Innealta
CAPITAL

COMMENTARY: APRIL 2011

GATHERING RISK

- Lately we have been fielding quite a few questions from investors regarding our current underweighting of equities relative to our benchmarks. We fear the answer will provide little comfort to the inquirer. We don't mean to suggest that the questions are invalid. Simply that, perhaps, we must continue to provide greater insight into our approach to investing and our depth of conviction in regard to our current fundamental outlook.
- Addressing the former, our last commentary proposed what recent shifts in equity values meant in the context of potential investor return premiums. This commentary will be dedicated to outlining why we believe that the inherent risks across most equity markets outweigh the corresponding expected returns.
- The greatest among these concerns include: the still very weak employment situation; federal- and local-level fiscal restraint; misdirected and otherwise confounding monetary policy; growing Middle East tension, rising energy prices and confused energy policies; unsustainable European sovereign finance; compounding woes in Japan; and ongoing turmoil in the residential real estate market and opacity within the financial sector.
- From an investment standpoint, make no mistake, as these events continue to unfold we expect Treasuries to continue to be the go-to asset class. There is no safer alternative, and on most any day that actual geopolitical, global macroeconomic or otherwise global fear actually impacted equity markets, we saw Treasuries rally. Such are the drivers of our portfolio compositions.
- In the meantime rest assured that we do properly understand the risks of our exposures. This can't be said for many in our industry. We need far more fundamental support to convince us that most equities are worth the risk. Until then we prefer our current income capital preserving approach.

REVIEWING THE RISKS

Lately we have been fielding quite a few questions from investors regarding our current underweighting of equities relative to our benchmarks. These queries are understandable—if not a bit frustrating given that they seem based on the benefit of perfect hindsight. Still, given the nature of our business they can be expected. The questions go something like this: How can we still be so concerned with equities given the trend since last fall? How on earth can we be so stupid as to not jump on this obvious breakout? What has changed since last fall to account for the astounding move in equity values?

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EMPLOYMENT

The employment dynamic two years ago was unlike anything we've experienced in almost 30 years. In fact, since World War II the only other period where the country has seen a similar magnitude of job destruction occurred in the early 1980s. Through the turmoil, we wrote extensively about how the magnitude of lost jobs—the absolute highest since the Great Depression—was unsustainable. It really was a simple exercise of finite mathematics. Given the finite number of employable workers, it was clear that eventually there would have to be a deceleration in job loss to some lower employment asymptote.

Our concern—then and now—is whether we can expect to see a meaningful and sustainable acceleration of job growth from this asymptote? Clearly the employment situation has recovered from the abyss. However, we have not seen the necessary increases in job creation that would be required to sustain organic economic growth.

Data properly reviewed indicate that we are more or less bouncing about this lower asymptote. Employment participation across the United States remains at its lowest level in over 30 years. Headline unemployment rates grossly mislead the current employment dynamic and almost all of the "improvement" seems to be generated from the simple principle of quotient algebra: subtracting the same number (folks leaving the work force entirely) from both the numerator and denominator results in a lower quotient (unemployment rate).

This is hardly a situation to get excited about. The fact remains that employment growth throughout the U.S. is severely stunted, and with the continued fiscal situation deteriorating in the public sector (more on this later), it doesn't seem that anything from a policy front is forthcoming to improve the scenario. In fact, one could argue that the nation's fiscal troubles may actually provide additional downside pressure on the rate of employment going forward. Finally, if consumer spending is the lifeblood of our economy (still upwards of 70% of GDP), how can we expect sustainable organic economic growth without higher employment? The answer, emphatically, is that we cannot.

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Worsening matters are structural issues that remain wholly unaddressed by our nation's leaders. Note that at the latest peak we were probably at an unsustainably high level of employment too, so our equilibrium rate is now considerably higher. More simply, the frothy economy was employing too many people—with many in positions of usefulness that would prove short-lived, no less. And that means that many of those positions once held or available are not coming back.

Add to the mix the growing length of time of the unemployed, which bodes ill for worker skill sets. This is exacerbated by the real estate situation (more on this later as well). As housing prices continue to slide, the debt-to-value gaps widen. The upshot of this continued trend is that workers who happen to own a home are far less able—and therefore willing—to relocate to seize the opportunity. (This, despite the fact that home values are still being carried on bank balance sheets at amortized value…more on this later as well).

