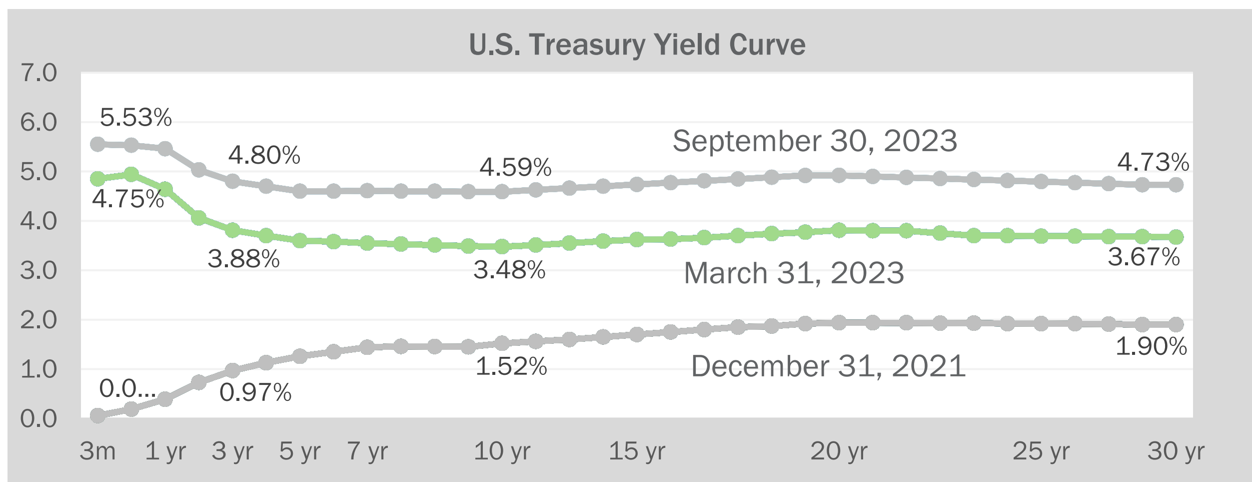
Canterbury Outsourced CIO

Third Quarter 2023 Commentary

Overview

The steadfast stance taken by the U.S. Federal Reserve to fight the post-pandemic inflation surge continues to be a significant driver of market volatility.



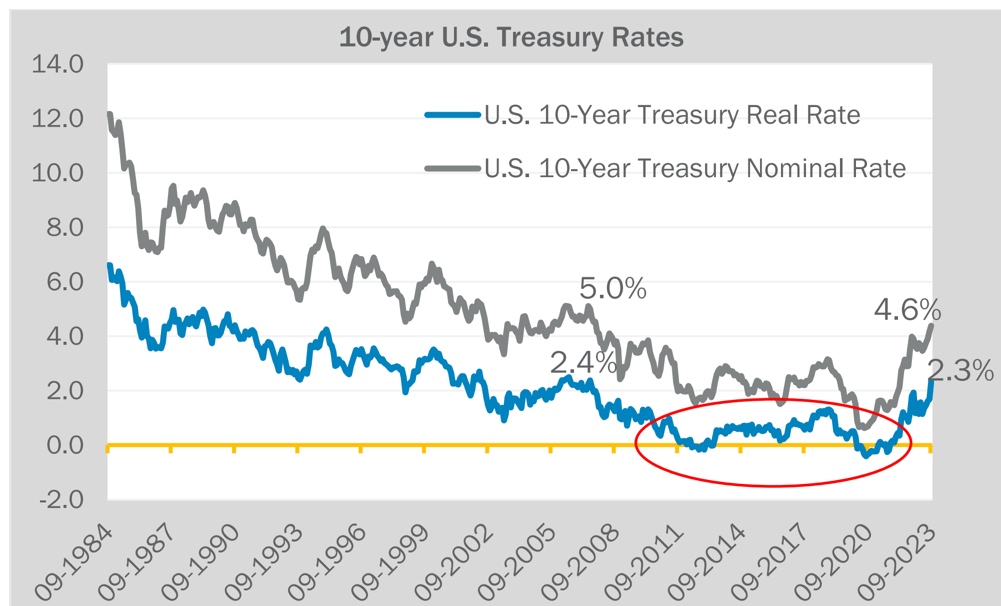


Figure 1 & 2. Source: U.S. Department of Treasury

Eighteen months after the first federal funds increase in March 2022, the U.S. Treasury yield curve has shifted meaningfully along all maturities. The inverted yield curve was seen as a harbinger of a potential recession, but the economy continued to do well as global supply chains reopened and pent-up demand for travel and services drove higher levels of economic

