Innealta
CAPITAL

COMMENTARY: OCTOBER 30, 2015

GAUGING GLOBAL MARKETS

The efficient management of actively managed portfolios requires the consideration of a diverse range of risks inherent to global multi-asset-class research. Indeed, expanding the investment opportunity set beyond the domestic borders greatly magnifies the breadth of analytical requirements to properly evaluate risk and return characteristics.

In addition to those factors that we can quantitatively evaluate on a mostly similar basis across country equity markets, there is the need to resolve country-specific factors that may influence equity returns. On the one hand, quantitative variables such as the potential impact of currencies…affecting returns for foreign investors…is an obvious addititonal characteristic amenable to quantitative review. On the other hand, qualitative variables such as geopolitical risk rank high among those critical to global multi-asset-class investing.

Investors should seek to balance individual investment opportunities against the range of potential risks they present, both quantitative and qualitative, collating them into portfolios designed to dilute those risks through diversification. This is the very essence of the work of the Investment Team at Innealta Capital.

LEVELING THE PERSPECTIVE

Taking a step back from specifics for a moment, security analysts must accept their own domestic perspective as a potential source of bias. This bias can lead an investor to assume characteristics of otherwise like-for-like exposures (e.g. two aggregate country equity markets) as identical when, in fact, they may not be. For example, structural variations, such as large differences in sector exposures, may skew results from comparisons that do not appropriately account for those differences.

Our process seeks to avoid such biases when gauging prospective risk-return levels for various country equity markets. We analyze each country in our global opportunity set in a similar overall way, preferring to assume a beta exposure when respective valuations are low, fundamental trends are positive and robust, and the risk environment is tame. Critical to these evaluations is the fact that we first must account for the factors that define "normal" levels and trends for each country equity market itself, as well as within a cross-sectional comparison among all countries. In turn, we can define "low" and "high" for the purposes of identifying favorable investment opportunities.

The above approach accepts the fact that defining characteristics particular to each country will result in structural differences in valuation. And this is true for relative comparisons that do not include the domestic equity market. Take, for example, the range of Asian economies presently in our Country Rotation Portfolio: Hong Kong, Singapore, South Korea and Taiwan. There may be few reasons to assume that aggregate absolute valuations (e.g. a price-to-earnings ratios) should be similar across them, when one minimally considers the fact that Financials-heavy indices of Hong Kong and Singapore are structurally very different than the Technology-heavier Taiwan and the more strongly diversified South Korean indices. Here, again, we seek to determine a "normal" state of valuation for each, so that we can assess which among them presents an attractive investment opportunity.

GEOPOLITICS STRAINS

Quantitative frameworks are well-suited to evaluate relative valuations, given their predominantly numerical nature. Sovereign credit risk, too, can be quantified and is thankfully so evaluated by a series of organization utilizing standardized methodologies. Other characteristics of country equity markets are not so easily quantifiable, even as they may well be as impactful. Of the many risks our Investment Team evaluates through the investment process, geopolitical risk tends to be one of the most challenging. Such risks include governmental change, civil and regional war, and others related to the political sphere that may impact equity market returns. Characteristically chaotic, geopolitical risk is difficult to model in isolation using traditional quantitative tools. A potential alternative approach is to incorporate the country-specific incremental geopolitical risk into the overall assessments of specific exposures. This approach is not free of challenge though. Local geopolitical risk may transcend a specific region or capital market and impact others.

A recent example is Russia's incursion into Ukraine. Readers may recall that prompted by a leadership vacuum created by the ousting of Viktor Yanukovych, Russian President Vladimir Putin took advantage of relatively strong demographic support for Russian unity to annex Crimea, then a region of Ukraine. Broad equity markets trembled, while local markets plunged. U.S. Treasuries rallied, however, in a flight to relative safety. Not too long thereafter, while the local impact persisted, it seemed broader effects dissipated, even as the potential for further deterioration on the ground certainly was possible. That potential, along with an ongoing deterioration in Russian equity fundamentals led the Investment Committee to close out the Russia position in the portfolio.

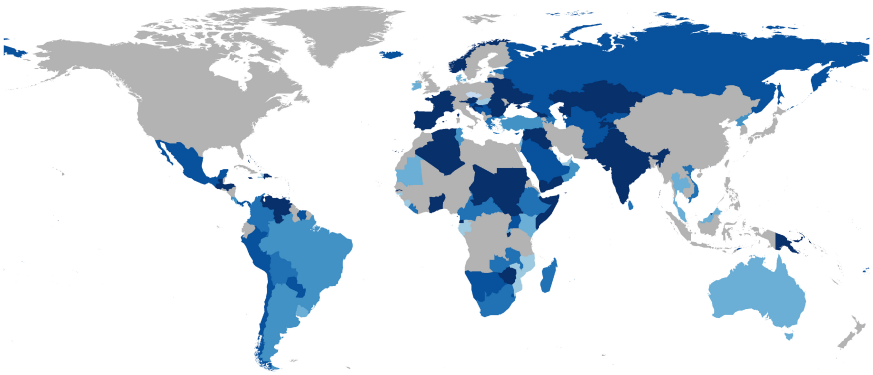
The Russian example offers just a glimpse of the aforementioned challenge of incorporating assessments of geopolitical risk into the investment decision making process. Our Investment Team regularly studies and discusses the potential ramifications of geopolitical risks and seeks to adapt portfolio exposures to reflect the team's assessments of capital market

views on such risks. In other words, geopolitical risk can be thought as the collection of country-specific vector of values that interacts with the entire universe of eligible countries quantitative risks matrix. A non-Innealta-proprietary view of a combination of sovereign credit and geopolitical risk, courtesy of the Organization for Economic Cooperation and Development is shown in Figure 1[1].

