ADVOCATE CAPITAL MANAGEMENT, LLC

Back to the Future, Part 2: A Helping Hand in a World of Positive Correlations

Alone we can do so little, together we can do so much

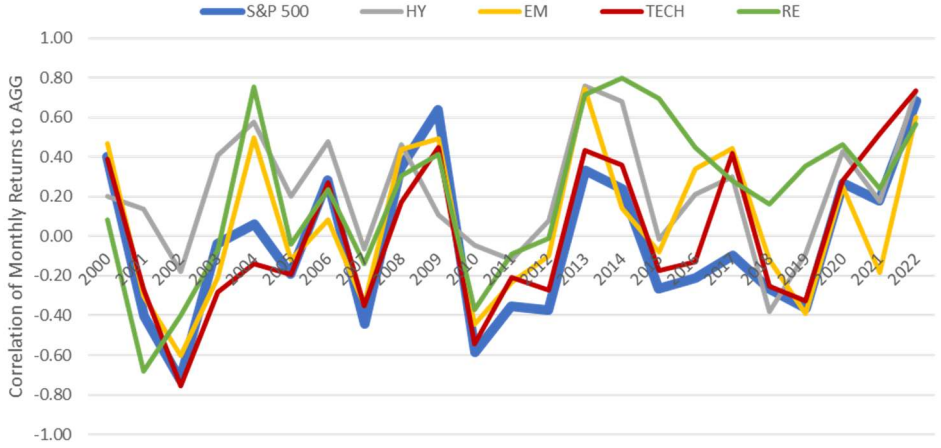
- Helen Keller

2022 brought higher inflation and interest rates, and perhaps most importantly for global investors, the highest cross-asset correlations in over two decades. Rising cross-asset correlation makes diversified portfolios less diversified and riskier than recent data might suggest. We review the design philosophy of Advocate Rising Rate Hedge ETF (NYSE: RRH) and its recent performance and correlation to various asset classes. In this new normal of positively-correlated assets, allocation to neutral and negatively correlated investments could help restore diversification and reduce risk to investor portfolios.

Brief Review: Higher Cross-Asset Correlation and Less Portfolio Diversification in 2022

We begin by bringing back two charts from Part 1 of our discussion – the rising cross asset correlation and the impact of lower diversification on equity-bond portfolios. The correlation across various asset classes is currently, in aggregate, at the highest level in the last 22 years. The chart below shows the correlation of various asset classes to bonds (Bloomberg Agg) using monthly return correlations for each calendar year (2022 correlation is calculated using return data from 31 Oct 2021 – 31 Oct 2022).

FIGURE 1. ANNUAL CORRELATION OF VARIOUS ASSET CLASSES (EQUITIES, HIGH YIELD, EMERGING MARKET, TECHNOLOGY STOCKS AND REAL ESTATE) TO BONDS (BLOOMBERG U.S. AGGREGATE INDEX), JAN 2000 – OCT 2022



Equity: S&P 500 Index (SPTR); HY: High Yield Index (LF98TRUU), EM: MSCI Emerging Market Index (MXEF), TECH: Nasdaq 100 Index (NDX), RE: US Real Estate Index (DJUSRE). Correlations of monthly returns over each annual period. Data period 2000 – Oct 2022. Sources: Bloomberg, Advocate

The rising positive correlation between asset classes, if sustainable, means the risk of equity/bond portfolios, risk-parity products and other multi-asset portfolios will likely be considerably higher than recent history might suggest.