activity. Despite higher prices across most industries, companies were able to relieve supply shortfalls, the labor market has remained tight, and corporate earnings have come through for many companies. The Fed's resolve to keep rates "higher for longer" to reach the 2.0% inflation target has pushed up longer-term interest rates, including 10-year and 30-year rates, more prominently in recent months, making the yield curve less inverted but at higher absolute rate levels. Some of the volatility seen this year in growth equities, real estate, and long-duration bonds reflects the changing cost of intermediate to long-term capital. At 4.6% nominal and 2.4% real, the 10-year Treasury rate remains low relative to history, but the recent moves may signal an end to the nearly 15 years of QE-driven low nominal and sub 1% real rates. If persistent, higher real rates of borrowing have the potential to shift the risk-reward dynamics for longer-duration investments, and the challenge for the Federal Reserve is the lag time between implementing higher rates and seeing its actual effect through reported inflation numbers. Usually, by the time they see unemployment rise as a sign to reduce rates, we may already be in an economic slowdown or actual recession.

Equities

The broad U.S. market equity indexes were well ahead of their peers for the first nine months of the year. The S&P 500 Index was up 13.1% relative to the Non-U.S. Developed Market MSCI EAFE Index, which returned 7.1%, and the MSCI Emerging Markets Index, up 1.8%.

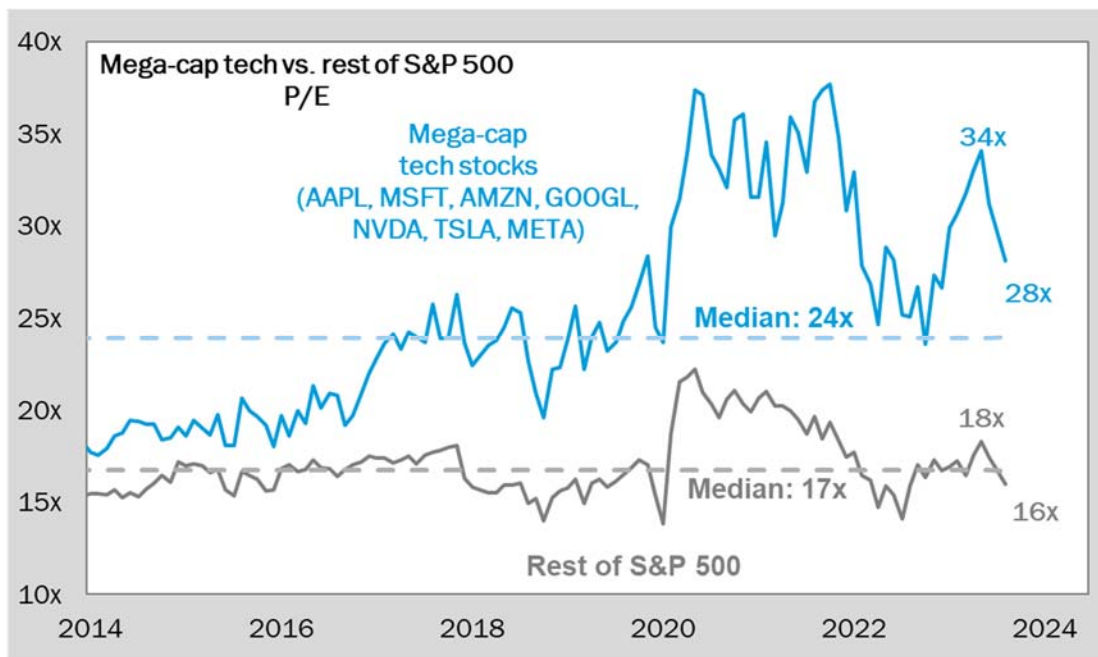


Figure 3a. Source: Goldman Sachs Global Investment Research

The relative performance is somewhat skewed, given the relative contribution of the top seven names in the index. The companies (AAPL, MSFT, AMZN, GOOGL, NVDA, TSLA, META) have raised their forward earnings estimate quarter over quarter, but their valuations have been well ahead of other stocks in the broad index. As of September end, they account for 27% weighting in the S&P 500 Index and were up 55% as a group on a YTD basis. The remaining constituents of the index were up 4% for the same period. As a comparison, the S&P 500 equally weighted index was up 1.8% on a YTD basis.

