QUARTERLY
INVESTMENT REPORT

Q3 2022

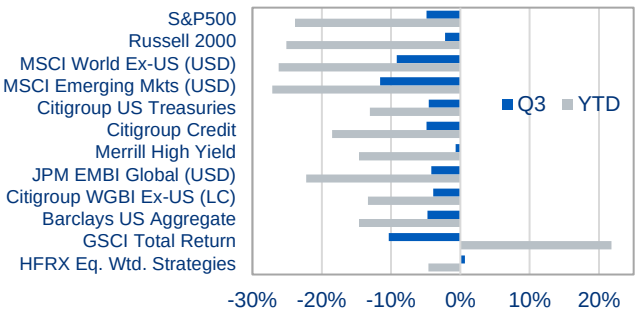
Strategic Investment Group®

Global Market Review

Summary

The economic backdrop remains unsettled and inhospitable. With price pressures increasingly entrenched, the risk that inflation can only be tamed at the expense of a recession is weighing heavily on global equity and bond markets. Moreover, market volatility has increased in the face of tighter financial conditions and dwindling liquidity. Mirroring past periods of high inflation, stocks and bonds have been highly correlated this year. Sharply falling stock and bond markets have combined to make the first three quarters of 2022 some of the worst for balanced portfolios in 50 years. The dollar's relentless rise continues, further tightening global financial conditions, and adding to the fragility of some emerging economies.

Exhibit 1
Performance of Major Market Indices
Source: Bloomberg. Year to date through September 30, 2022.

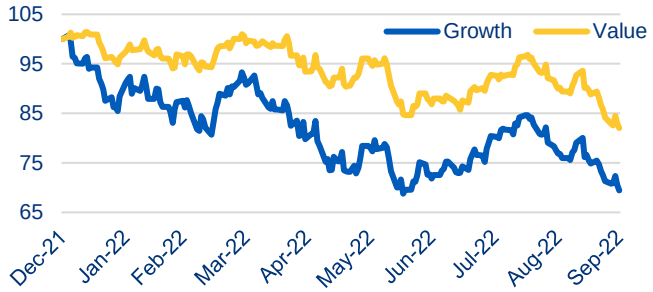


Stock and bond declines steepen in third quarter.

U.S. Stock Slide Steepens

Rising real yields and fears that a hard economic landing will hurt corporate earnings sent U.S. equities sharply lower in the third quarter. The S&P500 suffered its third successive quarterly decline falling 4.9% during the quarter to bring its loss so far this year to 23.9%. While most market segments have tumbled, growth stocks have been especially hard hit. Growth stocks have underperformed value by a wide margin, losing 30.6% so far in 2022 versus the 18% decline in value (Exhibit 2). Across sectors, the sole gainer is the energy sector, which is up 31% in the first nine months of the year, reflecting the sharp increase in oil prices. The telecom and tech sectors have experienced some of the steepest declines, falling 40% and 33%, respectively so far in 2022.

Exhibit 2
Amid General Decline, Value Stocks Outperform Growth
Source: Bloomberg. Index January 1, 2022 = 100.



Non-U.S. Stock Declines Outpace U.S.

Non-U.S. advanced economy equity markets fell in the third quarter. For U.S.-based investors, these declines were compounded by the dollar's appreciation. The MSCI World ex-U.S. index fell 9.2% in the third quarter to bring its decline so far in 2022 to 26.2% (Exhibit 3). Rising import prices, tighter external financing conditions, and a rising dollar weigh heavily on some emerging economies. Reflecting these pressures, emerging equity markets plunged 11.6% in the third quarter, bringing their loss for the year to 27.2%. Regional performance has sharply diverged. Markets in the EMEA region have lost 34% so far in 2022, reflecting the impact of Russia's invasion of Ukraine on emerging economies in Europe. Asian emerging equity markets have also fallen sharply this year (down

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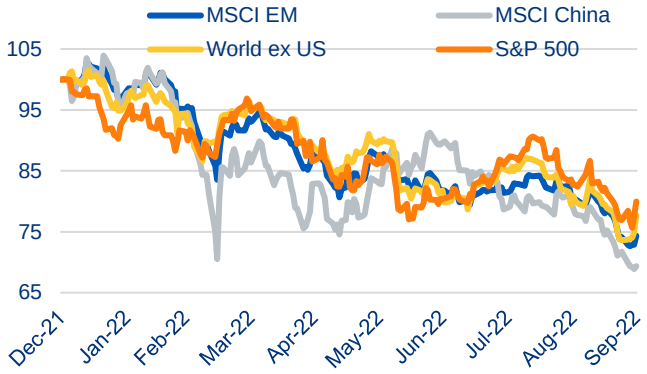
30.2%), reflecting weakness in Chinese equities, which are 32.1% lower. Latin American bourses, propped up by commodity exporters such as Brazil, have fared much better, losing only 3.5% in 2022.

