Overview

The first half of 2021 seems to have gone fairly quickly with vaccinations, a move toward normal life, and good market returns facilitating a smooth transition in the direction of post-pandemic normality. Compared to a year ago, the economic pendulum has swung from dire concerns about the pandemic to more optimism toward containment and economic recovery. The uneven pace of vaccinations and reopening across regions has led to inevitable constraints in supply chain as well as labor shortages as consumers and businesses try to return to pre-COVID activities. The Federal Reserve and most others are hoping that the current inflation spikes will be temporary and that prices will fall as capacity is added. However, the uncertainty is high, as shortages in inputs from lumber to microchips have pushed up prices on consumer essentials.

Prevailing 0% borrowing rates and over $7 trillion in stimulus spending have generated robust growth over the past few quarters in the U.S. Further, 4Q20 and 1Q21 GDP growth came in at 4.3% and 6.4% respectively after a 33% recovery in 3Q20. As of early July, the Conference Board estimates that the quarter over quarter 2Q21 GDP growth will be 9.0%. With the potential for another $6 trillion in infrastructure spending amidst rising prices and labor shortages, we could see growth and inflation push higher more steadily. Even if economic growth slows, the high level of federal deficits and liquidity in the markets can push down the value of the U.S. Dollar, making it more costly to buy the same goods. Hence that can still be inflationary.

While the concerns about inflation are well-founded, the U.S. has not seen year-over-year inflation persist over 4% since the 1980s. Advances in technology and globalization have boosted productivity and kept prices low over the past few decades. The Federal Reserve has been more concerned about deflationary pressures since the 2008 financial crisis, but this time it has hinted at moving to higher rates when they have achieved their objectives of higher average inflation and full employment.

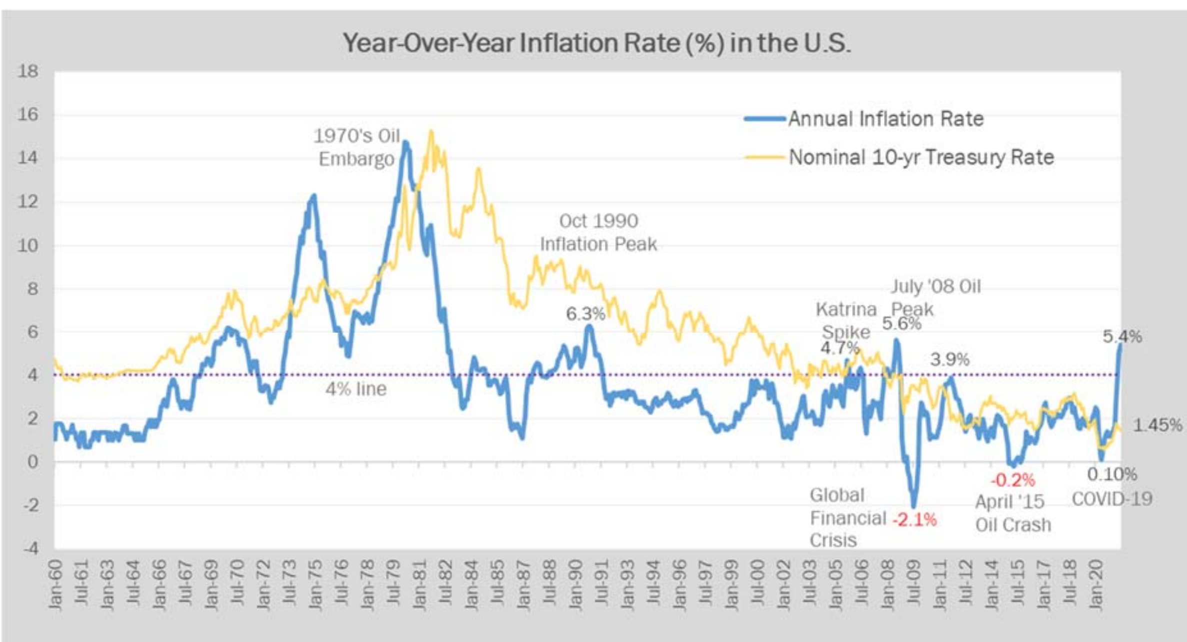

Figure 1. Source: Bureau of Labor Statistics, U.S. Treasury

At Canterbury, we have deliberated on the topic of inflation in multiple ways. While our objective is to not be reactive, we recognize that there are uncertainties surrounding the inflation outcomes over the next 2–3 years. As such, we continue to monitor the situation and strive to keep the portfolio resilient by maintaining balanced exposure to assets that are likely to benefit in different inflationary regimes. We will go into our thoughts in this letter about each asset class as we discuss performance and positioning.

