WIN MORE BY LOSING LESS

ALPHACORE WEALTH ADVISORY

SALIENT POINTS… ALPHACORE BELIEVES THAT:

- **RISKS IN STOCKS AND BONDS ARE UNDERESTIMATED BY MOST INDIVIDUAL INVESTORS**
- **ALTERNATIVE STRATEGIES HAVE THE POTENTIAL TO PROTECT CAPITAL**
- **A WELL-CONSTRUCTED PORTFOLIO THAT COMBINES ALTERNATIVE INVESTMENTS AND TRADITIONAL INVESTMENTS HAS THE ABILITY TO OUTPERFORM OVER TIME**

BACKGROUND

"DIRECTION IS SO MUCH MORE IMPORTANT THAN SPEED. MANY ARE GOING NOWHERE FAST." – UNKNOWN

Life comes at us quickly. Whether the focal point is Moore's law, the number of times we open our phones every day, the number of patents filed, the number of music albums released every year, or the number of schools to which the average college applicant applies, that number is going up. The information age is blasting a tarantella through its speakers and every industry is on the dance floor. Yet…

60% stocks, 40% bonds. Buy and hold for the long run??

The global investment landscape is changing and most financial advisors (and, ironically, robo-brokers[1]) repeat the same message. A cynic might suggest that financial advisors don't change because leaving the herd and doing something different would mean taking career risk (after all, if we all own stocks and the stock market falls 50%, then it's not my fault!). But let's assume financial advisors aren't driven by the fear of losing clients…

There is very strong empirical evidence that equity valuations and bond yields are good predictors of future returns for stocks and bonds.

These "timeless" investment mantras are just that: Devoid of any sensitivity to today's investment landscape. A quick glance at where we reside today—historically low interest rates, fairly-valued to slightly expensive global equity markets—should change a prudent investor's strategy. Why? *There is very strong empirical evidence that equity valuations and bond yields are good predictors of future returns for stocks and bonds*, respectively. Simply put, investors should watch where they're going because the path to growth matters.

This is not to suggest a market-timing strategy, as that can be an even more treacherous path. For the reasons laid out ahead, we believe a strategic allocation to a diverse set of assets will help to protect capital during corrections—and will ultimately lead to more consistent returns. Hence the article's name: **WIN MORE BY LOSING LESS.**

[1] "Robo-broker" is the term used to describe a financial advisor in the form of a computer Investors/clients can go online, log onto the robo-broker's website, input their financial information, and the robo-broker spits out a recommended investment allocation based on the historical returns of stocks and bonds.

“STICK TO THE PLAN”

When planning for retirement, most financial advisors and robo-brokers use software with fancy Monte Carlo simulations to help determine whether or not you will meet your financial goals. The problem with these programs is that they all rely on assumptions that stocks will earn between 9%-10% and bonds will earn about 6.5% ad infinitum. After all, we as a developed world have taken on more debt, and launched stocks and bonds to deliver compelling numbers! But caution: Garbage in, garbage out.

An advisor’s primary responsibility is to keep you invested as things are going poorly—a very difficult job at times—but that is exactly why advisors exist and their fees (generally 1-2% a year) actually do pay for themselves[2]. Do you recall how difficult it was to stay invested in the stock market in 2008 when pundits on CNBC were predicting a financial system collapse almost daily?

Imagine you were 40 years old back in 1998 and wanted to retire at 65. You lived through the tech wreck and the credit crisis and with the help of your financial advisor, you stayed 100% invested…what did you earn over the last 22 years? (Hint: It’s not very close to 9.5% assumed by the historical equity market return assumptions.) In fact, a diversified portfolio of stocks and bonds earned you 6.9% over the last 22 years[3]. The kicker: We believe the next 10 years look even bleaker, based on current price levels and valuations. Roll up your sleeves for this next section.

STOCKS AND BONDS: TOO RISKY?