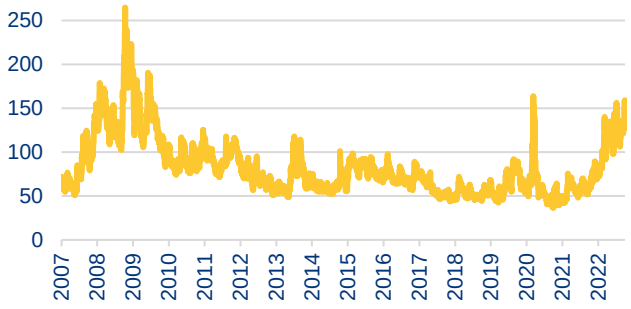
Exhibit 3
Steep Declines Across Global Equity Markets
Source: Bloomberg. Index January 1, 2022 = 100.



Policy Risks and Margin Spirals

Leaving aside the political drama, recent events in the U.K. gilt market and sterling highlight two sources of vulnerability to which global markets appear to be increasingly susceptible – policy risk and margin spirals. The risk that a policy misstep might undermine confidence is particularly high as central banks and fiscal authorities navigate the combination of high inflation, slowing growth, and the impact of supply shocks on households. More potentially worrisome is the risk that hidden pockets of leverage, similar to those that roiled the gilt market, will be uncovered as interest rates rise, liquidity evaporates, and financial conditions tighten. Such pockets of leverage can trigger margin spirals. These spirals are exacerbated by low market liquidity which increases volatility (Exhibit 4). High volatility in turn deters buyers from remaining in the market, further drying up liquidity.

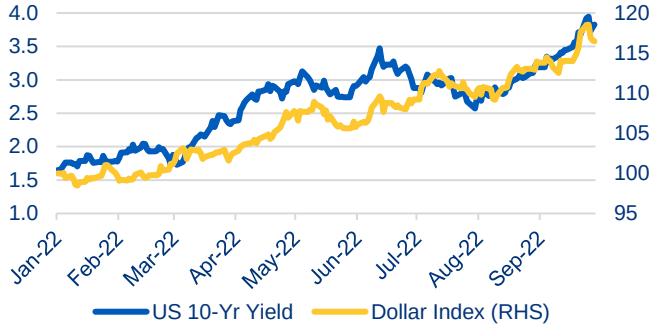
Exhibit 4
MOVE Index of Bond Volatility at High Levels
Source: Bloomberg. Option-implied Vol. Index January 1, 2022 = 100.



Yields Rise, Spreads Widen

U.S. Treasury yields rose in the third quarter with the 10-year yield hovering around 4%. Reflecting sharply rising yields, the decline of long-dated U.S. Treasury bond prices, of 27.9% so far in 2022, has outpaced the fall in U.S. equities. The real yield on 10-year TIPS is up 265 basis points so far this year, accounting for all of the gain in nominal 10-year U.S. Treasury yields over the period. Implied inflation expectations have declined slightly since the beginning of the year. Rising U.S. Treasury yields have contributed to the appreciation of the broad dollar index, which is up 17% so far this year (Exhibit 4). Both investment grade and high yield bonds fell further in the third quarter as spreads widened. So far in 2022, investment grade and high yield bonds have declined about 15%.

Exhibit 5
Rising Yields Drive U.S. Dollar Appreciation
Source: Bloomberg. Dollar Index 1-1-2022 = 100. UST Yields in %



Outside of the U.S., the WGBI ex-U.S. index of advanced sovereign bonds has declined 26.8% so far this year. Emerging market bonds are down 22.2%, and many issuers are trading at spreads of 1,000 basis points or more.

Beta Weighs on Hedge Fund Returns

Hedge funds as a whole are down 4.6% so far this year, largely reflecting the impact of beta exposure in a declining market environment. The recent performance of the industry has highlighted the importance of constructing hedge fund portfolios to minimize market beta so as to get the full benefits of diversification hedge funds can offer.

