Investment Narrative

Quarter Ending March 31, 2024

San Diego Foundation

After a strong year of performance in 2023 and continued resilience in the U.S. economy, domestic markets sustained their upward trend and outperformed international markets over the first quarter of 2024. Echoing the market dynamics seen last year, the most significant driver of performance was the technology sector, led by the "Magnificent Seven" (Nvidia, Meta Platforms, Tesla, Amazon, Alphabet, Microsoft and Apple). The other sectors also delivered meaningful support as investor sentiment shifted positively, despite a decreasing probability of six interest rate cuts that investors were anticipating at the start of the year. Dwindling confidence in rate cuts stemmed from slower than expected progress in inflation as it ticked slightly higher over the quarter. The Federal Reserve has remained consistent in their stance to refrain from monetary policy changes until inflation falls to 2%; after the first quarter forecasters believe inflation will likely end the year around 3%.

U.S. GDP growth showed its first sign of softening, coming in at 1.6% after several quarters of GDP growth above 2%. Despite softer GDP growth over the quarter, consumer spending remains strong amid a resilient labor market. Consumer sentiment increased. However, a lack of improving savings levels paired with increasing credit usage is evidence that the average household continues to be negatively affected by elevated prices. Equity markets continued their rally while fixed-income markets remained flat to negative amid the uncertainty of future interest rate cuts. The broad U.S. stock market, which is tracked by the S&P 500 Index, was up 10.6% for the quarter. The U.S. small cap market, represented by the Russell 2000 Index, was up 5.2% for the quarter. The U.S. bond market, reflected by the Bloomberg U.S. Aggregate Bond Index, was down -0.8 % for the quarter.

In contrast to the strong U.S. market over the first quarter, international developed and emerging markets showed signs of slowing growth and pockets of concern. International developed economies continued their trend of cooling inflation, ending the quarter with a year-over-year inflation of 2.4% in the Eurozone and 3.2% in the U.K. Although inflation has created a somewhat positive tone in international investor sentiment, other signs of economic difficulties keep confidence at bay. GDP growth was essentially flat, and unemployment remained elevated at 6.5%. Emerging markets experienced another quarter of strong GDP growth, driven mainly by India and China. While emerging market equities responded positively, Chinese equities have been a detractor to the overall market performance. The increasing geopolitical tensions with China coupled with uncertainty around the implementation of Chinese government restrictions has kept investor sentiment skeptical. Additionally, growing conflicts throughout the Middle East and Eastern Europe have investors cautious of international markets with the fear of experiencing another period of sharp price increases in natural resources such as oil and gas. The international developed markets, tracked by the MSCI EAFE Index, returned 5.8% for the quarter. The emerging markets region, represented by the MSCI Emerging Markets Index, was up 2.4% for the quarter.

Endowment

The Endowment Portfolio was up 4.4% for the quarter, outperforming its policy index by 0.3% net of fees. The portfolio's public equity exposure, driven by U.S. large cap stocks, was the most additive to the overall performance. This comes as no surprise given the strong performance of stocks like the Magnificent Seven. The portfolio's international equity exposure performed in line with its benchmarks but saw notable outperformance in the emerging markets value allocation. The real estate allocation was flat to slightly positive, driven by mixed performance from the underlying investments driven by market headwinds from a higher interest rate environment. The real asset book delivered moderate outperformance driven mainly by our infrastructure and commodity investments. The portfolio's private markets allocations lagged its benchmarks for the quarter but given the longer time horizon of these investments a short-term lag is not of concern. The hedge fund allocation was positive across all investments and delivered meaningful outperformance over its benchmark. Continued strong performance has resulted in the Endowment portfolio ranking in the top decile over trailing 3-year and 5-year periods, and near the top quartile over trailing 7-year and 10-year periods.

Non-Endowment

The Long-Term Portfolio delivered a 5.1% return, outpacing its policy index by 0.4% net of fees. Like the Endowment, the Long-Term Portfolio's outperformance is primarily attributable to U.S. large-cap equities. The second most significant driver of the portfolio's performance was its hedge fund allocation. The fixed-income allocation was slightly negative, reflective of the uncertainty around longer-term interest rates in the U.S. and emerging markets. Real assets delivered slightly positive performance and kept pace with their benchmark.

The Medium-Term Portfolio had a positive quarter with a 1.9% gain, slightly leading its policy index of 1.8% net of fees. Unlike the Endowment and Long-Term Portfolios, the Medium-Term Portfolio has a significantly lower exposure to equities and therefore captured less of the domestic equity rally over the quarter. The portfolio's 70% allocation to fixed income was flat for the quarter, benefiting from its exposure to shorter duration bonds which are less sensitive to changes in interest rates. Real assets had less of an effect on the overall portfolio, but still provided positive performance in line with the real assets benchmark.

The Intermediate-Term Portfolio was flat for the quarter. The portfolio is primarily invested in intermediate-term bonds. These responded well to a stabilizing rate environment, though the growing uncertainty of interest rates changes served as a headwind for the quarter. Overall performance was supported by the portfolio's allocation to shorter-term, low duration bonds ultimately resulting in a flat quarter.

The Short-Term Portfolio continued its trend of delivering positive yield, ending the quarter with a 1.3% return, bringing the trailing 1-year return to 5.3% net of fees. As interest rates remain elevated, the expected return profile of the portfolio should remain consistent. Significant cuts in rates by the Federal Reserve will negatively affect performance.

Sustainable Endowment and Non-Endowment

The Sustainable Endowment and Non-Endowment Portfolios experienced another positive quarter, concluding the period with a 4.4% gain net of fees. The portfolios lagged their policy index due to underperformance in their equity allocations. As a result of this underperformance by the underlying equity manager, we began a search process for alternative options that would adhere to the sustainability mandates of the portfolios. By the end of the quarter, we decided to transition the equity allocations to a passive strategy. We believe this change will positively benefit the donors invested in these pools by offering the same fossil fuel-free equity exposure with less volatility and more competitive pricing.