Canterbury Outsourced CIO
Fourth Quarter 2019 Commentary

Introduction

As most of our clients have long investment horizons, we focus more on longer-term returns. Previously, a 10-year horizon seemed to be a reasonable period for a full market cycle, but as we stand at the cusp of the 2020s, we look back at a rather unusual decade.

December 2019 marked the decade-long global economic recovery from the financial and economic crisis of 2007 to 2009, and was accompanied by an unprecedented ballooning in central bank balance sheets globally and a fall in interest rates to historic lows in most developed markets. Between January 1, 2010, and December 31, 2019, U.S. 10-year Treasury yield fell by nearly 200 basis points from 3.85% to 1.92%. In Australia, the 10-year fell from 5.6% to 1.3%. For the last few years, bond yields have hovered in negative territory in Japan and Germany. The prolonged period of low rates has partially been driven by disinflationary pressures. Whether this reflects the impact of globalization on wages, deflation from technological advances, or the reduced inclination of companies to respond to higher labor cost with price hikes, a high percentage of countries worldwide have experienced a prolonged period of low and stable inflation. These conditions were ideal for the performance of financial assets. In general, investors in government bonds, equities, and real estate mostly did well.

Bond returns for the decade were in low single digits, reflecting the low interest rates of the period — particularly when compared to the returns driven by higher rates over the longer 30-year period. Securities benefiting from leverage, such as equities, high yield bonds, and real estate, did particularly well given the low cost of debt. U.S. public and private equities posted 10-year annualized returns in the mid-teens, which are well above historic averages. Even the 30-year return for U.S. equities from 1990 to 2019, which captures two

