Canterbury Outsourced CIO

Fourth Quarter 2020 Commentary

Introduction

The year 2020 will be remembered as a year marked by crisis as well as the heroic responses that crossed national and regional boundaries. While the year began with steady growth, in March, the COVID-19 pandemic quickly shaped into a global crisis. This forced populations to engage in some form of isolation, distancing themselves from work, school, and even family members and friends. Central governments continue to respond with large monetary and fiscal stimulus to allow businesses and individuals to sustain themselves. The pandemic prompted a heroic, simultaneous global public-health initiative, resulting in the development of multiple vaccines in record time. Addressing the storage, transportation, administration, and tracking challenges of these vaccines will be essential to boosting confidence in the markets.

The vaccines bring hope to improving mobility and the possible return to steady economic activity over time, but the timing and nature of what will be deemed "normal" remain uncertain. As we enter a new year, many small businesses and individuals continue to struggle, reflecting the limitations faced by many industries that are still in lock-down. Consumer behavior has shifted positively towards e-commerce in areas such as retail and fintech, and the broad grassroots support against racial injustice and climate change has shifted priorities for many organizations.

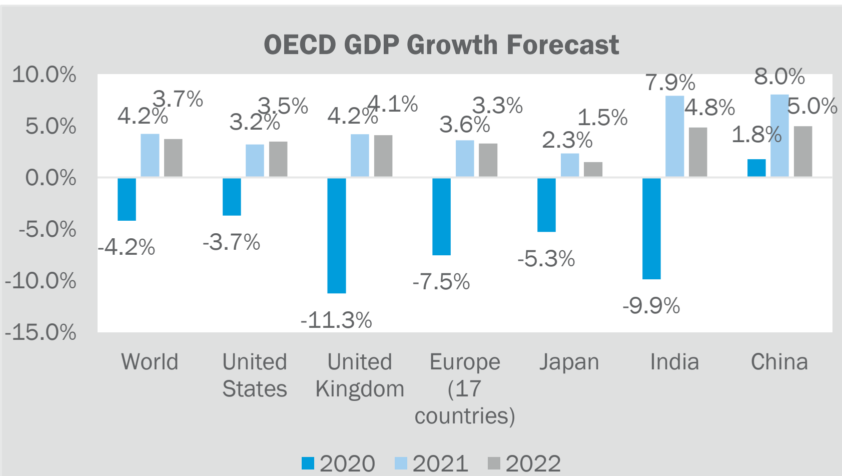

Figure 1. Source: Organization for Economic Co-operation and Development (OECD)

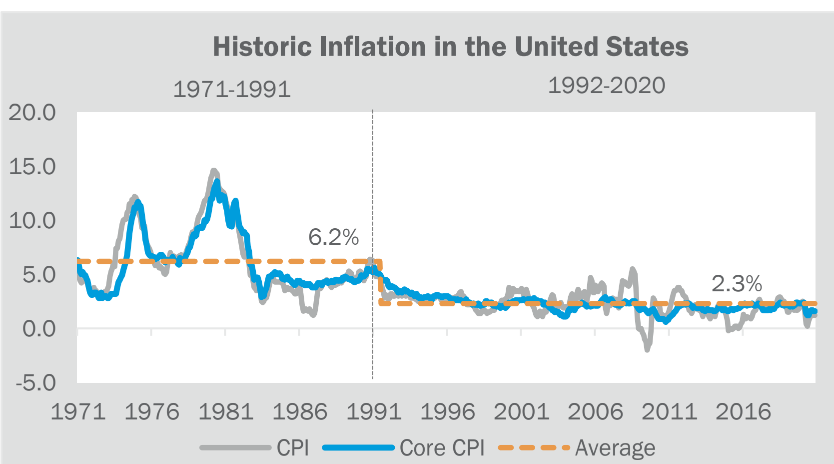

Figure 2. Source: U.S. Bureau of Labor Statistics

Looking forward to the year 2021, most central governments are expecting a rebound in the real GDP given the potential for improvement in mobility, widespread vaccination, and continued financial support. The global GDP is expected to increase by over 4% in the coming year, with higher growth expected for emerging countries, following a steeper decline in 2020, with the exception of China. The challenges to execution bring up other implications. With close to $7.5 trillion of stimulus provided over the last 12 months in the U.S. alone and the potential for more support in coming months, the significant increase in money supply raises the probability for higher inflation even as the November 2020 rate of 1.6% remains well below the level in recent history. The potential for further government support may also be limited in countries whose economies are more dependent on natural resources and have had their finances hit hard by the global slowdown.

