Canterbury Outsourced CIO

Fourth Quarter 2022 Commentary

Overview

At Canterbury, clients often ask us to provide our outlook for the markets over upcoming quarters. We have learned over the years, that the future, in the short or long run, is rarely the present extrapolated. The last three years alone would have proved us wrong repeatedly. In January 2020, there was great optimism for both Silicon Valley as well as China. That is where the action was, as global "Big Tech" from Alphabet to Alibaba seemed more powerful than major governments. The onset of a global pandemic served only to fuel these growth companies that enabled enterprises to operate with a virtual workforce.

Three years later, there have been over 100,000 layoffs across technology firms in 2022, with forecasts for further headcount cuts in the coming year. The Nasdaq-100 Index, representing the largest non-financial companies listed on the Nasdaq exchange, is down 33% for the year, with its top holdings down meaningfully: Apple (-26.8%). Amazon (-49.6%), TSLA (-65%), Meta (-64%), and MSFT (-29%). The Federal Reserve has gone from fighting deflation to making it loud and clear that they will pound inflation to submission, whether the market (or the economy) likes it or not. Higher rates have pushed down the valuation of high growth companies. However, these global franchises continue to dominate the market, taking advantage of the market pullback to make strategic acquisitions.

Outside the U.S., investors went from loving China's growth potential not so long ago to deeming it "uninvestable" amidst its zero-COVID policy and clamp down on the seemingly uncontrolled business practices of large technology companies. The MSCI China Index had dropped over 60% from the peak through October 2022. Yet when China decided to re-open post pandemic shut down, the Chinese stocks that were trading at multi-decade lows on a valuation basis, absolutely ripped, causing the index to jump over 36% between November and December 2022.

Europe was mired in multiple woes amidst threats of a large-scale war or at least a severe energy crisis over the winter months. The winter is still in its early stages. However, throughout 2022, the non-U.S. developed countries index, MSCI EAFE (-7.0%), was well ahead of the S&P 500 Index (-18.1%) in local currency and ended the year down 14.5% in U.S. Dollar terms.

The forty-year bull market in fixed income came to a volatile end, with the Barclays Global Aggregate Bond Index down 16.3% and the BC U.S. Aggregate Bond Index down 13.0%. There was no place for investors to hide in the public securities markets. Private equity provided some reprieve in 2022, but valuations in this segment tend to follow public markets with a 4–6 quarter lag.

As we enter the Chinese New Year of the Rabbit, one may forecast an economic recession based on the current inverted shape of the yield curve. However, we already had a mild recession in 2022, and the potential for one this coming year may already be priced into the markets through the recent decline. We are also not likely to spend too much time making a different, or any, prediction. After a difficult year, we feel that the most important driver of returns is having the discipline to stay invested. Given the general decline, valuations are more reasonable today than they were at the end of 2021, but there is no compelling dislocation that warrants a drastic shift in allocations at this time. Our closer watch is on individual managers, and we are vigilant in monitoring their investment discipline through these market swings.

Equities

The broad equity market decline hit every sector with the exception of Energy, which was up 65.7%. Given that much of the downward pressure on equities came from higher inflation and higher rates, the impact was

greater on growth-oriented sectors such as Technology (-28.2%) and Consumer Discretionary (-37.0%) as well as sectors tied to interest rates such as Real Estate (-26.1%). Value oriented strategies lost much less, with the Russell 3000 Value Index down 8% relative to the Russell 3000 Index and the Russell 3000 Growth Index returning -19.2% and -29% respectively.

A lower representation of Technology names in the non-U.S. Equity Index was conducive to better relative returns for the MSCI ACWI ex U.S. Index. In local currency terms, the index was down less than 8%, but the strengthening of the U.S. Dollar was a further drag on the performance in U.S. Dollar terms. As history has shown, the impact can also go the other way when the U.S. Dollar weakens relative to other currencies. As central governments on the European continent and Japan began to raise borrowing rates in their respective countries, we saw the impact with a decline in the relative value of the U.S. Dollar.

