Introduction

With less than three months left in 2020, this year has proven to be most unusual. COVID-19 related restrictions truly “hit home” globally, forcing individuals worldwide to readjust their physical, psychological, and social lifestyle for most of this year. This will likely continue for some portion of 2021. The rapid adaptation of working remotely, virtual gatherings, and contactless transactions may redefine “normal” activity for the long term in many industries, but widespread business closings and disruptions in supply chain within other industries are also very visible outcomes of the social distancing requirements.

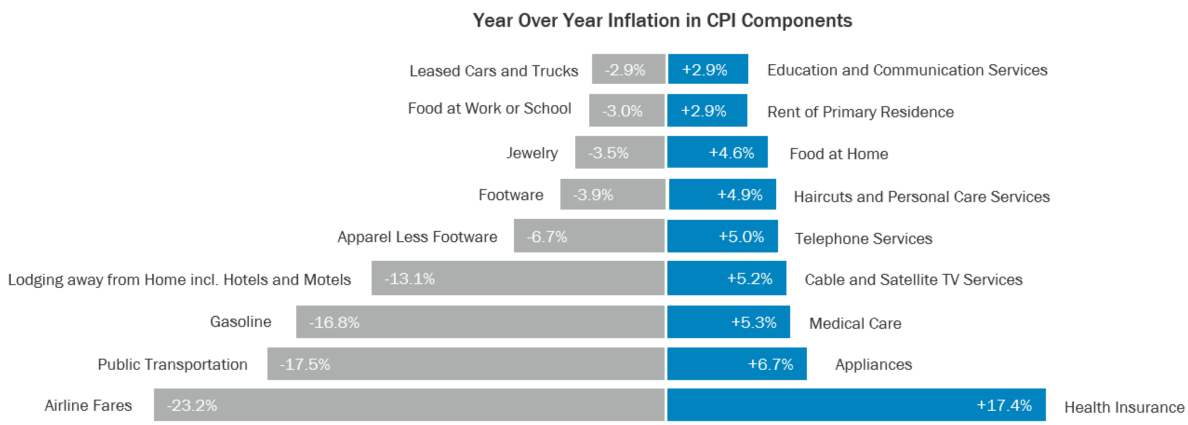


Figure 1. Source: U.S. Bureau of Labor Statistics as of August 31, 2020

The U.S. posted year over year GDP declines of 5% and 35% in the first two quarters of 2020, signaling that the economy was in an economic recession during the first half of 2020. During the third quarter, most states moved towards partial openings and estimates are for the nation’s GDP to be positive for the third quarter. Unemployment, which peaked at close to 15% in April 2020 fell to 8.4% in August. At the same time, though, the year-over-year increase in CPI was 1.3%, which is high for a period of recession. This “inflationary” pressure largely resulted from the stimulus placed in the hands of businesses and consumers and was supported by the basic laws of supply and demand. The price of necessities that people are buying has increased, while items deemed not “essential” during this time, have seen their prices fall.

However the date of delivery for an effective vaccine and the duration of the pandemic are yet unknown, and a recession towards deflation remains one of the top concerns for most central governments. Additionally, we have the uncertainties surrounding the U.S. presidential elections and the potential policy implications with a new government structure. Should there be more stimulus but continued stalling of economic activity, the effect could even be stag-flationary. If the economy continues to open further, the idle capacity created during the recession will allow productivity to increase without inflationary pressures.

These uncertain conditions hang a veil over the outlook for upcoming quarters and leave investors puzzled on some of the key drivers of financial securities: When and how will business and economic activity resume to support market valuations and whether we are headed for a future of inflation, deflation, or a continuation of the past decade’s lackluster price rises.

The performance of financial assets over the three quarters this year reflects a similar conundrum. After the dramatic downturn in March, we experienced a recovery in equity markets over the last two quarters, but at the end of September, the defensive Barclays U.S. Aggregate Index was still ahead of most equity indices on a year-to-date basis, partly also supported by the stimulus-related purchases of fixed income securities in the market. Yet the strongest performance for the period has been from U.S. growth stocks, mostly of companies with technology-enabled businesses.

