Canterbury Outsourced CIO
Third Quarter 2019 Commentary

Introduction

As one of the longest economic expansions in U.S. history persists, the news of the third quarter of 2019 focused on the financial impact of continuing trade wars, a potential global slowdown, geopolitical unrest, an inverted yield curve, central bank monetary policies, currency depreciation, market volatility, risk of a recession, and the potential impeachment of the U.S. President.

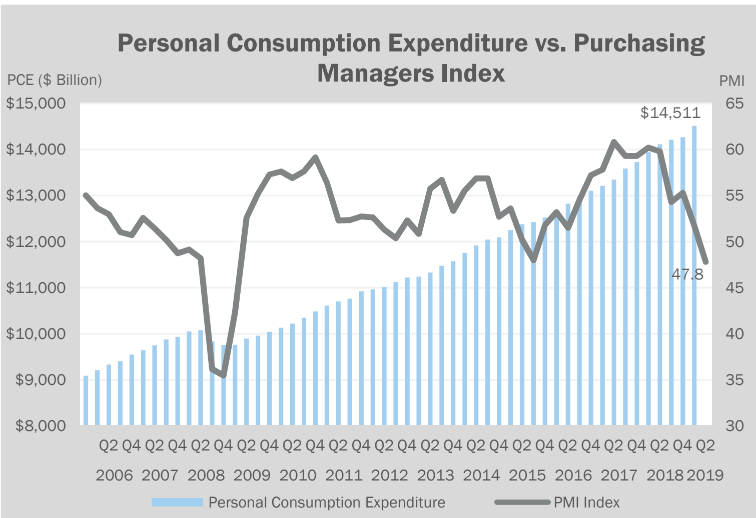

Figure 1. Sources: Bureau of Economic Analysis, Institute for Supply Management

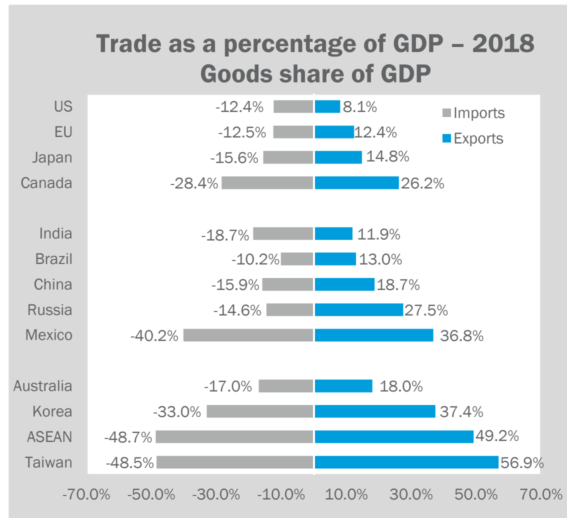

Figure 2. Sources: International Monetary Fund, JPMorgan Chase & Co.

In the U.S., personal consumption expenditure (PCE) figures indicate a firm upward trend that is driven primarily by robust job growth and low interest rates. At the same time, the Institute of Supply Management's most recent figures indicate that purchasing managers index level of 47.8% shows potential contraction in the manufacturing sector. If the economy deteriorates, there could be further interest rate cuts, but the divergent trends in economic data have also created more dispersion of views among members of the Federal Reserve regarding further changes in the Federal Funds rate.

While global trade wars and falling world trade volume have affected U.S. manufacturing activity, the impact generated has been greater outside the U.S. — especially among countries with a GDP that is more dependent on exports. Central Banks have been aggressive in buying bonds, lowering rates, and pushing the currency down to counter economic weakness. In countries where rates have already lingered in negative territory, this has shown little impact to foster further economic activity.

Since the end of 2017, we have observed a steady rise in the U.S. Dollar: first by the tax cut in 2018, then by the trade disagreements and slower growth in non-U.S. economies in 2019. In the near term, as yields have gone further negative in other major economies, more capital has flowed to U.S. Treasuries, pushing the yield on 10-year Treasuries down further to below 1.6%. As a result, this has caused the U.S. Dollar — seen as a safe haven currency — to further appreciate relative to other major currencies. With interest rate differentials between the U.S. and other developed countries dropping and a continued negative trade balance between the U.S. and its trading partners, the fundamentals appear to point to lower values for the U.S. Dollar in the future. Over longer periods, the currency effect has been close to zero.

In spite of all the daily market swings that occurred during this past quarter, there was a relatively small change in the overall market for the full period. The simple balanced index — made up of 60% global equities (MSCI ACWI Index) and 40% global bonds (Barclays Global Aggregate Bond Index) — was up 0.3% for the full quarter. Most gains in the portfolio came from earlier in the year from both across most segments of the portfolio.

