Canterbury Outsourced CIO

Fourth Quarter 2021 Commentary

Overview

After almost two years since the start of the pandemic, the world is still being impacted by COVID-19. A new variant of the virus has emerged, but the effect of the pandemic is slowly beginning to subside. Most people have developed some level of immunity to the virus, either through inoculation or infection. The global economy overall has also adapted to the virus as people have found ways to adjust their lifestyles to provide themselves with better protection and safety while still participating in economic activities. This resilience has allowed for the recovery in economic activity as well as a steady decline in unemployment and a greater increase in corporate revenue and profits.

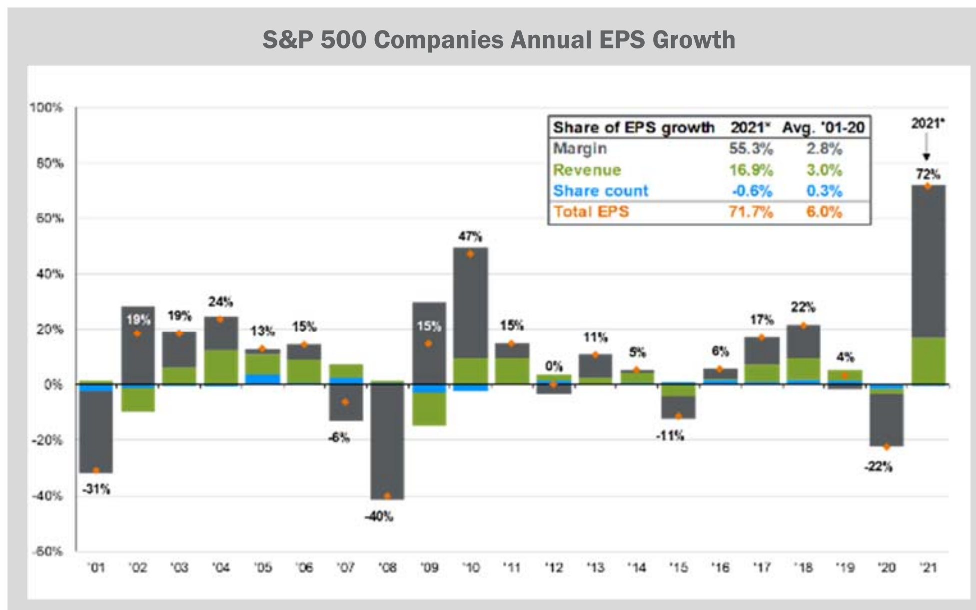

Figure 1. Source: Dow Jones S&P Global, JP Morgan

Figure 2. Source: U.S. Bureau of Labor Statistics

While the liquidity created by over $9 trillion in public stimulus was a big driver of the equity and credit market rally over the last 20 months, there was also improvement in fundamentals. After experiencing a decline in both revenue and margins in 2020, companies in the S&P 500 Index are estimated to report over 71% growth in year-over-year earnings for 2021. This growth and spending, coupled with continued bottlenecks in the supply chain, has been accompanied by inflation pressures that have reached levels last seen in the 1980s.

The combination of a tight labor market and fast wage growth has been one factor behind the higher inflation numbers. These wage increases can be fairly “sticky” and further fuel increases in the price of goods and services. These indicators may be one key reason why the Federal Reserve sped up their tapering of bond purchases and moved up the timing of the first three interest rate hikes to possibly March 2022. Thus, while the continued opening of the U.S. and global economy will be a positive for corporate revenue, the tightening of fiscal and monetary policies will provide some headwinds to the price appreciation of financial assets, particularly from current valuation levels.

We feel that this period of near-zero rates and uber accommodative central bank policies has lifted a lot of risk assets simultaneously, causing correlations to increase across various traditional and alternative segments of the portfolio. We have been looking at existing and emerging opportunities with caution, as the simultaneous strong bull markets across most risk assets over the last few years may not be sustainable as fundamental and macroeconomic dynamics evolve in the post-pandemic world.

