QUARTERLY
INVESTMENT REPORT

Q4 2022

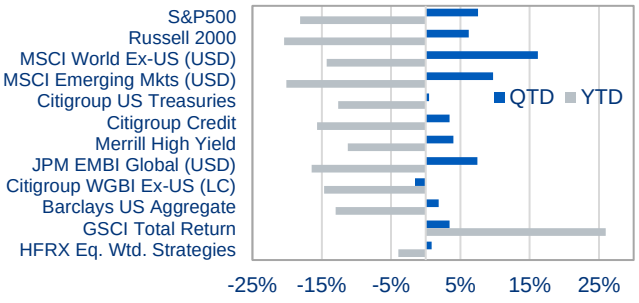
Strategic Investment Group®

Global Market Review

Summary

Global stocks and bonds suffered double digit declines in 2022, making last year the worst on record for balanced portfolios. War, inflation, and the central bankers' swing from stimulus to stringency sparked high levels of market volatility and declining liquidity. Both inflation and the pace of Fed rate hikes were at 40-year highs. The sudden shift to tightening, rising energy and food prices, and eroding real incomes undermined global growth prospects and hurt investor sentiment. Equity prices fell, sovereign bond yields rose, credit spreads widened, the red-hot housing market cooled, and assets gripped by speculative fever became less overheated. Only the U.S. dollar, private real estate, and commodities generated gains.

Exhibit 1
Performance of Major Market Indices
Source: Bloomberg. Year to date through December 31, 2022.

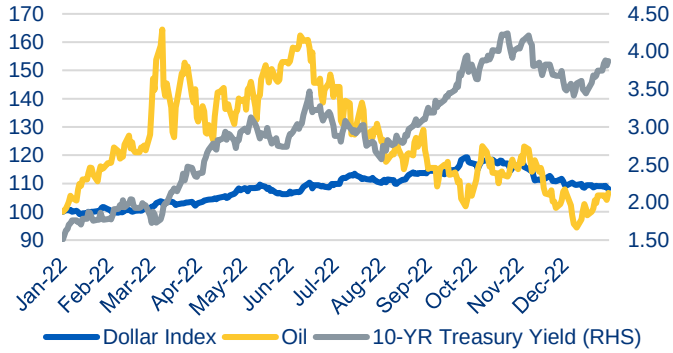


Global equity and bond markets plunged in 2022.

Drumbeat of Recessionary Signals

The global economy was buffeted by a number of shocks last year. War, the erosion of incomes by high inflation and especially energy and food prices, the breadth and pace of central bank rate hikes around the world, and the appreciation of the dollar were all powerful forces of contraction (Exhibit 2). The share of global income spent on energy in the first half of the year rivaled that of the oil shocks of the 1970s and 1980s which were closely followed by recessions. Reflecting these forces, survey data, leading economic indicators, and the bond market (in the form of an inverted U.S. Treasury yield curve) all point toward recession. There are, however, signs that inflationary pressure is waning and that the Fed and other major central banks may be able to slow the pace of tightening, thus reducing the severity of an eventual downturn. Historically, inflation has fallen with a lag following a sharp tightening of monetary policy and the effects of tightening have persisted well after rate hikes have ceased. These lags heighten the uncertainty of the outlook for markets and the complexity of the task facing monetary authorities around the world. The depth of an eventual recession hinges critically on how accurately global central banks judge these lags.

Exhibit 2
Forces of Contraction: Yields, U.S. Dollar, Energy
Source: Bloomberg. S&P 500 Index percent return.



An Especially Bad Year for U.S. Equities

The S&P500 fell by 18.1% last year, making 2022 one of the six worst years for U.S. equities since the Great Depression (Exhibit 3). Although the losses were widespread, those of tech

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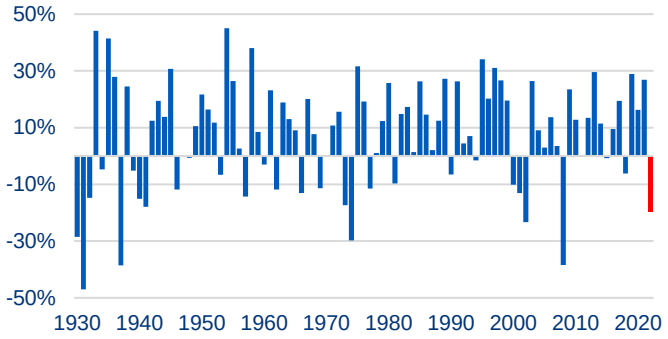
and growth stocks were especially steep. The FANG+ index of large-cap growth stocks in the tech sector (including Facebook, Amazon, Apple, Netflix, Google, Microsoft, and Tesla among others) plunged 42% in 2022. Tesla's fall of 69% was especially striking. Thanks in part to the tech sector's reversal of fortune, value stocks (-8%) outperformed growth (-29%) by a wide margin. Across sectors, only energy generated gains, rising a whopping 58.1% in 2022.

