Canterbury Outsourced CIO
Second Quarter 2024 Commentary

## Overall

Some suggest that news about inflation and higher prices might be somewhat exaggerated. Certainly, minimum wages have increased considerably, but so has the cost of essentials such as food, rent, insurance, and many non-durable goods. Homeowners took advantage of long-term, low-financing options in the initial stages of the Pandemic. However, as interest rates have risen and remained elevated, we are seeing a surge in credit card delinquencies and other loans linked to floating interest rates. One outcome of higher rates has been the steady increase in net interest payments as a percentage of the total Federal outlays, reaching levels not seen since the early 1990s. The projection for the net deficit could increase further if the tax cut and Jobs Act (TCJA) tax rates extend beyond 2025. During this election year, as the Republican camp advocates for higher tariffs on imports and the Democratic camp seeks to increase government spending further, it is likely that maintaining low CPI will continue to be the priority for the Federal Reserve, regardless of which party holds power. It's important to note that the long-term implications of mounting deficits could threaten the key advantage that the U.S. has, which is its superior credit quality and the global confidence in the government's ability to service its debt.

Higher rates have primarily affected individuals and businesses at the lower end of the income spectrum. However, this group does not significantly impact the overall economy. Overall, the willingness of the consumer sector to spend has not diminished, at least not yet. The U.S. continues to experience steady GDP growth at a rate of 2%, and the Federal Reserve has not yet been ready to declare a victory over the monster of inflation.

The European and Canadian Central banks have pursued different paths in their monetary policy. Canada and the ECB have cut their short-term lending rates by 25 basis points despite anticipating inflation to remain above their 2% target. As a result, the U.S. Fed Funds rate, at 5.25%, now stands significantly higher than the rates of 3.75% in Europe and 4.75% in Canada. In the short term, this has caused a flow of global capital into U.S. treasuries as investors seek higher yields. Consequently, the value of the U.S. Dollar has risen relative to other currencies, negatively impacting the performance of non-U.S. investments when converted into U.S. Dollars.

This period of steady economic growth may have contributed to the general melt-up of the equity markets. In the first half of 2024, the broad U.S. equity market index, the Russell 3000, recorded a substantial gain of 13.6%, while small companies, as represented by the Russell 2000 index, experienced as increase of 1.7%.

