The San Diego Foundation
Growing a Vibrant Region

INVESTMENT NARRATIVE
QUARTER ENDING SEPTEMBER 30, 2020

The global economic rebound continued in the 3rd quarter of 2020, taking the U.S. stock market into the green for the calendar year-to-date period. The U.S. markets led the way, with a strong performance out of the Emerging Markets. Developed markets outside of the U.S. delivered robust returns but lagged the rest of the world.

Unprecedented fiscal and monetary stimulus announced late in the first quarter and into the second quarter are largely responsible for the strong bounce back from the COVID-19 lows. However, there is no evidence that the COVID-19 pandemic is coming to a resolution, as new daily cases continue to climb in areas around the world. New lockdowns have been announced around several parts of Europe, and new daily cases have crossed the 100,000 mark in the U.S. at the time this memo was written. It is incredibly difficult to discount the difficulties that COVID-19 may produce as virus season is ramping up. The two competing forces, the pandemic and economic stimulus, continue to be the primary causes of market movements. So far, the stimulus is winning out. But without an additional fiscal stimulus package in the U.S., numerous programs have come to a conclusion that could cause further economic harm to the economy and its citizens.

The uncertainty around additional U.S. fiscal stimulus was largely the result of the upcoming election, another cause of potential market volatility. While the Federal Reserve has stated that additional fiscal stimulus is needed in the United States, government debt levels have increased dramatically, as several politicians have embraced the idea of Modern Monetary Theory ("MMT"). It is absurd to believe that the unlimited printing of money and issuing debt will not have long-term implications on the economy. However, it is unknown as to when those repercussions will take effect.

When examining the landscape of the global capital markets, it is difficult to find any asset class that can be labeled "inexpensive." The pandemic has created a series of winners and losers within particular asset classes, but it is difficult to assess if the losers represent real value, or if any of these industries are in long-term secular decline ignited by the pandemic. Within real estate, the office space is a prime example of this. Will COVID-19 serve as a giant remote working experiment, with long-term repercussions on how we work in the future? Or will people rush back to the office when given the "all clear?" This example serves as one of many key questions we continue to analyze as we search for investment opportunities.

Endowment

Despite the dramatic decline in global stock markets in February and March, equity markets witnessed an unusually strong recovery, in some cases taking markets into positive territory for the year. The Endowment Portfolio participated in the strong move since the market bottom, up 2.3% for the calendar year-to-date period, outpacing its Policy Index by 1.1%. Over the one-year period, the Endowment Portfolio produced a strong 8.1% return, outpacing its Policy Index by 1.8%. These strong one-year results do not tell the story of what happened over the course of the year, as significant volatility occurred earlier in the year due to the pandemic-induced global economic coma. Both stocks and bonds contributed to the strong absolute and relative returns over the last year, but areas like real estate and hedge funds detracted. We are happy to be sitting with a significant underweight to private real estate given future uncertainties surrounding the space. However, we continue to look for opportunities in the space to take advantage of what could be additional dislocation. Hedge funds helped to dampen the volatility experienced in the first quarter, but have lagged given the dramatic recovery in stocks.

Non-Endowment

The Long-Term Portfolio was up 5.2% for the third quarter, slightly trailing the Policy Index. Year-to-date, the portfolio was up 0.5%, and over the last one-year period it produced a 6.2% return. The portfolio benefitted from exposure to global equities and fixed income. Exposure to real estate investment trusts ("REITs") and hedge funds detracted from results. Strong manager selection in non-US developed stocks, emerging markets and fixed income were the primary contributors.

The Medium-Term Portfolio was up 3.2% for the third quarter, 4.9% year-to-date, and 8.3% for the one-year period, outpacing its Policy Index over all time periods. Given the heavy exposure to fixed income in the portfolio, the portfolio significantly benefitted from the Federal Reserve lowering U.S. interest rates to zero. Because bond prices and interest rates have an inverse relationship, lower rates meant capital appreciation in bond land. As a result, this is one of those bizarre anomalies where the one-year rate of return on the Medium-Term Portfolio is higher than that of the Endowment and Long-Term Portfolios.

The Short-Term portfolio produced a zero rate of return for the period. This portfolio consists entirely of money market funds, that produce returns that are highly correlated to short-term interest rates. As interest rates have gone to zero and the Fed has signaled that they may not change rates any time soon, the near-to intermediate-term expectation for this portfolio should be zero.

Due to the conundrum of zero rates, The San Diego Foundation plans to launch a new non-endowment portfolio on January 1, 2021. This portfolio, called the Intermediate-Term Portfolio, will invest 100% in short- and intermediate-term fixed income securities in order to generate a modest positive yield. This portfolio is not without risk. As noted above, should interest rates increase (particularly a quick or meaningful increase in a short period of time), these fixed income securities could witness capital depreciation. If you have an interest in moving from the Short-Term Portfolio to this portfolio, please contact your donor manager.