Equities

The ACWI IMI Index was down -0.18% for the quarter, reflecting a gain of 1.2% in U.S. equities, as shown by the Russell 3000, and a loss of 0.93% in non-U.S. equities, as represented by the MSCI ACWI ex U.S. In local currency, the latter index was up 0.74%, but the currency effect placed the index in negative territory when converted into U.S. Dollars. Emerging market equities were down 4.25% for the period, reflecting both the near-term impact of trade war on more export-oriented economies as well as the currency effect.

Over the course of the year, we have integrated a number of changes in the global public equity segment of the portfolio. We adjusted the U.S. equity segment to a core-satellite structure; half of the segment is allocated to a passive investment in the S&P 500 Index. Additionally, we added an inexpensive factor-based strategy and complemented it with three concentrated active managers that focus on a specific style or market cap.

While we believe that active managers can add value in their own market segment, it was difficult to combine skilled active managers that outperform their own style benchmarks to outperform the broad market benchmark. Markets are fairly valued and there is cyclicality to styles, but given the efficiency of the U.S. equity markets as well as the lower return expectations, this has reduced variability relative to the Russell 3000 Index and lowered fees for the overall segment while still providing room for the active managers to generate incremental returns over time beyond the broad benchmarks.

This is not the case in the non-U.S. segment, as the market benchmarks are not representative of the full investment opportunity, and we have seen good stock pickers consistently able to add value through active management.

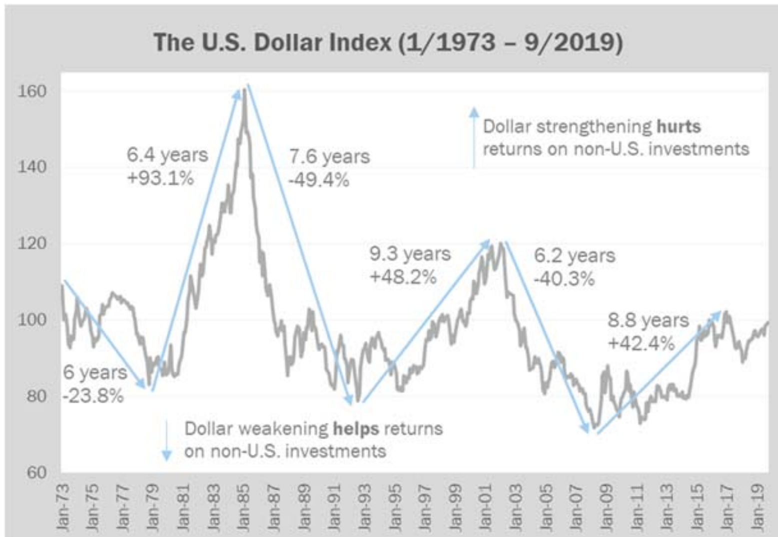

Figure 3. Sources: Investing.com

Active managers in the non-U.S. segment focus on investing in the stocks of well-run companies in different sectors and regions that present a strong likelihood of outperforming their competitors globally. Further, they happen to be domiciled in a country outside of the U.S. We added an international small-cap equity manager to broaden the scope of exposure to non-U.S. equity markets earlier in the year. While the underlying holdings are smaller companies, most still have a global presence in a market niche. The one factor that influences non-U.S. equity returns to some degree over short to intermediate periods is the currency effect, which as shown in figure 3, is cyclical and has been a headwind for U.S. investors since the global financial crisis in 2008.

Fixed Income

Concerns over global trade slowdown and potential global recession pushed rates down for government bonds across all maturities in most major economies during the quarter — in some cases, to greater negative territory. Central Banks pushed rates down for inter-bank lending, which caused short-term bond rates to fall. However, concerns over a potential recession led to capital fleeing toward safe haven government bonds of longer maturities as well, causing the rates to fall in the intermediate and longer ends of the curve as well.

