



Innealta
CAPITAL



A message from our Sub-Advisor regarding the Sector and Country Rotation programs
July 2014 Commentary

UNFORTUNATE EMPHASIS ON BUBBLES

It seems not a day goes by that at least one of the major papers doesn't have a "is a bubble" or an "isn't a bubble" headline. From the *Financial Times* on 07.30, "Top-rated government bonds defy gravity; Yields are low and prices look frothy, but this is not a bubble." From *The New York Times* on 07.19, "In a Subprime Bubble for Used Cars, Borrowers Pay Sky-High Rates." And from the same pages earlier in the month, "Welcome to the Everything Boom, or Maybe the Everything Bubble."

Can't help but also highlight this one from *The Wall Street Journal* on 07.30 as well: "Novelty of Bubble Wrap Never Seems to Get Old."

NOVELTY OF BUBBLE RAP

The rampant focus on bubbles is unfortunate. The emphasis shifts to arguments over who's got the better team. The suggestion is that investors should make all-or-none bets on one asset class or another. It might make for dramatic TV, but the drama perpetuates analytical myopia that results in investment decisions and the portfolios they define being inconsiderate of—and therefore eventually blindsided by—unexpected outcomes.

OUR HOLISTIC APPROACH

It's rather more challenging to develop and employ the critical thinking necessary to rationally navigate portfolios over longer-term cycles in investable markets that have become so materially distorted from years of central bank intervention. But that's very specifically the nature and objective of the work of the Innealta Capital Investment Committee.

Our directive is to be proper stewards of the trust and funds our clients have placed with us. In following that directive, we employ methodologies that are comparative in nature, appreciating fixed income for its relative stability and income, while enabling opportunistic exposures to beta as those markets on a risk-conscious, case-by-case basis so warrant. Fundamental to that process is the disciplined application of a quantitative framework that properly evaluates the prospective risk-relative return characteristics of a range of asset classes to optimize portfolio exposures within the context of the investment policy statements of our strategies.

Critical to the understanding of that process, we have no *methodological bias* against specific asset classes, even though our portfolios at any given time may reflect an *investment bias* that favors specific exposures over others. Put another way, our analytics are very naturally neutral to their inputs and outputs, designed only to identify optimal risk-relative return opportunities at the individual asset class and portfolio levels. By design, our strategies employ myriad views on distinct beta markets, while encompassing the potential to maintain exposure to a very wide range of fixed income and other asset classes.

We also take great care in monitoring the evolution and interaction of risk and potential opportunity across all our strategies. As a result, our analytical efforts involve very regular reevaluation of all components of the investment opportunity set. In

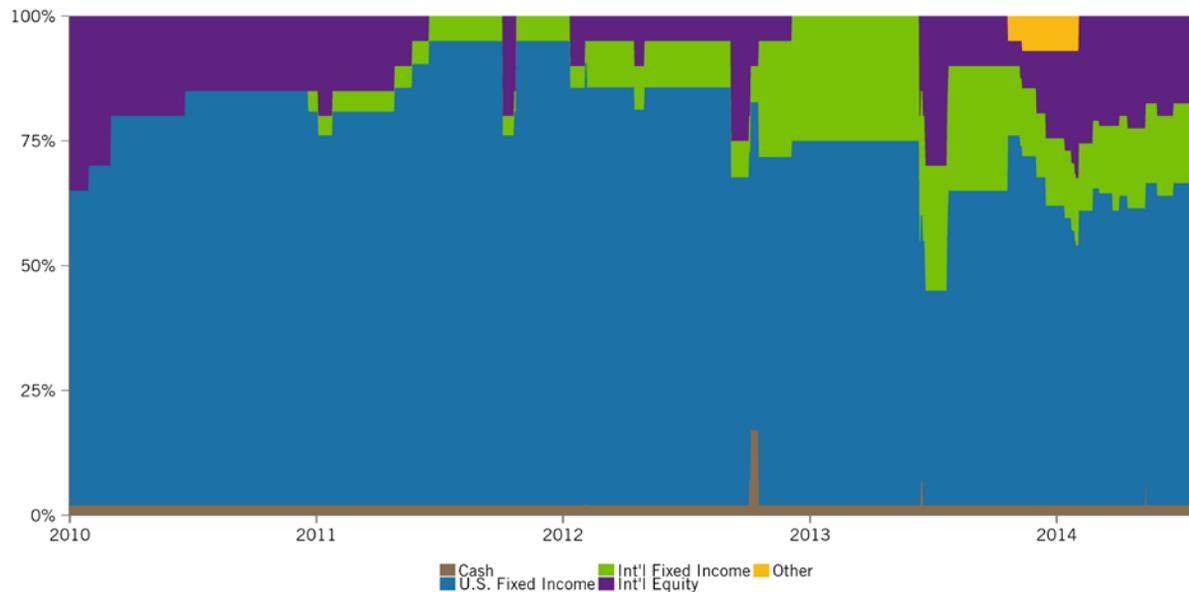
most cases, that means daily. Even more, the Investment Committee is free to act upon its interpretation of these analyses on a daily basis as well, thereby avoiding any arbitrary periodicity to portfolio decision making.

