commonfund

Fiscal Year-End and Mid-Year 2022
Market and Investment Review

July 6, 2022

As we reflect on fiscal year 2022, it is hard to attribute a single narrative to two distinctly different six-month periods. In Anna Karenina, Leo Tolstoy posited that "All happy families are alike; each unhappy family is unhappy in its own way." Investors likely resembled the former as 2021 ended and risk assets, from equities to credit spreads to cryptocurrencies, continued to outperform and interest rates remained low. However, the turn in sentiment in the second half of the fiscal year was palpable, and the "unhappiness" of the investor community continued to rise with no asset class, risky or riskless, left unscathed.

Inflation Rears its Ugly Head

A year ago, economic data was broadly positive, and corporate earnings were supported by the consumer emerging from the pandemic lockdowns. Businesses were reopening at a brisk pace while accumulated personal savings were the dry powder set to propel domestic growth. It was evident that monetary and fiscal policy efforts deployed at the depths of the pandemic had served their purpose although the accelerating inflation that emerged would be the next obstacle that global central banks would have to confront. Now, it is evident they were too slow to act. This became more apparent to investors as the new calendar year began with inflation reaching 7 percent. It has continued to rise every month since.

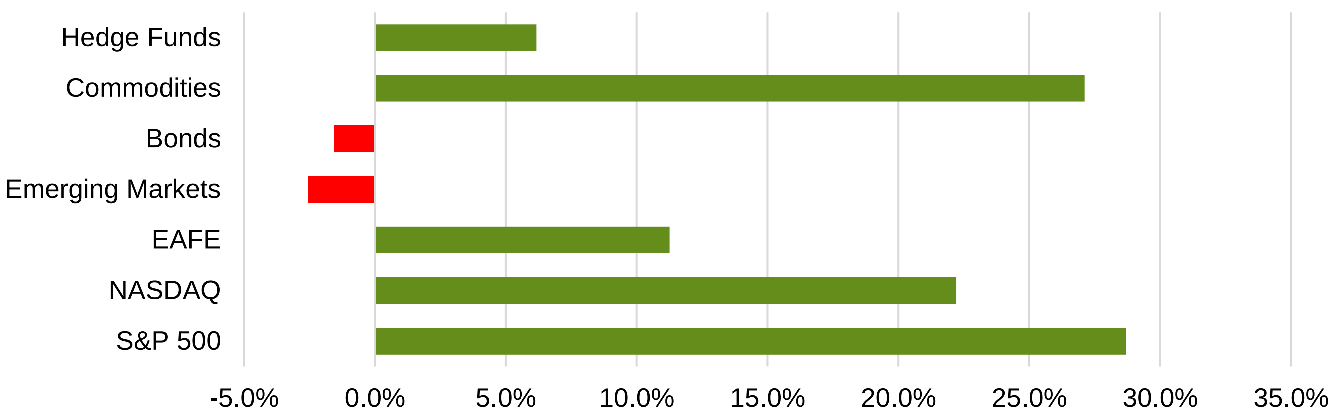
While supply chain woes are often cited as the main culprit of rising inflation, recent data shows that multiple components, including food, energy, shelter, and wages, are to blame. As a result, despite the Federal Reserve embarking on quantitative tightening via interest rate increases and a reduction in the balance sheet, there is still a lot of work the central bank must do to lower prices. The labor market and wage growth are too strong for the Fed to justify slowing its hiking cycle. The challenging economic circumstances have also dispelled the idea that market volatility will result in the execution of the "Fed Put" to protect investors. As of June 30th, consumer sentiment data shows long-term inflation expectations rising to 3.1 percent, which suggests that higher inflation is becoming anchored in the eyes of the consumer. All of this will make the FOMC's task more challenging. At the June FOMC meeting, central bankers voted to increase the Federal Funds rate by 75 basis points, the largest rate hike since 1994, moving market expectations for the remainder of the year and signaling an increased commitment to bringing down inflation. The market is currently pricing 175 basis points of additional hikes between now and year-end with four meetings left. Ultimately, the most effective tool the central bank has is communication and, coupled with policy actions, they must remain steadfast in the goal of achieving price stability.

Stocks and Bonds Take a Turn for the Worse

It is tempting to draw parallels to past market environments with the hopes of finding the outcome and optimal solution. However, whether it is a tech bubble, credit crisis or pandemic, each situation, and each remedy, is unique. The United States is in an inflationary environment not experienced in over 40 years. The era of zero rates that fueled risk assets is coming to an end as the business cycle moves past its peak. The difficulty of resolving today's issues has been manifested by the strong sell-off in financial assets in 2022.

