

March 2018 Commentary and Strategy Review

About the Strategy

The Fixed Income Portfolio ("FI") provides market exposure across various sectors within global fixed income via exchange-traded funds. Innealta's Investment Team manages the FI strategy relative to the Bloomberg Barclays U.S. Aggregate Bond index. Innealta Capital utilizes a proprietary quantitative framework that combines traditional corporate fundamental, macroeconomic and behavioral data to produce risk and return forecasts. The Investment Team then employs those forecasts, along with trading optimization techniques and portfolio design research, to create a unique portfolio, that, in our opinion, best suits a client's risk-adjusted goals within the fixed income space.

Outlook

Starting in March, financial markets experienced their first challenge to the prevailing market expectation that above-average and improving macroeconomic growth was a guarantee. In late February, U.S. President Donald Trump hinted at issuing tariffs on imported aluminum and steel (10% and 25%, respectively). Retaliation threats were issued by China and the European Union. The order that put them into effect was signed on March 8th, with an important caveat: many countries were, at least temporarily, exempted (e.g., Canada, Mexico, Brazil, and the entire EU), with the notable exception of China. Then on March 22nd, President Trump announced tariffs across a broad spectrum of Chinese goods, asking that China reduce its annual trade deficit with the U.S. by \$100 billion. At first, it was only known that imports worth \$60 billion would be taxed, and the list of specific goods was not released until more than a week later. In the meantime, stocks of likely targets for retaliation lost significant value (e.g., Boeing). As a tax on either imports, or exports, or both, tariffs are likely to decrease actual and expected macroeconomic growth. Moreover, the rhetoric on both sides has unleashed fears of a prolonged trade war.

During March, the multiple announcements of tariffs from the U.S. and other countries created a drag on risky markets, and increased overall levels of market volatility, both implied and realized. During March, the S&P 500 declined 2.69%, while the CBOE VIX index rose from 19.85 to 19.97. The VIX however remains above its 2017 average level of 11.09. The most significant potential global trade strain would be between the United States and China. Estimating the global impact of a trade war with China and other countries is beyond the scope of this paper. What is clear is that a trade war between the US and its top trading partners – China, Canada, and Mexico – could impact over 60% of U.S. trade, which accounted for 27% of the U.S. Gross Domestic Product in 2016 (World Bank). From a Chinese perspective, exports to the U.S. represent 20% of their exports, but the surplus with the U.S. – estimated to be \$375 billion by the Commerce Department – accounts for 65% of their overall trade surplus. Chinese trade represented 37% of China's Gross Domestic Product in 2016 (World Bank).

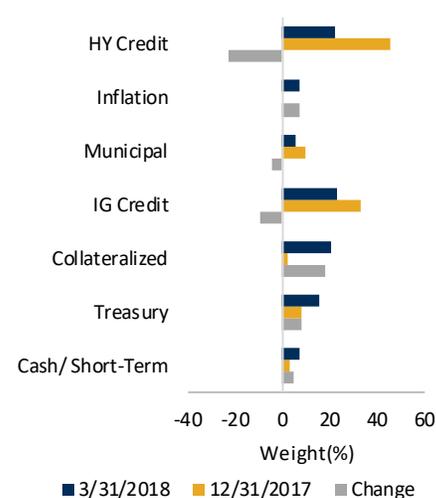
In the current environment, we anticipate headline risk (i.e. new announcements) around trade to dominate the market's focus. During April we expect that various macroeconomic surveys and behavioral data will provide more insight on whether macroeconomic growth will decline, or the market will revert to previous sustained growth expectations. Between now and then, we expect elevated market volatility to persist and, as such, are positioning our portfolios in a more defensive posture.