While the performance of the "magnificent seven" growth names continues to be part and parcel of the broad market-cap weighted index, it has also been the driver of its recent uptick in volatility in the face of the rising Treasury yields. During the month of September, the 10-year Treasury yields jumped 60 bp, and the S&P 500 Index was down 4.8%.

The weighting of these names is even more significant in the large growth index, with the Russell 3000 Growth Index outperforming the Russell 3000 Value Index by over 2210 basis points in the first nine months. This has been particularly challenging for active U.S. large growth managers that have a valuation discipline to stay in line with the index without holding these specific companies. We moved away from having an active U.S. large cap growth manager but also decided not to take a passive approach, given that nearly half the index consists of the top 10 names in the index. The allocation was shifted to the blended large cap index.

At the same time, the non-U.S. equity markets continue to be additive to portfolio returns. MSCI Europe was up 10.9% YTD through September, though the global equity markets have all had the same pull back with concerns over prolonged higher rates and a possible economic slowdown. We expect equity volatility to remain elevated and, therefore, are cautious. We seek to be proactive in speaking with clients about keeping short-term distribution amounts away from long-term investments and parked in cash-like instruments, particularly as cash can also generate some return at this time.

We have also had considerable conversations internally about our dedicated exposure to emerging markets. We continue to be bullish about the superior growth potential in emerging countries relative to developed economies. Still, we are also concerned about the many vulnerabilities related to government policies or commodity-oriented GDP growth.

Over the last ten years, the growth in the number of Chinese public stocks has increased the weighting of China in the MSCI Emerging Markets Index. As of August 31, 2023, about 45% of the index consisted of Chinese and Taiwanese companies. Less than a quarter of the index is made up of 20 countries not listed individually in the chart here.

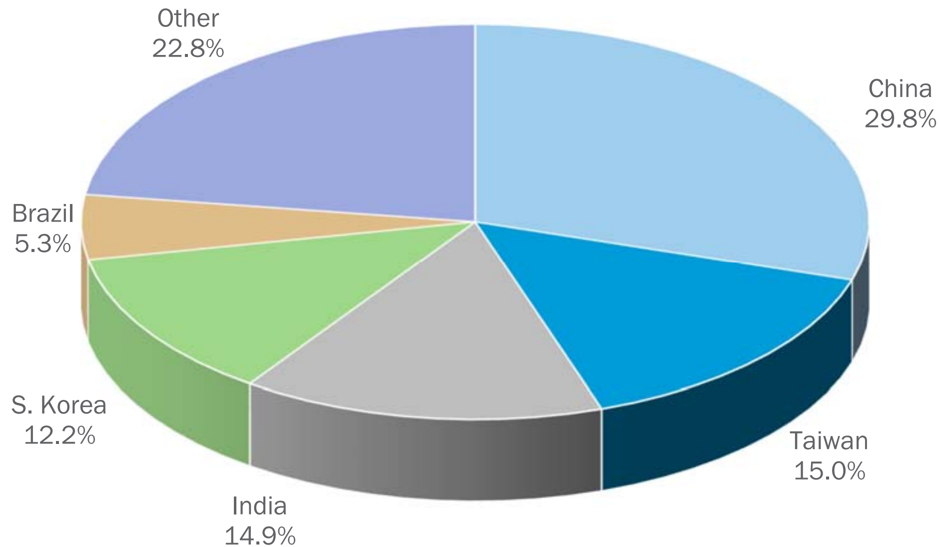


Figure 3b. Source: Morgan Stanley, MSCI

We feel that this concentration in the index makes it very inefficient and provides a great opportunity for active managers to add value through stock and country selection. There are multiple levers for managers to consider in addition to the bottom-up individual company dynamics. These include the concentration within the individual countries' stock markets, the relative value of their currencies, and the country's overall macroeconomic outlook. It has been particularly tough given the geo-political concerns in some of these major markets, but many of the companies are global franchises that have grown market share across borders.