Equities

In 2020, governments across most countries responded to COVID-19 with a broad set of monetary and fiscal stimulus, yet there has been considerable dispersion in the performance of the individual financial markets. U.S. equities continued to outperform their non-U.S. counterparts by a wide margin. For the year 2021, the Russell 3000 Index was up 25.7% while the MSCI EAFE Index was up 11.3% and the MSCI Emerging Markets Index returned -2.5%. A stronger U.S. Dollar was a headwind, as the return for the local currency MSCI EAFE Index was up 18.7%. Within U.S. equities, the value factor outperformed other factors such as small capitalization, momentum, or cyclical factors. The Energy, REITs, and Financial sectors in the S&P 500 Index were up 54.6%, 42.5%, and 35.0% respectively while Technology and Healthcare were up 34.5% and 26.1%. While there was broad-based performance within the index, the largest holdings, technology companies, are up over 70% since the prior to the pandemic in February 2020. The top 10 holdings make up 30% of the index and have a forward valuation of over 30x. The concentration risk has grown within the index. Even though these are formidable business enterprises, the performance of these 10 securities can have a disproportionate impact on the overall index performance, and we expect volatility to be higher as interest rates go up.

Within emerging markets equities, China’s underperformance resulting from the regulatory crackdown and imbalanced Chinese property market was a key driver for the poor performance of the Emerging Markets Index. Still, we have been bullish on Asia’s economic growth prospects relative to other emerging countries. Projections for large economies in the region greatly contribute to the growing global middle class, and incrementally more of the revenue generated by companies domiciled in emerging countries is coming from their home countries. This makes the equity markets in these countries less susceptible to export-oriented businesses which are tied to a few large developed economies.

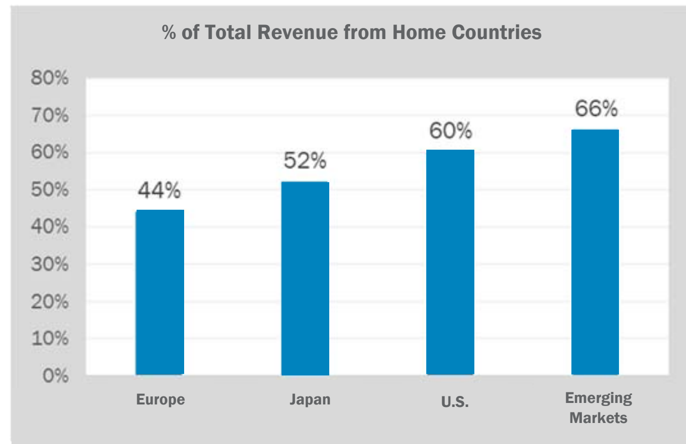

Figure 3 & 4. Source: MSCI, JP Morgan

We see the non-U.S. equity and fixed income segments as a diverse set of opportunities with the recovery dynamics, risks, and opportunities varying by sector and country. The opportunities to invest in individual companies have to be viewed in the context of the country and currency dynamics affecting their business. Non-U.S. equity markets are trading at relatively lower valuations, but we believe company fundamentals will become increasingly important as policy framework tightens. This is particularly true for non-U.S. equities where the broad universe of securities and the variability of information available on companies provides opportunities for active managers to add incremental performance through stock selection.

Fixed Income

Throughout 2021, we saw the U.S. 10-year treasury rate go from 0.93% to 1.52%, peaking at close to 1.75% in the first half of the year. A rising rate environment forces prices down, which is what has been the case across core fixed income segments such as Treasuries, Mortgages, and other investment-grade securities. Where the income levels have been low, the impact of higher prices has been to drive core bonds to negative total returns as prices declined. For the year, the Barclays U.S. Aggregate Bond Index returned -1.5%, while the BC Global Aggregate bond Index returned -4.7%, reflecting the impact of the strengthening U.S. Dollar. High Yield bonds, given their higher income, generated positive gains for the year with the BoA High Yield Master II Index returning 5.4% for the year. The spreads on high yield bonds at the end of the year declined to 3.1%, which compares to 3.6% in February 2020, indicating a high valuation for below-investment-grade bonds.

We do not believe that the core bond segment will make any meaningful contribution towards the total returns of the portfolio in the near future. The value of a fixed stream of income goes down as inflation levels rise. Where core bond yields are hovering under 2%, the “real” yield, which reflects yields net of inflation, has dipped into negative levels for some time. This implies that one would be losing 4.0% on the cash value of a 10-yr Treasury bond over its 10-year life.