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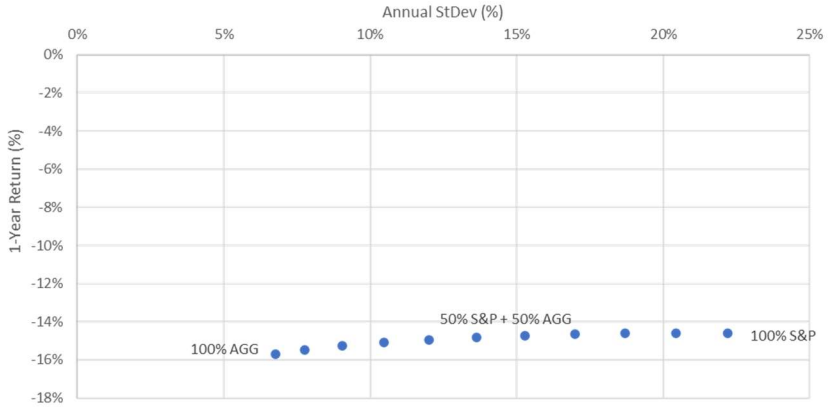
The chart below illustrates the risk-return profile of a portfolio of equities and bonds over the past 12 months, with asset allocation varying from 100% equity (rightmost point) to 100% bond (leftmost point). The portfolio risk-return profile as asset allocation moves from 100% equity to 100% bonds is quite flat and reflects minimal risk reduction from shifting allocation between equity and bonds. In other words, the bond component of an equity-bond portfolio has effectively lost its diversification effect.

FIGURE 2. PORTFOLIO VOLATILITY AND RETURN FOR ASSET ALLOCATIONS RANGING FROM 100% EQUITY (S&P 500) TO 100% BONDS (BLOOMBERG U.S. AGGREGATE). 31 OCT 2021 – 31 OCT 2022



Volatility and return data using 1-year monthly returns from 31 Oct 2021 to 31 Oct 2022. Sources: Advocate, Bloomberg

We can further visualize the impact of rising equity-bond correlation by comparing the volatility of equity, bond and 60/40 portfolios from the past 12 months versus 2019.

FIGURE 3. PORTFOLIO VOLATILITY FOR VARIOUS ASSET ALLOCATIONS: 100% EQUITY (S&P 500), 100% BONDS (BLOOMBERG U.S. AGGREGATE). AND 60/40 EQUITY/BOND PORTFOLIOS, 31 OCT 2021 – 31 OCT 2022

Asset Class	Annual Volatility in Last 12 Months	Annual Volatility in 2019	Relative % Change Since 2019
Equity (S&P 500)	22.2%	12.9%	+72%
Bonds (AGG)	6.8%	3.4%	+100%
60/40	15.3%	7.3%	+110%

Volatility data using 1-year monthly returns in 2019 versus the 31 Oct 2021 to 31 Oct 2022 period. Sources: Advocate, Bloomberg

In the last 12 months, the volatility of the 60/40 portfolio rose by more than 100% of the volatility experienced during 2019. This increase is significantly more on a relative basis than either bonds or equities experienced and highlights the impact of shifting equity-bond correlation on multi-asset portfolios. If positive equity-bond correlation is the new normal, ***multi-asset portfolios will likely exhibit much higher risk than the post-2000 experience might suggest***.

The Advocate Rising Rate Hedge ETF (NYSE: RRH): A Unique Approach to Rising Rate Portfolio Management

Advocate launched its RRH ETF about a year ago to provide investors with a means to benefit from rising rates. Some key RRH design factors are:

1. Capital efficiency. A modest investment in RRH could have a material impact on the risk profile of an equity, bond or equity-bond portfolio.
2. Multi-strat and Multi-asset approach. RRH is constructed and managed differently from most rising rate products in the market which tends to either short bonds or purchase options to short bonds.

Some key attributes of RRH's unique multi-strat approach are:

1. Ability to monetize gains while maintaining exposure. A given strategy may be full or partially closed out after richening and its risk capital may be reallocated to a new, cheaper strategy. This allows monetization while maintaining exposure to rising rates.
2. Flexibility to reposition portfolio as market conditions change. The multiple strategies underlying the RRH portfolio may be easily modified or altered as market conditions change.

Next, let us review RRH performance and asset correlations in the last 12 months.

