Year-End Update and 2019 Investment Outlook

What A Long, Strange Trip It’s Been

commonfund
Table of Contents

A Message From Our CEO 1
2019 Investment Outlook 3
Interest Rates and Central Bank Policy 5
Economic Growth and Earnings Outlook 6
Inflation 7
Policy Risk 8
Portfolio Positioning 10
Engaging the Whole Organization 11

About Commonfund

Commonfund was founded in 1971 as an independent asset management firm with a grant from the Ford Foundation. Together with or through its affiliates, Commonfund today manages customized investment programs for endowments, foundations and public pension funds. Among the pioneers in applying the endowment model of investing to institutional portfolios, we provide extensive investment flexibility using independent investment sub-advisers for discretionary outsourcing engagements, single strategies and multi-asset solutions. Investment programs incorporate active and passive strategies in equities and fixed income, hedge funds, real assets and private capital. All securities are distributed through Commonfund Securities, Inc., a member of FINRA. For additional information about Commonfund, please visit www.commonfund.org.
As we bid farewell to 2018 and head into 2019, I am pleased to provide you with an update on developments at Commonfund as well as our perspective on the markets and investing. Our roots as a not-for-profit organization dedicated to advancing the financial interests of institutional investors provide us with a close relationship with our clients. That mission, combined with our ongoing conversations with you, has shaped our priorities for 2019 and beyond:

- Client focus
- Investment stewardship
- Diversity
- Sustainability

**Client Focus**

One of the things we are most proud of at Commonfund is the close relationship that we foster with each client and the resulting deep understanding of the unique requirements of each organization with whom we work. This understanding informs our relationships with clients and we work diligently to continuously improve them.

For that reason, we were extremely gratified to be recognized in multiple categories for the third year in a row in the 2018 Cogent Reports™ US Institutional Investor Brandscape Study. The Study is based on the survey responses of 374 institutional investors with assets of $100 million or greater.

Highlights from the report include:

- Commonfund was named as one of the top 10 most trusted institutional asset managers
- Ranked #1 in relationship management and client service
- Ranked #1 for ESG and Impact Investing

**Investments**

Following this letter is our 2019 Investment Outlook. In it, our 63-person investment team, led by Peter Burns (Private Capital), Kris Kwiat (Public Markets) and Deborah Spalding (Asset Allocation), shares our views and our portfolio positioning.

After years of low interest rates, low volatility and steadily rising stock markets, we saw distinct turns in each of these areas – reflecting the late stage of the economic cycle. We cannot predict when this growth cycle will end, nor can we prevent its demise. However, we can prepare for the inevitable market downturn. Our recent emphasis on a “Crisis Playbook” and the incorporation of drawdown risk into our client portfolios are two ways that we are preparing for whatever the business cycle might throw in our path.

Be assured that our investment teams around the world are working diligently to identify and incorporate managers and strategies that can potentially add resilience and contribute alpha to the portfolios we construct on your behalf. We also continue to look for opportunities to control costs as we understand that every basis point saved contributes directly to the performance of your portfolio and the missions that you serve.

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1 For more information about the Study please see IMPORTANT NOTES | Survey Rankings (www.commonfund.org/important-disclosures/#survey_rankings)
Diversity

In August I communicated our intent to increase our commitment to diversity and inclusion as we believe they are key factors that will contribute to our success and that of our clients. Subsequently, our senior management team determined that an approach which incorporates this initiative into the very fabric of our business would be most effective.

To that end, we have created the Commonfund Diversity and Inclusion Office. The Office encompasses our external manager selection process, our own workforce, and our thought leadership. Caroline Greer, Managing Director in our Strategic Solutions Group, will serve as the inaugural chairperson of the Office. Joining Ms. Greer on the Diversity team will be George Sutlles, Managing Director and Director of Research for the Commonfund Institute, and Elaine Mizer, Chief Human Resource Officer.

