



Innealta
C A P I T A L

Innealta Commentary

January 10, 2011

2011 INVESTMENT OUTLOOK

Every year at this time we compile an internal list of issues we feel might (or should) affect the capital markets and therefore our products throughout the year. Historically, this list has been more or less an internal memo to those of us on the investment committee. We update it regularly and reference it frequently to ensure that we're fluid in our process. This year we're sharing with our investors some of these items.

The list is neither meant to be comprehensive, nor perpetual. Rather, the following convictions are highlights of those material notions that inform our investment strategy outside the context of our quantitative framework. Some takes might rate as obvious, while others are continuations of themes from last year. Finally, a few are more product development oriented, focused on continuing the tap into the ongoing expansion of the ETF market to broaden the investment opportunity set.

PRACTICAL CONSIDERATIONS FOR PORTFOLIO MANAGEMENT

Expanding asset exposures within our product line

During 2010, the ETF marketplace expanded significantly, a trend we expect to continue this year, though perhaps not at so grand a pace. As the equity slice of the market has filled out nicely, we will be interested in options focused on global sectors potentially coming to market. Meantime, fixed income ETFs should continue to proliferate, expanding our ability to disaggregate now consolidated bond positions (e.g. BND), while enabling access to heretofore unavailable (or otherwise unattractive from a tradability standpoint) segments, such as mortgage-backed securities. It is likely, however, that volume on the fixed income side will remain light, to a measurable extent limiting our ability to invest in certain ETFs, though we might find the option otherwise enticing. Finally, new opportunities are arising in the commodity arena, which may allow an expansion of access to those markets. Of particular interest are various proxies for commodity complexes, as well as a broader set of precious metals and energy.

Altering our asset allocation targets

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Pursued in tandem with the expansion of our asset class exposures, we may look to adjust our asset allocation targets. Last year we introduced gold to some of our products, reintroduced REITs to many of our products, and altered our secular equity targets between domestic and international equities. We also updated our exposures across the fixed income portion of our portfolios.

In a part notional, but mostly semantic shift, we shall characterize our secular-oriented framework, which is a slower-moving tactical process, as Secular Tactical Allocation (STA). This differs from the past habit of referring to the process more generically as Strategic Asset Allocation (SAA). The distinction is important. STA allows for the relaxation of the many binding constraints that underlie the SAA buy-and-hold framework, while leveraging the quantitative benefits of that portfolio construction approach.

In our opinion, no small segment of the investment industry misuses the SAA process and misunderstands tactical asset allocation. By frequently altering the SAA they effectively are making Tactical Asset Allocation (TAA) decisions, regardless of the periodicity of those decisions. This violates the theory that underlies the SAA approach. We prefer to be more conceptually coherent and use the STA terminology. The distinction between SAA and TAA is conceptually blurred, but in a way that's at the same time practical and consistent with the theoretical underpinnings of asset allocation theory. For example, a true SAA approach would delay the reallocation of portfolio slices based upon information that is timely (e.g. the evolving set of global sovereign debt scenarios, unemployment, recent price dynamics, fast changing macroeconomic or fundamental scenarios and geopolitical events). In effect, we employ two layers of tactical decisions within many of our products—STA and TAA. The approach, we believe, allows for an elevated level of flexibility in portfolio allocation decisions, while still maintaining the investment discipline afforded by the longer-term focused SAA framework.

2011 FUNDAMENTAL OUTLOOK

Evolving governmental fiscal realities

What will the new Congress do? Perhaps better: what can Congress do? The clearer answer seems, “not much,” given the split between the Senate and House in the legislative branch. That said, the tax-and-benefits compromise reached at the end of last year weighted the optimism we felt immediately following the election. Blustery wind-baggery to the opposite aside, it appears both sides of the ideological aisle are absolutely bereft of the facilities for implementing basic fiscal discipline. Washington never ceases to amaze...or depress.