We feel positive about our portfolios given market and manager performance through December 2020 and are optimistic about 2021, but feel it prudent to remain cautious and carefully balance areas of opportunity against the potential risk.

Equities

Over 2020, the broad equity indices experienced one of the most rapid sell-off in equity markets followed by an equally speedy recovery. The S&P 500 Index declined 34% within a month in March 2020 and subsequently appreciated over 70% to end the year up 18.4%. Where much of the rally was driven by technology and e-commerce companies that benefited from the "stay-at-home" environment, the markets broadened out in November and December with value-style indexes and small-cap companies outperforming their large-cap growth peers. For the fourth quarter, the Russell 2000 Value was up 33.4% vs the Russell 1000 Growth's return of 11.4%. However, for the year, the Russell 1000 Growth gained 38.5% vs. the Russell 2000 Value's appreciation of 4.6%. A similar and growing divergence exists in the performance of the non-U.S. equities relative to the S&P 500 Index over the last decade, with the MSCI EAFE and MSCI ACWI ex U.S. generating 3.6% and 5.1% return relative to the S&P 500 Index annualized return of 13.9% over the 10 years ending December 2020.

The strong outperformance of a narrow group of the top names in the large core index over the year has led to the top 10 names in the S&P 500 going from 19.6% of the index at the end of 2017 to 28.6% of the index on December 31, 2020. We are not negative on the top holding companies of the S&P 500 Index, but we feel it prudent to be cautious. Periods of liquidity and further inflow of capital into index strategies benefit the top holdings incrementally more and have the potential to create "bubbles" where valuations get to levels that company fundamentals may not support.

