ALPHACORE'S GUIDING PHILOSOPHY

Win More By Losing Less

ALPHACORE
WEALTH ADVISORY

INTRODUCTION

It is often said that the only constant is change. This simple adage can be applied to nearly every aspect of our lives, and especially our financial lives. Over the past few years, we've been riding an economic roller coaster, at times treacherous enough to unnerve even the most prudent investor. By forcing us to reconsider our long-held beliefs, this new landscape presents myriad opportunities for innovation in investment management, moving beyond the traditional long-only 60% stock, 40% bond portfolio.

Why the sudden shift? Here's a quick glance at where we are today – lingering inflation, rising interest rates, and persistent volatility in markets across the board – all a sharp pivot from just a few years ago. The problem with "timeless" investment mantras (such as the 60/40 asset allocation) is that they are likely to be devoid of sensitivity to present economic conditions. But most financial advisors are still hesitant to deviate from traditional wisdom. **At AlphaCore, we believe that stagnation may perhaps be the riskiest move of all.**

A shrewd investment strategy is dynamic and informed by macroeconomic factors. There is strong empirical evidence to suggest that current equity valuations and bond yields are very useful in predicting future returns. Investors should be paying close attention accordingly. This is not to suggest a market-timing strategy, but rather a strategic allocation to a diverse set of assets that strives to bolster a portfolio's resilience and consistency of returns. Hence AlphaCore's guiding philosophy (and the title of this article) – WIN MORE BY LOSING LESS.

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01. "STICK TO THE PLAN"

When planning for retirement, most financial advisors and robo-brokers use Monte Carlo simulation technology to gauge the feasibility of meeting your financial goals.

While this is great for generating a basic roadmap, it is important to acknowledge its limitations. Typically, Monte Carlo runs on backward-looking data and relies on stocks delivering 9-10% and bonds 6.5%, ad infinitum. But these assumptions often do not hold up in reality. When it comes to these forecasting tools, beware – garbage in equals garbage out.

Part of an advisor's responsibility to look out for their clients' best interest is keeping clients invested even when things are going poorly – a very difficult task at times. Recall the 2008 financial crisis, with CNBC pundits stoking fears of a total financial system collapse almost daily.

During the 2010s, a prolonged bull market propelled by quantitative easing[1] and near-zero interest rates spurred high confidence and even higher valuations. The S&P 500 achieved an annualized return of over 13% during this period, a staggering figure, well above its 7.1% historical average. But in 2020, the world seemingly changed overnight. As we now face high interest rates, persistent inflation and rising geopolitical unrest, the outlook for the equity market looks bleak – Fidelity projects a 3.9% annualized real return through 2042.[2] As stocks are no longer the return drivers they once were, investors need to look to other strategies to grow their wealth.

Furthermore, while the bond market is currently benefiting from today's high yields, Fidelity believes it is expected to produce a mere 2.1% annualized ***real*** (nominal - inflation) return over the next 20 years.

02. THE INFLATION STORY

The Federal Reserve defines stable prices as a 2% annual inflation rate, but since March 2021, inflation rates have far exceeded this target.

In February 2022, inflation rates surpassed 6%, the highest level seen in decades. We trace the climbing inflation rate to the beginning of COVID-19, when the supply for goods and services was limited, while demand for goods and services increased.

Although inflation slowed in the first quarter of 2023, levels still remain above the Fed's 2% goal due to various factors. First, both the increased demand in the energy market and the concurrent decreased supply

[1] Quantitative easing refers to the introduction of new money into the money supply by a central bank, stimulating economic activity. This is a relatively new tactic popularized after the financial crisis of 2008.
[2] https://institutional.fidelity.com/app/proxy/content?literatureURL=/9904178.PDF

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are fueling high prices. Today, the supply of energy is lower due to cutting carbon emissions, lower global investment, and rising carbon costs. Researchers in the UK have projected that energy prices will more than double their 5-year pre-2021 historic average by 2030.[3]

