Innealta CAPITAL

COMMENTARY: MARCH 2011

THE PREMIUM THERE

- Previous commentaries have presented Innealta's perspective on the many macroeconomic and geopolitical issues that seem to be largely ignored throughout much of the capital markets...equity markets in particular. This month we'd like to try something a little different and present a very simplistic equity valuation framework in order for our readers to better appreciate our concerns.
- These exercises often serve as a simple sanity check. Another advantage of utilizing a simplistic framework is the ability to more easily illustrate how our concerns with macroeconomic and geopolitical issues should be minimally considered and integrated into a valuation structure.
- Among our ongoing concerns: The increase in oil prices will have the same effect as a significant tax on consumers; employment growth remains remarkably elusive despite media reports stating otherwise; there will be a restructuring of sovereign debt in Europe; real estate remains a disaster and a huge drag on personal balance sheets; banks remain a big concern given the continued amortization of assets based on loan value (not marked to bid); municipalities will continue to cut budgets and terminate public employees; Congress will continue to push for fiscal austerity measures (hopefully!); monetary policy will be significantly challenged this year and, optimistically, will become more restrictive; and unrest will continue and perhaps even spread in the Middle East.
- This simple exercise was meant to highlight the tradeoffs between what most consider staples of any sound valuation framework. Our purpose here was simply to illustrate that as valuations continue to increase across many equity markets, the only variable that changes quickly enough is the very reward investors are purchasing, the equity risk premium. Buyer beware. We remain wary of the equity markets and believe that better and safer alternatives exist across the fixed income space.

Previous commentaries have presented Innealta's perspective on the many macroeconomic and geopolitical issues that seem to be largely ignored throughout much of the capital markets...equity markets in particular. This month we'd like to try something a little different and present a very simplistic equity valuation framework in order for our readers to better appreciate our concerns. The approach is an admittedly simplistic representation intended to illustrate the conceptual relationship between reward, valuation and risk. Our intent is to help our readers to develop an intuition behind what we spend our time doing here at Innealta. One might even conclude that our objective here is purely pedagogical.

This month we'd like to try something a little different and present a very simplistic equity valuation framework in order for our readers to better appreciate our concerns.

It is our belief that such intuition would be best established within a simplistic framework. The approach would enable the reader to more easily appreciate the trade-offs between traditional valuation inputs and outputs. The sensitivity between changes in the inputs and the output is an extremely important dynamic to understand. It is also very instructive to reverse engineer the relationship by solving for one of the inputs as a function of the other inputs (often referred to as endogenous variables) and the output (often referred to as exogenous variables). For example, we can solve for the endogenous discount rate as a function of the exogenous or given value (e.g., current equity values as dictated by benchmark valuations).

Comparative statics (or "what if?" analyses), also known as first-order conditions, are at the heart of understanding basic valuation. Also, by solving for an endogenous variable as a function of an exogenous variable we can test the efficacy of the logic being espoused throughout any given portion within the capital markets. We are convinced that many investment professionals fail to understand these concepts. Actually, we know this to be true given our many interactions with both portfolio managers and investment officers.

SANITY CHECK

These exercises often serve as a simple sanity check. It is very instructive to understand what a rapidly changing (exogenous) valuation dynamic must mean in terms of the corresponding changes in the endogenous inputs. Clearly, if valuations change rapidly then something must be changing within the model to justify the dynamic. We'd like to illustrate what this means to investors.

The use of a simplistic framework also allows us to more easily illustrate how concerns with macroeconomic and geopolitical issues should be minimally considered and integrated into a valuation structure. For example, if a change in fiscal profligacy impacts economic growth by 1% then how does this impact the implicit reward for investing in equities? Under our simple valuation approach we can perform this type of comparative statics analysis to at least build an appreciation for the risk and return trade-offs embedded in current prices. More often than not the absolute quantification of these trade-offs is far less important than the understanding of the sensitivities of risk and reward implicit in the equity markets.

A BASIC MODEL

Our basic valuation model includes four endogenous variables—forecasted earnings, E, a long-term risk free rate, R, an equity risk premium, ERP, and a perpetual growth rate, g. These four variables are then used to determine present value, V. Our simple framework assumes that E grows at g in perpetuity and that these perpetual earnings are discounted back at a discount rate equal to the sum of R and ERP. Intuitively, V is directly proportional to both E and g and inversely proportional to R and ERP. So as either E or g increase we expect V to increase as well. Conversely, as R or ERP increase we expect V to decrease.

We will focus our simple analysis within the context of the Standard & Poor's 500 index. Again, we reiterate that our model is for pedagogical purposes only. We readily admit and recognize the strengths and weaknesses of the framework. This is for illustrative purposes only. However, we'd be willing to wager that many on the equity side have little appreciation for the valuation dynamic and that despite the simplicity of this approach, it may very well be more sophisticated than that used by many investment professionals. It also holds across any equity space.

On a daily basis we read or can find references to aggregate earnings estimates or earnings multiples to either justify or argue against the current value of the S&P 500, which is our V. We can therefore use these as a starting estimate for E at any given point in time. Figures often cited over the past six months are between $85 and $95 in aggregate estimated earnings. Again, depending on the point in time when we employ the model, it makes sense to use estimates for economic growth for g (this must be true mathematically, since the equity markets can't grow more quickly than the economy forever otherwise it will become larger than the economy itself—which, of course, is paradoxical); likewise, our R can be estimated by using the long end of the Treasury curve at the time of the analysis. We are then left with ERP. What should that be?