ALPHACORE RESEARCH NOTE:

- **MOST VALUATION MODELS PREDICT THAT STOCKS SHOULD EARN BETWEEN 0-3%/YEAR**
- **FOR THE NEXT 10 YEARS, AND BONDS SHOULD EARN ABOUT 2%. WE BELIEVE THOSE RETURN NUMBERS AREN’T WORTH THE RISK. NOW FEEL FREE TO JUMP TO THE NEXT SECTION.**

Let’s start with bonds, because a fixed income investor need only look at a couple of simple, transparent metrics to get a good sense of future returns. Unlike a stock, where its net present value is a combination of a guestimate of the total future cash flows/dividends of the company discounted by some guestimate of future interest

[2] Vanguard estimates that “behavioral coaching” is worth about 1.5% per year. See “Putting a Value on Your Value,” *Vanguard*

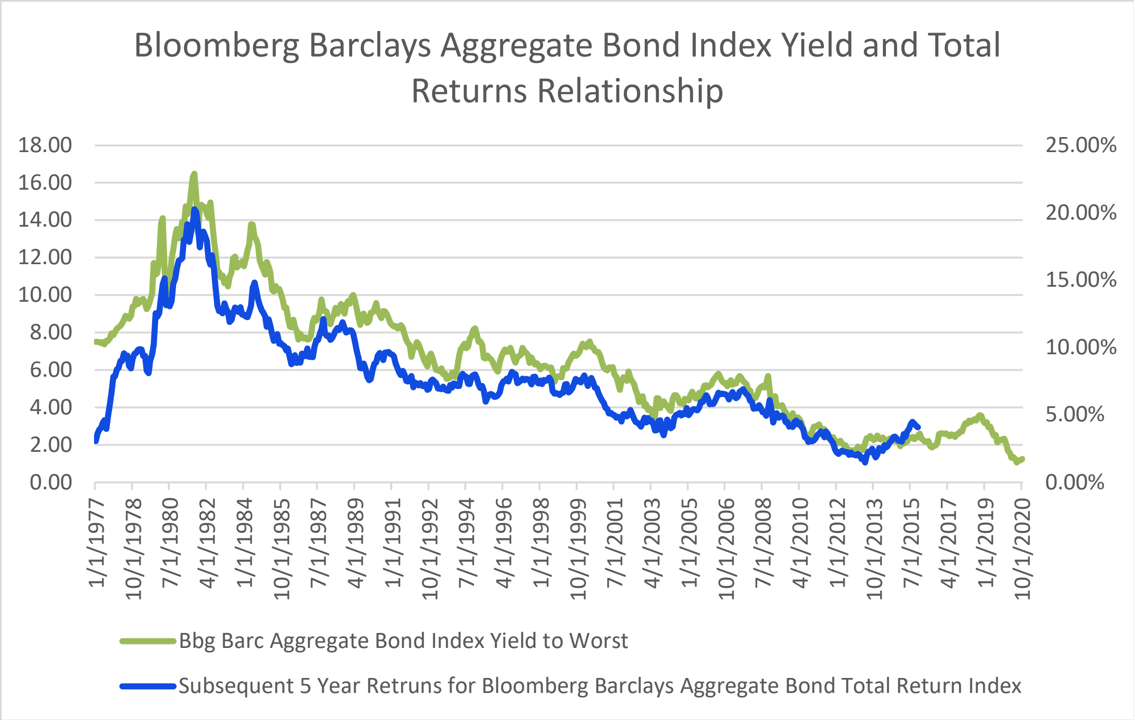
[3] Represented by 60% Russell 3000 Total Return Index, 40% Bloomberg Barclays Aggregate Bond Index

rates, a bond's future returns are related to two questions: 1) What is the current yield? 2) Will I get my money back (par) when the bond matures?

U.S. investment-grade bonds are poised to earn just 1.25% per annum for the next 5 years.

Assuming investment grade bonds have a very low default rate (i.e. the answer to #2 is "yes"), a clever investor could look to the coupon to determine the bond's returns. In fact, while a bond portfolio's returns are slightly more complex, current yields are a fantastic predictor of future returns (see *Figure 1*). The model in *Figure 1* suggests that *U.S. investment-grade bonds are poised to earn just 1.25% per annum for the next 5 years*[4]—before inflation. The picture for bonds in Europe and Japan is even gloomier (yields there are less than 1%- global investment grade bonds represented by the Bloomberg Barclays Global Aggregate Ex-U.S. Index were yielding just +62bps as of 10/31/2020). Based on the information outlined, we can state that bonds will very likely underperform relative to their 25-year annualized return of 5.0%.