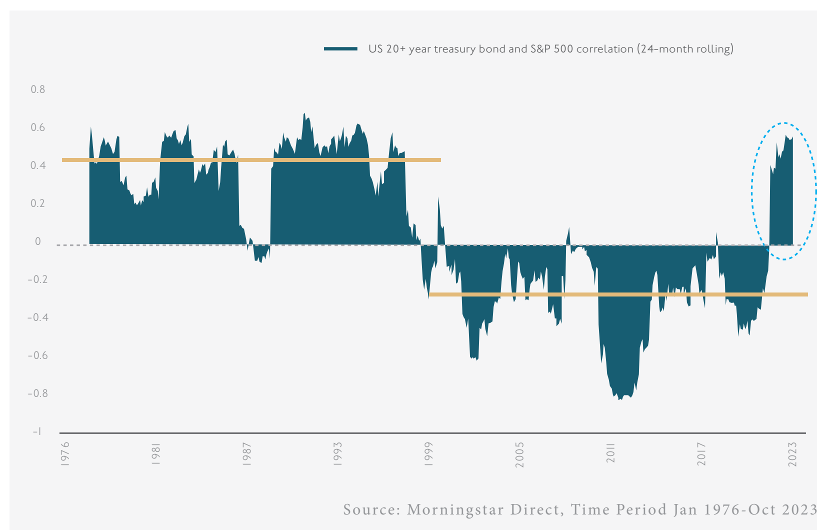
The tight labor force is also propelling inflation rates. As of October 2022, the number of retired workers exceeded the pre-pandemic expected trend by about 1.6 million people.[4] And with 10,000 boomers reaching retirement age every day, the shortage of labor is expected to only worsen over the next few years[5]. Labor is increasingly expensive: wages and salaries increased 4.6% during the 12-month period ending September 2023, according to the Bureau of Labor Statistics.[6] These high costs require businesses to increase their prices, thus increasing the Consumer Price Index. Additionally, geopolitical tensions are triggering elevated inflation levels. U.S. and China trade tensions are currently disrupting global trade stability. Growing protectionist sentiment creates friction to efficient trade terms, ultimately resulting in higher goods prices for consumers.

03. STOCKS AND BONDS: TOO RISKY?

For over half a century, the 60/40 portfolio has been lauded as the gold standard for investors looking to earn attractive risk-adjusted returns.

The logic behind this allocation strategy is simple – stocks offer long-term growth potential while bonds provide income and help mitigate some of the volatility in the equities market.

FIGURE 1:
· **Bonds don't hedge equities in an inflationary world**
Rolling 24 month correlation between U.S. treasury bonds and equi-



Source: Morningstar Direct, Time Period Jan 1976-Oct 2023

During periods of quantitative easing, these exhibit relatively low correlation to each other and offer differentiated risk profiles. But if the year 2022 taught us anything, it is that this strategy is far from foolproof. Depending on market circumstances, holding stocks and bonds alone can in fact be quite risky.

When the Fed increases short-term interest rates to combat inflation, the behavior of stocks and bonds becomes increasingly correlated, just as we witnessed last year as they declined in tandem **(Figure 1)**. We have now found ourselves in a situation that harkens back to the 1970s, when high oil prices, supply shortages and heightened geopolitical tensions were all triggers of high inflation. While it is difficult to draw an exact parallel between now and then, many believe that the next few years will more closely resemble the

[3] https://www.energysolutionsoxfordshire.org/high-energy-prices-here-to-stay-to-2030-and-beyond-says-new-report/
[4] https://www.federalreserve.gov/econres/feds/files/2022081pap.pdf
[5] https://www.federalreserve.gov/econres/feds/files/2022081pap.pdf
[6] https://www.bls.gov/news.release/pdf/eci.pdf