**Delinquent Balances by Loan Type**

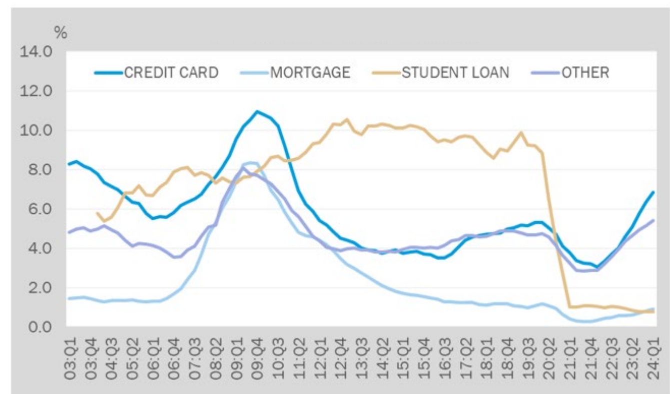



*Figure 1. Source: Board of Governors of the Federal Reserve*

**Federal Net Outlays as % of GDP**

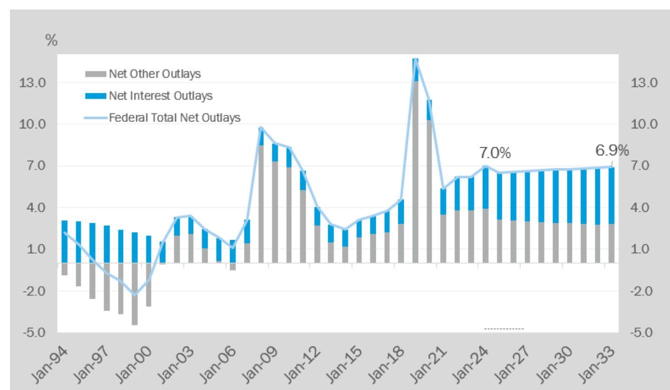



*Figure 2. Source: Federal Reserve Bk of St. Louis*

**IH24 Contribution to Performance of the S&P 500**

| | Return | Contribution | Cumulative | Avg. Index Weight |
|---|---|---|---|---|
| Microsoft | 36.1% | 9% | 9% | 7.15% |
| Apple | 13.9% | 3% | 12% | 6.25% |
| Nvidia | 193.8% | 28% | 41% | 4.88% |
| Amazon | 36.4% | 5% | 46% | 3.71% |
| Meta (Facebook) | 71.8% | 6% | 52% | 2.38% |
| Google | 33.7% | 7% | 59% | 3.94% |
| Berkshire Hathaway | 12.5% | 2% | 61% | 1.70% |
| Eli Lily | 48.8% | 4% | 65% | 1.39% |
| Avago | 56.4% | 3% | 68% | 1.34% |
| JP Morgan | 19.9% | 2% | 70% | 1.26% |
| Total | 10.70% | | | 34.00% |

*Figure 3. Source: FactSet, Standard & Poor's, DowJones*

**Comparative Performance through 6/30/24**

| | YTD 2024 | | 15-years | |
|---|---|---|---|---|
| | Local | U.S. Dollar | Local | U.S. Dollar |
| US (S&P 500) | – | 15.3 | | 14.8 |
| AC World ex-US | 11.0 | 6.0 | 8.0 | 6.7 |
| EAFE | 11.5 | 5.7 | 8.6 | 7.3 |
| Europe ex -UK | 10.3 | 6.2 | 9.4 | 8.1 |
| Emerging Mkts | 11.2 | 7.7 | 7.1 | 5.3 |

*Figure 4. Source: MSCI, Standard & Poor's, DowJones*

The large differential in performance is courtesy of the substantial impact of the top holdings in the large-cap index. Nvidia stock alone accounted for almost 30% of the S&P 500 return. The top 10 index holdings contributed to 70% of the year-to-date return, representing 10.7% of the total 15.3% return. For comparison, the equal-weighted S&P 500 return was up 5.01% for the same period. This concentration effect may not be sustainable, although it has been a prevailing trend for several years.

In recent decades, the GDP of both developed and developing nations has experienced growth spurred by the efficiency of global trade. Today, large global franchises can be found domiciled in many countries. The U.S. remains the largest single economy, comprising a quarter of global GDP, but the weighting of the U.S. equity market as a share of the global equity index has increased to a much larger proportion during the same period. Over the last 15 years, the relative outperformance of the U.S. equity markets has led to its share going from 42% in 2007 to 64% of the MSCI All Country World index at the end of June 2024. There has been a proportional cutback in the weighting to U.K., Japan, Europe-ex U.K., and Emerging market equities.

**World GDP Breakdown - 2022**

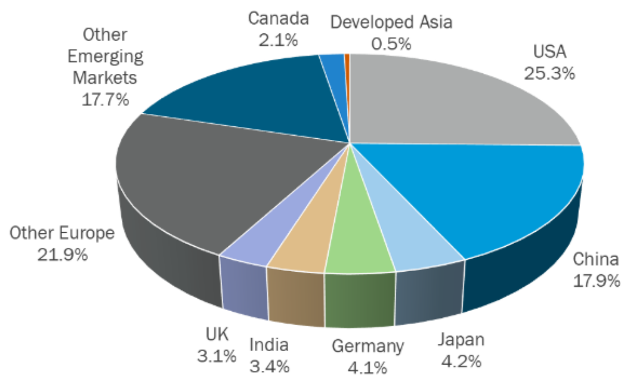



*Figure 5. Source: "World Development Indicators", World Bank*

**Share of Global Market Capitalization**

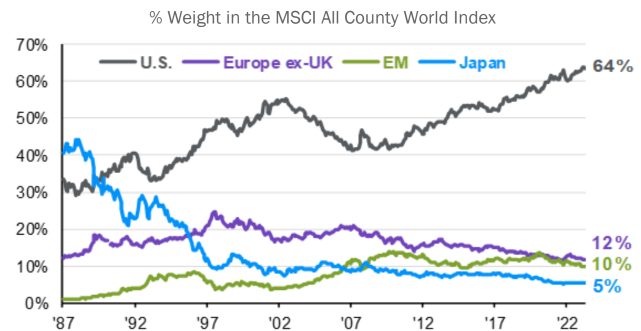
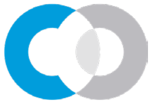



*Figure 6. Source: MSCI, JPM Guide to Markets, June 2024*

Whether this increase has been driven by the outsized contribution from the performance of the mega-cap Technology names or the prolonged period of the strengthening of the U.S. Dollar against other currencies, it has caused U.S. investors to be at a relative disadvantage to be invested in non-U.S. equities.