FIGURE 1: YIELD A GOOD PREDICTOR OF BOND RETURNS



Source: Bloomberg as of 10/31/2020

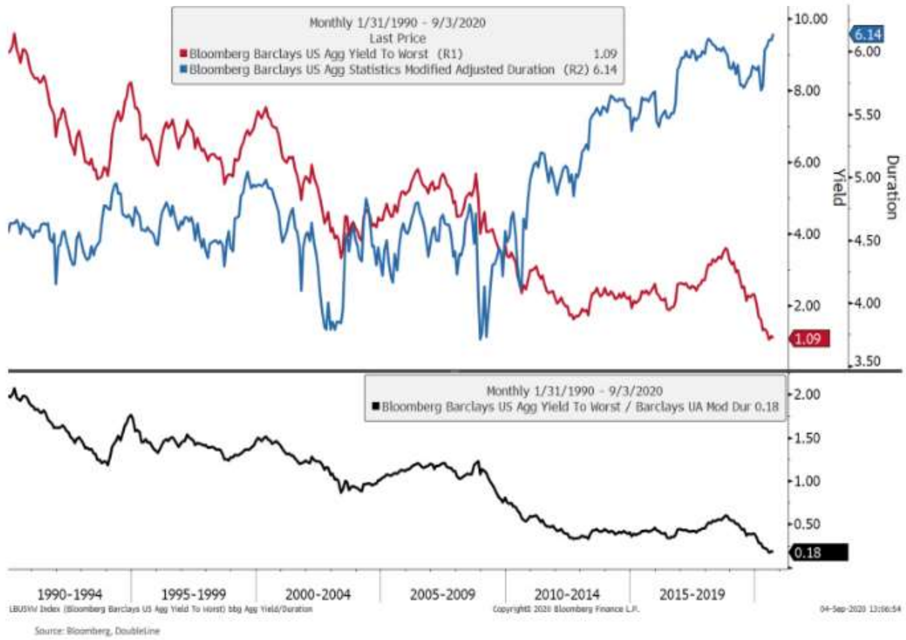
The duration profile of the benchmark index now sits at the highest levels in its history. It has long been our view that investors simply are not being compensated for the interest rate risk they are taking today!

More importantly, we believe that risks in the fixed income markets are grossly understated. As yields rise, fixed income prices fall according to their duration[4]. The duration profile of the benchmark index now sits at the highest levels in its history. Figure 2 illustrates that yield and interest rate sensitivity of the index is currently at its most extreme levels today. It has long been our view that investors are not being compensated for the interest rate risk they are taking today. One can argue that the current yield to duration ratio implies it could possibly be the worst time in history to take on passive fixed income risk today.

[4] Duration is a simple measure of a bond's sensitivity to interest rates. For example, a bond with a duration of 5 would lose 5% of its value if interest rates moved higher by 1%

With an index duration profile of ~6 years, a +1% parallel rise in rates across the curve implies at 6% decline in bond price. At a 1.25% current index level coupon, this type of asymmetric price downside could take nearly 58 months to recover. In today's low yield environment, one cannot carry themselves out of a hole that deep.

FIGURE 2: HISTORICAL YIELD AND DURATION PROFILE OF THE INDEX



WHERE'S MY YIELD?

Recognizing this unfavorable interest rate risk dynamic, many investors are taking down the duration in their portfolios (meaning a rise in rates will not hurt them as much) but want to generate a similar income stream. Instead of buying long-dated bonds, investors are choosing bonds issued by companies with shakier credit profiles (high yield bonds). We also believe this move carries significant risk. After all, **there has never been a liquid high yield bond market during a secular rising rate environment.** Why is that important? Because historically, a high yield borrower could **always** refinance at lower rates five years later. That truism, which held for 40 years as interest rates fell from 15% to 1%, is no longer the case. In our opinion, high yield bonds are still valuable as a small allocation but are not the solution.

We believe the income dilemma that investors are faced with today can be addressed by allocating to alternative sources of risk like middle market senior loans, mortgage credit, core real estate, and structured credit. We believe these types of exposures provide investors with the income necessary to fund their spending, help lower the duration of their total portfolios, while not sacrificing too much credit risk.

WHAT ABOUT EQUITIES?