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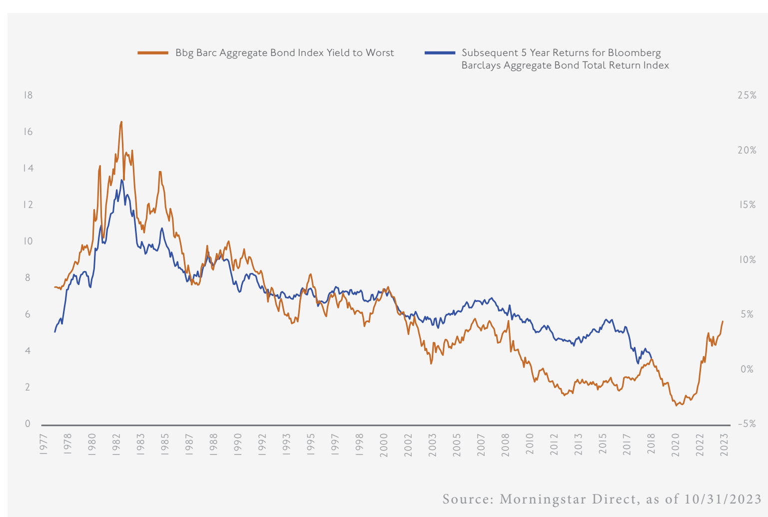
economic regime of 50 years ago than the preceding decade. If stocks and bonds remain highly correlated, alternatives may be more successful at diversifying portfolios and mitigating the risks of traditional assets. We'll get into that more later but let us first explore the recent performance and risk profiles of stocks and bonds.

Let's begin with bonds, which closed the third quarter of 2023 with negative performance. The high yield environment we now find ourselves in presents a potentially attractive opportunity to invest in fixed income, however, there are several headwinds not to be overlooked. The ever-expanding fiscal deficit is the foremost cause for concern. National spending has increased dramatically in the past few years, mainly due to COVID stimulus payments. The interest on this spending has increased as well, jumping from $500 billion to $900 billion in just two years. The growing deficit, which now stands at 7.5% of GDP, increases the need for bond issuance to compensate for budgetary shortfalls.

In August, bond ratings agency Fitch downgraded the U.S. government credit rating for the first time in history, citing an "erosion of governance" and rising debt as key reasons. Until national spending can be brought under control, our economy will continue to shoulder its burden. Mounting public debt crowds out private investment and endangers the durability of the U.S. dollar. Unproductive debt and slowing growth coupled with an ongoing inflation problem add to the riskiness of fixed income investments, once considered a safe haven in times of market distress.

FIGURE 2:
Bloomberg Barclays Aggregate Bond Index Yield and Total Returns Relationship



Source: Morningstar Direct, as of 10/31/2023

Now to stocks – coming off the unprecedented highs of the late 2010s, most assumed equities would continue their stratospheric trajectory into the 2020s. They were certainly in for a surprise. Though the past decade was certainly not without periods of uncertainty, nothing can compare to the tumult we have experienced over the past few years, beginning with COVID-19. Equities sharply fell, quickly bounced back to their pre-pandemic highs in late 2021, only to plummet once more in 2022.

When it comes to stocks, holding period matters greatly, especially since equity returns tend to mean-revert. The historical annualized total return for the S&P 500 Index since its 1957 inception through 2021 is 11.88%, while the 10-year annualized total return from 2010-2019 is much higher, 13.55%. But say you began investing in the stock market back in 1998 – your return would be vastly different than the long-term historical index. You would have endured 3 major drawdowns with losses exceeding 30%: the tech bubble collapse (2000), the Great Recession (2007-2009) and the COVID-19 pandemic (2020). A dollar invested in the market at that point in time would have only grown 7.47%. Though the market has thankfully recovered from its COVID-triggered trough, we aren't out of the woods quite yet. One of the key risks