Until we have a real debate on how to meaningfully reduce government spending, the fiscal disequilibrium issues facing the United States will not improve. What our elected officials fail to understand is that, while such potentially dire fiscal straits seem far less pressing than does the stubbornness of various domestic markets (employment, housing) to revive, the properly ambitious manners via which one pursues remedy for such scenarios require vast lengths of time to devise, implement and succeed.

What’s material to us as asset managers, then, is the not-so-delicate balance one must strike between the understanding of the potential and exponentially growing deleterious impact of inactivity on the matters not just of fiscal discipline but of global solvency and the reality of a market that on balance completely ignores these facts except in often seemingly random bursts of lucidity.

In short, we expect equity markets to mostly ignore the evolving U.S. fiscal scenario, except at such times as—more on this in a bit—the situation in Europe requires a more interventionalist approach. On the flip side, we believe fixed income markets will continue to price in longer-term scenarios that don’t expect tax-and-growth policies to succeed. However, we believe that such expectations (as much as we can attribute the recent shift upward in the U.S. Treasury yield curve to such thinking) have more than fairly been discounted in Treasury pricing.

Rising expectations for monetary policy

An independent group of academics is responsible for monitoring and guiding the economy of the United States, and by virtue of America’s derivative impact, the world. Quantitative easing, in our opinion, is nothing more than a grand academic experiment with the short-and intermediate-term objective of weakening the dollar. Even this objective is being thwarted due to the realities throughout the European Union.

Are we to expect more quantitative easing in the year to come? Our concern is that as unemployment continues to hover north of 9% and as the legislative process proves more ineffectual, the Federal Reserve may feel justified to extend its quantitative easing effort. On balance, we find such an extension more likely than not.

That could prove disastrous. What seems totally lost on these folks is the error in defining the problem as one of liquidity and not leverage. True, a credit crisis led to a *short-term* liquidity crisis. That crisis had been addressed...and amply so...for nearly two years. The

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more pressing issue is that economic growth is being hampered by the extraordinary excesses that were built up over the past decade (stemming from, in fact, too much and too cheap liquidity). This leverage problem will take many, many years to work off. Until the monetary authorities recognize and address that fact, the ever-increasing public debt load may very well become more problematic than the private debt load that led to the credit crisis.

Rather than supporting the deleveraging trend, however, the Fed seems bent on fostering optimism via the increase in risky-asset-based wealth...inflating more bubbles. How foolish. Especially when we know the Fed has done this before and should know better. First, homes make up the majority of most American's wealth and that by most important measures QEII unintentionally has increased downward pressure on housing markets. Further, it is imprudent to behave as a capital markets therapist, especially when the therapy is more drug than advice. Whether the patient is in a better place or not, such narcotic prescriptions can leave severe withdrawal syndromes in their wakes. Let's hope that the Federal Reserve comes to that realization.

Inevitability of Eurozone duress

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Among Ireland, Greece, Portugal, Spain and possibly Italy, in our opinion, there is only to wait for a sovereign debt restructuring. And given the evolving scenario, we think 2011 will be the year that the European Commission and the European Central Bank stop bandaging surface wounds and instead seek to stop the internal bleeding. Belaboring the metaphor... emergency surgeries are never pretty and often are not entirely—or at all—successful. So, after the 'when', we wonder how severe will be the domino effect throughout Europe, the global financial sector and the global economy.

There simply are not enough resources available to continue the current strategies. And various additional patches—the finest example being the issuance of common euro bonds to roll over individual country debt—are fraught with tangent problems, not the least of which is the growing weariness among stronger economies (Germany in particular, with new-member Estonia offering a different take) for subsidizing the weaker fiscally irresponsible members.

Albeit terribly painful, Europe would be best served by allowing the necessary restructurings to take place. A restructuring of the EU itself may perhaps even be required. Let the weaker members temporarily defect and establish strict rules and requirements for readmittance. The Maastricht Treaty already has been violated (many times, many different ways) and the credibility of the EU rightfully questioned.

