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The University of Iowa Center for Advancement (UICA)
Quarterly Investment Report – September 30, 2022

Overview

Attached you will find the investment performance report for the period ending September 30, 2022. High inflation continued to challenge investors in the quarter, with most traditional asset classes suffering performance losses. To combat inflation, the Federal Reserve hiked the policy rate by 75 basis points twice and increased the pace of their balance sheet winddown. The tighter monetary conditions have increased interest rates and credit risk premiums, creating a headwind for risk assets. Central banks around the globe used similar playbooks to the US Fed, creating few safe places to invest in the quarter.

The Long-Term Pool (LTP) returned -2.8 percent for the quarter, -5.9, 6.1, 5.5, and 6.8 percent respectively for the one-, three-, five-, and 10-year periods.

Global Equity

The global equity composite returned -3.5 percent during the quarter, -11.2 percent over the past year and an annualized 9.3, 7.7, and 9.3 percent over the past three-, five- and 10-year periods.

In what sounds like a broken record, persistently high inflation, rising interest rates, and recession fears continued to hurt equity markets in the quarter. This trend started when the calendar turned to 2022 and shows few signs of reversing. US equities outperformed their international developed and emerging markets counterparts, though all were negative for the quarter. US investors were also hurt by weakening international currencies.

One of the unique characteristics about private investing is the return smoothing that results from quarterly valuations. Unlike public markets, which are valued each time a stock trades, private markets update valuations at quarter end based on several factors such as public market comparables, private market comparables, fundraising valuations and discounted cash flow models. While a public company can be growing cash flows and earnings before interest, taxes, depreciation and amortization (EBITDA) and see its value fall, this does not happen as quickly in private markets. As an example, a company could be valued at a multiple of EBITDA, as EBITDA grows so does the value of the company. One would expect the multiple to fall as public equites fall, but this takes time as private investors determine if the public markets are experiencing a short-term phenomenon or if it will last longer. The softening economy will cause private equity values to fall at some point. We feel that our general partners have conservatively marked their portfolios today and do not expect drastic valuation write-downs, though some write-downs are likely.

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Global Fixed Income

The global fixed income composite returned -2.3 percent during the quarter and -6.8 percent for the trailing year. Over longer time periods the composite increased an annualized 1.2, 2.3, and 3.8 percent for the three-, five- and 10-year periods. Markets anticipated a dovish pivot by the Fed in July, but those thoughts were met with hawkish language as Fed Chair Jerome Powell warned "some pain" is on the horizon. While higher interest rates make fixed income more attractive, the path to higher rates has been rough as bond prices fall and total return investors are left with negative returns. Credit strategies have outperformed rate sensitive strategies, but cash was one of the few safe investments in the quarter.

Real Assets

The real assets composite returned -4.4 percent for the quarter, 8.2 percent for the one year, and an annualized 7.2, 6.1, and 6.0 percent over the past three-, five-, and 10-year periods. Part of the investment rationale in holding real assets is that they act as inflation hedges. When inflation increases, so should the value of real assets. In practice, inflation is almost always positive, but real assets do not always exhibit positive performance. The pace of inflation is likely what drives real asset valuation with real assets rising in value when the pace of inflation accelerates and falling when the pace decelerates. During the most recent quarter, the pace decelerated. Both natural resources and real estate struggled in the quarter, but commodities still have strong performance over longer time periods. All things equal, higher interest rates hurt publicly traded real estate, but economic weakness is also affecting valuations.

Diversifying Strategies

The diversifying strategies composite returned 1.3 percent for the quarter, 3.7 percent for the one year, and an annualized 1.7, 2.3 and 4.4 percent over the past three-, five-, and 10-year time periods. Event-driven strategies were hurt by falling credit and equity markets, but managed futures had solid performance. Cash flows from royalties remain strong, but valuations fell as public comparables suffered in the quarter.

Conclusion

Two years ago, we wrote that the higher-than-average returns we were experiencing would lower future long-term returns for investors. After three consecutive quarters of falling markets, banks and consultants are increasing their long-term capital market return assumptions. In theory this means investors' jobs are easier. The path to these long-term returns might be as bumpy as the past nine months have been. It remains to be seen if the Fed can deliver a soft landing and avoid a recession. Interest rates are likely to increase more in 2023 as the Fed combats inflation, so the short-term might be bumpy. Endowments invest for the long-term, but the road ahead might lead to some market dislocations that we can take advantage of. We feel that the portfolio is positioned appropriately to take advantage of the current market environment and to meet our return objectives into the future.

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