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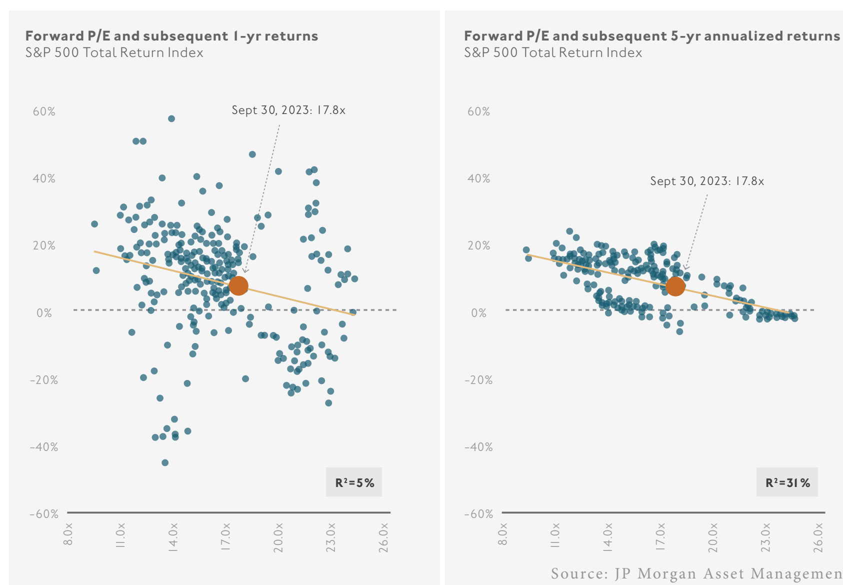
equity investors should be mindful of is the impact of rising wages and interest costs on margins. With the risk-free rate[7] hovering around 5% (as of Oct. 31, 2023), the cost of equity financing is now much higher, potentially squeezing firm's bottom lines. Furthermore, current forward price/earnings ratios (one of the most commonly used metrics to value equities, or how much you are paying for each dollar of earnings) for the S&P 500 Index suggest stocks are still overvalued, which bodes ill for their 1- and 5-year total return outlook. (**Figure 3**).

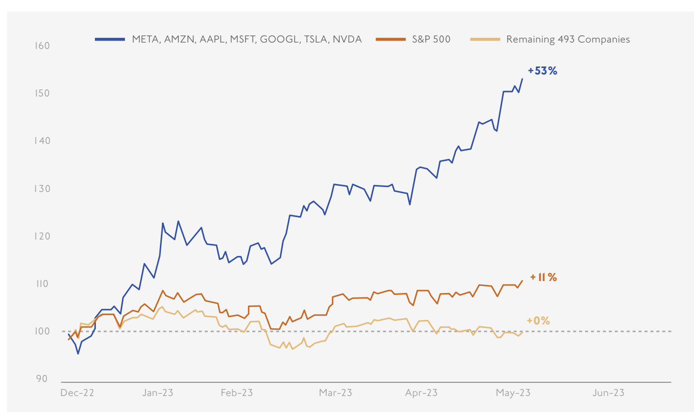
FIGURE 3:



Source: JP Morgan Asset Management

Furthermore, we've observed an extreme level of bifurcation and distortion in index concentration. Today, the top 10 names in the S&P 500 Index make up approximately 25-30% of the total weighting. Some indices, such as the NASDAQ 100, exhibit even more extreme concentration levels – the top 10 names comprise up to 60% of this index. This means that even those who "passively" own equities are exposed to greater concentration risk than ever before. The AI fervor-driven bull market of early 2023 clearly illustrates this phenomenon. Mega-cap tech stocks (Apple, Amazon, Alphabet, Nvidia, Tesla, Microsoft, Meta, a.k.a. the "Magnificent Seven") took off, buoying the entire equity market. Yet the disparity in returns for these companies versus the remaining 493 in the S&P 500 was massive **(Figure 4).** It is important for investors to be aware that by holding the S&P 500, one is largely taking a bet on a single sector.