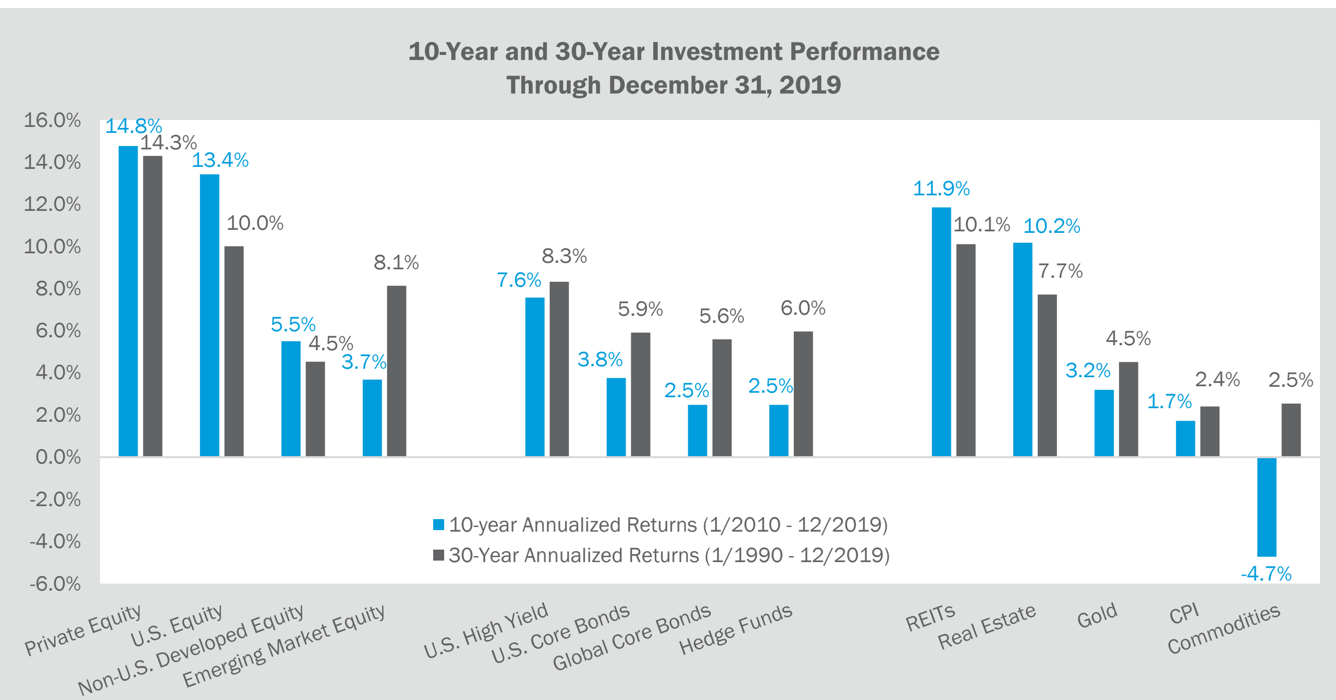

Figure 1. Source: Investment Metrics

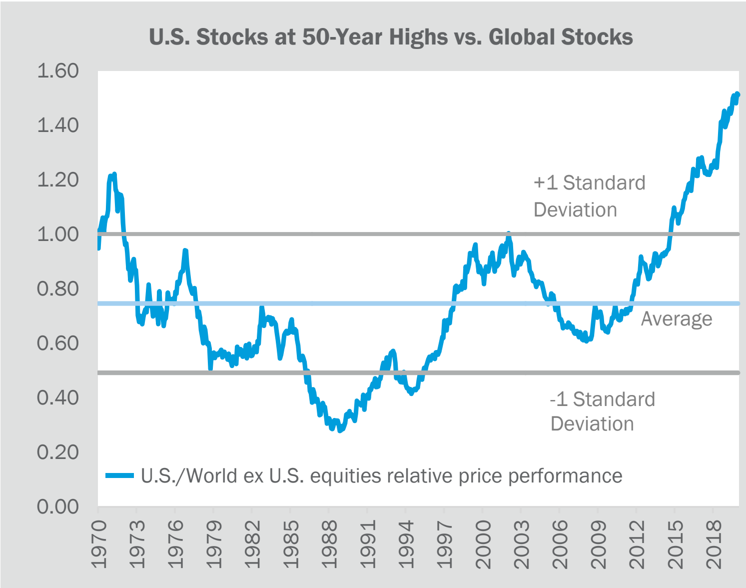

Figure 2. Source: MSCI

down-turns in the equity markets, is over 10%, driven largely by the performance of the most recent 10-year period. Of particular note is the large underperformance of non-U.S. equities relative to their U.S. peers. This has spurred some questioning of the merit of investing in any non-U.S. security.

Truly, if one had invested in the simple portfolio of S&P 500 Index and Barclays U.S. Aggregate Bond Index over the last decade, they would have done better than any diversified portfolio. Yet, as the graph in Figure 2 indicates, over the 10-year period, the relative outperformance by U.S. equities has reached beyond a two standard deviation range from the 50-year average. While one cannot bet on mean reversion based solely on length or magnitude of outperformance, we feel that one or more factors, such as greater clarity around the implementation of Brexit, improved growth in China, reduced trade tensions, or a weaker U.S. Dollar, may spur stronger performance for non-U.S. securities. In the same way, due to the poor performance of the material and energy sectors, their weightings have fallen steadily in equity indices over the last 10 years. However, in so far as these still make up the building blocks of the hard assets that surround us, these are not going away, and given the last 10 years of performance, they are trading at more attractive valuations today.

We reminisce positively at the strong performance of portfolios in 2019 but also see that the continuous outperformance of certain segments further increases their risk profile. We have been more disciplined about trimming gains and reallocating to areas that have lagged to balance the risks in the portfolio.

Equities

The end of December 2019 marked a stark difference in the U.S. equity markets from the year prior. Despite the Trump corporate tax cuts boosting 2018 earnings, the S&P was down over 4% that year, and in 2019, the index posted a gain of 31.5% despite downward revisions in earnings from the effect of higher tariffs and trade restrictions. The bulk of the variation in return is a reflection of valuation change during each of the two years. Perhaps it would be reasonable to see 2018 to 2019 as one period with a net annualized gain of 12%. At the end of December, the S&P 500 was trading at 18.5x, which is above the long-term average of 16x, but the market gains for 2019 were broad