Real Estate Generates Strong Gains

Real estate returns as measured by the NCREIF Open-End Funds Core Index (reported with a delay) rose 28.3% in the 12 months through June 2022. While all property types are up, industrial properties are generating especially strong gains, rising 48% over the period on the back of strong e-commerce demand. Oil prices dropped nearly 25% in the third quarter, leading to a 10.3% quarterly decline in the GSCI commodity index. For the year as a whole, the GSCI is up about 22%.

Private Equity Valuations Remain High

Private equity valuations have begun to reflect the steep declines in publicly traded markets but returns nevertheless remain positive. The Thomson Reuters/Cambridge Index of U.S. private equity (reported with a delay) gained 8% in the 12 months through June 30, 2022. Energy and buyout funds have outperformed venture and growth funds during this period. Capital flows into private equity slowed in 2022. Transaction volume is way down. Venture capital fundraising has also fallen dramatically after a record 2021.

Outlook & Strategy

Summary

The past three quarters have been among the toughest for balanced portfolios in over 50 years as both stocks and bonds have fallen sharply. The economic and market outlook remains unsettled. Inflation is stubbornly high, broad based across the consumption basket, and rampant across advanced and emerging economies. Global central banks are raising rates and mopping up liquidity to ease price pressures. But these tightening measures are bumping up against economic and market fragilities. The three main engines of global economic growth – China, the EU, and the U.S. – are already sputtering and face ongoing destabilizing shocks. Markets meanwhile face potential disruption as tighter financial conditions reveal unsustainable pockets of leverage, speculation, and asset pricing dependent on low yields and abundant liquidity. The risks of a hard economic landing and market turbulence as financial conditions tighten further are real.

Through the maelstrom, opportunities have emerged for disciplined investors focused on valuations. Speculative investments and momentum driven positions have fallen from favor. In their place, we see a return to fundamentals. We have positioned portfolios to help take advantage of what we view as a renewed preeminence of fundamentals as a determinant of asset pricing. Recent actions notably include a targeted neutralization of our longstanding duration underweight given the spike in yields to near fair value.

Turbulent Economic Backdrop

The world economy has been buffeted by two destabilizing shocks in quick succession – a pandemic followed by the largest land war in Europe since WWII. As a consequence of these shocks, and the policies taken to blunt their economic impact, the global economy faces the unhappy prospect of high inflation combined with a sharp, synchronized slowdown in growth across the main global economic powerhouses.

The U.S. economy has already experienced two successive quarters of contraction. So far, the recession has been mild and accompanied by continued low levels of unemployment and sustained household spending. Nevertheless, the prospect of continued Fed tightening to quell stubbornly high inflation raises the risk that the U.S. economy could be tipped into a deeper contraction. This risk is compounded by the drag on real household income from higher energy and food prices as well as the impact on U.S. output and expenditure of tighter policies and falling activity in the rest of the world.

The Chinese economy is also slowing and faces headwinds. China's zero-COVID policy has resulted in frequent lockdowns of major cities and economic hubs, undermining domestic growth, and disrupting global trade. Moreover, excess leverage and overbuilding has undermined confidence in the property sector – a key contributor to economic growth representing about one fifth of Chinese output – and raised doubts about the stability of the traditional and shadow banking sectors.

Meanwhile, the EU faces a devastating energy shock as well as the broader repercussions of Russian aggression. Natural gas prices in Europe are four times higher than in 2021 and gas deliveries from Russia are at 20% of the levels last year. High energy prices are taking a toll on industrial output and household expenditure.

Many emerging economies also face significant challenges. High energy and food import prices are contributing to rising inflation and undermining their balance of payments. The strong appreciation of the U.S. dollar is compounding these price pressures and increasing the cost of servicing dollar-denominated debt. At the same time, international capital markets have grown increasingly less receptive to emerging economies, leading to reduced access to funding and higher funding costs. Many emerging sovereign bonds are trading at distressed levels with spreads of 1,000 basis points or more.

Fragilities and Fault Lines

The passage from loose to tight financial conditions continues to be rough. Uncertainty about the persistence of inflation, the severity of the Fed's response, and its ultimate impact on economic output has kept measures of expected equity and bond market volatility high. Low market liquidity has intensified asset price oscillations. Stocks have plummeted, real U.S. Treasury yields are up, credit spreads have widened, and the dollar has appreciated to 20-year highs. The magnitude of the combined decline of stocks and bonds in the first nine months of the year is at extremes. It rivals the coordinated declines in other high inflation periods in the 1970s and 1980s, which were also difficult times for balanced portfolios.

