Canterbury Outsourced CIO
First Quarter 2019 Commentary

Introduction

Risk assets rose sharply in the first quarter of 2019, in spite of slowing economic growth. A more accommodative monetary stance by central banks helped to improve investor sentiment, which was affected in 2018 by trade frictions and moves by the Federal Reserve to normalize monetary policy. The political and economic background remains challenging, given possible repercussions of Brexit, the uncertainty of China's ability to shift from investment-driven to consumer-driven economic growth, and lingering concerns over trade conflicts as a threat to global growth.

Whether the current economic slowdown is a prelude to an economic recession in the U.S. or to what extent Brexit will affect growth in the Eurozone is hard for anyone to predict, but history has shown that capital markets find ways to overcome adversity and move forward. Over the last 25 years, we have had numerous anxieties and shocks as well as many drivers of growth, a number of which seemed much more salient at the time than they do now, when viewed in retrospect. In each case, the investment markets have overcome the impact and moved to subsequently higher territory to the benefit of the genuine investor. A balanced 60% equities/40% bonds index rose at an annual rate of 6.4% between January 1995 and March 2019, allowing the initial investment amount to grow 4.5x over this period.

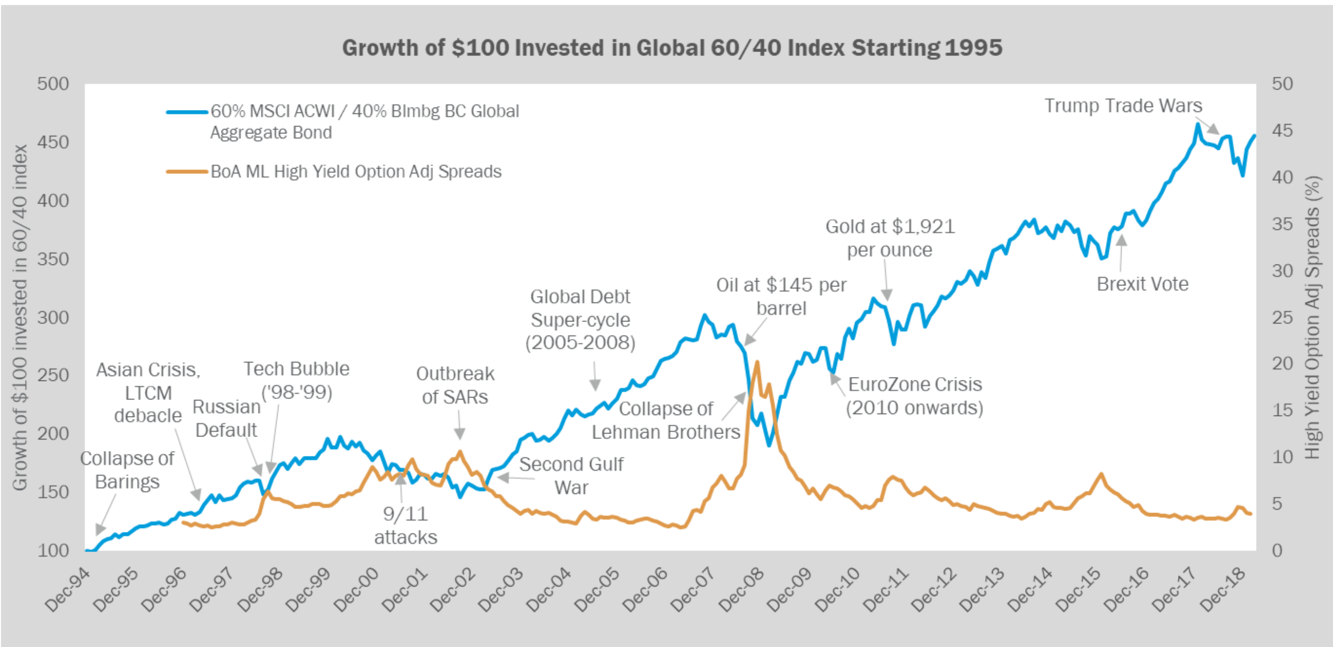

Figure 1. Source: MSCI, Barclays Global, Bank of America Merrill Lynch

Ten years after the market bottom in March 2009, there is genuine concern over the duration of the equity bull market, the persistence of low credit spreads, and whether the Federal Reserve will be able to architect a soft economic landing with their current management of the monetary policy, and further anxiety on how the markets will behave in light of that. But for most of our clients, who have a truly long-term horizon, it's the investment returns over longer periods that make it possible for them to carry out their missions. That is not to say that we would become complacent about short-term market moves, but being consistently invested is key, as is having the discipline to rebalance after strong market moves.