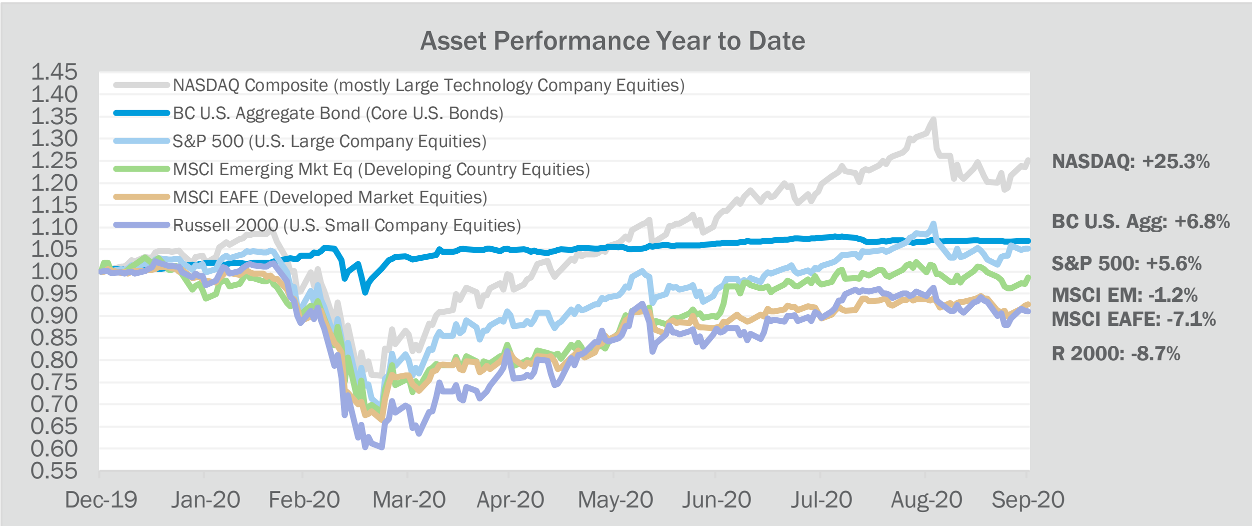


Figure 2. Sources: Standard and Poor's, FTSE Russell, MSCI, and Barclays Capital through September 30, 2020

Equities

The dichotomy of the dynamics across economic sectors is also apparent underneath the market-capitalization based equity indices. The equal weighted S&P 500 Index returned -4.5% for the first three quarters, while the market cap weighted S&P 500 Index was up 5.6%. Segments with exposure to names in industries such as Banking, Airlines, Energy, Retail, or Lodging performed far more poorly compared to those with businesses that support the "stay at home" orders. Within the Russell market cap weighted indices, value style indices, which have greater exposures in these sectors, were down between 11.5% and 21.5% on an YTD basis through September 2020. Growth style indices, that have seen their weighting to Technology increase over the last few years, were up between 4% and 24.3%.

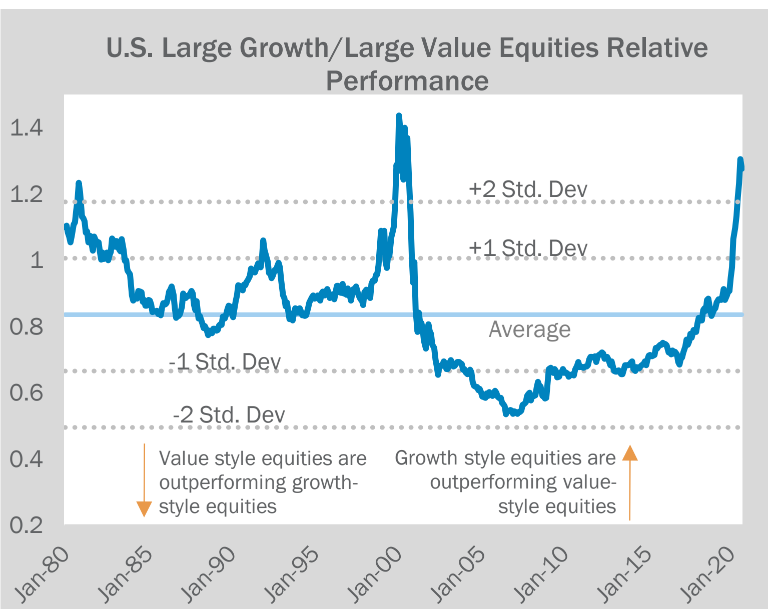


Figure 3. Source: FTSE Russell Indexes (Russell 1000 Growth/Russell 1000 Value) through September 30, 2020

