Canterbury Outsourced CIO

Second Quarter 2018 Review

Introduction

The second quarter was fairly volatile for the global financial markets. Concerns over tighter financial conditions, renewed dollar strength, and moderated global growth weighed on equity and fixed income markets. Our assessment is that the case for a structural global economic recovery is still in place. Central banks' concerted efforts toward monetary easing have put economic recovery on firm footing in most major countries. During the first quarter, year-over-year growth in GDP came at a steady pace of 2.4% in the eurozone and 2.8% in the U.S. Inflation has been rising but remains low, allowing central banks to move forward with pulling back quantitative easing measures and normalizing short term rates.

In June, the U.S. Federal Reserve Board raised short term rates by 25 basis points to over 1.75%, confirming that the economy is doing well (Figure 1). We anticipate that the federal funds rate will continue to go high enough to give the Fed enough leeway to make an impact during the next recession, when they need to boost economic activity by lowering rates. In the wake of the financial crisis in 2008, the Fed dropped short rates from 4% to near zero. We may not experience an economic recession for some time but are also cognizant that as short rates rise further, unless the longer end of the curve also goes up (possibly in response to higher inflation), we may have an inverted yield curve, which has historically portended a recession. As of the end of June, the Treasury yield curve was rather flat, with less than 50 basis points' differential across the yield on two-year bonds (2.5%), 10-year bonds (2.9%), and 30-year bonds (3.0%).

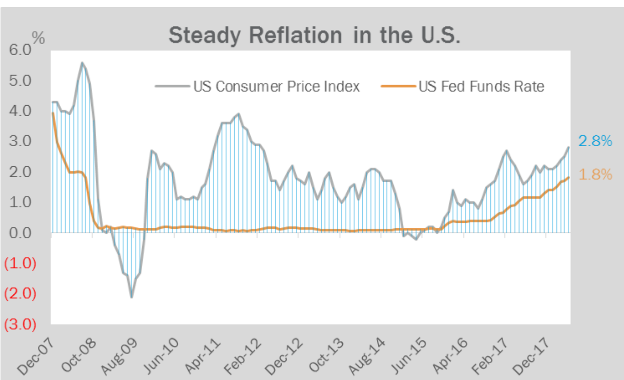


Figure 1. Source: Bureau of Labor Statistics, FedResBank of St Louis

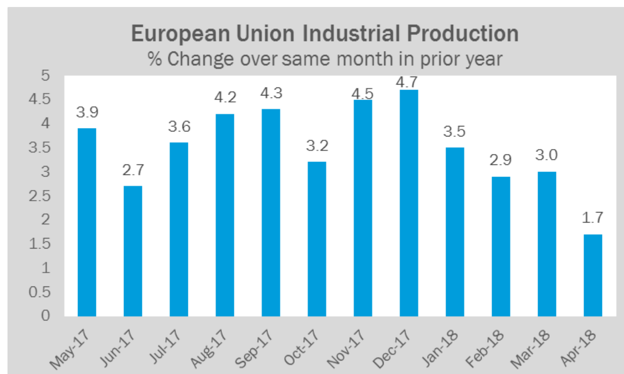


Figure 2. Source: TradingsEconomics.com, EuroStat

Over the first half of 2018, the positive impact of synchronized global recovery on the securities markets was interrupted by region-specific political issues that have been idiosyncratic to specific countries and by general tensions over disruptions to global trade. We experienced the first pullback in the equity markets in February this year, and the market remained range-bound through June, with continued news on the deterioration of short-term fundamentals in various regions.