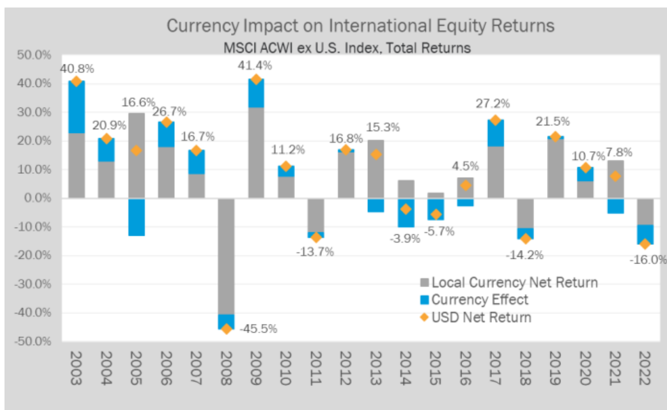


Figure 1. Source: Morgan Stanley Capital

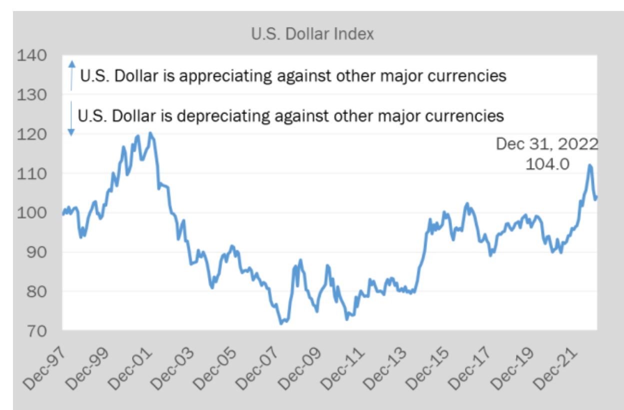


Figure 2. Source: www.investing.com

Over short periods, the markets can make strong adjustments in reaction to perceptions of changing geopolitical circumstances or government policies. In the fourth quarter, the MSCI ACWI ex U.S. Index was up 14.3% in U.S. Dollar terms, which was twice the return of the 7.2% return for the Russell 3000 Index.

While it is hard to say which way the currency will move over the short term, we feel strongly that from current levels, the U.S. Dollar will likely weaken over time and this will be a positive contributor to the performance of non-U.S. equities. They are also trading at a more attractive valuation of 12.0x forward earnings compared to U.S. equities (16.7x) and provide a higher dividend yield. We remain neutral to the MSCI All Country World Index in terms of geographic allocation between U.S. and non-U.S. equities.

The wild card remains that if we do have a recession in corporate earnings, then these valuation measures can also adjust higher, making equities not so inexpensive. As companies battle rising costs as well as potential earnings decline, there is an opportunity for stock pickers to distinguish companies with stronger fundamentals that will be able to weather the impact of a potential economic downturn. Where a zero rate environment and strong upward trend over the last 12 years in the equity market was a challenge for active managers, a broader dispersion of performance across stocks could provide more opportunities for asset managers to add value through stock picking. We look to the active managers making incremental contributions to returns in this environment.

Fixed Income

While 2022 marked the worst fixed income market performance in its history, with the BC U.S. Aggregate losing over 13%, the sharp rise in rates has also renewed the value proposition for the asset class. The 10-year U.S. Treasury yield has jumped from 1.4% to 3.9% over the 2022 calendar year. However, core inflation has also jumped over that time, causing the real yield to remain negative.

This implies that after inflation, an investor would still lose value on the investment they make in the 10-year bond. Should inflationary pressures reduce further, it would imply positive inflation-adjusted returns on Treasuries. This may renew some level of interest in owning long-term bonds that had been pushed out during the period when bonds were generating near zero rates.

In the U.S., the yield spread of credit instruments over comparable U.S. Treasuries remains positive, but the spreads remain tight. Investment Grade corporate bonds are trading at under 200 basis points, while high yield bonds are at around 500 basis points. While the higher yields contribute positively toward total returns, the risk is for spreads to widen further in case of recessionary pressures, particularly for high yield bonds. Many companies that secured financing during the last few years are at risk of higher borrowing cost, as they will need to refinance over the next few years. In the fixed income markets, the concerns are also around lack of liquidity during periods of stress, which can cause dramatic repricing of the public bonds. Should that kind of market dislocation occur, we would be poised to take advantage of the opportunity by allocating more toward this segment. At this time, we continue to maintain a lower than long-term target weight in fixed income.

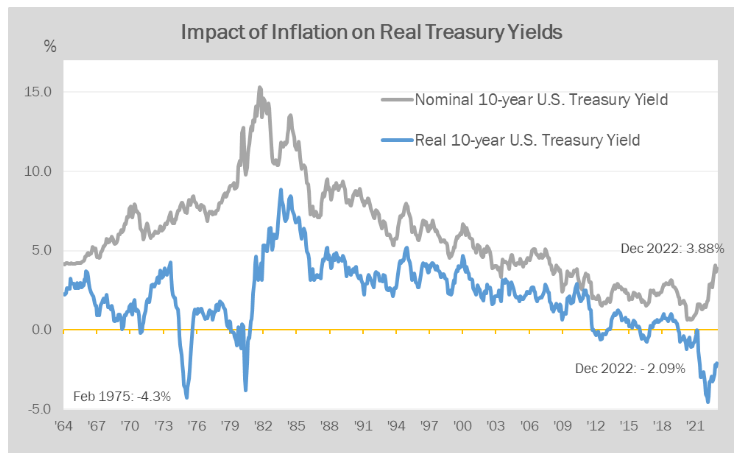


Figure 3. Source: U.S. Treasury Dept, Bureau of Labor Statistics

Real Assets

The Real Asset segment provided somewhat mixed results for the year. Sharp jumps in energy and commodity prices contributed positively to the segment, while the decline in Treasury and floating rate bonds were a drag on returns. The Morningstar U.S. Real Asset Index—which consists of 40% TIPS and the remainder in commodities, infrastructure securities, and natural resource companies—was down 8.2% for the year.

