

CIO Quarterly Commentary

2Q2021

A Season for Change

Happily, we can confirm that most vaccines appear to be working and that COVID appears to be on the wane in most places throughout the world. It is not over, but with some luck it will be substantially contained within the next 12 months everywhere. That means back to business as “normal” as we remember it. We will need to factor all the changes that COVID has forced onto the world into our investment thinking, of course, but at least we will not have to experience as much medical tragedy nor try to read epidemiological tea leaves (we hope) much longer. The great acceleration in technology adoption COVID forced upon the world may be a long-lasting phenomenon, we’ll see. Our first order of business in this re-opening, if you will, is to take stock of the basics.

Nearly six years ago, as we took the investment Hippocratic oath to do no harm, our first order of business was to eliminate portfolio exposures expected to underperform. The first thing we did was eliminate dedicated exposures to capital intensive sectors (commodities and REITs) from our equity portfolios. We also determined that Europe was not well positioned to produce attractive returns primarily because their equity markets were heavily skewed toward bank and other value-oriented stocks and the political/monetary structure of the Eurozone seemed destined not to work, at least not as well as other regions. While our longer-term Europe thesis may still be correct, for the next few years we think the tables may tilt back towards Europe (more later).

Next, we focused on boosting returns, and since mid-2016 have maintained a significant overweight to Chinese equities. Our off-benchmark position in US Treasury Inflation Protected Securities (TIPS) reached 50% of our fixed income holdings at year end 2019. At the beginning of 2021, we cut our overweight in Chinese equities by half, from 10% overweight to 5%. Similarly, after rising to 60% of our fixed income bond holdings in April 2020, we began selling our TIPS positions in November 2020, until we had eliminated the entire position by May 2021. Just as may be the case, over the long run, with our commodities, REITs and European equities positioning, these recent position changes could prove short-sighted. However, we would like to take this opportunity to explain the rationale for these new and fairly meaningful asset allocation changes in the portfolio and why we have transitioned away from positions we have held over the last several years. In the next few pages, we will explain our rationale, but first a little context....

The consensus view is now that the world economy will grow strongly this year. The vaccine rollout, pent up demand, government spending around the globe, and central bank bond buying are all helping to keep interest rates low and are combining to create a very favorable backdrop for economic growth. As the economy posts its strongest growth in nearly 40 years, we have expected stocks to continue to deliver reasonable gains. In fact, the first half of 2021 has already produced the sorts of annual returns we had hoped for in calendar 2021.

Inflation?

Inflation is today the great debate in markets. Strong economic growth also can bring growing pains, notably, tighter labor and commodity markets, which could produce higher inflation. Will the current burst of inflation pass as more people go back to work and produce the goods and services that a more vibrant economy demands? Or, will shortages persist, leading to higher wages and higher inflation expectations in general? Answering this question is difficult at this juncture. The Federal Reserve continues to expect the current elevated inflation readings to be transitory and for inflation to settle in a

band around the Fed's 2% target rate as time passes. The slightly higher current inflation rate in part makes up for the slightly lower rate of the last few years, resulting in about 2% average inflation, which remains the Fed's stated target.

On one hand, we believe several factors suggest the Fed will be proven correct. Most importantly, interest rates on the US 10-year Treasury bond remain about 1.6%, well below today's inflation readings. Rates on 30-year Treasuries similarly remain around 2.3%. No rational investor who believed inflation would exceed these levels would purchase these bonds at rates at or below expected inflation. Investors putting their money where their mouths are strongly indicates that the markets believe in the Fed's ability to target inflation around 2%. Anecdotally, we expect that large numbers of people will go back to work, global trade will pick up, technological advances will continue, productivity will rise, and shorter-term commodity price pressures will encourage more investment, all of which will help constrain ultimate price gains. Overall, structural elements such as productivity gains, globalization and the reduction in energy intensity that are currently weighing on inflation have historically been sufficient to keep it in check.

