Innealta Capital Sector Rotation Strategy

April 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.

Strategy Statistics

	Port	Benchmark
Alpha (%)	0.51	0.0
Beta (%)	0.4	1.0
R-Squared (%)	45.44	100.0
Std.Dev (%)	4.84	8.22

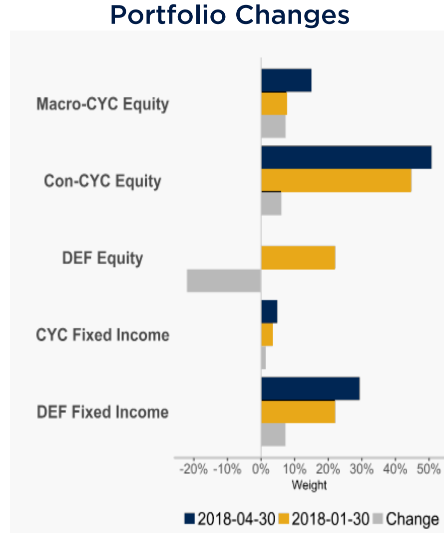
Source: Innealta Capital using data as from Bloomberg. Data from 12.31.2009 to 04.30.2018. Benchmark represents a 70/30 blend of the S&P 500 TR Index and the Bloomberg Barclays Capital U.S. Aggregate Bond Index. Inception date for the portfolio is December 31, 2009.

Outlook

During April, financial markets paused from the above average and increasing volatility that characterized the first three months of the year. Concerns around a full-scale trade war between the United States and China eased and the first few weeks of the earnings season showed better than expected growth in both sales and earnings. U.S. equities, as measured by the S&P 500, and International equities, as measured by the MSCI All Country World ex U.S. index ("ACWX"), appreciated by 0.38% and 1.60% respectively. The CBOE Volatility Index ("VIX"), a proxy for short-term financial market insurance demand, declined from 19.97 to 15.93. While shorter-dated option demand declined in April, demand for longer-dated options remains elevated and signals, at least in our opinion, the likelihood of elevated volatility over the next few months.

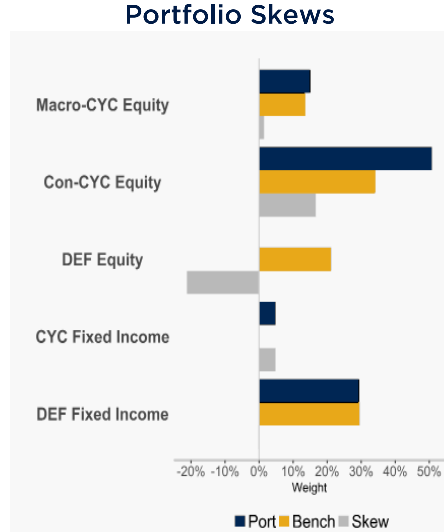
U.S. equity markets remain attractive, compared to U.S. Fixed Income. However, we continue to see a confluence of headwinds. What concerns us over the short-term is a slow-down in the macroeconomic growth indicators, short-dated fixed income markets that have not fully priced in tightening U.S. monetary policy, and a flattening yield curve. Despite U.S. equity earnings growing at a 20%+ year-over-year, we anticipate that elevated volatility and rising interest rates are likely to limit or even reduce equity multiples. Within our U.S. equity rotation strategies, we continue to overweight those sectors with higher earnings growth – Energy, Technology, and Financials – while respecting the higher volatility environment by lowering the strategy's overall expected volatility.

Portfolio Changes



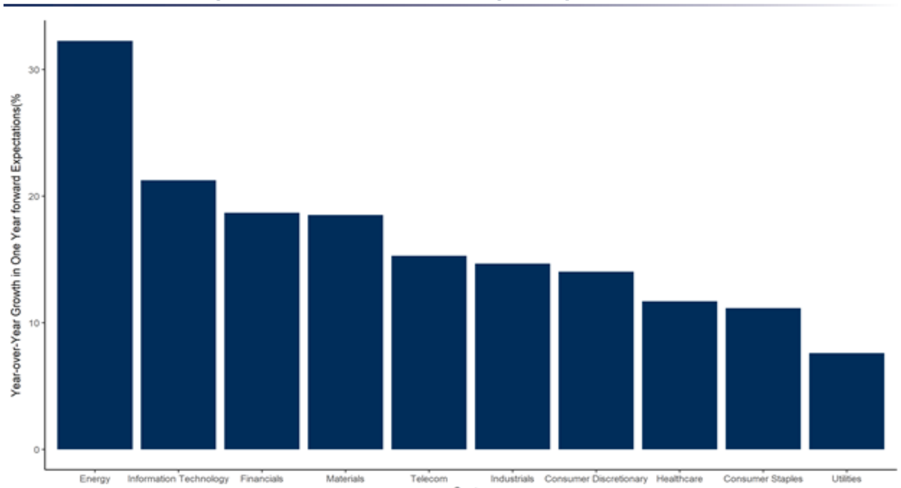
SOURCE: Innealta Capital using data from Innealta Capital and Bloomberg as of 04.30.2018.

