Introduction

First quarter investment results were defined by markets' reactions to the global virus-fighting lockdowns and closures of the developed world, resulting in a decline in the U.S. equity markets (Russell 3000 Index) of -20.9%, the non-U.S. equity markets (MSCI ACWI-ex U.S. Index) of -23.4%, U.S. high yield bond markets (Bmbg Barclays U.S. HY Index) of -12.7% and commodities (Bloomberg Commodity Index) of -23.3% in the first quarter of 2020. With services comprising over 75% of the U.S. economy, the decline in these indices highlight the extent of the shock to the nation's output as retailers, restaurants, and other service providers shut down in an effort to contain the outbreak. Nations across the developed and developing world took similar measures. The economic stoppage and social distancing are also impeding global manufacturing and display the potential to generate a larger impact on the global economy if the situation is prolonged.

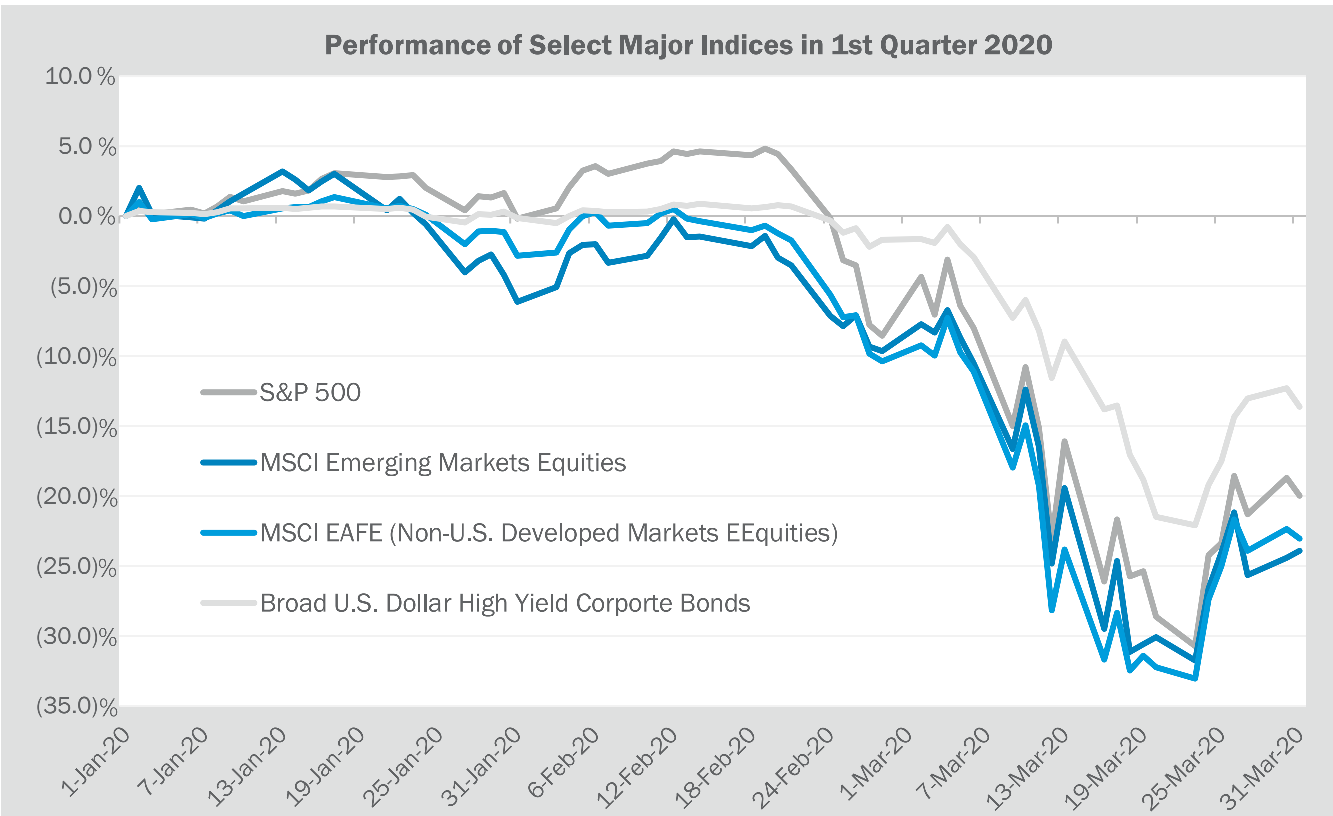

Figure 1. Sources: Standard and Poor's, MSCI, and Investing.com

Extraordinary times have led to extraordinary measures. The unprecedented nature of the potential economic impact of the virus explains why the central banks and governments have acted so swiftly and aggressively with monetary and fiscal policies to support their economies. The immediate focus has been alleviating the hardship from job losses, keeping consumption from falling sharply, and relieving borrowers' distress to maintain sufficient financial system liquidity to keep the effects of a possibly harsh short-term recession in the next 1–2 quarters from weighing on potential output into the long term.