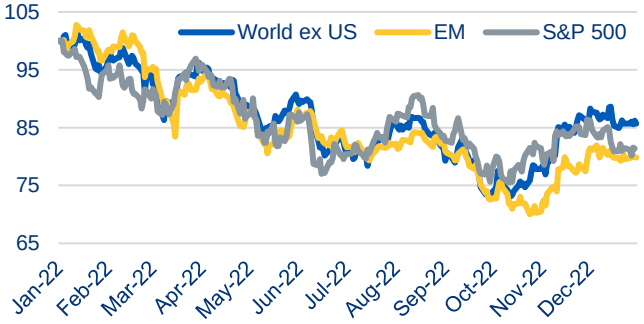
Exhibit 3
Sixth Worst Year for U.S. Equities on Record
Source: Bloomberg. Annual returns.



Non-U.S. Equity Markets Also Plummet

The combination of geopolitical turmoil, rampant inflation, and aggressive policy tightening also roiled non-U.S. equity markets. The MSCI World ex-U.S. index of advanced economy stocks fell 14.3% in 2022, with markets in Europe and Japan losing 15.1% and 18.5%, respectively (Exhibit 4). The strong appreciation of the U.S. dollar last year compounded the local currency declines in non-U.S. markets.

Exhibit 4
Steep Declines Across Global Equity Markets
Source: Bloomberg. Index January 1, 2022 = 100.

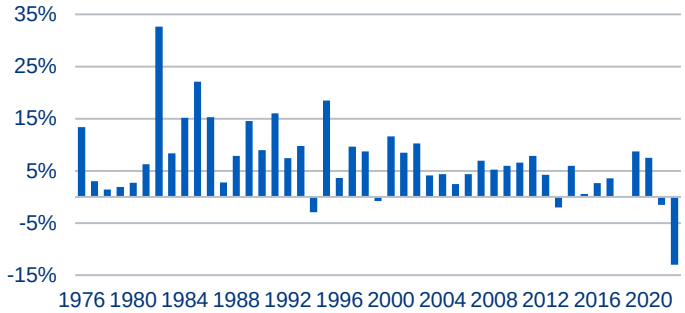


Representing 35% of MSCI Emerging Equity Market Index and a large share of global trade and output, the Chinese economy's changing fortunes have had an outsized impact on the performance of emerging equities. For most of the year, Chinese equities plunged reflecting slowing economic growth, a debt overhang in the property market, the heavy exposure of the financial sector to the property market, and Draconian lockdowns in pursuit of a zero-COVID policy. Notwithstanding a big bounce in the closing months of the year following the reversal of the zero-COVID policy, the Chinese equity market fell 23.5% last year, setting the tone for the broader emerging equity market.

U.S. Bond Market's Worst Year on Record

Bonds provided no refuge to investors last year. U.S. Treasuries as a whole lost 12.6% in 2022, with maturities of 10+ years falling 27.7%. The increase in U.S. Treasury yields was largely driven by an increase in real yields on TIPS, as inflation expectations remained stable. U.S. investment grade and high yield bonds also suffered double digit declines as credit spreads widened with growing expectations for an increase in downgrades and defaults as the economic climate sours. The U.S. aggregate bond index experienced its worst year on record, losing 13% in 2022 (Exhibit 5). Outside of the U.S., the WGBI ex-U.S. index of advanced sovereign bonds lost 22.1%, while the emerging bond market index fell by 16.4%.

Exhibit 5
Worst Year Ever for U.S. Aggregate Bond Index
Source: Bloomberg U.S. Aggregate Bond Index. Percent return.