Equities

Within a strong quarter across all equity markets, U.S. equities were ahead of non-U.S. peers, with the Russell 3000 index up 14% relative to the MSCI EAFE and MSCI Emerging Markets indexes, up 9.98% and 9.91% respectively. All 11 economic sectors within the Russell 3000 index were up for the quarter, bouncing back from the steep declines of the fourth quarter in 2018. Growth indexes continued to lead their value index counterparts in each market cap and regional category, given the strong performance of technology, industrials, and consumer discretionary sectors. The broad gains in the market made the quarter conducive to active managers adding value, and we saw the manager mix in both the U.S. and non-U.S. equity segments perform ahead of their respective benchmarks.

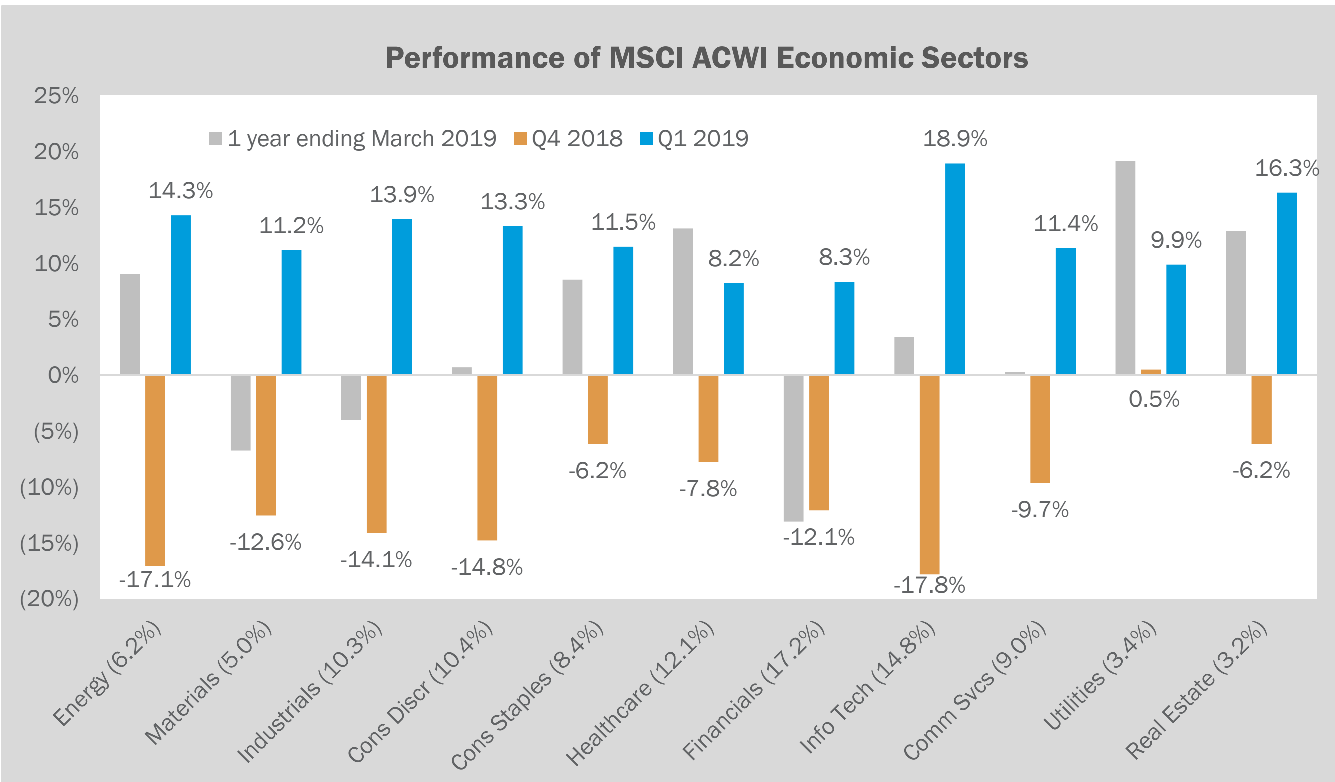

Figure 2. Number after sector name denotes weight of sector in index. Source: MSCI

We continue to find equities more attractive than fixed income in this low-rate environment. We have witnessed a decline in the U.S. equity market multiples as stock prices declined, but forward earnings continue to increase. At the end of March, the S&P 500 Index was trading at a forward price-to-earnings multiple of 16.4x, given consensus expected earnings of $180 for 2019.

One of our challenges over the last 10 years has been the difficulty for U.S. active managers to outperform their passive benchmarks on a consistent basis. One of the reasons has been the underweighting of the top names in the large-cap indexes that have been strong performers and driven the index returns. In recognition of the efficiency of this segment of the market, we have had half the U.S. large-cap segment allocated to the S&P 500 Index in the past. During the first quarter we added more to the S&P 500 Index by paring back the exposure to small-cap managers. This brings the market-cap breakdown in the U.S. equity segment in line with that of the Russell 3000 Index.