Equities

Global equities were up 12.3% in the first half of 2021, led by the U.S. equity markets. The Russell 3000 Index was up 15.1% compared to the MSCI EAFE up 8.8%, and the MSCI Emerging Markets Equities Index was up 7.5%. The “rotation” into value style equities that began November 2020 took a slight pause in the second quarter, as the Russell 3000 Growth Index was up 11.9% relative to the Russell 3000 Value Index that was up 5.2%. Our portfolios maintain a balance across market cap, style, and geographies. Non-U.S. and value style equities remain relatively more attractive given their underperformance over recent periods. As valuation disparities widen, the sensitivity also increases to the potential for reversal, which may be driven by changing economic or market dynamics or improving fundamentals.

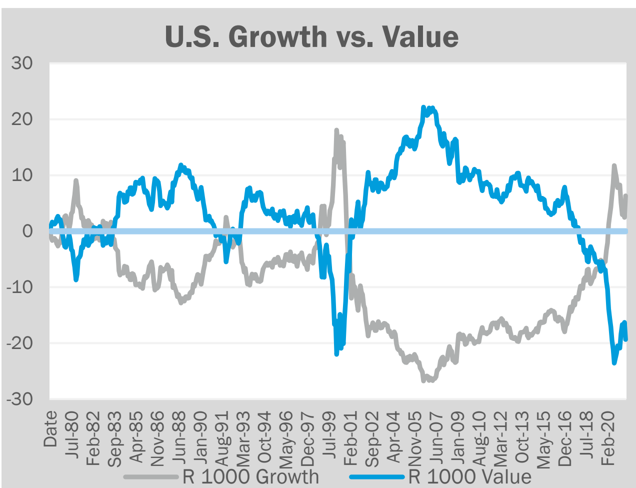

Figure 2. Source: FTSE Russell

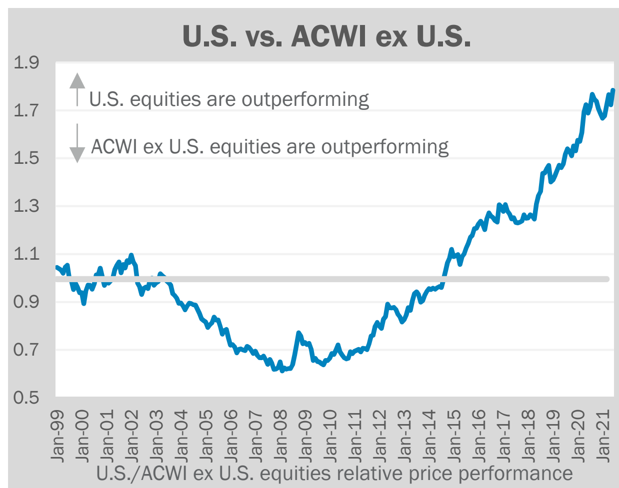

Figure 3. Source: MSCI, Inc.

If inflation spikes up rapidly and unexpectedly, this would generally hurt equities, in particular growth stocks, whose valuation often reflect longer duration growth expectations. However, we also see equities as a natural inflation hedge over the longer term, as companies that face rising costs also benefit from passing those costs on to their customers through higher prices. Over recent months, active managers have taken the opportunity to rotate into cyclical areas, such as natural resources and financial companies, as valuations became attractive and economic conditions began to improve.

Fixed Income

The large bond purchase programs launched in late March 2020 by the Federal Reserve have pushed bond yields down steadily to historic lows. Bonds that have fixed coupons are most vulnerable to price declines in a rising-inflation, rising-rate environment. The risks have increased further as the income “cushion” has declined with falling rates. The core Barclays U.S. and Global Aggregate bond indices have returned -1.8% and -3.2% in the first half of the year as rates moved from 0.9% to 1.5% on 10-year U.S. Treasuries. We have seen managers take advantage of relative valuations by de-emphasizing nominal Treasuries and rotating into TIPS, select corporate bonds, floating rate bonds, and other "spread" sectors to take advantage of higher potential yield. High yield has generated better returns, as they have a higher income component. However, when faced with a downturn in equities, high yield bonds are most vulnerable to illiquidity and price declines.