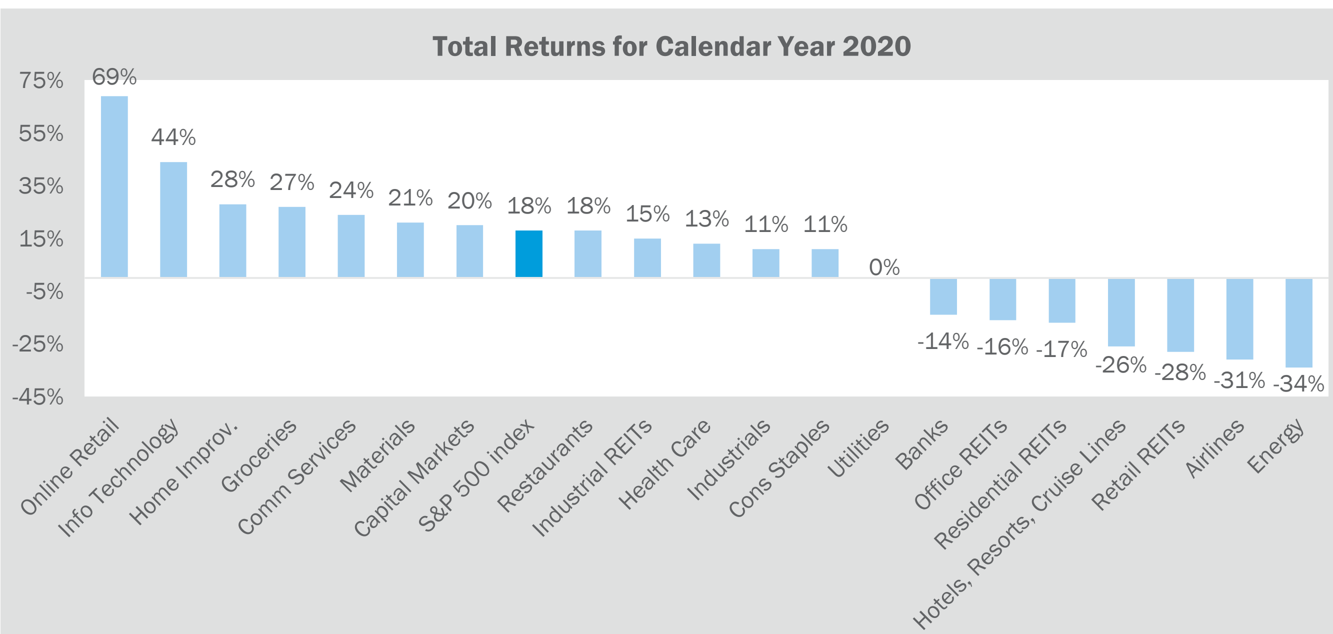

Figure 3. Sources: Standard & Poor's and JP Morgan

Given suppressed earnings expectations by companies in the current environment, the forward price-to-earnings ratio on the index is about 22.3x. Valuations may improve as forward-looking earnings are revised upwards with signs of economies opening. Should that trigger the onset of a new economic cycle that can improve the earnings prospects and return potential of many cyclical segments including Energy, Industrials, Basic Materials, Financials, many of which have lagged the performance of the broad indices in 2020?

Our equity portfolios remain balanced across styles, geographies, and market capitalization. It was good to see international equities, emerging market equities and small cap perform well ahead of the large growth segments during the quarter. As equities have run up over the last few quarters, we have taken opportunities during incidences of cash flow to bring allocations back close to target.

Fixed Income

In 2020, fixed income portfolios benefited most from exposure to sovereign bonds, particularly long-duration bonds, as they outperformed most other fixed income segments. The strong performance has pushed yields down to under 2% in most investment grade fixed income categories, leaving very little income cushion to protect against price decline should interest rates go up.

	U.S. 10-yr Treasury	U.S. 30-yr Treasury	U.S. TIPS	IG Corps	U.S. High Yield	MBS	Floating Rate	European High Yield	Emerging Mkt. Debt	Global ex-U.S.
2020 Return (USD)	10.6%	18.7%	11.0%	9.9%	6.5%	3.9%	1.4%	10.9%	5.3%	9.8%
Yield on 12/31/20	0.9%	1.7%	-1.1%	1.7%	4.2%	1.3%	0.5%	3.4%	4.2%	0.7%

Figure 4. Source: Barclays Capital

In the continuous effort to find relative value in the investment portfolio, it has become increasingly difficult to set high expectations for the fixed income segment. Unless interest rates go down further to below zero, fixed income securities will generate returns equivalent to their yield. At the end of 2020, the Barclays U.S. Aggregate Index had a yield of 1.12%. For investors looking to generate a 5% return on their investment portfolio, the only way to generate close to that would be through riskier high yield and emerging market bonds. These tend to correlate positively to equities and provide less protection during periods of decline in equity markets. We have taken a balanced approach in fixed income with an allocation of 60% to U.S. Core bonds to provide overall portfolio stability during periods of correction in equity markets and 40% to opportunistic