The last decade has been very good to owners of equities. As of October 31, 2020, holding the S&P 500 from October 31, 2010 would have delivered you a 240%, that's a 13.27% annualized return! During this time, investors lived through several violent pullbacks that exceeded -10%, some in excess of -30%. Below are some of the more notable periods of uncertainty that we saw in the last decade- violent periods like these may have caused some investors to get anxious and potentially sell at the worst of times.

- Oct. '11: U.S. downgrade, Europe/periphery stress (-19.4% drawdown)
- Feb. '16: Oil, U.S. recession fears, China (-13.3% drawdown)
- Feb. '18: Inflation, trade, tech (-10.6% drawdown)
- Dec. '18: Rising rates, trade, peak growth (-19.8% drawdown)
- Feb. '20: Global slowdown COVID-19, oil price collapse (-36% drawdown)

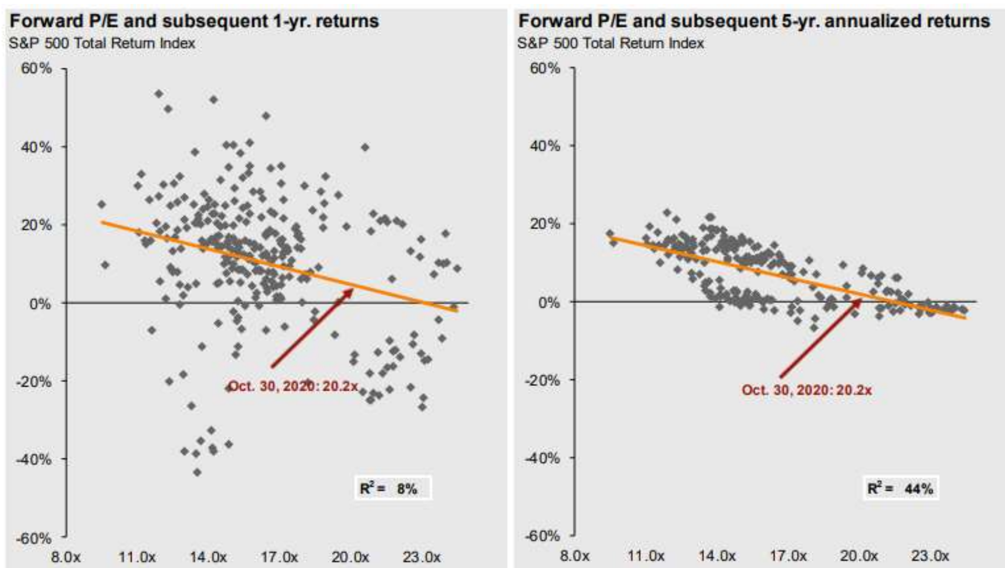
And to our next point…holding period matters. Let's not fool ourselves, the sobering reality is that equity returns tend to mean revert- we've experienced a very strong period of equity returns over this last decade. The historical annualized total return for the S&P 500 Index as of Oct 2020 since 1935 is much lower than what we've become used to in the last decade- the long term average is 10.38%. Long term, equity returns exhibit a significant degree of variability- the long term 10.38% annualized return comes with a 16.58% standard deviation. See Figure 3 which provides a historical look at 10-year rolling returns of the stock market since 1935.

FIGURE 3: ROLLING 10-YEAR EQUITY RETURNS SINCE 1935

Data: Ibbotson Associates, Morningstar, U.S. Bureau of Economic Analysis

Now, let's imagine that you began investing in the stock market back in January of 1998- your return experience would have been considerably different than the long-term historical Index return. An investor that took on equity exposure in 1998 would have experienced 3 major -30% plus corrections- tech bubble collapse, GFC crisis, and the 2020 COVID-19 panic. A dollar invested in the market index at that time would have only annualized at a 7.47% total return. With the COVID-19 pandemic having caused a halt in economic growth, we are now recovering from what has been the steepest and quickest equity drawdown in history. Meanwhile, we currently sit at elevated valuation levels that depict an unfavorable total return outlook for the subsequent 1 and 5 year returns for equities. As of October 31, 2020, the S&P 500 Index traded at a 20.25X Forward P/E ratio (P/E is a widely used relative value metric utilizing current market price vs. 12 month forward earnings) , while the 25-year average price to earnings ratio was roughly 16.50. The 1 and 5 year annualized return to P/E plot charts below show that forward looking returns will be muted. While these figures are not zero, but they are meaningfully on the lower end of the spectrum.