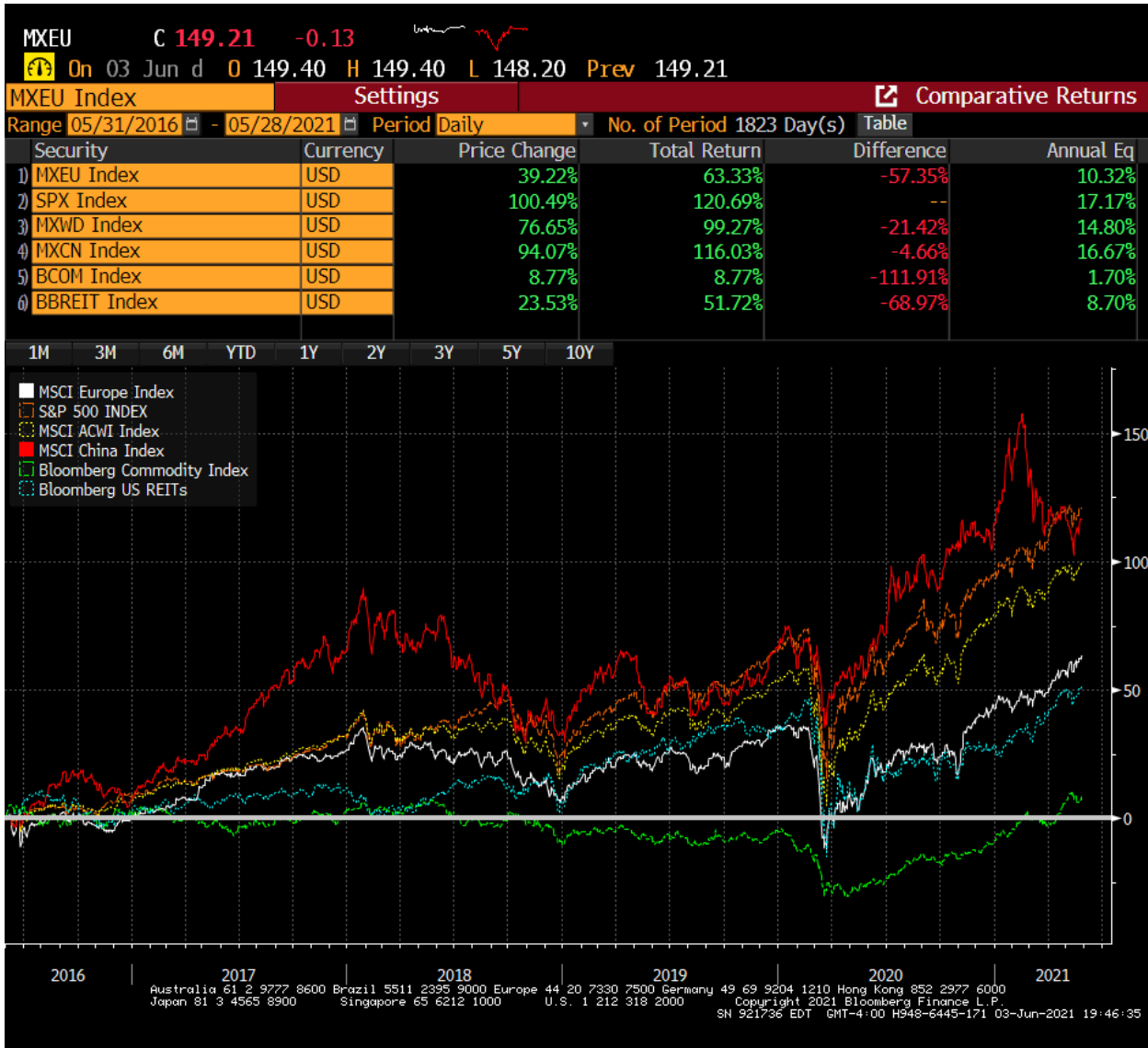
On the other hand, we remain mindful that a few new factors could overwhelm these elements and lead to higher inflation. First on our list would be the Fed's new inflation targeting approach. Targeting inflation of "around" 2% is very different from not allowing inflation to run hotter than 2%. This year we have already seen year-over-year CPI prints as high as 5.0%. Second is the continued massive stimulus being provided by both the Federal Reserve via bond purchases of \$80 billion per month, and by the Federal government as it seeks to pass another stimulus bill in the \$3-4 trillion range (with much of 2020's fiscal stimulus still waiting to be spent!). This double-barreled stimulus effort is of historic proportions, exceeding all previous peacetime spending as a percent of GDP. We are reminded of LBJ's "guns and butter" programs of the 1960s which were the precursor to the inflationary period of the 1970s and 80s. Should investors and consumers begin to believe inflation will become embedded going forward, the outcome could become a self-fulfilling one, with employers willing to pay more for inputs and labor, and consumers willing to pay more for the goods they buy. At the very least, we acknowledge that the chances of inflation becoming a problem are higher today than they have been for many years. Higher inflation would be a significant issue for capital markets as yields would rise and equity multiples likely would contract. Starting from today's elevated valuations that could mean several years of sub-par returns.

So What?