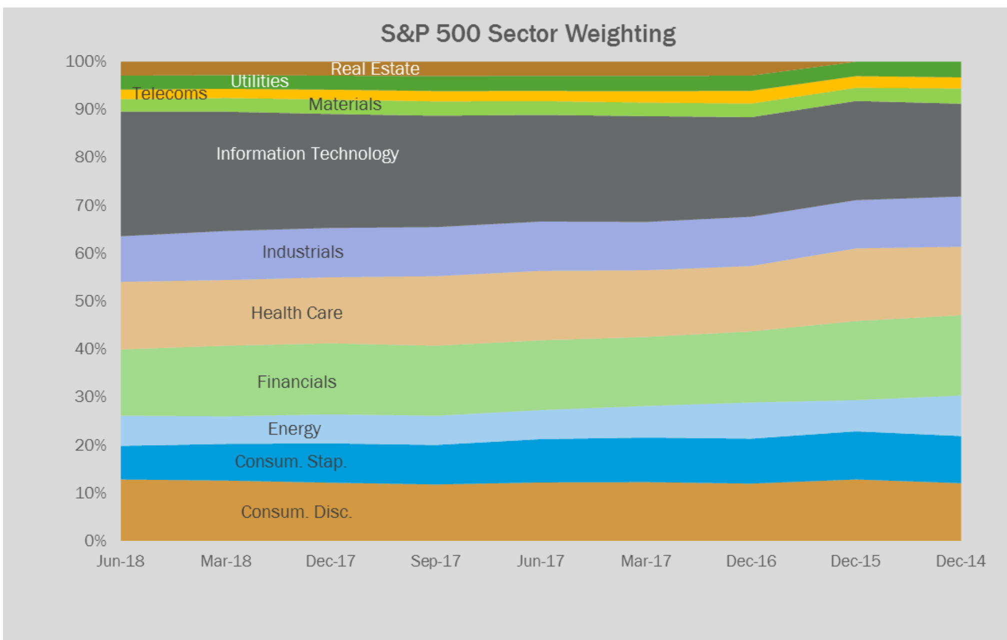
In Europe, purchasing managers' indexes and industrial production data indicate a slowdown from the 2017 year-end highs (Figure 2). Europe faced populism initially with the Brexit vote, but the more recent surge of pro-leftist political elections in Italy and Spain will pose challenges to sustained growth, given policy proposals that increase spending for entitlements on top of high levels of public debt. Italian bond yields rose sharply as the coalition took place, and the impact has also been felt on the euro, as it has slipped from $1.23 to $1.17 relative to the U.S. Dollar during the second quarter.

In North America, what started as a battle of tariffs between the U.S. and China in early April expanded over the quarter. Discussions between the U.S., Canada, and Mexico over NAFTA stalled when the Trump administration decided to impose tariffs on Canada, Mexico, and the EU on aluminum, steel, and certain manufactured goods such as automobiles. Some of the hard stand being taken by the Trump administration, such as that against Chinese trade practices, may be warranted, but the near-term impact has been a more cautious stance on emerging markets by investors, resulting in a pullback in emerging-market equity and fixed income returns for the period. There was also a general strengthening of the U.S. Dollar against a number of emerging market currencies, particularly export-oriented economies such as Argentina, Turkey, and Brazil.

Further restrictive tariffs and trades could have significant ramifications for companies whose business strategies capitalize on globalization or depend on a global supply chain. We are closely monitoring developments in policies of various countries, but at this time, we have not made any significant changes to the allocations in the OCIO portfolios.

Equities

The U.S. equity markets were ahead of most other country or regional equity markets for the quarter, with small cap equities performing ahead of their large cap counterparts. Growth continues to outperform value sectors for the most part as technology (+10.9%) and consumer discretionary (+11.5%) sectors led most other sectors for the first six months of the year. As of June 2018, the information technology sector constituted over 26% of the index, while sectors such as financials and energy shrank over the past five years. Value style lagged for the period as financials (-3.2%), industrials (-3.2%), telecom (-0.9%), and consumer staples (-1.5%) were down for the quarter. A steady rise in oil prices has boosted production and processing activity. For the quarter, energy names were up over 13%, recouping much of the negative performance from the first quarter.



Source: Standard and Poor's

Non-U.S. equities detracted from performance for the quarter and the first half of the year, resulting from both the local markets being down as well as the negative currency effect. Emerging markets were down the most, led by the drawdowns in export-oriented countries in Latin America, Europe, and Southeast Asia.