Portfolio Skews



SOURCE: Innealta Capital using data from Innealta Capital and Bloomberg as of 04.30.2018.

FIGURE 1: Change in Forward Earnings Expectations



SOURCE: Innealta Capital using data from Bloomberg as of 04.30.2018.

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Performance

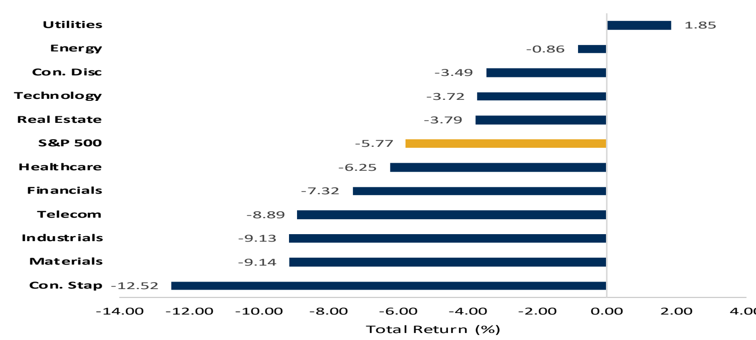
U.S. equity markets exhibited an increase in sector return dispersion despite volatility during April declining. The combination of higher oil prices, positive earnings surprise, and above expectations earnings growth were positive drivers to the Energy sector and helped to lift the April return of the sector to 9.36%. Similarly, unexpected negative earnings surprises weighed on the Consumer Staples and Industrials sectors as each returned -4.32% and -2.79% respectively during April.

During April, the Innealta Capital Sector Rotation Portfolio returned 1.37% gross of fees while its benchmark, the S&P 500, returned 0.38%. The portfolio benefitted from overweight allocations, relative to the benchmark, in the Energy and Consumer Discretionary sectors. The top contributors to the portfolio's performance were allocations to the Energy sector and the Consumer Discretionary sector while the top detractors to the portfolio's performance were allocations to the Consumer Staples sector and Financials.

On 04/24/2018, the Investment Committee rebalanced the portfolio to reflect the changing dynamics within the U.S. equity market. Overall the portfolio slightly decreased its fixed-income holdings (-2.0%) while increasing its equity holdings (+2.0%). We anticipate that the portfolio's expected volatility will remain the same because the rotation within the Fixed Income holdings was into less-risky sectors.
Within fixed-income, we continued to reduce overall duration risk while increasing floating rate risk. We did add slightly to the credit risk of the fixed-income holdings via an increase in bank loans. We continue to like the risk-reward characteristics of bank loans given the low default environment and rising LIBOR rates.

Within equities, we rotated the portfolio away from traditionally defensive sectors – healthcare, staples, and telecommunications – while increasing allocations to consumer-cyclical sectors – consumer discretionary, financials and technology. We continue to believe that those sectors where the expectations of future earnings are growing the most will exhibit above-average total return (See figure below).

FIGURE 2: Benchmark Performance, Trailing 3-Month



SOURCE: Innealta Capital using data from Bloomberg as of 01.31.2018 to 04.30.2018.

Top Contributors

1. Energy Select Sector SPDR ETF (XLE)
2. Consumer Discretionary Sector SPDR ETF (XLY)

Bottom Contributors

1. Consumer Staples Select SPDR ETF (XCP)
2. Financials Select Sector SPDR ETF (XLP)

SOURCE: Innealta Capital using Innealta Capital data from 03.31.2018 to 04.30.2018.

Strategy Performance

	Gross (%)	Net (%)	Benchmark(%)
1-Month	1.34	1.08	0.05
3-Month	-3.02	-3.35	-4.42
YTD	0.45	-0.17	-0.92
1-Year	9.85	8.4	9.07
3-Year	7.31	5.83	7.72
5-Year	4.91	3.42	9.48
Inception	6.13	4.71	10.38

SOURCE: Innealta Capital using data as of 04.30.2018. 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.

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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.*

DEF Fixed Income*: Defensive Fixed Income refers to any debt type contained within the Bloomberg Barclays U.S. Aggregate Bond or the Bloomberg Barclays Global Aggregate Bond index as well as inflation protected debt and municipal debt.* **CYC Fixed Income***: Cyclical Fixed Income refers to Emerging market debt, both USD and locally denominated, and U.S High Yield.* **DEF Equity***: Defensive Equity refers to the Healthcare, Consumer Staples, Utilities, and Real Estate sectors.* **Con-CYC Equity***: Consumer -Cyclical Equity refers to the Consumer Discretionary, Information Technology, Telecom, and Financials sectors.* **Macro-CYC Equity***: Macro-Cyclical Equity refers to the Energy, Materials, and Industrials sectors.*

*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.

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