A L P H A C O R E | I N S I G H T S

"STOCKS. BONDS. ALPHA AT THE CORE"

QUARTERLY COMMENTARY – 1Q 2021

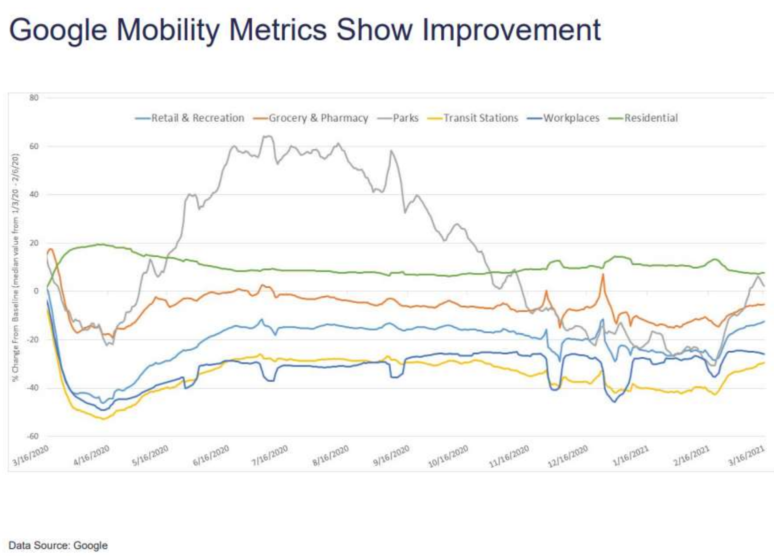
Introduction:

The first quarter of 2021 saw continued positive momentum in the economic recovery which was supported by several notable developments:

1) Additional fiscal stimulus in the form of a $1.9trn package, equivalent to nearly 9% of GDP creating strong demand tailwinds for the economy
2) The successful rollout and implementation of a vaccine program
3) Strong improvements in the labor market
4) Positively trending economic output figures and surveys

Both the fundamental economic and health/vaccine related data paints an outlook that looks promising. Mobility tracking data suggests that consumption behaviors continue to trend in a positive direction. Also, the US, U.K., Israel, the UAE, and Chile are making strong progress on vaccine distributions. Unfortunately, many emerging market countries are lagging behind, and the Eurozone's vaccination struggles present downside risks to the pace of their economic recoveries.

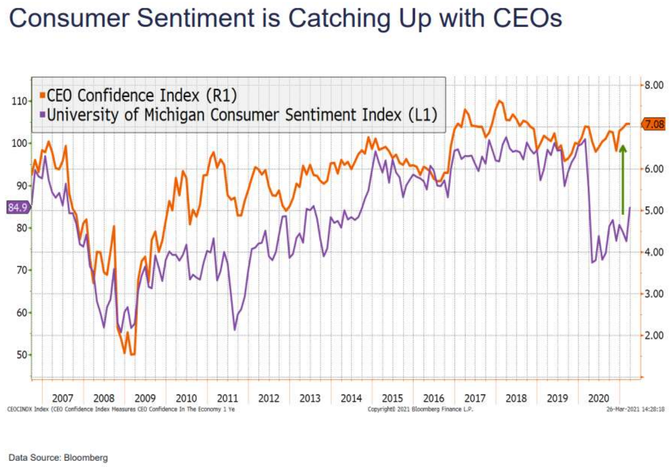
Exhibit 1: Mobility Across Different Consumer Behaviors:



In addition to increased mobility metrics, the lifting of restrictions has been positive for the labor market. The most recent US employment report showed a 916,000 rebound in non-farm payrolls for March which beat expectations. This still leaves employment levels roughly at 8.4mn lower than its pre-pandemic peak, however, increasing vaccination trends should further push more people back to work. Unfortunately, 3.1mn of the 8.4mn unemployed are linked to leisure and hospitality which will likely see a slow crawl back to pre-pandemic levels given ongoing restrictions on entertain related capacity. On the bright side, other sectors are showing strong increases in job openings.