The medical effects of the virus remain to be properly understood, but the economic impact of alleviating household hardship resulting from the sudden stop in income could raise the odds of a wave of pent-up demand being unleashed once the virus is contained.

Equities

For the first two months of the quarter, rivalries between Saudi Arabia and Russia on oil production and the initial news of the coronavirus in China weighed down on emerging markets equities and the energy sector; but news in late February of the virus becoming a pandemic created a waterfall effect globally across risk assets. The uncertainty surrounding the economic impact of such a pandemic in the modern age, the simultaneous response by governments and central banks as well as the participation of programmatic and algorithmic trading modules in the market place contributed to the spike in volatility and rapid rate of price decline over a matter of days.

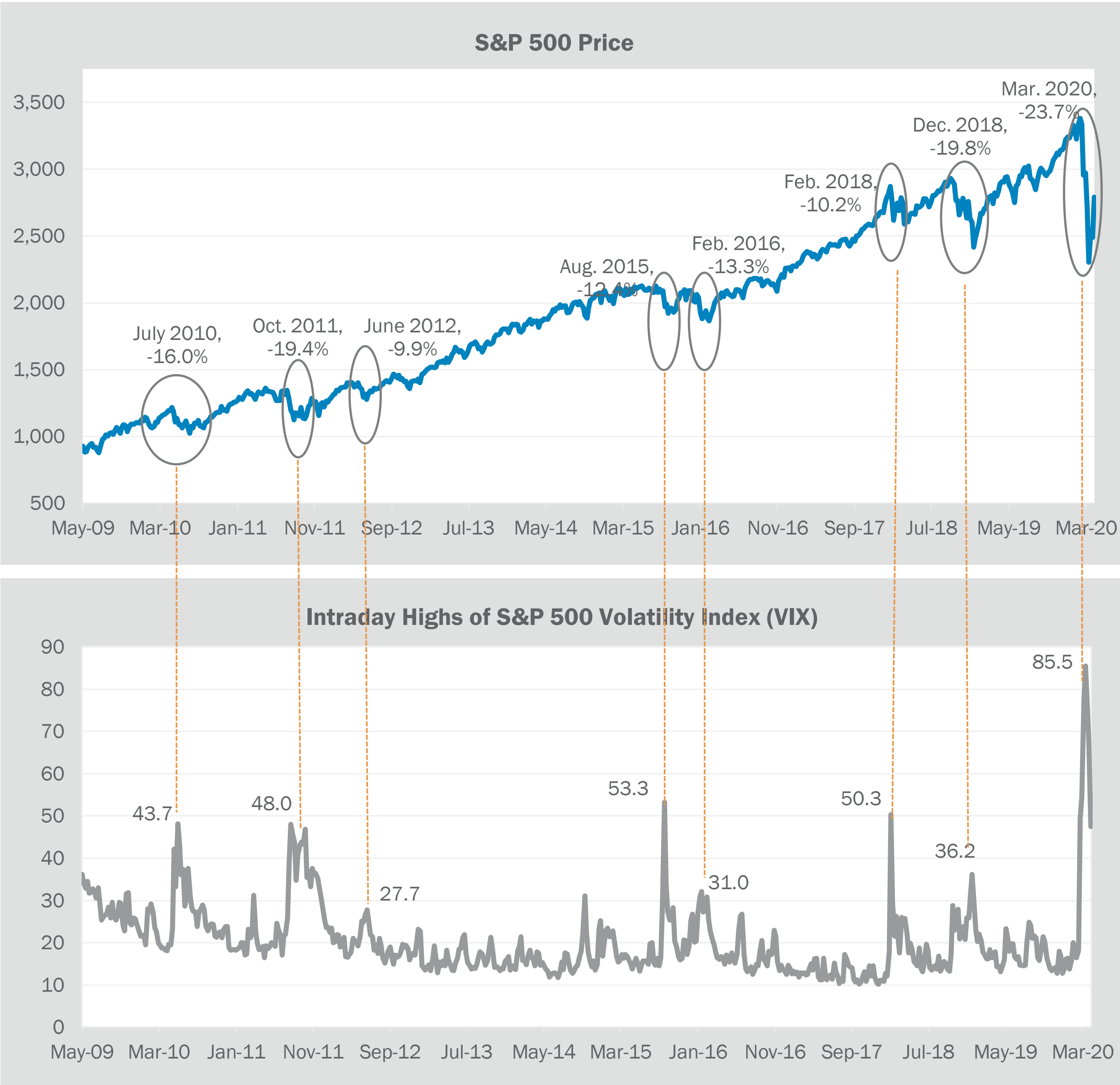

Figure 2. Sources: Standard and Poor's, Investing.com, and JP Morgan

In March, active and passive equity strategies were caught in the market downturn, declining in line with their benchmarks. The hardest hit were securities of companies directly affected by the shelter-in-place mandates: travel, lodging, leisure, restaurants, retail, and service-oriented businesses. Value-oriented strategies with higher allocation to energy, financials, airlines, and certain consumer industries underperformed growth strategies that have higher allocation to technology and healthcare. Small-cap style also fared worse given the greater vulnerabilities smaller companies have to economic declines and tight financing.

The magnitude of equity market decline was similar across developed and developing countries. Unlike prior market downturns driven by excesses and poor fundamentals in some segments of the economy (such as internet businesses in the late '90s or subprime mortgage lending prior to the financial crisis), economic fundamentals were fairly sound prior to the March downturn.

Looking forward, a prolonged duration of a limited workforce, school closures, travel disruptions could magnify the breadth and depth of the ripple effects across many economic sectors and industries. Also, it will likely impact the pace of recovery within and across economies. This is where opportunities will emerge for active managers, as they can assess which companies are likely to emerge with better outcomes and take advantage of the price dislocations that the markets have offered.

While it was difficult to face such market declines, we remained disciplined and rebalanced portfolios back to equities in late March, where equity allocations dropped well below their targets. It was important to position portfolios in assets we believe are priced to deliver strong returns going forward. Given uncertainties around the range of outcomes of the virus, the diversification within the equity segment across U.S. and non-U.S. as well as small and large cap was left unchanged.

Fixed Income

In March, the Federal Reserve cut interest rates by 150 basis points, bringing short rates close to zero to help weather the coronavirus' effects. Over the quarter, rates declined across the yield curve, reflecting the sentiment that the economic impact may have longer-term impact. For the quarter and year, Treasurys were the best-performing asset across investable assets, with the Barclays 1–5 Year Treasury Index up 3.8% for the quarter and 30-yr Treasurys up 11.1% for the period.