How does the extension of unemployment benefits help this situation? It doesn't. Perhaps if elected officials were to reallocate resources to more properly address the problem we might find a lever to lift the rate of employment. And, yet, what seems so obvious gets no political attention aside from the super-typical indictment, "you're doing nothing about…," that comes with no forward-thinking policy suggestion. So much easier—and often politically more expedient—to write checks to the unemployed rather than deal with the underlying issue. No surprise in the fact that the policy of passive ineptitude actually compounds the problem by further anchoring potential employees to unproductive situations.

FISCAL: FEDERAL AND LOCAL

"Sh__ rolls down hill!"—Unknown sage.

This quote was never more applicable as the demands for fiscal restraint descend from federal to local levels of government, a shift that is really just beginning and that will take years to play out. Cities and towns are receiving fewer and fewer state funds as states try to meet balanced budget requirements. We wish our federal government had the same legal mandate. Attempts at fiscal reform to date have been laughable at best…even tearful at times. Meantime, states are also being required to more broadly fund federally mandated entitlement programs (Obamacare). The economic significance of this dynamic is almost assuredly the loss of public jobs and services.

Over the longer run, recent developments in many states—most notably the willingness to address onerous public-servant benefit and retirement commitments—are setting the stage for local governments to wield the necessary authority to meaningfully and adeptly alter public finances. Still, we believe, even this dynamic will have a negative economic impact in the short run.

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If readers will allow the silver lining for a moment…all that noted, we don't see this fiscal discipline resulting in massive municipal bond defaults as some pundits have suggested. The highly questionable logic and reasoning used to come to that conclusion is so monumentally flawed and conceptually ignorant it would be comic if it weren't for the real economic loss it caused. From a buyers perspective it has created an investment opportunity. If we were cynical we might even conclude that the issuer of such nonsense has created an investment opportunity for themselves. After all it wouldn't be the first time that a pundit promulgated a self-serving circle of profit.

The defaulting of a municipal bond would actually prove so destructive to the ability to run public finances that the folks running our government at the local levels might actually prove pragmatic in their considerations; they're much more likely to choose the path of least damage and cut costs. Only as a very last resort, we believe, will municipalities find any form of restructuring a viable option relative to fiscal discipline.

MONETARY POLICY

Is the most dangerous person alive not Quaddaffi, Bin-Laden, Ahmedinejad or Kim Jong-il, but Federal Reserve Chairman Ben Bernanke? Yeah…yeah…that's going more than a bit overboard. And, yet, the rhetorical query highlights our concern regarding current monetary policy. Quantitative easing (QE) has been disastrous for the dollar and is feeding actual and expected inflation. We're sensitive to using the benefits of hindsight when evaluating policy decisions, so

even though we were opposed to QE1, we could forgive the effort in that we appreciated the Fed's fear of deflation. On the contrary, the rationale and stated objectives of QE2 were difficult to follow; that aside, by almost any gauge, QE2 has proven a grand failure. In fact, instead of what should have been the true purpose of such an effort—the moderation of interest rates—rates have risen precipitously.

Rewriting history, then, the Fed has been espousing revisionist rationale for QE2, which has turned to the promotion of risky asset classes in order to foster a wealth effect. Such a ridiculous notion, it's barely worth critiquing. In effect, Dear Ben is suggesting the only way out of this mess is to recreate the conditions that led to the mess.

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Well, Rita Mae Brown reminds us that, "Insanity is doing the same thing, over and over again, but expecting different results." The main beneficiaries of this insane policy have been speculators. The consequences, on the other hand, have been dire. QE2 has been so detrimental to the dollar that it has even lost value relative to the Euro—not exactly a financially sound currency (more later…).

It is our opinion—we would suppose made fact by the nature of Mr. Bernanke's recent commentary—that QE2 is purely a policy put option for the capital markets. Indeed, we witnessed a discrete change in the direction of equity values recently after a news headline flashed across the tape implying that the events in Japan (more later…) mean QE3 is likely as is a postponement of restrictive monetary policy by the European Central Bank (ECB). Talk about addictive behavior. Make no mistake, QE isn't about liquidity. It's about feeding the capital markets with cheap money to keep valuations artificially high, fundamentals be damned.

It is our opinion that this can't last forever—it may last longer than we thought plausible—but like all things financially artificial, the scenario eventually finds equilibrious fair value. Remember Tulipmania? We've seen this before, and yet how quickly so many have forgotten the result. It's like watching the movie Memento play out on the capital market stage, with participants having fully forgotten where they've been and having only weakly informed instinct driving the decisions they make. Perhaps, like our Leonard Shelby, folks should take better notes.