Furthermore, US Services Purchasing Managers Index (PMI is an index of the prevailing direction of economic trends in the manufacturing and service sectors. It offers information about current and future business conditions to company decision makers, analysts, and investors. Any reading above 50 indicates an expansionary view) rose to 60, its highest in more than 6 years, while the manufacturing PMI matched the second fastest level since 2007 at 59.0. While PMI data provides optimism on the

Exhibit 2: Consumer Sentiment Trends Improving:

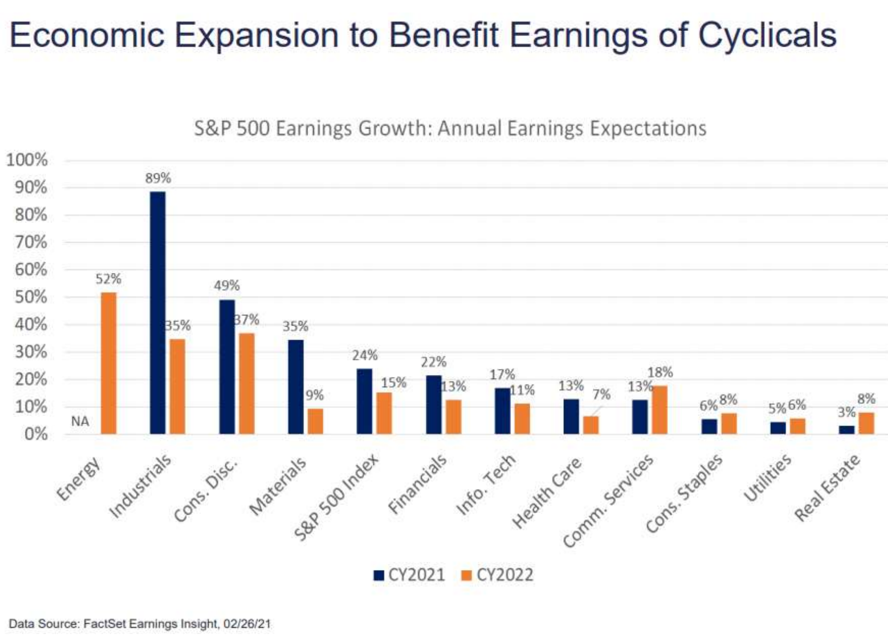


manufacturing and services side, it is also important to see that consumer confidence is also trending higher. Exhibit 2 below highlights this trend (it's expected that consumer sentiment lag CEO confidence given that executives in the corporate sector have a stronger pulse on business activity).

All of these developments should help to put the virus in the rear-view mirror as we begin to focus on full employment and growth. Consumer demand for goods and services should continue to recover, and as a result, we are expecting a robust earnings outlook across the corporate sector- particularly in the more cyclically sensitive areas of the market. Exhibit 3 below shows a chart of earnings growth expectations for both 2021 and 2022. Consistent with the recovery theme, sectors that are more cyclical leveraged (energy, industrials, materials, and consumer) are expecting the most robust growth prospects. Our optimistic outlook places two potential risks in the near term as it relates to a disruption towards the recovery:

1) Another wave nationwide wave in Covid-19 infections that could reenforce restrictions to activity, and continued disruptions in Eurozone and other parts of the world in regard to the vaccine distributions.
2) Overwhelming inflationary pressures from supply chain disruptions, and additional wage pressures.

Exhibit 3: Earnings Growth Expectations Across the Corporate Sectors:



Fixed Income:

