Innealta CAPITAL

COMMENTARY: APRIL12, 2016

ENHANCED DIVERSIFICATION

Diversification correctly has been deemed "the only free lunch in investing." However, the typical U.S. investor has failed to make a full meal of it. In this month's commentary we examine how international portfolios can benefit by fuller and more thoughtful diversification.

An initial step for proper diversification is achieving exposure to as wide a breadth of the markets readily and efficiently available for a given type of asset class. For example, two-fifths of the market capitalization of global equity markets is in countries outside of the United States. Hence, U.S. investors' portfolios can benefit from the expanded set of fundamental exposures—developmental, macroeconomic, demographic and political characteristics, among many others—those international markets represent.

However, we believe that even more benefit can be found by diversifying *within* those passive international equity exposures, an approach we refer to as *enhanced weighting*. And good news for U.S. investors is the evolution of exchange traded funds, which has greatly expanded the available universe of country-specific equity markets. As a result, augmenting portfolio diversification through both expanded representation and enhance weighting of equity markets (i.e., countries) is much easier to achieve in modern portfolios than it was just a few years ago.

RETHINKING REPRESENTATION AND WEIGHTING

Nonetheless, achieving enhanced representation is only part of the solution. Generic passive capitalization-weighted regional allocations miss the mark when it comes to the second step in improving portfolio diversification. A key driver of that thinking is the fact that most passive indexes are market capitalization-weighted, with no "cap" on the percentage representation of individual country equity markets in the index. So, while investment strategies that seek to track that index might be great ways to diversify a purely domestic U.S. exposure, the index can be seen as allowing the undue influence of a few countries to overshadow the broader merits of the many.

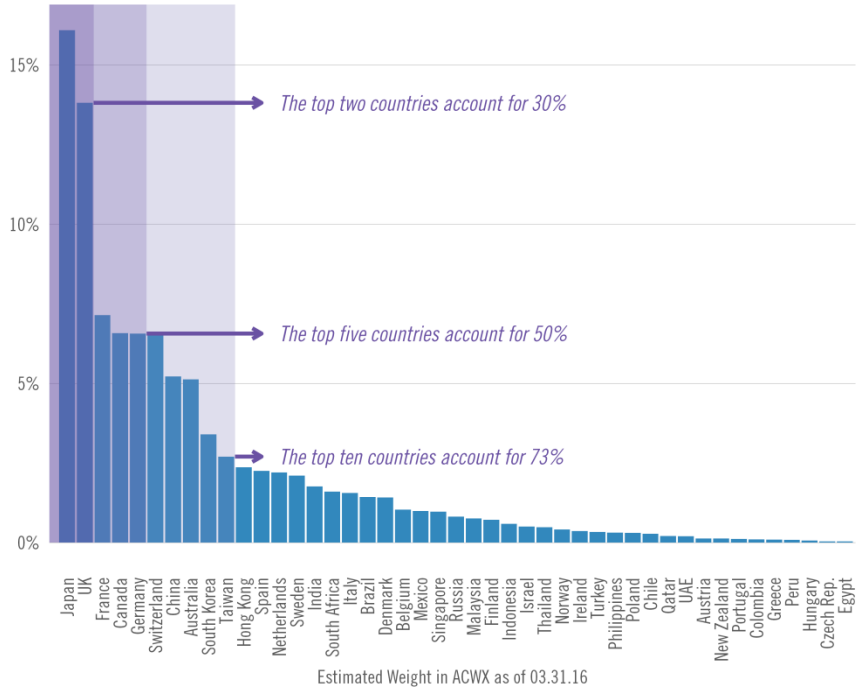
The MSCI All Country World ex. USA (ACWX) Index, for example, is a commonly used benchmark by U.S. investors to measure the performance of international markets. According to MSCI, the index captures large- and mid-cap representation across 22 developed market countries and 23 emerging market countries, and covers approximately 85% of the global equity opportunity set outside of the United States. At a glance, the index seems reasonably diversified, at least in terms of representation.