FIGURE 4: PLOTTING FORWARD P/E AND SUBSEQUENT HISTORICAL RETURNS

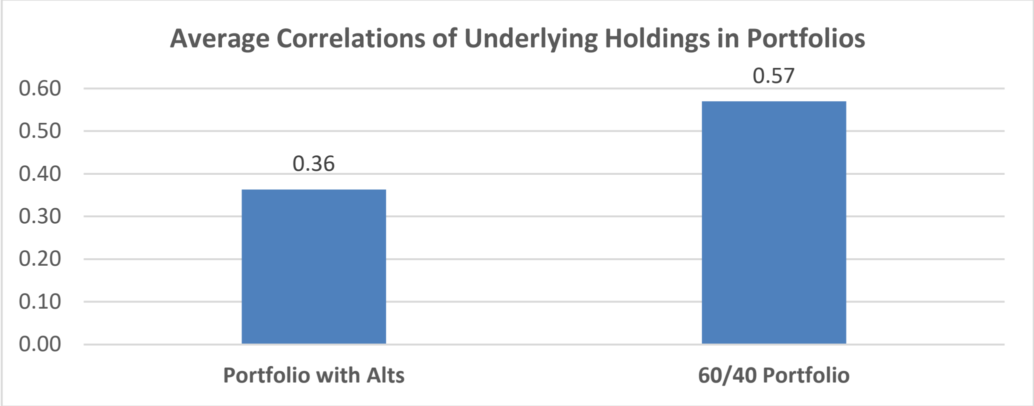


Source: FactSet, Standard & Poor's, Thomson Reuters, J.P. Morgan Asset Management.
Returns are 12-month and 60-month annualized total returns, measured monthly, beginning September 30, 1995. R^2 represents the percent of total variation in total returns that can be explained by forward P/E ratios.

Furthermore, the pandemic has caused a tremendous degree of bifurcation and distortion in terms of index concentration. The index today exhibits its highest level of concentration ever. The top 10 names in the S&P 500 Index represent approximately 30% of weighting. Some indices like the NASDAQ 100 Index exhibit concentration levels that are even more extreme. The top 10 names found in the NASDAQ 100 amount to nearly 55% of the index weighting. That isn't meant to scare anyone, but just to get people to think about what it means to own passive equities today. Granted, central banks have changed the global investment landscape through various quantitative easing programs and have created unprecedented liquidity that could push stock prices even higher. We believe it is important to own equities, but rather than take significant equity risk like a traditional 60/40 model does it is most prudent to take a cautious (hedged) approach with some of the traditional equity allocation. Risks to the downside are too great to ignore. Sourcing and allocating to managers that can deliver equity level returns in a long-short format with lower variability provides tremendous advantages associated with minimizing timing risk.

Our belief is that the solution to a well-diversified portfolio lies in alternative investments. This changing global investment landscape has given rise to a whole menu of investment options that simply were not available to individual investors ten or fifteen years ago. Many alternative strategies employ hedged approaches to investing, which means they don't profit as much when markets are up or (more importantly) lose as much when markets are down. Alternatives, as well as being hedged, are very different from one another—much different than one stock fund is from the next. *Figure 5* shows the average correlations within a traditional 60/40 portfolio, as well as the average correlations in a portfolio with alternative strategies. Average correlations of roughly 2/3 vs. that of a traditional portfolio suggest that the AlphaCore portfolio will be more of a stick in the mud if markets turn south (an AlphaCore portfolio is meant to be a sample portfolio that allocates to equities, fixed income, and alternative exposures).

