CIO Quarterly Commentary
Q4 2023

TIFF INVESTMENT MANAGEMENT

How Good Can It Get?

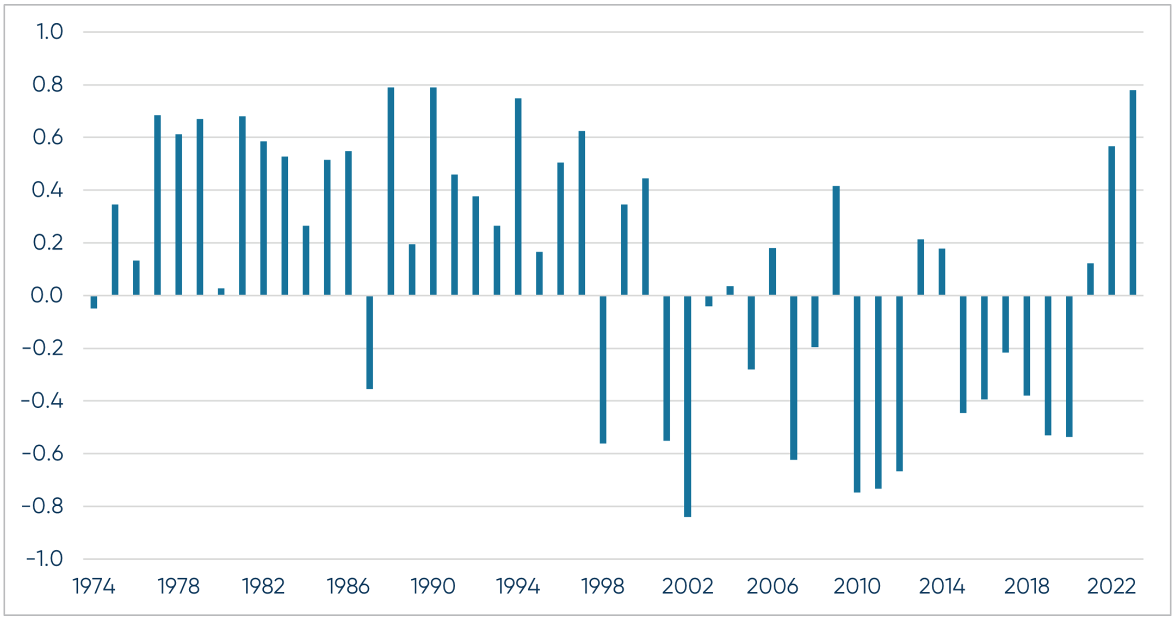
In financial markets, the impact of bad news can vary. Often, it's straightforwardly negative, and other times, paradoxically, it becomes good news. Currently, the markets are eagerly awaiting an economic slowdown that could reduce job and wage growth. This hope is driven by the belief that the Federal Reserve will then be able to initiate an easing cycle, rewarding investors for looking beyond a potential recession towards brighter economic prospects. This is the market's version of anticipating future opportunities, much like "skating to where the puck will be." Historically, during economic downturns, this anticipatory behavior pushes earnings multiples higher as current earnings hit their lowest point. This contrasts with robust economic conditions where earnings are at their peak and earnings multiples are closer to their lows. If markets accurately predict shifts in interest rates and earnings, this pattern makes sense. However, as we've witnessed this year, markets can sometimes prematurely discount changing earnings or future interest rate levels, necessitating corrections back to previous levels when conditions revert, as occurred this fall.

We've seen this movie twice in 2023. Markets believe that the Federal Reserve, along with other global central banks, is approaching the easing phase of the economic cycle and have given investors a second glimpse of what this could mean. In November, global stocks surged by 9.3%, and the Bloomberg US Aggregate Bond Index ("Agg") rose by 4.5%. This echoes the earlier June/July period when stocks gained 9.8%, driven by bond yields stabilizing due to weaker employment reports. Of course, subsequent economic strength led to a decline in bonds by 5.4% through mid-October, accompanied by a 7.8% decrease in stocks, setting the stage for November and December's rally. The critical question now is whether this year-end trend is a genuine shift or another false start.

Will There Be a Goldilocks Scenario?

Nobody can predict the future, of course, but we all have our opinions. In our view, the market's intentions have become clearer through recent events. If the economy, jobs and wage growth cool, bond yields could decrease, leading to gains in bond prices and larger gains in stock prices. In both rally episodes this year, equity returns have outpaced bond returns. For the past 20 years or so, when stocks and bonds were negatively correlated, this would not have happened because stock and bond prices moved in opposite directions. However, over the past three years, the correlation between stocks and bonds has been positive, meaning bonds have not protected portfolios during stock declines as prices of both securities have moved in the same direction.