Within the non-U.S. equity segment, we added an international small-cap manager to further diversify this segment. The existing managers primarily hold mid- to large-cap securities. Companies in the international small-cap equity segment may be smaller in market capitalization, but many are dominant players in their niche industries and have strong business prospects both within their countries and globally as they continue to grow into larger enterprises.

Fixed Income

Despite equity markets posting double-digit gains for the first three months, bond yields declined over this period, with U.S. 10-year Treasury bond yields falling from 2.66% on January 1 to under 2.41% at the end of March. Despite unemployment levels close to 3.8% in the U.S., wage growth has not been strong, and headline inflation has declined from 2.9% in July 2018 to 1.9% in March 2019.

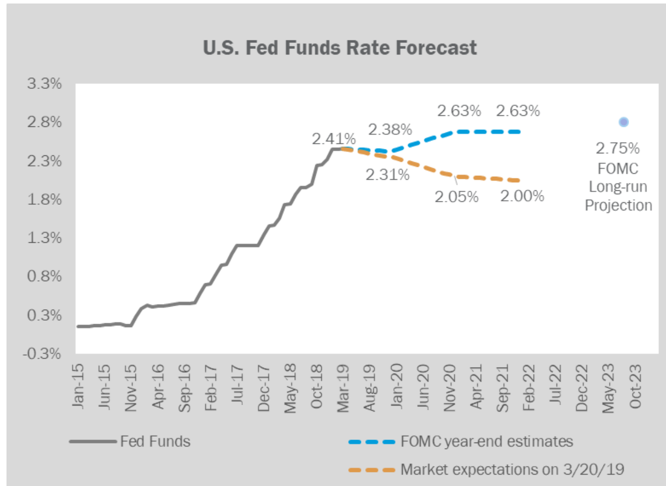

Figure 3. Source: St. Louis Fed, U.S. Treasury

Even as short-term rates have increased from 0% to 2.4% over the last 5 years, market expectations have been for the Fed Funds rate to come down. The yield curve has flattened considerably since December 2013, particularly as long yields have also come down. In comparison to sovereign bond rates in other developed countries, such as 0.18% in Japan and 0.62% in Germany, U.S. Treasuries seem more attractive and continue to draw foreign investment capital. We see core fixed income as an anchor to the portfolio during periods of equity market downturn, such as in the fourth quarter of 2018, and here we have maintained an overall short duration in the fixed income segment of the portfolio, as there has been little to gain in yield by moving out on the yield curve.