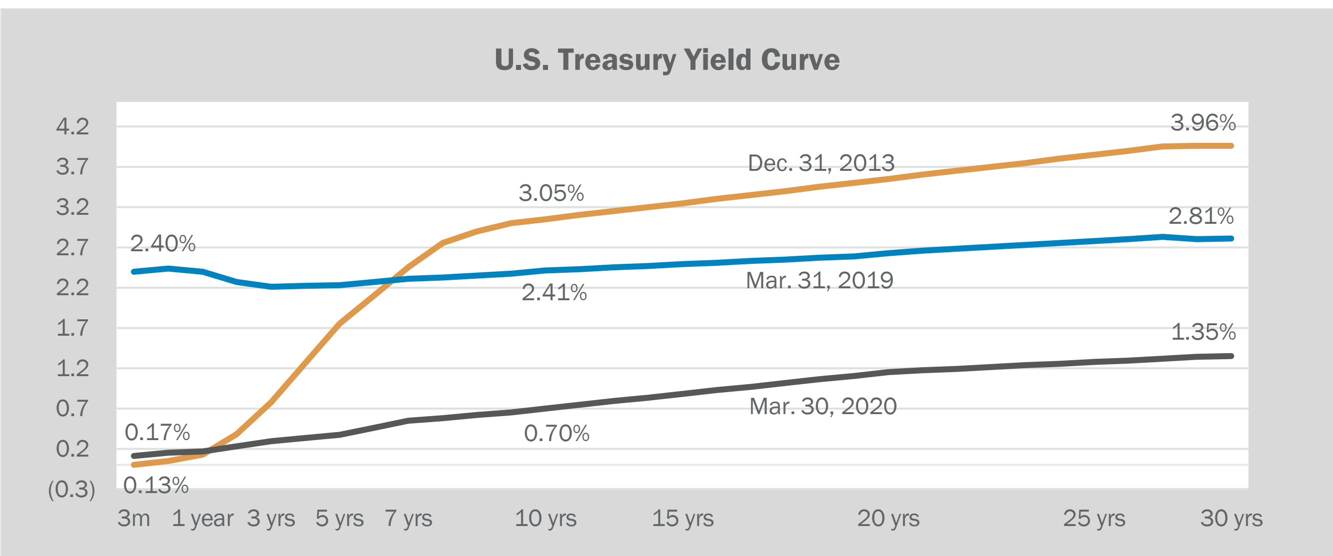

Figure 3. Source: U.S. Department of Treasury

Normally, a decline in bond yields would result in the appreciation of bond prices. However, the rapidity of the market decline in March unspooled normal correlations across asset classes. Core fixed income, which usually appreciates during a period of selloff in risk assets, also declined during the period. Very short-dated instruments across Treasurys, corporate debt, and asset-backed securities maturing within a few months, are usually very liquid. However, these instruments faced "technical" illiquidity due to large selling pressure amidst redemptions and margin calls during the period. Prices of these securities were marked down in the absence of adequate demand in the market place. For March, the Barclays U.S. Aggregate Bond Index was down 0.6%. A similar dynamic played out across other fixed income instruments, with lower credit quality securities facing greater price declines. Option-adjusted spreads on high yield bonds widened close to over 1000 bp in late March and "stabilized" at still elevated levels of close to 900 basis points in early April.

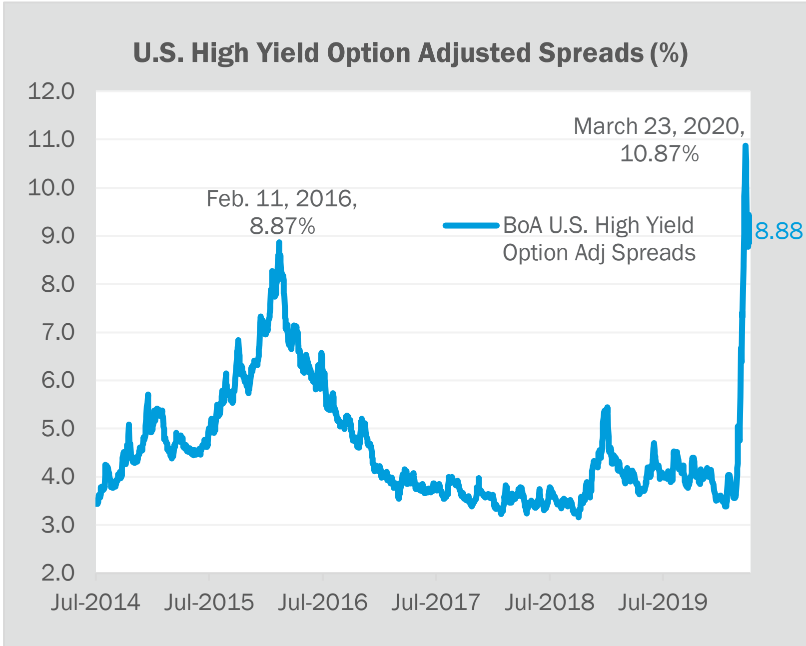

Figure 4. Source: St. Louis Federal Reserve

We took advantage of these spreads in late March to add more to high yield in most client portfolios. Historically, when spreads widen to 1000 basis points, return potential for the following three years has been in the double digits. We have allocated to active managers, who we believe can add value through active security selection. If the market provides us with more opportunities in the upcoming months, we will make other shifts to position the portfolio in assets that we believe are priced to deliver strong returns going forward.

The Federal Reserve (guided by its mandate from congress to promote stable prices and the stability of the financial system) was also aggressive in launching a number of facilities, totaling over $400 billion, to improve market functionality. Through the end of March, this included the purchase of Treasurys, asset-backed securities, mortgage-backed securities, investment-grade bonds as well as credit facilities that would support bond and loan issuances to small and large businesses. As these facilities make their way through the system, they will likely improve market liquidity as well as the business prospects for many enterprises. In the meantime, managers have been actively sifting through the market place in search of bonds that are trading at a discount to their fundamentals, across both security types as well as region. Non-U.S. bonds were not only hit by the virus related market shocks but also by the currency impact, as the U.S. Dollar appreciated relative to most other currencies in the midst of the crisis.

We have been carefully monitoring the non-U.S. fixed income segment amidst the issues related to trade wars from last year and now amidst the potential global slow down. Current spreads would indicate that much of the potential downside has been priced in, but as economic recovery remains fragile, we believe that the volatility may remain high in this segment over the near term. Valuations disparity across regions and currencies have become even more extreme as a result of this drawdown. The return potential may take longer to materialize given near-term uncertainties around the virus' impact in different countries.