RRH Performance and Asset Correlation in the Last 12 Months

The performance of various asset classes and RRH in the last 12 months is shown in the following table. The second part of the table also shows the return correlation of various asset classes to RRH, which was negative in the past 12 months.

FIGURE 4. RETURNS OF VARIOUS ASSET CLASSES AND RRH AND RRH CORRELATION TO ASSET CLASSES IN THE LAST 12 MONTHS (RRH NAV AND MV 12M, ITD AND ITD TO LATEST QTR NET RETURNS SHOWN), 31 OCT 2021 – 31 OCT 2022

	S&P 500	Bloomberg US Agg	Emerging Market	Tech (Nasdaq 100)	US Real Estate	US High Yield	RRH NAV Net Returns (12m, ITD, ITD to latest qtr-end)	RRH MV Net Returns (12m, ITD, ITD to latest qtr-end)
12m Total Returns	-14.6%	-15.7%	-32.9%	-28.0%	-23.5%	-11.8%	+44.1%, +45.2%, +28.5%,	+42.7%, +45.4%, +29.0%,
RRH Correlation to Assets	-0.20	-0.72	-0.13	-0.38	-0.07	-0.26		

RRH net return includes gross expense ratio of 0.85% per annum. Performance quoted represents past performance and does not guarantee future results. Investment return and principal value of an investment will fluctuate so that an investor's shares, when sold or redeemed, may be worth more or less than the original cost. Current performance may be lower or higher than the performance quoted. This information is not intended to be investment advice. Diversification may not protect against market risk. For most recent performance, please visit www.rrhetf.com.

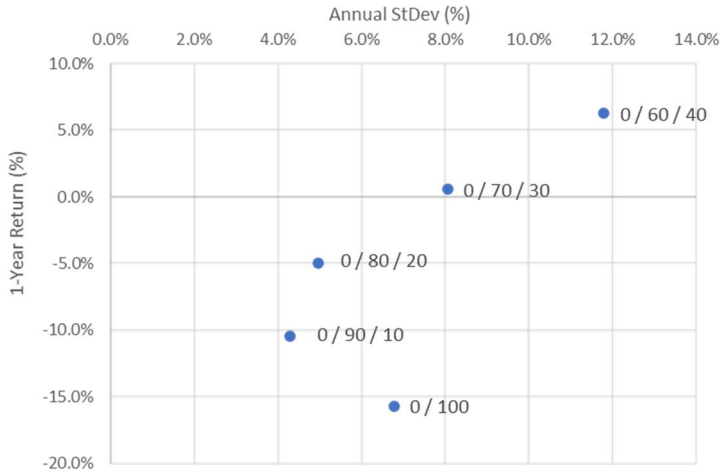
S&P 500 Index: SPTR; Bloomberg US Aggregate Index: LBUSTRUU; Emerging Market Index: MXEF; Nasdaq 100 Index: NDX; Real Estate Index: DJUSRE; High Yield Index: LF98TRUU. Red denotes negative asset return, green denotes positive asset return and negative correlation.

Monthly return data 31 Oct 2021 – 31 Oct 2022. RRH net monthly total return data for RRH ETF. Sources: Bloomberg, Advocate

Impact of RRH Allocation on Equity, Bond and 60/40 Risk-Return Profiles

Over the past 12 months, adding a modest RRH allocation (< 25%) to a bond-only portfolio (Bloomberg U.S. Aggregate Index) could have reduced portfolio risk while improving return.

