

February 2018 Commentary and Strategy Review

About the Strategy

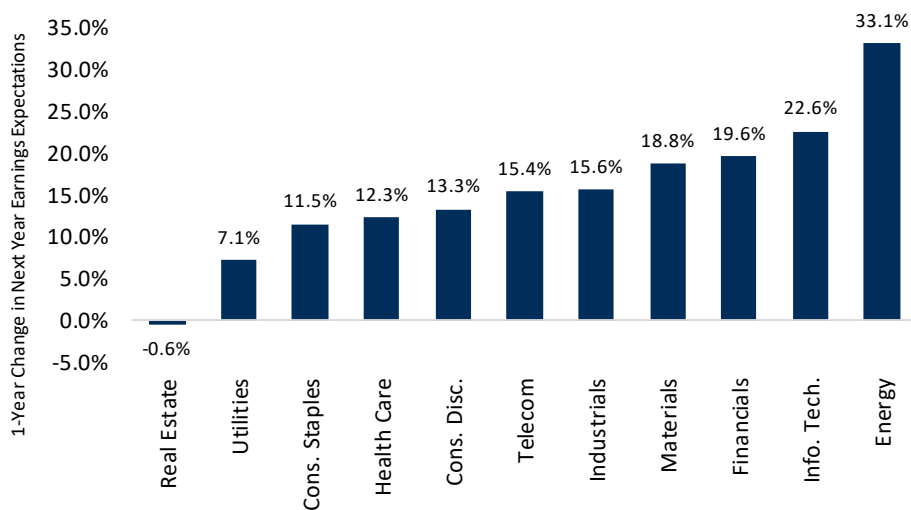
The Sector Rotation Portfolio (“SRP”) provides market exposure across U.S. equities and U.S. fixed income via exchange-traded funds. Innealta’s Investment Team manages the SRP strategy to a balanced benchmark of 70% S&P 500 Index and 30% Bloomberg Barclays U.S. Aggregate Bond Index. This benchmark reflects the average desired weight of equity and fixed income investments through a business cycle. 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 U.S. equity and U.S. fixed income.

Outlook

Within the U.S. equity opportunity set, we remain cautiously optimistic and believe that certain sectors show increasing potential relative to others based on various behavioral, macroeconomic, and corporate fundamental drivers. The increased volatility observed during February has not changed our core thesis within the U.S. equity markets. Domestic equity valuations remain elevated relative to history and monetary policy is expected to continue to tighten. Consumer and manufacturing sentiment indicators remain high but have recently slowed.

The one major positive within U.S. equity markets has been earnings growth. According to FactSet, the Q4 2017 blended earnings growth rate for the S&P 500 is 14.8%. Assuming this value does not change, it would constitute the highest earnings growth rate since Q3 2011. Across sectors, the Energy sector exhibited the highest actual growth rate. The “Chart of the Month” tabulates earnings expectations by calculating the one-year change in the one-year forward earnings across sectors. Again, the Energy sector is the top ranked sector with Technology and Financials coming in at second and third. We maintain a favorable overweight in the Energy sector due to improving earnings, lower relative valuations, and rising commodity prices.

Chart of the Month



SOURCE: Innealta Capital using Bloomberg data as of 02.28.2018

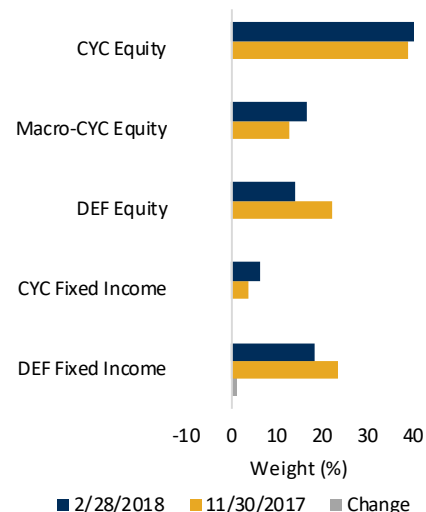
The chart above displays the 1-year change in expected 1-year forward earnings of individual GICS sector indices of the S&P 500 as of 02.28.2018

Strategy Statistics

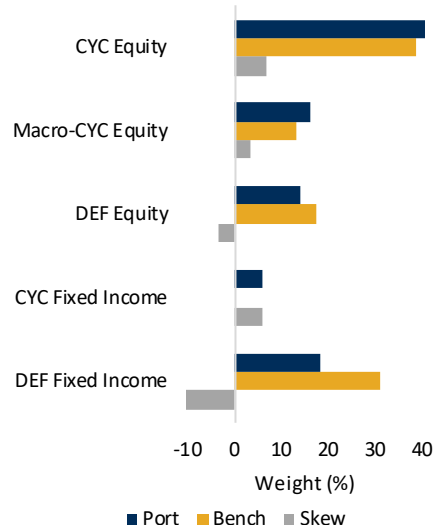
	Port	Benchmark
Alpha	0.46	0.00
Beta	0.39	1.00
R-Squared	0.45	1.00
Std. Dev.	4.86	8.25

Source: Innealta Capital using data as from Bloomberg. Data from 12.31.2009 to 02.28.2018. Benchmark represents a 70/30 blend of the S&P 500 TR Index and the Bloomberg Barclays Capital 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 and Bloomberg as of 02.28.2018

