Innealta CAPITAL

U.S. Equity Commentary October 2018

WHAT IS HAPPENING TO THE SECTOR CLASSIFICATION SYSTEM?

- On September 28, 2018, the Global Industry Classification Standard ("GICS") will undergo a structure revision, affecting the Consumer Discretionary, Information Technology, and Telecommunications sectors.

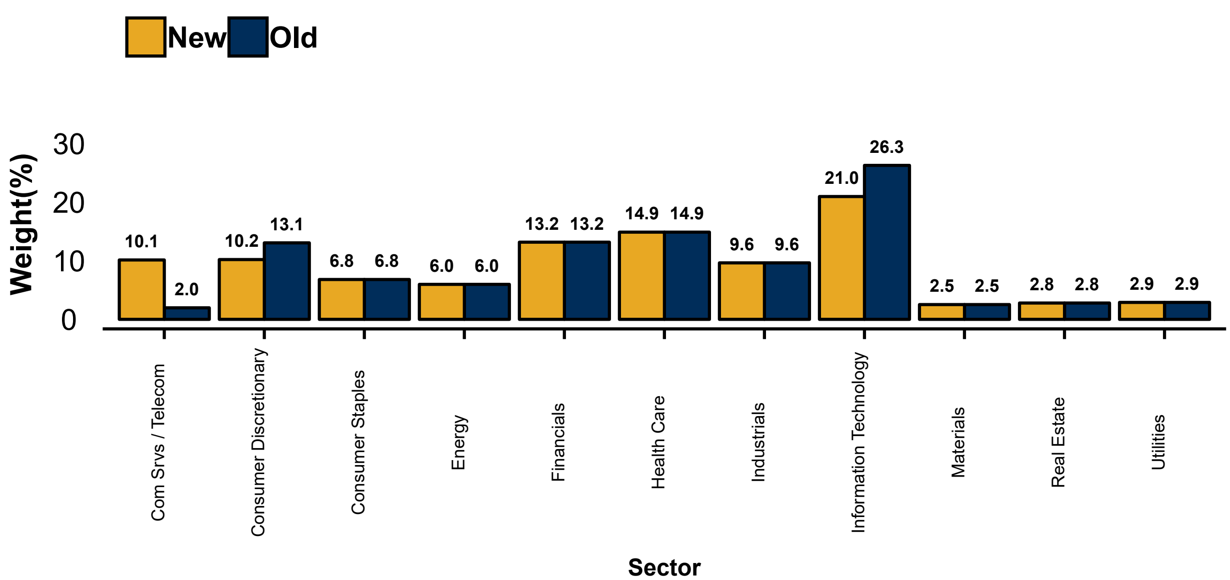
- The Telecommunications sector will be renamed the Communication Services sector and be broadened to include companies from the Consumer Discretionary and the Information Technology sectors. The change is meant to address what the MSCI and S&P Dow Jones, the co-developers of the GICS, see as the changing dynamics in the way people communicate, entertain, and share information.

- As a consequence of the classification change, the new Communication Services sector will become the fifth largest sector by market capitalization, representing approximately 10% of the S&P 500 index.

- The aforementioned changes were announced back in November 2017, providing market participants ample time to adjust their portfolios and consequently, we anticipate increased volumes but no increase in volatility.

FIGURE 1: SECTOR WEIGHT IN THE S&P500 BEFORE AND AFTER GICS CHANGES

Takeaway: Communication Services sector will represent approximately 10% of S&P 500, while Consumer Discretionary and Information Technology sectors will reduce their combined representation by approximately 8%.



Source: Innealta Capital using Bloomberg data. As of 09/27/2018.

IS THE NEW SECTOR AN ATTRACTIVE OPPORTUNITY?

- We believe the new Communications Services sector represents an attractive opportunity.

- From a valuation perspective, as of September 31, 2018, the price-to-cash flow ratio, using twelve months trailing cash flows, of the Communications Services Select sector index and the S&P 500 index was 12.6x and 13.8x respectively. Based on this valuation ratio alone, the Communication Services sector appears 8.8% cheaper than the S&P 500.

- From a growth perspective, as of September 31st, 2018, the year-over-year sales growth of the Communications Services Select sector index was 19.5% while the year-over-year sales growth of the S&P 500 was only 9.7%. Based on this metric, the Communication Services sector appears more attractive ooportunity to purchase growth than the S&P 500.

- Overall, the new Communications Services sector will likely have higher sensitivity to macroeconomic growth than the Telecommunications sector, sector, which in our opinion, will be favorable due to our view of macroeconomic growth.