Liquid Alternatives

One key defining characteristic of the market drawdown in March was the rapidity of the price decline. There was no time for active managers to shift their portfolios to avoid market exposure. Managers with higher net exposures, particularly with a long bias, benefitted from strong performance in 2019 but were also more vulnerable to the decline during the market shock in March.

For the quarter, security selection proved to be less of a factor in driving performance compared to sector exposures. Portfolios with exposure to energy, travel, lodging, leisure, retail, restaurants, and financials took a greater hit, both within fixed income and equity securities. In the aftermath of the March decline, managers have had to revise the financial models on the companies in their portfolio to determine the potential magnitude of business downturn and look for opportunities that have been created by the market to rotate into more attractive positions.

The forward path for fixed income securities have both positive (from various stimulus) and negative (potential business and credit downturn) forces driving them, enhancing both the risk as well as the return potential from the pricing levels established during the March downturn. The dynamics are also expected to evolve based on the duration of the "social distancing" related slowdowns as well as the potential path of recovery.

Despite the stimulus programs provided by central governments, such liquidity and economic crisis also increase the possibility of credit downgrades and defaults for those companies that do not have the wherewithal to survive the downturn. At the end of February, it was estimated that half of the universe of investment-grade bonds consisted of BBB securities, which are just one grade above junk status. In March, the bonds of large issuers such as Ford and Occidental Petroleum were downgraded from BBB to BB status. It is expected that rating agencies are likely to downgrade the credit rating of many other BBB companies over the coming quarters.

Moody's: Macroeconomic Forecast Indicators and Default Rates

	Actual (%)			COVID-19 Related Scenario (%)		
Time Period/Scenario	**2001–02**	**2008–09**	**As of Feb. 2020**	**Sharp, Short Downturn**	**Similar to 2008**	**Severe Recession**
Default Rate (Actual Peak/12-Month Forecast)	9.6	13.4	3.1	6.8	16.1	20.8
U.S. Unemployment Rate (Peak)	6.0	10.0	3.5	6.1	10.0	15.0
U.S. High Yield Spread (Peak)	1,014	1,833	500	1,060	1,833	2,500
Europe Unemployment Rate (Peak)	9.1	10.3	8.3	9.7	12.5	15
Europe High Yield Spread (Peak)	1,373	1,949	419	1,014	1,949	2,500

Figure 5. Source: Moody's Investment Services as of March 30, 2020

Real Assets

The supply feud between Saudi Arabia and Russia in conjunction with the near shutdown of consumer service businesses across the globe pushed oil prices down to a low of $20 a barrel in mid-March before settling in the mid 20s at the end of the quarter. This put the financial prospects of many energy-related businesses and projects in jeopardy, causing investors to fear revenue losses and dividend cuts amongst securities such as MLPs.

Amidst fears of global economies coming to a halt, commodities faced sharp declines. The Bloomberg Commodity Index fell 23.3%, while the Alerian MLP Index fell over 57%. The diversified fund that we have invested in within this segment held up relatively better in this environment — down less than 20%. The strategy includes both inflation as well as interest rate-sensitive securities in the mix.

Private Equity

There was little change in the reported fund values of private equity funds. This segment of the portfolio remained relatively stable. However, it is expected that the change in public market values will work its way into the valuation models of private equity firms, and the markdowns are likely to come at a lag of 1–2 quarters. The initial signs in this asset class have been a slowdown in fundraising activity during the first quarter as investors reassess their liquidity requirements and private allocations relative to targets in their portfolios.

While we expect private equity commitment amounts for 2020 to be revised downwards given decline in total portfolio values, we would continue to make commitments. Our experience has shown us that market dislocations provide great buying opportunities for private funds and have the potential to generate strong returns for funds that are able to make purchases in this environment.

Overall Remarks

We recognize that this turn of events is significant for the investments our clients have trusted us to steward. Canterbury is fully operational and committed to navigating your investments through the market volatility and organizing our thoughts for future investments. Panic often creates mispricing. We have taken opportunities to rebalance segments of the portfolio amidst the market volatility during the second half of March. We believe there will be positive outcomes for remaining fully invested. During this time, we will continue to focus on capital preservation alongside the long-term opportunities.

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 $24.0 billion in assets as of December 31, 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. Learn more about Canterbury Consulting at www.canterburyconsulting.com.