Fiscal Year-End and Mid-Year 2023
Market and Investment Review

The end of fiscal year 2023, and mid-point of the calendar year, marks the end of the pandemic years. At this point, many have returned to the workplace, at least part time, in-person meetings have become more frequent and, importantly, college campuses are full and commencement ceremonies were open to all as an occasion for families to celebrate achievement.

The capital markets have also given investors a reason to celebrate. Global equities have generated double digit positive returns and the rapid rise in interest rates that eroded the benefits of diversification in the previous fiscal year has paused. Many of the headlines have been familiar topics to those who have been investing since the early 2000’s: banking crises, technology stock outperformance, and debt ceiling negotiations. As Mark Twain said, “History doesn’t repeat itself, but it often rhymes.”

After the most aggressive rate hike cycle in 40 years, the Federal Open Market Committee (“FOMC” or the “Fed”) delivered a much-expected pause in June to assess the economic impact of 500 basis points of tightening in the fed funds rate. However, with inflation still well above expectations and the unemployment rate at historic lows, the Fed has reserved the right to begin raising again, which we expect them to do. Nevertheless, recent data suggests much progress has been made on the inflation front with the most recent CPI data dipping below 5 percent for the first time in two years and well below the 9.1 percent reading at last fiscal year end. However, the core inflation measure, as well as a host of wage indicators, remains above historical trends. Much of the “stickiness” in wages is being driven by the competitive labor markets. While there have been more frequent headlines regarding layoffs in select industries, survey data suggests that corporate managers are still fearful of reducing headcount and being unable to replace skilled labor when needed. These dynamics highlight the difficult road ahead for domestic central bankers as they remain focused on the two percent target for inflation. However, they are not alone as central banks around the globe are also struggling with post-pandemic price stability.
In a twist, the Fed's efforts to reduce inflation may have been aided by the regional bank crisis in mid-March and its impact on lending. Prior to this there had already been signs of a slowdown in lending activity. The Federal Reserve Senior Loan Officer Opinion Survey displayed a doubling amongst major lenders reporting tightening since July 2022. Our expectation is that the events of the late Spring will serve as another form of tightening, with potentially a greater effect on consumers than higher interest rates. As for the distress at regional banks, it should not come as a surprise that held-to-maturity/available-for-sale portfolios on bank balance sheets have been significantly impacted by the aggressive monetary policy moves. However, in the aftermath of the 2008 credit crisis, particularly with the Basel III Accord, the financial health of the banking sector is stronger than in the past and, therefore, better prepared for a financial dislocation. Capital ratios are a key measure of a bank's financial strength and sit at much higher levels than any point prior to 2008, and much of the last decade.

The market reaction to the collapse of several financial institutions over the last six months has been surprisingly resilient as evidenced by positive equity markets. Conversely, much of the market volatility occurred in the place investors would least likely expect it – the short-dated U.S. Treasury markets. The 2-year U.S. Treasury note yield exceeded 5 percent in early March only to finish 100 basis points lower at month-end. This included the biggest one-week drop in the 2-year yield since 2008. A flight to quality and lowering of terminal rate expectations by market participants played a significant role in these rate moves. Risk-free interest rates have, once again, trended higher yet remain below peak levels. At the same time, credit spreads remain contained and are still far from the recessionary levels of the past. The current levels are in line with the median since 2000 but remain below the average and well below recession averages. The yield curve has become significantly inverted in a very short period of time and inverted yield curves have historically been consistent predictors of recessions.

Another surprising market dynamic has been the strong performance of equity markets and the drivers of that
performance this fiscal year. The 2022 stock market laggards have been the 2023 performance leaders. Since October, U.S. stocks have risen at an impressive pace despite significant macroeconomic headwinds and bank troubles.

FIGURE II

YESTERDAY’S SECTOR LAGGARDS ARE TODAY’S LEADERS

Shifting sentiments and falling rates have reversed last year’s trends in high duration stocks

More recently, a narrow basket of information technology stocks has made an outsized contribution to overall equity market performance, much like what was observed at the end of 2021 when the S&P 500 rose nearly 30 percent with approximately 24 percent of the market capitalization of the index responsible for the bulk of that positive performance. This has come as a surprise as higher rates have weighed on valuations of high-growth equities and as S&P 500 corporate earnings have posted negative growth for two sequential quarters.

