Innealta Capital

Innealta Capital Sector Rotation Strategy

May 2018 Commentary and Strategy Review

About the Strategy

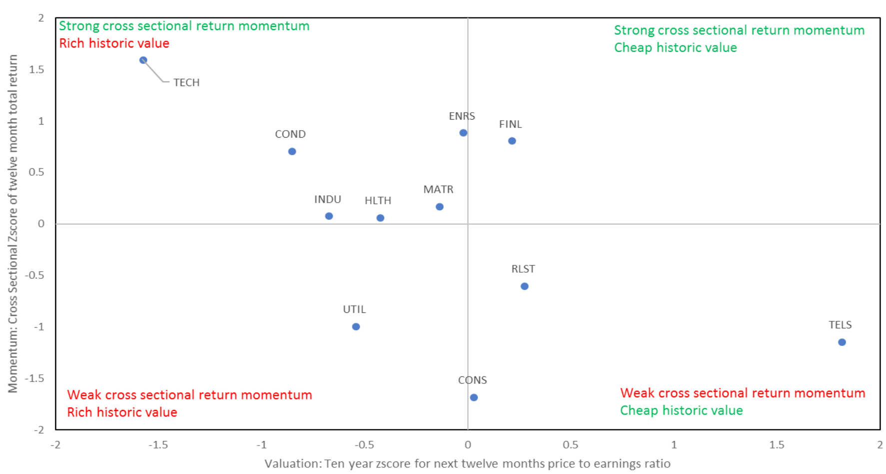
The Sector Rotation Portfolio ("SRP") provides market exposure across U.S. equities and U.S. fixed income via exchange-traded funds. Innealta's Investment Team manages the SRP strategy to a balanced benchmark of 70% S&P 500 Index and 30% Bloomberg Barclays U.S. Aggregate Bond Index. This benchmark reflects 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

Momentum and valuation are two of the many core analytical techniques utilized in Innealta Capital's investment framework to evaluate opportunities within financial markets. Empirical research has shown that return streams based on momentum and value strategies tend to provide positive alpha and to have a low correlation with one another. Figure 1 applies a valuation metric, calculated as a z-score based on its unique history and a momentum metric, calculated a cross-sectional z-score using twelve-month total return.

The figure has a few key takeaways. First, the Financials sector appears attractive both from a momentum and valuation perspective. Financials still have not recovered from the 2008 crisis and have begun picking up momentum as expectations of rising rates and potential loosening of the bank compliance environment. The energy sector also appears attractive to us as rising and stable commodity prices are driving improving earnings. Two sectors which we prefer to avoid, unless we would like to dampen the portfolio's overall expected volatility are the Utilities and Consumer Staples sectors. In both sectors, valuations are rich relative to their respective histories and momentum, which is measuring investor demand, is weak. Both sectors have constrained dividend payout ratios that, in a rising rate environment, will likely create a headwind for relative performance and increase the attractiveness of other investments. Other sectors in this figure represent trade-offs between momentum and value. In the Technology and Consumer Discretionary sectors, we are cautiously optimistic as strong return momentum is outweighing above-average valuation. We anticipate this is likely to continue provided that macroeconomic growth remains stable or increases. Although the Real Estate and Telecommunications sectors offer historically cheap value, we would like to see either an increase in actual earnings or a reduction in correlation to the fixed income markets.

FIGURE 1: Cross-Sectional Value and Momentum Analysis



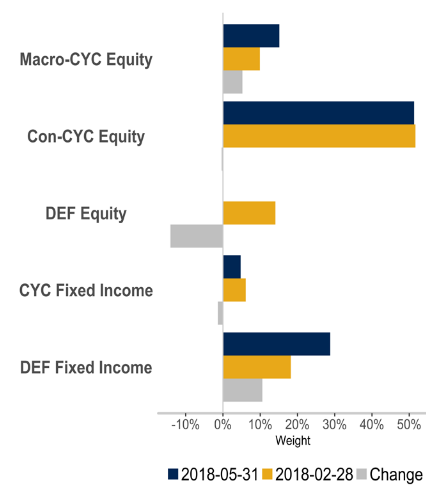
Source: Innealta Capital using Bloomberg data. Time frame 05/31/2008 to 05/31/2018, frequency weekly. "TECH" refers to the S&P 500 Information Technology Select Sector index. "COND" refers to the S&P 500 Consumer Discretionary Select Sector index. "INDU" refers to the S&P 500 Industrials Select Sector index. "HLTH" refers to the S&P 500 Healthcare Select Sector index. "MATR" refers to the S&P 500 Select Sector index. "ENRS" refers to the S&P 500 Energy Select Sector index. "FINL" refers to the S&P 500 Financial Select Sector index. "UTIL" refers to the S&P 500 Utilities Select Sector index. "CONS" refers to the S&P 500 Consumer Staples Select Sector index. "RLST" refers to the S&P 500 Real Estate Select Sector index. "TELS" refers to the S&P 500 Telecommunications Select Sector index.