We continue to have a slight overweight to U.S. equities relative to the MSCI ACWI index, but remain committed to exposure to non-U.S. countries as well. Our weighting to emerging markets equities is at around 13% of global equities, marginally higher than that in the index, but the exposure is tilted toward Asia, where we see greater growth potential and a lower correlation to the cyclicality of commodity prices.

Fixed Income

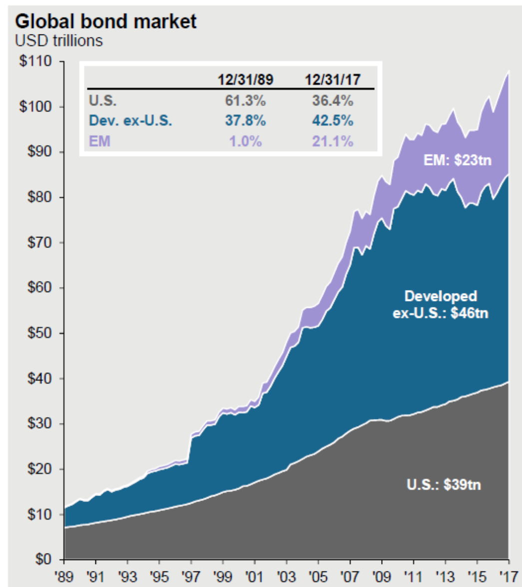
The impact of currency volatility and rising rates is greater on fixed income securities given that income makes up a good portion of the total return for the segment. Our fixed income segment is diversified across regions and sectors and has been structured to reduce the impact of rising rates while at the same time capturing a yield advantage.

We see a few key objectives for the fixed income segment:

— It is an anchor to the portfolio and provides diversification away from risk assets such as equities. Today, 60% of the fixed income segment is exposed to core fixed income sectors such as government bonds, mortgages, and investment-grade corporates.

— It provides exposure to a global opportunity set, which includes non-U.S. bonds, particularly higher yielding emerging-market bonds. This segment has the potential to generate higher returns than core fixed income and to enhance performance over the overall segment. While this segment can be more volatile, we allocate to managers who focus on fundamentals and due diligence of the financial health and balance sheets of the economies issuing the bonds. The global fixed income component makes up about 30% of the fixed income segment at this time.

— It captures opportunistic elements and capitalizes on these when the opportunity is truly meaningful. This is primarily higher yielding, credit-oriented securities. Given the narrow level of credit spreads at this time, only 10% of fixed income is dedicated to this segment, and is primarily in the form of high-yield fixed-rate and floating-rate bonds.



Source: JPMorgan Chase

The reporting on our fixed income segment will be segregated by each of these objectives to better illustrate attribution of the segment's overall performance. This will also allow our clients to better see how composition of the segment changes over time as opportunities evolve in this area.

Real Assets

Brent crude oil prices, which began the year at under $60, climbed to over $74 at the end of June. Not only does this have a meaningful impact on input prices across many parts of the economy, but at this level, it can also stimulate further production activity among major oil-producing regions and boost related processing and infrastructure activity.

For the quarter, the segment made a positive contribution, boosted by most of the individual components, including MLPs, natural resource equities, TIPS, and commodities. As inflation continues to remain a positive economic force, we expect this segment of the portfolio to benefit from its positive correlation to inflation. This will also be beneficial during periods when higher, unpredicted inflation could have a negative effect on the financial securities in the portfolio.

Marketable Alternatives

As the general level of volatility in the equity and fixed income markets has gone up, hedge funds have been proactive in reducing their overall net exposures by reducing their gross exposures, raising cash on the margin, or shifting to areas with better opportunities.

As the yield curve further flattened, multi-strategy managers moved away from pure capital-structure arbitrage opportunities and moved to capitalize on merger and acquisition activity across a wide range of economic sectors. So far in 2018 in the U.S. alone, well-publicized deals include the merger between Amazon and Whole Foods, AT&T and Time Warner, CVS and Aetna, and Disney and Fox. Corporations with large cash balances that saw their stock prices improve have taken the opportunity to expand their businesses both vertically and horizontally to improve market share. The new tax regulations have incentivized companies to pull back cash reserves from offshore accounts and deploy them.

