Innealta
CAPITAL

COMMENTARY: SEPTEMBER 3, 2015

VOLATILITY REALIZED

Capital markets have become increasingly agitated over the past few weeks on expanding insecurities in regard to global macroeconomic growth and the ability of global monetary policy to support it. Investors seem to be concerned that the slowdown in China has proved materially more negative than officials have yet to admit. These fears have transmitted almost indiscriminately to markets perceived to be leveraged to global macro growth, with commodity-, manufacturing- and trade-dependent equities most particularly affected. The upshot is that the Investment Committee remains cognizant that these fears may deepen and multiply. Even so, the long decline in certain equity markets, developing in particular, has resulted in further differentiation in equity valuations, such that the team expects additional tactical opportunities to arise in the near future. Meantime, present portfolio holdings remain top-of-mind, with the Committee ready to alter exposures as assessments of risk/return prospects evolve.

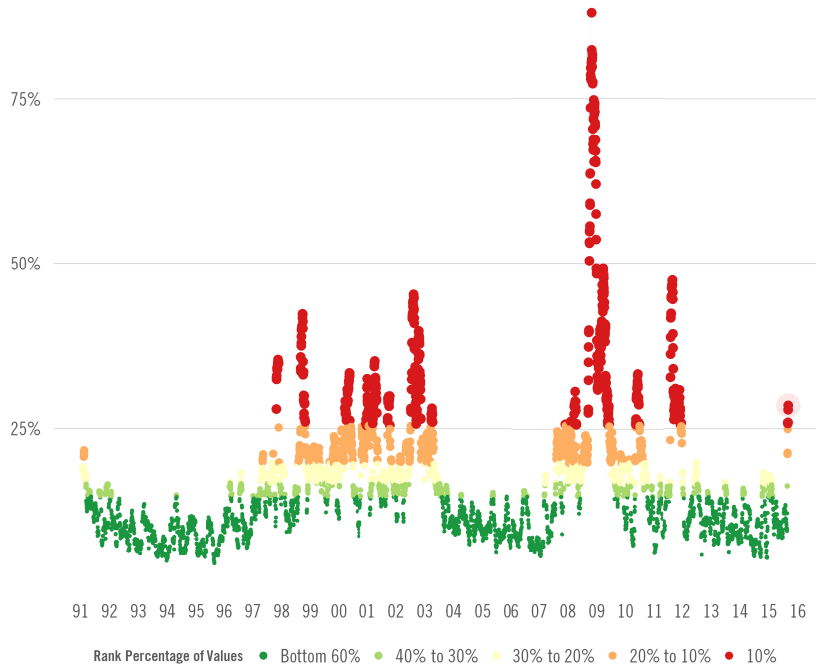
U.S. MARKET JOINS IN

While we have been experiencing heightened realized volatility in emerging markets and developed markets outside of the United States for some time now, the past three weeks are the first real expression of volatility we have seen in the U.S. since December 2011. Figure 1 shows daily realized 22-day volatility values from February 2, 1991 to August 28, 2015; we assigned colors to the days when realized volatility fell into the one of the four highest-volatility buckets. As can been seen in the latest values, realized volatility over the past month is among the top 10% of values of that time period.