Another repeat storyline from years past that we have seen this fiscal year was the political wrangling to raise the debt ceiling for the U.S. Treasury as the federal deficit is well over 100 percent of GDP, up from 35 percent in 2007. The anxiously awaited “X-Date” when the government would no longer be able to fund its obligations was a cause for concern and if missed would have resulted in a pause on payments for a multitude of government programs including Medicare, Social Security, and government and military salaries. A similar political debate about the appropriate level of government spending and its effect on the national debt and deficit reached a crisis level in 2011, leading to the passage of the Budget Control Act of 2011. The result of the most recent negotiations is the Fiscal Responsibility Act of 2023, which limits discretionary spending for the next six years and ultimately could reduce spending by over $2 trillion over the next decade. Thankfully, a market response like 2011 was avoided as the parties involved understood the gravity of a potential default and the impact it would have on the global economy.

As we move through calendar year 2023, we are impressed with how resilient the U.S. economy has been and even more surprised by the S&P 500’s strong performance. We had surmised that after 500 basis points of rate hikes in less than 12 months, aggressive quantitative tightening, a banking crisis and a debt
ceiling standoff, a recession would be inevitable. However, the economy continues to grow, albeit at a slower pace, supported by consumption and residual government spending from the fiscal policies of successive administrations. As a result, the capital markets seem to be optimistically pricing an economic deceleration that manages to achieve price stability while keeping growth and employment healthy. As we move through the rest of the year, this optimism may be challenged. There are still residual fiscal policies (student loan deferrals) and pandemic era changes (return-to-office) that are left to be dealt with. Ultimately, a soft landing for the U.S. economy seems very hard to achieve, as our tactical asset allocation dashboard (Figure III) indicates strong headwinds and, therefore, we remain cautious.

FIGURE III

TACTICAL ASSET ALLOCATION

Seven key factors that drive our tactical equity to fixed income allocations

<table>
<thead>
<tr>
<th>Indicator Key</th>
<th>2021</th>
<th>2022</th>
<th>2023</th>
</tr>
</thead>
<tbody>
<tr>
<td>Favorable</td>
<td>+</td>
<td>+</td>
<td>-</td>
</tr>
<tr>
<td>Moderately Favorable</td>
<td>+</td>
<td>+</td>
<td>=</td>
</tr>
<tr>
<td>Neutral</td>
<td>=</td>
<td>=</td>
<td>=</td>
</tr>
<tr>
<td>Moderately Negative</td>
<td>=</td>
<td>=</td>
<td>=</td>
</tr>
<tr>
<td>Negative</td>
<td>+</td>
<td>+</td>
<td>+</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Key Macro Factors/Catalysts</th>
<th>Q1</th>
<th>Q2</th>
<th>Q3</th>
<th>Q4</th>
<th>Q1</th>
<th>Q2</th>
<th>Q3</th>
<th>Q4</th>
<th>Q1</th>
<th>Q2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Global Growth</td>
<td>+</td>
<td>+</td>
<td>+</td>
<td>+</td>
<td>+</td>
<td>+</td>
<td>+</td>
<td>+</td>
<td>+</td>
<td>+</td>
</tr>
<tr>
<td>Monetary Policy Positioning</td>
<td>+</td>
<td>+</td>
<td>+</td>
<td>+</td>
<td>+</td>
<td>+</td>
<td>+</td>
<td>+</td>
<td>+</td>
<td>+</td>
</tr>
<tr>
<td>Yield Curve</td>
<td>+</td>
<td>+</td>
<td>+</td>
<td>+</td>
<td>+</td>
<td>+</td>
<td>+</td>
<td>+</td>
<td>+</td>
<td>+</td>
</tr>
<tr>
<td>Equity Risk Premium (ERP)</td>
<td>+</td>
<td>+</td>
<td>+</td>
<td>+</td>
<td>+</td>
<td>+</td>
<td>+</td>
<td>+</td>
<td>+</td>
<td>+</td>
</tr>
<tr>
<td>Leading Economic Indicators</td>
<td>+</td>
<td>+</td>
<td>+</td>
<td>+</td>
<td>+</td>
<td>+</td>
<td>+</td>
<td>+</td>
<td>+</td>
<td>+</td>
</tr>
<tr>
<td>Employment</td>
<td>+</td>
<td>+</td>
<td>+</td>
<td>+</td>
<td>+</td>
<td>+</td>
<td>+</td>
<td>+</td>
<td>+</td>
<td>+</td>
</tr>
<tr>
<td>Inflation</td>
<td>+</td>
<td>+</td>
<td>+</td>
<td>+</td>
<td>+</td>
<td>+</td>
<td>+</td>
<td>+</td>
<td>+</td>
<td>+</td>
</tr>
</tbody>
</table>

