The San Diego Foundation
Growing a Vibrant Region

INVESTMENT NARRATIVE
QUARTER ENDING MARCH 31, 2021

Global stock markets continued their strong rebound in the first quarter of 2021, as a slowdown in COVID-19 infections, a new White House administration, and increasing access to vaccines helped to indicate a turning point in the economy. Throughout much of the quarter, talks of an early-stage economic recovery resulted in significant stock market rotation, with economically sensitive and cyclical-based companies seeing a bid for the first time in several years. Meanwhile, longer term U.S. interest rates began to rise, penalizing longer duration growth companies that were more attractive at lower interest rates because future growth could be discounted at a lower discount rate. This led to a strong rotation in favor of "value" stocks, which significantly outperformed growth stocks for the quarter.

The increase in longer-term interest rates led the bond market to post negative results for the quarter. The 10-year Treasury note saw its yield increase from 0.93% at the end of 2020 to 1.74% by the end of the first quarter. Because the price of a bond moves inversely with interest rates, bonds suffered price depreciation. With yields extremely low heading into the quarter, the bond price depreciation was only partially offset by yield, resulting in bonds posting negative total returns.

The extreme move in the 10-year Treasury was partially set in motion due to the looming prospect of inflation. Concerns over a strong economy, creating higher employment, rising commodity costs, supply chain bottlenecks, and massive fiscal stimulus packages all contributed to concerns over inflation. The Federal Reserve has directly told the market that it believes inflation is "transitory." In other words, inflation may heat up for a short period of time before it once again levels off. While that may indeed be the case, easy monetary policy in the U.S. and a change in the method in which the Fed measures inflation within its dual mandate have many concerned that capping inflation, once it starts, may be a much more difficult exercise than the Fed anticipates.

While the U.S. markets showed continued signs of an early-stage economic recovery, other countries across the globe continued to struggle with additional waves of the COVID-19 pandemic. Non-U.S. stock markets were generally positive for the quarter, but both developed and developing countries lagged the U.S. The rotation to value stocks was a prevalent theme across geographies, resulting in strong performance from value-based managers and wide dispersion from their growth-based counterparts.

Endowment

The Endowment Portfolio was up 3.4% for the quarter, lagging its policy benchmark by 1.0%. Strong performance was widely distributed across asset classes, apart from bonds, where the portfolio produced a negative rate of return. Relative to the Endowment's policy benchmark, the portfolio underperformed entirely due to the strong returns of the private equity benchmark. Benchmarking private equity is a difficult exercise at-best, and we believe our private equity portfolio is at an important inflection point in being able to produce strong relative performance for future quarters to come.

For the one-year period ending March 31, 2021, the Endowment posted a strong 35.8% return. As the stock market bottomed in late March 2020, this one-year period represents almost a full rebound from the bottom. The Endowment portfolio has also posted strong performance results over the 3-, 5- and 10- year periods, outperforming its long-term objective of CPI+5%.

Non-Endowment

The Long-Term portfolio was up 3.3% for the quarter, outpacing its policy benchmark up 2.9%. More importantly, the portfolio is now up 37.9% over the last one-year period. As a rotation to value stocks marked one of the primary themes for the quarter, the portfolio's hedge funds posted strong results. Many hedge funds follow value-based philosophies. A bid in value stocks helped to buoy this area, as previously under loved, cheap securities appreciated throughout the quarter. Over the 1-year period, just about all asset classes produced a positive rate of return, led by strong stocking outside the U.S. markets.

The Medium-Term Portfolio produced a 0.1% rate of return for the quarter, in line with its policy benchmark. Over the last year, the portfolio was up 19.5%. With 65% of its exposure to bonds, strong performance from stocks was all but offset from weakness in bonds. The one-year period represents a "perfect storm" to the upside of this portfolio. Significant declines in interest rates and a strong rebound in the stock market led to gains that will unlikely ever be replicated for the Medium-Term portfolio.

On January 1, The San Diego Foundation launched a new non-endowment portfolio called the Intermediate-Term portfolio. With the Short-Term portfolio, invested entirely in money market funds, yielding zero, we attempted to create a new portfolio invested entirely in short to intermediate term bonds. The new portfolio posted a -1.8% return for the quarter, as fixed income markets suffered due to rising rates. We hope this portfolio will be able to offer Short-Term portfolio donors an alternative, but as evident by first quarter results, this portfolio does have sensitivity to interest rates and can produce negative results.

The Sustainable portfolios posted a 0.6% rate of return for the quarter, lagging their policy benchmark. Over the one-year period, the Sustainable portfolios were up over 44%, significantly outperforming their benchmark. Because the size of these portfolios are relatively small, they so far lack the diversification of other long-term TSDF portfolios. That lack of diversification was a strong benefit over the last year, as both stocks and bonds rallied significantly from their March 2020 lows.