The San Diego Foundation
Growing a Vibrant Region

INVESTMENT NARRATIVE

QUARTER ENDING SEPTEMBER 30, 2021

After a remarkable recovery from the COVID-19 lows of March 2020, global capital markets paused in the third quarter of 2021 after very strong results in prior quarters. Concerns over Federal Reserve policy, employment, and inflation led the headlines. Federal Reserve policy remained highly accommodative due to weakness in the labor market and "transitory" inflation increases. The labor market conundrum is quite interesting. Despite a record number of job openings, a lower labor force participation rate has caused unemployment to fall slower than expected. There are a number of potential reasons for the shrinking labor force participation – from the abundance of government stimulus checks to Americans changing their mentality after the COVID crisis. Whatever the reason, slack in the labor market has allowed the Federal Reserve to continue to keep rates at zero while maintaining the current pace of quantitative easing, despite rising inflationary concerns. The Fed has maintained a belief that inflation is transitory, due to a slowdown in operations during COVID and logistical issues within the supply chain. However, a recent statement by the Fed acknowledged that while still transitory, inflation may persist for longer than anticipated. It has been many years since the U.S. economy faced inflationary concerns. As a result, concerns over persistent inflation are quite valid, making future Fed policy direction of utmost importance.

The S&P 500, a strong proxy for the U.S. stock market, generated a positive rate of return for the third quarter at 0.6%. Non-U.S. indices were largely negative for the quarter, with the MSCI Emerging Markets index down over 8%, largely due to concerns over increased market regulation in China. Intermediate-Term fixed income was flat for the quarter, as longer-term interest rates fluctuated due to concerns over potential inflation. Alternative investments generally produced strong rates of return in the third quarter, led by private equity investments.

ENDOWMENT PORTFOLIO

The Endowment portfolio produced a 1.4% rate of return for the third quarter, slightly underperforming its Policy Index by 0.2%. Despite the relative underperformance, producing a positive rate of return proved challenging for most investment plans. The San Diego Foundation measures its return against a group of non-profit investment plans of similar size. For the quarter, our return fell in the 12th percentile, 1 being best and 100 being worst. The median non-profit plan was down 0.3% for the quarter.

Endowment results were primarily driven by returns in real assets, real estate, and private equity. Real assets, or tangible assets, are a segment of the portfolio we've recently increased and diversified in order to protect the portfolio against unexpected inflation. With inflationary concerns abundant, this segment of the portfolio is producing appropriate rates of return. Real estate, which also has an inflationary component, was strong as our investment managers in the space did particularly well on a relative basis. In private equity, very strong returns were driven by a further post-COVID recovery. While private equity contributed to performance on an absolute basis, it was a slight relative drag as our portfolio slightly trailed the private equity index for the quarter.

Exposure to Non-U.S. equities was a detractor from results, as this segment of the portfolio generated negative rates of return. However, our Emerging Markets managers were able to lose far less than the index, helping to protect capital during a volatile period for these regions. Fixed income was a detractor, as our investment managers in the segment underperformed their benchmark. Hedge funds, which have been a very strong contributor year-to-date and over the 1-year period, lagged during the third quarter.

NON-ENDOWMENT PORTFOLIO

The Long-Term Portfolio was down 0.4% for the third quarter, slightly trailing its Policy Index. While U.S. large cap stocks produced a positive rate of return, U.S. small cap, Non-U.S. developed markets and Emerging Markets all produced negative rates of return. Furthermore, the fixed income and hedge fund segments of the portfolios also posted modest losses. Real assets were the strongest asset class of the portfolio, primarily due to the threat of inflation. Please note that there is a relatively large cash balance as of September 30, but this cash was raised for rebalancing purposes. Cash levels in the portfolio are typically less than 1%.

Over the 1-year period, the Long-Term portfolio was up 20.7%, outpacing its Policy Index. Many of the same drivers that resulted in underperformance in the third quarter were highly additive during the 1-year period. Equities were also extremely strong for the year given the strong recovery from the pandemic.

The Medium-Term Portfolio was down 0.4% for the third quarter, slightly underperforming its Policy Index. Fixed income, which makes up 65% of the portfolio, offered a 0% rate of return. Stocks were therefore responsible for the losses for the third quarter, driven by exposure to developed non-U.S. and Emerging Markets. Over the last 1-year period, the Medium-Term portfolio produced an 8.8% return, outpacing its Policy Index.

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 portfolio offered a 0.0% rate of return for the quarter, as meandering longer-term rates posed a challenge for fixed income managers. Year-to-date and since its inception, the portfolio is down 0.6%, largely a result of longer-term rate increases during the first quarter of the year.

The Sustainable portfolios posted a 0.1% rate of return for the quarter, outpacing their Policy Indices. RBC, each portfolio's global equity manager, produced a positive 0.1% rate of return for the third quarter, while the bond segment was flat. Over the 1-year period, the Sustainable portfolios are up over 20% and outpacing their Policy Indices due to strong performance in both stocks and bonds.