GAUGING THE PREMIUM

Before we try to quantify ERP let's review its interpretation. The equity risk premium is the reward or return above the risk free rate that an equity investor is expecting or that is implicit in current prices or values. Stated another way, when an investor purchases equities at a price V, the implicit return above treasuries for that investment is the ERP. We recognize that we have been somewhat sloppy in defining our investment horizon but recall that under our structure this

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horizon matches the maturity of equity itself, which is perpetuity. Some will argue also about our use of the long Treasury yield as a risk free measure—but to do so is really to miss the point of this exercise. Note also that more complicated multistage discounting approaches will have the same interpretation. Quantifying and estimating the ERP is more an art than science, despite what some investment professionals may lead one to believe.

For our purposes it is instructive to solve for the ERP using current values, V and the aforementioned estimates of the other inputs. ERP is very important for investors to understand as it is the return to the equity exposure that is implicit in equity valuations at any given moment in time. Moreover, unlike the other inputs to the valuation model, the ERP is the only one that we can expect to move as quickly as valuations. While macroeconomic or geopolitical events can and do affect the other endogenous variables, they remain more secular than the ERP. Finally, due to the very nature of risk measures—standard deviation of return—the ERP is by far the more dynamic of the two dimensions that define investment decisions. That is, risk, like the other endogenous variables, is a slower-moving measure; as the ERP adapts with valuations, so does the risk-return tradeoff at any given moment in time. It's vital that long term investors appreciate this process. It is even more vital for us in the Tactical Asset Allocation business.

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At the end of last summer, using reasonable inputs the ERP was somewhere between 6.5% and 6.75%. These are below the level used by many pundits to defend equities over alternative asset classes. Fast forward to the end of February and it had been reduced to somewhere between 3.5% and 3.75%. That's a reduction of well over 40% in just six months! Did risk decrease by a proportional amount over that period? At least then the risk-return tradeoff would be intact. But that's a tough (impossible) sell given the slow moving and definitional nature of risk. One also has to consider all of the macroeconomic and geopolitical events that continued to evolve over this period. The bottom line is that aggregate equities seem not to be priced to reward investors for their inherent risks—and far less so now than they were in August of last year. The same analysis across most domestic and many international equity markets have similar results.

WHAT IF...?

How sensitive is our ERP to changes in some of the other endogenous variables. What if commodity inflation is eventually complemented by wage inflation and drives up R? Well, if the long end were to increase to 6% that would result in a reduction of the ERP all the way down to somewhere around 2.3%, *ceteris paribus*—or another 35% or so! What if rates remain constant but economic growth were to slow by 1%? That results in a reduction of 30% or so, again *ceteris* *paribus*. It's easy to appreciate just how sensitive our implicit reward is to reasonable changes in the inputs. Investors need to be aware of this reality.

REITERATING OUR CONCERNS

What could affect the inputs? How about all of the concerns we've raised over the past few months. Among others: The increase in oil prices will have the same effect as a significant tax on consumers; employment growth remains remarkably elusive despite media reports stating otherwise; there will be a restructuring of sovereign debt in Europe; real estate remains a disaster and a huge drag on personal balance sheets; banks remain a big concern given the continued amortization of assets based on loan value (not marked to bid); municipalities will continue to cut budgets and terminate public employees; Congress will continue to push for fiscal austerity measures (hopefully!); monetary policy will be significantly challenged this year and, optimistically, will become more restrictive; and unrest will continue and perhaps even spread in the Middle East. These are but a few concerns. The equity markets seem to increase V no matter what and this has the undesirable reality of decreasing ERP. Eventually, it has to approach zero.

This simple exercise was meant to highlight the tradeoffs between what most consider staples of any sound valuation framework. Our purpose here was simply to illustrate that as valuations continue to increase across many equity markets, the only variable that changes quickly enough is the very reward investors are purchasing, the equity risk premium. Buyer beware. We remain wary of the equity markets and believe that better and safer alternatives exist across the fixed income space.

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At Innealta Capital, we are cognizant of the continuing rise in equity markets despite mixed economic news and understand that our limited exposure to equity at the current time may raise concerns for you or with your clients. We remain committed to our mandate of Winning by Not Losing and are mindful of the many macroeconomic risks present in the global environment today. Our focus is on managing risk and smoothing out portfolio volatility. More than ever before, we can serve as a complementary manager to your existing set of solutions. Our conservative posture provides for downside protection, while the tactical, nimble nature of our portfolios allows for greater equity exposure as economic conditions improve.

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- Extensive Experience Managing Multi-Asset Class Portfolios
- History of Winning by Not Losing
- Binary Decision Making Framework - Easy to explain to clients
- Flexible/Adaptive Approach Focused on Risk - Ability to seek yield
- Reduced Portfolio (and Practice) Volatility
- 30% Solution (complementary to existing stable of managers)
- International Exposure (granular access to particular countries)
- Institutional Credibility with Boutique Accessibility

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Innealta is an asset manager specializing in the active management of portfolios of Exchange Traded Funds. 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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