As shown in Figure 1, though, Japan and the United Kingdom represent about 30% of the MSCI ACWX, with France, Switzerland and Canada bringing the total exposure just among the top five country equity weights to 50%. The top ten countries represent nearly three-quarters of the index, leaving the remaining 35 competing for a mere quarter of the index weight.

FIGURE 1

MSCI All Country World ex. USA Index Estimated Weights

As of 03.31.16. Estimates for country equity market weights in the MSCI All Country World ex. USA Index. SOURCE: Innealta Capital using month-end capitalization data from MSCI and FactSet Research Systems via FactSet Research Systems



ROOM TO IMPROVE

Incremental diversification atop passive, capitalization-weighted exposures can provide additional risk-adjusted return over that static market-weight allocation. The goal is to develop appropriate methods that survive the test of time. International equity index exposures provide easy targets, as the most well-known are heavily exposed to a slim number of country equity markets.

We developed an equal-country-weight version of the MSCI ACWX to demonstrate the potential benefit of improved diversification among allocations at the country-equity-market level in international markets.[1] In Figure 2 we show the long-term returns of both the market-cap-weight and the equal-country-weight indexes. Obvious at the outset is the long-term outperformance of the more diversified (same representation/membership, but more diversified by weight/allocation) equal-country-weight index reconstruction, versus the capitalization-weighted version.

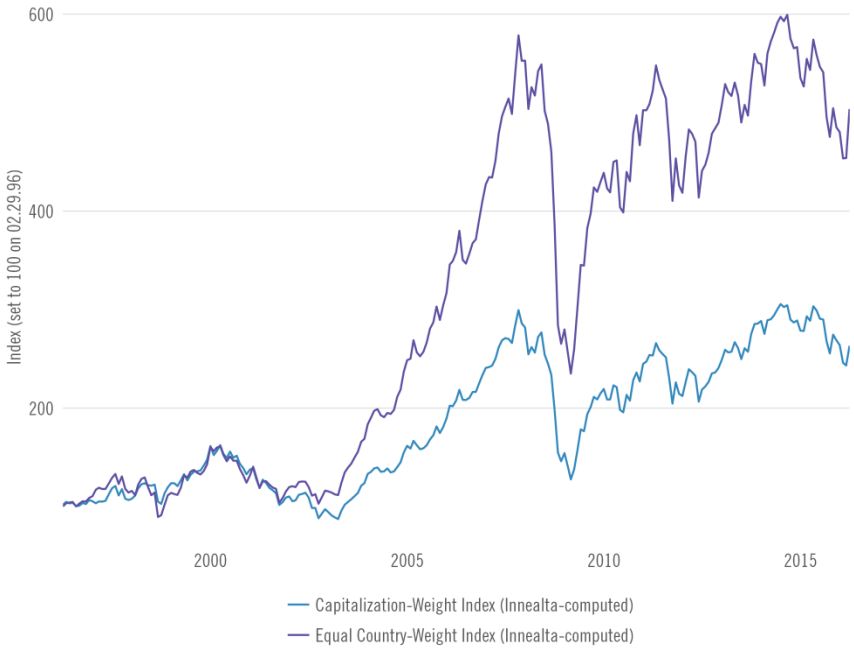
[1] Using index market capitalization data provided by MSCI via FactSet Research Systems we created an equal-country-weight version of the MSCI All Country World ex. U.S. Gross USD Index. The MSCI All Country World Index (ACWI) has a longer history than the ACWX, so we first gathered the dates of membership for the various countries MSCI has included and excluded from the ACWI over the years. We then removed the United States from the group and recalculated index weights using month-end data for market capitalization, making some exceptions for certain total return series that were not available at the time of publication. In turn, we constructed a monthly time series of total returns for the cap-weighted international equity index, using the gross USD returns of the underlying country equity markets. We used the gross returns as, at the time of publication, they were the fullest set of data we could assemble. This approach results in a time series of total returns that broadly matches that of the ACWX.

To present one approach for remapping country market weights within the index, we next recalculated country-member weights so that they would be equal at each month end (which presumes a monthly rebalancing of the index). Therefore, at the end of 1996, each of the 44 member countries received a 2.27% weight in the equal weight index, while we assign a 2.22% weight to each of the 45 country equity markets presently represented in the index. We then constructed a monthly time series of total returns for the equal-country-weight index.