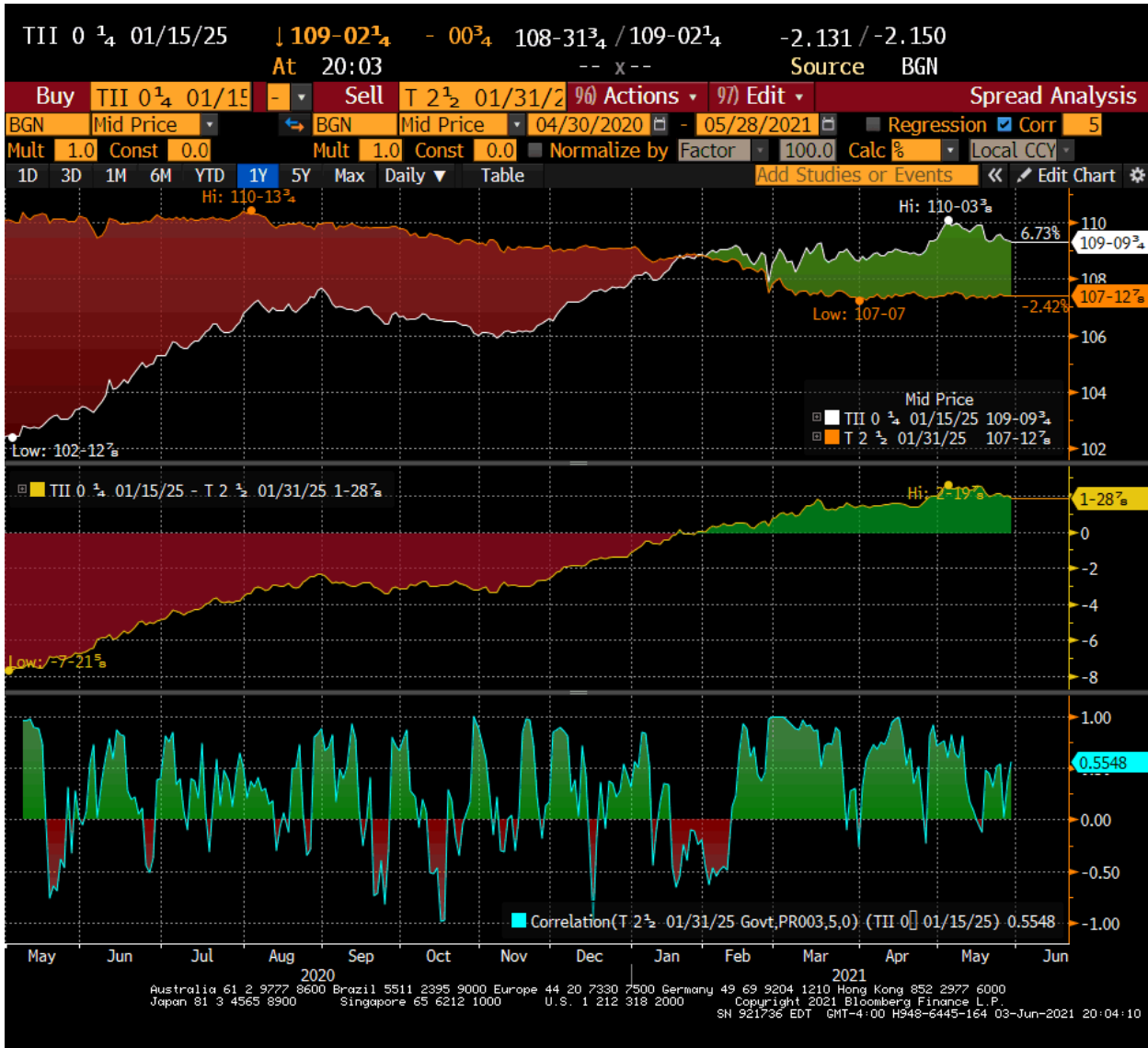
So, what are we doing about all this you ask? Well, for the first time in essentially 5 years we are adding to our European equity holdings. European equities have underperformed US equities over the last 10 years by 8.2% per annum, over 200% cumulatively. Over the last 5 years they have lagged by 6.9% per annum. Today, valuations in Europe are well below other regions of the world. Europe bungled their COVID vaccine rollout causing investors to hesitate to return to the region and allowing China and the US to lead global markets higher last year. Going forward, however, we believe Europe will catch up rapidly on the vaccine front, that the Eurozone savings pool resulting from governments' desire to protect against economic fallout from COVID is substantial, and that the creation of the European Recovery Fund with shared responsibility across nations is a step toward European integration. All of these elements could support faster European growth and attract global investor attention. Further support for broader European integration and sharing of obligations across countries could result in a faster growth rate well into 2022 and possibly beyond. We believe the sclerotic European economy and its stock markets are finally on a path to become much healthier.