POV (Equity vs. Fixed Income) | + | + | + | = | - | = | - | - | - | - |

Source: Commonfund June 2023

Equities Remain Resilient

Equity markets have been surprisingly resilient this fiscal year with the MSCI ACWI Index up 16.5 percent and the S&P 500 Index up 19.6 percent. Markets began to rally late last year as expectations grew of the Fed nearing the end of their rate hike cycle, buoying risk appetites after two years of multiple compression. What first began as a “close-to-peak interest rate lead equity rally” has morphed into a thematic rally for risk on/Artificial Intelligence fueled equities, creating a narrowly focused market environment, particularly in the U.S. For detail, the top 10 weighted securities in the S&P 500 Index have contributed approximately 75 percent of the return of the index so far this calendar year. Figure IV depicts the difference in performance between the cap weighted and equal weighted S&P 500 return this fiscal year, highlighting the magnitude of the narrowly focused market.
Active equity managers that run more diversified portfolios generally have been unable to keep pace with a market driven by a select few names as bottom-up stock selection and diversification have gone unrewarded. Geographically, regional positioning has begun to favor non-U.S. markets after years of underperformance. Valuations remain compelling outside of the U.S. and that has translated into overweights in our portfolios that can tilt toward different regions of the world. Europe has become a larger weighting in portfolios as has non-China emerging markets. Our managers are particularly interested in the prospects for select Latin and South American markets on the view that a pause in U.S. interest rates will lead to a top in the U.S. dollar (perhaps this is underway already), creating room for countries with high domestic real rates to cut rates, spurring equity rallies. Recent market activity in Brazil is an early example of where we see this playing out.

Over the past year, private equity was also impacted by the challenging macro environment. Valuation declines were muted, given the typical discount to comparable public companies and for the most part continued steady earnings growth in the underlying companies. However, while most private equity backed companies have shown resilience, we expect that to be challenged going forward. Buyouts in the lower and middle-market require less leverage than larger and more expensive transactions and growth equity investments require little to no debt. As a result, the effects of the rising cost of debt have been much less pronounced in the lower end of the market. Despite the slowdown in capital raising and exit opportunities, we see the current environment as one of stress, not distress, and it is during these times that history demonstrates that private market participation has been particularly rewarding.

In buyouts and growth equity, we continue to believe sector specialists and other strategy specialists operating in the lower end of the middle-market are best positioned for potential outperformance. We believe the current market outlook may provide managers advantaged entry valuations for attractive companies, as well
as the continued opportunity to sell these businesses into an increasingly capitalized private equity capital base in the future. Additionally, our investment thesis includes managers targeting high growth, high recurring revenue, and profitable companies across SaaS, tech-enabled business services, and healthcare services verticals.

In 2022, we observed later-stage venture capital valuations falling in tandem with public software valuations. In addition, we saw non-traditional investors such as mutual funds, hedge funds and sovereign wealth funds retreat from the venture market. Early-stage valuation movement, however, has been muted in comparison. We have seen over decades that technology innovation occurs irrespective of the business cycle – some of the greatest companies in history were created in periods of economic dislocation – proving the value of taking a long-term perspective. In this environment, we continue to see compelling opportunities to invest in venture capital across stages (with an early-stage bias) through primary funds, direct investments, and secondaries. We continue to favor established, capacity-constrained managers that should be well-positioned in the current environment given their experience navigating prior market corrections. Furthermore, we believe now is an attractive time to invest in venture capital given the broad menu of investable opportunities and a monumental platform shift occurring in Artificial Intelligence.

The secondary market remains small and inefficient relative to the overall private equity market. Even in a tough macro-environment, the secondary market recorded its 2nd largest year on record in 2022 with $108 billion transacting. Limited Partners (“LPs”) are becoming increasingly proactive with managing their portfolios and commitments through various market cycles and opportunities. This has led to continued strong deal flow at attractive pricing from the LP side of the market in the first half of 2023. With liquidity now being accessible from both LP-led and GP-led transactions, combined with record primary fundraising over the last 15 years, we believe the secondary market is poised for tremendous growth and should be able to double in size by 2026.