The Office will serve as a resource and clearinghouse of information for diversity in the asset management industry broadly. Specific initiatives that the Office will pursue include promoting the importance of diversity and inclusion in endowment and foundation governance, sourcing and placing diverse managers within client portfolios, and providing firm-wide opportunities for professional and organizational development. It also reaffirms Commonfund’s belief that diversity is a crucial component in both developing a dynamic workforce and constructing robust investment portfolios.

Sustainability

We are committed to working with our clients to integrate ESG and sustainability into their investment portfolios consistent with their needs and preferences. To illustrate our own commitment, we published our first Corporate Responsibility Report this past year (available at commonfund.org). The Report details the work being done across all aspects of our business to incorporate responsible and sustainable practices.

Also, we developed our first screened global equity strategy this year designed for our clients that have faith-based missions and mandates. Importantly, this strategy is benchmarked to the unscreened MSCI All Country World Index. This reflects our belief that investors seeking to align their portfolio with their mission should not have to compromise their risk and return expectations. Stay tuned for more initiatives to come.

Closing Thoughts

2019 marks the 50th anniversary of the publication of two seminal studies by the Ford Foundation, “The Law and Lore of Endowment Funds” and “Managing Educational Endowments.” These studies established the foundation upon which Commonfund was built and paved the way for institutions to adopt the more sophisticated investment practices of today. At Commonfund Forum 2019 we will chronicle the evolution of investing over the past 50 years and will look ahead to show how small steps can lead to giant leaps when stewarding perpetual capital. We hope that you will join us in March in Orlando, Florida.

As always, we are honored by the trust that you have placed in Commonfund to manage the assets of your institution. It is a responsibility that drives us to be excellent every day.

Mark Anson
Chief Executive Officer and Chief Investment Officer
As we close out 2018, we look back on the year and are reminded of the famous Grateful Dead lyric, “lately it occurs to me, what a long strange trip it’s been.” After years of steady gains, investors began to question the sustainability of the extended bull market cycle. Volatility, as compared to recent history, not only spiked but persisted throughout the year as investors repriced risk across portfolios. Sentiment shifted back and forth, with downside volatility in the first and fourth quarters obscuring what was generally a positive market environment during the middle of the year.

Despite the negative commentary, conditions remained supportive, particularly in the United States. Corporations continued to announce increases in top- and bottom-line results, job creation was strong, and household balance sheets and consumer spending remained healthy. Still, with the Federal Reserve ending its accommodative stance, investors wagered whether the pace of rate increases would simply cool the economy or push the United States into recession. And as the drumbeat of a trade war reverberated louder, investors turned their attention to a post-tax cut world and questioned whether growth could continue at such a vigorous pace. Not surprisingly, this did not create a favorable environment for either stocks or bonds.

**The United States Continued to Lead the Way in 2018**

What resiliency we did see in markets was largely confined to the United States. This came as no surprise given the relative strength of the domestic economy. Emerging market equities, on the other hand, declined month after month following an eight percent jump in January. Slower growth in China, a stronger U.S. dollar and falling commodity prices created a headwind for emerging markets that had just come off a two-year rally. Countries like Turkey, which had boasted impressive growth over the past few years largely fueled by a weaker U.S. dollar, faced higher debt service costs due to rising U.S. interest rates and slowing exports. International developed markets also struggled. Accommodative policies in Europe failed to stimulate consistent growth and inflation while political battles, including Brexit in the United Kingdom and Italy’s impasse with the European Union over its budget, left investors wondering when, and if, the international markets would finally catch up to the United States.

**2019 Investment Outlook**

What a long, strange trip it’s been.
Nowhere to Hide

We see conflicting data and jittery investors as a normal part of late cycle conditions. And so, we were not surprised to see unsteadiness in the markets, particularly given the protracted period of low volatility since the financial crisis. What was striking to us, however, was that in this latest market rout, there was nowhere to hide. Figure 1 shows the best performing asset class for each year going back to 2000. In 2018, the best performing asset class, U.S. Bonds, was 0.01 percent, which was the lowest over the past nineteen years.