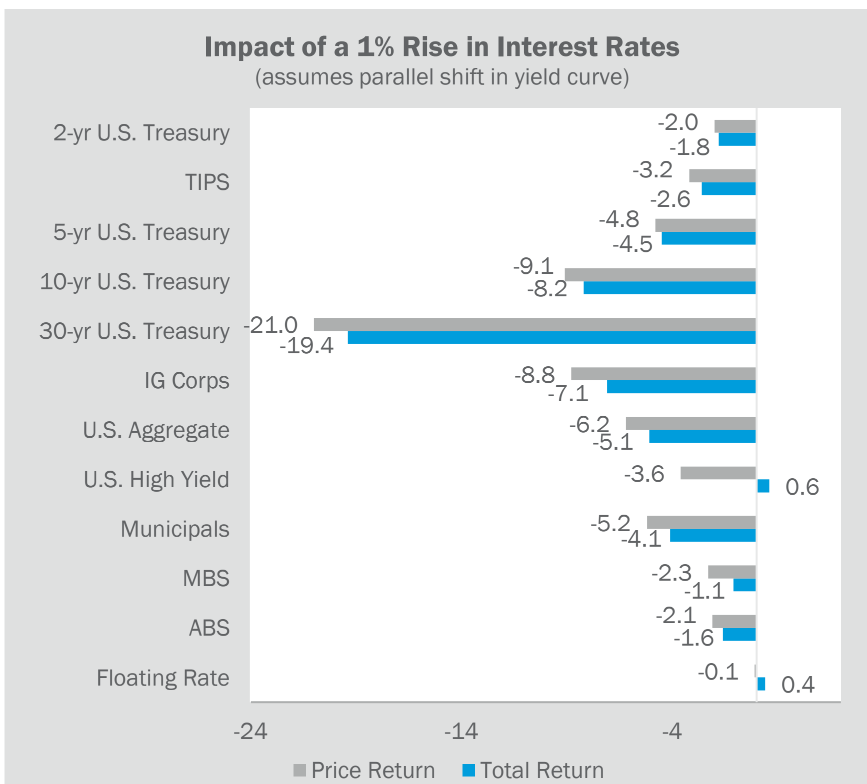

Figure 5. Source: Barclays Capital and JP Morgan

bond strategies as a way to improve the returns in the segment.

We took a stance to maintain a shorter duration in the fixed income segment relative to the Barclays Aggregate Index. While our active managers have held up better than the benchmarks over the years, the segment has lagged during periods when treasuries have rallied. As we approach near-zero interest rates, we continue to keep our overall duration less than that of the benchmark. We also feel it is important to have active managers in this segment that can tactically allocate across sectors and securities.

Real Assets

The real asset segment has held up well on a relative basis given the pandemic related economic slowdown. Even as the S&P 500 Index returned 18.5% for the year, the energy sector was down over 30% within the index. The segment is invested in a pooled fund that is diversified across commodities, real estate, infrastructure, and floating rate securities, including TIPS. All have positive sensitivity to inflation and are designed to protect the portfolio during periods of unexpected inflation. The segment was up over 10% for the fourth quarter, recouping the price decline from the March period. This segment has struggled in the last few years, as inflation has remained very low and even dipped negative during some periods. It is 5% of the portfolio given its volatility. However, we feel it continues to have a place in the portfolio as we move into periods of less certainty regarding potential inflationary pressures.

Liquid Alternatives & Hedge Funds

We wrote in our prior letter that we had determined to exit from our liquid alternative managers. Where active managers were having difficulty outperforming the broad market index, the challenge was greater for tactical allocation strategies where the managers can short and seek to rotate from highly valued areas towards the more attractively valued segment. Their valuation discipline that worked over prior market cycles was simply not working in an environment where a narrow segment of the market continued to perform so far ahead of other securities. We trimmed the segment once in September and trimmed it again at the end of December. The proceeds from the sale are being allocated to equities. In our experience, the liquid alternative funds were exhibiting volatility that was similar to the equity segment but lagged in returns. Where return expectations have come down across asset classes, we also saw this as a way to further bolster the portfolio's ability to generate the required long-term return of CPI + 5%. As a result of the transition, the overall allocation to equities has gone up in those portfolios that had liquid alternatives.

Where we have hedge funds, we have found the managers more nimble in their efforts to manage their next exposure as well as their ability to rotate across opportunities. Growth-oriented, long-short equity managers fared better in general given the environment, and credit-oriented managers were able to take advantage of the large new issuance of corporate debt during the summer. We made some changes in the manager line up in areas where we felt the manager's risk and returns were not in line with our expectations given the market environment over the year.

Private Equity

The trends in private equity tend to be hard to see in real time, as activity and performance are often reported at a lag of at least 1–2 quarters. A downturn in public equity markets tends to have an effect on valuations in general, affecting the multiples at which transactions are completed in private markets. The impact of public equity market decline in 2008 had a sizeable impact on marked values of fund holdings and the median 3-year returns across private equity strategies in the following quarters. Given the rapid rebound in public equity markets this time around, there may be less of an impact on private fund values. The market correction did provide a window of opportunity for funds with dry powder at an attractive value in the summer.

