TIFF INSIGHTS

CIO Quarterly Commentary

4Q2020

The Year of Living Dangerously

We will all remember 2020 for different things.

First and worst, we will remember 2020 as the year when COVID-19 spread throughout the world and killed nearly 2 million people globally, including nearly 400,000 Americans. Depending upon how you count, that is the greatest loss of American life ever, except for the Civil War. The year also experienced a number of other tragic events that sparked calls for social justice solutions to create positive and lasting changes.

Happier 2020 memories will include more time with family, friends and relatives, those stricken by COVID-19 who thankfully survived and recovered, renewed appreciation for our essential workers, discovering new creative outlets and ways to binge watch TV, and saying goodbye to that dreaded commute. Along with, and mostly due to COVID-19, 2020 produced a long list of economic anomalies, including:

- *GDP swings*: the largest single quarter drop in US history (-31.4% in Q2) immediately followed by the largest single quarter gain (+33.4% in Q3)
- *Unemployment swings*: unemployment rising from 4.4% to 14.7% in one month, and then falling back to 6.7% over the next 7 months
- *Market swings*: the fastest decline into a bear market from an all-time high for the US stock market, followed by one of the greatest bull markets, and quickest recoveries, to new highs
- *Market firsts*: oil fell to the point that investors were briefly <u>paid</u> $17 to accept delivery of a 55-gallon barrel; and Apple's market cap crossed $2.25 trillion, exceeding the entire value of the UK index FTSE 100
- *Unprecedented growth areas*:
    - Tesla grew in value to $670 billion, (and depending upon the day, it equals the approximate value of BMW, Mercedes, Volkswagen, Fiat/Chrysler, Ferrari, Honda, Toyota, Subaru, Mazda, Mitsubishi, Ford, and General Motors *combined*)
    - FANGAM (Facebook, Amazon, Netflix, Google, Apple and Microsoft) stocks now have a larger market cap than every individual country except China
    - Zoom gained 400%, Pinterest 250%, Overstock 600%, Moderna 400%, Plug Power 1000%, and Workhorse 550%, to name a few examples
- *Anticipated challenges*: businesses that interacted directly with consumers had a very difficult year. Bankruptcies mounted particularly in retail, restaurants and automotive, ensnaring well-known brands: Brooks Brothers, Neiman Marcus, and JC Penny; California Pizza Kitchen, Ruby Tuesday, and Sizzler; Dollar Thrifty Automotive Group, Advantage Rent a Car, and Hertz
- *Contradictory outcomes*: the US experienced record savings rates, record retail sales, but also record unemployment – and all at roughly the same time
- *Modern Monetary Theory (MMT) rushed in*: global governments, including the US, tried to save their economies by printing and spending more money than ever before, and with the US budget deficit currently around -20% of GDP we remain hopeful that MMT will prove a temporary situation and soon the economy will be able to stand on its own two feet

- *Medical miracles*: the world quickly developed and began to administer at least three COVID-19 vaccines, providing hope that the platforms used to create these vaccines will enable even more rapid vaccine development for the next global scourge

For us, the key takeaways from these wildly disparate events are that some were predictable (i.e., spikes in unemployment and bankruptcies resulting from a recession), but many more were not. Unpredictable outcomes keep us humble while reminding us of the difficulty of consistently outsmarting the markets.

How Did the Portfolios Fare?

Overall, 2020 results were pretty good, and we are optimistic about the prospects for 2021. Within the tumultuous year we all experienced in the markets, our team rose to the challenges created by COVID-19, overcame distance, remained disciplined and had some good luck to go along with the inevitable bad. Let's review what worked, and what challenged us.

Some of the things that worked during 2020 in the portfolios included: generally maintaining full equity exposure despite the market volatility and even remaining slightly above benchmark on average across our portfolios; rebalancing into equities during the February and March selloffs (contrarian market positions are never easy and require both a game plan and sometimes a strong stomach); overweighting China versus well-known benchmarks due to our confidence in our investment thesis (including our managers); implementing our direct equity investment program; and generally our manager line-up – this was a strong year for our active returns.