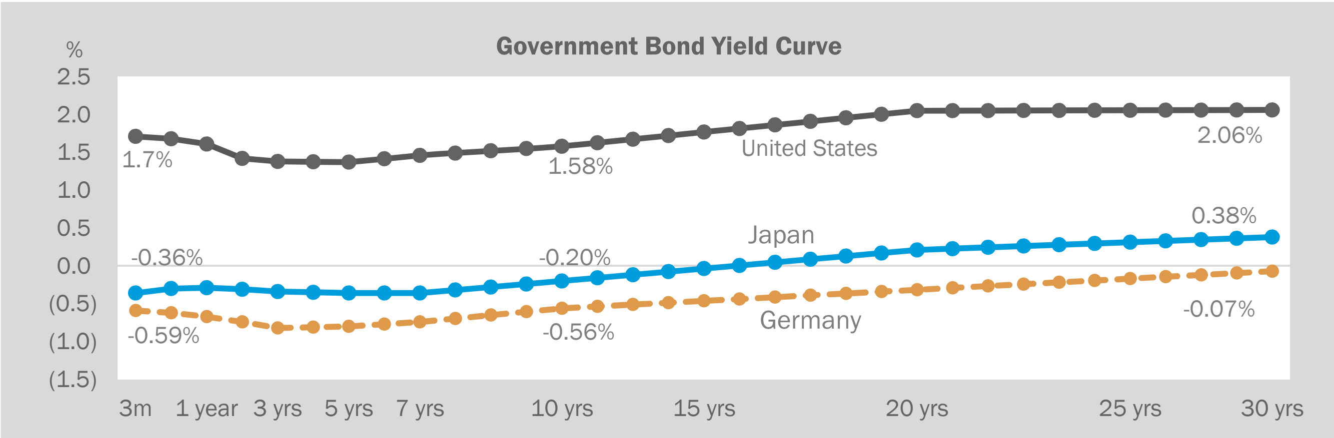

Figure 4. Source: Macrotrends, data as of 10/9/19

With recent rate cuts in the U.S., short-term rates have lowered, but so has the 10-year Treasury rate, which went from 2.0% at the end of June to under 1.7% at the end of September. This decline in rates resulted in a rally of government and investment-grade bond prices globally. The Barclays U.S. Aggregate Bond returned 2.3% for the quarter and 8.5% for the year-to-date period, while the Global Aggregate Bond returned 0.72% and 6.3% for the same periods. High yield bonds were up over 11.5% for the first nine months of the year; they were bolstered by the potential for these companies to refinance their debt at lower rates, and thus, improving their prospects for good financial standing despite economic slowdown.

We remain cautious, however, because the recent rally has only further increased the risk profile for these bonds. As more governments and corporations have locked in longer-term bond issuances at lower rates, the duration of the benchmarks representing these securities has also lengthened, while the yields have gone further down. If rates fall further, that will be positive for these bonds, with longer bonds rallying the most. However, the impact is proportionally negative if rates move up.

We believe that core fixed income provides some portfolio protection during periods when there is risk aversion in the markets. The average yield on the U.S. Aggregate Bond Index is 2.26%, while its average duration is 7.0 years. If rates remain range-bound, the return on core bonds will be close to the yield, while if rates do move up, then the risk is high for negative returns. The fixed income segment (consisting of actively managed portfolios of U.S. core fixed income global bonds as well as some credit) has an average duration that is below that of the Barclays Global Aggregate Bond Index, but with an aggregate yield that is higher than that of the benchmark.

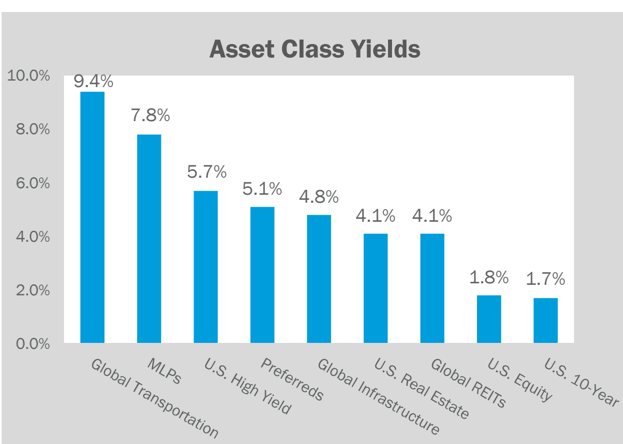

Figure 5. Source: JP Morgan

Real Assets

In this segment, the diversified basket of strategies was slightly negative for the quarter. The price of commodities, natural resource equities, and MLPs were down for the quarter due to concerns over an economic slowdown. However, lower rates helped the performance of REITs and infrastructure assets. Given falling yields elsewhere in the portfolio, this segment provides some yield advantage because many of the real asset categories generate fairly healthy yields, reflecting increases in real estate prices as well as hikes in rents and tolls.

As a diversified basket, there is also exposure to alternative energies, such as water and interest-related instruments, including TIPs and floating-rate bonds. The aggregate portfolio has a yield of over 3.0%, which provides some stability of return.

