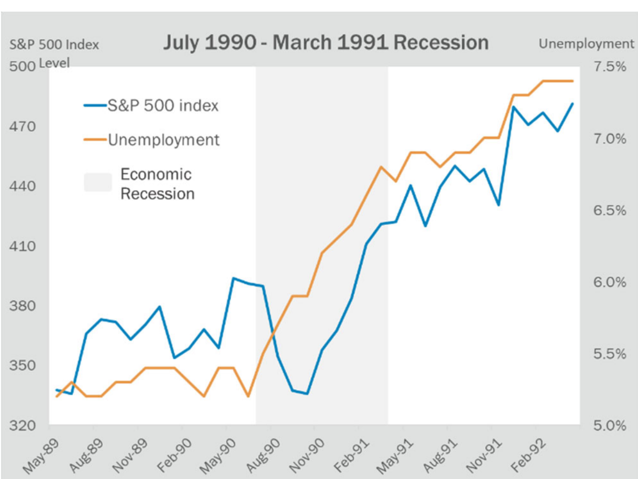
Canterbury Outsourced CIO
Third Quarter 2022 Commentary

Overview

For the third consecutive quarter, both stocks and bonds declined in tandem. The S&P 500 fell 5.3%, the 10-Year Treasury rose 85 basis points, and 2-Year Treasury yields rose 130 bp, resulting in the most inverted yield curve in several decades. The U.S. Dollar appreciated for the fifth straight quarter, increasing 7%. At the same time, crude oil and gold fell more than 20% and nearly 8% respectively.

Amidst the noise of dismal market returns lies the concern of whether the tightening of financial conditions, which are driven by expectations of a more aggressive global rate hike cycle, will lead to a recession. Should a recession occur, many are still unsure if it will be a mild one or a true “hard landing”. Despite short-term interest rates increasing by over 300 bp, a low unemployment rate of 3.8%, stable home prices, healthy income gains, and manageable debt servicing have prevented a recession so far. To date, credit spreads have not blown out, which often occurs heading into a recession. With high yield option-adjusted spreads at 5.5% at the end of September 2022, corporate fundamentals still reflect stability. Thus, even though we are experiencing an inverted yield curve, which is a harbinger of impending recession, it may be too soon to consider a recession to be a foregone conclusion.

We don’t seek to be nonchalant about recessions, as the anticipation and preparation for a recession can have a self-fulfilling effect. The possibility of economic recession has increased with rising rates, in particular if the supply-side and pandemic-related disinflation does not emerge in a significant way. In some cases, firms planning for slowdown may cut back on production or pursue organizational changes through mergers and acquisitions to maintain a healthy bottom line. While many entities had deleveraged during the decade after the global financial crisis, there are still entities that may not be able to absorb rising borrowing rates, particularly if this is accompanied by slowing economic and consumer activity. The repricing of securities has created both opportunities and challenges for businesses that are pursuing transactions, and this is prevalent in both public and private markets. It remains to be known if the valuation correction that we have seen with the major indices reflects a “fair” value in a higher interest rate environment.



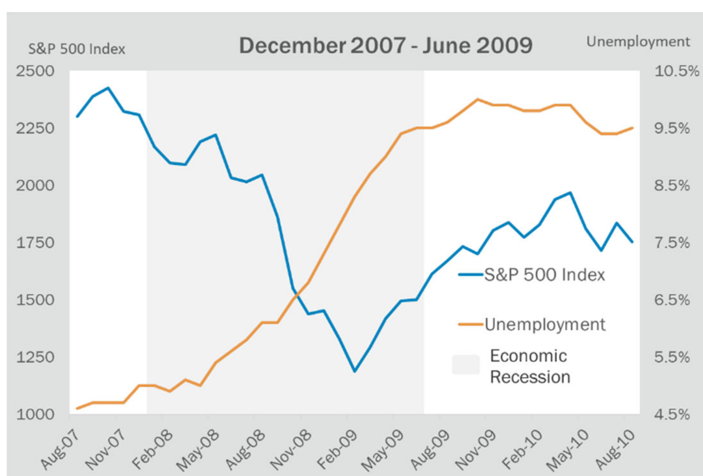


Figure 1 & 2. Source: SP Dow Jones, Natl Bureau of Econ Research, Bloomberg, JP Morgan

Historically, we have seen equity markets decline in anticipation of an economic recession, but the trough of the decline often precedes the end of the recession by several months as well. The charts of prior recessionary periods illustrate how the equity markets can be a leading indicator of economic activity, while unemployment data can often be a lagging indicator, rising as we go into a recession and continuing an upward trend sometimes after the recessionary period has ended.

