The University of Iowa Center for Advancement (UICA) Quarterly Investment Summary – September 30, 2019

Overview

The first quarter of the fiscal year saw increased tensions between China and the US, the first Fed rate cut since 2008, and weakening US economic data. The accommodative monetary policies in the US and Eurozone produced mixed results in stocks and mostly positive fixed income returns.

Global Equity

The global equity composite returned 1.7 percent during the quarter, 0.7 percent over the past year and an annualized 9.3, 7.8, and 9.0 percent over the past three-, five- and 10-year periods.

Driven by a high consumer confidence and strong corporate earnings, domestic equity markets continue to post strong returns. While US stocks as a whole rose, this was primarily driven by large cap stocks as mid cap stocks were barely positive and small cap stocks fell. Value finally outpaced growth, but only in mid cap and small cap stocks.

Weak economic activity caused the European Central Bank to move interest rates further into negative territory, which helped equity markets and weakened the Euro currency. Ever since the United Kingdom voted to leave the European Union in 2016 there has been uncertainty about how the separation would work. This headwind continued during the quarter as negotiations weighed on markets and weakened the British pound. Emerging markets were hurt by a slowdown in China, impacts of the ongoing trade war and higher oil prices. US investor returns in all regions of developed international and emerging markets were lower than local currency returns during the quarter.

The robust fundraising activity in private equity continues to be a concern, with $167 billion of capital raised for North American focused buyout funds[1]. At the same time more capital is being raised, limited partners (LPs) are consolidating the number of manager relationships, leading to larger funds being raised. During the quarter Blackstone closed Blackstone Capital Partners VIII on $26 billion, a new record for a buyout fund. We believe the alignment of incentives between the general partner (GP) and LP diverges as fund size increases. As fund size increases, GPs can rely more on the management fee and less on the incentive fee. LPs still need a higher return for their illiquidity risk, but that becomes less likely if GPs are not as concerned about earning the incentive fee. Against this backdrop, private equity continues to have the strongest performance of any asset class in the LTP, beating public markets by more than 600 basis points annualized since our first investment in 2010. While we are doubtful that level of outperformance will persist, we continue to search for the best GPs to partner with.

1 Pitchbook, data as of September 30, 2019

Global Fixed Income

The global fixed income composite gained 0.8 percent during the quarter and 4.3 percent for the trailing year. Over longer time periods it increased an annualized 4.5, 3.6, and 6.6 percent for the three-, five- and 10-year periods. The quarter saw the 30-year Treasury hit an all-time low and the 2-year/10-year spread invert for the first time since the Global Financial Crisis. The 2/10 spread is seen as an indicator of a potential recession, but it does not guarantee a recession. Two Fed rate cuts reduced the degree of the inversion. Rate sensitive strategies offset losses in distressed credit strategies in the quarter.

Real Assets

The real assets composite returned -2.4 percent for the quarter, -2.6 percent for the one year, and an annualized 6.0, 4.4, and 6.9 percent over the past three-, five-, and 10-year periods. Aided by low unemployment and lower interest rates, REITs posted strong performance. Oil prices spiked during the quarter after Saudi Arabia's Abqaiq crude processing facility was attacked by drones and missiles. Prices rebounded to pre-attack levels after indications that the facility, which generates 7% of the global oil supply, was operating normally. Overall, oil prices fell during the quarter, creating a headwind for public and private natural resources.

Diversifying Strategies

The diversifying strategies composite returned 1.3 percent for the quarter, 3.0 percent for the one year, and an annualized 3.8, 3.6 and 5.4 percent over the past three-, five-, and 10-year time periods. Trend following strategies continue to enjoy strong performance, posting the highest quarterly return or any asset class in the LTP. Event driven strategies performance was moderately positive, while hedge fund beta was slightly negative.

Conclusion

The previous two quarters saw nearly every asset class post positive returns, but the first quarter of the fiscal year was more mixed. US stocks, fixed income, and REITs were up as international stocks and most real assets were negative. The Fed lowered interest rates in July and August while the BLS reported the lowest headline unemployment rate (3.5%) in 50 years. Diversified portfolios have not been rewarded since the longest bull market in history started in March 2009. Falling interest rates and higher equity markets mask an equity risk premium that is more than double its long-term average[2]. Lower rates have pushed investors to take more risk to achieve their return goals. We are not immune to this, but we try to take additional risk where we have an advantage. A long-time horizon is an advantage that all endowments enjoy but investing the same way as our peers will not lead to outperformance.

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.

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2 AQR, Bloomberg. Data from January 1, 1970 – July 31, 2019. S&P 500 Total Return Index, 3-Month T-Bills.