FIGURE 2

International Equity Indexes: Cap-, vs. Equal-Country-Weight

These indexes comprise back-tested data. Indexes are unmanaged and one cannot invest in an index. Past performance, actual or back-tested, is not indicative or a guarantee of future performance. From 03.31.96 to 03.31.16. SOURCE: Innealta Capital using month-end capitalization and total return data from MSCI and FactSet Research Systems via FactSet Research Systems

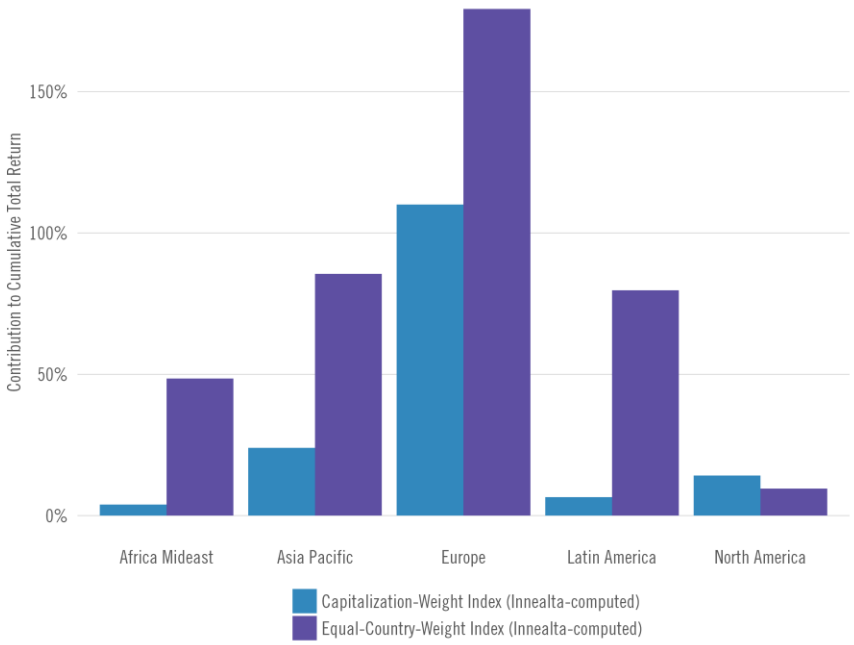


We also see in Figure 3, via this very simple, demonstrative equal-weight strategy, that the regional composition of long-term contribution to index total return shifts to those regions that held weaker weights in the cap-weighted index, but which saw on average higher total returns. That shift, in turn, pushes overall long-term total return higher for the equal-country-weighted index.

FIGURE 3

Cumulative Contribution to Index Total Return

These indexes comprise back-tested data. Indexes are unmanaged and one cannot invest in an index. Past performance, actual or back-tested, is not indicative or a guarantee of future performance. From 03.31.96 to 03.31.16. SOURCE: Innealta Capital using month-end capitalization and total return data from MSCI and FactSet Research Systems via FactSet Research Systems