Annual Correlation Between S&P 500 Index and Bloomberg US Treasury Index
(1974 to 2023)[1]



This suggests that interest rates might be too high to allow for predictable economic growth, causing both stock and bond prices to rally or decline together. When this occurs, it becomes more challenging to cushion equity declines, and in our opinion, it may be wise to require higher yields from a bond portfolio that no longer provides effective diversification. Investors are hoping that rates are now high enough that the Fed has room to cut short rates to boost demand, thereby supporting both the economy and market prices. As the fear of rates being too high subsides, we may return to a negative correlation environment.

All challenging investment questions revolve around the future, not the past. Answers to these questions are essentially educated guesses, formed through a careful analysis of the current and expected circumstances, and should include a generous helping of skepticism. In a high inflation environment, as bond yields rise, bond prices fall. This leads to an increase in the cost of capital, limiting opportunities for corporate earnings growth and reducing the present value of future earnings. These factors collectively exert downward pressure on stock prices. However, if the economy

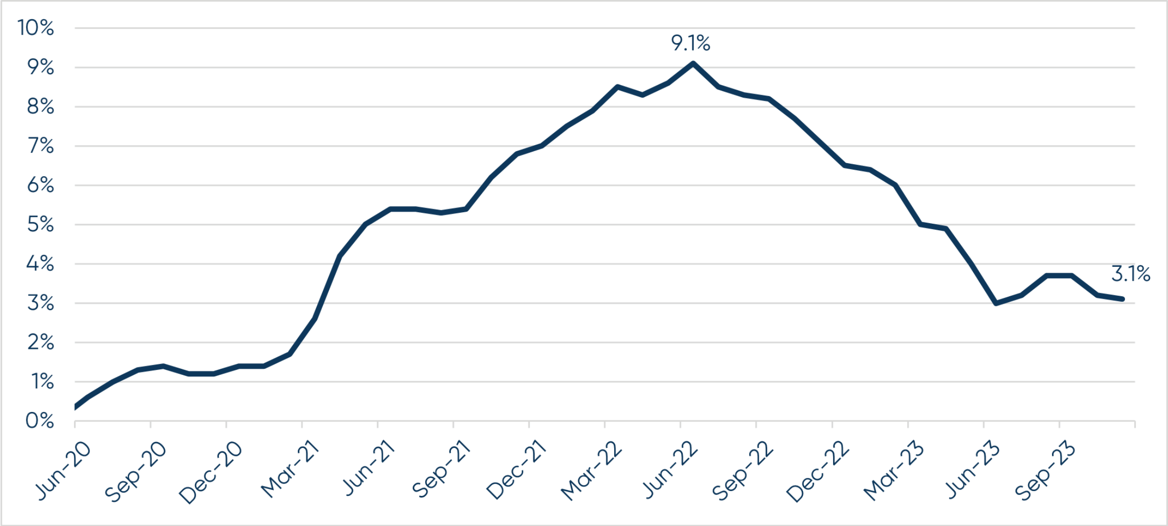
[1] Source: Bloomberg.

can maintain its health while inflation and interest rates decrease, we may observe both bond and stock prices rising, as we have in two distinct instances this year, resembling a potential "soft landing" scenario. So what will it be?

Inflation has noticeably eased, with year-on-year CPI dropping from 9.1% in June 2022 to 3.1% in November 2023, which is a positive development.

US Consumer Price Index

(%, June 2020 to November 2023)[2]



Our concern has always centered around wringing out the last 1 to 2% of inflation. Some Federal Reserve governors have hinted that they may not raise rates again – and could potentially shorten the duration of elevated rates. Until December, Jerome Powell has refused to adopt this stance and insists on the Fed's commitment to lowering inflation to the 2% target while avoiding a recession. His opening of the door to such a view in December fueled the late-year bond rally. Achieving this target without a recession would benefit both bond and stock markets. The risk is that the path to 2% inflation might trigger a recession. To clarify, successfully threading the needle of lowering inflation while avoiding a recession would likely help both bonds and stocks; causing a recession would likely benefit bonds – with lower rates and higher prices – but hurt stock prices due to declining expectations of future earnings.