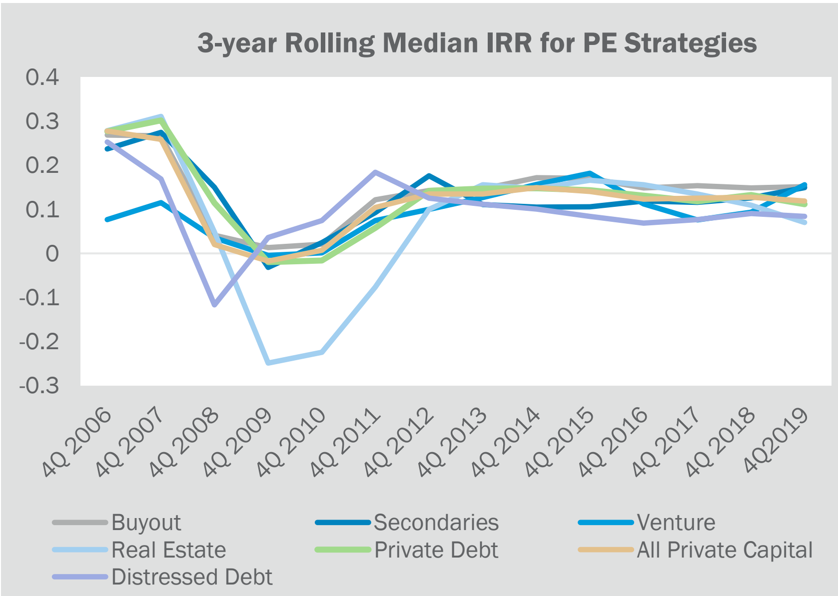

Figure 6. Source: PitchBook

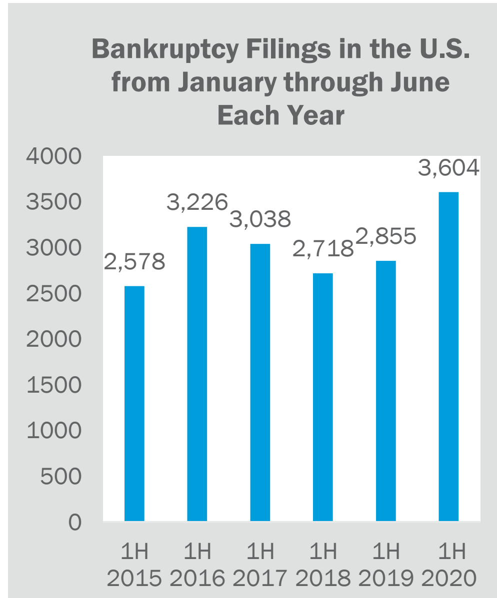

Figure 7. Source: PitchBook

What remains to be seen is the impact of the slow economic recovery on businesses that have been affected by the lockdown. The number of bankruptcies in the U.S. in the first half of 2020 exceeded that of any of the last five years, with the number likely to be higher in the following quarters through the lockdown period. This will likely reduce the growth prospects for a segment of companies owned by private equity firms but may also create opportunities for private funds that are looking for distressed investments. Our preference has been to find private equity managers that adhere to a valuation discipline in their purchases and are less reliant on leverage to bootstrap their companies. We continue to closely monitor the funds our clients are in and scrutinize the new funds we diligence for signs of stress as well as opportunity.

Overall Summary

During this uncertain period, the importance of a strategic, long-term approach is more important than ever. We are humbled by your trust in our judgement and truly appreciate the opportunity to serve you.

We also want to take a moment to acknowledge and express our gratitude to clients who have been providing additional support to their communities during the pandemic — in many cases, doing so with reduced operational resources. We value our role in helping manage your investments so you can focus on your mission.

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 $23.6 billion in assets as of June 30, 2020. 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. Learn more about Canterbury Consulting at www.canterburyconsulting.com.