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The University of Iowa Center for Advancement (UICA) Quarterly Investment Report – June 30, 2023

Overview

Attached you will find the investment performance report for the period ending June 30, 2023. The Federal Reserve raised interest rates 3.5 percent during the fiscal year, lowering inflation from 9.1 percent in June 2022 to 3.0 percent in June 2023 along the way. Despite the rate headwind, equity markets mostly rallied. Other risk assets were a mixed bag, credit fixed income did well while commodity prices fell. The economy remained resilient through bank collapses, the continuing Russia-Ukraine war, and a contracting manufacturing sector, but there are signs of weakness in consumers.

The Long-Term Pool (LTP) returned 2.6 percent for the quarter, 6.4, 11.1, 6.2, and 6.9 percent respectively for the one-, three-, five-, and 10-year periods.

Global Equity

The global equity composite returned 4.4 percent during the quarter, 12.9 percent over the past year and an annualized 14.2, 9.4, and 10.1 percent over the past three-, five- and 10-year periods.

Equity markets rebounded from a tough fiscal year 2022 with positive performance in the US, developed international and emerging markets. Rising interest rates are thought to act as a headwind to growth companies, but growth outperformed value globally and particularly in the US. US markets were driven by seven large cap, growth, tech stocks: Apple, Microsoft, Amazon, Alphabet, Nvidia, Tesla, and Meta Platforms. Emerging markets benefited from countries that had technology exposure, but only posted a slight gain as China's slow economic recovery remains a difficult obstacle to overcome.

Fundraising in venture capital and buyouts has decreased in 2023 according to Pitchbook data. This is mostly caused by over-allocation to private equity due to the denominator effect created when public equites fell in 2022. Some of this has been resolved by a public equity recovery, but it persists due to tighter credit markets and higher interest rates that slowed sales of portfolio companies. Realizations lower the market value of a fund and without realizations market values can remain higher than expected. It remains to be seen how this affects fund returns, as time hurts internal rates of return. While our private equity portfolio has always avoided funds that use excessive leverage, our general partners often sell portfolio companies to those funds, so we are indirectly affected by higher debt costs. Private equity funds are long-lived assets, but they do have finite lives. The secondary market has created a new market for continuation vehicles that offer general partners the opportunity to hold onto portfolio companies beyond the life of a fund while offering limited partners liquidity. This nascent strategy can be attractive to general and limited

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partners for different reasons, but performance data for continuation vehicles is difficult to find. We have been offered the opportunity to invest in these vehicles in a few instances, and have taken liquidity each time, but evaluate each on a case-by-case basis.

Global Fixed Income

The global fixed income composite returned 1.2 percent during the quarter and 3.4 percent for the trailing year. Over longer time periods it increased an annualized 2.4, 2.9, and 3.6 percent for the three-, five- and 10-year periods. Central bankers around the globe continue to combat elevated inflation by raising interest rates. Zero interest rate policies caused investors to look elsewhere for returns, leading many to private credit. Interest rates are higher and private equity fundraising is down, but private credit fundraising is strong on the back of direct lending. Direct lending funds supply the debt used by many private equity funds to purchase companies. The lender receives a coupon payment and some equity upside. The equity upside or use of leverage by the lender can make attractive fixed income returns. It remains to be seen how these lenders do in an environment with more defaults.

Real Assets

The real assets composite returned -3.0 percent for the quarter, -8.3 percent for the one year, and an annualized 12.4, 3.9, and 5.1 percent over the past three-, five-, and 10-year periods. Public real assets returns were mixed in the quarter, with REITs rising and commodities falling, but both struggled for the fiscal year. Private real assets were not immune to the struggles seen in the public strategies, falling for the year. The volatility and potential for negative returns in a rising interest rate environment push investors away from public real assets and into private strategies. One of the benefits of real assets is their perceived high, positive correlation to inflation, but private investments have lower correlations to inflation because they are only marked to market quarterly. This requires private real assets to achieve higher total returns, which they have rarely delivered compared to other private strategies. Private real assets can have a role in diversifying buyout and venture returns, but only if they deliver appropriate returns. US energy production is expected to hit record output levels and real estate is in the midst of a downturn that could last years, making investments in the asset class a tough bar to clear in the near term.

Diversifying Strategies

The diversifying strategies composite returned 2.2 percent for the quarter, 0.7 percent for the one year, and an annualized 8.0, 1.6 and 3.4 percent over the past three-, five-, and 10-year time periods. Managed futures had a strong quarter, but a slightly negative fiscal year as trends reversed sharply quarter to quarter. As the private capital portfolio grows, the diversification provided by managed futures becomes more important to the endowment. There are several strategies that provide diversification from private capital, but managed futures are one of the few with a high and positive Sharpe Ratio. In other words, they offer diversification and positive excess return for each unit of risk relative to the risk-free rate (cash).

Conclusion

The Fed continues to fight inflation while attempting a soft landing of the economy. Despite their comments that rates will stay higher for longer, the market seems to think that rates will fall sooner than the Fed. Banks have instituted tighter lending requirements which slows down the economy, but private credit funds have raised hundreds of billions to take their place. Equity markets are up double digits for the calendar year, but it doesn't feel like we are in a market that is taking off. It feels more likely that returns will be narrower than in past years, not all boats will be lifted. We feel that the portfolio is positioned appropriately to take advantage of the current market environment and to meet our return objectives in the future.

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