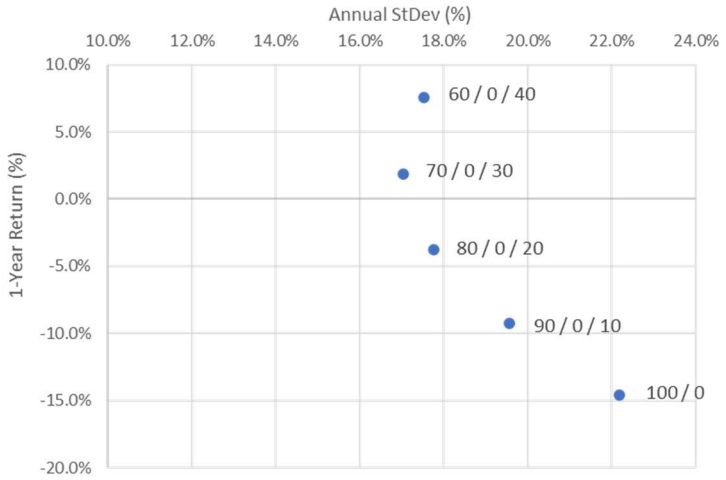
FIGURE 5. RISK-RETURN IMPACT OF RRH ALLOCATION TO BOND-ONLY PORTFOLIO (BLOOMBERG U.S. AGGREGATE INDEX)



Weightings indicate allocation to Equity / Bond / RRH. RRH net return includes gross expense ratio of 0.85% per annum.
Performance quoted represents past performance and does not guarantee future results. Investment return and principal value of an investment will fluctuate so that an investor's shares, when sold or redeemed, may be worth more or less than the original cost. Current performance may be lower or higher than the performance quoted. This information is not intended to be investment advice. Diversification may not protect against market risk.
For most recent performance, please visit www.rrhetf.com.
Bond index: Bloomberg US Aggregate Index (LBUSTRUU). Volatility and return data using 1-year monthly returns from 31 Oct 2021 to 31 Oct 2022.
Sources: Bloomberg, Advocate

Adding RRH allocation to an equity-only portfolio (S&P 500) could likewise have reduced risk and improved return in the last 12 months.

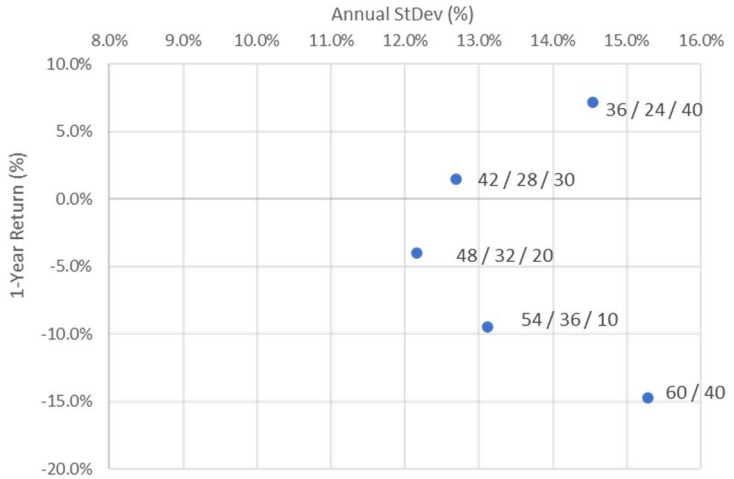
FIGURE 6. RISK-RETURN IMPACT OF ADDING RRH ALLOCATION TO EQUITY-ONLY PORTFOLIO (S&P 500 INDEX)



Weightings indicate allocation to Equity / Bond / RRH. Equity Index: S&P 500 (SPTR). Volatility & return using monthly returns: 31 Oct 2021 - 31 Oct 2022. RRH net return includes gross expense ratio of 0.85% per annum.Performance quoted represents past performance and does not guarantee future results. Investment return and principal value of an investment will fluctuate so that an investor's shares, when sold or redeemed, may be worth more or less than the original cost. Current performance may be lower or higher than the performance quoted. This information is not intended to be investment advice. Diversification may not protect against market risk. For most recent performance, please visit www.rrhetf.com.
Sources: Bloomberg, Advocate

The impact of adding RRH allocation to a 60/40 portfolio could have similarly reduced portfolio risk while improving return in the last 12 months.