Strategy Statistics

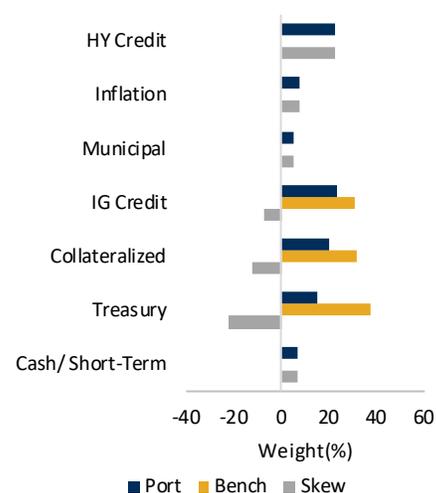
	Port	Benchmark
Alpha (%)	0.03	0.0
Beta (%)	0.8	1.0
R-Squared (%)	44.4	100.0
Std.Dev (%)	3.35	2.78

Source: Innealta Capital using data from Bloomberg. Data from 12.31.2009 to 03.31.2018. Benchmark represents the Bloomberg Barclays U.S. Aggregate Bond Index. Inception date for the portfolio is December 31, 2009.

Portfolio Changes



Portfolio Skews



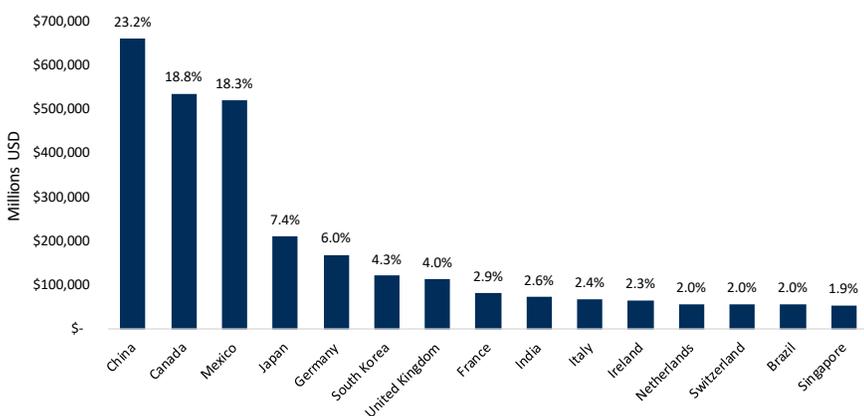
SOURCE: Innealta Capital using data from Innealta Capital as of 03.31.2018

Performance

Concerns about a global trade war and pace of potential U.S. Federal Reserve rate hikes increased financial market volatility. Unlike February, when inflation concerns created negative performance across fixed income, March's volatility exhibited a flight-to-quality behavior. Longer-dated Treasuries and local-currency Emerging Market debt were the top performers while EM High Yield and Floating Rate debt were the bottom performers. Investors did not simply buy duration as U.S. Investment Grade, which has a duration like U.S. ten-year treasuries underperformed. During the month, the Bloomberg Barclays U.S. Aggregate Bond index returned 0.64% while the Innealta Capital Fixed Income portfolio returned 0.45% net of fees.

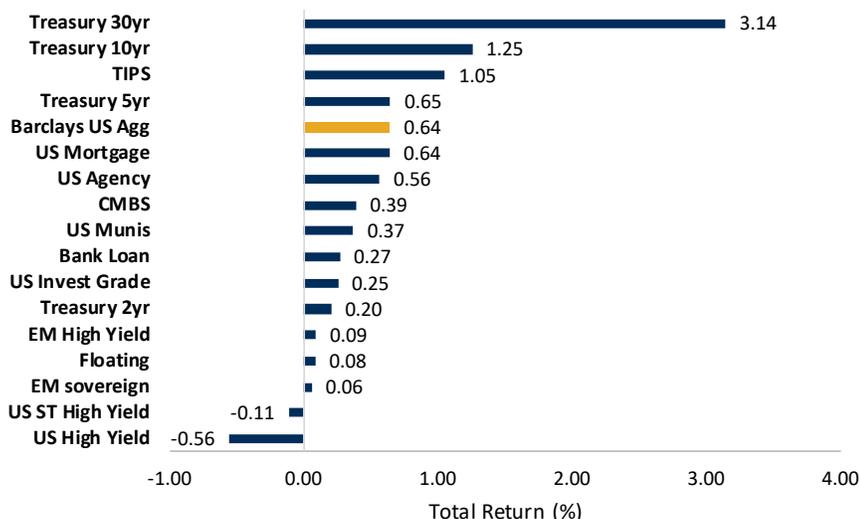
Overall the Investment Committee ("IC") believes that future macroeconomic growth will be positive, which should benefit more credit-sensitive assets, however we acknowledge that the improvement pace of growth is slowing. As such, the IC elected to reduce the amount of credit-sensitive assets within the portfolio. Specifically, the IC reduced holdings in U.S. High Yield, dollar-denominated Emerging Market sovereign debt, and Emerging Market High Yield. The IC increased positions in short-dated treasuries and related debt. The portfolio continues to have overweight allocations to credit sensitive debt, municipal debt and inflation-protected debt.

