Investment Narrative

Quarter Ending December 31, 2023

San Diego Foundation

With the ever-increasing hopefulness of a soft landing, coupled with a resilient economy, markets in the U.S. pushed forward in the fourth quarter and concluded a strong year of performance. Although almost every sector within the stock market had a positive year, the overall strong performance was driven mainly by the technology and telecom sectors. Data shows that a large portion of the year's strong performance can be attributed to seven stocks: Apple, Microsoft, Amazon, Nvidia, Meta Platforms (formerly known as Facebook), Tesla and Alphabet (Google) – also coined 'the magnificent seven.' Outside of those stocks, the performance of other individual companies varied as some prospered and others struggled. This theme is also representative of the state of the U.S. economy. Unemployment remained at multi-decade lows and GDP growth stayed positive. GDP growth in the third quarter was 4.9% and current projections for the fourth quarter expect another period of growth. Inflation showed persistent signs of slowing which has been the main litmus test for gauging whether the Federal Reserve ("Fed") will raise or cut interest rates. As inflation continues to cool, investor sentiment increases around the possibility of a soft-landing approach by the Fed, and in turn, cuts to interest rates. The Fed's last rate hike was in July 2023 and there has not been much evidence that another will occur. As such, bond prices stabilized, and the overall fixed-income market responded well with positive returns.

Simultaneously, not everyone ended 2023 completely convinced that all of the economic worries had been alleviated. Although inflation data has shown improvements, the indicators used mainly track the rate of change in inflation rather than absolute inflation. In other words, the prices of goods and services stayed elevated and continued to rise higher, but at a slower rate than what was experienced in 2021 and 2022. A lot of consumers felt this pressure throughout the year as people turned to credit cards and savings to afford their lifestyles. Some believe that what is seen as economic strength is actually a story of a struggling consumer that has no other option than to absorb the higher living expenses; this phenomenon can signal growth, but the stamina of the consumer is uncertain in regards to their ability to continue absorbing elevated prices. However, in the absence of significant signs of deterioration in the economy, investors felt confident in the U.S. markets and experienced a healthy rally. The broad U.S. stock market, which is tracked by the S&P 500 Index, was up 11.7% for the quarter and ended the year with a substantial 26.3% return. The U.S. small-cap market, which is represented by the Russell 2000 Index, was up 14% for the quarter and delivered a 16.9% return for the year. The U.S. bond market, which is reflected by the Bloomberg U.S. Aggregate Bond Index, was up 6.8 % for the quarter and concluded the year with a 5.5% return.

Conditions in most of the international developed and emerging market countries traveled tandemly through the year on a similar course to that of the United States Inflation in the eurozone and U.K. dwindled significantly, which gave the European Central Bank (ECB) and Bank of England (BOE) a bit of relief. Third quarter GDP growth was flat in the eurozone and U.K. which brought a lot of investor uncertainty on whether these regions will experience a contractionary period in the upcoming quarters. At the same time, valuations on international developed stocks were cheap and attracted many investors looking to opportunistically diversify away from U.S. stocks. Similarly, investors looked to emerging market stocks as much of the region's economic issues were priced in over 2022 and 2023 resulting in attractive investment opportunities. Geopolitical tensions heightened towards the end of the year, especially within the Middle East, but came with less shock to the markets given the ongoing turmoil in the overall emerging market regions. As such, Q4 saw a healthy rebound from its lows and finished the year very strong. The non-U.S. developed markets, which is tracked by the MSCI EAFE Index, was up 10.4 % for the quarter and ended the year at 18.2%. The emerging markets region, which is represented by the MSCI Emerging Markets Index, was up 7.9% for the quarter and returned a notable 9.8% for the year.