FIGURE 1

Trailing Realized 22-Day Volatility of S&P 500 Daily Returns

From 12.31.90 to 09.03.15. SOURCE: Innealta Capital using data from Bloomberg

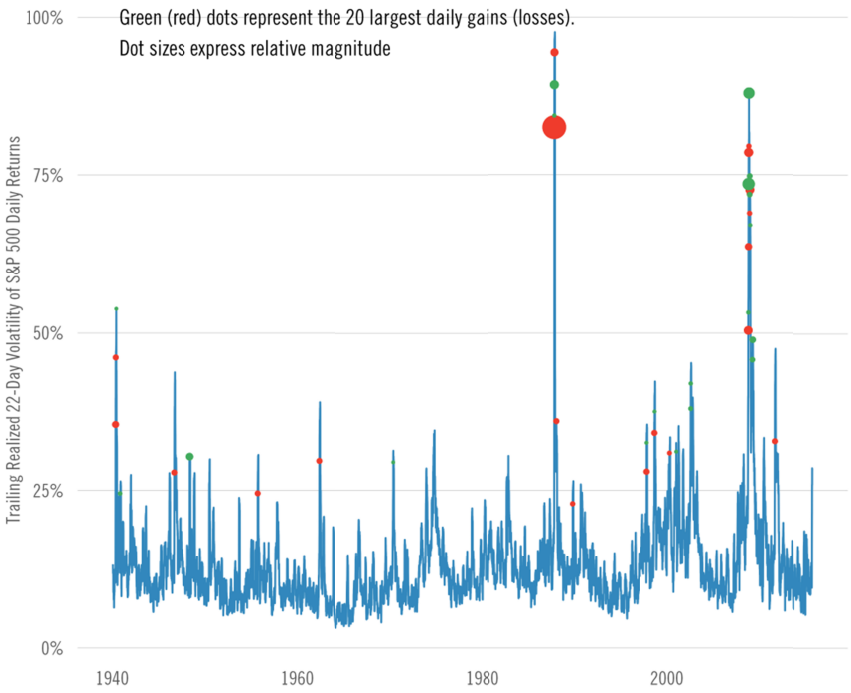


Not surprisingly, periods of heightened volatility carry with them most of the worst daily losses for major market indices. Similarly, the same high volatility periods include the best daily gains. Figure 2 shows trailing realized daily volatility, along with the series of 20 best and worst daily returns from January 1940 to August 2015. We can observe from Figure 2 that large gains and losses are clustered within the most volatile periods, with few big gains showing up without large losses nearby. But, the chance of missing both the best and the worst days is slim, such that the better option is to sidestep the tumult to the extent possible.

FIGURE 2

Realized Volatility and the 20 Largest Daily Gains and Losses

From 01.31.40 to 09.03.15. SOURCE: Innealta Capital using data from Bloomberg



Volatility is a powerful driver of fear, with heightened fear, in turn, potentially expressed in further volatility. With fear and volatility currently roiling, the Innealta Investment Committee remains vigilant to the potential for an even larger dislocation. The team is mindful that neither fear nor volatility in the aggregate should, by themselves, alter the evaluation of the inherent value in the specific allocations presently included in our portfolios. Their effects do, though, animate the discussion in ways that force greater emphasis on near-term risk vis-à-vis long-term risk-relative return potential. And, to the extent that we see risk gauges within the framework also deteriorating, the team will be quick to alter exposures as a result.

The Committee has sought to infuse such observations in recent client consultations. Though broadly light in our exposure to beta, many of the equity exposures in our Rotation Portfolios have weighted portfolio performance in the recent period. Our Investment Committee remains vigilant to the range of pressures these exposures will continue to face. While forces specific to individual exposures and more broadly facing the portfolio remain top of mind, the team continues to retain a favorable view toward all allocations within the portfolios. Focusing in on the Country Rotation Portfolio, we will share some higher-level observations is support of present positioning.