We also reserve the right to get smarter in our work. In that sense, the quantitative frameworks are evolving works in progress. A methodical, thoughtful evolution. The Committee augments and alters these frameworks to incorporate new opportunities as well. And our portfolios in many ways have benefitted from the rapid and extensive expansion in the exchange-traded fund landscape.

RECENT AND PRESENT POSITIONING

Over the past few years, our strategies have remained underweight beta relative to what we might consider their average expected allocations over longer-term horizons. These decisions have been based firmly on the Investment Committee's interpretation of the quantitative framework, which, again, is designed to identify strong fundamental and favorable valuation trends, within the context of affirmative risk, macroeconomic and technical trends. Put plainly, whether one looks at regional equity markets, or country- or sector-specific equity markets, such alignment has been missing from most beta markets for much of the past half-decade. Though that has been the norm, it is not the rule. Numerous tactical decisions within both Rotation Portfolios confirm as much. And the first half of 2014 has proved even a bit more active on the tactical front in both Rotation Portfolios.

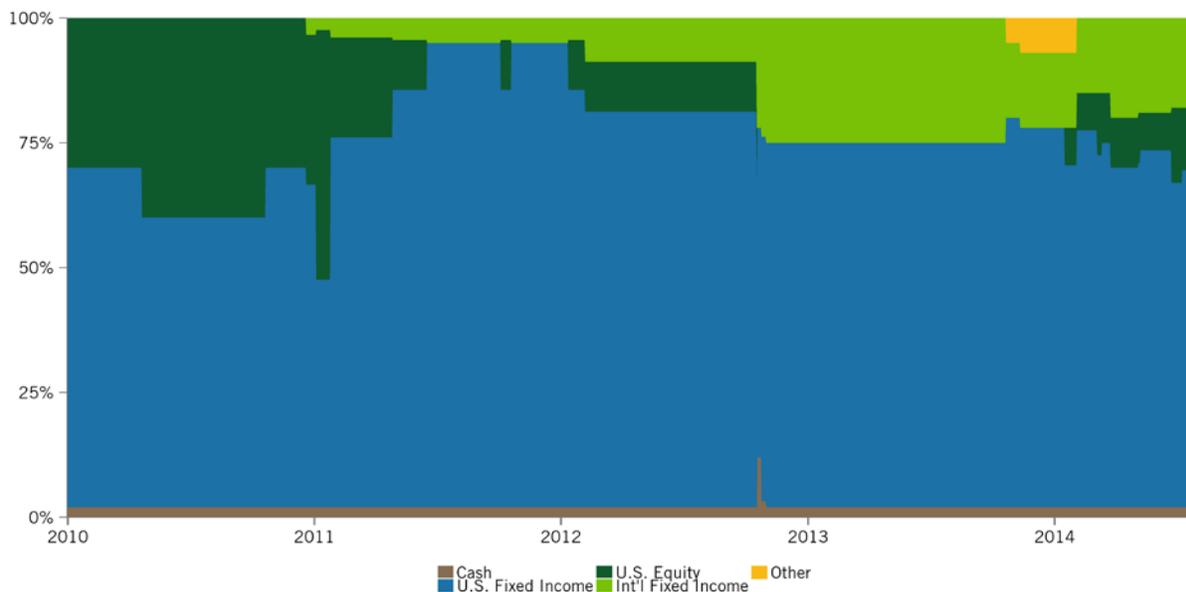
Figure 1: Country Rotation Portfolio Exposures