Beta Weighs on Hedge Fund Returns

Hedge funds as a whole fell 3.9% last year, largely reflecting the impact of beta exposure in a declining market environment. The recent performance of the industry and markets more generally have 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 Assets Are Sole Gainers from Inflation

Real assets were among the only assets to generate positive returns last year. Real estate as measured by the NCREIF Open-End Funds Core Index (reported with a delay) rose 21% in the 12 months through September 2022. Industrial and multi-family properties generated especially strong gains, while offices lagged. The GSCI commodity index gained 26% last year, largely reflecting rising energy prices.

Private Equity Valuations Remain High

Private equity valuations remain disconnected from recent sharp public market declines. The Thomson Reuters/Cambridge Index of U.S. private equity (reported with a delay) was little changed in the 12 months through September 2022. Energy and buyout funds outperformed other segments, while venture funds lagged by a wide margin. Capital flows into private equity slowed in 2022. Following record levels in 2020-21, venture capital IPO activity dried up in 2022.

Outlook & Strategy

Fundamentals reasserted themselves as an anchor to asset prices last year. High asset valuations and a severe inflation shock increased market volatility, reduced liquidity, and triggered a spike in stock and bond correlations. The axiomatic 60:40 balanced portfolio used by institutional investors as a point of departure for portfolio construction misfired as stocks and bonds simultaneously fell. This made 2022 an exceptionally bad year for balanced portfolios (see this quarter's Special Topic).

We draw three key lessons from last year's experience of high correlation and steeply falling prices across stocks and bonds. First, to be robust, portfolios must derive their diversification from many well-calibrated active positions to avoid any single factor dominating returns. Second, hedge funds designed to have low market beta are an invaluable source of portfolio diversification as well as alpha. Finally, fundamental valuations must be the main driver of active positioning.

Looking forward, we continue to see a favorable environment for active management. Valuation dispersion remains wide, and volatility is likely to stay high as central banks calibrate the degree of tightening needed to quell inflation. We remain cautiously positioned, significantly underweight overvalued assets, while actively exploiting large and plentiful valuation anomalies.

Strong Prospects for Active Management

We see continued strong prospects for active management aimed at exploiting security level valuation anomalies. Equity valuation dispersion has fallen from its recent peak, but remains high, suggesting a continued favorable environment for active management (Exhibit 1). We believe that the roster of active managers in our clients' portfolios is well equipped to continue to identify and exploit valuation anomalies within markets.

Exhibit 1

Wide Valuation Dispersion Creates Alpha Opportunities

Sources: Bloomberg and Strategic calculations. Industry neutral valuation dispersion using forward P/E.

Despite the strong outperformance of value stocks last year, they remain attractively priced relative to growth.

Overall, we retain a slight underweight position to public equities, reflecting a significant underweight to the U.S. market and smaller overweight positions in developed and emerging non-U.S. equities. Three fundamental aspects of global equity markets favor non-U.S. markets over the U.S.: multiples, earnings, and currency valuations.

First, the gap between U.S. equity valuations and the valuations of developed non-U.S. equity markets is near multi-decade highs. In the case of emerging markets, this gap is at a 15-year high. Elevated relative U.S. multiples reduce the expected relative performance of U.S. equities.

Second, corporate earnings in the U.S. are at historic highs following an extended period of above trend growth. Corporate earnings growth in developed and emerging equity markets in contrast has been below trend. The risk of earnings compression in the U.S. is therefore higher, while the valuations of non-U.S. equities appear much better supported.

Finally, the U.S. dollar is significantly overvalued. A reversion of the dollar to more normal valuation levels would result in a translation gain on non-U.S. assets. Moreover, the high valuation of the dollar boosts the competitiveness of foreign firms and contributes to their earnings growth potential.

Balanced Positioning in Private Equity

We retain a neutral allocation to private equities. We believe that a well-balanced allocation across buyout, growth, and venture strategies diversified by stage, sector, and vintage is the key to designing a robust private equity portfolio.

Private market valuations are adjusting with a lag to last year's declines in the public equity market. Within our private equity investments, we are maintaining a significant allocation to strategies that favor businesses with strong cash flows and relatively low leverage. We plan to continue to avoid highly speculative ventures such as crypto-related strategies.

Hedge Funds Diversify Balanced Portfolios

The wide valuation spreads illustrated in Exhibit 1 create a particularly favorable environment for skilled hedge fund managers whose strategies focus on exploiting valuation anomalies. Our hedge fund overweight complements active positions within other asset classes designed to benefit from a reversion to fair valuations.