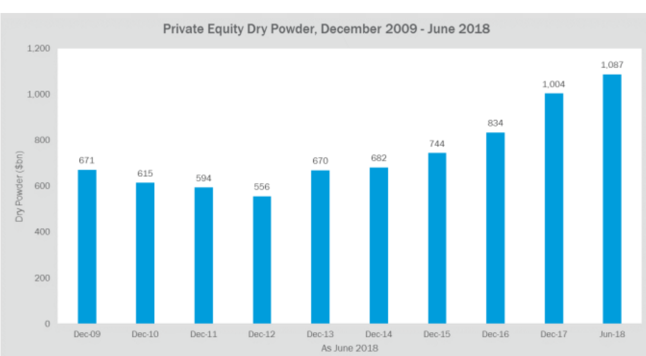
Managers with exposure outside the U.S. faced greater headwinds as non-U.S. equity and fixed income markets pulled back in the quarter. Those with positions that have a longer duration thesis have also come under pressure as the steady increase in interest rates make refinancing more expensive and the emergence of new technologies has increased the speed with which newer enterprises can replace older, more established organizations across economic sectors, from healthcare to financials to telecom.

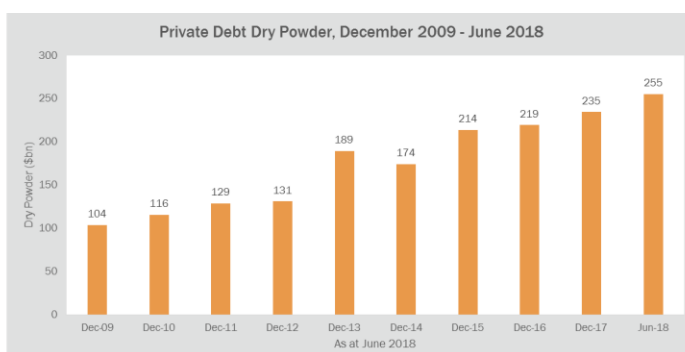
Private Equity

A strong economic environment, positive investor sentiment, and generally trending equity markets continue to generate robust demand for private equity. Many managers in this space have been actively raising funds and deploying capital at a rapid pace.

The drop in corporate tax rates has made it more feasible for companies to either grow through acquisition or consider selling their non-core assets to enhance the value of their equity. This has generated more deal opportunities for private equity managers. At the same time, the multiples on the private equity deals have gone up over the last few years. Certain private managers have been adding more debt on their underlying portfolio companies to try to improve leverage, while other managers, who have been more conservative with purchase multiples and leverage risk, are holding out for more attractive opportunities. The amount of "dry powder" has steadily increased over the last few years.

As of the end of June, there was over $1 trillion in dry powder across private equity funds and over $255 billion in dry powder across private debt funds. A large portion of this cash resides within the mega-sized funds that have been raised in recent years and will likely be deployed in very large deals. We continue to take a more measured approach to new commitments. While we feel it is important to maintain vintage-year diversification in making private equity commitments, we do not feel the rush to overcommit at this stage of the market cycle.





Source: Prequin

We have not made any major changes to the portfolio but have been diligent about rebalancing portfolios, particularly the growth segments, to manage the risk exposures in this oscillating market environment. While markets are fairly priced to slightly rich in many areas, we are also not of the opinion that we need to pull back exposures and take a more conservative stance. It is possible that we may be in this range-bound market environment for an extended period of time. Further, our clients have long-term assets that have to last over multiple market cycles. We feel it is important to participate in markets at this time but have ample liquidity so that it is possible to realign exposure should there be a dislocation creating new investment opportunities.

We remain committed to helping our clients meet their objectives.

Poorvi R. Parekh
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 (OCIO) 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 OCIO 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.