THE RE-OPENING RALLY CONTINUED INTO 2021

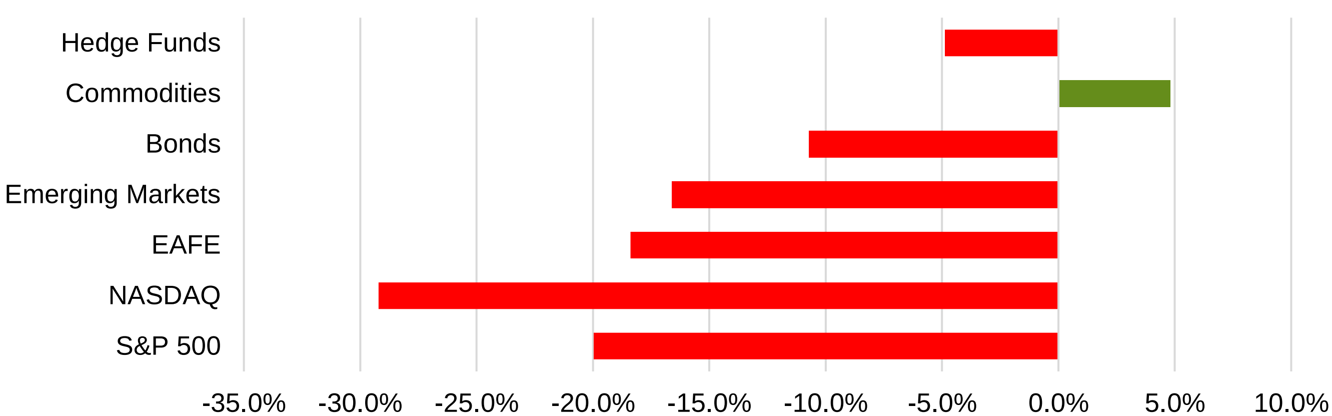
2021 Index Returns



NOTE: Hedge fund returns based on HFRI HFOF Composite. Commodities based on S&P Large/Mid Cap Commodity and Resource Index. Bonds based on Bloomberg Barclays Aggregate Bond Index

BUT (VIRTUALLY) NO PLACE TO HIDE THIS YEAR

Year-to-date index returns (as of 6/30/2022)



NOTE: Hedge fund returns based on HFRI HFOF Composite as of 5/31/2022. Commodities based on Bloomberg Commodities Index. Bonds based on Bloomberg Barclays Aggregate Bond Index

Growth companies that relied on low-cost debt financing to grow operations, but have yet to achieve profitability, have seen their equity prices tumble. Non-cyclical sectors, like healthcare and consumer staples, have not been immune to the indiscriminate selling, however, they tend to fare better as they are less dependent on the business cycle. This is evident in their relative outperformance versus the broader indices. The Russell 1000 Value Index has outperformed the Russell 1000 Growth Index by nearly 15 percent on a year-to-date basis. These indices are representative of the rotation that has taken place as the value index is composed of companies with low price-to-book ratios and high dividend yields while the growth index is composed of companies in rapidly expanding industries with higher price valuations. Much of the equity market weakness in 2022 has been the risk-off trade reflected in equity prices even though the earnings outlook has remained mostly intact. On the surface, this dynamic could make company valuations more attractive. However, as the economy slows, we expect corporate earnings will as well, which will be a point of focus for the remainder of the year.