There was a bit of a taperless tantrum in markets this quarter as longer-term U.S. Treasury yields continued to rise faster than the rate of inflation- as a result, the U.S. Treasury market suffered its worst quarterly performance in nearly 40 years. The 10-year Treasury yield concluded the first quarter at 1.74%. This rise in Treasury yields was driven by positive prints seen in several economic indicators. This cyclical recovery and the growth rates associated with consensus economic forecasts placed output well above the 2.5% figures that we have become used over the last decade. As a result, inflation indices have been on the rise over the past few months. While some of the price increases are partly due to base effects, there are a number of signs that point to new inflationary pressures in the US economy. The increase in prices can partly be attributed to a rise in energy prices- which accounted for more than 2/3 of the PPI increase seen in February. If demand steadily increases and labor markets continue to tighten at a healthy clip, we could see an increase in inflation not seen in quite some time. The market is expecting some rise in inflation as indicated by the 10-year breakeven inflation rate which came in at 2.38% by quarter end- this is the highest level seen in more than five years. Central bankers at the Fed do not seem to expect much in terms of inflation and suggest that any observed increases will be transitory in nature. We are a bit skeptical here- when we look at the economic indicators, we see a scenario that strongly suggests higher inflation is to come. Nonetheless, they have also stated that rates would remain low even if inflation were to overshoot above their 2% target. Given the rapid move in rates during the quarter, we released a more detailed intra-quarter piece on inflation for our clients and prospects that highlights how our portfolios are constructed to address inflation concerns- **please reach out to your advisor for the piece.**

Nothing notable stood out during the quarter in credit markets. Valuations remain elevated and credit spreads tightened during the quarter which was consistent with the market's optimism for a strong recovery- a narrowing spread environment implies confidence in the economic outlook and future credit conditions. By quarter end, high yield bonds offered roughly ~3.10% of spread- ultimately sitting at all time tights.

On an absolute basis, bond yields remain at unfavorable levels and therefore we maintain our underweight positioning towards duration. This is because current bond yields serve as the best predicter of future bond returns. Just to put things in perspective, the ~+80bps rise in the 10-year bond yield this quarter resulted in the high-grade bond proxy, as measured using the Bloomberg Barclays Aggregate Bond Index, delivering a negative total return of -3.37%. With the benchmark index now yielding annualized income of roughly 1.4%, the coupon component alone cannot carry an investor out of this hole assuming rate moves stall out at these levels. Now consider a scenario where consumer demand out strips supply over the next few quarters, and an economy that experiences a faster than forecasted recovery- such an outcome could translate to elevated levels of inflation which makes the case for holding bonds even less compelling (FYI, from 1998-2020, the median inflation rate was 2.5% year over year- even in a no rise in inflation environment, bond holders have little to look forward to on a real return basis). We certainly never claim to be macro strategists making big calls on rate moves and inflation. However, we are investors that can spot a poor total return opportunity when we see one- regardless of the inflation outcome. Fixed income and credit substitutes in the form of alternative strategies and asset classes, in our opinion, are far better places to look for total return and income in this environment.

Equities:

While we saw episodes of volatility in the equity markets sprinkled throughout the quarter- all major equity indices finished in positive territory for the period. Rotation was the dominant theme as sub-index level returns highlighted meaningful return dispersion between sizes, sectors, and styles. Small caps beat large caps, value beat growth, and cyclicals outpaced technology and defensive sectors.

- Small-cap stocks represented by the S&P SmallCap TR Index posted a 18.24% quarterly return, while large cap stocks represented by the S&P 500 Index TR Index finished the period with a +6.17% quarterly return.

- In terms of the Value vs. Growth dynamic, value stocks bested growth counterparts by a spread of +10.31% during quarter- the widest quarterly return spread in over 10 years.

- From a sector standpoint, Energy and Financials were the best performing sectors- posting +31.71% and +16.72%, respectively.

Activity in the equity markets this period was marked by a broadening out of the reopening theme – we continued to see a strong bid for cyclicals and value stocks that began back in November of last year with the emergence of various vaccines. Tech/growth stocks have been heavily favored areas of the equity market over the last decade- with investors paying hefty premiums for anything that hailed top line growth. With a renewed outlook for a strong economic recovery, rising inflation expectations and the potential for additional infrastructure focused stimulus- investors are showing an ability to put virus concerns in the rear-view mirror and navigate a new phase of this cycle. Style, and sector rotations will likely continue to play an important role in equity market returns for the remainder of the year.

As we mentioned above, there were brief moments of volatility that can attributed to what we would all categorize as a consequence of excess liquidity in the market given the unprecedented levels of fiscal and monetary stimulus:

1) **Reddit Mania:** A day trading, retail driven euphoria that seemed to draw some notable attention late last year gained full steam in January when a small group of speculative investors helped drive up the prices of several heavily shorted stocks amongst the hedge fund community- names like GameStop, and AMC (which were deteriorating businesses over the last decade given secular trends in digitalization of consumption). These hedge funds were generally on the other side of this trade by expressing that the prices of such stocks would fall. The run up in these names at one point rallied hundreds and thousands of % in gains causing massive losses for some hedge fund managers and profits for others.