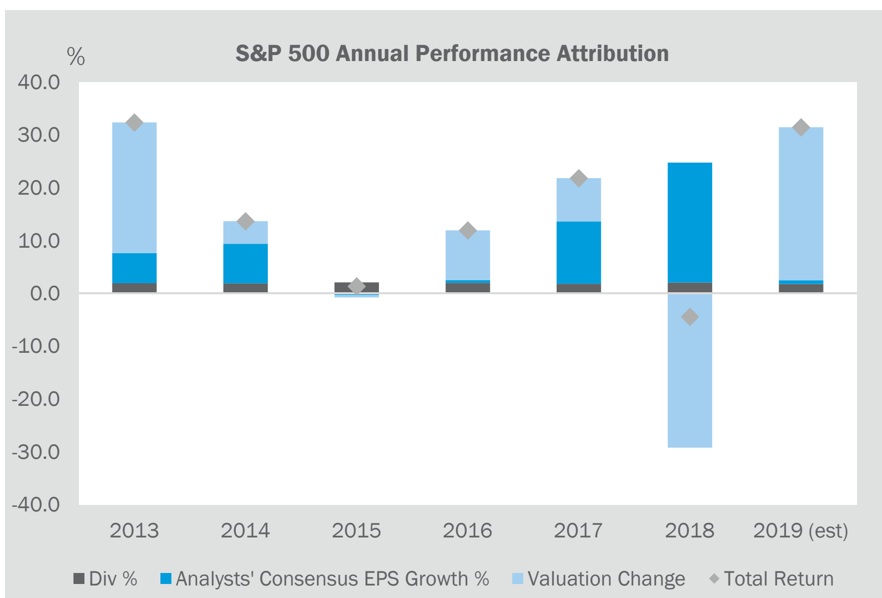

Figure 3. Source: Standard and Poor's

with most sectors participating in the rally, and given the low interest rate environment, valuations are not necessarily extreme.

For 2019, almost all segments of the global equity markets posted strong results. Non-U.S. equities were up over 20% returns for the year, with emerging markets up over 11% in the fourth quarter alone. Some of this may reflect subsiding concerns about a global recession in the near term or more clarity on the political path toward Brexit. A weaker U.S. Dollar also helped, as the MSCI ACWI ex U.S. IMI Equity Index was up 6.2% in local currency but up 9.2% in U.S. Dollar terms. We have maintained a neutral stance in our exposures to regions and style relative to the broad equity benchmarks, taking advantage of cash flows to trim from the faster gainers and reallocating to areas that have lagged.

Fixed Income

While the equity segment drove much of the gains in the total portfolio, the fixed income segment also contributed meaningfully. United States Treasuries continued to surprise on the upside, as 10-year Treasury yields fell from 2.66% to 1.92% during the year. Managers that had longer duration securities benefitted in this environment. Core fixed income was up over 6%, with U.S. bonds outperforming their non-U.S. counterparts. At the same time, as the equity markets did well, so did the performance of credit issues, particularly high yield bonds. The Bloomberg Barclays U.S. High Yield Index was up 14.4% for the year, and overall default rates remain low. However, we are observing areas of weakness in certain sectors. We believe active managers have room to add value in the area of fixed income, but we are closely monitoring our active managers for the value they have added through security selection.