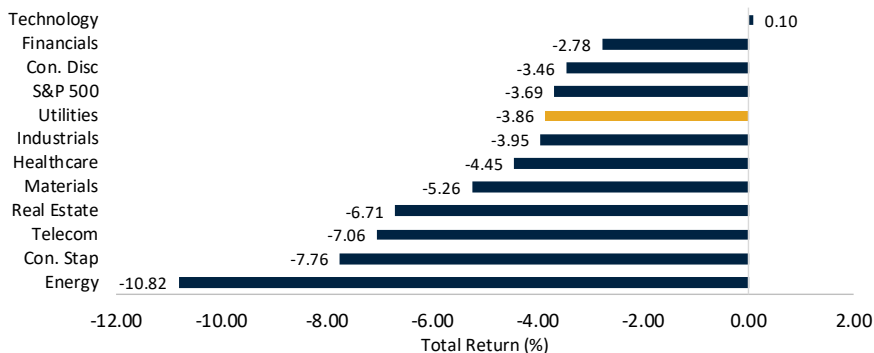
Performance

The S&P 500 snapped a fifteen-month win streak returning -3.69% during February. This marked the first month of negative performance since October 2016 and the largest monthly loss since January 2016. At the start of the month, concerns around rising inflation and rising U.S. treasury yields dominated headlines. Then on February 8th, the market became increasingly concerned about whether volatility ETFs that shorted VIX futures had unsustainable rebalance needs. That day the S&P 500 closed 3.74% down. Over the next few days as investors worked through the details of the short volatility ETF unwind, the S&P 500 recovered. Figure 2 below shows the changes in the CBOE Volatility Index (“VIX”) over the past year. Although this index experienced a significantly large increase during February, we anticipate that the Index will return to longer term averages (~16) and believe the change does not signal the onset of a bear market.

During February the Innealta Capital Sector Rotation Portfolio, on a gross-of-fees basis, returned -3.40% while the blended benchmark returned -2.90%. Allocations to floating rate bonds and short-maturity fixed income were the top two contributors to the portfolio’s performance. Allocations to the Energy sector and Consumer Staples sector were the top two detractors to the portfolio’s performance. The portfolio concluded the month with overweight allocations, relative to the benchmark, in Cyclical fixed income, Cyclical equities, and Macro-cyclical equities, while underweight allocations in Defensive equities and Defensive fixed income.

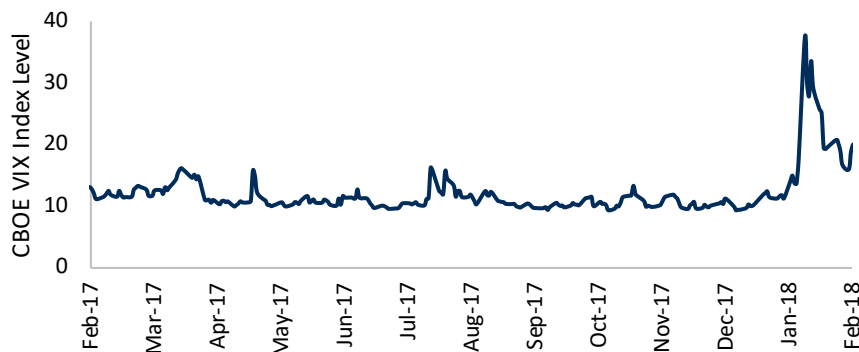
On 02.16.2018, the portfolio rebalanced to reflect the changing market conditions. Overall the portfolio continues to reflect the investment team’s view of continued global reflation. At the aggregate level, the overall amount of equity increased by 3.25%. Allocations to fixed income partially shifted from fixed rate to floating rate sectors. A more detailed note explaining the investment team’s rationale can be found [here](#).

FIGURE 1: Benchmark Performance, Trailing 1-Month



SOURCE: Innealta Capital using Bloomberg data from 01.31.2018 to 02.28.2018

FIGURE 2: CBOE VIX Index, Trailing 12-Months



SOURCE: Innealta Capital using Bloomberg data from 02.28.2017 to 02.28.2018

Top Contributors

1. iShares Floating Rate Note ETF (FLOT)
2. First Trust Enhanced Short Maturity ETF (FTSM)

Bottom Contributors

1. Energy Select Sector SPDR (XLE)
2. Consumer Staples Select Sector SPDR (XLP)

SOURCE: Innealta Capital using Innealta Capital data from 01.31.2018 to 02.28.2018.

Strategy Performance

	Gross	Net	Benchmark
1-Month	-3.40	-3.43	-2.90
3-Month	0.98	0.65	1.58
YTD	0.06	-0.25	0.65
1-Year	9.90	8.41	11.93
3-Year	7.48	6.00	8.14
5-Year	5.10	3.57	10.78
Inception	6.21	4.80	10.82

SOURCE: Innealta Capital using data as of 02.28.2018. Benchmark represents a 70/30 blend of the S&P 500 TR Index and the Bloomberg Barclays Capital 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 composite is measured against a blended benchmark: 70% S&P 500 Index / 30% Bloomberg Barclays U.S. Aggregate Bond Index. **The S&P 500 Index** is a broad market sample based on the market capitalizations of 500 large companies having common stock listed on the NYSE or NASDAQ. **The Bloomberg Barclays US Aggregate Bond Index** 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. **The CBOE Volatility Index (VIX Index)** is a key measure of market expectations of near-term volatility conveyed by S&P 500 stock index option prices.

The "Benchmark Performance, Trailing 1-Month" chart contains return data for the individual S&P 500 sector indices as defined by GICS. Additional information can be found at <http://us.spindices.com/index-finder/?currentSearchCriteriaName=&AssetFamily=equity&query=energy&resultsPerPage=25>.

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

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.

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