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Catholic Foundation of Southwest Iowa

Market & Portfolio Commentary – March 20, 2020

Foundation Stakeholders:

We live in unprecedented times. As such, we have found over the years that it is critical to over-communicate during times like these. We want everyone reading this letter to know that we are actively **on the pulse** of COVID-19 and the implications of this health crisis on your investment assets at the Catholic Foundation. While our focus in this update will be on the economy and your financial assets, we first and most importantly want to acknowledge the disheartening human tragedy of this global outbreak. There will be lives lost, pervasive isolation and loneliness (we are social creatures), and families/friends torn apart for unknown periods of time. We are all experiencing tremendous feelings of vulnerability. Facing all of this adversity, we are confident that we can all come together and act in unity to get through to the other side of this tremendous hardship. It will require individual fortitude across our society as well as strong leadership and action from both the public and private sectors. Our hope is that this can serve to mend much of the divisiveness that has plagued this country for far too long. The will of the American spirit is strong, and we fully expect the American people and economy to endure in the end.

I want to first address performance. Below are estimated performance figures for the calendar year of 2020 through the market close on March 17th:

Strategic Growth Fund: -14%
Moderate Growth Fund:-10%
Capital Preservation Strategy: -0.50%

We empathize with the reality that negative returns are **never** fun. Reputable studies on "loss aversion" by Nobel laureates in the field of behavioral psychology show that a loss hurts more than 2x that of the satisfaction one receives from an equivalent gain. We understand that one "cannot eat relative returns". Strong long-term returns come with the cost of enduring, at times, significant volatility. It is important to note that the **Strategic Growth Fund was up almost 17%** in 2019, and the **Capital Preservation Strategy has generated an estimated trailing 12-month return of 2.5%**.

We encourage patience and a long-term orientation for those stakeholders invested in the Strategic and Moderate Growth Funds. Drawdowns and uncertainty, of course, incite fear in many investors. Behaviorally, this can induce feelings of the need to limit losses by "going to cash". Empirical data unequivocally shows that such dramatic and emotional decision-making in an attempt to "time the market" can leave one susceptible to a permanent impairment of capital (in other words, an ultimately unrecoverable loss or a VERY big hole to dig out of). **This is the ultimate risk**. Luckily, markets have historically tended to mean revert over time. I'm over-simplifying here but, in other words, losses are followed by gains and gains are followed by losses. The timing and magnitude of the mean reversion varies greatly, but that creates the risk of selling after a decline in value. We have found over the years that investors stand to actually benefit heading into and during a bear market if they have the "Three C's": **courage, conviction and capital**. We are fortunate to have **all three** and are prudently focusing on how we best leverage this for your benefit going forward. Our focus continues to be on how we protect the portfolios from further declines, but also now includes an allocation of time, energy and resources to assess what we want to own coming out of the other side of this crisis. This is NOT us calling for a bottom. There still could be significant additional pain that the market is not pricing in at the moment. We want to be able to check two boxes: (1) if we see more value destruction we want to have additional dry powder to continue to systematically rebalance by selling recent outperformers (typically government and short term bonds) and buying recent underperformers (typically stocks); and (2) we want to make sure we own the *right* assets coming out of this huge dislocation. We own cash and bonds to take advantage of the dislocation in the markets and have – in a disciplined, systematic and unemotional fashion – modestly rebalanced the portfolios three times in the last 3-4 weeks. We believe these recent decisions will benefit stakeholders looking out 1-3 years. We believe strongly that it is better to be an incremental buyer in these types of environments rather than a seller. As of the time of this writing, we are pleased with how we have protected your capital through this challenging environment. We remain steadfast, focused, and promise to never get complacent given that this is obviously still an extraordinarily fluid situation.

Shifting to the economy, we believe we will see some **shocking** and probably scary GDP and unemployment figures. We've seen economic forecasts for Q2 2020 GDP declines of 10% from Evercore ISI and Bloomberg has reported that an early poll has suggested that 18% of American workers have already lost jobs or hours as a result of the spread of the Coronavirus. Such figures would be unprecedented in the modern developed world, and some data we have seen is even worse than what we have shared with you today. With all that said, the capital markets are generally functioning, and are trying to price a plethora of uncertainty, including: (1) the strain on output and employment, (2) the impact on corporate earnings, (3) the disruption to supply chains, (4) the length and depth of the economic disruption, (5) consumer spending activity, and countless other uncertain variables. **At this point, it is our view that a global recession is inevitable**. This is currently being priced into financial markets, as correlations across asset classes have increased dramatically over the past two weeks. A big question we have now is whether we experience a technical recession that lasts only a couple of quarters, or a more prolonged downturn that stretches into next year. We are still of the view that the coronavirus outbreak will result in more of a technical recession. Typically, recessions that are caused by external shocks (i.e. a global pandemic) do not last as long as recessions that are the result of endogenous problems in the system that manifest themselves in a significant *fundamentally-driven* slowdown.

Going into this crisis, global growth was actually on the upswing. Financial imbalances were not *that* severe, particularly in the developed world. The private sector across most economies was spending less than it was earning. Usually, recessions begin when the private sector is over-extended. Further, we are almost certainly going to get a sizable fiscal policy response, which will help. We would also add that the magnitude of the downturn could very well be mitigated by the fact that businesses and households are going to be looking to *increase* inventories. Businesses right now are very worried that the supply chains they rely on will falter – so many are actively looking to increase inventories. That is not what happens in a typical recession. In a typical recession, firms try to scale back inventories and reduce production in order to do so – which ultimately leads to ever weaker growth. Households are obviously also stockpiling all sorts of goods as well.

There is a great deal of fear and uncertainty amongst investors of all shapes and sizes. Many investors lost sight of real risk following, per Bloomberg data, a decade long run of 13.6% annualized total returns from the S&P 500 from 2010 through the end of 2019. Many endowments, foundations, pension funds and individual investors have been caught with 70-80% of their portfolios in equities heading into this crisis. This is not a time for victory laps, but we were fortunate (as of the time of this writing) to have resisted the temptation to bail on broad diversification strategies and allocate more heavily into the momentous equity markets. Ahead of this bear market, we were overly conscious of late cycle investment risks. **We were underweight global equities and overweight cash, bonds and other uncorrelated assets heading into this crisis. We had north of 40% of the portfolio in what we call risk dampening investments.** While we do not own a coveted crystal ball, we simply were of the view that particularly the US equity market was priced to perfection and the risk/return tradeoff for equity assets was relatively unfavorable. This led us to take risk out of the portfolio. Late last year, we exited a modestly sized allocation to a dedicated midstream energy strategy that is off over 50% from where we sold it. Also last year we committed to and set aside ~5% of the portfolios to capitalize on distressed, turnaround, and rescue financing opportunities to buy into good companies with bad balance sheets at extremely attractive prices. While the outlook for corporate default rates was very low as recently as one month ago, we believe that the distressed for control investment style could generate especially strong returns going forward.

We want to be very accessible and stand ready to talk with anyone at any time about the portfolios, performance, and/or quickly evolving market and economic events. Please do not hesitate to reach out.

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