

July 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.

US Equities Outlook

Despite the continuing trade rhetoric between U.S. and Chinese government officials over the last five months, U.S. equity markets seemed to brush off the risk. Implied volatility indices closed the month at or near to year-to-date lows, and equity markets closed the month at or near all-time highs. The U.S. corporate earnings were a major positive driver of U.S. equity market performance during July. U.S. corporate earnings continue to surprise analyst estimates, as over 75% of companies reported positive earnings surprises, and 70% of companies reported positive revenue surprises. As of this writing, the blended U.S. corporate earnings growth for Q2 is 20%.

U.S. equity investors face an interesting conundrum in that valuations, by almost any measure, are elevated relative to history, yet earnings growth is also elevated relative to history. Additionally U.S. earnings’ growth, whether measured using actual earnings or earnings estimates, exceeds that of other Developed Market countries. The figure below shows the one-year change in the one-year forward S&P 500 earnings estimates and the S&P 500 price to one-year forward earnings estimates. Earnings estimates have increased more than 20% in the last year, and expectations for next year are close to 10%. In summary, U.S. equity valuations have not increased at the same rate as trailing earnings growth. We tend to believe that the growth matters more in the short to medium term (i.e. less than three years), while the valuations matter more in the longer term (i.e. greater than three years). When we combine other macroeconomic growth indicators, we see actual yearly owning growth between 12% to 15% as a reasonable baseline.

FIGURE 1: S&P 500 VALUATIONS VS EARNINGS GROWTH



Source: Innealta Capital using Bloomberg data. As of 07.31.2018. Frequency daily. “NTM” refers to next twelve months.

Performance

U.S. equity markets posted strong July performance, with the S&P 500 returning 3.72%, the NASDAQ 100 returning 2.76%, and the Russell 2000 returning 1.74%. The Innealta Capital Sector Rotation Strategy returned 1.70% during July, while its primary benchmark, a blend of 70% S&P 500 Total Return Index and 30% Bloomberg Barclays US Aggregate Bond Index, returned 2.60%. The top-performing sectors within the S&P 500 during July were Industrials (+7.32%), Healthcare (+6.61%), and Financials (+5.27%). The worst performing sectors within the S&P 500 during July were Real Estate (+1.08%), Energy (+1.42%), and Consumer Discretionary (+1.83%). During July, the Innealta Capital Sector Rotation Strategy, on a gross-of-fee basis, returned 1.70% while the strategy's benchmark, a blend of 70% S&P 500 and 30% Bloomberg Barclays U.S. Aggregate bond index, returned 2.61%. The top contributors to the strategy's performance in July were allocations to Financials and Technology.

During July, the Innealta Capital Investment Team did not make any position changes in the strategy. The strategy maintained overweight positions, relative to its benchmark, in Consumer Cyclical equities and Macro Cyclical equities. The investment team maintains a view of positive macroeconomic growth, rising inflation, less accommodative monetary policy, and low to medium volatility.

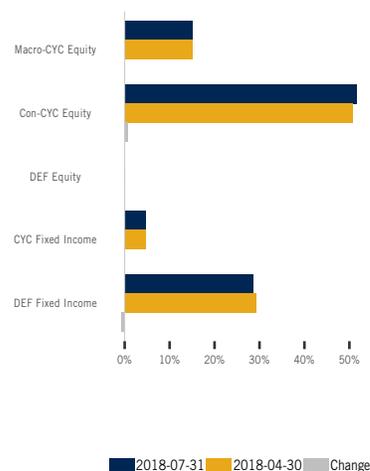
FIGURE 2: S&P 500 July Sector Returns



SOURCE: Innealta Capital using data from Innealta Capital and Bloomberg as of 07.31.2018. Each of the sector shown in the monthly performance bar chart correspond to the respective S&P 500 Select Sector total return index. For example the "Industrials" return corresponds to the S&P 500 Industrials Select Sector index.

Portfolio Changes

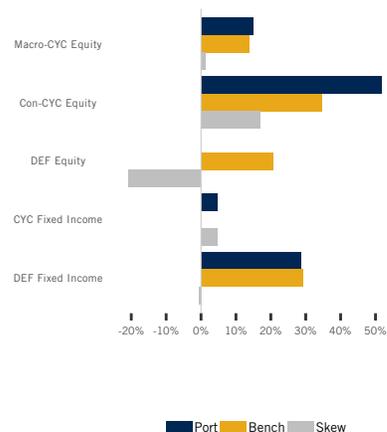
Trailing 3 Months



SOURCE: Innealta Capital using data from Innealta Capital and Bloomberg as of 07.31.2018. See last page for complete definitions.

Portfolio Skews

As of 07.31.2018



SOURCE: Innealta Capital using data from Innealta Capital and Bloomberg as of 07.31.2018. For example, "DEF Equity" represents the percentage of either the portfolio or the benchmark comprising securities classified as defensive equity. See last page for complete definitions.

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 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, LLC is an independent registered investment advisor and is the investment advisor for certain mutual funds. AFAM Capital, Inc. is an independent registered investment advisor and is the investment advisor to individually managed client accounts and certain mutual fund. Investing involves risk, principal loss is possible, and there can be no assurance that investment objectives will be achieved. Past performance is no guarantee of future results. Innealta Capital, LLC and AFAM Capital, Inc. only transact business in states where each is properly registered or exempt from registration. Registration of an investment adviser does not imply any certain level of skill or training. Innealta Capital, LLC and AFAM Capital, Inc. are not affiliated.

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