Our clients have heard us speak about the cyclicality in relative performance across styles and the importance of diversification. We have been humbled by the duration and magnitude of the current trend of outperformance by growth stocks. At the end of September 2020, the cumulative difference in relative performance between the two styles was more than two standard deviation above its historic average as measured since the inception of the style indices over 50 years ago in 1979.

For over a decade now, portfolios tilted towards growth have outperformed broad indices, while any type of diversification away from growth has hurt relative performance. The larger and larger weighting of the top names in the indices has also made it difficult for active managers to outperform their benchmarks unless they have even more concentration in the largest names in the benchmarks. Our U.S. equity portfolios have 50% allocated to a passive strategy replicating the S&P 500 Index. Exposure to value managers as well as small-cap managers has detracted from performance relative to the broad market index. At this point, we feel that it remains prudent to take a balanced approach across geographies, market capitalization, and style while not losing sight of fundamental financial health of the underlying companies.

We do not believe we can forecast when the trend will turn on value outperforming growth but earlier this year when the markets provided us with the dislocation in equity markets, we were quick to take advantage of that. We rebalanced portfolios into equities and were poised to participate in the equity market recovery with the equities allocated close to target in the portfolios.

Fixed Income

Despite the near-term conundrums of the equity markets, perhaps the asset class that has incited most debate at the firm has been fixed income. Our fixed income segment has contributed positively over the last few years but has fallen behind the Treasury-heavy Barclays U.S. Aggregate Index. Going forward though, we question the attractiveness of most fixed income securities. Looking forward, the 10-year yield of most developed country sovereign bonds provides little in the form of expected returns to contribute towards the 4–5% real spend rate that most clients must abide by. At the same time, the long duration makes most of these bonds vulnerable to price declines if rates go up over the next 3–5 years.

High Yield and emerging market debt provide better yields, but the risks are also greater in these areas. We were nimble in High Yield when spreads widened to 1000 bp in March this year and added more to our high yield managers. We felt that the managers were poised to benefit from the price increase in these bonds as credit spreads narrowed from those levels.

	9/30 Yield	YTD Return	Duration	Correlation to 10-year
U.S. Aggregate	1.2%	6.8%	6.1 yrs	0.88
Global ex U.S. Aggregate	0.8%	4.9%	8.1 yrs	0.25
U.S. High Yield	5.8%	0.6%	6.3 yrs	(0.25)
European HY	4.8%	0.9%	4.0 yrs	(0.30)
EM Debt ($)	5.1%	(0.5%)	7.7 yrs	0.09
EM Debt (Local Currency)	4.5%	(6.3%)	5.4 yrs	(0.04)
EM Corporate	4.3%	2.6%	5.9 yrs	(0.05)

Figure 4. Sources: Barclays and JP Morgan

By the end of September, however, high yield default rates had also gone up from 3% to over 5.7%, and further defaults are likely in sectors, such as Energy and Retail, which continue to come under pressure in the current global economic slowdown. Investment-grade bonds provide better credit quality, but a large part of that universe consists of BAA bonds, many of which have high levels of debt and the issuing company may be still working to overcome pandemic related business interruptions. A downgrade of credit quality to high yield status can prompt a sell-off in the bonds of that company. As yields have come down, the return prospects do not seem attractive given the potential risks.