We continue to find non-U.S. equities more attractively valued than U.S. equities. We are bullish on their upside potential, and even though large U.S. technology companies continue to show strong earnings, there is value in having exposure to all the non-U.S. equity markets. However, from the portfolio risk management perspective, we have adjusted the regional breakdown in the global equity segment to 65% U.S. equities/35% non-US equities to be neutral to the benchmark. We continue to have active management in this segment and have added exposure to international small-cap equities to broaden the opportunity set.



## Fixed Income

In recent years, fixed-income investments have faced the challenge of zero and rising rates. However, we anticipate positive contributions from the fixed-income segment in the future. Currently, 10-year real yields are positive, as the inflation rate has fallen below the 10-year nominal yield, indicating that fixed income can add positive value after inflation. Yields are also higher across most fixed-income sectors across regions and credit quality. While it's important to consider security selection, the data suggests that current levels provide a good starting point to generate mid to high single-digit returns in the coming years, barring any strong shock to the system. Any deterioration in fundamental economic or corporate financial conditions could pose a challenge for bond holders, but it could also lead to a decrease in interest rates, potentially boosting bond prices. Overall, we believe that diversification can be beneficial.

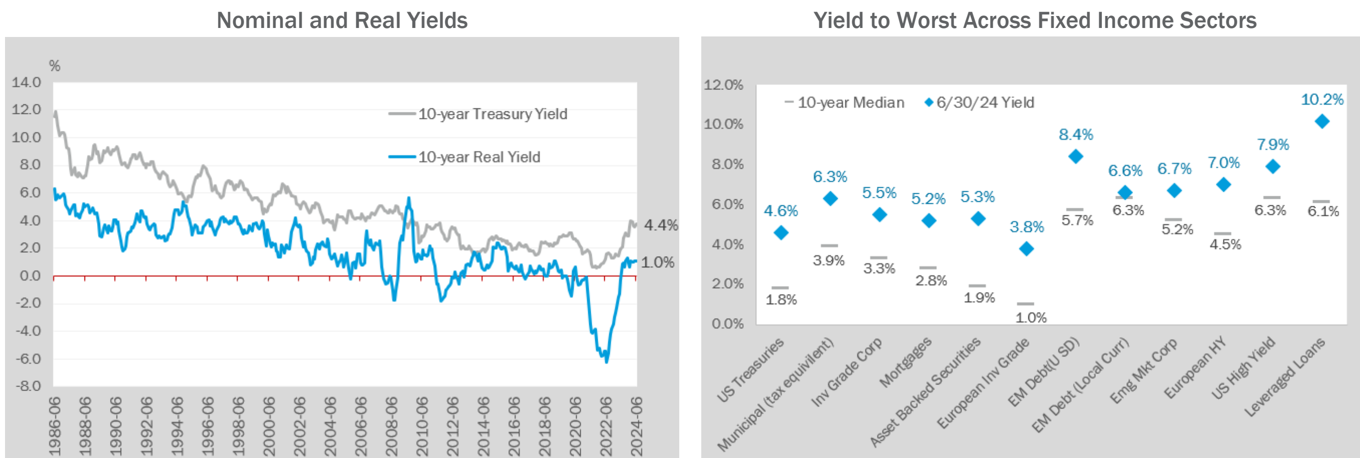



*Figure 7. Source: U.S. Treasury Dept, U.S. Bureau of Labor Statistics*

*Figure 8. Source: Barclays Bloomberg Index data, JP Morgan*

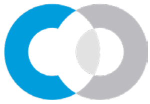
Furthermore, if we do not observe a significant increase in inflation, it is unlikely that interest rates will rise significantly from their current levels. This situation will work in favor of portfolio managers with longer durations. The current environment presents favorable conditions for fixed-income managers to enhance their performance by utilizing various tools, including security and region selection, yield curve positioning, and duration management.

## Private Equity

The pace of deal-making and fundraising peaked in 2021 across most private equity sectors. Record inflation, rising interest rates, and uncertain economic forecasts have slowed private equity deal-making. Despite the lack of new funding rounds, many venture-backed "unicorns" are still being held at high valuations. However, companies such as Robinhood and Bumble, which went public in 2021, saw their prices tumble in 2022, causing other potential IPO candidates to wait for a stronger market demand.