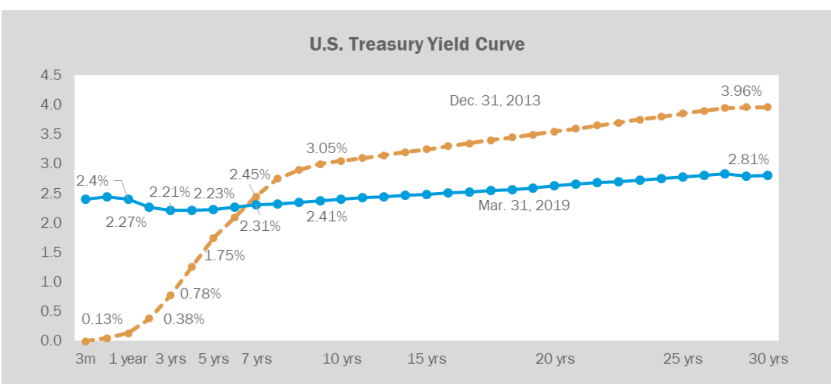

Figure 4. Source: St. Louis Fed, U.S. Treasury

What has contributed to returns has been the exposure to floating-rate securities where interest payments have adjusted upwards with rising short rates. For the first quarter, high-yield bonds rose as credit spreads tightened from the highs in the prior quarter. The low-interest-rate environment has allowed many of these companies to continue to refinance their debt, and we have seen that despite the equity market volatility, credit spreads have not widened by the same magnitude, and default rates have remained low. For the quarter, core fixed income as represented by the Bloomberg Barclays U.S. Aggregate Index was up 2.2%, while Merrill Lynch High Yield Bonds Index was up 7.4%.

Another source of positive yield contribution has been the selective exposure to emerging-market bonds within the non-U.S. fixed income manager portfolios. Both U.S.-Dollar denominated bonds and local currency bonds provide a yield of around 6%, which have added value over time. The exposure has been limited, as this is adversely affected every time the U.S. Dollar rises relative to other currencies.

Hedge Funds

Hedge funds recovered some of their losses from the fourth quarter of 2018, led by the performance of the long-short equity managers. For 1Q19, the HFRI Equity hedge index was up 7.9% for the quarter while the broad diversified fund-of-funds index was up 4.5%. Where managers added to their long positions as the markets corrected in the prior quarter, they were able to capture more of the upturn during the early months of 2019. However, with the sharp decline and bounce back in equity markets over the last six months, many long-short equity managers have been whipsawed as they try to manage their gross and net exposures in the different market environment.