FIGURE 5: AVERAGE CORRELATIONS BETWEEN FUNDS IN A PORTFOLIO



ILLUSTRATIVE EXAMPLE: SOURCE: MORNINGSTAR. THE ALPHACORE PORTFOLIO AVERAGE HOLDINGS CORRELATION ABOVE IS REPRESENTED BY TRADITIONAL EQUITIES (US AND NON-US EQUITY ETFs), FIXED INCOME (INVESTMENT GRADE AND HIGH YIELD BOND ETFs), AND ALTERNATIVES (INCLUDES PRIVATE CREDIT REPRESENTED BY THE CLIFFWATER DIRECT LENDING INDEX, PRIVATE EQUITY REPRESENTED BY THE CAMBRIDGE ASSOCIATES US BUYOUT INDEX , AND HEDGE FUND INDICES REPRESENTED BY THE HFRI HEDGE FUND COMPOSITE INDEX). THE 60/40 PORTFOLIO IS A COMBINATION OF TRADITIONAL EQUITY (US and NON-US), CREDIT (HIGH YIELD, AND BANK LOANS), AND FIXED INCOME ETFS (HIGH GRADE CORP AND NON-CORP BONDS). ANALYSIS WINDOW IS 5/1/2011-6/30/2020, PERIOD USED IS THE COMMON INCEPTION TIED TO ETF HOLDINGS IN BOTH MODELS.

Despite those enticing characteristics, investment advisers are reluctant to step outside their comfort zones and allocate significantly to alternatives. It may be because alternatives take a significant amount of expertise. For example, if an advisor picks a bad equity manager, then that manager will underperform its peers by 1.6%, on average. If an advisor picks a bad hedge fund manager, then that underperformance could be almost 4x as bad according to some studies- the dispersion of returns amongst managers and strategies in a hedge fund peer group is far greater than the dispersion and variability of returns in a long only equity category. *When you own an alternative strategy, you trade market risk for manager risk.* That point needs to be underscored and understood—*choosing alternative strategy mutual funds/strategies has the potential to improve risk adjusted returns if it is done well—but it requires expertise.*

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AlphaCore Capital was founded to serve high net worth individuals as its founder was seeking a strategy to manage a liquidity event from the sale of an investment firm. While investigating the asset allocation landscape, many investment advisors and brokers proposed portfolios that were eerily similar to one another (and to a 60/40 portfolio). Ironically, the main difference between one advisor and the next was their fee structure. We believe that while most advisors think they are doing the right thing with a 60/40 portfolio, that traditional model is too risky given today's environment. Many advisors know they should use alternative investments but choose not to because the risk of choosing poorly is too great. *Even a good alternative investment can cause a bad client experience if it is poorly understood and the advisor gets out at the wrong time.*

WHAT IS ALPHACORE?

Even a good alternative investment can cause a bad client experience if it is poorly understood and the advisor gets out at the wrong time.

When the economy is doing well then the rising tide will lift all "beta boats"

As the etymology suggests, the "core" in our investment philosophy is alpha-driven (rather than beta-driven). This distinction is important, and as such, our portfolios have a core allocation to alternative strategies. While beta is incredibly useful, a more integrated global financial system means that betas (common risk factors like equity risk, credit risk, and interest-rate risk) are becoming more closely linked. Put simply, *when the economy is doing well then, the rising tide will lift all "beta boats."* Twenty years ago, that wasn't the case. A more traditional portfolio (using 30+ years of investment history) underestimates the impact of a global system that has lightning-fast price discovery, mutually-dependent central banks, and integrated national economies.

Through quantitative methods and by using our network cultivated over the last 25+ years, we believe our access and research process to specialized money managers in the alternative investment space is well refined.

ALPHACORE IS A WEALTH ADVISORY FIRM WITH A NATIONAL CLIENTELE DEDICATED TO PROVIDING OUR CLIENTS WITH COMPREHENSIVE WEALTH MANAGEMENT PLANS UTILIZING TRADITIONAL AND ALTERNATIVE STRATEGIES. WE HELP OUR CLIENTS ACHIEVE FINANCIAL PEACE OF MIND REGARDLESS OF MARKET CONDITIONS.

THE ALPHA

The alpha of the portfolio (about a quarter to a third) will be allocated to alternative strategies—strategies that are less dependent on (or independent from) global growth for returns. These strategies are generally available in highly-regulated mutual funds and many have developed solid 5-10+ year track records—evidence that “alternative mutual funds” are a viable, long-term solution. Investment strategies categorized as “alpha” will include long short equity, market neutral, long short credit, multi-strategy, and event driven. We also look for areas where price discovery is slower, coverage by analysts is lighter, and markets are less liquid.