PRICE TO EARNINGS DOWN EVEN AS EARNINGS REMAIN POSITIVE

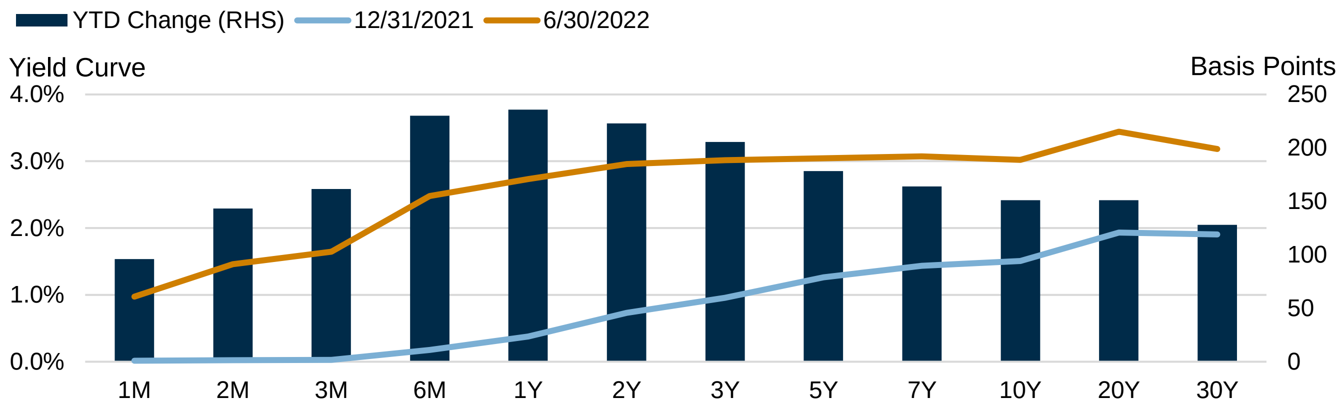
S&P 500 P/E Compression | EPS vs. PE growth

			Attribution	
	P/E	**2022 Return**	**EPS %**	**PE %**
S&P 500	16.8	-18.2%	5.0%	-23.2%
Energy	11.8	45.8%	35.3%	10.5%
Utilities	20.2	-0.5%	1.9%	-2.4%
Materials	14.8	-9.0%	4.9%	-13.9%
Consumer Staples	19.5	-9.2%	1.7%	-10.9%
Health Care	15.4	-9.2%	2.2%	-11.4%
Industrials	17.2	-14.5%	3.2%	-17.7%
Financials	12.1	-15.8%	2.4%	-18.2%
Real Estate	40.5	-19.4%	6.2%	-25.6%
Information Technology	19.7	-25.3%	6.9%	-32.2%
Communication Services	14.9	-27.4%	0.4%	-27.8%
Consumer Discretionary	21.5	-30.7%	1.6%	-32.3%

Source: Piper Sandler. As of May 19, 2022.

Perhaps, the most disappointing impact on investor portfolios is the deeply negative returns in the fixed income markets. As we approach June 30th, the benchmark Bloomberg U.S. Aggregate Total Return Index is on pace to have its worst year ever largely due to a selloff in U.S. Treasuries. Clearly, the moniker "risk free asset" refers to credit risk and not interest rate risk. After a benign decade coupled with low interest rates, investors have seen rates increase almost 200 basis points across the U.S. Treasury curve, acknowledging less accommodative monetary policy. Only recently have the corporate credit markets begun to follow suit as corporate yields have started to move higher on the expectation of increased credit risk. Investment grade debt is more exposed to interest rate movements as compared to high yield bonds due to longer maturities and thus higher duration or interest rate risk. Conversely, high yield bonds react more to the economic cycle and a weakening economic outlook, which drives credit spreads—the compensation for credit risk—wider. The yield on the benchmark Bloomberg High-Yield Index is currently at levels last seen in the depths of the global financial crisis and higher than the rate in the March 2020 pandemic rout. Importantly, while signs of stress are starting to seep into corners of the credit markets, this move in junk yields is much more reflective of the movement in U.S. Treasury yields than credit spread. Currently, high yield credit spreads are not particularly elevated relative to longer term averages. This suggests that while the high yield opportunity set may be compelling on a yield basis, on a spread basis investors are not being paid meaningfully more at this juncture for this type of credit risk—relative to long term averages—warranting caution.

