The University of Iowa Center for Advancement (UICA) Quarterly Investment Summary – September 30, 2018

Overview

The U.S. economy continued to improve during the quarter. While inflation accelerated to a six-year high, unemployment dropped to its lowest level since 1969 as consumer and business confidence reached multi-decade high levels. U.S. equities posted strong quarterly returns while global trade tensions caused international developed and emerging markets equities to struggle. The Federal Reserve raised interest rates 25 basis points as they continued a tighter monetary policy leading to price declines in higher quality fixed income markets.

The Long-Term Pool (LTP) returned 1.9 percent during the quarter, 8.2, 9.2, 7.2, and 8.1 percent respectively for the one-, three-, five-, and 10-year periods.

Global Equity

The global equity composite returned 1.4 percent during the quarter and an annualized 12.9, 9.5, and 8.9 percent over the past three-, five- and 10-year periods.

U.S. equity markets had strong returns during the quarter as the S&P 500 reached an all-time high closing price of $2,930.75 on September 20th. Every industry sector had positive performance, helping the U.S. market finish ahead of other markets across the globe. Large cap stocks outperformed small cap while growth continues to outperform value. Growth has outperformed value over the trailing one-, three-, five-, and 10-year periods and large cap has outperformed small cap trailing one-, five-, and 10-year periods. The composites bias to small cap and value has been a headwind during the current growth and large cap bull market.

Emerging markets underperformed the broader equity market as investors worried about an economic slowdown in China and trade tensions. Emerging markets economies that import oil were hurt as oil prices increased. The Latin America region had the strongest performance, while Asia struggled. International developed markets were positive in the quarter as Brexit negotiations weighed on the United Kingdom. The Eurozone has shown signs of economic weakness, but the European market was positive. Japan had the strongest regional performance.

Fundraising for private equity buyouts continues to be concerning. While the 2018 pace has slowed, it remains at the historically elevated levels seen in recent years. Two funds over $5 billion closed during the quarter in an environment that rewards record-breaking fund sizes. Fewer GPs are raising funds, but funds being raised are larger. Our belief remains that larger funds negatively affect the alignment of incentives between GPs and LPs, and our bias is to smaller funds. When we are locking up capital for a decade or more, we prefer small buyouts due to their potential for higher returns and reduced leverage. We may make commitments to new partners, but our focus is increasing the size of re-ups with existing managers to limit the number of managers in the portfolio.

Global Fixed Income

The global fixed income composite gained 1.2 percent during the quarter, and it increased an annualized 5.0, 4.2, and 8.0 percent for the three-, five- and 10-year periods. The 25 basis point federal funds rate moved U.S. Treasure rates higher for the fifth consecutive quarter and helped flatten the yield curve, a closely watched indicator of a potential recession. Higher quality fixed income sectors have struggled during this increasing interest rate environment while credit sensitive sectors have performed well. Investors that have been chasing yield over the last decade have moved into high yield and bank loan strategies, but it remains to be seen if those funds will have enough liquidity should a crisis develop.

Real Assets

The real assets composite returned 5.3 percent for the quarter and an annualized 10.7, 7.3 and 5.3 over the past three-, five- and 10-year periods. The rising interest rate environment has created headwinds for U.S. REITs, but performance was positive for the quarter. Outside the U.S., REIT performance was negative. Private real estate had a better showing, but property values are above levels reached at the prior market peak. Private natural resources funds had the strongest returns in the composite during the quarter as energy prices rose almost 5 percent in the quarter and over 25 percent year-to-date through September. Rising oil prices also helped MLPs, which were also aided by a rebound in domestic crude oil production levels. Commodity prices declined against the headwind of rising interest rates.

Diversifying Strategies

The diversifying strategies composite returned 0.4 percent for the quarter and an annualized 3.4 and 5.0 percent over the past three- and five-year time periods. The composites performance was mixed in the quarter. Hedge fund beta and managed futures strategies struggled as the mix of a risk-on environment and lack of persistent volatility created headwinds for defensive strategies. Event driven strategies with larger merger and acquisition portfolios performed well.

Conclusion

While returns for the first quarter were good, the market changed course when the calendar moved into the second quarter of the fiscal year. Volatility came back to the financial markets as an accommodative monetary policy and tax reform seem like distant memories. Threats of a trade war and further rate hikes took center stage as investors realized the level of debt on the balance sheet of corporations and the U.S. government and sold risky investments. It is possible that markets rebound quickly, and no market dislocations occur, but our portfolio remains liquid in order to act quickly when the opportunity presents itself. As always, our focus remains on achieving our target returns while lowering the probability of a permanent loss of capital, identifying investment managers that can deliver outperformance, and maintaining sufficient liquidity.