**Figure 1**

**NOT MUCH WORKED IN 2018**

<table>
<thead>
<tr>
<th>Year</th>
<th>U.S. Bonds</th>
<th>Emerging Markets Equity</th>
<th>U.S. Equity</th>
<th>Real Estate</th>
</tr>
</thead>
<tbody>
<tr>
<td>2018</td>
<td>0.01</td>
<td>37.8</td>
<td>5.2</td>
<td>13.9</td>
</tr>
<tr>
<td>2017</td>
<td>12.0</td>
<td>30.1</td>
<td>18.2</td>
<td>26.4</td>
</tr>
<tr>
<td>2016</td>
<td>3.2</td>
<td>32.4</td>
<td>28.0</td>
<td>26.4</td>
</tr>
<tr>
<td>2015</td>
<td>8.3</td>
<td>78.5</td>
<td>39.4</td>
<td>55.8</td>
</tr>
<tr>
<td>2014</td>
<td>13.9</td>
<td>35.1</td>
<td>34.0</td>
<td>31.6</td>
</tr>
<tr>
<td>2013</td>
<td>10.3</td>
<td>31.6</td>
<td>37.8</td>
<td>26.4</td>
</tr>
<tr>
<td>2012</td>
<td>13.9</td>
<td>30.1</td>
<td>39.4</td>
<td>55.8</td>
</tr>
<tr>
<td>2011</td>
<td>13.9</td>
<td>32.4</td>
<td>37.8</td>
<td>26.4</td>
</tr>
<tr>
<td>2010</td>
<td>13.9</td>
<td>30.1</td>
<td>39.4</td>
<td>55.8</td>
</tr>
</tbody>
</table>

Source: Bloomberg and NAREIT. U.S. Equity=S&P 500 Index; Emerging Markets Equity=MSCI Emerging Markets Index; U.S. Bonds=Bloomberg Barclays Capital U.S. Aggregate Bond Index; Real Estate=NAREIT Equity Index

The primary purpose of a diversified portfolio is to ensure that as one asset class underperforms, others compensate to help mitigate the effect of downward moves and volatility. In 2018, however, the diversification benefit failed to materialize. One likely explanation is that investors had little conviction in their outlook for asset prices. Bonds were deemed risky as short-term rates rose and the yield curve flattened. Equities appeared overvalued, and P/E multiples contracted in anticipation of slower growth. Real assets struggled under weak commodity prices. And, many hedge funds rode markets down due to high market exposure in their aggregate positions.

In short, 2018 was a challenging year for institutional investors that sought to achieve annual returns sufficient to fund spending and keep pace with inflation. While investors understand that this is a long-term target not necessarily to be achieved in any given year, the developments of 2018 gave them cause for concern. Like the song says, “Sometimes your cards ain’t worth a dime...”

2019 Market Outlook and Positioning

Of the many questions on investors’ minds going into 2019, the one we hear most often is, “where are we in the cycle?” It’s an important question given we have been in a bull market since 2009, which is the longest market run in the careers of most professional investors. The centuries old proverb, “all good things must come to an end,” is in the forefront of everyone’s minds. In fact, this proverb has been uttered numerous times over the past few years as investors have become increasingly more tentative about being invested in assets achieving new highs on a regular basis.

The sharp market moves in the fourth quarter served to stoke that anxiety, which is more acute than usual for behavioral reasons. Simply put, investors have forgotten what volatility feels like. Years of steady upward moves, with only small temporary pullbacks, have led to “muscle memory loss” and the inability to look through short-term volatility. Figure 2 shows the number of days that the market moved +/- 1 percent over each of the last twenty years. Clearly, the experience of the second half of 2018 is more in-line with the historical norm (though still below average) than it is the exception. And that uncomfortable market environment has made many investors react based more on sentiment than economics.