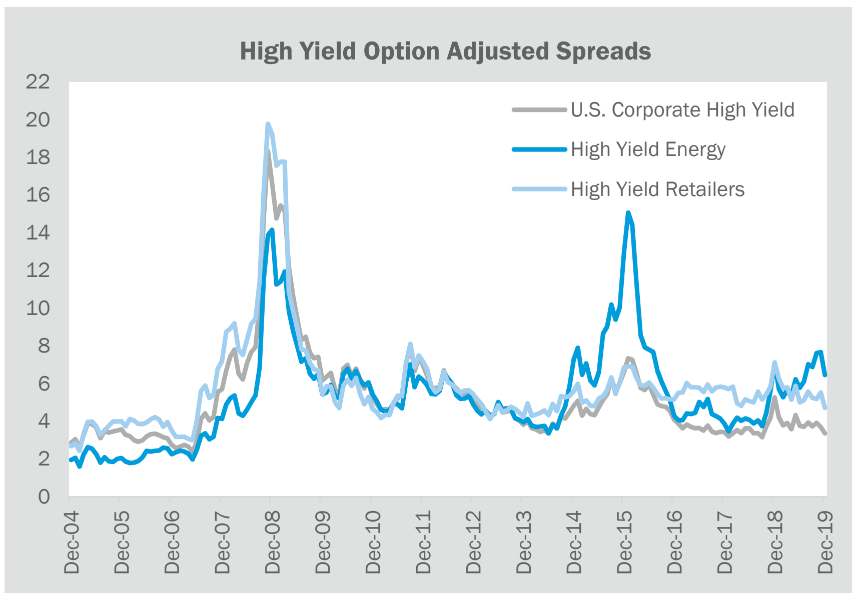

Figure 4. Source: Barclays Capital

In the area of high yield bonds, for example, overall spreads have remained tight for most of the last 10 years. However, most recently, we have seen spreads widen on the bonds of certain industries that have come under pressure. Even if there is no overall recession, certain sectors, such as energy and retail, are experiencing structural changes. Bonds of companies in these sectors may offer higher coupons but are also subject to greater risk of defaults. The credit managers in the portfolio have migrated over the last few years toward a higher quality bias in general, but some have opportunistically invested in attractive bonds within "stressed" sectors where the company is showing improving fundamentals and, therefore, has less risk of faltering compared to its industry peers.

The current market environment of tight spreads is reflective of the mature stages of a recovery, so market conditions remain vulnerable to potential changes in fundamentals — even if we continue to experience slow or decelerating economic growth.

The fixed income segment of our portfolios has almost half of its exposure to core fixed income, which is defensive in nature and will likely provide an anchor to the portfolio if riskier segments become more volatile.

Real Assets

The sentiment that a recession is less likely in 2020 helped pushed higher returns for natural resources and commodity-related strategies. Natural Resource equities were up over 17.6% for the year, while commodities and MLPs were up 7.7% and 6.6% respectively. Over the course of this year, we broadened the exposures in the portfolio's real asset segment to take advantage of opportunities that have positive sensitivity to both inflation as well as interest rates.

Even though this has been a challenging environment for real assets over the last decade, this segment continues to remain in the portfolio as a potential hedge for the financial assets over short periods. Over the long term, it is also a diversifier, sourcing alternative returns from non-financial hard assets.

Liquid Alternatives

The past decade of strong equity market returns and low interest rates have been difficult on many diversifying strategies. The impact has been acutely felt by hedge funds. Capital has flowed out of hedge funds in many cases to be reallocated to less expensive, long-only, equity index strategies. Long-short equity funds have borne a large brunt of the outflow. Also, shorting securities has been challenging and costly in certain cases. Long-biased strategies and funds with global exposures have held up better, as they have been able to explore a broader opportunity set and participate more positively in trending markets. However, they have also experienced higher volatility due to the higher net exposures.

Multi-strategy funds that invest across equities, fixed income and across the capital structure of a company's balance sheet have held up more positively over the last 10 years. Figure 5 (illustrating the dispersion of 12-month returns across various hedge fund strategies) shows that relative value and multi-strategy funds generated better returns — even in the bottom quartile of performance over this period. Funds focused on the emerging markets experienced the most challenging periods as both weaker local market performance and currencies adversely affected performance.