U.S. TREASURY YIELD CURVE



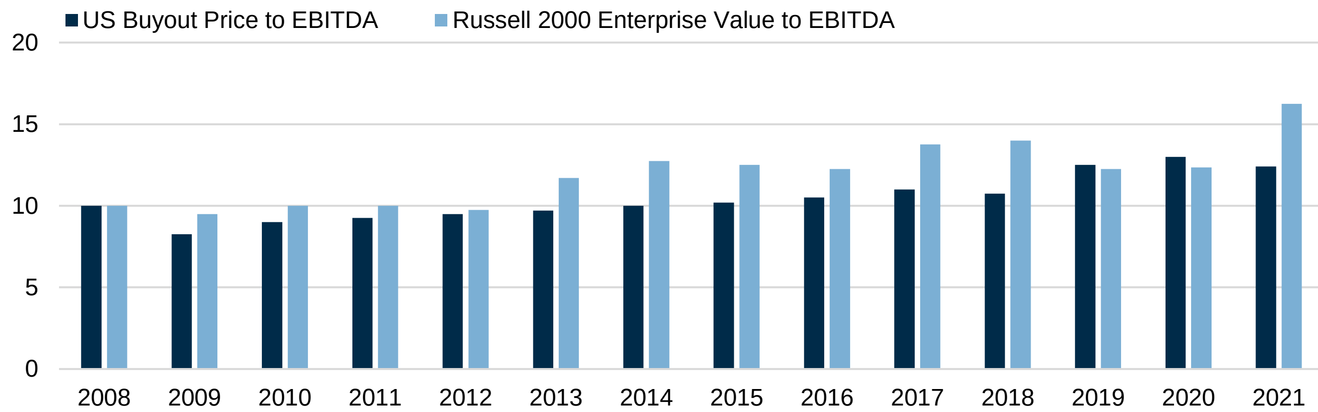
Source: Bloomberg

Diversification Works Again

Diversifying away from traditional asset classes has been a benefit to investors. Hedge funds broadly have dampened portfolio volatility. However, not all hedge fund strategies have outperformed. Equity hedge and event driven strategies performed well as we completed 2021 but have struggled more recently. In 2022, macro managers that can move across asset classes, including commodities, have excelled, as have equity hedge funds that are oriented more toward value and fundamentals. Incorporating real assets into a portfolio was also beneficial as investors have seen outsized returns in the energy markets this year. In fact, the only positive performing sector in the S&P 500 year to date is energy. For market participants with the flexibility to take on illiquidity, private credit remains a compelling opportunity. In this space, investors can generally obtain a yield advantage relative to public market credit, thorough diligence/underwriting of the borrower, attractive default and recovery characteristics and more stable valuation due to the general non-marketability of the debt.

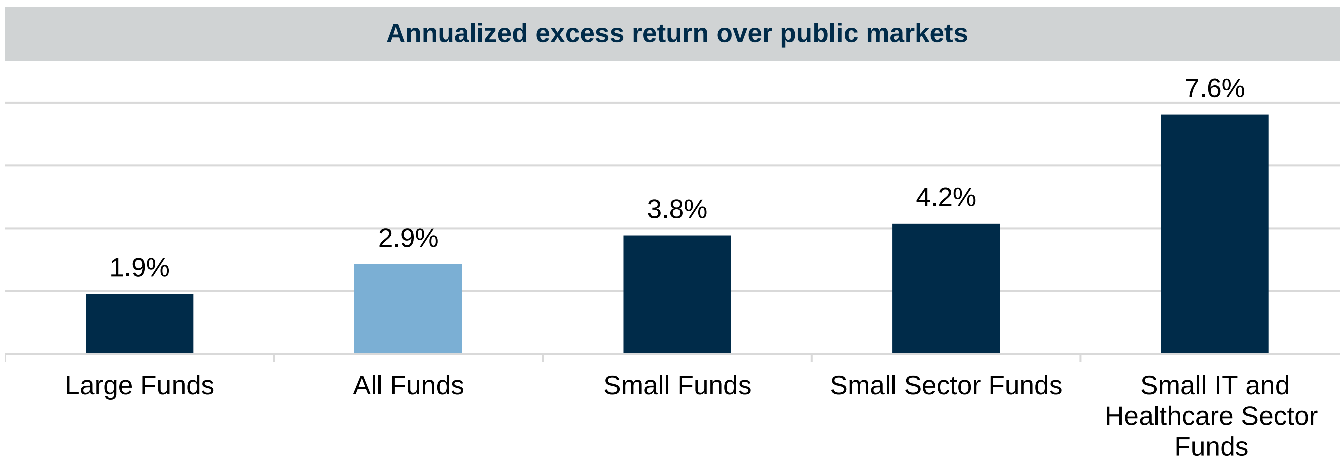
Private equity valuations have risen considerably, rewarding investors, however, the significant amount of capital invested in these strategies, coupled with their ability to deploy capital throughout the whole business cycle, makes them well positioned to benefit from the current dislocations. Returns to private strategies over the past two years have been extraordinary and investors should expect to see valuations moderate going forward as the lagged prices in these portfolios catch up with market realities. Nonetheless, we continue to find compelling opportunities in early-stage venture capital, buyouts and real assets and sustainability strategies globally. In addition to primary investments with leading managers, selective co-investments allow for the potential of more concentrated positions in companies. Secondaries continue to be a rapidly growing part of the market opportunity set and contribute meaningfully to investor portfolios. Our approach continues to focus on smaller sector-oriented funds as we believe they provide the best opportunity to earn the liquidity premium and capture manager alpha.