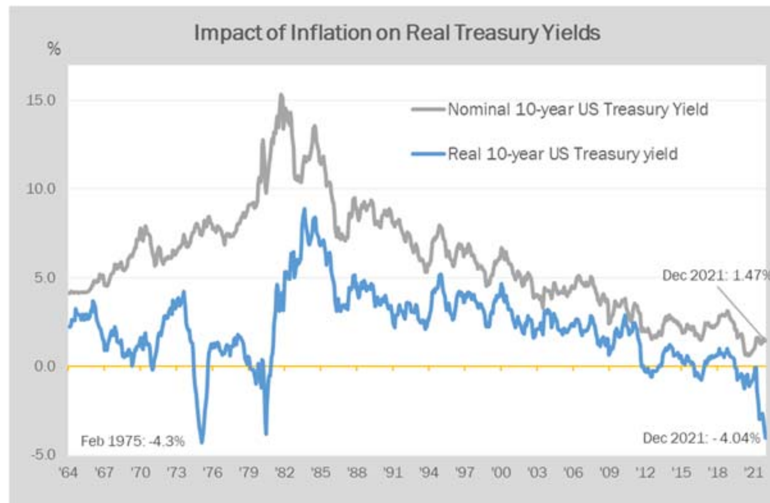

Figure 5. Source: U.S. Treasury, BLS, Federal Reserve of St. Louis

Today, core bonds remain as part of the fixed income segment for their diversification benefit. They provide a defensive hedge to the portfolio during periods of strong equity market drawdowns. Within the fixed income segment, they are complemented with credit-oriented strategies and non-U.S. managers that can actively add value through security and region selection. We have trimmed the overall fixed income segment towards the lower end of permissible range and continue to look for other alternatives to traditional fixed income that have low correlation to equities and can potentially generate higher returns. Some options, such as private credit, provide higher return potential, but the strategy comes with illiquidity as well as potential corporate stress if there is an economic downturn.

Hedge Funds

Given their ability to maneuver through equity and credit markets, hedge funds have provided one way for active managers to take advantage of securities that have rising as well as declining prospects. The slew of reorganization and bankruptcies in sectors affected by the pandemic, merger, and acquisition activity driven by a robust equity market as well as industry disruptions and the large issuance of debt by companies for operational and share buyback programs have provided a myriad of investment opportunities, both on the long and short side for these dynamic funds.

Where markets were trending up from the lows of 2020, these funds were largely biased towards the long book, but as valuations have gone up, we have seen many of the managers add hedges to their books and reduce their net exposure. Through November 2021, the YTD return for HFRI hedged indices for equities and event-driven strategies were up over 10%, while the HFRI Diversified Fund of Funds Index was up 5.3% for the same period. We do not expect hedge funds to keep up with very robust equity markets but they are able to add more value. Aside from where they add value in being able to take advantage of opportunities that are not open to long-only strategies. During periods of prolonged market downturn, they have been able to incrementally lower overall portfolio volatility.

Real Assets

This is one segment of the portfolio that has positive sensitivity to rising inflation. The segment captures both the price appreciation of hard assets such as commodities, real estate, and infrastructure, but also those securities that benefit from rising rates, which is often the result of higher inflationary pressures.

The allocation is to a diversified program that includes infrastructure securities, natural resource equities, commodities, REITs, TIPs, as well as floating return debt where the coupon adjusts upwards as interest rates go up.

We have kept this segment small so far, at 5% of the portfolio, as it is yet not totally clear if inflation pressures are being driven primarily by transitory supply chain disruptions.

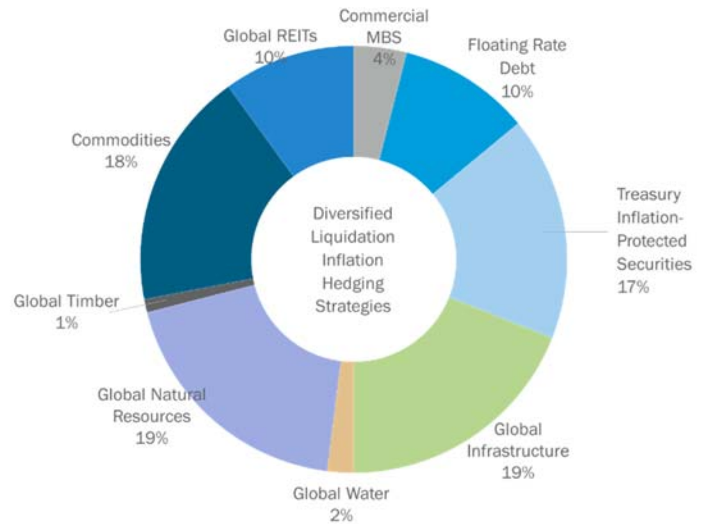

Figure 6. Source: Principal Funds

Private Equity

Just as public equity markets recovered rapidly after the March 2020 drawdown, private equity activity has also seen very little impact from the pandemic. After a small decline in 2020, deals and exits have risen to higher levels than in 2019, both in count and in value.