Liquid Alternatives

Even as equity and credit strategies have posted gains, there has been a steady increase in stress within certain industries. Changing demographics and the “Amazon effect” has hit the retail sector hard with the bankruptcies of stores, such as Forever 21, Sears, Toys R Us, and Payless Shoes. A similar dynamic exists in industries, including transportation, energy, service, and communications. In the first nine months of this year, more than 20 bankruptcies have been filed among companies with over $1 billion in assets.

At the same time, rising equity value has also triggered corporate mergers and acquisitions across industries and is driven by companies seeking synergies through vertical integration or acquisition of competitors to increase market share. A steady pace of corporate activities has provided investment opportunities for equity and credit-oriented hedge funds to seek out mispriced securities that show the potential for revaluation through some corporate action. Certain opportunities, such as the PG&E debt restructuring, can be a longer-term play. While others, including announced mergers, may have a shorter timeframe within, which the intrinsic value can be realized.

Top 15 Bankruptcies in 2019 through September 30

Company	Assets at Time of Filing ($ Billion)	Effective Date	Industry
PG&E Corporation	$ 71.4	Jan-19	Energy
Windstream Comm.	$ 13.1	Feb-19	Communications
Ditech Holding Corp	$ 12.3	Feb-19	Finance
Weatherford International PLC	$ 6.5	Jul-19	Energy
Bistow Group Inc	$ 2.9	May-19	Transportation
Sanchez Energy Corp	$ 2.2	Aug-19	Energy
Hexion Holdings	$ 2.1	Apr-19	Chemicals
Philadelphia Energy Sol'n	$ 2.1	Jul-19	Energy
Purdue Pharma LP	$ 2.0	Sep-19	Pharmaceuticals
Halcon Resource Corp	$ 1.8	Aug-19	Energy
Vanguard Natural Resource	$ 1.5	Mar-19	Energy
Forever 21, Inc	$ 1.4	Sep-19	Retail
Alta Mesa Resources, Inc	$ 1.4	Sep-19	Energy
PHI, Inc	$ 1.4	Mar-19	Transportation
Legacy Reserves, Inc	$ 1.4	Jun-19	Energy
Brinks Home Security	$ 1.3	Jun-19	Services
Double Jump, Inc (DC Solar)	$ 1.2	Jan-19	Energy
Stearns Holdings, LLC	$ 1.2	Jul-19	Finance
Global Cloud Xchange Ltd	$ 1.1	Sep-19	Communications
Payless ShoeSource	$ 1.0	Feb-19	Retail
FullBeauty Brands	$ 1.0	Feb-19	Retail

Figure 6. Source: Business Insider, as of 10/3/19

Announced M&A Deals in U.S. by Industry
2000–2018 Distribution by Number of Deals

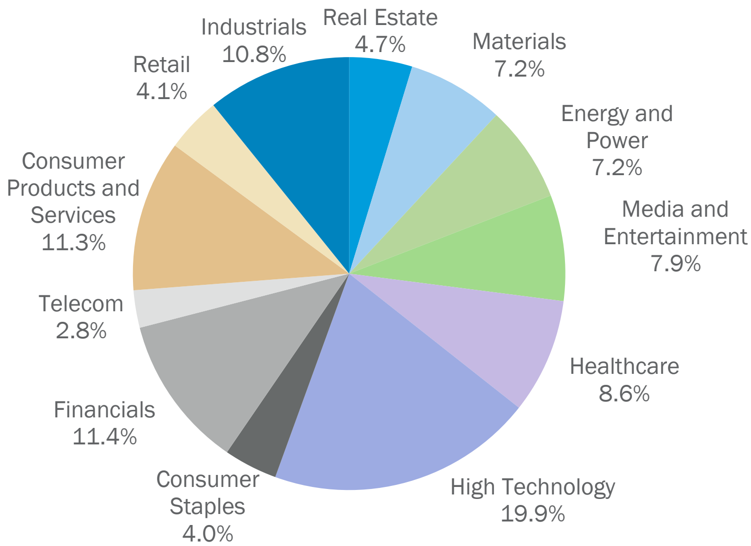

Figure 7. Source: Institute for Mergers, Acquisitions & Alliances

Hedge fund managers have been able to add value this year because the changes in the competitive landscape within industries have provided opportunities on the long and short side of their books. Credit managers are seeing more opportunities to purchase bonds of stressed and distressed companies at discount, and add value through actively participating in the restructuring process.

Dynamic asset allocation funds that tend to simply invest in public securities have shown mixed results over the year. Those with a value bent that has tilted toward non-U.S. and emerging market securities have lagged relative to those that have had a U.S.-centric focus.