That is not to say that we should ignore market signals. We too watch the news flow to determine whether we are aligned with investor behavior and whether our own expectations deviate from conventional wisdom. So, in answering the question, “where are we in the cycle?”, we would say that we are getting close to the end. Trying to
predict the next recession has become a popular pastime of financial news pundits. However, barring a shock to the global economy, we believe a recession in 2019 is unlikely. That is not to say that the U.S. economy will continue to grow at the pace we saw in 2018 in which GDP grew nearly three percent in real terms, but conditions do generally support continued growth. Nevertheless, the drivers of strong economic growth, including deregulation, accommodative interest rates, and moderate input costs have largely run their course. As the U.S. Federal Open Market Committee (FOMC) ends its accommodative stance, higher interest rates are likely to increase pressure on both corporations and the consumer. As the economy slows and lending standards tighten, we could see credit spreads widen in 2019.

While we feel that it is a fool’s game to try and call the top of the cycle, we are carefully watching several indicators to determine our late cycle tactical positioning. Today, our four key areas of focus are:

1. Interest rates and central bank policy
2. Economic growth and earnings outlook
3. Inflation
4. Policy risk

**Interest Rates and Central Bank Policy**

Since December 2015, the FOMC has hiked rates nine times, bringing the Fed Funds upper bound from 0.25 percent to 2.50 percent. We have started to see the impact on the consumer of higher borrowing costs for housing, autos and revolving debt. Given that consumer spending accounts for about 70 percent of GDP, we would expect that higher rates will create a headwind for economic growth in the coming year, even if the Fed is near the end of its rate hiking cycle. While some of this may be mitigated by lower fuel prices and increased tax refunds, the trend is towards more pressure on the consumer.

It is important to remember that we are coming from an environment of interest rates close to zero. Like low volatility, investors have become accustomed to low rates, and it is too easy to forget that such a long period of ultra-low rates is the exception rather than the norm. The Fed is aware of this and has approached rate increases in a measured and consistent fashion thus far. During the tumultuous fourth quarter of 2018, the Fed projected a softer message as the economy digested higher rates, signaling the Committee is moving from relentless quarterly rate hikes to a more data-dependent stance.

![Figure 2](image-url)
In 2018, we saw 10-year bond yields rise from 2.40 percent to as high as 3.25 percent in November before falling back to 2.68 percent by year-end. Should long-term rates resume rising, stocks will increasingly have to compete with bonds for investor dollars. However, as seen in Figure 3, the earnings yield of the S&P 500 Index remains well above the 10-year Treasury yield, suggesting that stocks remain relatively attractive.

**Figure 3**

**STOCKS REMAIN RELATIVELY ATTRACTIVE VS. BONDS**

Numbers in percent | As of December 31, 2018

<table>
<thead>
<tr>
<th></th>
<th>10-Year Treasury Yield</th>
<th>S&amp;P 500 Current Earnings Yield</th>
</tr>
</thead>
<tbody>
<tr>
<td>1988</td>
<td>5.86</td>
<td>2.68</td>
</tr>
<tr>
<td>1993</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1998</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2003</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2008</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2013</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2018</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Bloomberg

Going into 2019 we are more concerned with the shape of the yield curve. While the U.S. interest rate curve has been in a flattening trend for some time, the trend accelerated into the end of the year. Typically, the yield curve flattens at the end of the hiking cycle. This causes a concern that the curve may invert, which is historically a predictor of a recession in the next nine to twelve months. In November there was a partial inversion in the two- to five-year portion of the curve but, as shown in Figure 4, we have not seen the full yield curve invert. It is helpful to the market that long-term rates remain contained, and with inflation under control and moderate real growth, we see the yield curve remaining quite flat with only a moderate risk of inversion in the second half of 2019 or in 2020.