Sellers have been slow to accept lower valuations, and buyers are generally unwilling to pay 2021 prices in an economic landscape that looks very different. Tighter lending standards from banks at a time of wide bid-ask spreads have led to the slowdown in M&A activity since 2022. The longer investment cycle has posed new challenges for buyout fund managers, as the extended holding period for companies can put pressure on IRRs, especially if the cost of debt has increased due to rising interest rates. In this environment, skilled and active managers are crucial to adding value through operational improvements and by selective add-on of business segments.

For over a decade, many private equity funds took advantage of the zero-interest rate period, generating strong performance by capitalizing on rising stock prices and flipping companies at higher multiples. At higher rates, companies burdened with high levels of debt are less able to pivot in the face of changing macroeconomic conditions or industry dynamics.



**U.S. PE Deals: Buyout vs. Add-on**

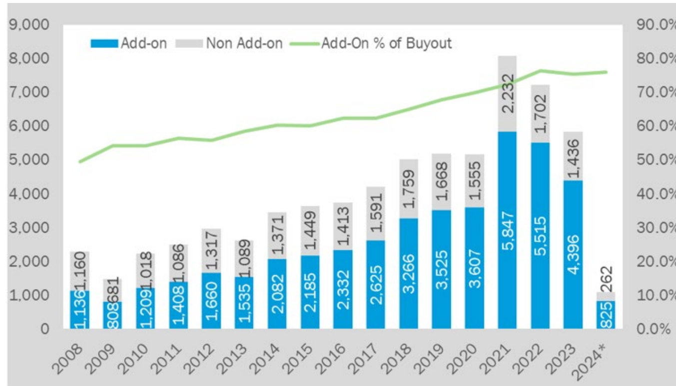



*Figure 9. Source: Pitchbook, 1Q2024*

**U.S. PE Deals by Sector**

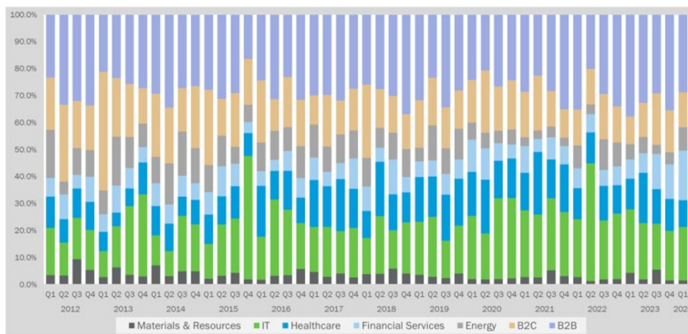



*Figure 10. Source: Pitchbook, 1Q2024*

At the same time, economic uncertainty can affect private equity in different ways. While it may undermine the valuations of portfolio companies, it also presents new investment opportunities at lower entry points. Private equity funds generally have well-defined strategies, and the current environment serves as a test of their ability to flex and adapt to seize investment opportunities. Funds are leveraging their expertise and relationships to create vertical consolidations across sectors, a practice historically more common among corporate strategic buyers. Companies that can adjust to changing supply chain dynamics in the face of geopolitical risks, evolving trade regulations, and increasing costs will likely emerge as leaders. Private equity firms also have an advantage in securing add-on components, compared to public companies, especially in the face of public and government scrutiny.

Over the years, private equity deals have been dominated mainly by the Technology and business-to-business ("B2B") sectors. The B2B sectors include Industrials, Services, and other businesses that provide services primarily to other businesses. Digital transformation continues to be a key value-creation theme across sectors. Bolstering supply chains is a rising priority amid geopolitical tumult. As the holding periods for portfolio companies hold times extend, there is a renewed emphasis among fund managers on fostering strong corporate cultures within these companies.

The longer investment cycles enable private equity firms to execute their value-creation strategies more effectively. Additionally, there is a growing trend of continuation funds, special vehicles designed for individual company positions that private equity managers would like to set aside for longer maturation. While these create a separate timeline for the investment outside the investment fund's life, they also introduce new terms, fees, and other contingencies that may affect the ultimate monetary value realized by limited partners (L.P.). We have approached these opportunities with caution and selectivity.