FIGURE 1: Top U.S. Trading Partners



SOURCE: Innealta Capital using data from Bloomberg as of 12.31.2017.

FIGURE 2: Benchmark Performance, Trailing 1-Month



SOURCE: Innealta Capital using data from 02.28.2018 to 03.31.2018 from Bloomberg.

Top Contributors

- iShares Barclays 20+ Year Treasury Bond (TLT)
- VanEck Vectors EM Local Currency Bond (EMLC)

Bottom Contributors

- VanEck Vectors EM High Yield Bond (HYEM)
- iShares Floating Rate Note (FLOT)

SOURCE: Innealta Capital using Innealta Capital data from 02.28.2018 to 03.31.2018.

Strategy Performance

	Gross (%)	Net (%)	Benchmark(%)
1-Month	0.46	0.45	0.64
3-Month	-1.92	-2.11	-1.46
YTD	-1.92	-2.11	-1.46
1-Year	1.32	0.46	1.2
3-Year	0.95	0.14	1.2
5-Year	0.81	0.04	1.82
Inception	3.36	2.71	3.32

SOURCE: Innealta Capital using data as of 03.31.2018. Benchmark is the Bloomberg Barclays U.S. Aggregate Bond Index. Inception date for the portfolio is December 31, 2009.

Disclosures & Important Information

The U.S. Dollar is the currency used to express performance. The strategy includes portfolios charged bundled or wrap fees and portfolios charged transaction fees or trading costs. Bundled fee portfolios pay a fee based on a percentage of assets under management in place of a transaction fee. They include the advisor's fee and, in most cases, also include a fee for investment management and portfolio monitoring. Live returns are presented net of management fees, gross of withholding taxes on any dividends, interest or capital gains, and include the effects of trading costs and reinvestment of all income. Net of fee performance was calculated using actual management fees charged to the client. Gross returns are shown as supplemental information, include the effects of the reinvestment of all income, and are stated gross of all fees except for transaction fees, when charged.

Past performance is no guarantee of future results.

Investing involves risk, principal loss is possible, and there can be no assurance that investment objectives will be achieved. Past performance is not indicative of future results. Exchange traded funds (ETFs) are subject to risks similar to those of stocks, such as market risk, and investors who 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. Investments in foreign investments may incur greater risks than domestic investments. For more information on the risks associated with investment in ETFs, please refer to AFAM Capital's Form ADV Part 2A.

Policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request. Actual investment management fees will vary, beginning at 1.5% per annum. Our full management fee schedule is described in more detail in AFAM's Form ADV Part 2A.

Alpha is a measure of the difference between a portfolio's actual returns and its expected performance, given its level of risk as measured by beta. **Beta** is a measure of volatility, or systematic risk, of a portfolio in comparison to a benchmark. A beta greater than one indicates more volatility, while a beta less than one indicates less volatility than the relevant benchmark. **Annualized Standard Deviation** is a measure of the dispersion of investment returns from the mean. A higher standard deviation indicates higher volatility. **R Squared** is a measure of how close the relationship is between a portfolio and its benchmark.

For comparison purposes, the strategy is measured against the Bloomberg Barclays US Aggregate Bond Index.