FIGURE 4:
Indexed Return



While it is still important to hold equities, rather than take on significant risk in a 60/40 model, it is more prudent to opt for a hedged strategy to help mitigate downside risk. Allocating to funds that utilize a long-short approach may help accomplish this goal.

[7] The rate of return an investor can expect to earn on an investment that carries zero risk, typically proxied by the 10 year Treasury rate.

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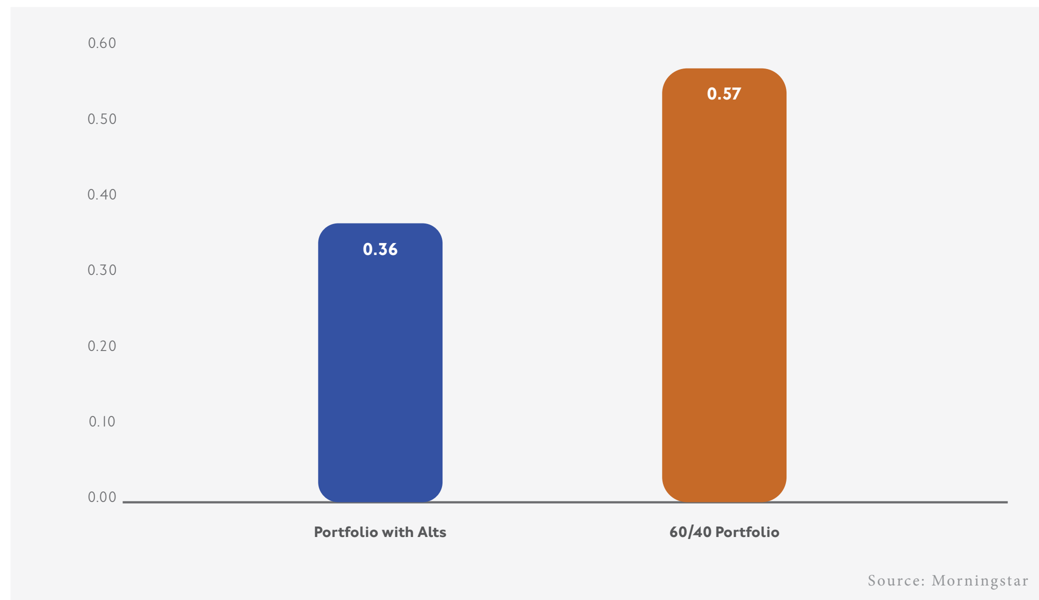
04. ALTERNATIVES: LOWERING YOUR RISK (IN THE RIGHT HANDS)

We believe the key to a well-diversified, resilient portfolio lies in alternative investments.

The changing global landscape has given rise to a menu of investment options that were simply inaccessible to individual investors a decade prior. Many alternative strategies are hedged, so although they will not profit as much in a bull market, losses tend to be less intense when markets are down. Because alternatives are highly differentiated, they have the potential to greatly reduce asset correlations in the overall portfolio. As **Figure 5** illustrates, the average correlation in a portfolio that incorporates alternative strategies is roughly 2/3 of that of a traditional 60/40 portfolio. **Applying this logic to portfolio construction makes AlphaCore portfolios better equipped to withstand market fluctuations.**

FIGURE 5:
Average Correlations of Underlying Holdings in Portfolios



The sophistication of alternative investments requires a significant level of expertise. Select the wrong equity manager, and the fund is typically expected to underperform its peers by 1.6% on average. But select the wrong hedge fund manager, and that underperformance could be almost four times as bad, according to some studies. This is because the variability of returns within a hedge fund peer group is far greater than that of a long-only equity peer group. With exposure to alternative strategies, you are trading market risk for manager risk. If executed well, alternatives have the potential to vastly improve risk-adjusted returns, but they demand a high level of manager skill.

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Dick Pfister, CAIA®
CEO, FOUNDER
ALPHACORE WEALTH ADVISORY

WHY START WITH ALPHACORE?