FIGURE 7. RISK-RETURN IMPACT OF ADDING RRH ALLOCATION TO 60/40 EQUITY-BOND PORTFOLIO



Weightings indicate allocation to Equity / Bond / RRH. Bond index: Bloomberg US Aggregate Index (LBUSTRUU), Equity Index: S&P 500 (SPTR).
Volatility & return using monthly returns: 31 Oct 2021 - 31 Oct 2022.
Performance quoted represents past performance and does not guarantee future results. Investment return and principal value of an investment will fluctuate so that an investor's shares, when sold or redeemed, may be worth more or less than the original cost. Current performance may be lower or higher than the performance quoted. This information is not intended to be investment advice. Diversification may not protect against market risk.
For most recent performance, please visit www.rrhetf.com. Sources: Bloomberg, Advocate

The table below summarizes the "optimal RRH allocation" that could have generated maximum risk reduction to equity, bond and 60/40 portfolios over the last 12 months.

FIGURE 8. RISK-RETURN IMPACT OF ADDING RRH ALLOCATION TO A BOND-ONLY, EQUITY-ONLY AND 60/40 EQUITY-BOND PORTFOLIOS, 31 OCT 2021 – 31 OCT 2022.

Asset Class	Annual Volatility	12-Month Return	Optimal RRH Allocation	Annual Volatility (Relative % change)	12-Month Return
Equity (S&P 500)	22.2%	-14.6%	30%	17.0% (-23%)	1.9%
Bonds (AGG)	6.8%	-15.7%	10%	4.3% (-37%)	-10.4%
60/40	15.3%	-14.7%	20%	12.2% (-20%)	-4.0%

Performance quoted represents past performance and does not guarantee future results. Investment return and principal value of an investment will fluctuate so that an investor's shares, when sold or redeemed, may be worth more or less than the original cost. Current performance may be lower or higher than the performance quoted. This information is not intended to be investment advice. Diversification may not protect against market risk.
For most recent performance, please visit www.rrhetf.com.
Bond index: Bloomberg US Aggregate Index (LBUSTRUU), Equity Index: S&P 500 (SPTR).
With RRH allocation, the remaining portfolio allocation is based on original allocation percentage.
Volatility and return data using 1-year monthly returns from 31 Oct 2021 to 31 Oct 2022.
Optimal Allocation indicates level of RRH allocation that generated the lowest risk (volatility) in the last 12 months.
Sources: Bloomberg, Advocate

Some notable impacts of RRH allocation in portfolios over the past 12 months:

1. The addition of RRH re-established the efficient frontier for all 3 portfolios (equity, bond, 60/40).
2. Even a modest allocation to RRH within a bond-only portfolio can have a dramatic impact on portfolio risk. A 10% allocation to RRH from an AGG-only portfolio could have reduced portfolio risk by over a third and could have reduced the negative return by one-third.
3. A 20% allocation to RRH from a 60/40 portfolio could have reduced portfolio risk by 20% and reduced the negative return by about three-quarters.

Final Thoughts – Seek Negative Correlation in a Positively Correlated World

The return of positive equity-bond correlation and the highest cross-asset correlation in the last 22 years is a worrisome new development in global markets. Advocate believes that positive equity-bond correlation may be the new normal in a high inflation, high interest rate regime (just as it was in the pre-2000 years). Investors should stress-test their multi-asset portfolios to ensure acceptable portfolio risk in this positive equity-bond correlation environment.

Advocate believes that negatively-correlated investments may be attractive in the new normal of positively correlated assets. In this new normal, diversified portfolio are clearly becoming less diversified and more risky than post-2000 data might suggest. Modest allocations to negatively correlated investments such as RRH could help restore portfolio diversification and help investors manage the risk of equity, bond or multi-asset portfolios.

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Chief Investment Officer
Advocate Capital Management

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Returns, return volatility and correlations are computed by calculating one standard-deviation of various asset class indices and monthly RRH market-value net returns from 31 Oct 2021 to 31 Oct 2022.

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