2) **Selloff in Tech and Growth Stocks:** Then in February, the rapid rise in bond yields triggered a repricing within the equity markets that saw shares of technology and growth focused names hit correction territory. Our past commentaries covered concerns that our team had with the unreasonable valuations and high multiples that many story stocks carried throughout 2020. The move in yields was the needle that was needed to prick this bubbly area of the stock market.

3) **Leverage Blow-Up:** Lastly, late March saw a crushing blow to a large family office led by a veteran hedge fund manager that was heavily levered to a dozen or so individual stocks through various instruments with multiple global investment banks. Unfavorable stock price movements triggered what is considered the largest ever margin call and would eventually lead to large unwinds of risk across many of these large banks.

Our investment committee takes risk management seriously, and this means monitoring and staying on top of all our managers and exposures- we are happy with having avoided any major impacts from these specific events during the quarter. I believe our due diligence efforts and more value aware approach to investing largely kept us out of some of these manias. We maintain our cyclical and value tilts within our core equity allocation, and currently have our growth equity exposures hedged to some extent through some of our alternative strategies. We also maintain our conviction in ex-US market exposure- they are attractive form a relative value standpoint vs. broad US equities. Non-US equity indices are also more heavily weighted to cyclicals and financials. While timing of the economic recovery across regions will be uncertain and the strength of each recovery a bit uneven - we generally feel that this will be a broad-based global recovery and most policy makers will do whatever it takes to get economic output back and beyond pre-Covid 19 levels. In such a scenario, we think ex-US equity exposures are an important component of an overall equity allocation.

Alternatives:

The choppiness and volatility provided in both equity and fixed income markets created a strong backdrop for active managers across our platform. Alternative strategies often run portfolios that take both long and short positions - and in doing so, managers can generate returns in both rising and falling markets. Sideways and choppy markets are ripe for active managers- these types of markets tend to experience strong rotations across styles, factors, and sectors. Such portfolios that can go both long and short a variety of instruments are able to generate strong returns when given the appropriate environment.

Our long-short equity managers were able to deliver strong alpha driven returns. In particular, our value focused long short equity manager delivered an outsized quarter with the strong sector rotations serving as a tailwind. Their long portfolio focuses on owning strong businesses with sustainable cash flow generation, with enduring moats and consistent histories. Their short portfolio centers around the selling of concept stocks, and deteriorating businesses with no free cash flow businesses. While the long portfolio delivered strong returns, it's worth highlighting the outsized contributions the manager captured on their short side. The collapse in high flying story stocks (think of the stocks found in all too popular innovation ETFs) given the rapid rise in yields was an important catalyst that helped deliver strong returns on the short side. Not all of our equity substitutes performed well. Some of our quantitative long-short equity managers finished the quarter with on benchmark returns or with slight negative returns. These strategies have faced significant headwinds in the last few years given violent factor volatilities and stretched equity valuations in certain parts of the market. We see a better outlook for this line-up of managers – the quarter's second half performance was far better when fundamental based factors helped drive returns in these strategies.

On the fixed income side, duration served as a headwind for many traditional fixed income managers. Our alternative managers took full advantage of this environment and were able to generate strong returns given their more credit centric positions and active duration hedging capabilities. Strong contributions came from our structured credit managers – these are strategies that opportunistically allocate across a variety of credit sectors which include residential mortgage back securities (RMBS), commercial mortgage-backed securities (CMBS), asset backs securities (ABS), and collateralized loan obligations (CLOs). A combination of spread tightening and active interest rate hedging helped these managers outperform traditional bond and credit indices by over +400-500bps for the quarter. Looking forward, these managers will look across the commercial real estate market and opportunistically find bonds in the CMBS sector that are trading at meaningful discounts to intrinsic value. Commercial real estate debt securities present a long-term distressed type of opportunity set that potentially offers strong equity like returns from a relatively low volatility asset class. Other areas of strong performance came from our private credit exposures- these portfolios have remained resilient despite the duration headwinds faced by more traditional bond portfolios given their shorter maturity profiles and floating rate coupons. We have long used private credit allocations in place of traditional fixed income, namely private corporate credit. These diversified corporate loans are yielding significant spreads over generic forms of credit like high yield bonds, ~300-400bps over.