**Figure 4**

**A POTENTIAL YIELD-CURVE INVERSION?**

As of December 31, 2018

basis points

<table>
<thead>
<tr>
<th></th>
<th>10-Year — 3-Month Yield Spread</th>
<th>10-Year — 2-Year Yield Spread</th>
<th>NBER Recession Periods</th>
</tr>
</thead>
<tbody>
<tr>
<td>1976</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1980</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1984</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1988</td>
<td></td>
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<td></td>
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<tr>
<td>1992</td>
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<td>1996</td>
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<td></td>
<td></td>
</tr>
<tr>
<td>2000</td>
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<td>2004</td>
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<tr>
<td>2012</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2016</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Bloomberg, National Bureau of Labor Statistics

The climate is a bit different outside the United States. The European Central Bank (ECB) was dealt a late setback in 2018 when inflation readings were lower than expected. Nevertheless, the ECB plans to end its €2.6 trillion ($2.96 trillion) bond purchase program at the end of 2018. Even so, it is expected to keep monetary policy highly accommodative by maintaining its balance sheet at the current size for the next few years and holding interest rates at record lows. In Japan, very low inflation of 1.0 percent is forcing the Bank of Japan (BOJ) to maintain its massive stimulus for longer than expected. Recently, the BOJ maintained its short-term interest rate target at minus 0.1 percent and restated their intent to guide 10-year government bond yields to around 0.1 percent. The central bank also pledged to keep rates extremely low for an extended period.

**Economic Growth and Earnings Outlook**

The growth outlook for earnings has turned less favorable, with earnings revisions lower across the globe. U.S. equities price moves through the latest earnings season were lackluster, despite good results, in part due to analyst expectations that higher labor costs and tariffs will likely put pressure on margins in the coming quarters. As seen in Figure 5, corporate earnings have peaked in the United States and are expected to decelerate from here but should
remain positive. Figure 6 shows that the story is similar in most of the world. However, top-line growth in the United States continues to be strong, and the U.S. may be an outlier in 2019 in terms of growth.

In October, the International Monetary Fund (IMF) lowered its 2019 global growth forecast from 3.9 percent to 3.7 percent, citing increased trade protectionism, reduced foreign direct investment in emerging countries, and higher global political risk. From Asia to Europe, signs are emerging that economies are slowing.

China is likely to be a key driver of positive but slowing global growth trends in 2019. While tariffs have not helped, the Chinese economy had been moderating even before the trade war was initiated. Industrial production has slowed to its lowest rate in three years while retail sales have taken a pause, suggesting that consumer spending, while still very strong, is reflecting some hesitation about future economic conditions. The country has gone to great lengths to maintain its growth target of 6.5 percent, including injecting liquidity and letting short-term rates fall. Should domestic demand remain soft, this could result in further policy easing. The government has sought to implement structural reforms, including income tax reform, a more favorable climate for businesses, and reducing its heavy reliance on debt to stimulate growth, which ultimately should help to increase economic stability. The challenge for China is that exports account for 19 percent of Chinese GDP versus 12 percent in the United States, making it more vulnerable in the event of a drawn-out trade war. This will put increasing pressure on the consumer to keep the economy on track to meet 2019 forecasts.

After a brief spike toward three percent in the middle of the year, U.S. inflation remained subdued in 2018, ending the year just over two percent, about where it started. An efficient labor market coupled with low oil prices has largely kept prices for goods and services contained.

As we begin the new year, data on average hourly earnings and wholesale prices suggest that wage pressures are building, particularly in the service sector. This includes not only the highly skilled areas in the information sector, but also in retail and leisure hospitality. While we are watching this closely, several factors have helped to keep labor costs in check.
Longer term, most economists look to the Phillips Curve, as seen in Figure 7, to understand how employment will drive wages and inflation. The model contends that there is an inverse relationship between the rate of unemployment and the rise in wages, and this held true for many years as is seen in the chart on the left. Thus, it would be expected that as unemployment in the United States hits multi-decade lows, there should be a corresponding increase in CPI due in part to higher labor costs as businesses compete for skilled labor and reward employees to increase retention. However, this relationship has not held over the past 20 years as seen in the chart on the right. Additionally, the predictive ability of the relationship has degraded. In fact, since 2010, the year-over-year growth in average hourly earnings have trended in a tight range between 2.6 and 3.1 percent – hardly the jump that would be expected from a sub-4 percent unemployment rate.