The volatility we have seen in both the equity and fixed income markets will likely continue so long as there is evidence of underlying inflationary pressures, yet the risk remains both on the upside as well as the downside. The challenge is further complicated in non-U.S. markets. Energy supply issues and geopolitical tensions in Europe and the Asia-pacific region have further reduced confidence that a recession can be avoided. However, these markets have underperformed those of the U.S. over the last few years and are trading at more attractive valuations. The upside-to-downside reward potential for these markets has become more compelling over time, albeit the difficulty to time the turnaround.

Equities

With the third quarter decline, global equities, as represented by the MSCI ACWI, were down 25.6% on a year-to-date basis. Nearly all sectors had negative returns, with the exception of Energy. Rising rates hurt growth-oriented sectors most, with the Information Technology and Telecom sectors down 31.4% and 39%. The Russell 3000 Growth Index was down 30.6% relative to the Russell 3000 Value Index that was down 18%.

While, in the near term, equities may have more downward pressure if corporate earnings decline in the face of further restrictions from rising interest rates, many stocks have already "recalibrated" to a lower valuation. At the end of September, the forward price-to-earnings ratio of 15.1x for the S&P 500 is attractive relative to the long-term average of 16.8x.

Non-U.S. equities, with the ACWI ex U.S. Index down 26.5% for the year to date period, were slightly behind the -24.6% return of the Russell 3000 Index. In local currency, however, the ACWI ex U.S. Index was down 16.18%. This indicates that on a fundamental basis, non-U.S. equities held up better than their U.S. counterparts. Much of their underperformance in U.S. Dollar terms was due to the strengthening of the U.S. Dollar. At September end, the U.S. Dollar Index had appreciated 16% YTD and was at its highest level in 20 years. Yet, non-U.S. equities seem mostly unloved given their underperformance over the last 10 years.

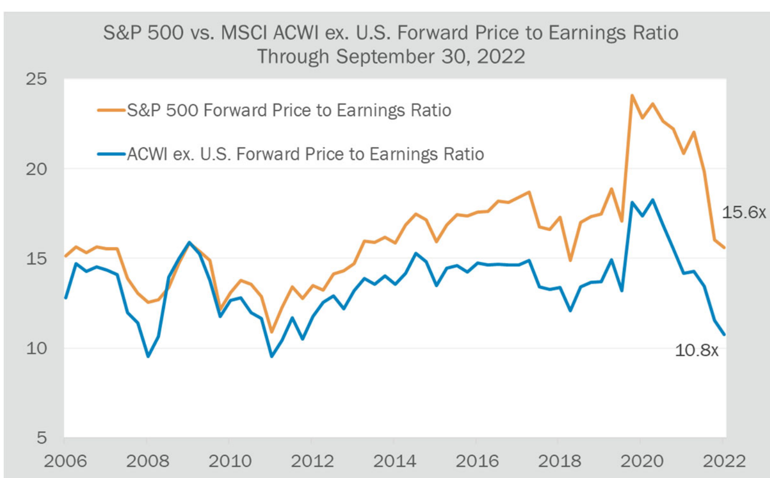


Figure 3. Source: SP Dow Jones Indices, MSCI

The ACWI ex U.S. Index is trading at a price-to-forward earnings of 10.8x relative to 15.1x for the S&P 500 Index, indicating lower investor expectations for non-U.S. equities. While it is difficult to determine the performance of any market segment over a 12- to 24-month period, if we look out towards the next 10 years, we are unlikely to experience the same level of appreciation in the U.S. Dollar from current levels. We are more optimistic about the upside potential and feel that that over the next 10 years, the performance of non-U.S. equities will not lag by the same magnitude of 8-9% annualized rate of return that it has over the last decade. While we are not ready to overweight non-US equities, we have chosen to remain neutral in our geographic exposures relative to the MSCI ACWI Index at this time.

A more structural concern for us going forward is that with the Federal Reserve's "new normal" neutral rate of interest at 2.5%, the projected path for the Fed Funds rate in the future will be more restrictive than the near zero rates we experienced over the last 15 decades. Going forward, equity returns may remain more range-bound over the medium to long term as both inflation and interest rates stabilize at higher levels. In our view, this will require investors to taper their future investment return expectations, particularly relative to covering ongoing spending needs after inflation.