While searching for an investment strategy to manage a recent liquidity event, AlphaCore founder Dick Pfister recognized a whitespace in the wealth advisory marketplace.

The numerous firms he consulted all proposed eerily similar portfolios, all built according to the traditional 60/40 wisdom – the only difference from one firm to the next being their fee structure. Thus, AlphaCore was born with the goal of providing differentiated, bespoke investment solutions to high-net-worth individuals. Given the volatility of today's economic environment, we believe the traditional model of investing is simply too risky. Though alternative investments have proven potential to elevate portfolio performance, they carry a high risk of placing trust in the wrong manager. When it comes to more sophisticated assets, manager experience is essential to a positive client experience. AlphaCore leverages its research capabilities and extensive manager network to design well-rounded portfolios built to endure market fluctuations.

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WHAT IS ALPHACORE?

As the etymology suggests, obtaining alpha is "core" to our investment philosophy.

Alpha is a measure of a strategy's excess return above its benchmark. Beta, a more commonly used metric in portfolio construction, measures an investment's volatility relative to the market. The goal of most investment managers is to manage a portfolio to a specified beta so that the returns will track those of an index. Though this passive method of investment has worked well in the past, the global financial system has since undergone a transformation. Today we live in a world of near-instantaneous price discovery, interconnected central banks and integrated national economies, and as a result, betas or asset risk factors (such as equity risk, credit risk or interest rate risk), have become increasingly interlinked. Of course, this is great when the economy is doing well, as asset classes will rise in tandem, but not so great when the economy is doing poorly. Thus, we believe an active management approach that employs alternative strategies with low correlation is better suited to our current market environment. With a quantitatively driven research process and unparalleled access to specialized money managers, AlphaCore has established itself as a firm in the alternative investment space.

THE ALPHA

Alpha is primarily generated through alternative strategies; thus, the portfolio will be allocated accordingly, with approximately 1/4 - 1/3 in assets whose returns are less dependent on global growth. These are generally available as highly regulated mutual funds, many of which have 5-10-plus year track records. Some examples of alpha-generating investment strategies include long short equity, market neutral, long short credit, multi-strategy, and event driven. We also seek to allocate to under-the-radar areas of the market, with slower price discovery, lighter analyst coverage and less liquidity. When appropriate, we will make investments in illiquid or private assets, such as commercial real estate, private credit or equity, private LPs and hedge funds. These require a higher level of investor specialization, and therefore, client sophistication, risk tolerance, liquidity needs and environmental factors will all be considered to determine suitability.