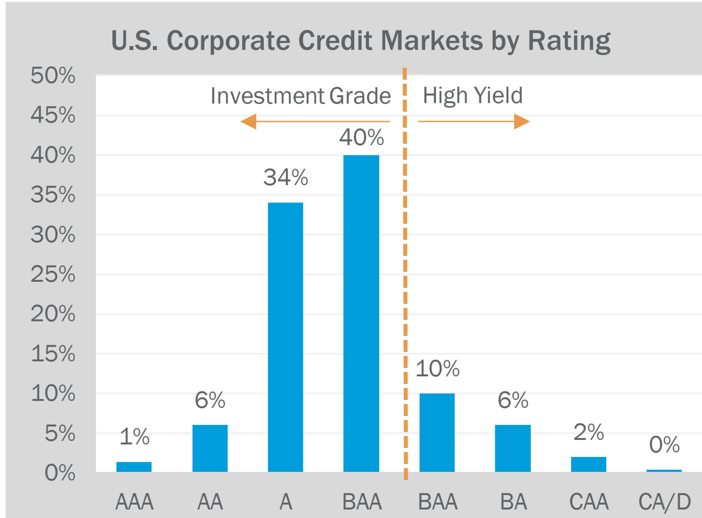


Figure 5. Sources: Barclays and JP Morgan as of September 30, 2020

Going forward, we continue to value U.S. core fixed income as providing the crucial “anchor” against equity market volatility, but investors may have to rely more heavily on equities to meet their return potential from the portfolio.

Liquid Alternatives

The forces that beleaguer equities have infiltrated other segments of the portfolio as well. Over the last 8–10 years, most “diversifying” strategies have underperformed the core equity markets and core fixed income markets. Both hedge funds and dynamic asset allocation strategies have lagged if they have a value tilt or have diversified away from the narrow set of large growth names that have performed well in recent periods.