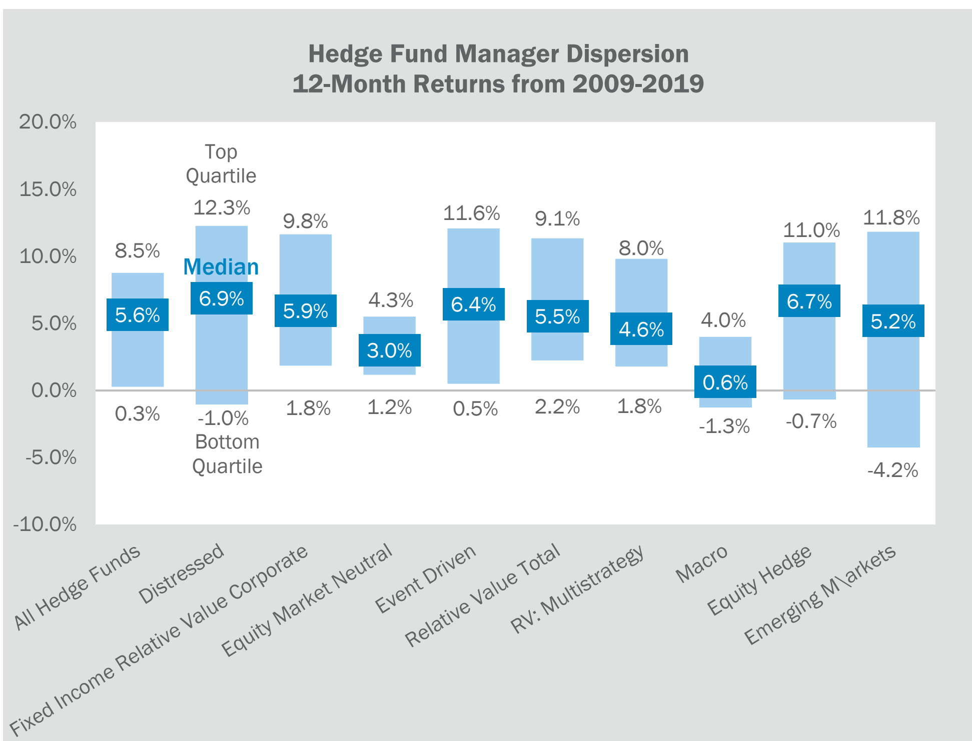

Figure 5. Source: Hedge Fund Research

Despite frustrations over performance relative to broad market benchmarks, clients that held hedge funds over the last 10 years benefitted positively from their exposure. There was a higher level of manager turnover, as business prospects were often tied to the performance and asset flow in these strategies. More positively, many funds reduced fees and offered better liquidity terms to keep their investor base.

Mutual funds with dynamic asset allocation strategies faced similar challenges during this period. Funds with a value-bias approach, any hedging, and non-U.S. exposure struggled to keep pace with broad market returns.

The market alternatives segment helps to reduce overall portfolio volatility. This benefit was not easy to appreciate over the last 10 years, as markets trended upwards in low volatility. We continue to maintain a target weight to this segment as a discipline — not only as a hedge during a higher volatility environment but also as a strategy to take short positions and benefit from market downturns when the opportunity arises.

Private Equity

The pace of private equity deals and fundraising has declined over the last year, partly as a result of rising multiples and partly because many fund managers still have considerable "dry powder" left to invest in the last fund they raised. Much of the decline is attributed to the drop in the number of very large deals that are over $1 billion. Smaller deals tend to make up a larger portion of the deal flow, many of which are purchases made as add-on to existing firms. The firm, PitchBook, which maintains statistics in the area of private equity, reported at the end of September 2019 that over 70% of the deals are add-on purchases to existing private-equity-backed companies.