MIDDLE EAST AND ENERGY PRICES AND POLICIES

Wherever else but a well-functioning and fundamentally driven market can we start a war on a Friday and find the equity markets rallying on the following Monday? It's all good. I wonder if the equity types realize that this isn't a sporting event, but rather literally life and death. One wonders (again, it's the cynic) if

policy makers purposely waited until after the close on a Friday to "agree" to implement the No Fly Zone around Libya. Even though no objective of this policy is forthcoming, we are meant to assume that it was to save innocent life. So why then was implementation conveniently delayed until the close of capital markets? We hope that the decision wasn't based on the same logic as used by the FDIC when closing a bank. Perhaps this is a bit too cynical but what passes as foreign policy initiatives these days leads one to wonder who is making the decisions and why.

So what happens in Libya once the policy is "successful," whatever that means? Like Egypt, do we really expect an American-like republican government to suddenly appear like a phoenix from the ashes we helped spark? Are the leaders that replace the existing regimes really going to be friendly to the West? Perhaps…perhaps not. Not every "rebel" is a good and fair-minded soul. In fact, the history of this region strongly suggests otherwise. Further, what will our policy be toward Bahrain, Syria, Yemen, Saudi Arabia and others (we already know our foreign policy toward Iran) when more innocents get murdered in the streets in the pursuit of constitutional and representative government? Can we expect more of the same policy as that in Libya? Expect hypocrisy. And if you're a leader in Israel, what do you do?

These events all lead to higher and more volatile fossil-based energy prices. In fact, we'd argue that oil has found a new pricing range between $90 and $130 barrel (WTI). This will most likely produce a meaningful drag on discretionary spending over the coming years—an effect no different than a tax. According to the pundits, though, this feature of the global macro environment is nothing to worry about. Apparently there is little risk to higher energy prices and that our robust economic growth can easily withstand this hit. Really? Tell that to all of the folks unemployed and upside down on their mortgages. In our opinion, the only beneficiaries of our Middle East policy are those operating a government subsidized electric car plant. Did you know that for an electric car to be economically viable relative to current vehicles, oil would need to be about $300/barrel? How's that for solid energy policy? Heaven forbid we consider alternative drilling locations less geopolitically dangerous! Apparently, it's better to militarily intervene in a sovereign country than to endanger a caribou or a horseshoe crab.

EUROPE

It looks like it's a race between Greece, Ireland and Portugal as to who will prove the first to restructure (read: default) on its debt. Who knows what term they'll used to describe it, but in our minds there is no 'if' there, folks. And once one of them does it, the others are near sure to follow. Might one of those followers be a

larger country? Spain perhaps? It's not a crazy scenario, rather probabilistically reasonable, in fact. The ever changing European Financial Stability Facility is supposedly going to be able to handle such events. We doubt that very much…there are neither the funds, nor sufficient political willpower yet. The economic size of the problem exceeds anything being proposed—much less agreed upon—and one must view the situation from the standpoint of the German taxpayer to truly understand the barriers that a Euro-sovereign bailout must overcome to prove successful.

Just this past week, Portugal pulled ahead of Ireland upon the dissolution of its government over austerity policies. Look out for more such deadlocks, some likely inter-governmental: Ireland's new government would be foolish to acquiesce to the institution of higher corporate taxes in order to obtain better debt terms from the European Union (EU). Ireland's long-term growth is closely tied to the comparative advantage it now has with low corporate taxes relative to other European countries. To eliminate that in lieu of restructuring is just too short-sighted, a fact that's seemingly not lost on the Irish. If we were advising them, we'd strongly recommend restructuring in the short term, with the medium-term pain of departure from the EU an acceptable consequence of greater long-term stability. To do otherwise would lead to far higher unemployment as corporations leave the Emerald Isle for more profitable opportunities.

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With Portugal and Spain leading the news pages, however, it'd be a mistake to forget the dire straits that Greece sails. And then there's Spain. This would be the country that could very well break the EU if it were to restructure. A restructuring by any of the aforementioned countries will wreak havoc on the European capital markets and the financial sector in particular (and perhaps create a buying opportunity), but Spain could destroy the EU. It's truly too big to fail. However, with over 20% unemployment, a woefully undercapitalized banking sector, a disastrous real estate market, insanely high entitlement commitments, and a highly tenuous economic outlook, it's conceivable that a restructuring is possible. But, alas, no risk here according to our equity brethren!

Making matters a bit more complicated is the rhetoric coming out of the ECB regarding a shift to more restrictive monetary policy. Until the events in Japan, it was largely expected that such a policy change was to take place as soon as next quarter. Short-term inflation concerns have rightfully gotten Trichet's attention, though, and he has begun to sound far more hawkish in his speeches. This has caused the dollar to depreciate relative to the Euro, which is amazing given the state of the EU sovereign debt market. Circling back, we can only thank Ben for such otherwise imaginative possibilities! You can't make this stuff up.