Real Assets and Sustainability Present Opportunities
Fundamentals in real estate remain relatively healthy with low vacancy levels and positive rent growth. However, some markets and sectors are decelerating or seeing negative trends. Every real estate cycle is different, and we believe the current cycle is one of the most complex in history. Whether it was the “Savings and Loan Crisis” of the 1980s or the “Global Financial Crisis” in the 2000s, nearly all real estate sector fundamentals and values deteriorated during these systemic events. The current market, which has seen interest rates increase nearly 500 basis points, is more idiosyncratic than these prior cycles in our view. In the office sector, Class A office in a growth market like Florida is performing vastly differently than a Class B asset on Third Avenue in New York City. As another example of the idiosyncratic nature of the real estate market, a multi-family asset financed with long-term, fixed rate agency debt is worth more than the same asset bought with unhedged floating rate debt. Further, demand growth continues in several sectors including digital infrastructure and logistics while residential demand also remains strong in the face of limited supply. These countervailing forces did not exist in prior cycles or were not relevant to the portfolios held at that time.

However, declining debt availability, rising interest rates and increasing expenses have put pressure on

---

1Fund managers that accept only a limited number of investors and/or were oversubscribed in their last vintage fund. The assessment of whether managers are capacity-constrained is based on CF Private Equity’s internal database, qualitative assessment and conversations with managers and has not been independently verified.

2Jefferies, Global Secondary Market Review January 2023
growing revenue. Transaction volume has declined dramatically as bid/ask spreads remain wide. Sector pricing dispersion is high with cap rates for favored sectors such as logistics trading historically rich versus its consumer spending counterpart, retail strip centers. While these forces impact current portfolios in various ways, they are creating opportunities for high quality asset managers to deploy capital into stressed and distressed opportunities, particularly into deals with pending debt maturities.

Access to low-cost, secure, domestic sources of energy and resources continued to dominate the headlines over the past year. While shortages eased, the threat of supply disruptions from the combination of the ongoing war in Ukraine, U.S.-China trade tensions, sustained under-investment in upstream supply, and general supply chain issues persisted with the specter of volatility remaining in play for many major commodities. Even as some inflationary pressures have begun to ease, the potential for a fundamental lack of supply for energy, agricultural products and critical minerals remains a concern going forward. We believe there will continue to be a need for investment across the spectrum into energy including both conventional resources and those associated with the energy transition. We also see opportunities in other areas with favorable supply/demand and sustainability dynamics like food, agriculture and water, and broader resource efficiency. Furthermore, regulatory tailwinds, like the Inflation Reduction Act, only add to the potential benefits companies and investments stand to realize in this environment as governments are increasingly focused on resource security and onshoring supply chains.

Fixed Income and Credit

The fiscal year presented a challenging environment for Fixed Income investors. Yields, spreads, and currencies all proved to be volatile as uncertainty around the economic and geopolitical backdrop kept investors guessing throughout the year. From a sector perspective, investors were rewarded for taking corporate credit risk as investment grade bonds, high yield bonds and broadly syndicated loans all generated positive total and excess returns for investors willing to take on corporate credit risk in an uncertain environment. Generating the best outcome was floating rate debt, which benefited from the tail wind of the Fed’s tightening cycle. Aside from these sectors, Treasuries and securitized debt proved to be less accommodative to investors, while the dollar generally weakened relative to non-U.S. currencies. Given the speed of the tightening cycle that was largely unanticipated by many borrowers, corporate credit defaults began to ramp up as time progressed. While still broadly benign relative to long-term historical averages, we expect this trend will continue. We and our managers remain vigilant on our positioning in this environment.

Hedge Funds

On top of positive performance generated in 2022, Hedge funds again performed positively over the first half of 2023, with individual strategy returns reflecting several notable shifts in market conditions from the year that preceded it, particularly in single stock and credit-oriented strategies.

While the backdrop featured an equity market that trended upward, this was also widely viewed from a fundamental perspective with skepticism, and managers’ risk appetite was sporadic, a partial contributor to several reversals. The period surrounding the failure of Silicon Valley Bank had a particularly acute impact on Macro strategy returns. Common short rates and fixed income positioning put many managers on the wrong side of a strong reversal. The result - just a few days in March had a disproportionate impact - and was one key driver of macro being the bottom performing strategy category year-to-date.

Meanwhile, for stock-picking strategies such as equity market neutral and equity hedge, a rise in cross-sectional dispersion across equities marked a notable (and generally welcome) sense of relief from last year’s
macro-driven environment. As a result, managers increased their gross exposures relative to last year, reflecting a more sanguine outlook for single-name stock-picking and return potential of idiosyncratic risk as opposed to macro-driven equity risk.

