The University of Iowa Center for Advancement (UICA) Quarterly Investment Summary – September 30, 2017

Overview

The U.S. Federal Reserve's announcement that it would begin to shrink its balance sheet dominated the quarter's news. The decision, coupled with rate hike expectations in December and March, hurt fixed income markets, but was largely dismissed by equity markets, which advanced all over the world. In spite of hurricanes Irma and Harvey, unemployment improved to its lowest rate since December 2000, while labor participation rates and employee wage growth both improved as the economy demonstrated resiliency in the face of the natural disasters.

Global Equity

The global equity composite returned 5.0 percent during the quarter and an annualized 9.6, 10.9, and 5.0 percent over the past three-, five- and 10-year periods.

Once again, equity markets around the globe increased during the quarter. In the U.S., small cap stocks outperformed their large cap peers while growth outperformed value. Value has underperformed growth over the trailing three-, five-, and 10-year periods as well, potentially setting up a reversion to the more consistent trend of value outperformance.

Outside the U.S., emerging markets outperformed developed markets and U.S. investors were aided by a weaker dollar. Value beat growth during the quarter and year, but still trails over longer-time horizons. Small cap outperformed large cap in both developed and emerging markets.

The hedged equity portfolio continues to struggle as the bull equity market continues. Shorting stocks is a significant headwind when every equity market is going up. The low volatility of equity markets is also proving difficult for hedged strategies. Exposure to small cap stocks and emerging markets helped performance.

Fundraising for private equity buyouts is on pace to reach the highest level since the global financial crisis. According to Preqin, committed capital that has yet to be deployed is more than $1 trillion for the first time. They also report that management fees have increased since 2015. This is clearly a general partners market. As limited partners, we are cautious about making new commitments in this environment. Most of the fundraising dollars are going toward mega funds, which raise $4.5 billion or more per fund, an area where we have no interest. If we are locking up capital for a decade or more, we prefer small buyouts due to their potential for higher returns and reduced leverage. We may make commitments to new partners, but our focus is increasing the size of re-ups with existing managers to limit the number of managers in the portfolio.

Global Fixed Income

The global fixed income composite gained 1.3 percent during the quarter, and over longer time periods it increased an annualized 3.4, 5.3, and 8.2 percent for the three-, five- and 10-year periods. All U.S. fixed income sectors had positive returns during the quarter helping both rate sensitive and credit strategies. The divestment of the Federal Reserve's balance sheet could be the major story in the bond market going forward. While their intention is to have little to no effect on markets, it remains to be seen if they can sell $4.5 trillion in bonds with no unintended consequences. The increase in the Fed's balance sheet since the global financial crisis had a high correlation to equity market performance, so the biggest effect might not be contained to fixed income. With low interest rates and tight credit spreads, it is likely that the global fixed income portfolio offers fewer attractive areas of investment.

Real Assets

The real assets composite returned 4.6 percent for the quarter and an annualized 3.6 and 5.9 percent over the past three- and five-year periods. Private natural resources funds had the strongest returns during the quarter as energy sector posted gains due to hurricanes Irma and Harvey. Commodity prices aided performance, also helped by the energy sector. MLPs were hurt by fears that volumes would not make it to pipelines. Real estate also added to performance, with private real estate outperforming REITs. International REITs outperformed their domestic peers.

Diversifying Strategies

The diversifying strategies composite returned 1.8 percent for the quarter and an annualized 3.9 and 6.3 percent over the past three- and five-year time periods. Nearly every strategy in the composite had positive performance, with hedge fund beta strategies posting the highest returns. Event driven strategies also posted strong performance, while managed futures were flat as trend following proved difficult outside of equities.

Conclusion

Once again, the fiscal year is off to a strong start. Just three months into the fiscal year, the LTP is over halfway to the assumed annual return goal needed to outperform inflation, spending, and fees. While this is generally good, we are now in the eighth year of an equity bull market and interest rates remain low, but are rising, most allocators are worried that future returns will not be so rosy. Equity market valuations are troublesome, but we have no way of knowing when a bull market might end. We can invest with discipline and maintain liquidity to react to market dislocations if they should occur. While we write this summary each quarter, our time horizon is much longer than three months. We think of investment opportunities over three-, five-, or 10-year time periods. Shorter time periods are noise. As always, 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.