FIGURE 1

OECD Country Risk Classifications

Data are as of 01.31.15. Dark blue areas denote regions of highest risk classification. Light blue areas denote regions of lower risk. Grey areas do not have data available. SOURCE: Innealta Capital via Organization for Economic Cooperation and Development



ADAPTABLE QUANT

Russia, of course, is a perennial enigma. China is just as notorious for requiring unconventional approaches for investment analyses. The country is uniquely influential in geopolitical and macroeconomic matters, at once boundless in its potential to create investment opportunity and confounding in its ability to stymie otherwise orthodox analysis. As the country matures economically, diplomatically and militarily, relevant analytics must accommodate that evolution.

That's no simple assignment. As recent history demonstrates, the pace of change in the Middle Kingdom can blur the eyes. Increasingly over the past few quarters, China has shifted from being a source of to being a drag on global growth. We view the renminbi devaluation and subsequent shift in monetary policy as pieces of a collection of evidence that suggests China's economic growth is slowing at a rate faster than that reflected in official government projections and, as importantly, the aggregate expectations of capital market participants. In the view of the Innealta Investment Committee, these policy shifts and the macro trends that drive them are emblematic of a still-young country on an ascendant trajectory, not of one facing any sort of grand reversal of growth and fortune. Indeed, the struggle officials faced in producing effective responses to capital market volatility reflect only a *desire* to...as opposed to a *need* to...exert control. China, with or without those efforts to "right" the equity markets there, is sure to continue to march along that rising path, no doubt with the occasional stumble along the way.

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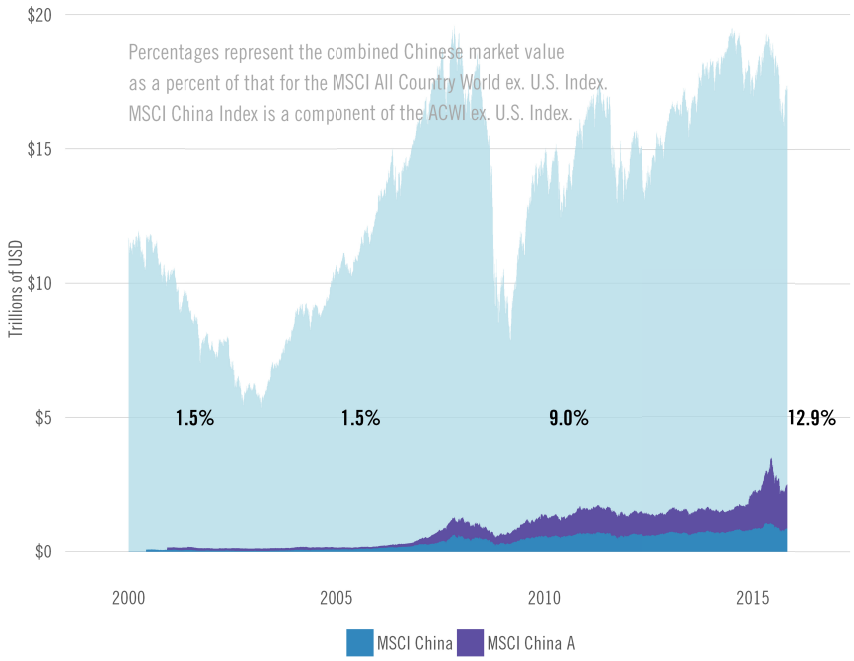
[1] From the OECD Web site: "As far back as 1976, OECD countries began coordinating their policies on export credits...Today, this Arrangement still ensures the operation of an orderly credit market and seeks to prevent countries from competing to offer the most favorable financing terms for exports." The OECD's "country risk" metric, "is composed of transfer and convertibility risk (i.e. the risk a government imposes capital or exchange controls that prevent an entity from converting local currency into foreign currency and/or transferring funds to creditors located outside the country) and cases of force majeure (e.g. war, expropriation, revolution, civil disturbance, floods, earthquakes)." The OECD does not rate High Income OECD countries and High Income Euro Area countries.

Our Investment Committee does not foresee a dramatic decline in Chinese growth on the medium-term horizon. And the Chinese government's obvious willingness to support its continued growth should be seen as a potential counterbalance to pressures in otherwise more dire scenarios. As we show in Figure 2, China's relevance to capital markets continues to grow. Longer term, we continue to believe that the Chinese economy will only intensify in its impact on global macroeconomic trends by virtue of gains in relative heft and advances in its global integration.

FIGURE 2

China Equity Market Scale

From 12.31.99 to 10.29.15. MSCI China Index captures large- and mid-cap representation across China H shares, B shares, Red chips and P chips. With 143 constituents, the index covers about 85% of this China equity universe. The MSCI China A Index captures large- and mid-cap representation across China securities listed on the Shanghai and Shenzhen exchanges. SOURCE: MSCI via FactSet Research Systems



MARKETS EVOLVE, WE EVOLVE

In sum, while quantitative investment management firms restrict themselves to standardized quantitative reviews, the Investment Committee at Innealta Capital takes a more adaptable approach, accepting the challenge of "getting smarter" as markets evolve. There are aspects unique to global multi-asset-class investment that add complexity to the team's analytical efforts. These complexities naturally differentiate the product set, thereby enabling distinct solutions for a range of clients for whom the expanded horizons are suitable. As we continue to broaden internal perspectives and enhance technical expertise, the team expects to further expand the offering set to accommodate a more comprehensive range of investor requirements.

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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.

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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AFAM Capital, Inc.
12117 FM 2244
Building 3, Suite 170
Austin, TX 78738
P: 512.354.7041 F: 512.402.1014

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