From 12.31.09 to 07.31.14. Data on this page are derived from composites of portfolios managed directly by Innealta Capital. Holdings and performance data of those portfolios managed and/or otherwise traded by partners of Innealta Capital may differ greatly from these data. SOURCE: Innealta Capital

The Committee maintains careful watch of all existing potential beta exposures, while engaging regular, comprehensive reviews of fixed income allocations and opportunities. As we head further into 2014, with the end of QE tapering near and the market's focus turning increasingly to rising interest rates, we foresee tactical opportunities becoming more frequent as risk-market volatility rises. Meantime, to the extent any more rapid shifts in the term structure create opportunity to alter fixed exposures to a more optimal yield/duration dynamic, the Investment Committee stands ready to do so.

Figure 2: Sector Rotation Portfolio Exposures



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ON RUSSIA

Always, one should seek to balance individual opportunities against the range of potential risks they present, collating those opportunities into portfolios designed to dilute those risks through diversification. This is the very essence of the work we do at Innealta.

Of the risks the Investment Committee considers in the investment process, geopolitical risks tend to present the most challenges, not the least of which is the fact that they, by definition, exist outside of the firm's quantitative framework. However, the team regularly details and discusses the potential ramifications of geopolitical risks, and seeks to adapt portfolio exposures to reflect the team's assessments of the markets' views on such risks.

On specific geopolitical risk exposure that is top-of-mind for the Investment Committee is the ongoing ownership of Russian fixed income and equity securities. Just this week, the European Union and the United States amped the pressure on Russia to effectively cease and desist in Ukraine via sanctions much more specifically intended to have a broader macroeconomic impact than prior efforts to incite a Russian pullback. The team's view is that these sanctions reflect the West's still relatively weak offense—they might hurt a little, but they're unlikely to hurt a lot—and that the Russian equity market, nonetheless, reflects unduly pessimistic outlooks for what in the end are feeble restrictions. As it stands, the balance of reviews remains for the time being in favor of continued holding of the Russia exposures.

Relevant risk factors remain in flux as governments enact these measures to pressure Putin to forgo any additional designs on Ukraine. With history as a guide, what's almost assuredly unlikely is that matters within Ukraine will soon find an orderly resolution. The review of the evolving scenario remains at the forefront of Investment Committee discussions.

IMPORTANT INFORMATION

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Any investment is subject to risk. Exchange traded funds (ETFs) are subject to risks similar to those of stocks, such as market risk, and investors that have their funds invested in accordance with the portfolios may experience losses. Additionally, fixed income (bond) ETFs are subject to interest rate risk which is the risk that debt securities in a portfolio will decline in value because of increases in market interest rates. The value of an investment and the return on invested capital will fluctuate over time and, when sold or redeemed, may be worth less than its original cost. This material is not intended as and should not be used to provide investment advice and is not an offer to sell a security or a solicitation or an offer, or a recommendation, to buy a security. Investors should consult with an investment advisor to determine the appropriate investment vehicle. Investment decisions should be made based on the investor's specific financial needs and objectives, goals, time horizon and risk tolerance. All opinions and views constitute our judgments as of the date of writing and are subject to change at any time without notice.

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 exchange-traded fund 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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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.

Contact your financial advisor for additional information.

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