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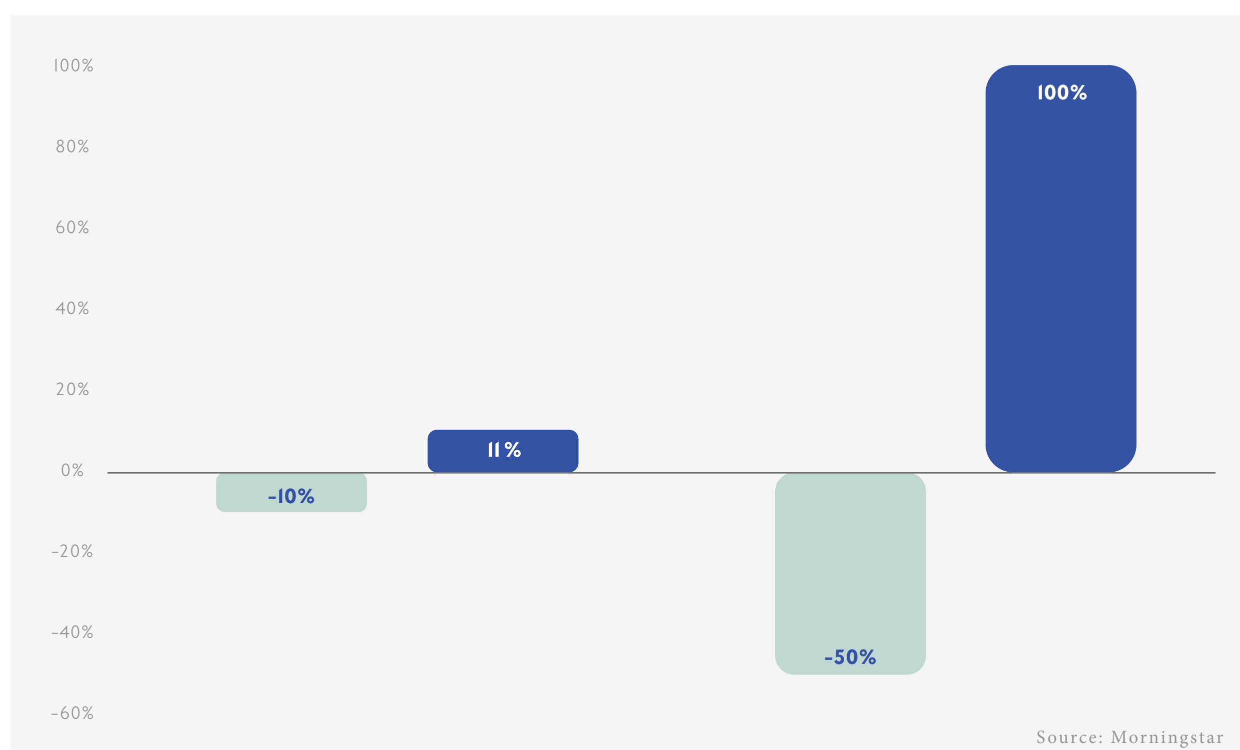
THE BETA

In addition to alternatives, traditional equity and fixed income are integral to a well-diversified portfolio. At AlphaCore, we access equity "beta" exposure mainly through low-cost exchange traded funds (ETFs), or managed account strategies that incorporate tax loss harvesting overlays. On the fixed income side, we incorporate mutual funds with core fixed income and high-grade credit exposures. We believe that the inefficiency in bond markets is best navigated using actively managed funds. Though we utilize inexpensive exchange traded funds for benchmarking purposes, they are not the best way to gain access to these markets. Rather, credit exposures across our client portfolios are largely found in illiquid structures, like interval funds and business development companies.

With a traditional 60/40 portfolio, investors are especially vulnerable to market volatility. While this strategy may yield outsized returns in a bull market, these gains may be quicky erased if market conditions go south. AlphaCore's intention is to design portfolios that are more capable of withstanding market swings. Mitigating losses during downturns results in capital compounded at a more consistent rate over time. **Figure 6** illustrates the effectiveness of our model. If you lose 10%, you must earn 11% to make up for the loss. But say your portfolio loses 50% (an increasingly likely scenario given recent market behavior), you would need to achieve a 100% return to recover your money. **AlphaCore's guiding philosophy can be distilled into a simple mantra – WIN MORE BY LOSING LESS.**

FIGURE 6:
Drawdown Recovery to Breakeven



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SOURCES:

[1] Quantitative easing refers to the introduction of new money into the money supply by a central bank, stimulating economic activity. This is a relatively new tactic popularized after the financial crisis of 2008.

[2] https://institutional.fidelity.com/app/proxy/content?literatureURL=/9904178.PDF

[3] https://www.energysolutionsoxfordshire.org/high-energy-prices-here-to-stay-to-2030-and-beyond-says-new-report/

[4] https://www.federalreserve.gov/econres/feds/files/2022081pap.pdf

[5] https://www.j2t-recruiting.com/post/the-impact-of-baby-boomers-retiring-in-2023

[6] https://www.bls.gov/news.release/pdf/eci.pdf

[7] The rate of return an investor can expect to earn on an investment that carries zero risk, typically proxied by the 10 year Treasury rate.

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