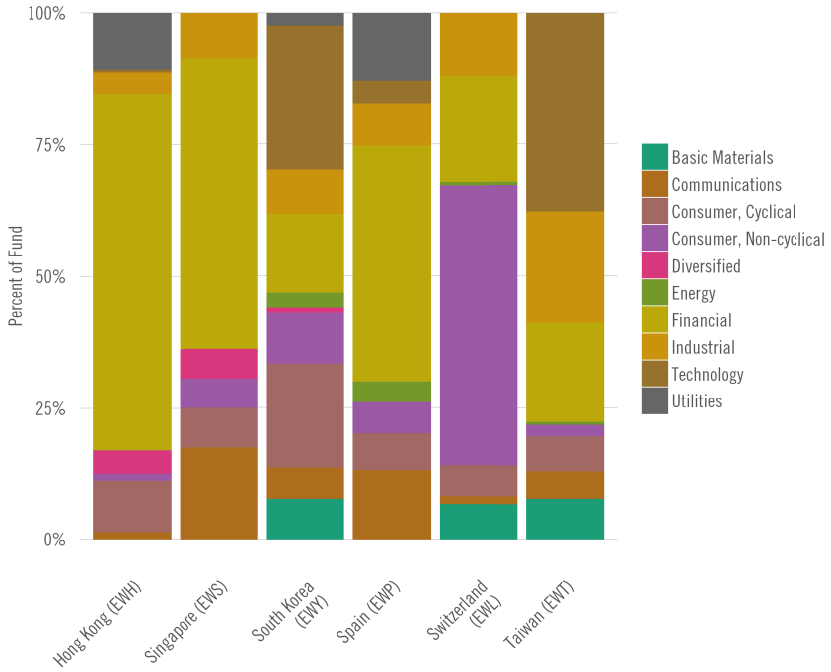
COUNTRY ROTATION PORTFOLIO POSITIONING

The Country Rotation Portfolio maintains a 30% exposure to equity in the aggregate, including four developed-market (Hong Kong, Singapore, Spain and Switzerland) and two developing-market[1] exposures (South Korea and Taiwan). At first glance, one notices a strong South East Asian component to the portfolio. Nonetheless, the exposures in the Country Rotation Portfolio are similar far more by their location on the globe than they are by their fundamental characteristics. A review of the sector exposures, for example, gives a glimpse of what we mean. Figure 3 shows the sector breakout of the individual holdings of all equity ETFs presently within the portfolio.

FIGURE 3

Country Rotation Portfolio Equity Sector Breakout

As of 09.03.15. Excludes minor amounts categorized as "Government." SOURCE: Innealta Capital using data from Bloomberg



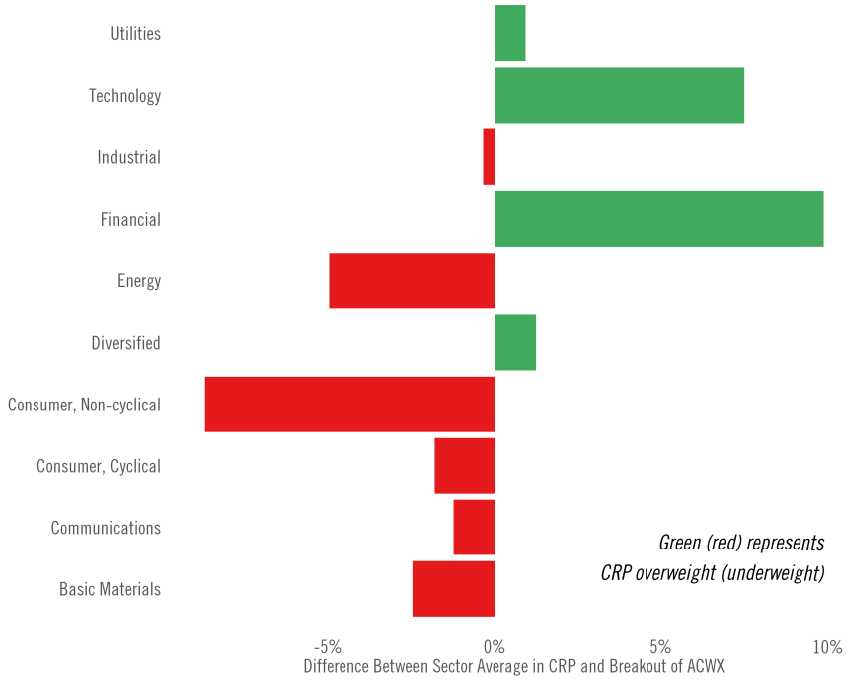
It is difficult to quantify indirect exposures to various sectors in such a review as the process only collates individual companies into one specific sector. Nonetheless, with the range of sector exposures a prime factor in gauging overall diversification, the portfolio scores relatively well here. Figure 4 shows a comparison of the average sector exposure in our portfolio to that of the iShares MSCI All Country World Index ex-U.S. ETF. Comparing those two sets of portfolio weights, our Country Rotation portfolio shifts a heavier Consumer exposure to Financials and Technology, otherwise showing more even weights among the other sectors. The heavier Financials component suggests a stronger link between the indices and the broader country economies they reflect. Even so, notable in the portfolio is the relatively underweight to the Basic Materials and Energy sectors, on which the declines in commodities markets, oil in particular, clearly have had a negative impact.