Conversely, if the Fed begins easing too soon and inflation does not fall all the way to the 2% target, it could disappoint bond investors and potentially keep rates high – or even push long-term interest rates somewhat higher. In isolation, this would be detrimental to bonds and not particularly helpful for stocks. However, it might allow the economy to keep growing faster than anticipated, which could benefit stocks.

[2] Source: US Bureau of Labor Statistics. Consumer Price Index, 12-month percentage change.

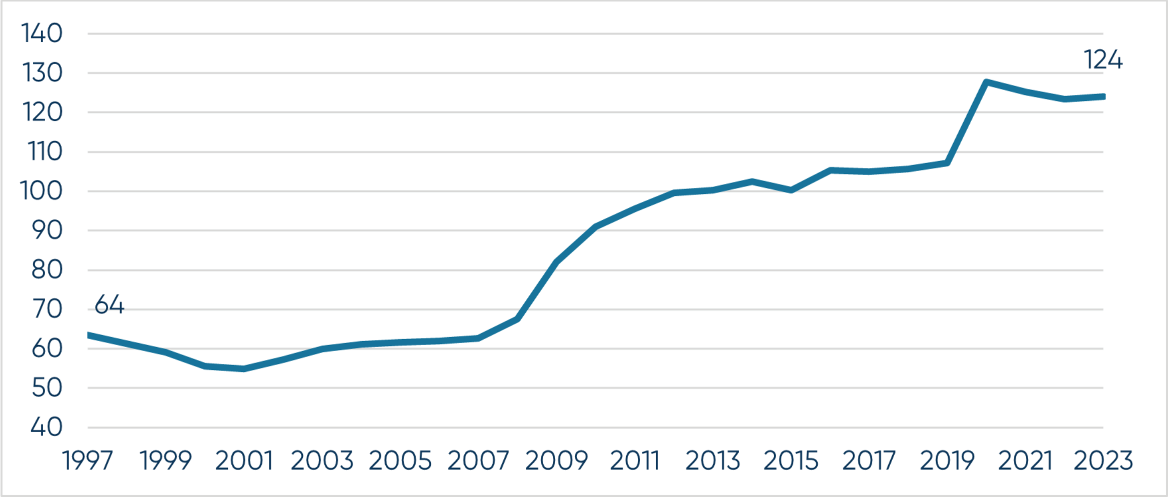
The direction of stocks would ultimately hinge on the relative extent of rising interest rate disappointment versus earnings growth enthusiasm in this scenario.

We Have Increased Our Bond Duration, But US Fiscal Risks Remain

In this still-fluid environment, we plan to position portfolios closely to our long-term Strategic Asset Allocation weights. With regard to the hedge fund allocation, the diversification benefits remain important, and we continue to see better returns from hedge funds than from bonds – even at today's higher interest rates. Yes, we like bonds better than we did a year or two ago, for sure. In fact, we have increased our bond duration by about 2 years to 4.25 years in response to the better value we have seen in fixed income. The coast is not totally clear, however, as factors such as elevated government debt levels, changing demographics, the green transition, and onshoring suggest that future equilibrium inflation could be higher than the levels observed over the past two decades when these factors were not as significant.

It's important to note that the recent extension of our bond duration signifies our confidence that bonds are now a viable investment. Although our duration still falls short of the Bloomberg US Aggregate's 6.25 years, this extension signals our belief in the investability of bonds. Our primary remaining concern above centers on the US budget situation.

US Federal Debt as Percentage of GDP
(December 1997 to December 2023)[3]