The MSCI Europe Index is a significantly more value-oriented stock index than the S&P 500. On May 31, 2021, financials, industrials, and materials comprised 39.44% of the MSCI Europe Index compared to 23.84% of the S&P 500. The growthier information technology, consumer discretionary and communication services sectors are only 24.08% of Europe, compared to a sporty 49.06% of US weights. This more value-oriented composition of European stocks could benefit from faster economic growth and would also likely perform better in a rising rate world, even if the European Union fails to further integrate and therefore grows slower than it could (or should). We also believe European inflation appears further off than any potential US inflation. As a result, for the first time in the last 5+ years, we are of the opinion that European stocks may have more runway than their US counterparts on many fronts.

Turning to our China exposure, we will note that our belief in “first-in-first-out” investment benefits is a key reason that we trimmed our biggest overweight significantly. Reducing our China exposure by 5% at year-end 2020 allowed us to lock in a big part of the benefit of last year’s excellent performance. China remains one of the cheapest, fastest growing regions in the world and we believe it will likely continue to outperform the world over some reasonable period of time. In the interim, as investors position for a recovery from the pandemic, we suspected Chinese stocks may be due for a breather, which now seems to be occurring, as evidenced by the following chart that shows relative performance of various US and international equity market indices over the five years ended May 28, 2021. (The chart does not include any manager alpha.)



Returning to the inflation debate, where we acknowledged both sides of the argument and the difficulty today of maintaining a firm opinion on which direction it might head. We recently sold our TIPS and moved back into treasuries because, as with Chinese stocks, we had been well rewarded for owning them. Over the last year or so, TIPS in the 3–5-year maturity range have outperformed comparable maturity treasuries by approximately 8%. In the world of fixed income that is significant outperformance. We sold the TIPS at what we viewed as attractive prices, realizing an attractive return for purchasing these relatively low risk securities back when few investors had any interest in protecting themselves against possible inflation. If in the next year inflation moves even higher, we may wish we had not sold our TIPS because the price relative to comparable treasuries will move higher still. Nevertheless, a fair price for something we bought cheap led us to lock in the relative performance. Conversely, if secular forces push inflation lower, as we earlier contemplated, we'll be happy we sold when we did. The chart below indicates the price change of a TIP outperforming a comparable maturity Treasury by about 8 points (after allowing for the 2% higher coupon of the Treasury) and helps to illustrate why we closed our TIPS position and moved back into nominal Treasuries.



Leaving Us Where?

So, intentionally, these moves over the last several months leave our portfolio about as evenly balanced to our benchmark as it has been over the last five years. Other than China (where we are still moderately overweight), our only meaningful tilt within the portfolio is toward equities generally, where we remain about 69% invested as we write this (4% overweight). We overweight equities at the expense mostly of fixed income. We also remain invested in shorter maturity bonds than our benchmark, so if rates rise, we should lose less than the benchmark and vice versa. Yes, we remain cautious in the fixed income portion of the portfolio. Our 20% hedge fund weighting is allocated reasonably close to our segment targets of 40% in equity long/short, 20% in macro/credit, 20% in relative value and 20% in directional. We will attempt to keep the beta of our hedge fund portfolios around 0.3x to broad equity indices so that we don't suffer too badly in an equity downdraft and still capture a reasonable portion of the longer-term beta offered by equity markets.

Our recent strong performance has been fueled by a propitious combination of manager alpha and additive portfolio tilts. For now, we will be more heavily reliant upon our ability to continue to find and

partner with the best investors in the world if we are to outperform our benchmarks. If history is our guide, that's a good place to be.

Finally.

We are optimistic that this terrible pandemic will soon draw to a close and hope that you experienced a few silver linings. For example, an extended stay at home with your parents or your children (whatever their age) may be a lasting positive memory. Next up, as we all attempt to return to normal, everyone is wondering what the new work environment might look like. For our part, the TIFF team expects to return to the office shortly after Labor Day. That said, we are proud of how the team has performed under the stresses of the last year outside of the office. We all very much look forward to seeing our colleagues in person and to meeting some of our newer colleagues in person for the first time. In the meantime, we hope your summer is great and that the economy keeps growing inflation free!

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 hope the second half of 2021 is as fruitful as the first and a healthy and happy time for everyone.

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