Some things that worked less well during 2020 included: some modest hedging strategies we employed when the market seemed, to us, too euphoric and / or too certain that COVID-19 would pass without long-term effects; underweighting bonds (although recently that position has rebounded and started working); trimming certain growth winners after strong runs; and underperforming selected managers in certain strategies.

Back Toward Normal in 2021?

By the end of 2021 we will all know precisely what was in store for us during the year. Even without a crystal ball in hand, we will nonetheless share a few ideas about where we have been and where we might be going.

China and Beyond: China was both the country in which the COVID-19 virus first started, and the first one to halt its spread. Early virus containment enabled China to experience among the best overall 2020 major stock market returns in the world. As the rest of the world struggled with the virus, and central banks printed money for people to spend, Chinese manufacturers functioned as the world's factory floor. China was the first to see its GDP rebound to new highs; there are high hopes that the US will see similar results early in 2021, with other countries to follow. We believe that an economic recovery is priced into equities heading into the new year.

The best world is one in which we all work together, both respectfully and cooperatively. Episodes that interrupt this cooperative environment can be destabilizing. Politically, we expect to see less turmoil and a more "normal" level of US engagement throughout the world. This new (old) normal likely will recognize China as a competitor, as well as a friend, while trade policies are expected to remain tougher than they were four years ago. We expect the acceleration of China and the rebound in the US to be joined by other countries. While there are plenty of value stocks in China and the US, these two countries are home to most of the world's great growth companies. By contrast, Europe, Japan, and other emerging market countries have more value companies. If there is a rotation from growth to value in stock performance, these countries may be positioned to perform relatively better next year.

Rate Considerations: Turning to rates, if global GDP accelerates, we could see inflation rise. Expansionary fiscal policy coupled with easy monetary policy and a Fed that is targeting a range of inflation around the 2% level seem like the ingredients for a back-up in yields. A rise above 2% inflation could spook the bond market and cause yields to rise. Ironically, a stronger global economy with declining unemployment and rising rates could be the next hurdle for the stock market. This scenario definitely would be a back to the future moment, as it suggests the bond vigilantes may saddle up for the first time in nearly 40 years. Students of history will recall that in the 70s and 80s, capital markets enforced financial discipline on governments seen as too profligate by pushing up interest rates. Replacing fixed income allocations in portfolios with something "better" will be important going forward. Globally, the $18 trillion in debt that currently produces negative nominal yields will not help investors earn real returns of 5% going forward.

If the Fed targets or pins 10-year Treasury yields at, say, 2%, then a decline in the value of the US dollar is likely. As the world's great debtor nation, some believe more US bonds may not be sought by other nations, and the dollar could lose its reserve currency status. While we worry about this potential scenario, we do not believe that it is likely for many years. We do think that a modest rise in inflation coupled with expansionary fiscal and monetary policy actions will lead markets to conclude the US is monetizing debt, which would likely cause the USD to weaken in 2021. In our opinion, however, until there is a suitable replacement, the world will continue to hold its wealth, and transact, mainly in US dollars.

Some near-term risks: The new year starts in a particularly precarious fashion. On January 5, the state of Georgia holds two runoff Senate elections. Odds currently suggest a 25% chance of Democrats winning both seats. If one or both seats remains Republican, the resulting split with a Democratic house and a Republican Senate is, in our view, ultimately preferable for stocks. We also have the odd juxtaposition of spiking COVID-19 cases and deaths coupled with the approval, manufacturing ramp up, shipping, and administering of FDA-approved vaccines. If there are no glitches in the manufacturing or supply chain, then COVID-19 could be eradicated sooner; if there are significant stumbles then the recovery may falter at least for a period. That faltering has the potential to slow the recovery and, in the worst scenarios, to do lasting damage as a prolonged downturn (without yet more stimulus) could lead to permanent loss of businesses and more permanently unemployed. We are happy to see the US government provide individuals and small businesses another fiscal boost as we exit the COVID-19 era so that they have a chance to recover. We are closely following these various possibilities as they keep us somewhat nervous entering the new year. That said, we expect to be mostly free of COVID-19 before the end of 2021. That result will be good for the economy and for stocks – not to mention society overall.