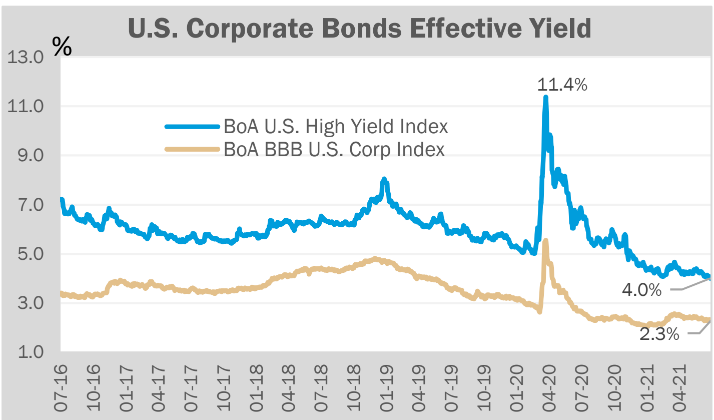

Figure 4. Source: St. Louis Federal Reserve

10-yr Sovereign Bond Yields (6/30/21)			
Developed		**Developing**	
Australia	1.5%	Brazil	9.2%
Canada	1.4%	India	6.1%
Germany	-0.2%	Indonesia	6.7%
Japan	0.0%	Mexico	7.0%
United Kingdom	0.7%	S. Korea	2.1%
United States	1.4%	Thailand	1.6%

Figure 5. Source: Bloomberg

Even at a yield of 1.4%, U.S. Treasuries generate higher yield than other developed country sovereign bonds. Our global bond managers have been selectively picking up EM bonds, as there is more confidence in those economies raising their vaccination rates and reopening their economies. As the U.S. Federal Reserve contemplates cutting back on bond purchases, this may push yields higher in the U.S., while yields may have room to fall in those economies that have lagged in the recovery process.

We have maintained a shorter duration in the fixed income segment relative to the Aggregate Index. This has helped relative performance so far this year but has not prevented the segment from facing unrealized price declines. Our return expectations on bonds have fallen given sub 2.5% yield on core bonds, but they continue to be in the portfolio to protect against potential equity market downturns. In most of our OCIO portfolios, we have tilted the allocation to fixed income toward the lower end of the permissible range for this asset class.

Real Assets

Hard and soft commodities stand to benefit most from unexpected rising inflation. Over the last 12 months, the segment has benefited from the rise in oil prices as well as the prices of industrial metals. Oil prices dropped below $20 in late March 2020 and climbed to over $73 at the end of June 2021. This is still below the highs reached in 2010. Some of this is due to travel still hovering below normal levels. We have also seen a greater shift toward using clean energy as more countries seek to control their carbon emissions. Prices have pushed up much further for certain industrial metals, such as copper and cobalt, as demand continues to rise for semiconductor chips that go into most consumer goods as well as electric vehicles.

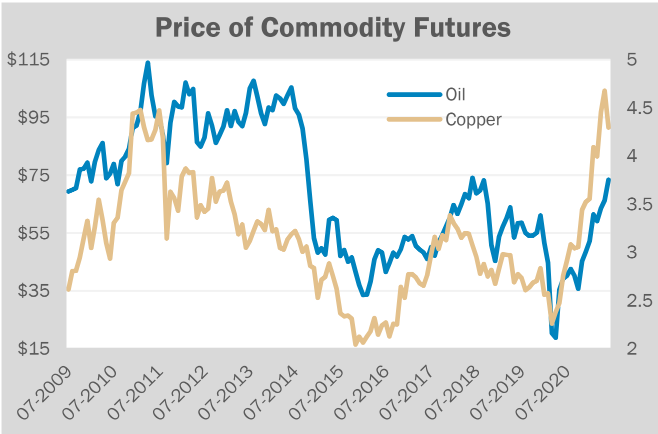

Figure 6. Source: Investing.com

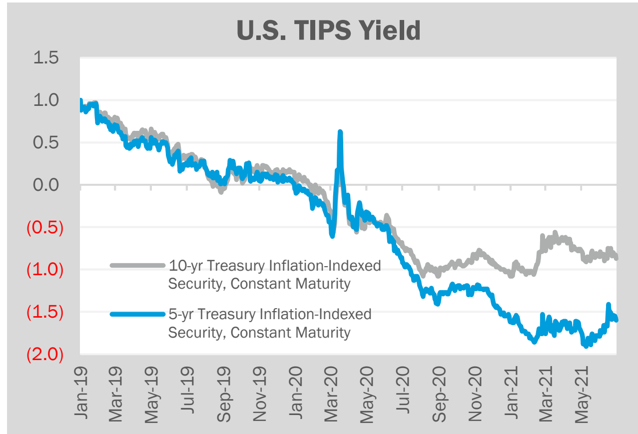

Figure 7. Source: Federal Reserve Bank of St. Louis

The strategy we have employed in the real asset segment includes both real assets as well as floating rate securities whose coupons adjust upwards with rising rates. The manager has included primarily corporate and mortgage based structured products and tilted away from TIPS. Over the last 12 months, the yield on U.S. TIPS, both 5 year as well as 10-year securities, has turned negative. This would imply that investors would lose money if they were to hold the TIPS to maturity.

