The San Diego Foundation
Growing a Vibrant Region

INVESTMENT NARRATIVE
QUARTER ENDING DECEMBER 31, 2018

2018 is certain to be remembered as the year that volatility returned to the market. After several years of low interest rates and highly accommodative central bank policy globally, tightening conditions in the U.S. and slowing growth abroad led to a volatile year for most major asset classes.

The volatility transpired throughout both the equity and fixed income markets. As the Federal Reserve continued its tightening policy in the United States, the U.S. dollar strengthened significantly against most foreign currencies. Fears of slower economic growth in the U.S. accelerated late in the year. With the Federal Reserve Bank unwilling to alter policy, U.S. stocks suffered a 20% peak to trough decline.

Outside of the U.S., slower economic growth prospects coupled with trade tensions and weaker currencies resulted in declines far greater. When the year ended, U.S. stocks represented by the S&P 500 had fallen 13.5% for the fourth quarter and 4.4% for the year. Non-U.S. developed markets, measured by the MSCI EAFE, fell 12.5% for the fourth quarter and 13.8% for the year. Emerging markets, while losing less than developed markets in the 4th quarter, finished the year down 14.6%.

Despite the precipitous equity market losses in late 2018, stocks recovered a good deal of their losses in January 2019. However, non-U.S. economies continue to show weak growth prospects and trade tensions continue to be heightened. The biggest change has been the posturing of the Federal Reserve Bank, which now appears to have softened its stance of future tightening.

With the return of equity market volatility and Federal Reserve Bank tightening, the bond market also witnessed increased volatility. 10-year Treasury rates fluctuated throughout the year, beginning 2018 at 2.46% before reaching a November peak of 3.24%. By the end of the year, they had fallen back to 2.69%. Volatility in several fixed income classes spiked as the result of increased credit risk fear towards the end of 2018.

Endowment

The Endowment portfolio was down 7.6% for the 4th quarter and down 5.4% for the calendar year. Results in fixed income, real estate and hedge funds were strong. However, these results were more than offset by losses in global equities and commodities. The portfolio's exposure to non-U.S. equities, in part due to weaker economic growth and the strong U.S. dollar rally, represented the largest losses in the portfolio. From a valuation perspective, we continue to believe that non-U.S. equities are cheaper relative to the U.S. and represent better long-term value for the next 10-year period.

Non-Endowment

The Long-Term Portfolio was down 7.4%, outperforming the Policy Index by 0.8%. Although this is a significant loss, the numbers show our portfolio is generating the returns we expect relative to the benchmark. With most asset classes seeing losses, fixed income was the lone bright spot in terms of total return, up 1.2%. However, U.S. small cap stocks and hedge funds led the portfolio in relative performance. While they were down 18.3% and 3.3% respectively, they were up 1.9% and 1.7% to their respective benchmarks.

The Medium-Term Portfolio was down 3.3% for the quarter, mirroring its Policy Index. Just as the Long-Term portfolio saw the only positive returns in fixed income and relative outperformance in U.S. small cap, the Medium-Term portfolio also saw huge relative gains in emerging markets.

The Short-Term Portfolio was up 0.5% during the quarter and remains in line with its policy index. As the Federal Reserve continued its tightening policy in 2018, interest rate hikes resulted in higher yields on money market funds. However, as rate hikes slow, yields will remain flat.