Endowment

The Endowment Portfolio was up 5.7% for the quarter and ended the year with a commendable 10.8% return. Performance was in line with the policy index that saw returns of 6.1% and 11.1% respectively. The portfolios allocation to public equities was most additive to performance especially in U.S. large-cap stocks. Given the macroeconomic uncertainties globally, the portfolio was tactically positioned with a slight overweight to U.S. large cap stocks and was rewarded for doing so. Real estate and Private Equity were the least additive to performance for the year due to valuations staying relatively flat to being marked slightly down in the fourth quarter, softening full-year performance. Real estate continued to face persistent headwinds from lack of demand in commercial retail and office. Additionally, higher interest rates curbed the volume of transactions and somewhat pivoted to a buyer's market. Some institutional real estate firms felt the pressure to sell as more investors ask for a return of capital. The real estate book was down 8.5% for the year. Private equity also saw a slowdown in deal flow in the higher interest rate environment, which kept valuations relatively flat at best. Some private equity companies underwent slight write-downs in the fourth quarter, but for the year the private equity allocation recorded a 1.0% return. All the other asset classes in the portfolio were positive. For the 3-year and 5-year periods, the portfolio produced annualized returns of 6.4% and 9.8%, respectively, which ranks the portfolio in the top decile compared to similarly sized endowment and foundations. For the 7-year and 10-year periods, the portfolio's annualized returns were 8.2% and 6.8% respectively, ranking the portfolio in the top quartile on a peer comparison.

Non-Endowment

The Long-Term Portfolio had a strong fourth quarter delivering a 7.6% return and ending the year up 13.2%. The portfolio performed in line with its policy index and benefitted from having all of its equity exposure in the broader public markets, which experienced a strong rally over 2023. The portfolio's fixed-income managers also had a stellar year of performance and all other asset classes were positive. For the 3-year, 5-year, 7-year and 10-year periods, the portfolio delivered annualized returns of 4.0%, 8.3%, 6.9% and 5.6%, respectively. For all periods, the portfolio has remained aligned with its policy index or offered modest outperformance.

The Medium-Term Portfolio also saw meaningful performance in Q4 of 7.0%, solidifying a 2023 return of 9.8%, a 40 basis point outperformance against the policy index. Given the portfolio's 70% weighting to fixed income, the stabilization of bond prices across the second half of 2023 was a material tailwind for the portfolio. Additionally, manager selection for the portfolio's fixed-income allocations was largely additive to the outperformance of the portfolio. After the most recent performance, the portfolio strengthened its longer-term track record. For the 3-year period the portfolio remained flat as a result of intense downward pressures on stocks and bonds during that time. For the 5-year, 7-year and 10-year periods the portfolio delivered annualized returns of 4.7%, 4.3% and 3.4%, respectively.

The Intermediate-Term Portfolio also benefitted from the stabilizing rate environment and posted a 5.7% return against its policy index of 5.1%. Being that the portfolio is highly concentrated in intermediate-term bonds, the possibility of the Fed stopping rate hikes or even cutting rates was positively received and pushed bond prices higher. The positive performance is healthy reversal after a difficult 2022 and 2023 of negative returns. For the full year, the portfolio produced a 6.5% return and outperformed its policy index by 100 basis points. Over the last 3 years, the annualized return was -1.2%, but still outperformed its policy index by 60 basis points.

The Short-Term Portfolio kept course into the fourth quarter and delivered another 1.4% return for the period. The past year of higher interest rates was significantly additive to the performance of the portfolio and delivered returns that had not been possible when interest rates were near zero. For the full year, the portfolio served a 5.1% return; this is drastically different from its long-term track record of 2.2%, 1.8%, 1.7% and 1.2% for the 3-year, 5-year, 7-year and 10-year periods, respectively.

Sustainable Endowment and Non-Endowment

The Sustainable Endowment and Non-Endowment Portfolios experienced a healthy rally in the quarter, which resulted in an 11.1% return and a 30 basis point outperformance against the policy index. The equity manager for the portfolios ended the year strong, but still underperformed its benchmark by a great margin. For the full year, the portfolios delivered an 11% return, but failed to capture the additional 700 basis points of returns offered by the policy index. The investment team determined that the current equity product has too much volatility and tracking error for the current amount of assets. As such, the team has decided to transition the equity product to a passive index product that still offers donors a fossil fuel-free exposure that more accurately tracks the index. As the portfolios grow in size, the investment team may consider further diversifying the portfolio by layering in more active strategies.