Fixed Income

Given very low treasury rates, we have been bearish about government bonds for a number of years. The cyclical bear market we have seen in government securities may continue as long as inflationary pressures remain high. However, the bond vigilantes seem to be indicating that while near-term rates continue to rise with the Federal Funds rate, rates may remain more capped over longer periods. Nonetheless, we have just gone through the worst three quarters of bond market performance experienced in its history.

As yields have risen across most fixed income securities, the bond segment of the portfolio is generating close to 5% in yield at the end of September, and our active managers are opportunistically adding more to intermediate bonds. This is helping add more yield and also positioning the portfolio to benefit from price appreciation by "rolling-down" the yield curve when short-term rates do stabilize or even begin to fall.

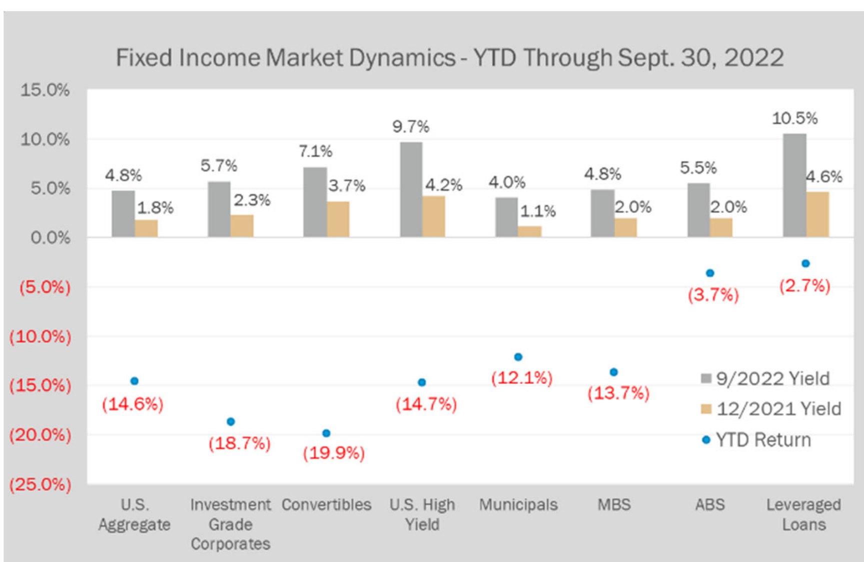


Figure 4. Source: Bloomberg Capital

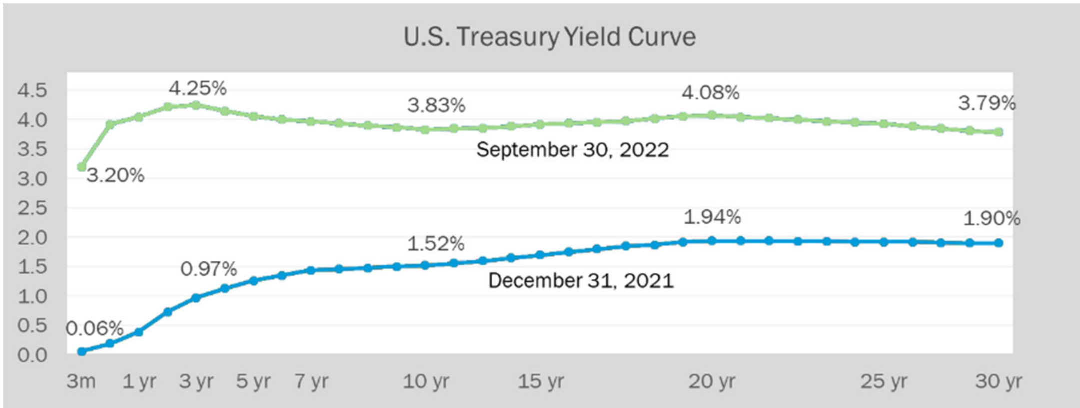


Figure 5. Source: U.S. Treasury

We remain short in the duration of the overall segment relative to the Bloomberg Aggregate Index. Over the course of this year, however, as spreads have widened and yields have risen, we have seen the underlying managers in this segment adjust their portfolios to add incremental duration with high quality, investment-grade issues.

Where we are staying cautious is in the area of high yield bonds. On the one hand, the higher yields have provided some offset to declining prices. On the other hand, the prospect of rising rates is more challenging on below investment grade companies that may be more leveraged. If option adjusted spreads do widen to levels that we had seen in March 2020, we will likely be quick to take advantage of the dislocation and add more to this area.