While necessary to bring inflation down, the synchronized tightening of monetary conditions by global central banks has the potential to further destabilize global markets grown accustomed to easy money. The strong appreciation of the

U.S. dollar against most currencies compounds these pressures, especially in the case of emerging economies. Warnings of the potential risks that could be exposed by tighter financial conditions have been provided by recent developments in the U.K. gilt market.

As monetary and financial conditions tighten, asset prices and leveraged positions predicated on the persistence of easy money become vulnerable. At extremes, leveraged positions can become subject to margin spirals. In these vicious cycles, falling asset prices trigger margin calls, leading to the forced sales of assets that further pressure prices and result in additional margin calls. The risk of such spirals is highest when markets are volatile, and liquidity is low.

Volatility and illiquidity can also be self-reinforcing. Illiquid markets are more prone to wide price swings. Such swings deter investors from remaining in the market, further eroding liquidity, and creating the conditions for even higher volatility.

In the past, such cycles have been broken by the injection of liquidity into the market by central banks. Following this playbook, the Bank of England successfully intervened to calm the recent turbulence in the gilt market. However, this intervention constituted a policy about face and put the goals of fighting inflation and maintaining financial stability at odds, thus highlighting the difficult crosscurrents facing central banks.

Emerging markets face potential turbulence from U.S. dollar appreciation, which is at its highest level in over 20 years. Previous cycles of dollar appreciation have been associated with emerging market debt crises. The current cycle of tightening financial conditions and dollar appreciation has the potential to trigger widespread debt distress across emerging economies. Such a development would pose a further weight on global growth and financial stability.

Navigating Portfolios in Turbulent Markets

The chief bulwark against market turbulence is a judiciously structured and well diversified asset allocation strategy that is consistent with an investor's long-run return objectives and ability to withstand short-term risk. For this reason, we have collaborated closely with you to identify an asset allocation that we believe has the right risk and return characteristics for your goals and circumstances. While painful, recent market drawdowns are well within the ranges considered when designing your asset allocation strategies. Moreover, our active management of your portfolios has added value and thereby helped blunt some of the impact of the markets' declines.

A second key to navigating portfolios through turbulence is a disciplined approach to portfolio rebalancing. Timely rebalancing has the potential to add significant value and put the portfolio in the position to benefit from a market rebound. Failing to rebalance undermines the potential for a portfolio to achieve its long-term return objectives.

Finally, by focusing on fundamental valuations, active management can help shield portfolios from the worst of market declines. We believe that the best way to add value is through a disciplined investment process founded on valuation focus, diversification, and the careful calibration of a large number of independent active positions. We aim to control active risk by ensuring that no individual position constitutes a disproportionate share of the total risk budget. Fortunately, we believe there remain significant valuation anomalies that can be exploited by skilled active managers.

Current Portfolio Positioning

We retain a below-benchmark allocation to publicly traded equities. This position is structured as a substantial underweight to U.S. equities that remain significantly overvalued despite recent declines. Partially offsetting the U.S. equity underweight, we maintain small overweight positions to more attractively priced non-U.S. advanced and emerging equities.

Within the non-U.S. equity market, we have recently neutralized the underweight position to Japanese equities. This move aims to benefit from the highly attractive valuation of Japanese equities and of the yen that is at 30-year lows.

Across global equities we retain an overweight to value stocks. Despite their recent strong relative outperformance, value stocks remain much more attractively priced than growth shares. Moreover, the earnings growth of value stocks has outpaced that of their growth counterparts.

The recent evolution of U.S. Treasury yields provides an example of how we calibrate our active top-down portfolio decisions. Aware that market timing is a high-risk venture with a low probability of success, we approach such positions cautiously. In the course of this year, nominal and real yields have rebounded sharply and are currently hovering near fair value. As yields increased, we undertook a phased reduction in our longstanding duration underweight and now target a neutral position. Each step of the process was calibrated to the degree of divergence between market pricing and fundamental valuations.

The ongoing tightening cycle has widened credit spreads, made access to credit more challenging, and triggered an increase in credit downgrades. Despite recent spread widening, corporate bonds remain unattractive. We therefore have retained our underweight to credit risk.

We remain neutral to real estate and other real assets. Real estate investments offer valuable inflation protection as well as diversification benefits and opportunities to add value.

We maintain a strong overweight to hedge funds. Our focus on constructing hedge fund portfolios to minimize their exposure to broad movements in the equity and credit markets has been invaluable this year. Low beta hedge funds have generated positive returns, unlike most other assets. At the same time, the diversification offered by our low-beta hedge fund portfolio has dampened the impact of declining markets on portfolios.