GROWTH AT A REASONABLE PRICE?

- We remain cautious about Information Technology ("TECH") as cash flow expectations begin to decelerate while valuations are close to all-time highs over the past thirteen years.

- TECH has been the top-performing sector in the S&P 500 over that last three years, outpacing the S&P 500 by approximately 69% (127% vs 58%). Over that same time frame, TECH earnings per share grew 58% while the average earnings per share growth in other sectors was only 15.5%.

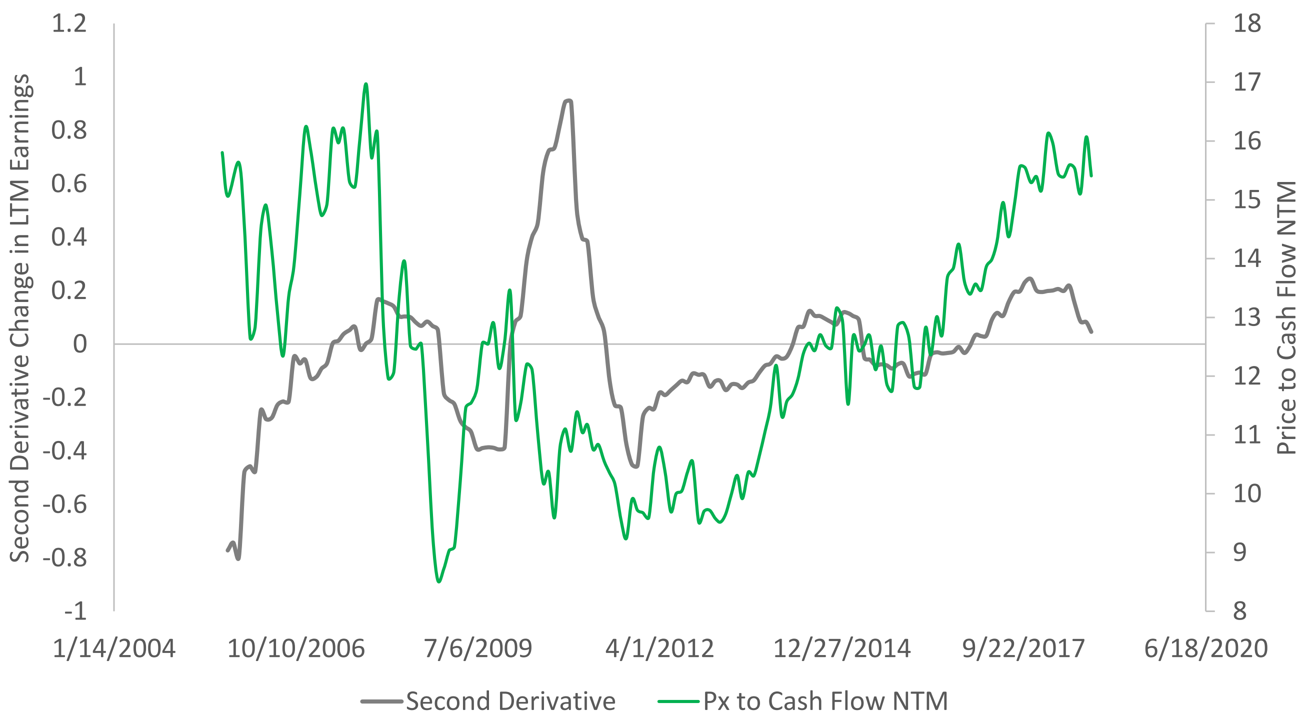
- We observed deceleration in the TECH one-year forward cash flow per share expectations. Similar events had occurred in 2007, 2010 and 2014, each marking a period when TECH valuations started to flatline or decline.

- The deceleration of cash flow expectations is itself a reason for concern. However, it is the combination of the deceleration and the historically high valuations that worries us the most. In prior periods when expected cash flow decelerated, the sector had a valuation cushion. Today at approximately sixteen times forward cash flows, we do not think a valuation cushion exists.

- Third quarter corporate earnings announcements, which will begin in October, will be an important signal to investors about potential TECH return performance.

FIGURE 2: TECHNOLOGY GROWTH VS VALUATION

Takeaway: Acceleration in TECH earnings has slowed at a time when valuation closed at fifteen year highs



Source: Innealta Capital using Bloomberg data. Time frame 01/01/1994 to 09/28/2018.

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