[1] Per index provider MSCI; fellow provider FTSE considers South Korea a developed economy.

FIGURE 4

Equity Sector Breakout: CRP Average, Vs. All-Country ex. U.S. ETF

As of 09.03.15. Excludes minor amounts categorized as "Government." SOURCE: Innealta Capital using data from Bloomberg



Correlations across Countries

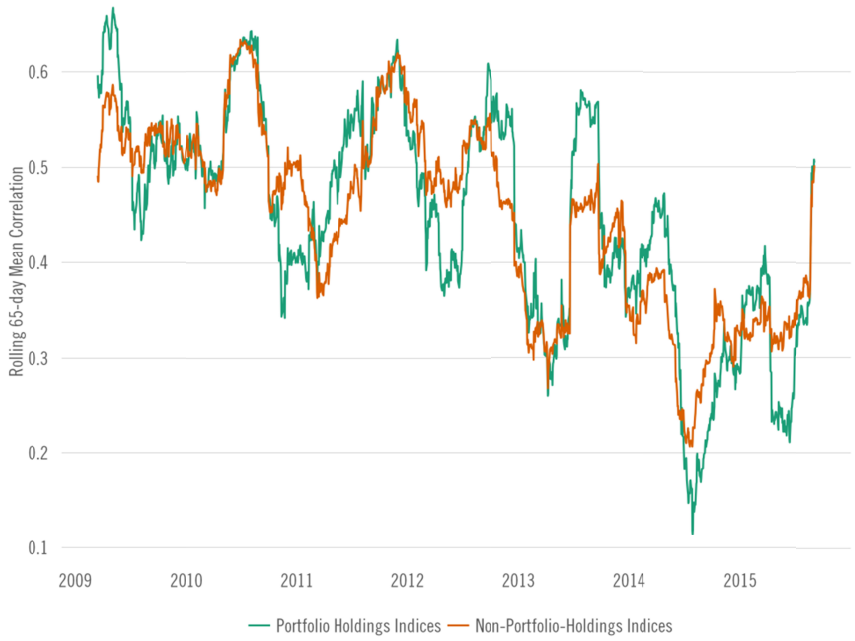
A relatively simple review of mean correlations among portfolio exposures provides an additional take on their diversity. We looked at two sets of indices underlying the ETFs in the CRP opportunity set: those we presently own and those we do not. In Figure 5, we plot the rolling 65-day average values of the correlations among the indices[2] in each basket.

[2] For each group of indices, we calculated the mean of the pairwise values from a correlation matrix of daily returns for each trailing 65-day period. The daily series of those values are charted in Figure 5.

FIGURE 5

Index Group Rolling 65-Day Mean Correlations

From 03.16.09 to 09.03.15. Indices are those relevant to the ETFs in the Country Rotation investment opportunity set. Non-portfolio holdings presently include: Australia, Austria, Belgium, Brazil, Canada, Chile, China, Colombia, Egypt, France, Germany, India, Indonesia, Israel, Italy, Japan, Malaysia, Mexico, Netherlands, Peru, Philippines, Poland, Russia, South Africa, Sweden, Thailand, Turkey and United Kingdom. Portfolio holdings presently include: Hong Kong, Singapore, South Korea, Spain, Switzerland and Taiwan. SOURCE: Innealta Capital using data from Bloomberg



Upon visual inspection, the average rolling correlation among the group of portfolio holdings is not systematically or otherwise substantially different than those exposures in the opportunity set that we presently do not own in the Country Rotation Portfolio.

CLOSING

Innealta's Investment Committee remains confident in present positioning even as many have suffered negative shifts in investor sentiment; our portfolios would look broadly and specifically similar were we allocating these portfolios today. That is not to suggest, however, that our present takes are static ones. The team stands ready to adjust portfolio exposures to the extent additional data and detail warrant.

More broadly speaking, we believe too few capital market participants seem to be looking to macroeconomic growth as the answer to the disorder, instead seeking additional support from central banks. We already have heard calls for a domestic resumption of quantitative easing as a result of recent market turmoil. Only when markets come to the conclusion that these interventions are the very source of the present turmoil can we expect more rational assessments of inherent value to find broader acceptance.

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.

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.

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