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Deterioration in municipal solvency

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The analogy between many municipalities throughout the United States and the periphery throughout Europe is uncanny. Much of the source of the problems are public unions (many of us are all too aware of the recent situation in the state of New York). They have decimated

many municipal budgets in the same manner that the UAW has destroyed the auto industry. The very idea of a public employee union is a perversion of the original justifications for unions; by nature of their ability to elect officials, public trade unions over time push the disequilibrium in bargaining power to the exact opposite extreme. Fortunately, many recently elected local officials, their having not grown up under the wings of the union albatross, realize this and will force necessary changes to employment contracts. In the long term many municipalities will benefit from such efforts.

It is our opinion that Chapter 9 of the bankruptcy code will find great use in 2011. The dynamic that follows will be interesting. Investors most likely will flock to fiscally sound municipalities. Some however, may exodus the municipal market altogether. Those states with the biggest problems include California, Illinois and New York. Virginia is among those currently in the best fiscal condition.

Sustainability of economic momentum

The flow of recent economic data certainly has been, on balance, positive. That said, many of the economic indices are still at recessionary levels. There has been no V-shaped recovery. We thus wonder whether economic improvements can continue in absence of government transfer payments. As of this writing, our doubt remains large.

It is astounding how the capital markets continue to cherry pick which economic releases to exalt/ignore. Most interpretations seem to suffer from the denominator phenomena about which we have written frequently: year-over-year comparisons must be interpreted very carefully when the denominator is very small.

How does one conclude that the economy, without government subsidy, can sustain growth when the underemployment figure¹ approximates 17.0%? Add to that the residential real estate quandary and it is hard to imagine how private consumers can be expected to spend profligately, the very basis for the great majority of U.S. economic activity (consumer spending still comprises more than 70% of GDP, a level higher than any prior to September 2008). What happens when the Christmas credit card bill comes due?

Moreover, the possibility of \$4 per gallon of gasoline will further weight sustainable unsubsidized consumer spending. How about those winter heating bills? It truly is remarkable to listen to talking heads suggest we're on a path toward sustainable improvement in home economics while personal bankruptcy filings remain near record levels.

In our opinion, these very basic and common sense fundamentals (the household budget constraint) have been ignored for far too long. Irresponsible fiscal and monetary policies are the reasons for this unsustainable dynamic. At a time when the Bureau of Labor Statistics finds it necessary to redefine the definition of long-term unemployment in order to properly quantify the massive employment issues we face, we have an equity market that is pricing in above-average consumer spending for the next few years. You really can't make this stuff up.

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¹As defined by the U.S. Bureau of Labor Statistics, total unemployed, plus all persons marginally attached to the labor force, plus total employed part time for economic reasons, as a percent of the civilian labor force plus all persons marginally attached to the labor force. Data are found among the Household Data monthly Employment Situation report

In our opinion there is far too much bullishness across the equity space. Similarly, there is far too much bearishness across the U.S. Treasury space. And as the macroeconomic fundamentals and policy forces are working against each other, we currently are comfortable with our treasury exposures. Nonetheless, we stand ready to alter these allocations opportunistically.

The only way equity types can justify an increase in equity values while the risk free component of the discount rate is increasing is by having an exponentially decreasing equity risk premium.

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Feeling and being contrarian

In our opinion there is far too much bullishness across the equity space. The last time equity bulls were so prevalent was back in the fall of 2007. Then, few saw what was coming, while the underlying macroeconomic fundamentals were trending far more positively than they are now. Is this comfort and joy merited? For all the various reasons we already have covered, we think not.

Similarly, there is far too much bearishness across the U.S. Treasury space. The talking heads continue to ring the alarm of inflation. They claim that monetary policy will produce long-term inflation, which subsequently drives bond prices down. We believe this is overdone and may prove short-lived. The excess capacity throughout the U.S. economy is far too large to source meaningful and sustainable inflationary pressures. In fact, it is the deflationary forces that are driving much of the current monetary policy. Expectation-driven monetary policy, however, is most likely not enough to overcome the *very real* significant excess capacity currently available within our economy. Finally, with the recent shift upward in the treasury curve, corresponding dividend yields look downright paltry.