Fixed Income

Through 2023 we have continued to see rising rates push down hurt fixed income values, but as rates have gone up, we have also seen the benefits to total return of the higher income component in offsetting the price decline.

With cash-like instruments generating over 5% yields, while core fixed income is still in negative territory, we have heard from clients about the temptation to hold everything in short-term cash and bonds. Still, at some point, core fixed income will play an important role in adding value when rates go down or as protection in times of equity market shock. This will also be the first choice for liquidity in times of equity market drawdowns.

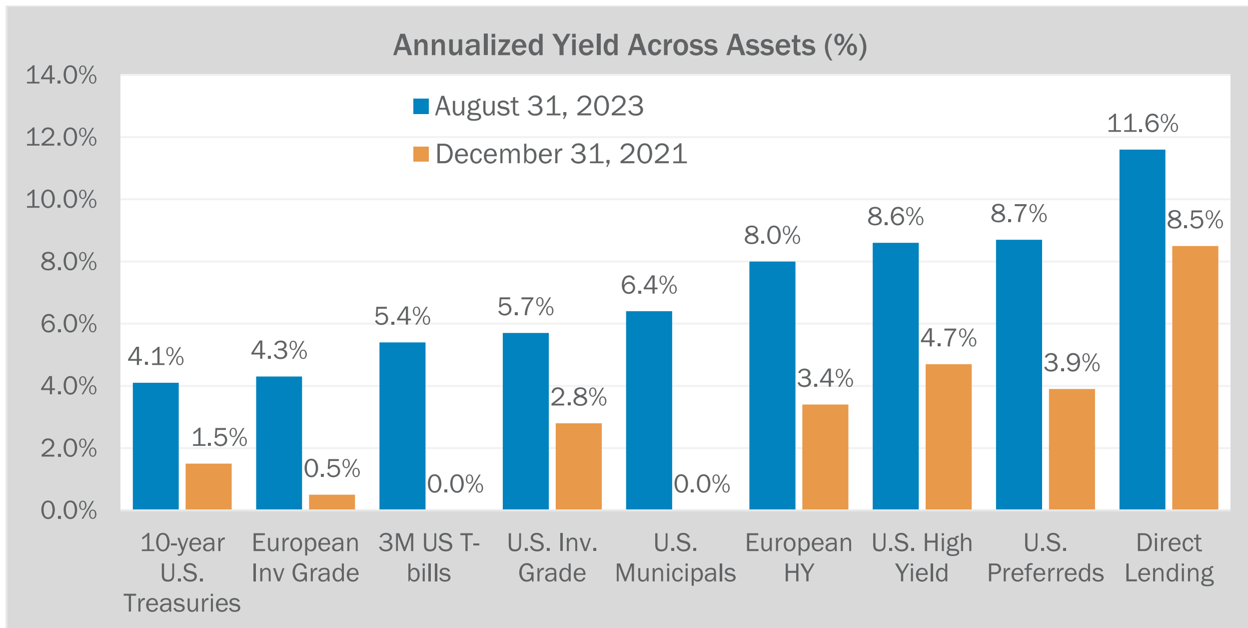


Figure 4. Source: Cliffwater Direct Lending Index, Bloomberg. Direct lending index as of June 30, 2023

We remain short in duration relative to the benchmark, but we have made the fixed income segment more conservative with less currency exposure and fewer elements that correlate to equity markets. We remain constructive on the yield advantage provided by credit and look to have that exposure either through private or public credit.

Opportunistic Credit

Some of the opportunities in credit have been in the alternative space, and that is where we have made additions to both private and hedged credit strategies. Five percent risk-free returns with short-term treasuries have made it possible to earn a higher premium with credit instruments. As private funds have become the more significant provider of debt funding to private equity-sponsored transactions, direct lending and other types of private credit opportunities have also become more prevalent. The growth in private credit reflects a structural change in the providers of corporate financing as banks have become more restrictive in their lending practices, making it possible for private funds to take on that role.

We remain cautious about leverage ratios and have been selective in finding firms that invest with middle-market companies with healthy financials. We are particularly concerned that as short-term borrowing rates increase, the companies as funds that seek leverage, have the ability to weather a potential economic slowdown that may impact earnings and the ability to cover their interest cost.