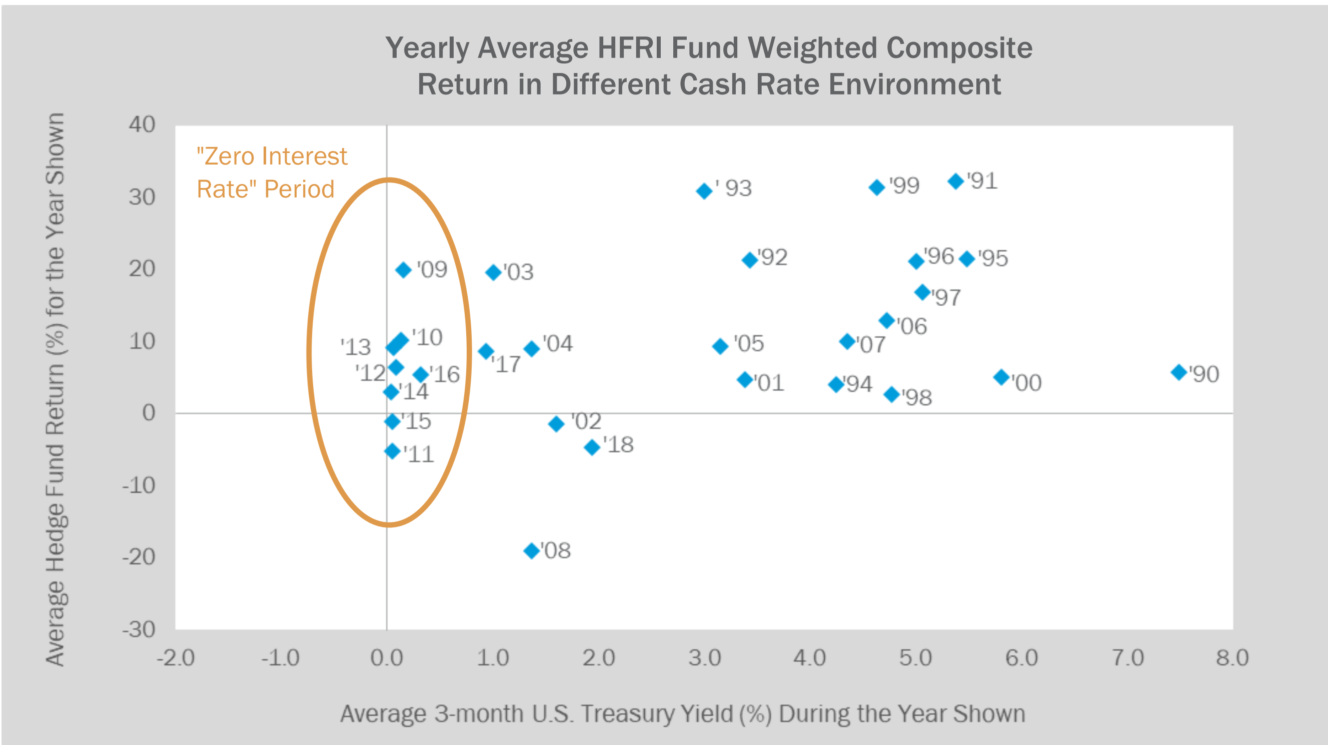

Figure 5. Source: St. Louis Fed, Hedge Fund Research, JP Morgan

The graph above shows the average performance by year of a broad and diverse group of hedge funds, as represented by the HFRI Fund Weighted Composite, in different cash rate environments. The "zero interest rate" environment we have had over the last few years were challenging for hedge funds. Fixed income-oriented funds that depend on yield, global macro strategies that rely on carry, and arbitrage strategies that rely on cash spreads all generated lower returns.

As markets have evolved over the last 25 years, so have hedge fund strategies. The hedge fund peer group represented by the composite has also become more robust over time. It would seem unlikely that the group can replicate the performance of the 1990s, but as short-term rates increase, a number of hedge strategies should have greater potential to improve performance.

Real Assets

A rebound in the price of basic material during the first quarter pushed liquid real asset strategies higher as well. The Bloomberg Commodity Index was up 6.3% for the period, while the price of WTI-Crude went from $45 at the end of December to $60 at the end of March. At this price, many oil and gas exploration and production projects become more feasible, boosting the outlook for both the companies as well as for related infrastructure securities such as MLPs. The S&P Natural Resources Index was up 16.2% and the Alerian MLP Index was up 16.8% for the quarter.

We continue to look for ways to broaden this segment of the portfolio with other strategies that can further diversify the sources of return as well as the sources of volatility.

Private Equity

We have been writing for a while about the capital overhang in the private equity marketplace, both in terms of the large amounts of capital being raised as well as the amount of dry powder that existing funds need to deploy. For that reason, we have been very selective in the funds that we have brought to clients, not only scrutinizing the manager's edge but also trying to avoid the very "crowded" areas of private equity, which have much more capital bidding on fewer available deals.

At the same time, we believe it is important to continue the discipline of committing across private equity styles and vintage years. Our Research Group recently did an assessment on the historic performance of a broad set of funds presented in the Preqin database. When looking back to funds raised from 2005 onwards, their performance through June 30, 2018 has been positive and meaningfully higher than the public equity market equivalent. Even funds raised at the peak of the prior cycle, such as 2005–2007 funds, show positive IRRs.