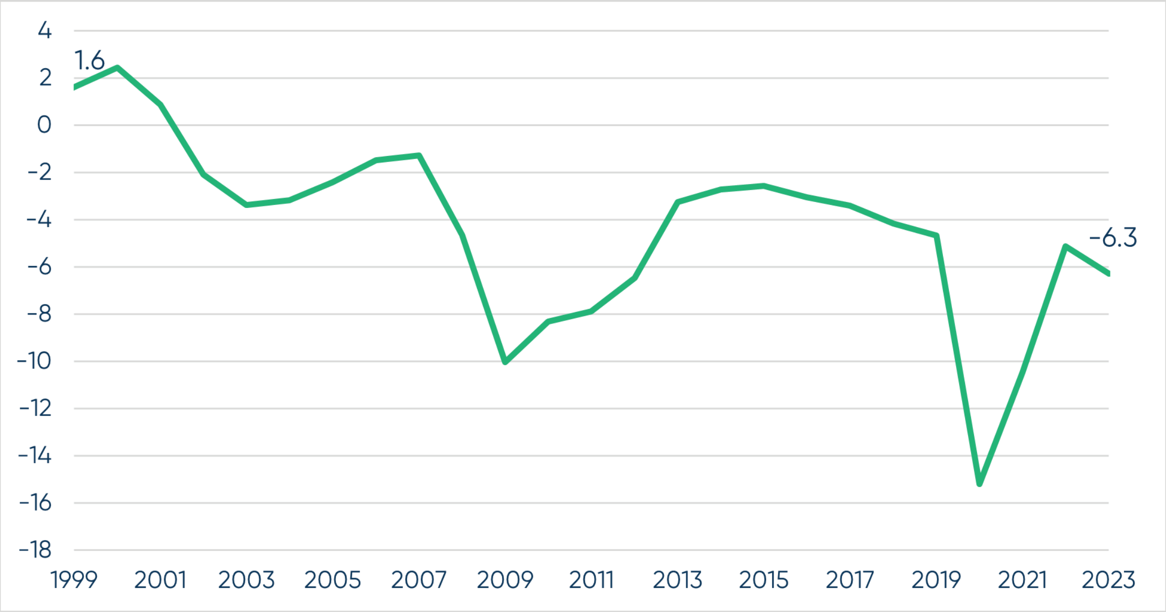


[3] Source: Bloomberg. FEDDGFDP Index: White House US Federal Debt Gross Federal Debt in Percent of GDP.

Over the past 15 years, our fiscal situation has significantly deteriorated. Gross US Federal Debt as a percentage of GDP has nearly doubled, going from 64% to 124%.

This trend appears set to continue, given persistently high annual deficits, even during favorable economic conditions. Rising interest rates paid on this debt further compound this problem. The impact of deficits during the next recession could exacerbate an already precarious situation. As the chart suggests, it isn't one party or the other, but both parties that have contributed to this worsening situation. The last time we ran a budget surplus was nearly 30 years ago!

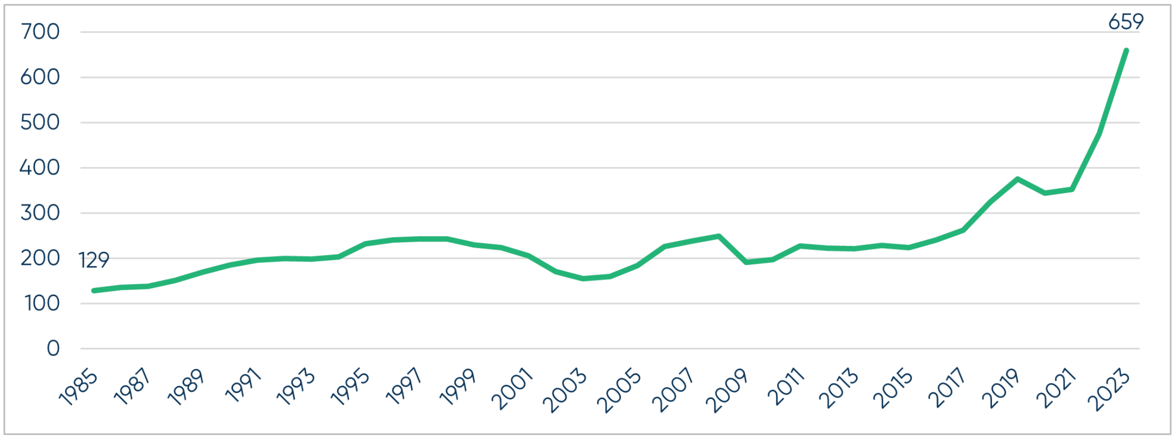
US Surplus/Deficit as a Percent of GDP
(December 1997 to November 2023)[4]



This past summer, Fitch downgraded the US credit rating to AA+, and in November, Moody's maintained its AAA rating, but placed the US on negative watch due to "large fiscal deficits and a decline in debt affordability." (S&P downgraded the US credit rating in 2021). This pushes the US down to the 13th highest-rated sovereign credit globally.[5] A concern that was once distant is now a more imminent reality. It is our hope that, in the near future, we will elect responsible politicians who can collaborate to change our fiscal trajectory before market forces compel us to do so. To be clear, we do not think the US is in imminent danger of a fiscal calamity, but we need to start working to avoid such a calamity and, until we start showing some signs of doing so, the market may demand higher yields on US-issued debt.

[4] Source: Bloomberg. FDDSGDP Index: US Treasury Federal Budget Deficit Or Surplus as a % of Nominal GDP.
[5] Source: Bloomberg.

