Canterbury Outsourced CIO
Third Quarter 2018 Review

Introduction

For most of 2018, news of trade wars and tariffs dominated headlines. Concern about the impact that the swelling number of tariffs can have on the price of U.S. exports and imports, and the further implications for global trade, has been one reason for higher volatility in equity markets. At the same time, however, the U.S. equity markets have continued to climb, with the S&P 500 up 10.6% for the three quarters ending September. Perhaps the economic drag from tariffs could be trumped by the corporate tax cuts, repatriation of corporate cash, and increased government spending that are part of the $1.5 trillion U.S. fiscal stimulus package introduced at the beginning of 2018. Per the Commerce Department, U.S. GDP grew 4.2% in the second quarter and is estimated to grow at an annualized rate of 3.6% for the third quarter.

The Federal Reserve, feeling comfortable with the economic growth, raised interest rates another 0.25% in September, but this still keeps borrowing rates under 3%, as shown in Figure 1. The Fed has kept interest rates lower for longer than in prior rate-tightening cycles and has been slow to raise rates, even as unemployment has fallen to 3.7% as of September 2018. Inflation has picked up, but remains low at 2.7% relative to the 50-year historic average of 4%.

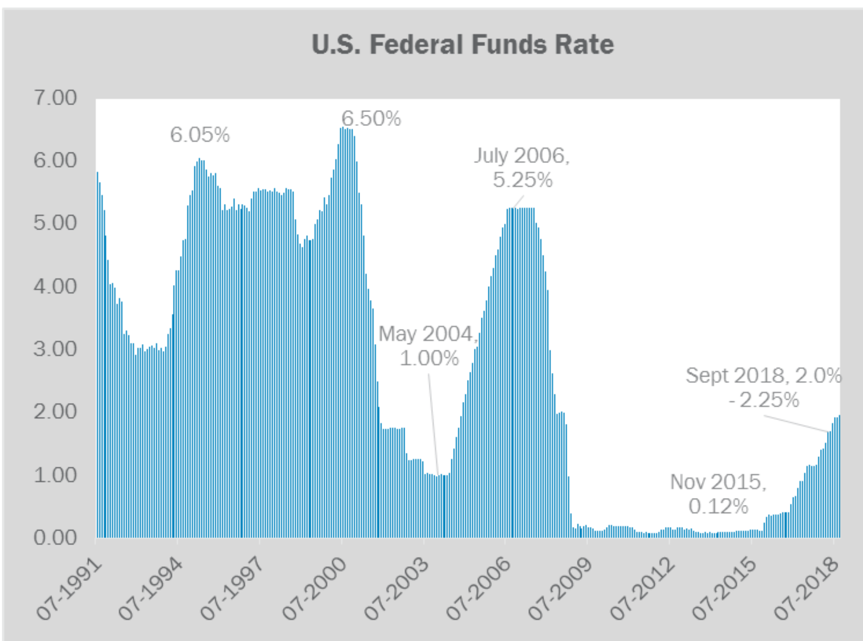

Figure 1. Source: Fed Res Bank of St. Louis

Globally, the pace of economic activity has been positive as well, but we are seeing growing divergence in growth rates across economies in the near term, both in the developed and developing world. The positive effects of quantitative easing in Europe and Japan have met the hurdles of Brexit negotiations, adverse political developments in countries such as Italy, and trade restriction pressures. Further, as interest rates in the U.S. have gone up, the near-zero rates in Europe and Japan have caused more capital to flow into the U.S. The result has been an appreciation of the U.S. Dollar relative to other currencies for much of the year. Over the last ten years since the global financial crisis, the U.S. equity markets have moved farther than their non-U.S. equity counterparts, with the S&P 500 returning 12% for 10-year annualized, versus the MSCI EAFE (non-U.S. developed markets) and the MSCI Emerging Markets Indices, returning 6.2% and 5.4%, respectively. We do not think this divergence is sustainable in the long run. With the MSCI ACWI ex USA Index trading at a P/E multiple of 12.9x compared to 16.8x for the S&P 500, the potential is greater for non-U.S. securities to outperform over the next 10 years.

