the middle of 2012 through June of this year. Readers may recall that, early on and to this day, we have pondered justifications for the gains. In our view, the fundamental support has not been there. Offering a glimpse into one aspect of our quantitative "dashboard" that has informed our reviews, we also have plotted a simple earnings trend calculation in the second chart in Figure 1. It is clear that the price moves came well in advance of the modest improvement in the earnings dynamic. In our view, however, that dynamic—for the most part adverse since mid-2011—was not supportive of a positive take on the region, at least on its own. And as the rather meager earnings trend has been matched by other metrics we follow, the general take, at least on the fundamental front, has been broadly bearish on the region's equity markets.

Figure 1: Price, Earnings and Earnings Trend for European Developed Equity Markets



From 12.30.05 to 11.05.14. Index data shown as percent change from values on 12.30.05. SOURCE: Innealta Capital using data from Datastream

The mismatch in those two trends—prices were rising far more quickly than earnings—resulted in a secondary slight against the region's investment attractiveness: rising valuations. At least as measured by the price-to-earnings ratio, a simple trend review of which can be seen in Figure 2, European equities gradually became relatively more expensive through most of 2012.

In fact, this trend toward richer valuations has continued throughout 2014. Though the European aggregate index has struggled, the weak earnings strength earlier in the year proved ephemeral. Earnings are back on the downtrend, and with them our expectations for further gains in the European bourses.

Figure 2: Price-to-Earnings Ratio Trend for European Developed Equity Markets

From 12.30.05 to 11.05.14. SOURCE: Innealta Capital using data from Datastream

A GLIMPSE AT BROAD WEAKNESS

Again, we offer this overly simplified example to provide some insight into the mechanics of the firm's proprietary quantitative framework. Further, in doing so we also want to express that such lack of support can be found in many developed markets. That is not to say that there are not pockets of opportunity elsewhere. For example, while the Malaysian equity market was caught up in the broader emerging market selloff of October, dynamics among fundamental and valuation trends were sufficiently positive, again in the context of the range of additional metrics the Investment Committee reviews, to warrant exposure to that equity market in the Country Rotation Portfolio. And a select few developed markets may be "percolating" in terms of their investment potential.

But the Committee continues to believe that the gains seen in many equity markets over the past few years generally have lacked fundamental and macroeconomic support, weakening their defensibility and ultimately, in our view, their longevity. The Committee thus continues to position portfolios among those fixed income exposures presenting the most attractive risk-conscious yield opportunities, while providing the flexibility to take advantage of tactical opportunities the team expects to arise from increased volatility as capital markets come down from their Central Bank-induced highs.

IMPORTANT INFORMATION

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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.

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Diversification does not protect against loss in declining markets.

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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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