Hedge Funds

Where hedge fund performance has lagged the upward trending market over the last decade, it is during periods of prolonged market volatility that they prove their value in helping to reduce overall portfolio volatility and preserve value. While the performance of long-short equity managers has been mixed over the course of this year, the multi-strategy managers have been able to add more to their hedges and take the opportunity to find value across a company's capital structure. Through the end of August 2022, the HFRI Event-Driven Index returned -4.09% compared to -14.6% for the Bloomberg High Yield Index.

We feel that periods of market volatility can also create opportunities for hedge strategies. The tightening of financial conditions creates various disruptions in the normal functioning of the financial markets. Wider credit spreads indicate that investors are less willing to hold debt and are requiring a higher return to provide funding. Equity volatility reduces the certainty of transactions and affects investor confidence as well as risk appetite. Higher volatility also affects the pricing of commodities, currencies, and derivatives associated with financial securities.

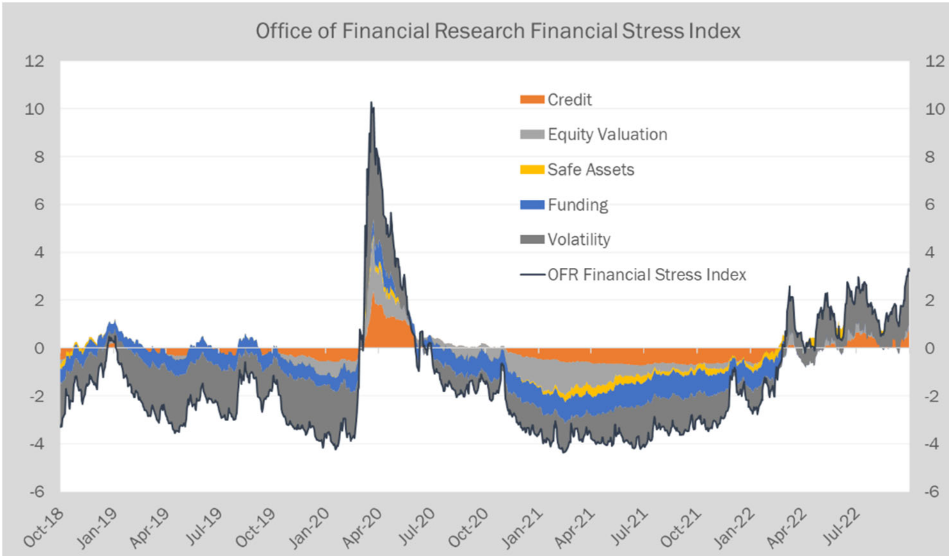


Figure 6. Source: Office of Financial Research

The OFR Financial Stress Index, which measures the elements that contribute to the market conditions, shows above average stress levels for most of 2022. This is primarily led by volatility and tight credit situations. A prolonged period of tight financial conditions increases the vulnerabilities that companies face and a greater likelihood of "break" events, such as distress and defaults. The environment provides opportunities for hedge funds to pick up publicly traded debt and equity securities that trade below their intrinsic value and either hold them until market conditions improve or actively participate in the debt restructuring process.

Real Assets

The rising rate, high inflation environment that we have experienced has had mixed results on our inflation hedge bucket. The inflation hedge segment contains a diverse program that includes hard and soft real assets as well as floating rate credit and government debt. These strategies are positively correlated to a rising inflation environment but are also affected by the stage of the economic cycle.

Over the first three quarters of 2022, commodities and hard assets have made positive contributions with price increases. However, the impact on floating rate securities, from Treasury inflation protected securities (TIPs) to corporate loans have seen price declines in the face of rising interest rates. The Morningstar U.S. Real Asset Index, which

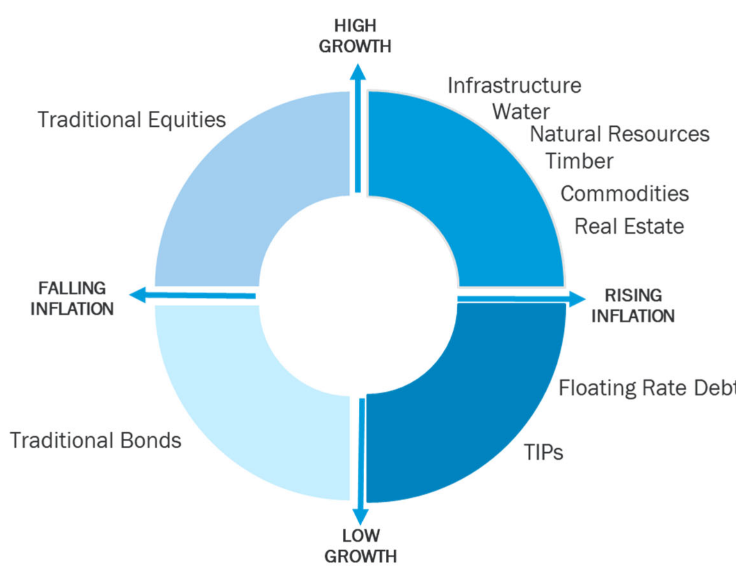


Figure 7. Source: Principal Group

includes a 40% allocation to TIPS, was down 13.9% on a YTD basis. The diversified fund that we have in this segment performed ahead of the index, but was not spared from the price declines.