Strategy Statistics

	Port	Bench
Alpha (%)	0.62	0.0
Beta (%)	0.4	1.0
R-Squared (%)	45.43	100.0
Std.Dev (%)	4.85	8.19

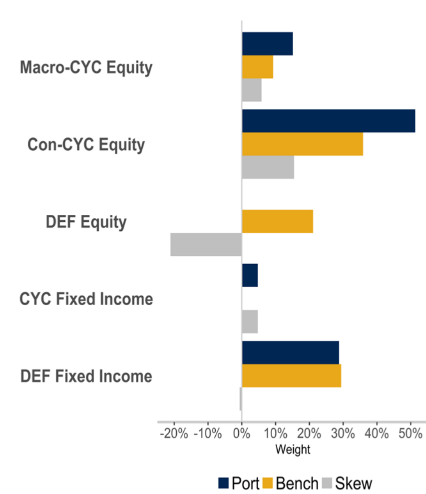
Source: Innealta Capital using data as from Bloomberg. Data from 12.31.2009 to 05.31.2018. Benchmark represents a 70/30 blend of the S&P 500 TR Index and the Bloomberg Barclays Capital U.S. Aggregate Bond Index. Inception date for the portfolio is December 31, 2009.

Portfolio Changes



SOURCE: Innealta Capital using data from Innealta Capital and Bloomberg as of 05.31.2018.

Portfolio Skews



SOURCE: Innealta Capital using data from Innealta Capital and Bloomberg as of 05.31.2018.

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Performance

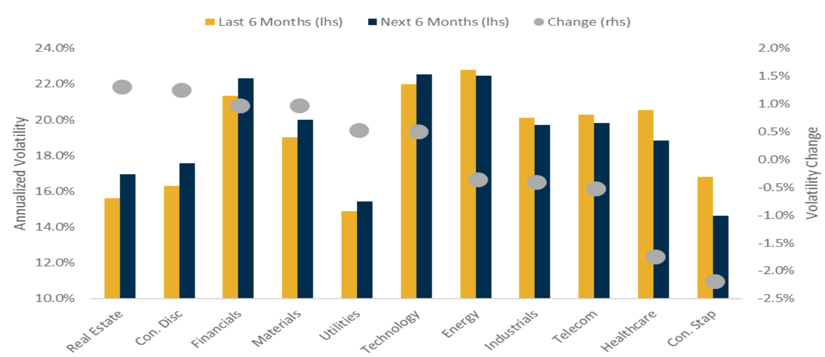
Over the past ten years, the month of May has generally been one of the lower performing months, on average, as news flows during the month is usually light – first-quarter earnings announcements complete and the summer holiday starts. This year, however, U.S. equity markets posted strong performance, as dollar strength subsided and trade war concerns eased. The S&P 500 returned 2.4%, marking the second-best monthly performance during 2018.

Similar to April, sector return dispersion increased despite volatility declining. The Information Technology sector posted a 7.37% return, the second-best month in 2018. The Information Technology sector sits at the nexus of exchange rate and trade concerns as the sector has the highest percentage of sales outside the U.S. Defensive sectors, such as Telecom and Consumer Staples, continued their underperformance relative to the benchmark. The negative performance somewhat surprising given the positive performance of fixed income markets during May.

During May, the Innealta Capital Sector Rotation Portfolio returned 2.03% gross of fees, while its benchmark, a blended index of 70% S&P 500 index and 30% Bloomberg Barclays U.S Bond Aggregate index, returned 1.90%. The portfolio benefited from overweight allocations, relative to the benchmark, in micro-capitalization equities, small-capitalization equities, and the Energy sector. The top contributors to the portfolio's performance were allocations to the Technology sector and the Energy sector, while the only detractor to the portfolio's performance was an allocation to the Financial sector. The Innealta Capital investment committee did not rebalance the portfolio during May.

Heading into the remainder of 2018, we forecast a marginal increase in realized volatility across sectors. The historic volatility observed in 2017 reversed in February and March 2018 following the volatility ETF liquidity event and the trade war news. Over the next twenty-six weeks, approximately a half-year, we forecast significant volatility increases in the Real Estate, Consumer Discretionary, and Materials sectors, while we forecast significant volatility decreases in the Consumer Staples, Healthcare and Telecom sectors.

FIGURE 2: Volatility Forecast



Source: Innealta Capital using Bloomberg data. Time frame 05/25/2008 to 05/25/2018. Current volatility refers to the annualized volatility calculated using weekly returns from 11/24/2017 to 05/25/2018. Projected volatility refers to the predicted annualized volatility using weekly returns from 05/25/2018 to 11/23/2018.

Top Contributors

1. Technology Select Sector SPDR ETF (XLK)
2. Energy Select Sector SPDR ETF (XLE)

Bottom Contributors

1. SPDR S&P Homebuilders ETF (XHB)
2. Financial Select Sector SPDR ETF (XLF)

SOURCE: Innealta Capital using Innealta Capital data from 02.28.2018 to 05.31.2018.

Strategy Performance

	Gross (%)	Net (%)	Benchmark(%)
1-Month	2.03	1.96	1.9
3-Month	2.42	2.07	0.31
YTD	2.48	1.79	0.96
1-Year	11.14	9.62	9.81
3-Year	8.12	6.62	8.11
5-Year	5.7	4.18	9.65
Inception	6.32	4.91	10.52

SOURCE: Innealta Capital using data as of 05.31.2018. 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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