"Barclays Agg" refers to **The Bloomberg Barclays US Aggregate Bond Index** which is representative of the entire universe of taxable fixed-income investments. It includes issues of the US Government and any agency thereof, corporate issues of investment grade quality (Baa/BBB or better), and mortgage-backed securities. "Treasury 2yr" refers to the **The Merrill Lynch 2-year U.S. Treasury Futures Total Return Index** which measures the performance of a fully collateralized rolling 2-year U.S. Treasury futures position. "Treasury 5yr" refers to **The Merrill Lynch 5-year U.S. Treasury Futures Total Return Index** which measures the performance of a fully collateralized rolling 5-year U.S. Treasury futures position. "Treasury 10yr" refers to **The Merrill Lynch 10-year U.S. Treasury Futures Total Return Index** which measures the performance of a fully collateralized rolling 10-year U.S. Treasury futures position. "Treasury 30yr" refers to **The Merrill Lynch 30-year U.S. Treasury Futures Total Return Index** which measures the performance of a fully collateralized rolling 30-year U.S. Treasury futures position. "US High Yield" refers to **The iBoxx USD Liquid High Yield Index** which is an index composed of U.S. dollar-denominated, investment-grade corporate bonds. "TIPS" refers to **The Bloomberg Barclays US Treasury Inflation Notes TR Index Value Unhedged USD Index** which consists of inflation-protection securities issued by the US Treasury. They must have at least one year until final maturity and at least \$250 million par amount outstanding. They are rated investment grade by at least two of the following rating agencies: Moody's, S&P, Fitch. They must be fixed rate, dollar denominated and non convertible. "US Munis" refers to **The S&P Municipal Bond Index** which is a broad market value weighted index that seeks to measure the U.S. municipal bond market. "US Invest Grade" refers to **The iBoxx Investment Grade Index**, which is composed of U.S. dollar-denominated, investment-grade corporate bonds. "US Mortgage" refers to **Bloomberg Barclays US MBS Index Total Return Value Unhedged USD**, which measures the performance of investment grade fixed-rate mortgage-backed pass through securities of GNMA, FNMA, and FHLMC. "US Agency" refers to the **Barclays U.S. Agency Index**, which measures performance of callable and non-callable agency securities issued by US government agencies, quasi-federal corporations, and corporate or foreign debt guaranteed by the U.S. government. "EM sovereign" refers to the **JPMorgan EMBI Global Core Index**, which measures a broad, diverse U.S. dollar denominated emerging market debt instruments. EM High Yield" refers to the **Morningstar Emerging Markets High Yield Bond Index**, which tracks the performance of the below-investment grade U.S. dollar denominated emerging market sovereign and corporate bond market. "Bank Loan" refers to the **S&P/LSTA U.S. Leveraged Loan 100 Index**, which measures the performance of the largest facilities in the leveraged loan market. "CMBS" refers to the **Bloomberg Barclays U.S. CMBS Investment Grade Index**, which measures the market of conduit and fusion CMBS deals with a minimum current deal size of \$300 million. "Floating" refers to the **Bloomberg Barclays US FRN <5 Years Index**, which is a subset of the US Floating-Rate Note (FRN) Index, which measures the performance of USD denominated, investment grade, floating-rate notes across. "US ST High Yield" refers to the **Markit iBoxx USD Liquid High Yield 0-5 Capped Index** which tracks exposure to liquid high yield corporate bonds maturing between 0 and 5 years. "US 5yr BE, US 10yr BE, and US 30yr BE" refers to the **US Breakeven Indices**, which measure the breakeven inflation rate by subtracting the real yield of the inflation linked maturity curve from the yield of the closest nominal Treasury maturity. The result is the implied inflation rate for the term of the stated maturity.

Innealta Capital is a division of AFAM Capital, Inc., a Registered Investment Advisor to individually managed client accounts and certain mutual funds. The firm only transacts business in states where it is properly registered or exempt from registration. Registration of an investment adviser does not imply any certain level of skill or training.

It is not possible to invest directly in an index. Blended benchmarks are calculated daily and rebalanced quarterly.

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