Investment Narrative

Quarter Ending June 30, 2023

San Diego Foundation

The markets continued their upward path into the second quarter, prolonging the healthy rally that commenced at the beginning of the year. Ongoing developments of artificial intelligence (AI) pushed the technology sector higher, which in turn rose the tide across the public equity landscape. The promise of new innovation, as well as a persistently resilient economy, has kept investor fears at bay. GDP growth ticked higher, unemployment remained near historic lows, consumer spending stayed consistent, and inflation continued to soften throughout the quarter. With inflation appearing to be on its heels, the Federal Reserve kept its course of action of additional, smaller rate hikes and made an additional 0.25% increase in May. In the absence of any materially negative economic developments, recession worries waned month over month, but many investors and economists are not convinced that the U.S. is completely out of the weeds as debt levels reached historical highs and credit quality and personal savings dwindled.

Despite a lingering recession concern, equity markets appreciated an economically uneventful quarter and continued to trend higher. The broad U.S. stock market, which is tracked by the S&P 500 index, was up 8.7%. The U.S. small cap market, tracked by the Russell 2000 index, was up 5.2%. Bond prices continued to struggle as the Federal Reserve has stayed its course of additional rate increases. As such, the U.S. bond market, which is reflected by the Bloomberg U.S. Aggregate Bond Index, was down 0.8%.

Like the U.S. markets, the international markets and emerging markets had a great start in the new year and continued their course into the second quarter. With the help of strong rally in the U.S. markets, company valuations in the international and emerging markets remained attractive. Investment dollars continued to flow to these regions as the primary investment theses surrounding these markets went unchanged – investors looking to further diversify and mitigate exposure to a potential U.S. recession, expected tailwinds from a softening U.S. dollar, and continued economic stabilization as these regions shake the last of the lingering pandemic headwinds and enter an inflation downtrend. Without any additional developments or catalysts in these regions, performance somewhat softened on a relative basis but remained additive. The non-U.S. developed markets, which is tracked by the MSCI EAFE Index, was up 3.0%, and the emerging markets region, which is represented by the MSCI Emerging Markets Index, was up 0.9%.

Endowment

The Endowment portfolio earned a 3.0% return for the second quarter, outpacing its policy index by 0.2%. All the portfolio's asset classes were positive, however the most significant contributor to the portfolio's outperformance over the last quarter was its exposure to domestic large-cap equities. Q2 concluded our fiscal year bringing the Endowment's full fiscal-year performance to 7.7% and outpacing its policy index by 1.7%. A slight overweighting of domestic and global equities over the last 12 months, as well as the fixed income book's relative performance were both additive to the portfolio's outperformance for the fiscal year.

Non-Endowment

The Long-Term portfolio was up 3.7% for the quarter, beating its policy index by 0.7%. The main contributors to performance were the allocations to domestic large-cap equity and hedge funds. At the beginning of the year, the portfolio's hedge fund and real assets exposure were a drag on performance. Since then, hedge funds have rebounded nicely, but real assets continue to be a drag. As energy and utility prices normalize, related investments proceed to underperform. For the full fiscal year, the portfolio returned a positive 10.1%, outpacing its policy index by 1.3%.

The Medium-Term portfolio experienced a positive 1.2% return, surpassing its policy index by 0.2%. A majority of the upside capture is attributed to the portfolio's domestic large-cap equities; however, this portfolio is only 25% allocated to equities and therefore limited in benefitting from the domestic equity rally observed in the first two quarters of the year. Fixed income prices have been stabilizing due to the decreased pace of interest rate hikes, but as the hikes persist the sector struggles to turn a positive return. The portfolio's fixed income book delivered a negative return, but our manager selection and strategic allocation to low-duration bonds helped in producing sound performance on a relative basis. For the fiscal year, the portfolio was up 4.8%, 0.7% ahead of its policy index.

The Intermediate-Term portfolio was down 0.3% for the quarter, but beat its policy index by 0.3%. The portfolio's concentration in intermediate-duration bonds was negatively affected by the Federal Reserve's additional rate hike in May. Over the fiscal year, the portfolio delivered a strong relative performance of 1.9% against its policy index yielding only 0.1%.

The Short-Term portfolio was up 1.2% for the quarter and 3.8% for the fiscal year. As expected, the portfolio has enjoyed, and will continue to benefit from, a higher interest rate environment.

The Sustainable Endowment and Non-Endowment portfolios were up 1.6% for the quarter, but underperformed their policy index, which experienced a 4.7% return in the same period. For the fiscal year, they delivered a 5.0% return against their policy index which returned 11.8%. The main detractor of performance is the portfolios' global equity allocation. An important criterion for these portfolios is to be divested of fossil fuels exposure. As such, performance was significantly hindered in the 2022 calendar year when energy stocks experienced a strong rally. Even though the portfolios missed out on material upside capture, they were still able to deliver positive performance.