This begs the question – which part of the equation is broken? Employment has been consistently improving since 2009 when the unemployment rate peaked at 10 percent. Perhaps the relationships have simply changed as we see evidence that the global economy has evolved thanks to demographic trends, efficiency gains from technological innovation, and the “gig” economy – a new class of workers that choose lifestyle over the traditional work environment (e.g., Uber) and work at will and as needed – thus are difficult to quantify.

Ultimately, it remains to be seen whether the historically low unemployment rate will spur inflation. While we don’t claim to know if or when real inflationary pressures will surface, we continue to closely monitor several indicators for the telltale signs.

**Policy Risk**

Policy risk tends to be the most difficult to price, but also the most likely to surprise. Unfortunately, there has been an upswing in both policy and geopolitical risk, including effects from Brexit, rising nationalism, increased cybersecurity threats, and heightened tensions in North Korea and the Middle East. Going into 2019, we see the greatest threat in a potential escalation of the trade war with China, which began with the first shot from the Trump Administration in March of 2018. The challenge in predicting the outcome of a trade war can be seen in Figure 8, which shows a timeline of the U.S.-China trade war actions, as well as an estimate of expected negative impacts. If all of the threatened tariffs by both sides were implemented, they could potentially reduce U.S. GDP by 30 basis points and Chinese GDP by 80-100 basis points. On top of this, the tariffs could add 20 basis points to inflation. Unfortunately, the direction and magnitude of this war, whether it is fought in words or in levied tariffs, is uncertain, and the range of potential outcomes and the impacts on financial markets is wide and difficult to predict. Markets generally are ill-equipped
Figure 8
TIMELINE OF U.S. AND CHINA TRADE WAR ACTIONS

2018

**EXPECTED NEGATIVE IMPACT OF TARIFFS ON COUNTRY GDP**

2018 - 2019 | Numbers in percent

<table>
<thead>
<tr>
<th>Implemented 25% on $50 bn of traded goods</th>
<th>Potential 10% on $200 bn of traded goods</th>
<th>Potential 25% on all Chinese exports to the US</th>
</tr>
</thead>
<tbody>
<tr>
<td>US GDP</td>
<td>-0.1</td>
<td>-0.2</td>
</tr>
<tr>
<td>China GDP</td>
<td>-0.2</td>
<td>-0.3</td>
</tr>
<tr>
<td>World GDP</td>
<td>-0.1</td>
<td>-0.2</td>
</tr>
</tbody>
</table>

Source: Bloomberg, Cornerstone Macro and Commonfund Research. As of October 2018.
to price trade policy uncertainty, which is one reason why we have seen increasing market jitters and volatility around trade policy-related news. We acknowledge the uncertainty of political risk but currently we do not have sufficient economic signals to justify a re-balancing of our client portfolios.

**Portfolio Positioning**

Entering 2018 we remained modestly overweight equities as we have been for the past few years. We sold into strength over the year, finally reducing our equity position to neutral versus the policy portfolio in the fourth quarter. We also remained neutral in our regional exposure. Although we acknowledged low valuations outside of the United States, we did not see a catalyst to support mean reversion, and we preferred to retain exposure to the U.S. where fundamentals were stronger. In fixed income, we sought to dampen the effects of higher interest rates by remaining in shorter-duration U.S. Treasuries and by having an overweight to credit.

Overall, despite the results cited in Figure 1, we continue to believe in the diversification benefits of our strategic allocation approach which focuses on drawdown and recovery, rather than minimizing volatility. We do this because, in comparison to other investors, institutional nonprofit investors tend to have among the longest time horizons, given that they are often perpetual institutions. Largely because of this, the most relevant, material risk for non-profit portfolios is not volatility, but rather a severe drawdown in portfolio value that compromises the ability to spend in support of a mission.

Examples of how this approach manifests include increased allocations to core bonds and reduced allocations to hedge funds. Our hedge fund strategies are constructed to minimize correlation to equity markets and credit – which are the primary risks that already reside in policy portfolios – thereby capturing those risk premia in a cost-efficient manner. We also support prudent allocations to illiquid private strategies that have the potential to deliver returns above public markets. In the last year, we’ve expanded private investments to include senior lending strategies which primarily generate returns from income and cash flows rather than growth in the economy.