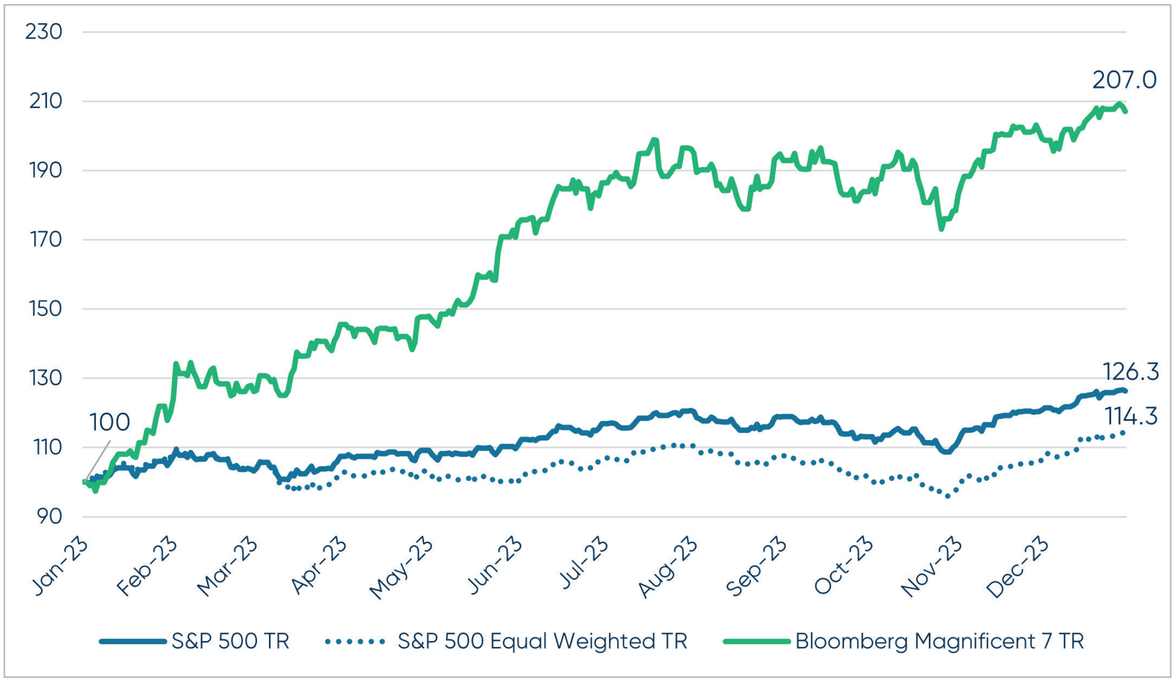
US Interest Expense on Public Debt Outstanding
($bn; 1985 to 2023)[6]



Magnificent 7 Led This Year's Narrow Rally

We are positioned for a future economic slowdown that won't necessarily be a severe recession, but could create an opportunity to add to our investments in stocks at attractive levels. We have seen the expected bounce back from the terrible 2022, but it was a very narrow rally led by the Magnificent 7 ("Mag7").

Cumulative Wealth of the Magnificent 7 Versus the S&P 500
(January 1 to December 31, 2023)[7]



[6] Source: Bloomberg. FFSOINT Index: US Treasury Federal Budget Net Outlays Net Interest.
[7] Source: Bloomberg.

These seven stocks – Amazon, Apple, Google (Alphabet), Meta (Facebook), Microsoft, Nvidia, and Tesla – surged by 107.0%, and the broader S&P 500, which includes them, increased by only 26.3%. The equal-weighted S&P 500, similarly, rose by only 14.3%. Roughly estimated, the Mag7 stocks began the year at around a 15% weight in the S&P 500 and have contributed approximately 15 percentage points of the S&P 500's 26 percentage point return this year, accounting for more than 50% of the overall market return.

The last paragraph obscures several key points:

1. If you didn't own any of the Mag7, you very likely had much lower returns compared to the S&P 500 last year
2. Active managers faced challenges in keeping pace with this index because they often underweight mega-cap stocks
   - Instead, they seek "better" ideas in smaller cap stocks in their efforts to generate idiosyncratic alpha
   - Growth stocks massively outperformed value stocks by 31%
3. US stocks outperformed non-US stocks by 10%, leaving the global index, MSCI ACWI, in the middle at 23%

Since the US represents about 62% of ACWI, the Mag7 contributed very roughly one-third of the return of the entire global index!