Real Assets

Even as oil prices declined from their peak levels in mid-2022, they remain elevated compared to pre-Covid levels. Much of this is not demand-driven but the result of the war in Russia and the deliberate decision by the oil-producing countries in the Middle East to limit supply. Whether this will prolong inflationary pressures over longer periods or hasten the process of economic slowdown remains to be seen. Still, where we have a portfolio of financial assets that are negatively correlated to inflation spikes, the exposure to hard assets and commodities in the real asset segment provides a reprieve by offering some positive correlation to higher inflation. The segment also consists of floating-rate loans and other equities that generate income, which adjusts with changes in interest rates or inflation. The segment overall has provided over 4.5% yield over the last 12 months.

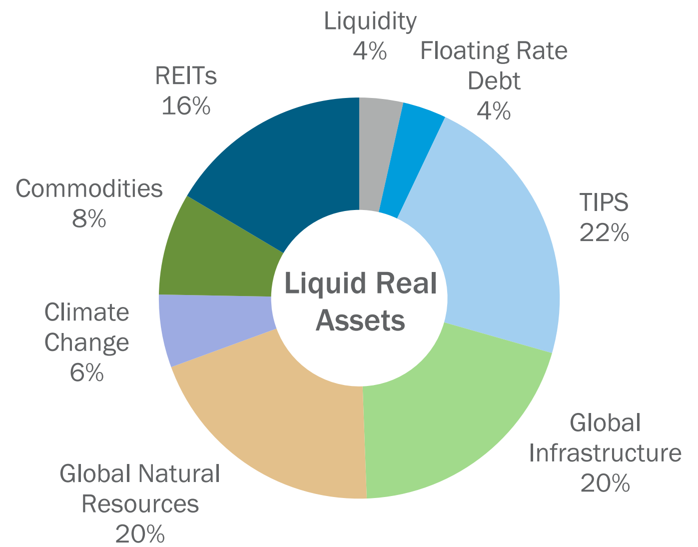


Figure 5. Source: Principal Asset Management, as of June 30, 2023

Private Equity

The pace of private equity fundraising has certainly subsided in the last 12 months, and we see fund managers taking longer to get their funds to a final close. In the face of the rising cost of debt and the decline in portfolio values in 2022, buyers are stepping back to re-underwrite their purchase price and sellers are holding back with anticipation to receive their original ask price. As deals take longer to finalize, there has been slower deployment of capital, and we have seen deal volume decline. Compared to 2021 and even the lower values in 2022, the number of funds raising capital and the amount raised is much lower in 2023. A larger portion of purchases have been for the purpose of add-ons to existing platform companies

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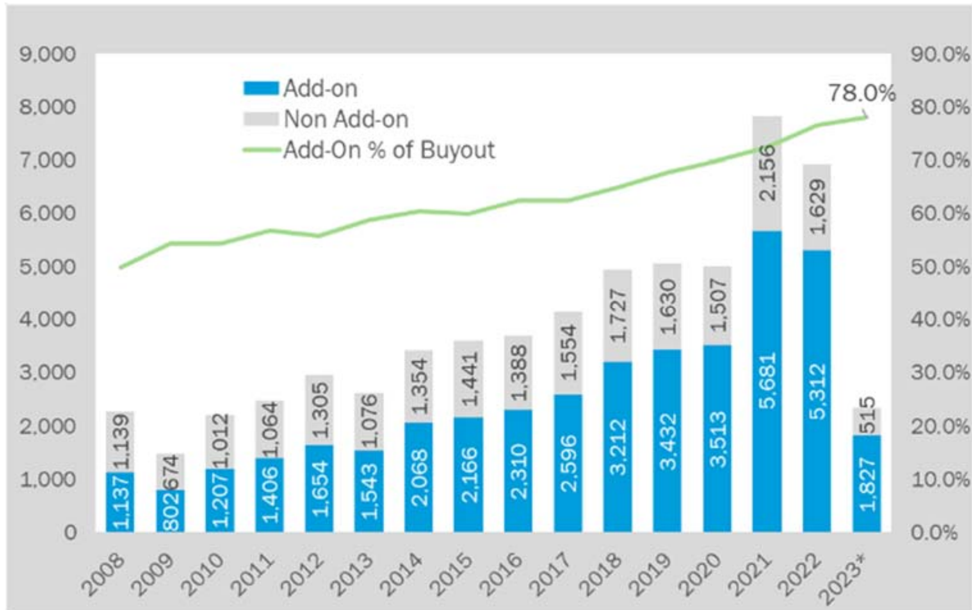