Moreover, we have designed our hedge fund portfolio to minimize market beta. Hedge funds are likely to remain especially valuable as a source of diversification and alpha in the current environment.

Yield Makes a Comeback

Spurred by high inflation and Fed tightening, bond yields and bond market volatility rose sharply last year. As yields approached fair value, we moved to eliminate our longstanding duration underweight and are currently maintaining a neutral position to duration. With yields at about fair value, we expect last year's spike in stock and bond correlations to moderate, restoring the diversification benefits of holding fixed income in a balanced portfolio.

Credit spreads over Treasuries are also approaching fair value after a sustained period of spread compression. However, the outlook for credit is mixed, and we are retaining a slight underweight to credit. Firms have extended the maturity of their liabilities, reducing near-term refinancing risks. Credit spreads widened last year in anticipation of a tougher climate for earnings growth and credit quality, and now provide better compensation for bearing risk. Nevertheless, there remain reasons for caution. We are late in the credit cycle. An extended period of abundant liquidity encouraged investors to reach for yield, leading to the accumulation of a large stock of low-rated issuance.

As is the case for equities and hedge funds, the prospects for added value in the credit sector appear favorable. The valuation dispersion across securities is high and an eventual economic downturn would likely increase downgrades and defaults, thus broadening the scope for adding value through active security selection. We believe that our active credit barbell approach combining U.S. Treasuries on one end of the barbell and strategies in higher yielding segments of the market at the other is well suited to exploiting opportunities in this environment.

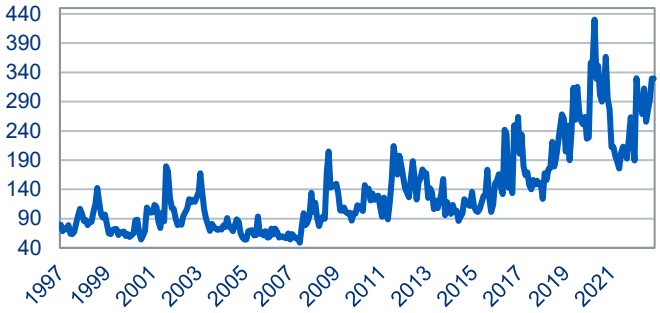
Risks Ahead

With the tide of liquidity rapidly receding, the risk of exposing market fragilities is rising. An extended period of extraordinarily easy monetary conditions encouraged borrowing, leverage, and speculation. Markets now face high volatility and low liquidity, a combination that can be self-reinforcing. Thinly traded markets are susceptible to sharp swings and such swings deter investors from remaining in the market, further impairing liquidity. In this environment, there is a heightened risk of funding crises and margin spirals popping up without warning in unexpected places. If such funding crises arise, central banks may be forced to shift their stance from fighting inflation to stabilizing markets.

Exhibit 2

High Levels of Global Economic Policy Uncertainty

Source: Bloomberg. Index of web references to policy uncertainty.



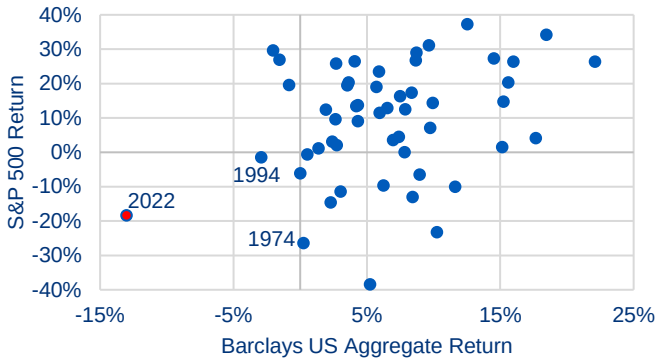
Moreover, the ultimate extent and impact of the current cycle of global central bank tightening is unknown. Central banks across most advanced and many emerging economies are struggling to calibrate their response to a combination of high inflation and slowing economic growth. Given the unique set of circumstances that spawned the current inflationary phase, the lagged response of economic activity to tighter policies is more than usually unclear, increasing the risk that measures to quell inflation could inadvertently precipitate a hard economic landing. As a result, uncertainty over the prospects of the global economy and the policies influencing its future direction is high (Exhibit 2). We therefore remain conservative in our overall positioning relative to market risk while being aggressive in our hunt for value added. We believe that a focus on fundamental valuation and a broad set of diversifiers will continue to serve us well as our ultimate guide for portfolio positioning through the turbulence ahead.