2015	2014	2013	2012	2011	2010	2009	2008	2007	2006	2005
33.3 Secondaries	20.0 Secondaries	17.1 Buyout	19.5 Buyout	21.4 Venture	17.5 Buyout	17.7 Buyout	13.3 Secondaries	13.2 Buyout	11.8 Growth	19.2 Growth
17.9 FoF	18.3 Buyout	15.2 Secondaries	18.5 Secondaries	18.6 Secondaries	15.9 Growth	15.6 Distressed	13.1 Distressed	10.2 Growth	10.0 Buyout	11.1 Buyout
14.8 Buyout	15.2 Venture	14.0 Real Estate	15.3 Venture	17.9 Real Estate	14.3 Secondaries	15.0 Secondaries	13.0 Buyout	9.7 Secondaries	8.1 FoF	7.6 FoF
13.4 Venture	13.1 Real Estate	14.0 Growth	15.0 Real Estate	14.6 Buyout	14.0 Venture	15.0 Real Estate	13.0 FoF	9.7 Venture	6.6 Distressed	6.4 Secondaries
13.1 Growth	13.0 Growth	12.8 FoF	14.4 FoF	14.1 FoF	13.8 Real Estate	13.3 FoF	9.1 Venture	9.6 FoF	5.8 Venture	4.3 Distressed
12.7 Real Estate	12.6 FoF	11.5 Venture	13.8 Growth	9.7 Growth	12.6 FoF	10.7 Venture	8.9 Growth	7.9 Distressed	5.4 Secondaries	3.5 Venture
12.5 Distressed	10.8 Distressed	10.6 Distressed	9.3 Distressed	9.0 Distressed	10.8 Distressed	5.7 Growth	8.8 Real Estate	6.6 Real Estate	3.1 Real Estate	2.8 Real Estate

Figure 6. All numbers are median net IRR for funds in the corresponding vintage year. Source: Preqin as of June 30, 2018

What is also apparent is that no one strategy has been the top performer every year, and therefore diversification plays an important role. Distressed funds raised between 2010 and 2015 have seemingly lagged, which may be a symptom of the strong corporate debt environment we have had. This may not be the case over the next 10 years. Our approach in this area has been to find managers who toggle between buyout and distressed opportunities based on the business and industry dynamics at the time of investment. We also look for managers who do not simply rely on managing the company's balance sheet, but implement operational improvements to enhance the company's value during the investment period.

Overall Remarks

The strong bounce-back in the first quarter has helped recoup some of the pullback from the prior quarter, but we have also seen greater dispersion in performance across sectors and regions. Even with general slowdown in global growth, there is greater divergence in the economic, political, and market conditions across countries. We have maintained diversification in the portfolios both by asset class as well as by managers.

We thank you for your trust in us. Please feel free to call with any questions or concerns.

Sincerely,

Poorvi R. Parekh, CFA
Director of Outsourced Investments

Ms. Parekh is a member of the Board of Directors, a shareholder of Canterbury, and directs the Canterbury Outsourced CIO platform, which caters to institutions and private clients who wish to outsource day-to-day management of their portfolios to Canterbury. In that role, Ms. Parekh is the chair of the Canterbury Outsourced CIO Committee and a member of each of the firm's five Manager Research Committees. She joined Canterbury in 1996 as the manager of analytics with responsibility for directing the firm's account analysts and client services group. In that role, Ms. Parekh secured many of the asset allocation modeling and research software tools we use today. In 2001, she became the director of manager research, responsible for oversight of all manager, fund, and product research; maintenance of Canterbury's proprietary research database; and chairing the Investment Manager Research Committee. Ms. Parekh graduated from the University of Hong Kong with a Bachelor of Arts in economics. She completed her Master of Business Administration at Shenandoah University.

About Canterbury
Canterbury Outsourced CIO provides a full outsourced solution for managing custom portfolios through an open-architecture investment implementation. Canterbury offers each client a customized asset allocation that is closely monitored and adjusted to meet the client's investment and liquidity goals. As a firm, Canterbury has 30 years of experience selecting and monitoring investment managers and incorporating them in client portfolios. For clients on the Canterbury Outsourced CIO platform, Canterbury assumes the day-to-day responsibilities of making manager selections and changes, instituting comprehensive risk management systems, and enacting administrative and back office functions. Canterbury effectively becomes a co-fiduciary, an investment partner, and an extension of the investment staff by taking on the management and administrative functions of an internal investment office.