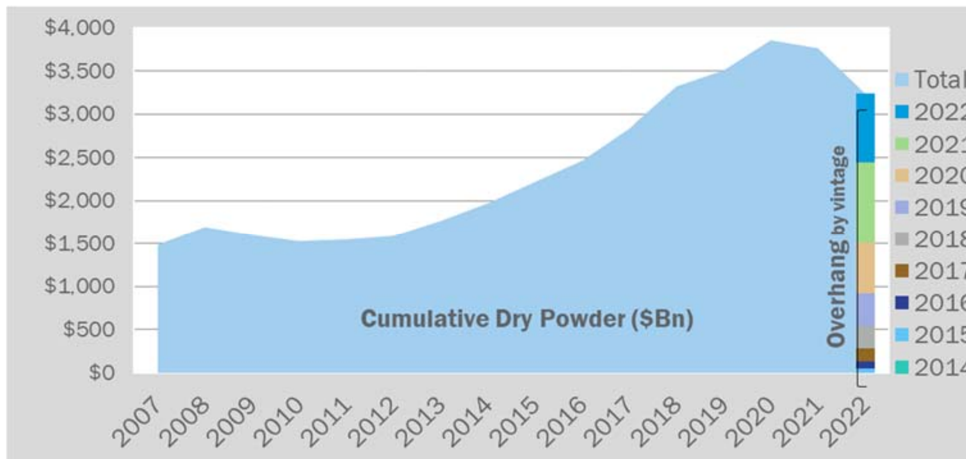

Figure 6 & 7. Source: Pitchbook, as of June 30, 2023

Many large pension funds that have mature private equity portfolios look to manage their annual commitment amounts to manage the weighting in private equity within their overall portfolio. As there have been fewer sales and distributions from existing funds, there has been less need to commit to new funds, particularly as the "denominator" of the overall portfolio also declined in much of 2022. The slower pace of new funds coming to the market has also allowed work down the close to $4 trillion of "Dry Powder" still being held in funds as an overhang.

We do see some mark down in private equity holdings, with the larger markdowns taking place in venture capital funds, particularly early-stage venture. At the same time, the prospects for venture continue to be strong with the burgeoning of new forms of transformative technologies in the field of Artificial Intelligence, blockchain, renewable energy, and the many verticals that continue to emerge to support the application of such technologies in different industries.

Overall Summary

While market gyrations can be unsettling, they also create catalysts for mispricing securities and investment opportunities for managers. Unlike previous periods where excesses in the market created heated economies, which drove prices higher, we see more resilience across sectors. Our clients have long investment horizons, and the key for us is to help them weather any downturn in a way that allows them to meet their ongoing liquidity needs while at the same time staying invested in the market to participate in the long-term growth potential.

We remain grateful to our clients for their trust in us.

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 seeking to outsource the day-to-day management of their portfolios. In this 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. Joining Canterbury in 1996 as the manager of analytics, she directed the firm's account analysts and client services group, securing many of the asset allocation modeling and research software tools we use today. In 2001, she became the director of manager research — overseeing all manager, fund, and product research; maintaining 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 and completed her Master of Business Administration at Shenandoah University.

About Canterbury

Canterbury Consulting is an independent investment advisory firm based in Newport Beach, CA. Canterbury provides consulting services to tax-exempt organizations, including community foundations, educational endowments, religious organizations, arts and cultural foundations, and health care organizations, as well as family offices. Founded in 1988, the firm designs and manages custom investment programs aligned with each client's goals. Canterbury acts as the investment office for its diverse clients and provides objective investment advice, asset allocation, manager selection, risk management, implementation, and performance measurement. Named one of the Best Places to Work in Money Management by Pensions & Investments in 2022, 2021, and 2020 as well as one of the Best Places to Work in Orange County by the Orange County Business Journal in 2023, 2022, 2021, 2020, and 2015. Canterbury Consulting strives to deliver performance and service that exceeds the needs and expectations of its clients. Learn more about Canterbury at www.canterburyconsulting.com.

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