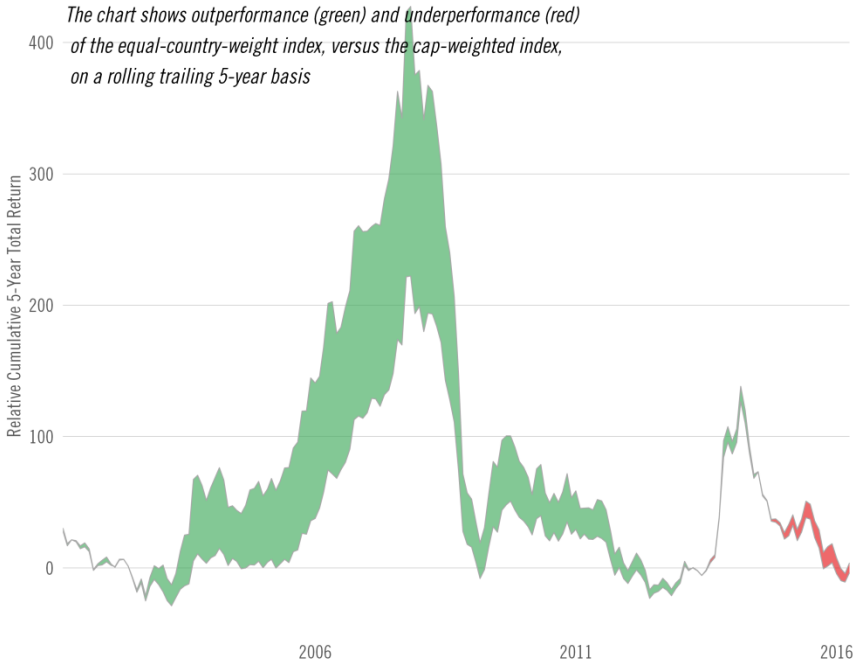


That outperformance is not invariable, however, as there have been periods when the equal-country-weight index has underperformed the cap-weighted index. Those periods, identifiable in rolling trailing 5-year return data, are highlighted in Figure 4.

FIGURE 4

Rolling Trailing 5-Year Total Return: Equal-Country- Minus Cap-Weight

These indexes comprise back-tested data. Indexes are unmanaged and one cannot invest in an index. Past performance, actual or back-tested, is not indicative or a guarantee of future performance. From 03.31.96 to 03.31.16. SOURCE: Innealta Capital using month-end capitalization and total return data from MSCI and FactSet Research Systems via FactSet Research Systems



Over most periods, risk for the equal-country-weight index, as measured by the annualized standard deviation of total returns, is higher than that of the cap-weighted index in this hypothetical example. Nonetheless, total returns mostly were sufficiently superior for the former such that the resulting return/risk metrics were more attractive as well for the equal-country-weight index.

FIGURE 5: Trailing Total Return

	Annualized Return		Annualized Standard Deviation (Risk)		Return / Risk[1]	
	Equal	Cap	Equal	Cap	Equal	Cap
One-Year	-7.30	-8.81	5.51	5.12	-1.32	-1.72
Three-Year	-0.86	0.77	14.67	13.60	-0.06	0.06
Five-Year	-0.72	0.76	17.00	15.67	-0.04	0.05
Ten-Year	3.46	2.39	21.36	19.25	0.16	0.12
Fifteen-Year	10.10	5.43	19.68	17.94	0.51	0.30
Since 03.31.96	8.42	4.96	19.78	17.38	0.43	0.29

[1]Calculated as the simple ratio of annualized return and annualized standard deviation. SOURCE: Innealta Capital using data from MSCI and FactSet Research Systems via FactSet Research Systems

TACTICAL TILTS

Innealta's Country Rotation Strategy is cognizant of the potential impact of underrepresentation and underweighting to investors' portfolios. Hence, we include in our eligible universe the broadest range of country equity markets practicably available. The strategy seeks to further the benefits of enhanced weighting and representation through quantitatively driven,

tactical management of portfolio-level exposures to international equity markets. Our methodology reviews potential exposures to a list of over 40 country equity markets for their relative attractiveness, as gauged by our daily review of fundamental and behavioral market characteristics that have shown to be indicative of future relative performance. Risk management is sought both in terms of the individual exposures chosen and the impact that the mix of those exposures has on overall portfolio return variability.

We are heartened by the fact that the ETF industry has greatly expanded the ability to implement international diversification. We believe domestic investors have only just begun to realize the benefits of expanded exposures to international markets. Focusing on more thoughtful methods to broaden representation of and manage allocations to international markets, we also believe Innealta can improve upon the approaches many presently implement in such efforts.

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 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.

The MSCI All Country World Index Ex-U.S. is a market-capitalization-weighted index designed to provide a broad measure of stock performance throughout the world, with the exception of U.S.-based companies. It includes both developed and emerging markets. The S&P 500 Index is S&P's broad-based market index representing a sample of leading companies in leading industries. A person cannot invest directly in an index. Blended benchmarks are rebalanced quarterly.

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.

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Contact your financial advisor for additional information.

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