Private Equity

It continues to be a sellers' market as equity markets have remained strong. PE funds have been taking advantage of the valuations to monetize their positions. Recent high profile IPO "failures," including WeWork and the lackluster post-IPO performance of companies, such as Uber, Lyft, Slack, Peloton and others point to the perils of high valuations — particularly in late-stage venture. But across all fund types in general, there has been a slowdown in the creation of new funds and a meaningful drop in the amount of capital raised over the last two years.

Figure 8 on the next page illustrates the year-over-year total fund count and capital raised globally across all fund types, inclusive of buyout, venture, debt, real asset, and co-investments. At the end of March, there was over $1.3 billion of "dry powder" held across different types of private equity funds, and many funds continue to work their way through that capital, being more cautious with new purchases, given economic uncertainty and market valuations. We have seen many funds put the money to work through making add-on acquisitions to their existing portfolio companies.

Where clients have the ability to add private equity, we have been making selective commitments, mostly to smaller funds, where the manager can have a larger pool of opportunities to sift through and where debt multiples and may not be as elevated, and multiple options can be explored to add incremental value.

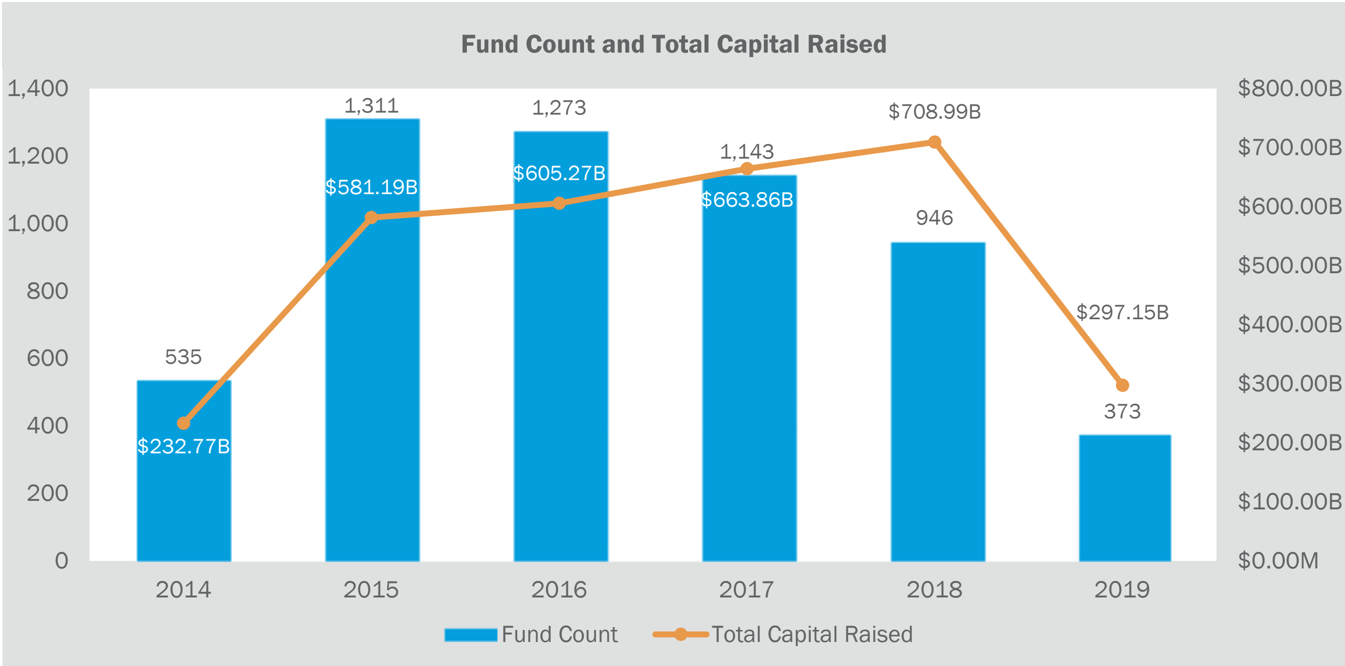

Figure 8. Source: PitchBook Data, Inc.

Overall Remarks

We have observed a rise in market volatility across regions and asset classes. While it raises the risk profile for investing, it also creates buying opportunities for managers. Valuations are not compelling in any asset class. Thus, we believe that in this kind of environment, it is crucial to be diversified to avoid idiosyncratic risks associated with any one market or asset class. Many of our clients have a long-term time horizon that will last multiple market cycles. However, if there is a dislocation in the markets, it is important to have the liquidity to take advantage of buying opportunities.

We 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, overseeing $22.8 billion in assets as of June 30, 2019. 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.

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