Against this backdrop, it feels as though most equity strategists are no more knowledgeable than Chauncey Gardiner. Ignorance reigns. And as the macroeconomic fundamentals and policy forces are working against each other, we currently are comfortable with our treasury exposures. Nonetheless, we stand ready to alter these allocations opportunistically.

Increasingly paradoxical equity valuations

At the same time, literally, equity strategists are using aggressive accommodative monetary policy—required, of course, by a flailing economy—to justify aggressive bullishness on equities. Last we checked, asset values are determined largely by discounting future cash flows or earnings. The only way equity types can justify an increase in equity values while the risk free component of the discount rate is increasing is by having an exponentially decreasing equity risk premium. In other words, the return above treasuries implied by current equity values is getting ever smaller. Interestingly, the more that equities are sold on the logic of quantitative easing, the smaller this premium must be getting to justify valuations. At what point does it go negative?

Growing geopolitical strife and strain

In addition to perpetual Israel/Palestine tensions we now have Iran, North Korea, civil unrest throughout Europe and the potential for tariff and currency wars largely due to current monetary policies.

Ignorance of the financial sector

Yes, the double-entendre is an intended one. Since the onset of the credit crisis there has been very little improvement in the real estate collateral that underlies large swaths of the balance sheets throughout the financial sector. In fact, without the postponement of mark-to-market accounting many banks might be insolvent. Interestingly, even with this accounting chicanery more banks have been shuttered this past year than in any since the savings and loan crisis in 1992. Both residential and commercial real estate values continue

to fall. Fiscal policies have unsuccessfully attempted to produce synthetic equilibriums and have done nothing more than postponed what seems inevitable.

In our opinion these markets have more downside than upside potential in the near term. And as it likely will take years to flush out the excesses of the previous decade, valuations likely will take a long time (they may not ever) to return to levels seen in 2006.

The government destroyed the residential real estate market in this country by pushing a highly addictive brew of cheap money and misdirected policy. The consequence is a massive overhang of now deteriorating capacity that will take who knows how long to fill. For example, there apparently exists more than 21 ft² of commercial retail space per U.S. citizen. Meantime, the commercial office space vacancy rate now exceeds 17%.

Their theatricality aside, current efforts to remedy do little more than prolong the withdrawal. Until the government removes itself from this market it will never achieve a sustainable equilibrium. In our opinion, Freddie Mac, Fannie Mae, and now the FHA should all be eliminated as should the mortgage interest tax deduction.

Ever more precious metals

Even with almost 30% return in our gold positions over 2010 we still like the secular characteristics supporting gold. We would consider adding to our gold positions in the event of any short-term selloff. Some of the other precious metals have just come too far too fast. Silver has experienced a runup that is hard to justify over the last year. Though on a five year basis gold and silver have close to the same total return—silver has done most of it in just over a year.

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CONCLUSION

These are but a few of the realities that we consider on a daily basis. We stand ready to opportunistically take advantage of the capital markets through our allocations as these and other dynamics affect risk-adjusted expected returns. The world remains a remorselessly complicated read and as a result our humility is never far from the process. Hubris is ignorance and is short lived. Our decision process is always based within a long-term investment context. Our products have been designed that way. We recognize that many investment decisions are made more on the “what have you done for me lately?” mindset. We are not of that ilk and never will be. We are grateful to all of our investors for showing the continued confidence in our expertise. Rest assured that we don’t take this responsibility lightly and that it is with a historically validated conviction that we will serve you well over the long term.

Gerald Buetow is Chief Investment Officer of Innealta Capital. Innealta Capital is a quantitative asset management firm specializing in the tactical management of Exchange Traded Fund (ETF) portfolios. 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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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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