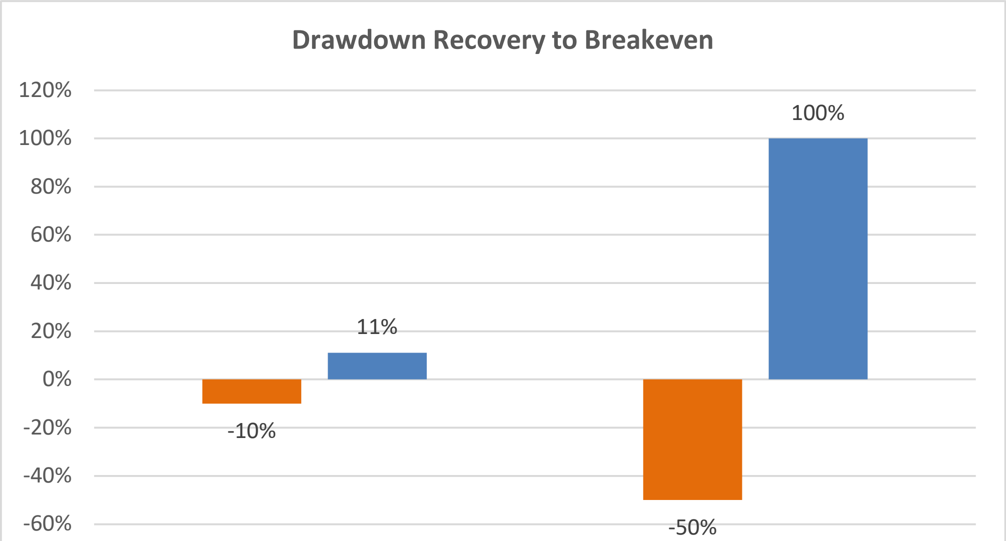
When appropriate, our models will allocate to less liquid strategies/assets or strategies that require a high degree of specialization. Important for consideration in allocating to these less liquid strategies are the client’s sophistication, suitability, risk tolerance, need for liquidity, and certain other behavioral or environmental factors. These types of less liquid exposures may include allocations to asset classes such as core commercial real estate, private credit, and private equity through registered quarterly liquid mutual funds known as interval funds”, or private limited partnerships. Specialized hedge fund and alternative strategies may also be accessed through fund structures.

THE BETA

Traditional developed equity and bond markets should still be a part of a well-diversified portfolio. We generally access equity “beta” exposures through low cost exchange traded funds or managed account strategies that incorporate tax loss harvesting overlays. On the fixed income side, we prefer utilizing mutual funds for core fixed income and high-grade credit exposures. We believe there is inefficiency in bond markets to justify active management. The credit exposures across our client portfolios generally rely more heavily on more illiquid structures like interval funds and business development companies. Simple exchange traded funds are a good benchmark to beat and have the lowest trading costs but are not necessarily the best way to access these markets.

In summary, our intention is not to hit home runs with a balanced portfolio—but instead rely on losing less during troubling times in order to compound our capital at a more consistent rate. Also, this portfolio can be 100% liquid, which has been a very attractive feature to some investors. The strongest way to demonstrate why we believe this model is a prudent way to invest is demonstrated in *Figure 6*. Simple math, but something that may not occur to us on our own: If you lose 10% then you need to earn 11% to make back that loss. If you lose 50% then you need a return of 100% to recover your money. The heart of AlphaCore can be boiled down to this simple statement: **WIN MORE BY LOSING LESS**.

FIGURE 6: WIN MORE BY LOSING LESS – AN ILLUSTRATIVE EXAMPLE



The illustrative example above is showing a hypothetical -10% and -50% drawdown on capital, and highlights the subsequent cumulative returns necessary to breakeven after each of these respective drawdowns.

IN SUMMARY:

- **WE BELIEVE THAT EQUITY AND FIXED INCOME MARKETS CARRY SIGNIFICANT RISKS AND THE BEST WAY TO COMBAT THOSE RISKS IS BY USING A TRULY DIVERSIFIED PORTFOLIO WITH AN ALLOCATION TO ALTERNATIVE STRATEGIES.**
- **WE BELIEVE OUR EXPERTISE GIVES US A UNIQUE EDGE IN BUILDING PORTFOLIOS SPECIFICALLY TO MEET OUR CLIENT GOALS.**