Hedge Funds

The uneven recovery of companies since the onset of the pandemic has created a wide dispersion in the performance of their stocks. This has helped long-short equity managers look for mispriced securities, both on the long and short side. Equity managers have taken advantage of the rebound in value style as well as small-cap segments of the market.

There has been a lot of issuance of new debt, as companies have refinanced their debt at lower rates. While this has been beneficial for financially sound companies, it has also allowed many “zombie” companies that are otherwise unprofitable to continue to survive a little longer. At the same time, the prolonged period of stress in segments such as retail, leisure, and travel has also created organizational issues with companies in these sectors and spurred event-driven opportunities, such as mergers, acquisitions, and bankruptcies.

Multi-strategy managers have participated in the broad array of investment opportunities, from long and short investment in securities to becoming providers of liquidity and short-term financing during a period when banks have been much more restrictive in their lending practices.

Private Equity

Despite the global economic disruptions caused by the COVID-19 pandemic, the financial markets, public equity markets in particular, continued to appreciate. Private equity markets experienced similar robust activity. While private equity managers experienced a decline in fundraising activity, the pace of deal flow, investments, and exits activity picked up in the second half of the year across buyout and venture.

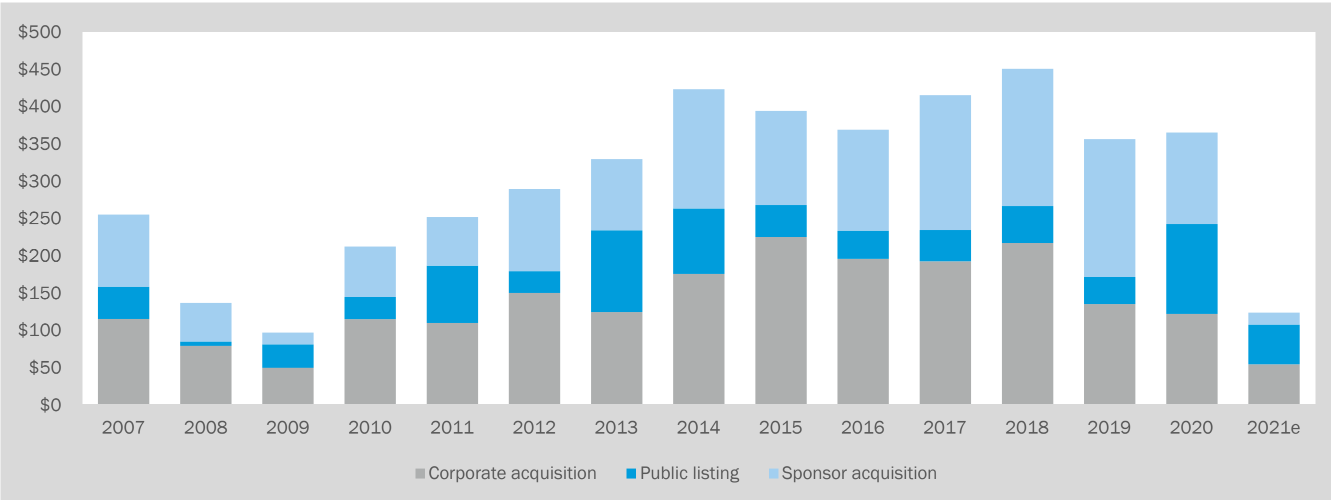

Figure 8. Source: PitchBook as of March 31, 2021

The above chart shows that the pace of exit activity in 2020 surpassed that of 2019 with an increase in the number of exits through public listing. For our client portfolios that have exposure to private equity, we have maintained the discipline of committing capital in line with the pacing model established for the client's private equity segment. Where managers experienced some slowdown in fundraising activity in the summer of 2020, this year's situation has completely turned around with well-reputed managers being over-subscribed as a norm and investors being forced to cut back on their subscriptions. As more capital has moved to private equity in search of some illiquidity premium over public markets, we feel it has become all the more important to remain selective with the managers but also remain consistent in our commitments to high-conviction funds.

Overall Thoughts

Amidst conversation of moving business operations and economic activity "back to normal", we feel that the broad levels of financial market appreciation, the large trade deficit in the U.S., and the even larger levels of government stimulus will likely create some very different drivers of what may become "normal" in a post-pandemic era. We will continue to keep the portfolio diversified to both participate in new opportunities as well as to mitigate the risks of areas that have done well and appreciated.

If you have questions or concerns, please do not hesitate to let us know. 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 one of the Best Places to Work in Orange County by the Orange County Business Journal in 2020 and 2021. 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.