The University of Iowa Foundation (UIF)
Quarterly Investment Summary – June 30, 2017

Overview

Equity and bond markets around the world increased during the quarter shaking off political gridlock in the U.S., elections in France, and missile launches by North Korea. Volatility in equity markets remains low, causing some concern that it is "too low" as central banks continue to increase interest rates and end quantitative easing.

Global Equity

The global equity composite returned 2.8 percent during the quarter, 17.1 percent over the fiscal year and an annualized 6.1, 10.5, and 4.3 percent over the past three-, five- and 10-year periods.

Over the past 12 months, equity markets around the globe have produced double-digit returns, which has helped endowments rebound from flat to negative performance in fiscal year 2016. Similar to other endowments, our largest asset class is global equities which was the asset class with the best performance since the market bottom in March 2009. Domestically, our value bias was a headwind while our small cap bias was a tailwind. Internationally, the value and small cap biases helped with a declining U.S. dollar also adding to returns. Emerging markets beat developed international markets, with both up over 20 percent for the fiscal year. The biggest story in equity markets is the growth of passive strategies, which currently holds 40 percent of U.S. stocks according to Pictet Asset Management. PwC estimates that passive funds will hold 22 percent of global assets by 2020. Generally, active management beats passive management in flat or falling markets. Investors moving in to passive strategies are extrapolating the returns of the past eight years. Historically, equity markets lose more than 20 percent every eight years. This is more likely a time to be cautious than a time to be aggressive.

The hedged equity portfolio had strong returns during the fiscal year, but trailed long only markets. Hedged equity in general has struggled due to lower volatility caused by a market that has risen steadily since March 2009. Strategies with net exposure less than the 100 percent net exposure of a long only strategy cannot keep pace during double-digit return years. The value and small cap bias also hurt the hedged equity portfolio.

The private equity fundraising market improved for general partners, with 2017 on pace to have the largest fundraising activity ever. This year has seen the largest individual fund fundraise ever at $24.6 billion. With public equity markets at, or near, all-time highs, such robust private equity fundraising is a concern. Private markets report on a lag, but through December 31, 2016, private equity returns have been positive since the 2003 vintage year. The exit environment has slowed as fewer companies have gone public. Valuations have been a concern for many of our partners, but patience and discipline can be more easily displayed by smaller, younger teams that don't have billions of dollars that they must put to work.

Global Fixed Income

The global fixed income composite gained 1.5 percent during the quarter and 7.7 percent for the fiscal year. Over longer time periods it increased an annualized 2.8, 5.9, and 8.5 percent for the three-, five- and 10-year periods. Three interest rate increases during the fiscal year and a steepened yield curve created a headwind for rate sensitive strategies, but credit strategies were able to add value. With the expectation that interest rates will continue to rise and expectation of the Federal Reserve to commence its balance sheet roll off soon, it is likely that this asset class undergoes the most changes in the near term.

Real Assets

The real assets composite returned negative 0.9 percent for the quarter, 4.3 percent for the fiscal year, and an annualized 2.0 and 6.2 percent over the past three- and five-year periods. Real estate, led by public REITs, helped performance in the quarter, but REITs have struggled over the past year. Natural resources were hurt as the energy sector declined nearly double digits. This negatively affected commodity futures and MLPs during the quarter.

Diversifying Strategies

The diversifying strategies composite returned negative 0.4 percent for the quarter, 4.6 percent for the fiscal year, and an annualized 4.1 and 6.6 percent over the past three- and five-year time periods. The composite's event driven managers had the best performance during the quarter, while hedge fund beta and equity biased funds struggled. Global macro strategies also struggled due to trend reversals in choppy markets. Our trend away from strategies with high assets under management and toward smaller, more nimble strategies continues.

Conclusion

Many of our investment partners have written in their quarterly letters about markets being overvalued. While that may or may not be true, endowment investors must remain invested. With this in mind, there is a bias in the portfolio toward liquid strategies that allows us to allocate capital quickly. This is true not only for the endowment as a whole, but also with individual investment decisions. The endowment has the ability to take liquidity risk but we will not do so blindly in any market. Manager skill and the ability to produce alpha seem to be cast aside in pursuit of passive investing. This strategy works when markets rise, but no one seems to be thinking about when markets fall and dollars flow out of passive strategies en masse. Our focus remains on achieving our target returns while lowering the probability of a permanent loss of capital, identifying investment managers that can deliver outperformance, and maintaining sufficient liquidity.