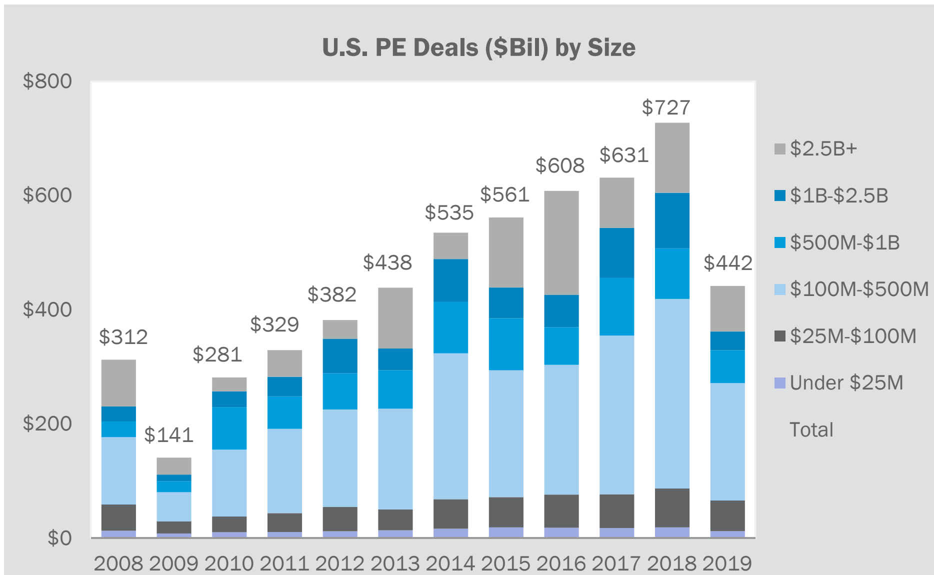

Figure 6. Source: PitchBook

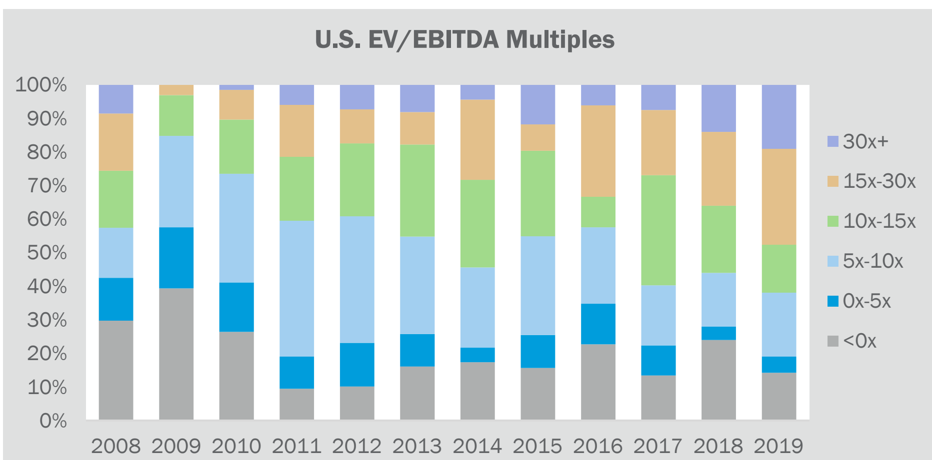

Figure 7. Source: PitchBook

Over the years, we have also seen a steady increase in the multiples of the deals. PE firms that pay "up" a higher multiple for their initial purchase often build up the firm through acquisitions. If they can purchase the smaller acquisitions at a lower multiple, that can bring down the overall multiple of the combined entity. We have deliberately avoided firms that look to primarily add value through such financial engineering. Our bias is toward funds that acquire smaller firms with lower levels of leverage and add value through operational improvements. Whether the subsequent sale is to another private equity firm or a strategic buyer, the return is more accretive, as there is less leverage to pay off. Should the economy or market go sideways, the lower leverage levels also give these companies a greater chance to survive through the down-turn.

We are proponents of investing in private equity (if that amount of illiquidity can be accommodated), as it has proven to generate a premium above public markets over the long term and over market cycles. However, given the amount of capital that has flowed into private equity, we feel it is time to be very selective, particularly in areas that have been hyped up. In 2019, we witnessed a number of failed IPOs, such as WeWork, Uber, Peloton, and others, which at the end of the year, were trading well below their offer price. There are opportunities in this space and our focus has been to find the smaller firms with experienced founders, who we feel have the skill and access to possibly establish their own VC franchise over time.

Overall Remarks

We made a number of manager changes over the course of 2019 and are comfortable today with the manager line up as well as the allocations. We are vigilant of underlying exposures, especially as we see greater dispersion of performance within sub-segments of different markets. Some of these provide opportunities, while others are signs of inherent weaknesses. We will not hesitate to make any changes when there is a compelling reason, but we also want to avoid making assumptions of imminent reversion to long-term averages, as this low interest rate and low growth environment may linger on.

We are grateful for your trust in us and wish you a very happy and healthy 2020.

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 — 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 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, overseeing $20.2 billion in assets as of December 31, 2018. Canterbury provides consulting services to tax-exempt organizations — including community foundations, educational endowments, religious organizations, arts and cultural foundations, health care organizations as well as individuals and family offices. Founded in 1988, the firm designs and manages custom investment programs aligned with each client's specific goals. Canterbury acts as the investment office for its diverse clientele and provides objective investment advice, asset allocation, manager selection, risk management, implementation, and performance measurement. Canterbury strives to deliver performance and service that exceeds client needs and expectations. Learn more about Canterbury Consulting at www.canterburyconsulting.com.