Trade restrictions affect all countries, but protectionist initiatives in developed countries have a disproportionate effect on emerging economies. Many emerging markets are facing account deficit conditions as trade restrictions reduce foreign revenues, pressuring currencies. Making matters worse, many countries carry significant amounts of USD-denominated debt, exacerbating the debt burden. Two countries that have experienced the most dramatic currency depreciations this year are Argentina and Turkey, with declines of

50% and 40%, respectively. Not all emerging markets are created equal: Countries such as Mexico, Brazil, Hungary, and Malaysia have a growing middle class (see Figure 2), large foreign currency reserves, and strong balance sheets, but fears of contagion have dominated the markets.

The U.S. Dollar Index, Figure 3, ended the quarter at 94.8, essentially the same as it was in February 2015. The strengthening of the U.S. Dollar has been a major reason for the negative performance of non-U.S. equities this year, but as the graph shows, the index tends to fluctuate over time, making non-U.S. securities, particularly emerging market securities, more volatile in the near term. However, the strong economic and demographic fundamentals in these countries provide positive impetus for corporate earnings growth in the long run.

In this environment of rising yields and healthy economic growth, we continue to favor equities over fixed income in our portfolios. Further, given the transient nature of currency movements and the more attractive valuation that non-U.S. securities offer, we feel that it is important to maintain our exposure to non-U.S. securities, particularly emerging markets securities.

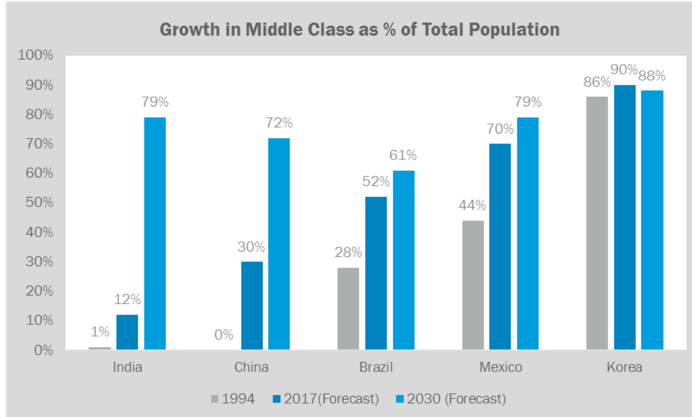

Figure 2. Source: Brookings Institute, JP Morgan

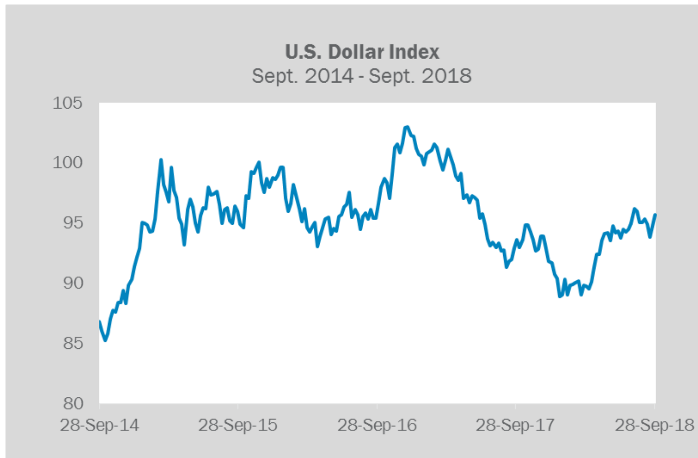

Figure 3. Source: investing.com

Equities

Over the last two years, growth sectors have disproportionately outperformed value segments in equity markets. In Figure 4, a comparison of individual sectors within the S&P 500 indicates that eight of the eleven sectors underperformed the overall index cumulatively between January 2017 and September 2018.