We often hear that there is little transparency in private equity, given the nature of private partnerships and the infrequency of pricing. We agree with the lack of public information, but we feel it is our role to assess a manager's capabilities by doing diligence on the historical and ongoing management of their underlying portfolio companies. With each new fund commitment, we re-underwrite a manager's capabilities to test our confidence in the manager going forward. We also closely monitor each fund's underlying investments once we have client money in the fund, particularly during challenging economic and market environments.

## Private Credit

Just as the private equity market has grown over the last decade, so has the private credit market, with assets under management now exceeding $1.7 trillion. A considerable portion of these loans are made to companies backed by private equity funds; therefore, the pattern of fundraising activity has fallen over the last three years, mirroring the trend in the private equity markets.

Private credit growth is primarily driven by direct lending, which totals around $800 billion, or about half of the total. Additionally, there is a growing amount of committed but uninvested capital (or 'dry powder') in the industry, with the majority of this capital residing in the very large funds that provide direct loans to the very large private equity deals sponsored by large leveraged buyout funds. Our focus has been on middle-market direct lending funds that provide loans to middle-market companies, including both sponsored and non-sponsored entities.

**Direct Lending Fundraising Activity**

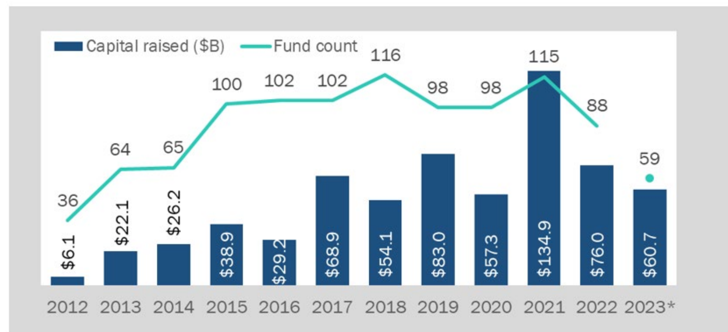



*Figure 11. Source: Pitchbook, 1Q2024*

In the aftermath of the SVB Bank collapse and the further cutback in lending activities by banks, there has been a greater opportunity for private credit funds to provide financing to segments of the economy that the banks are not servicing. Real Estate debt and credit special situation funds are able to structure rescue financing at attractive rates in sectors that have gone through some stress and are going through active restructuring with strong equity backing by private sponsors. These opportunities provide some level of diversification away from direct lending when there is a slowdown in new deals in the private equity arena.

**Debt Capital Raised ($B) by Type**

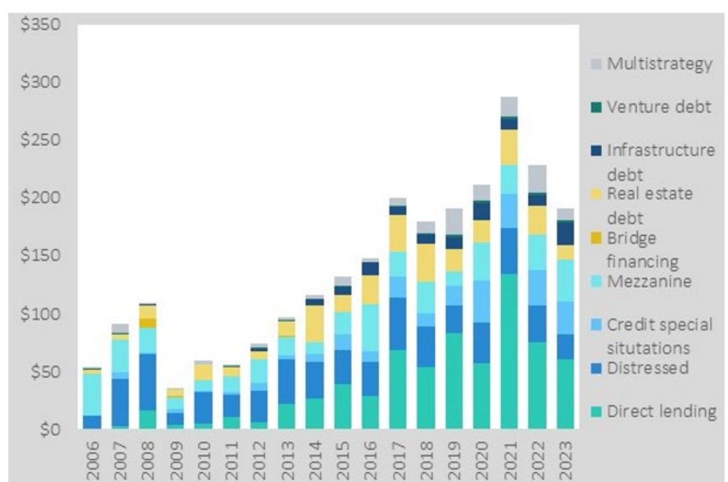



*Figure 12. Source: Pitchbook, 1Q2024*

## Overall

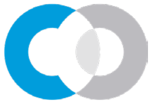
In conclusion, with a narrow group of areas leading investment performance over this prolonged market cycle, it has been challenging to perceive the value of a diversified portfolio. Our role is to manage the risks around the narrow market and, at the same time, identify areas for potential future value. If markets provide a major dislocation, we will swiftly add more to areas that have been hard hit. In the absence of that, we may make changes on the margin to manage risks and explore new opportunities. Most importantly, we ensure the portfolio aligns with the client's objectives and liquidity needs.

We appreciate the opportunity to serve you and are grateful for your trust.

Sincerely,


**Poorvi, R. Parekh, CFA**

*Director of Outsourced Investments*



**Poorvi, R. Parekh, CFA**

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 — overseeing all manager, fund, and product research; maintaining 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**

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