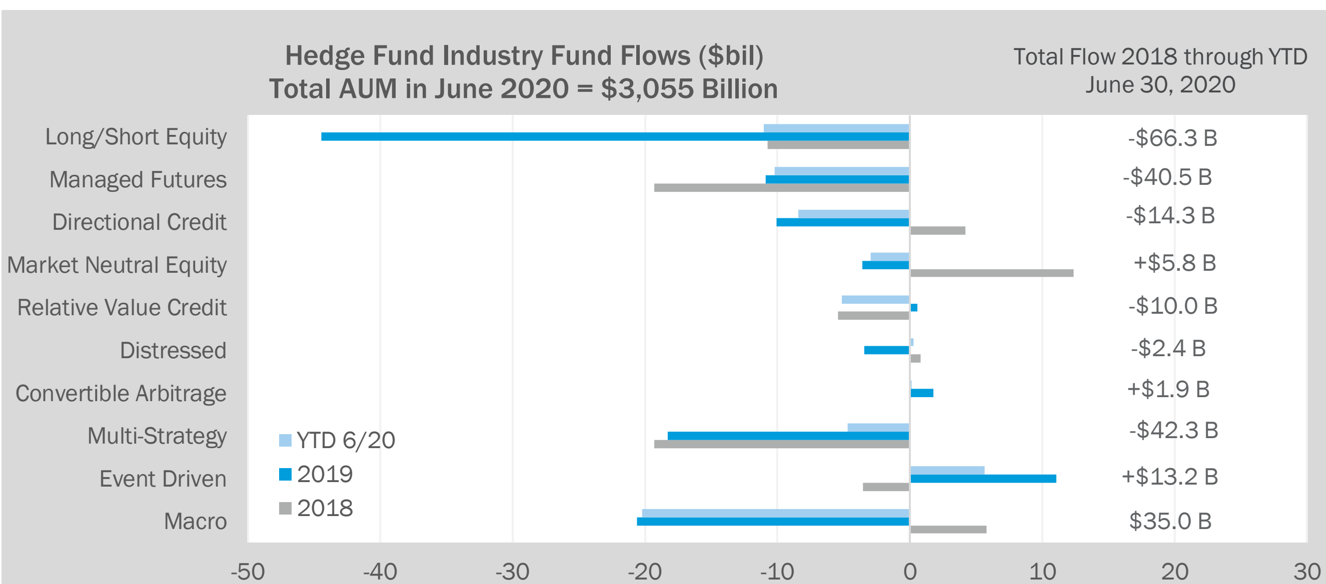


Figure 6. Source: eVestment

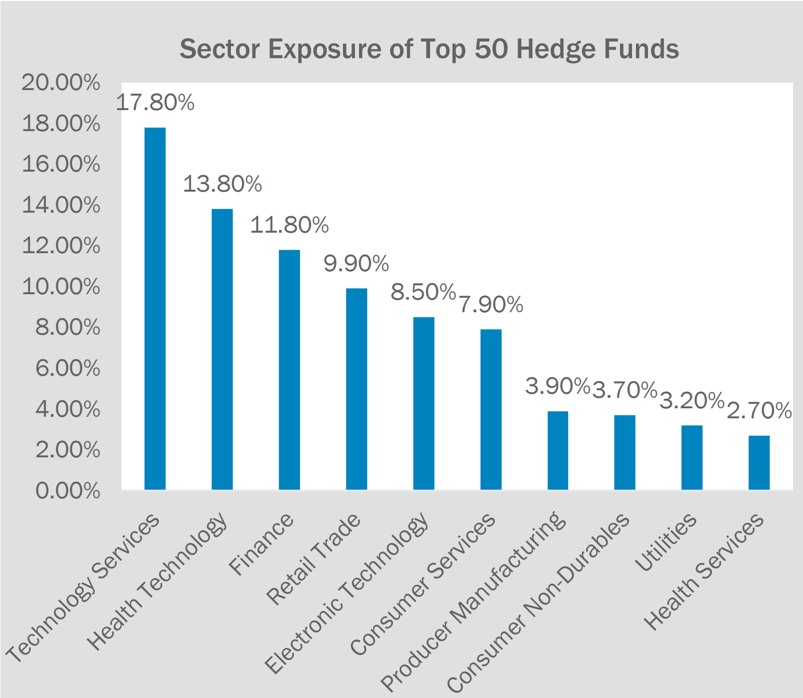


Figure 7. Source: JP Morgan as of September 30, 2020

While we respect the investment discipline of some of these managers, we are mindful of the operational impact that underperformance can have on these firms, particularly if these managers begin to experience attrition of investor assets and of in-house talent. Long/short equity managers, many of which are boutique size firms, are more vulnerable from a business perspective. Equally concerning are managers that have drifted to areas outside of their expertise to “improve” performance. We will redeem from managers if we deem that they are “drifting” from their capabilities and invest with those where we can set proper expectations. Hedge funds that have continued to gain assets as a result of relatively better performance seem to also have migrated to a higher allocation to growth-oriented sectors.

In taking a look at the broad question of meeting long-term return objectives, we have taken steps to cut back on some of the dynamic asset allocation positions and have added more to equities. We have been vigilant in making these tilts to stay within the permissible ranges allowed for each asset class within the client’s investment policy statement.

Real Assets

The real asset segment is a 5% allocation in portfolios. This segment of the portfolio has performed in line with the manager’s diversified real asset benchmark in a recessionary environment. We continue to hold it as a hedge for any unexpected spike of inflation.

For the third quarter, the segment was up almost 7%. The strategy participated in the broad market rally and benefited from higher energy and commodity prices in the second and third quarters. Demand for natural resources remains muted globally, but the recent performance has also made valuations historically cheap. The allocations to a mix of defensive utility and natural resources holdings as well as transport and infrastructure related companies give this an attractive forward-looking profile as economies open further in the next year.

Private Equity

In one of the most unusual years within the investment industry, there has been considerable pull back in private equity fundraising and deals activity.