While the S&P was up 34.7% for the period, the information technology sector was up almost twice as much, at 67.5%. In particular, the strong performance of e-commerce names have driven sector returns and much of the overall index. The consumer discretionary and healthcare sectors were also ahead, but industrials, financials, and consumer staples names, which typically make up a large portion of the names in a value portfolio, underperformed the broad benchmark. Dividend-oriented sectors such as utilities and REITs lagged in a rising interest rate environment, while energy and telecommunication names were close to flat.

The same phenomenon affected non-U.S. equities. Growth-oriented equity strategies outperformed value-oriented strategies by a wide margin, and many active managers cut back exposure to high-growth e-commerce names due to valuation concerns or fundamental reasons, causing their performance to fall behind their respective indices for this period.

As important as Google, Amazon, and Apple are as businesses, the domestic economy runs on the contribution of companies across a wide breadth of sectors. Within the equity markets, the information technology sector

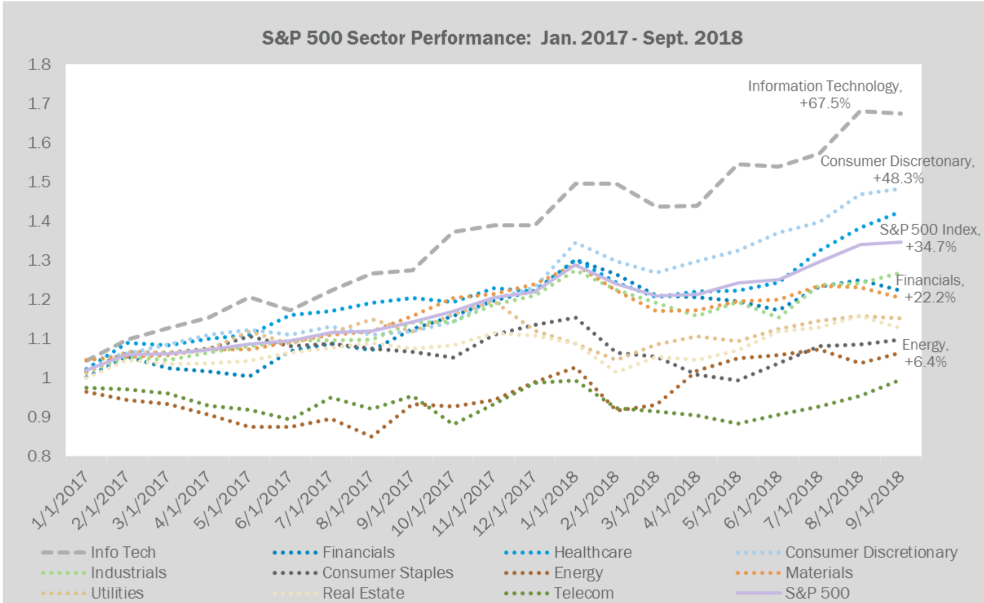

Figure 4. Source: Standard & Poor's

has grown from 15% of the S&P 500 in 2008 to 24% in September 2018. As a result, the weighting of other sectors has proportionally reduced within the index. We do not believe that this wide dispersion in sector performance can persist indefinitely.

More likely, it raises the risk of a valuation correction in some of the names that have appreciated the most. Alternatively, undervaluation in other securities may be a catalyst for corporate events that spur a readjustment in their prices. Either action can work to realign the weighting of various economic sectors in the index to their proportional share of the economy. There is normally a counter-cyclical relationship between value and growth styles, and we have sought to maintain a balance of the two in the equity segment of the portfolio. We take advantage of cash flow within the portfolio to rebalance across large-cap and small-cap names, as well as value- and growth-oriented managers.

Fixed Income

It has been a tough environment for core fixed income securities as short-term rates have steadily increased, but intermediate and long-term rates have not moved much at all. Two-year Treasury rates were at 2.81%, just shy of 24 bps from the 10-year Treasury rate of 3.05%. The low yields offered by Treasuries and related high-quality bonds offer little cushion to offset the price decline from rate increases. The broad fixed income indices, the Bloomberg Barclays U.S. Aggregate and the Barclays Global Aggregate Bond Indices, have an additional hurdle of long duration at 6 years and 7 years, respectively. The two benchmarks, therefore, are down this year, returning -1.6% and 2.4%, respectively. JPMorgan Chase provides an interesting chart, shown in Figure 5, that shows the relationship between starting bond yields and subsequent five-year returns.