Special Topic

Portfolios Lose Their Balance

Institutional investors seek to strike a balance between real asset growth and capital preservation, and rely on diversification, the only free lunch in finance, to achieve that end. The classic point of departure for such diversified, "balanced" portfolios is the 60:40 split between equities and bonds. This axiomatic approach to portfolio construction badly misfired in 2022, as both stocks and bonds fell by double digits (Exhibit 1). Following two decades of a mostly inverse relationship between stock and bond returns, their correlation spiked to become strongly positive (Exhibit 2). This quarter's special topic considers the factors that led portfolios to lose their balance in 2022, and the lessons that can be drawn from this experience.

Exhibit 1
Balanced Portfolios Lose Their Equilibrium
Source: Bloomberg. U.S. stocks and bonds annual returns, 1970-2022.



Why Balanced Portfolios Stumbled in 2022

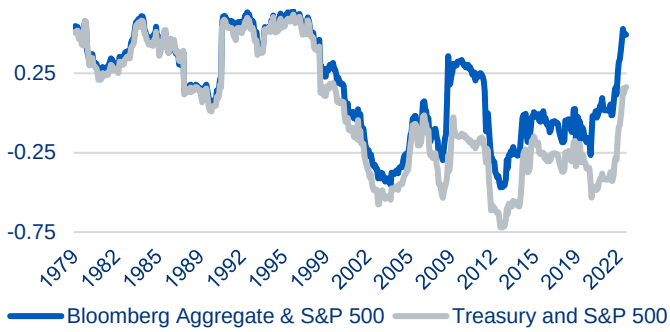
Global economies and markets suffered an inflation shock last year triggered by lingering post-pandemic supply chain bottlenecks, abrupt shifts in consumption patterns and employment preferences, highly stimulative fiscal and monetary policies, and Russia's invasion of Ukraine. The uncertainty over the outlook for growth and inflation engendered by this shock was the main driver of the spike in correlation across stock and bond markets seen in 2022. This increase in correlation reached levels reminiscent of the inflation shocks of the 1970s and 1980s and the 1994 global bond market crash.

The high valuations prevailing across global equity and bond markets after years of abundant liquidity made them especially susceptible to the inflation shock, contributing to the magnitude of the market declines. The S&P 500 suffered its sixth largest annual fall since the Great Depression and the aggregate U.S. bond index had its worst year ever. As highlighted in Exhibit 1, last year is the only year in the last 50 in which stock and bond returns were both highly correlated and sharply negative.

Correlations in Perspective

Since 1900, the average correlation between stocks and bonds has been positive, but low. However, correlations can vary significantly and abruptly change sign (Exhibit 2). Seen from this very long perspective, the two-decade period of mainly negative correlation prior to last year is anomalous. U.S. Treasuries and stocks were negatively correlated throughout this period, while the credit risk embedded in the broader aggregate bond index resulted in a period of positive correlation during the 2007-09 Great Financial Crisis when stocks fell, and credit spreads widened. To investors who had grown accustomed to the negative correlations of the past two decades, the shock of 2022 was especially jarring. However, asset correlations need not be negative for portfolios to benefit from diversification. They just need to be less than one.

Exhibit 2
Inflation Triggers Spike in Stock and Bond Correlations
Source: Bloomberg. Rolling 3-year correlations.



Regaining Equilibrium

As we have just experienced, correlations across asset classes are unstable and notoriously prone to approach one in times of market turmoil, depriving balanced portfolios of expected diversification benefits at the worst possible time. Testing the impact of fluctuations in cross-asset correlations should therefore be a key part of assessing portfolio risk.

It is also essential to diversify portfolios across a wide range of factors. We rely on two main sources of additional diversification. First, we design our hedge fund portfolio to generate the bulk of its returns from a highly diversified stream of added value, while minimizing its beta. The diversification provided by low-beta hedge funds is invaluable in times of market turmoil similar to last year. Second, across all asset classes, we focus on generating value added from a large number of well-calibrated active positions. Alpha generated in this way is more robust and repeatable than added value derived from a few large active positions. Our approach of embedding multiple diversifiers in client portfolios succeeded in cushioning last year's blow to balanced portfolios. We believe that the 60:40 architype remains a valid point of departure, provided that it is complemented by a broad set of diversifiers.

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.