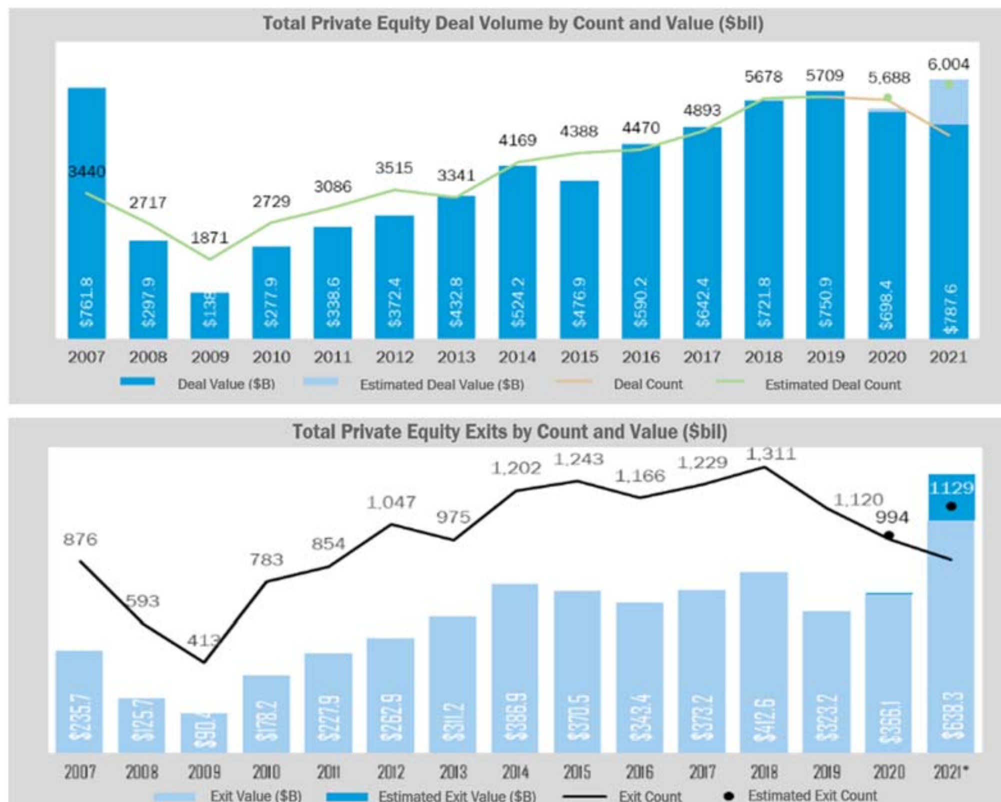

Figure 7 & 8 Source: Pitchbook Quarterly Data, Sept 30, 2021

This reflects both the capital flow into this area as well as the managers taking advantage of any pricing fluctuations to execute on potential opportunities. The multiple expansions that we have seen in public markets have also carried over to private deals. We have been monitoring our managers and have stayed biased towards those that look to add value through operational improvements and strategic acquisitions rather than financial engineering and high leverage. Highly levered companies could face double headwinds should economic growth decelerate and high inflation pressures cause rates to move higher than expected.

Overall Thoughts

In the near-zero rate environment, portfolios have tilted incrementally away from bonds and towards equities. While it is important to remain invested, we are also cognizant of the potential for higher portfolio volatility over shorter periods. Our clients that have long-term investment horizons have the staying power to weather through interim mark to market fluctuations, but we have been proactive in working with clients to address near-term cash needs as well. After three years of strong performance by risk assets, expectations for future annualized returns have tapered to below 5% for most asset classes. Moving forward, our key task will be helping our clients continue to solve the “math problem” of generating returns that help meet the hurdle of “spend rate + inflation” in the face of less accommodative economic, monetary, and fiscal conditions.

We thank you for your trust in us and remain at your service.

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.

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