With a yield of 3.5% for the Bloomberg Barclays U.S. Aggregate Bond Index as of September 2018, we seem to be out of the tail period of close-to-zero yields, which portends slightly improved fixed income returns over time, but the return expectations at this level still pale in comparison to the high single- and double-digit returns that could be derived from fixed income in the 1980s and '90s.

In the face of rising rates, the fixed income segment in the portfolio is currently designed to remain short relative to the benchmarks, while generating a higher yield. Much of this comes from corporate issues as well as non-U.S. exposure. The adverse impact of the strengthening U.S. Dollar was felt on non-U.S. names in our portfolio as well, but much of this was mark-to-market. Our managers have selective exposure to emerging market bonds, primarily to Mexico and Brazil. Even though these countries are running account surpluses relative to the U.S., their currencies have come under pressure. This year's performance is more a reflection of the volatility of the non-U.S. securities.

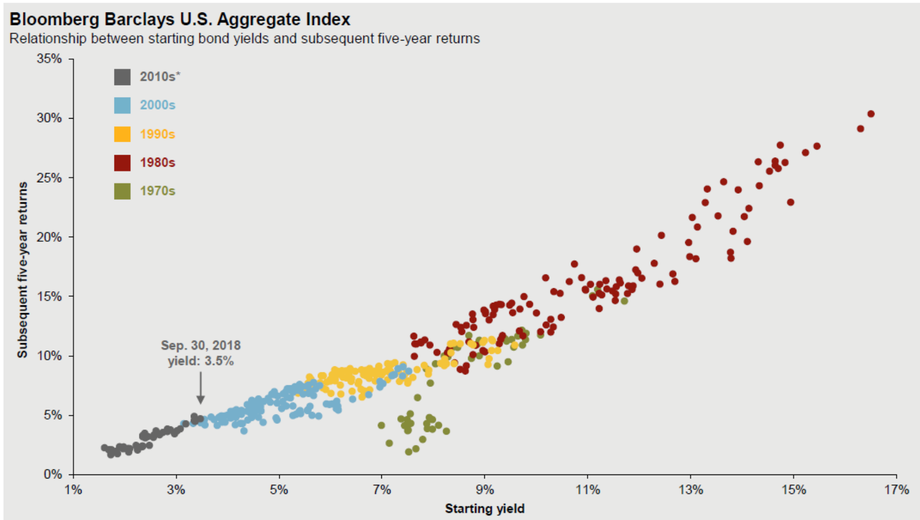

Figure 5. Source: JP Morgan Chase

Where we have been more vigilant is in the area of corporate bonds, across both investment-grade and high-yield issues. Compared to the market-based high-yield index, our managers have less exposure to companies that have borrowed beyond capacity to pay and that have business risk tied to higher refinancing rates or cyclicality in their businesses. Our experience has been that default rates can remain low for a while and then suddenly spike, and many of these "zombie" companies can find themselves incapable of servicing or refinancing their debts.

Hedge Funds

Long/short equity managers with a growth bent held up well during the quarter. Most of their gains have been on the long side of the portfolio; multi-strategy managers with the ability to invest across the capital structure of a company's balance sheet have added more long exposure to equity securities. On the short side, some managers have targeted securities of retailers whose businesses are at risk, given the encroachment of online retailers.

Credit-oriented managers have continued to benefit from price appreciation caused by the further tightening of credit spreads, but many have moved away from companies that have over-leveraged their businesses. There is growing opportunity in event-driven situations in which companies with undervalued securities rationalize their businesses through new acquisitions or by spinning off non-core business lines. The divergence of performance across securities in any one industry creates positive investment opportunities for hedge fund managers.

