The San Diego Foundation
Growing a Vibrant Region

INVESTMENT NARRATIVE
QUARTER ENDING MARCH 31, 2018

After a year in which global equity markets experienced historical lows in volatility, the first quarter of 2018 marked a major course correction for both markets and economies. In January, markets picked up where they left off last year, rallying strongly into the New Year. Euphoric sentiment became apparent, setting the market up for its first correction in several quarters.

The U.S. market struggled due to some new realities that became front and center during the quarter. This included the prospect of higher interest rates, the possibility of inflation due to the tight labor markets, and the political uncertainty regarding tariffs and a potential trade war. Volatility was exacerbated by a few groups betting against volatility (i.e. shorting volatility in a leveraged format). Shorting volatility is not a new phenomenon, and the fate of those doing it with leverage has resulted in the same outcome cycle after cycle. A levered exchange-traded note and exchange-traded fund that bet against volatility in February declined by over 90% over the course of two trading days.

While non-U.S. equity markets continue to trail the U.S. in interest rate policy and quantitative easing, the volatility in the U.S. was felt globally. Surprisingly, the Emerging Markets posted the best results for the quarter, up 1.4%. In past cycles, global stock market volatility has typically led to investors exiting the Emerging Markets space, particularly because the space tends to be the most volatile across the global stock market. That wasn't the case in the first quarter, particularly due to a weakening U.S. dollar and cheaper valuations in Emerging Markets. The S&P 500 was down 0.8% for the quarter, while non-U.S. developed stocks were down 1.5%.

As interest rates rose in the U.S., bond funds also produced a negative rate of return for the quarter. Investors have long been expecting higher interest rates, with the fear that both equity and fixed income markets could fall at the same time, leaving nowhere to hide. That was the case in the first quarter, though certain areas like Emerging Markets debt produced strong returns.

Endowment

The Endowment Portfolio ("Endowment") returned 0.3% for the first quarter, outperforming its policy index by 10 basis points. The quarterly result ranked in the 35th percentile of other similar non-profit institutions, with 1 being best and 100 being worst. Despite most markets producing negative results during the quarter, the Endowment Portfolio had several components protecting capital and producing positive rates of return.

The San Diego Foundation has always believed in running diversified pools of capital. The first quarter was a great example of why we believe in the power of diversification. Despite fixed income markets being down for the quarter, our position in Colchester, an Emerging Markets local currency manager, produced a 5.8% return for the first quarter. Furthermore, our hedge fund portfolio, designed to protect capital in down markets, produced a positive 1.0% return for the first quarter. While the Endowment portfolio will never keep up with a robust equity market when times are good, we continue to believe in diversification and expect to be able to meet our return objective over a full market cycle while minimizing volatility.

Non-Endowment

The Long-Term Portfolio was down 0.7% for the first quarter, in line with the Policy Index. There were a few primary differences from the Endowment for the quarter, primarily because the Long-Term Portfolio is designed to maximize liquidity for grantmaking. Therefore, certain areas of the portfolio are different than the Endowment, and produced weaker results for the quarter. In the Endowment, we utilize private real estate managers. In the Long-Term Portfolio, we utilize REITs, a liquid asset class designed to capture exposure to real estate. During the quarter, REITs were down 8.1%, while the Endowment's private real estate managers produced a positive rate of return. The other primary difference was the hedge fund portfolio, which is designed for liquidity in the Long-Term Portfolio.

The Medium-Term Portfolio was down 0.4% for the quarter, ahead of its Policy Index by 30 basis points. While the portfolio holds far less exposure to equities, its exposure to fixed income hurt as U.S. interest rates increased during the quarter.

The Short-Term Portfolio increased 0.3% during the quarter. As the Federal Reserve continued its tightening policy in 2018, interest rate hikes resulted in higher yields on money market funds. While there is some discussion around the number of potential rate hikes in 2018, the Federal Reserve seems to be on a course for continued tightening, which should further boost yields throughout the year.