While overall market conditions are likely to remain turbulent, we are positioned to continue to benefit from the ongoing return to fundamentals. We are actively on the hunt for emerging opportunities for adding value.

Special Topic

2022 Idea Lab Highlights

This year's Idea Lab considered the challenges and opportunities of managing portfolios in the present period of high inflation, rising interest rates and recession risks, a strongly appreciating U.S. dollar, high debt burdens, and elevated market volatility. While it is impossible to do justice to the breadth and depth of the discussions across the two-day forum, four areas were particularly noteworthy: the risks lurking in current market dynamics, the opportunities created by the return to fundamentals in liquid and private markets, the indispensable role of a sound operational infrastructure, and the sage insights on governance of Charles D. Elllis, former chairperson of the Yale Investment Committee and author of *Winning the Loser's Game*. Additionally, special sessions reviewed Strategic's initiatives in the areas of diversity, equity, and inclusion and environmental, social, and governance investing and introduced Michelle McCloskey, our new Executive Chairperson.

Portfolio Construction Amid Uncertainty

The Strategic team set the stage with a discussion of current market dynamics, focusing on the potential ramifications of the increasingly aggressive measures taken by major central banks to quell stubbornly high inflation. Although the macro backdrop is highly uncertain and inhospitable, the return to fundamentals is helping those, like Strategic, who have been focused on generating alpha by exploiting the wide dispersion of valuations within and across markets. Strategic's tactical positioning, which has included being less exposed to rates and overvalued equities, while favoring diversifying strategies provided by hedge funds and private markets, has exploited these opportunities, and added value to client portfolios.

The theme of heightened uncertainty was echoed by guest speaker Anatole Kaletsky. In his view, tightening by central banks to contain inflation was likely to tip the global economy into recession and reveal pockets of fragility in financial markets, similar to that just experienced in the U.K. gilt market.

Opportunities Emerging Across Markets

A common theme cutting across the numerous investment managers who spoke at Idea Lab was the emergence of bottom-up investment opportunities despite the unsettled macro backdrop. The hedge fund panel highlighted the benefits of a micro focus on company fundamentals. With markets returning to fundamentals, the ability to exploit pricing anomalies by shorting richly valued securities while also minimizing beta has proven especially advantageous. The panels on private markets explored two ends of the spectrum. After boom times and massive inflows, venture capital funds are adjusting to the correction in public markets and a significant reduction in new funding. On the other end of the spectrum, discerning deep value buyout strategies are finding opportunities at good prices as liquidity declines and leverage becomes more costly. A similar return to fundamentals is also evident in the public equity markets, opening up opportunities to add value through careful security selection and portfolio construction despite the painful drop in the broad market.

The Importance of Time Away

Our dinner keynote speaker, Doris Kearns Goodwin, shared anecdotes from the lives of "her guys," or the transformational presidents whose lives she has chronicled: Theodore and Franklin D. Roosevelt, Lyndon B. Johnson, and Abraham Lincoln. A common thread across these lives was excellence in leadership that grew from personal challenges. Ms. Kearns Goodwin closed her remarks with a challenge to adopt another characteristic common to these presidents and find time to relax, refuel, and recharge, something that these leaders intuitively understood as necessary to achieving one's best.

Unsung Heroes of Portfolio Management

Despite constituting the essential backbone of portfolio management, the professionals managing the operations, trading, and control infrastructure are the unsung heroes of investment management. To allow clients to take a look under the hood of the middle and back office, our operational professionals demonstrated more insights around their role in adding value through timely rebalancing, ensuring orderly trade settlement and proper accounting, and helping clients meet the demands of auditors.

Good Governance and Investment Returns

We concluded with an interactive workshop on governance best practices led by investing luminary Charles D. Ellis and Strategic's own Nikki Kraus, author of *Endowment Management for Higher Education*. The workshop covered the composition of the ideal committee, structuring orientation sessions for new members, and succession planning. Mr. Ellis cautioned against blindly following the "Yale Model" of investment success. Arguing that each endowment was unique, he advocated instead that each investment committee should tailor its investment strategy to fit the institution's unique circumstances and objectives.

We hope that this overview of highlights of Idea Lab 2022 encourages you to join us next year. We were thrilled to host the event in-person for the first time since 2019 and look forward to welcoming you to our offices again in 2023.

Note: Opinions expressed herein are current as of the date appearing in this material and are subject to change at the sole discretion of Strategic. This document is not intended as a source of any specific investment recommendations.