



ON RECENT MARKET MOVES

- First and foremost—our thoughts and prayers are with the Japanese people as they struggle through this natural catastrophe.
- Even as we express our hopes for recovery and renewal for the Japanese nation, we remain very concerned about the increased strain the recent disaster will have on both the Japanese and the global economy in the coming months and years.
- The disaster has effectively undone a generation of infrastructural development. It will require massive spending and borrowing (at what cost?) just to get back to break even (that is, to last week's already tenuous economic state). This does not bode well for an economy that has experienced periodic bouts of deflation over the past few decades and that has experienced below-average growth during that period as well. The long-term ramifications for the Japanese economy are not promising. We had our concerns prior to the disaster and now we hold little hope for meaningful long-term growth out of Japan.
- The investment opportunities across the ETF space further limit our interest to Japanese equity exposure, despite the meaningful selloff. ETF products have largely experienced a muted response thus limiting any short-term trading opportunities.
- Global macroeconomic growth, already on fragile footing, will be further challenged by the destruction experienced in the world's third largest economy. The borderline mirage-like reasoning being trumpeted by large sell side firms is very, very difficult to take seriously. We have yet to see any reasonable presentation that at least minimally considers the opportunity cost associated with the massive spending and borrowing that will be required to rebuild. This transfer of resources will indubitably challenge global economic growth.
- To reiterate our other ongoing concerns: Even with this week's pullback, the increase in oil prices will have the same effect as a significant tax on consumers; employment growth remains remarkably elusive despite media reports stating otherwise; there will be a restructuring of sovereign debt in Europe; real estate remains a disaster and a huge drag on personal balance sheets; banks remain a big concern given the continued amortization of assets based on loan value (not marked to bid); municipalities will continue to cut budgets and terminate public employees; Congress will continue to push for fiscal austerity measures; monetary policy will be significantly challenged this year and, optimistically, will become more restrictive; and unrest will continue and perhaps even spread in the Middle East and North Africa.

- That said, given the dramatically negative response across many equity markets, we took the opportunity to true up our equity exposures across a number of portfolios. With the latest corrective phase, we had allowed our equity exposures to drift meaningfully lower; that is, we tactically addressed our intra-quarter rebalance decisions that would have pulled up equity exposures before this last week's-worth of market turmoil. While not adding additional exposure to the targets, this morning's rebalance took advantage of a strong early dip to fit the allocations.
- In regard to our current equity exposures in the Country Rotation Portfolios, Taiwan remains of heightened concern, as does Australia (though to a much lesser extent). While we do not find it reasonable to sell into this panic environment, we will continue to monitor those positions closely.
- As for U.S. equity exposures in the Sector Rotation Portfolios, we continue to favor the Industrials and Information Technology spaces, both of which—if any sector does—may actually benefit to some extent from the rebuilding process upon which Japan must now embark.
- While moderately exploiting this recent sell-off through our tactical rebalance decision, our long-term equilibrium investment thesis remains intact. In fact, we'd argue that the development in Japan might accelerate our already growing concerns regarding underlying fundamental and macroeconomic support across most equity markets.
- As the economic challenges are more properly incorporated into equity valuation, we believe that better opportunities will present themselves later in the year. In the meantime, we still prefer our fixed income exposures over most equity exposures. As equity risk increases meaningfully, this preference becomes even more obvious to us.

As a reminder, we have had benign equity exposure in our portfolios throughout the last year and in 2011. The monumental events of the last week in Japan, while tragic and devastating to so many, have not meaningfully impacted or heightened volatility in our portfolios. At Innealta Capital, we remain committed to our mandate of Winning by Not Losing and are mindful of the many macroeconomic risks present in the global environment today. Our focus and discipline continue to be managing risk and smoothing out portfolio volatility. More than ever before, we can serve as a complementary manager to your existing set of solutions. Our conservative posture provides for downside protection, while the tactical, nimble nature of our portfolios allows for greater equity exposure as economic conditions improve.

IMPORTANT INFORMATION

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For more information, contact Scott Silverman at 949.540.7307.

AFAM | Innealta Capital
85 Argonaut, Suite 220
Aliso Viejo, CA 92656
P: 949.499.3215 / 888.994.6827 F: 949.499.3218