VALUATION MULTIPLE FOR PRIVATE EQUITY AND PUBLIC EQUITY



SECTOR-FOCUSED AND SMALLER FUNDS OUTPERFORM

Private Equity | December 31, 2021



Past performance is not indicative of future performance. Large funds are private equity funds over $5 billion; small funds represent private equity funds under $1 billion; small sector funds are private equity funds under $1 billion that are sector funds (versus generalist) and: small IT and Healthcare sector funds represent private equity funds under $1 billion that focus on the IT and Healthcare sectors. Source: Burgiss. Represents all US Private Equity funds (including all “Equity” funds excluding venture capital) across vintage years 2002-2016 as determined by Burgiss. The Annualized Excess Return is calculated using the pooled Gredil, Griffiths and Strucke Direct Alpha method compared against the S&P 500. The calculation was performed by Burgiss.

A Challenging Global Economic Outlook

While much of the discussion has focused on the domestic market environment, we would be remiss to not acknowledge global factors that are also impacting investors. It would have been a difficult investment environment if only borrowing costs were rising this year. However, this has been compounded by global instability and the remnants of the pandemic in certain sections of the world. Notwithstanding the humanitarian tragedy, the Ukraine/Russia war pushed already elevated prices higher for food and energy. Close to 50 nations are dependent on Russia and Ukraine for over 30 percent of their wheat imports and these two countries are some of the largest exporters of maize, rapeseed, barley, and sunflower oil. Also, Europe gets roughly 40 percent of its natural gas and more than 25 percent of its oil from Russia. This conflict will continue to inflict significant economic damage throughout Europe in an already difficult environment which may result in a recession for the Euro area. In China, the adherence to “zero-covid” policies is severely impeding efforts to achieve the stated growth targets set forth at the National People’s Congress. As for the United States, the intentional slow-down of the domestic economy will make previous estimates of mid-single digit real GDP growth seem aspirational as the year progresses, but a recession may still be avoidable. In this particularly difficult global growth environment, the road ahead is riddled with obstacles.

Stay the Course

Looking forward, although it is difficult to envision a quick resolution to the current market dislocation, it is important to reaffirm the benefits of a long-term strategic investment policy. Portfolios are designed to meet the mission of organizations in perpetuity. It is natural for investors to fall victim to recency bias and focus on short-term portfolio volatility. However, the true risk to an organization is not being able to meet its obligations. Diligently reviewing spending policies, assessing a portfolio's illiquidity budget and, perhaps most importantly, diversifying an investment portfolio across asset classes, are the key steps to achieving consistent long-term growth. Our research shows that diversifying across illiquid and liquid strategies greatly enhances a portfolio's ability to achieve intergenerational equity. The financial markets are a real-time indicator of how much the investing environment is changing, however, we believe the current volatility will prove episodic. Strategic policy allocations are designed to withstand periods such as these and should evolve to harness the market environment of the future.

Closing Thoughts and Developments at Commonfund

While we still battle the last remnants of Covid across the country, Commonfund is fully open for business. We never really closed our doors, but after two years of a virtual-only environment, we were ready to re-occupy our offices at the beginning of the calendar year. In fact, our New York offices have become so popular that we are now at capacity on a daily basis.

Looking forward, we expect a hybrid work environment to be part of our business reality. We discovered from many of our team members that the reduction in commuting time improved both their productivity and their efficiency. At the same time, we recognized that while you can maintain the culture of an organization in the 2D space of computer screens, you still need the 3D space of in-person meetings to grow, nurture, mentor and build the culture of a professional organization.

I would like to thank all our clients who made the effort to join us for our annual Forum in Orlando, Florida. It was a great event (as always!) with Sue Herera from CNBC as our emcee, plenty of sunny weather, great networking, excellent food, and fun and interesting panels. In all, we had over 400 clients representing almost $200 billion in assets under management with 40+ speakers spread across 23 sessions providing thoughtful content. Please mark on your calendar for next February 13-15 at The Boca Raton resort in Florida.

As a closing thought, I would like to take a moment to speak on Diversity. At Commonfund, we focus on "do" instead of "should" when it comes to our Diversity Model: Diversity in our workforce, Diversity in our investment portfolios and Diversity in our thought leadership. As one datapoint, we have 26 interns at Commonfund this summer—the potential future leaders of our firm. Over 50 percent of our intern class are women and over 50 percent are People of Color. We work hard every day to ensure that Diversity is embedded into every facet of our business model.

Finally, we want to thank you for your partnership and trust in Commonfund. We are committed to earning it every day.

Mark Anson and the Commonfund Investment Team

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