Private Equity

Amidst complex macroeconomic and geopolitical backdrop, rising interest rates and falling public market indexes are impacting the pricing environment in private equity as well. Deal activity and multiples have dropped, but the lower public equity prices also create attractive deployment prospects for sponsors to take companies private. In many cases, firms that raised capital in the robust 2021 funding period are still well capitalized, but future financing rounds will likely be more challenging.

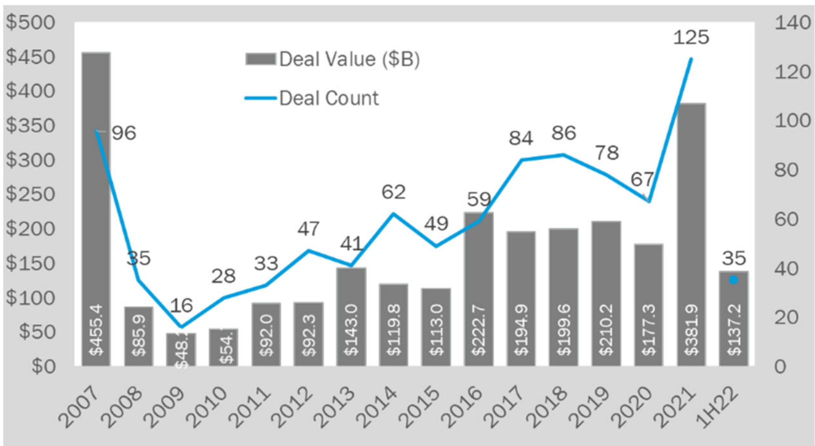


Figure 8. Source: PitchBook, Q2 2022

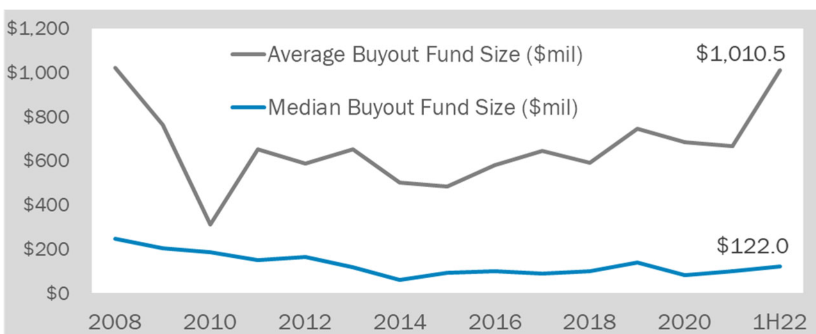


Figure 9. Source: PitchBook, Q2 2022

Per the private equity database provider PitchBook, deal activity is well below 2021 levels. Yet, the pace at which funds are raising capital has not abated. Through the first half of 2022, the average buyout fund size is over a billion, even though the median is well below $150 million. This is reflective of the sizeable amount of capital that very large institutions and pension funds have committed to private equity and the continued pacing that they will need to make to reach their higher targeted exposures. It is possible that the dry powder that continues to build in large funds will help provide a "floor" to private equity transaction prices. This will be seen on a lag. As we are beginning to receive June end fund statements, we are certainly seeing lower marks in some areas, such as Venture and Growth funds. For us, it has been important to maintain the pace of commitments we have projected for our clients. Down markets provide more attractive investing opportunities and better return potential for funds of the respective vintage years. At the same time, we are closely monitoring the liquidity profile of our clients' portfolios. As managers seek to take advantage of the buying opportunities, we want to make sure clients have enough liquidity to meet the capital calls.

Overall Thoughts

In summary, while we are in a challenging market environment, through September 2022, there has not been any dislocation so far that would warrant making a major shift in the portfolio. However, we are closely monitoring allocations. Should the opportunity present itself, we will be quick to rebalance the portfolio.

We remain grateful for your 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 — 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. 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 individuals and 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 2020 and 2021 as well as one of the Best Places to Work in Orange County by the Orange County Business Journal in 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.