Nearly our entire alternative manager line-up this year well exceeded their traditional equity and fixed income benchmarks. Such an outcome is atypical as many of these strategies are hedged portfolios and are managed to lower beta and volatility profiles- as such, returns can be more muted vs. that of long only exposures in strong trending markets. However, in the right environments- alternative strategies from both a relative and absolute return perspective can provide portfolios meaningful levels of return contribution and drawdown mitigation.

Conclusion:

We remain optimistic about our asset allocation approach, and believe the environment ahead remains a favorable one for alternative strategies. It has always been our view that the traditional 60/40 portfolio model is broken and will continue to face headwinds moving forward. While bond yields have risen meaningfully over the last 6 months, they are still near all-time lows and remain unattractive from an absolute return perspective. Secondly, generic forms of corporate credit provide investors little additional compensation for their embedded level of credit risk. Layer on increasing inflation expectations and you are faced with real return outcomes that make traditional bonds and credit nearly un-investable. On the equity side, it is our view that valuations remain elevated, and forward-looking returns will likely be more muted if one were to just take a passive index approach. There is too much dispersion and volatility to ignore, and by not incorporating active management- we think investors will be leaving returns on the table. The rest of 2021 should be an environment that favors more active forms of investing like alternatives strategies, and private asset exposures like private credit and real estate.

An important part of investing is about repurposing capital for tomorrow. While many may argue that secular trends (aging demographics, digitalization, and low rates) will continue to favor large cap technology names, and innovative growth companies- we believe the newly introduced macro and cyclical effects should be given more attention in your asset allocation. Let me also say- **valuations do matter!** These dynamics have reinserted themselves into asset pricing and we believe they will largely be the force behind the market moving narratives for the next several quarters. With that said, we still see bubble pockets all across risk assets. The run-up in cryptocurrencies speak to such liquidity driven manias, and for some has provided inflation hedging fascinations.

We quickly forget the fundamental drivers of investing because macro dynamics are slow moving and are often confirmed by lagged indicators. Cycles are also long lasting and what worked in the past works for extended periods of time- and therefore, we fall victim to some degree of tunnel vision. **We think investors should not underestimate the demand creation that these unprecedented levels of fiscal policy may create.** Washington is discussing the potential passage of an infrastructure focused bill which could serve as further fuel for this recovery. A concerning outcome of course would be an inflation overshoot. Ignore this scenario and those investors subscribing to the 60/40 model, which likely overweight growth and duration exposures today, will be faced with a gut-wrenching reality check. Our investment committee worked diligently over last few years to build what we believe to be a robust investment platform and thoughtfully constructed differentiated portfolios for all the right reasons. **<u>In our opinion, our clients are best served allocating a meaningful portion of their portfolios in alternative strategies and assets.</u>** All that patience and hard work is now paying off, and I believe we have turned a new page here in the markets where alternative allocations will be increasingly more important. As always, thank you again for your trust and confidence in our team, and we look forward to speaking with you soon- hopefully in person in the very near future. Please reach out to any of our team members if you may have any questions.

Best,

Johann Lee, CFA

Director of Research

Market Indices:

- S&P 500 Index: The S&P 500 Index, or simply the S&P, is a stock market index that measures the stock performance of 500 large companies listed on stock exchanges in the United States.

- Bloomberg Barclays US Aggregate Bond Index: Bloomberg Barclays US Aggregate Bond Index is a broad base, market capitalization-weighted bond market index representing intermediate term investment grade bonds traded in the United States.

- The S&P SmallCap 600 Index: S&P 600 Index is a stock market index established by Standard & Poor's. It covers roughly the small-cap range of American stocks, using a capitalization-weighted index.

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