Real Assets

The long road to recovery seems to finally be in place for the real asset segment, as global growth has firmed up demand for commodities, and the overhang of excess capacity has boosted the price of major commodities. Some of this is reflected in the steady increase in the price of oil from $60 at the beginning of the year to over $73 at the end of September 2018. New areas of production, such as those in the Permian Basin, have been slow in building out the necessary infrastructure to optimize their production processes. Managers invested in these areas have lagged their peers but see the longer-term potential in their investments.

The market for MLPs, which has been going through structural changes in equity ownership and dividend-distribution strategy, has also seen a recovery in prices.

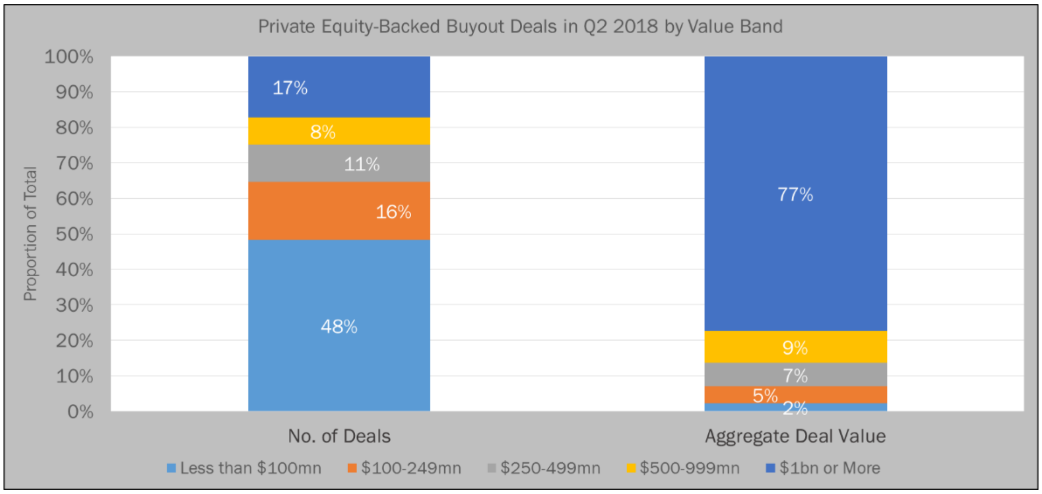

Figure 6. Source: Prequin

Most clearly, inflation has been slowly increasing, and we may be in a new era of a longer period of rising inflation. This segment of the portfolio will benefit the most from bouts of unexpected inflation, which will be immediately reflected in higher commodity prices and benefit the securities of companies in the natural resource sector.

Private Equity

The robust equity markets continue to fuel activity in private equity markets as well. The pace of deal-making has steadily increased over the years; most of the very large deals involve taking public companies private. In the second quarter of 2018, Envision Healthcare Corporation was taken private for close to $10B. There were multiple deals over the $5B mark during the quarter. These have high visibility and are competitively bid. The very large buyout funds have a distinct advantage with the size of their funds to execute on these mega deals. However, the greater number of transactions remain in deals that are under $100MM. These tend to be less visible and less competitively bid.

In Figure 6, Prequin reports that, in the second quarter of 2018, a total of 209 private equity-backed buyout deals were completed for a total of $118B. While the few large deals make up over three quarters of the aggregate value of the deals, they represent only 17% of the number of deals during the period.

We have been very selective in this environment, finding private equity managers that have operating expertise and are looking for small to mid-size companies that are seeking financial partners. We have focused on managers that have proven their abilities by adding value to the underlying company not through leverage, but through improvements in the company's strategy as well as business operations.

Overall Remarks

Compared to the robust performance of 2017, the returns this year may prove to be more moderate for a diversified portfolio. Most markets are fairly valued, which is why we have maintained an overall balanced approach across asset classes in the portfolio and felt it important to trim the winners to reallocate to areas that have lagged on a relative basis. Most importantly, we have been keen to maintain enough liquidity in portfolios to both meet distribution needs and have the ability to capture any opportunities that a potential pull-back in the market may provide.

We remain at your service.

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.