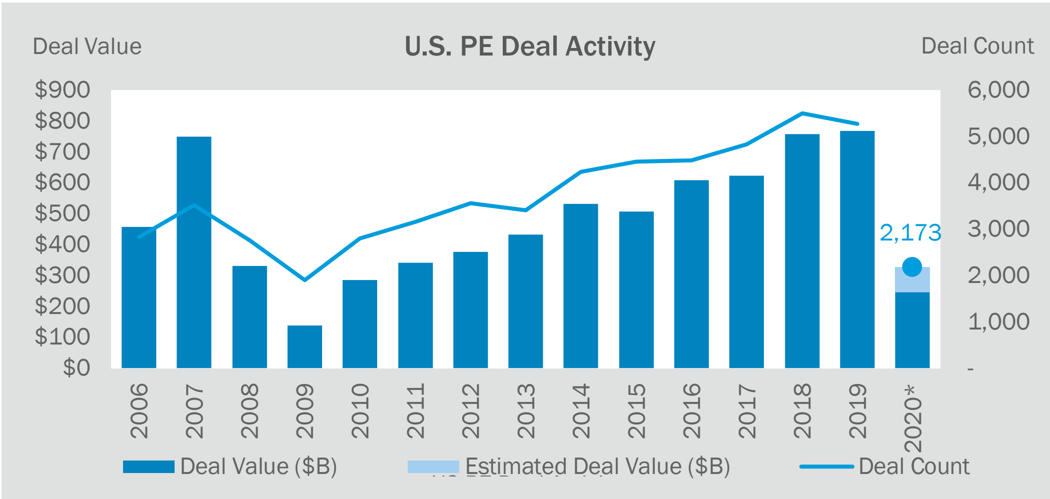


Figure 8. Source: PitchBook as of June 30, 2020

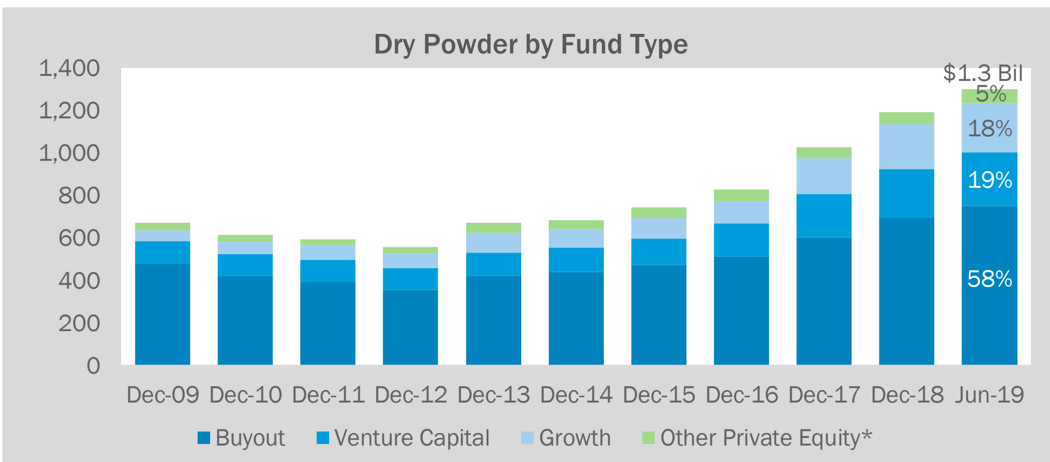


Figure 9. Source: PitchBook as of June 30, 2020

Our assessment of historic vintage years performance has shown that having a continued discipline to commit across market cycles and vintage years becomes crucial to capturing opportunities. Social distancing measures have slowed down some of the work that goes behind both fundraising and deal making, but we have seen a steady stream of capital calls from our managers.

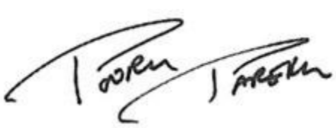
Unlike the tight lending conditions after the global financial crisis in 2009, this time there is much more help for businesses with a variety of stimulus funding and forgivable business loans. However, the intermediate-term financial aid cannot completely mitigate the fate of companies that are simply running out of money. COVID-19 related operational cutbacks have certainly hastened many changes that were already taking place in certain industries, such as consolidations in the airline industry and the growth in ecommerce at the expense of brick-and-mortar retail. Large corporations continue to seek growth through acquisition, while disruptions in various industries are giving opportunities to new entrants. Broad market valuations have not corrected much given the brevity of the market downturn, thus security selection and having a valuation discipline has become even more crucial, particularly given the rising amount of "dry powder" that managers feel must be put to work within the investment period of their funds.

Overall Summary

Portfolios have for the most part recovered from the market losses faced earlier in the year. Our bigger concern now is looking at future expectations from where we are today and determining how we can help our clients meet their long-term return growth objectives. While manager selection is an important element, we feel this will likely require a reconsideration of the overall strategic allocation framework. We look forward to discussing this with our clients in person as we meet, albeit virtually, over the upcoming quarters.

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 $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.