Within asset classes, on the margin, we continue to focus on identifying sources of excess return that can still flourish in the higher volatility, late cycle, slowing growth environment that we foresee. Valuations in many sectors of the private capital markets remain fully priced and significant amounts of capital have been raised by the industry over the past several years.

With this backdrop in mind, Commonfund favors a quality bias within public equities – companies with sustainable and visible cash flows and healthier balance sheets. We are focusing on structured credit and asset-backed securities as well as private, middle-market senior lending strategies as opposed to owning high yield corporate bonds where spreads are thin. We also remain shorter-duration in investment-grade bonds and Treasuries. In hedge funds, we seek less crowded trades that are not as prone to issues in periods of deleveraging and those strategies that demonstrate sustainable ability to generate alpha or excess returns. These strategies are identified using Commonfund’s proprietary quantitative and qualitative methods.

We are cautious about deploying capital in certain segments of the private market; most notably, larger leveraged buyouts, generalist firms and later stage venture capital. Given these concerns, we remain focused on opportunities in the small/mid-market area of private equity and early stage venture where capital is scarcer, our managers can execute their operational value-add skills and valuations tend to be generally more favorable. Within natural resources, we remain focused on opportunities with low levels of leverage and lower discovery and development costs as well as those benefitting from technological tailwinds. We continue to be more tactical in our approach to accessing investments, particularly as we analyze opportunities in primaries, co-investments, aged primaries and secondaries.

Real Estate, we believe, remains in relative equilibrium with cap rate spreads to Treasuries near their historical average. In aggregate, supply and demand remain largely in balance with some sectors and geographies experiencing excess supply leading to decreasing occupancies and lower but still positive rent growth. We continue to prefer sectors with positive secular growth trends, such as data centers, industrial and multi-family as well as sectors with defensive characteristics such as senior housing, medical office...
and student housing. Our preference continues to be with value-add managers using prudent levels of leverage and who generate a significant portion of their total return from cash flow.

**Engaging the Whole Organization**

At Commonfund we believe and advise clients that setting, and adhering to, long-term policy is fundamental to a perpetual pool’s ability to support an organization’s mission. Long-term strategic policy serves to guide fiduciaries and investment managers regardless of market conditions. To establish long-term policy, fiduciaries must consider return targets, risk tolerances, and illiquidity budgets in the context of strategic asset allocation and spending policy. These policies, which are too often considered in isolation, should be established with a comprehensive evaluation of the financial ecosystem of the institution they are meant to support. We don’t believe that it is time to be, “Truckin’ – got my chips cashed in.”

We created and continue to enhance a proprietary database that measures 200 different financial and operating metrics and is based on over 1,000 financial statements from more than 300 non-profit institutions. We use this “Big Data” as the basis for analyses that help our clients make informed policy decisions. At this late point in the business cycle we are also using these metrics as an input into discussions with clients on their preparedness for the next crisis, recession or other inevitable downturn. Asking questions as simple as “what are we going to do if our portfolio drops 20 percent?” can help set expectations that can guide investors through challenging conditions when they arise. But it’s important to recognize that there are many layers to explore when creating a comprehensive “crisis playbook.” Many investment committees spend time on the quantitative aspects of scenario analyses and stress testing. But it is also important to ask, “What are the likely behavioral/emotional reactions of your investment committee?”

Asking these questions can be an effective starting point to creating a framework for your crisis playbook. This playbook can serve as a roadmap to guide you when the storm is at its peak, visibility is low, crystal balls are murky, and tensions are high. At a fundamental level you will need to decide if you are going to stick with your existing strategic policy, if you are going to reduce risk in your portfolio, or if you need to cut or increase spending. While these questions seem basic, they are important to ask today, as your answers can have long-term, significant impacts on how you navigate the next crisis, the degree to which you recover…and how fast you can recover to meet your long-term spending policy.
Important Notes

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