The San Diego Foundation
Growing a Vibrant Region

INVESTMENT NARRATIVE
QUARTER ENDING DECEMBER 31, 2020

2020 was a very significant year for the global capital markets, as well as for humanity as a whole. The emergence of COVID-19 and its rapid spread across the globe paralyzed the global economy. Businesses were forced to shut down to prevent further spread of the pandemic and reduce the heavy burden placed on the healthcare system. Global markets cratered in February and March before unprecedented measures from the Federal Reserve and other central banks helped ease the hysteria. Fiscal stimulus followed, particularly here in the United States, ballooning the U.S. debt burden to new levels. Markets rebounded almost as quickly as they fell. To add pressure to an already challenging environment, a highly contested presidential election was held in November resulting in the nomination of President Joe Biden. Following the election, the announcement of two highly effective COVID-19 vaccines led to extreme market euphoria heading into year-end. When all was said and done, the U.S. stock market posted a positive 18.4% rate of return. U.S. small cap stocks and Emerging Markets stocks were up a similar amount, followed by other developed countries.

With U.S. interest rates plunging, the Fed signally low rates for the indefinite future, and a change in Fed policy to allow for range-bound inflation rather than targeted inflation, growth stocks continued their massive outperformance of value stocks. In the fourth quarter, there was a massive "reopening" trade that spurred value stocks to dramatically outperform growth stocks. This is an important phenomenon to watch, as growth stocks have generally outperformed value stocks by a huge margin since the Great Financial Crisis.

The plunge in interest rates once again allowed fixed income instruments to deliver strong returns. While credit instruments, particularly those below investment grade, were hit hard in the initial market downturn, the Federal Reserve's willingness to support prices turned the credit markets around dramatically, leading to a record year of new issuance. With the 10-year yield at just over 1%, the prospects for future strong returns from fixed income instruments are very low. If inflation were to rise to 2% for the next 10 years, a comfortable level for the Fed, there is little to no chance of achieving a positive inflation-adjusted rate of return.

Endowment

The Endowment Portfolio participated in the strong 4th quarter rally, up 11.0% and ahead of its Policy index. For the calendar year 2020, the Endowment Portfolio produced a strong 13.5% return, outpacing its Policy Index by 1.8%. Over the last 10 years, the Endowment Portfolio was up 7.4%, outpacing its Policy Index and its long-term stated objective of CPI+5%. All segments of the portfolio were additive to performance for the quarter and the year. One of the largest relative outperformers was the Endowment's exposure to private equity. As we have written in past, The San Diego Foundation has been constructing a private equity portfolio for the last several years. As is typical with other institutional private equity investors, exposure to the asset class in the first few years tends to lead to relative underperformance (also known as the J-Curve). In 2020, the Endowment Portfolio exited its J-Curve, as the exposure delivered a 26.1% rate of return, well above its benchmark.

Non-Endowment

The Long-Term Portfolio also participated in the 4th quarter rally, up 11.2% for the third quarter, outgaining the Policy Index. For the calendar year, the portfolio was up 11.7%, in line with the Policy Index. Relative outperformance came in the Emerging Markets equity exposure as well as the fixed income exposure. Hedge funds, which we utilize to dampen volatility, did so in the first quarter when markets were down significantly, but failed to participate in the rally that occurred throughout the rest of the year.

The Medium-Term Portfolio shared in the strong results, up 6.0% for the quarter and 11.2% for the one-year period, increasingly exceeding the policy by 0.7% and 1.7% respectively. As this portfolio holds 65% of its exposure in fixed income, it is highly unusual to see a one-year period in double digits. While this occurred in 2020, the prospects for return from fixed income are now highly impaired, given the low level of interest rates around the world and the strong desire for yield from global investors.

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 launched a new non-endowment portfolio on January 1, 2021. This portfolio, called the Intermediate-Term Portfolio, invests 100% in short- and intermediate-term fixed income securities in order to generate a modest positive yield. This portfolio is not without risk. 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.