US Markets and Our Managers: Okay, we will say it. Priced at 23.5x expected 2021 earnings of $160 per share, US stocks as measured by the S&P 500 are expensive. They got this way by going up some while earnings collapsed during the COVID-19 recession. The markets recovered as nicely as they did primarily because everyone looked forward. Had you asked, we would have been reticent to predict such a strong bounce back for equities given the overall economic backdrop. Other stock markets around the world are less expensive because non-US stock prices did not recover to the same extent as those in the US.

Our discipline in 2020 of rebalancing into weakness helped make it a pretty good year. It never feels good selling treasury bonds that are going up in price to invest in equities that are being pummeled, but you usually get rewarded for doing so. Our rebalancing discipline also caused us to trim growth positions and add to value positions repeatedly in 2020. This rebalancing kept a relative lid on “what could have been” but enables us to enter the new year with continued confidence. Despite growth stocks outperforming value stocks by the largest margin ever (35% in 2020), our manager roster is strong and balanced, and we have more style diversity than many others. If earnings in the US do not recover as quickly as the markets are discounting, and stocks here take a pause, we believe our non-US managers can contribute to overall returns, and our value managers can protect against possible rotation away from growth. Our hedge funds can help us maintain portfolio ballast and have the potential to provide higher returns than fixed income. Until rates rise meaningfully, higher stock valuations may become part of the new normal. Think TINA. *There is no alternative* (TINA) is our argument for both the dollar’s continued strength, and for stocks globally, although the straight line up for stocks we have experienced since mid-March is most likely over.

Progress on elements of a green new deal likely will be made. If market mechanisms are included, we could see a new group of technology leaders in areas such as electric vehicles, wind and solar electricity generation, charging stations, and others. We are excited to see new areas of biotechnology research come to light, and hope some of our managers will capitalize on these and other emerging opportunities. We do not expect the cone of possible outcomes to be quite as wide for stocks in 2021 as it was in 2020. This is important, as we expect that slightly higher equity exposure will be needed to generate acceptable overall portfolio returns in 2021 as fixed income returns lag. If all goes well, however, this portfolio construction should make for another successful, albeit possibly bumpy year.

To us, 2021 looks like an environment in which active management alpha will be required to achieve 5% real rates of return as we transition back into a growing global economy. We expect to maintain a balanced roster of exposures that we anticipate will serve well in a range of market environments. For the first time in a while, it might pay to partner with a good value manager, a good European manager, a good Asian manager, and several good hedge fund managers. Thankfully, we have a solid head start with managers in all these areas and look forward to the many exciting investment challenges and opportunities to come in 2021.

Leadership: Finally, on a personal note, we say goodbye to our long-time CEO, Dick Flannery. Dick led TIFF for 17 years and was a friend to me, and virtually every TIFF employee and Member during his tenure. He will remain a good friend, and although he will continue to support TIFF as a senior adviser, he eventually will become much easier to find on the golf course where his new goal will be to shoot his age.

Happily, we replaced Dick with another terrific CEO, Kane Brenan, who I am proud to call partner. When you meet him, you will quickly see in him what we all saw, a winner. In the CEO role we move from strength to strength. Elsewhere we made good progress in 2020 increasing the diversity of our boards and senior management, adding Katie Koch, Robert Durden, Mai-Anh Tran and Deb Boedicker to our boards, and Lisa Matson, Michael Murray, and Jessica Porter to our senior management ranks. We were lucky in each case to get such incredibly talented people to help us in our efforts to be the very best partner with you we can be. On the investment team we have the same senior team we’ve had for several years. While some change can be good, I am very happy with the level of talent and effort each person on our team brings. Working remotely this year reinforced to me what a strong investment group we have. In 2021, we are expanding our intern program to broaden our incoming talent pool and expand opportunity for more young people to learn about investment management. We hope this program spawns future TIFF leaders.

We Are Excited for 2021

Like most of you, we are ready to put 2020 in the past, and we look forward to 2021 with optimism and excitement. We are confident that our manager roster is strong, our team is fully engaged, and our company is positioned for success. We look forward to the day when we can get off Zoom and get back together in person with our colleagues and with you.

As always, we sincerely appreciate the opportunity to manage your capital and to help you achieve your organization's financial goals. We are here to assist you, so please do not hesitate to contact us. We wish you a healthy and happy new year.

Your TIFF Investment Team

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