Innealta CAPITAL

COMMENTARY: FEBRUARY 8, 2016

A WORLD OF PROBABILITIES

There is no such thing as a clean, isolated relationship in economics. Linkages are not only common, they are the rule when studying economic dynamics. Continuously changing probabilities, rather than static, invariable relationships, determine outcomes in our world. We see the constant challenge of divining and then expressing the nature of these relationships as core to our work. And in those efforts, which we also count among the greater sources of intellectual interest, we seek to maximize our attempts to correctly estimate potential outcomes and their respective probabilities and cleverly and innovatively invest by taking into account the distribution of those potential outcomes. In the end, we must constantly question our world views, while ensuring that we do not stray from a disciplined approach to risk management.

DISCIPLINED LEARNING

Though one can say as much for just about any investment environment, macroeconomic and capital market trends over the past decade have proved mostly unprecedented given the apparent, strong relationships to central bank policy. So while our methodology is rooted in a preponderance of academic literature, the past few years have shown that markets in the short term can behave quite erratically. However, this is unsustainable over long periods of time. Like household plumbing, markets can maintain maximal levels of pressure only so long before they fail. It is our opinion that this time has come.

The upshot is that we must understand that our approach *may not be ideal for a range of short-term environments* and that the external expectations for our strategies (those of clients' and of clients' clients') may be that we should adjust our approach accordingly. Importantly, the Innealta Investment Committee never will succumb to external pressures to alter the investment process in ways we cannot support with intuition, extensive analytics and appropriate review for fit with present philosophy and process. Our goal is to help our clients achieve their investment goals. In that pursuit, however, we will not chase flavor-of-the-month trends. That is, we will refuse to dramatically alter our approaches to adjust to shorter-term abnormalities. Even so, we may modestly adjust them to facilitate a more temperate ride.

BANGING ON THE MODEL

As one example, the Team maintains an ongoing project to develop longer-term views on factor-supportive environments (or factor regimes, which would be times when portfolio exposure tilts to specific factors that can be expected to provide the means for relative outperformance). Though they may be powerful over longer-run periods, well-known investment factors (e.g. value and momentum) may experience long periods of underperformance. For example, domestic value stocks have underperformed growth stocks in terms of total-return for more than a decade. And we presently are reviewing existing academic work and developing our own analytics exploring how the effects of momentum diverge from historical expectations during times of market stress. Already top of mind, given equity market trends so far in 2016, we think the results of this work will prove particularly relevant as we proceed further in to the year.

GOVERNANCE OF HUMILITY

In all such endeavors, the key to their ultimate success is to leave behind the arrogance of knowledge superiority. Our processes must ensure that inherent to our decisions is to know that they never will be 100 percent correct, especially in the short term. Any and all investment choices can be proved in many ways to have been suboptimal with the benefit of hindsight. Knowing that is half the battle. The other half includes the proper incorporation of balancing factors that can limit the impact of being incorrect at any point in the decision making process. The cycle is iterative: we observe, analyze, decide, evaluate and adjust course (where appropriate).

REVIEWING MARKETS: MUCH WORK AHEAD

Readers will note that over the past few months the Investment Committee has sought to bolster the portfolios against some of the tumult that capital markets have experienced so far this year. The “some of” is congruent to the discussion above and is a component of the desire to balance the portfolios against the opportunity costs of caution in the present environment.

As the team seeks to fully understand the various concerns rising from all corners of the capital markets and prepare optimal courses of action, among the top-of-mind topics are the following questions:

1. What direct effects will sustained low levels in energy prices have on corporate solvency and credit market health and liquidity? How might these effects differ by sector (e.g. Industrials and Financials)?
2. How defensible is the presumption that the low-energy-price “tax cut” can support global macroeconomic growth?
3. How large an impact on the broader credit space might duress in commodities and industrials have on investor appetite for credit?
4. How will the views on investment-grade credit exposures track with those of high yield?
5. How do we adjust our perception of “value” against the possibility of continued global macroeconomic weakness?

As readers might expect, we could go on and on. However, the point was not to present an exhaustive list. Tomorrow there will be new items to add and new findings to review and incorporate into our investment decisions. Rather, we wanted to express the danger in believing the global economy moves in direct linear fashions and that those relationships are static in nature. Additionally, we wanted to express the truly complex and dynamic nature of the pressures and supports for capital market investments. And both reflect our desire to balance opportunism with the caution that we hope should protect portfolios from truly onerous volatility and drawdown.

COMMENT ON RECENT MARKET TRENDS

Due to the recent market movements and the ever-increasing availability of opinions about the near-term performance of both equities and fixed income, we feel it is helpful to address how current shifts in sentiment are affecting our portfolios and what our team expects throughout the end of 2016.

Our proprietary quantitative framework has indicated for some time now that various equity markets around the globe are significantly overvalued relative to historical metrics. In our view, this overvaluation has been exacerbated due to unprecedentedly generous monetary policy and broadly confused and misdirected fiscal policy.

The latest plunge in domestic equity markets has lacked an easily identifiable trigger, though one easily can name more than a few potential causes: slowing global macroeconomic growth, broad commodity price declines, global geopolitical instability, generally overvalued developed equity markets, and growing divergence among and uncertainty regarding central bank policy.

Ultimately, the correction that we have been expecting may be upon us. We find that our portfolio positioning has held up very well during this period, in no small part due to decisions made over the last six months. Relevant trades have focused on:

- Prudently trimming high yield fixed income
- Privileging exposures on the most stable U.S. Sectors (e.g., utilities, consumer staples) in the Sector Rotation Portfolio
- Limiting global equity exposure in the Country Rotation Strategy to those markets with more durable domestic growth and more attractive valuation dynamics, while avoiding the largest detractors (e.g., Greece, Brazil) to non-U.S. equity performance

Each of these approaches has resulted in outperformance relative both to our prior positioning and to a range of relevant benchmarks. Our present shorter-term thinking is that prior to the end of this year:

- U.S. equity, on average, will have dipped well into bear market territory
- Implicit volatility measures will remain heightened
- Central banks will seem increasingly desperate to support capital markets, with resulting efforts likely diminishing credibility
- Global equity and fixed income markets will present multiple and various tactical opportunities to potentially achieve relative outperformance. Tactical managers further should benefit from an opportunity to provide substantial relative downside protection and subsequent upside gains to clients once markets find sufficiently firm footing

IMPORTANT INFORMATION

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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 broadbased 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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