Relative value credit similarly has presented increasingly compelling opportunity sets in single-name selection, with market factors including rising volume of new issuance, approaching corporate maturities, and a better outlook for special situations. Many of these opportunity sets are likely to expand further through the second half of the year.

Closing Thoughts and Developments at Commonfund

As we are now almost two years removed from the worst of Covid, we find that a hybrid work environment is part of our current business reality. Through the journey of Covid and societal lockdowns, we learned that the reduction in commuting time improved productivity and efficiency for many of our team members. Yet, we recognize that we still need the third dimension of in-person meetings to maintain and grow our culture of investment excellence and exceptional client service. As a result, we are back to a three-day week in the office with two flex days at the discretion of each team leader to gather her/his team in the office or virtually based on economy, workflow, and team building.

As we welcome our largest group of summer interns (25!), we are keenly aware that mentoring and training is a three-dimensional experience. Video meetings are great for efficiency but educating Commonfund's next generation requires the interpersonal interaction that only comes with in-the-office training.

And, speaking of our interns, this is our most diverse group yet. Forty percent of our interns are women and over 50 percent are people of color and other minorities. As we look to build Commonfund's next generation of leadership, our intern program truly reflects the inclusive and diverse tapestry of our broader society.

As a closing thought, I would like to thank all our attendees who made the effort to join us for our annual Forum in Boca Raton. Sue Herera did her typically wonderful job as moderator and emcee to kick us off while the Commonfund staff worked hard to cook up perfect weather, great food, incredible speakers, and fun events. In all, we had over 300 clients representing approximately $850 billion in assets, from 7 countries and 46 states. In addition, we had 47 speakers providing insightful and thought-engaging ideas across 30 different panels, presentations, breakout sessions, and discussion groups. Next year we will be at the JW Marriott Grande Lakes in Orlando, Florida, March 10-12, 2024. Please mark the dates on your calendars and I hope to see all of you during the next year.

Thank you for your partnership and trust in Commonfund.

Mark Anson and the Commonfund Investment Team
Certain information contained herein has been obtained from or is based on third-party sources and, although believed to be reliable, has not been independently verified. Such information is as of the date indicated, if indicated, may not be complete, is subject to change and has not necessarily been updated. No representation or warranty, express or implied, is or will be given by The Common Fund for Nonprofit Organizations, any of its affiliates or any of its or their affiliates, trustees, directors, officers, employees or advisers (collectively referred to herein as “Commonfund”) or any other person as to the accuracy or completeness of the information in any third-party materials. Accordingly, Commonfund shall not be liable for any direct, indirect or consequential loss or damage suffered by any person as a result of relying on any statement in, or omission from, such third-party materials, and any such liability is expressly disclaimed.

All rights to the trademarks, copyrights, logos and other intellectual property listed herein belong to their respective owners and the use of such logos hereof does not imply an affiliation with, or endorsement by, the owners of such trademarks, copyrights, logos and other intellectual property.

To the extent views presented forecast market activity, they may be based on many factors in addition to those explicitly stated herein. Forecasts of experts inevitably differ. Views attributed to third-parties are presented to demonstrate the existence of points of view, not as a basis for recommendations or as investment advice. Market and investment views of third-parties presented herein do not necessarily reflect the views of Commonfund, any manager retained by Commonfund to manage any investments for Commonfund (each, a “Manager”) or any fund managed by any Commonfund entity (each, a “Fund”). Accordingly, the views presented herein may not be relied upon as an indication of trading intent on behalf of Commonfund, any Manager or any Fund.

Statements concerning Commonfund’s views of possible future outcomes in any investment asset class or market, or of possible future economic developments, are not intended, and should not be construed, as forecasts or predictions of the future investment performance of any Fund. Such statements are also not intended as recommendations by any Commonfund entity or any Commonfund employee to the recipient of the presentation. It is Commonfund’s policy that investment recommendations to its clients must be based on the investment objectives and risk tolerances of each individual client. All market outlook and similar statements are based upon information reasonably available as of the date of this presentation (unless an earlier date is stated with regard to particular information), and reasonably believed to be accurate by Commonfund. Commonfund disclaims any responsibility to provide the recipient of this presentation with updated or corrected information or statements. Past performance is not indicative of future results. For more information please refer to Important Disclosures.