JAPAN

Most analysis we've seen on the economic consequences of the tragedy in Japan have been far too sanguine. Estimated costs of rebuilding are in the $350 billion range. And this ignores the radiological fallout, the extent of which remains highly uncertain as of this writing. We have yet to see any sound analysis that includes proper quantification of the opportunity costs associated with this event. Japan has basically not grown in 20 years and has experienced bouts of deflation over that period. Its current debt level is well above what any reasonable economist would consider sustainable. Prior to the catastrophe we had concerns—now we hold out little hope. What will be the true cost of rebuilding? Keynesians are ecstatic as now the Japanese policy makers will have to spend like mad men. Do they even have the debt capacity to do so? Do they bleed down their foreign currency reserves? Does the yen suffer as a result? Do foreign currency dynamics even matter?

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We just think the risks are far too high and the unknowns far too many to consider the situation understandable, let alone investible. But there we were, immediately following the event, watching some talking heads try to convince listeners that this was a net good thing for global economic growth. This is as poorly reasoned as the equity rally following the onset of war and the municipal bond conclusion on massive defaults this year.

This kind of nonsense only happens during wildly decoupled markets. Remember, during the late 1990s when research analysts were quoted stating that "fundamentals don't matter anymore"? We do. And it's difficult to watch, but we prefer safer exposures. Equity market participants seem to accept any rationale to run the markets up and current frenzy and monetary policy is enabling this dynamic to continue. Rest assured the risks are significant and we prefer to manage them until more reasonable minds prevail.

THE RESIDENTIAL REAL ESTATE MARKET AND FINANCIAL SECTOR

The news from the residential real estate sector just keeps getting worse—along every meaningful dimension. Remember what was at the heart of the credit crisis? That'd be structured securities based on residential mortgages. Ultimately, the value of these mortgages is driven by the value of the underlying real estate, which has declined for the better part of five years now. Many experts suggest that they have considerably further to go to reach equilibrium. This may or may not be accurate, but we're pretty confident that a sustainable increase is not in the offing. As individuals fall further and further behind on payments we should expect to see more supply, followed by even further price decreases. Compound this issue with the aforementioned employment realities and it should be easier

to appreciate our concerns in regard to consumer spending, not to mention the health of industries tied to home building.

Perhaps more concerning from a systemic perspective is the state of our financial sector. Current accounting standards have been adapted to allow banks to account for these loans on an amortized basis from issuance value and not on a marked-to-market basis. This chicanery was an effort to stem panic during the heart of the credit crisis. But these fictional values are being used to inform capital-adequacy requirements throughout the banking system. The metaphorical Potemkin village fits ever so aptly here. Bankers will protest that market values shouldn't be used—but they use this argument only when it is to their advantage. We'd argue that something is worth only the bid. Basing solvency requirements on artificial accounting measures is as problematic as using earnings estimates to justify current valuations. It's a completely circular and self perpetuating logic.

The problem is still there. And marking the matter to today's bid, from a pure valuation perspective it can be argued that it's worse than it was at the height of the crisis. The gap between book value and market value is still there—and it's literally getting larger by the day. As a result, the wealth transfer from the massive loss in real estate values is lurking out there somewhere. It may not be as immediate as the sovereign issues in Europe but that is due entirely to our policy makers doing their best to try and "fix" the problem with entirely idiotic policies like the first time home buyer tax subsidy or the ever successful HAMP (Home Affordable Modification Program).

Policies toward housing and residential real estate are even more misguided than those regarding unemployment. It seems inevitable that they'll manage to produce a strategy that compounds the problem and completely ignores its source. This ever positively reinforcing cycle just never seems to come to end. This shouldn't be surprising because in order for it to end the problems, creators would have to admit that they're the problem.

TYING THE BOW

Needless to say we have concerns about the inherent risk implicit throughout much of the capital markets. We believe that risks are very high and that they need to be properly managed. Ignoring these risks is perilous to wealth accumulation and preservation. We prefer to get some clarity and to take the trend followers and high frequency traders in stride. Frighteningly, policy makers in Europe seem to better grasp reality than their American counterparts. Europe may thus offer opportunity sooner than later. The U.S. may follow soon afterward. Innealta will continue to monitor opportunities and exploit them as they become available.

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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 and discipline continue to be 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.

About Innealta Capital:

- 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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