A multi-decade period of declining inflation brought about by globalization and the digital revolution has created new dynamics on inflation. While the digital revolution continues to improve productivity across many sectors, there is also an undeniable move toward renewable transition, the reshoring of critical supply chains and political pressure toward net zero that is forcing changes in the dynamics of industries and the cost of production. While this may not translate to runaway inflation, it will likely continue to push up production costs in the medium term and contribute to inflation being more "sticky" beyond the short-term fluctuations in commodity prices that are normally associated with economic cycles.

The investment we have in this segment is a multi-strategy portfolio that dynamically shifts between hard and

soft assets, floating rate instruments as well as new emerging areas related to sustainability.

Hedge Funds

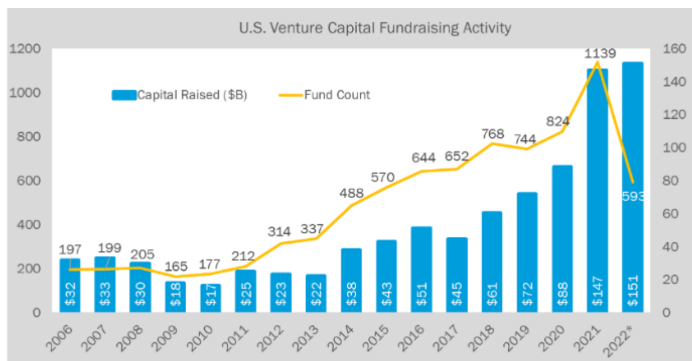
In 2022, hedge funds proved to be additive, providing diversification away from the long only exposures of the equity and fixed income markets.

Most long-short equity managers reduced their net exposures, while the multi-strategy managers increased market hedges to reduce the beta in the portfolio. The result for this segment was a return that compared favorably to both the equity and the fixed income segments of the portfolio. We continue to think of hedge funds as part of the “capital preservation” segment of the overall portfolio and expect them to contribute to reducing the portfolio’s volatility profile.

We continue to scrutinize each segment of our portfolio, as every dollar invested in one segment has to compete with the value added by other portfolio investments over time. The high fees paid to hedge funds have been a particular hurdle. Over the last 15 years, hedge funds have been challenged to keep up with the long only equity and fixed income markets. Investors were able to enjoy strong returns without paying the high fees associated with hedge funds. For these funds to maintain their place in the portfolio, they will have to continue to provide value through a differentiated return or as a distinct source of diversification based on the market environment.

Private Equity/Private Debt

The pace of fund raising did not abate in any major way within the private capital sector. While buyout funds continue to draw the larger share of capital in this area, there has been a steady growth in other areas as well. Venture Capital has seen a major growth in the number of funds as well as the amount of capital raised in the last 15 years.



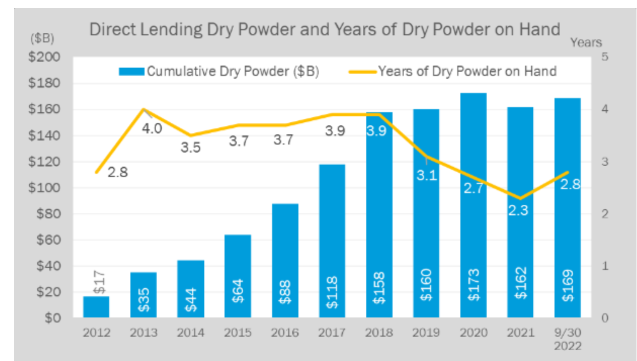


Figure 4 & 5. Source: PitchBook, September 2002

The large number of private equity deals has also increased the demand for debt financing and spurred the growth of private debt funds that specialize in lending to companies that are being sponsored by private equity firms. Within the last 10 years, these funds have become the preferred source of debt finance for many private equity firms. In 2022, the amount of capital raised by direct lending funds was greater than the amount raised cumulatively across venture capital funds. As with private equity, these private loans do not face the mark to market volatility of leveraged loans. We have employed these strategies in client portfolios as an additional source of income-oriented return that can complement public fixed income. We continue to find this area to

be frothy given the rapid rise in the amount of capital that has moved into this space. Thus focusing on high quality managers that have the discipline to diligence and structure each deal to protect their investors has been the key priority in fund selection.

We think of ourselves as strategic investors. We have not made tactical shifts in portfolios amidst the swings in the markets. However, we have, on the margin, made adjustments over time. We moved to a shorter duration within the fixed income segment several years ago, which proved helpful over the last 2 years. We have been cautious about non-U.S. equity and fixed income markets, but do believe that they provide long-term opportunities. We have made room for new investment opportunities, such as private debt, that provide better value for the fees paid, particularly if they also offer a differentiated source of return. At the same time, we have been keen to adhere to the values and criteria specified by each client for their investment assets.

We value the trust placed in us by our clients and consider it a privilege to be given the opportunity to steward their capital. We remain grateful to our clients for their confidence.

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 2021 as well as one of the Best Places to Work in Orange County by the Orange County Business Journal in 2022, 2021, 2020, and 2015. 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.