Some attribute the Mag7's outperformance to defensible, robust business models with strong cash flow growth prospects. Although this is true today, long-term investors must ask themselves whether this will remain true in coming years. It is possible, but it is historically rare for companies to maintain their position among the top 10 global market capitalizations for consecutive decades. It will be intriguing to observe if the Mag7 continue to be "magnificent" in 2030. Alternatively, it's possible that these stocks contributed disproportionally to the return because other stocks only gained around 13%, due to weaker underlying fundamentals. If this is the case, any upcoming economic challenges could potentially worsen already-weak fundamentals more than anticipated.

Our belief is that the market has telegraphed its likely direction once we exit the high inflation/interest rate environment: It will rise. There might be a few more false starts along the way, but ultimately, investors will be rewarded for investing in the asset class historically known for delivering the best returns. Any volatility encountered during the journey will likely be rewarded in the end.

Markets in the Context of the 2024 Presidential Election

All of this is not to say that things couldn't be better. It seems evident that many Americans aren't particularly enthusiastic about the upcoming November elections. Many will find themselves choosing the lesser of two evils, rather than a candidate who genuinely excites them. It would be wonderful if we had a presidential candidate who could inspire a majority of Americans. Unfortunately, that does not appear to be the case today. When that day does arrive (which we optimistically anticipate!), imagine the power and excitement of having Americans unite in pursuit of betterment for our country and the world.

Outside the US, two wars continue, and US/China relations remain a concern. The world needs the US to become that shining beacon on the hill once again. Until then, it seems probable that market returns will be a muted shade of green rather than the vibrant green that they will become again someday.

In election years, markets often show a pattern of meandering for the first 8 to 10 months until the likely winner becomes clearer. Typically, when the next president secures the most Electoral College votes, a sense of optimism/relief returns because more people voted for the winner and their policies. This usually leads to a late-year rally. Given recent gains and the historical trend of markets pausing until election clarity emerges, the early part of 2024 could be more uncertain and volatile than expected. Should an opportunity arise to accumulate equities at more attractive prices, we intend to increase our exposure modestly during any weakness.

Our Portfolios

In addition to extending our fixed income portfolio duration this year, we made a range of strategic and tactical decisions across our portfolios. First, in equities, from a strategic perspective, we decided to reduce our exposure to China to roughly benchmark weight. After several team members spent weeks in China throughout Q3 and Q4, we felt the ongoing recessionary conditions and political uncertainty were not likely to abate in the near term, and we adjusted accordingly. Second, we decided to reallocate away from fundamental Japanese equity and towards Japanese passive as we continue to research our options in that market. We have not given up on Japan and remain near benchmark weight; however, we do believe a more active engagement approach is needed to generate superior index-relative returns. Throughout the year, we spent time studying and meeting with systematic investment firms as well as multi-manager platforms. This process resulted in partnerships with two firms not previously open to us and may result in one or two more over the next 12 months. The hangover of 2022's dislocations created an opportunity that we believe will help us in years to come. Similarly, from a tactical perspective, the dislocation in closed-end funds which started in earnest in 2022 and continued in 2023 has driven many to historically wide discounts to NAV relative to their previous 25-year history, and we found a creative investor to help us profit from what we expect will be a narrowing of those discounts over time as the forces of mean reversion take hold.

We were equally active on the diversifiers side of the portfolio, where in 2023 we trimmed back several of our strongest performing funds that benefited from the market rebound and have rotated capital into less market-sensitive strategies which we believe will benefit the portfolios in 2024. In many instances, we had taken advantage of 2022's market volatility to add to (or at least not redeem from) these same managers during last year's significant dislocations. The rise in precious metal prices, recovery of European financials, the emergence of AI, dislocation of credit, and recovery of Carbon Credits are a few themes which contributed positively in 2023. We also gained more access to a couple of managers that had been closed where capacity has become available. With luck, our good fortune in 2023 coupled with these allocation adjustments could help us in 2024 as well.

As we begin 2024, we're coming off a strong Q4 rally, and most strategists are optimistic. The expectation is for the Fed to start easing in the first quarter or two, with the 10-year Treasury yield possibly declining to around 3.5% by year end. The economy and stocks are anticipated to remain firm. Often when most investors believe something, it is already discounted in the markets, and they can become prone to the unexpected. Next year could play out that way. Our portfolios are built to survive and thrive in the environment we see ahead in 2024.

As the new year progresses, we expect brighter days ahead. Inflation is unlikely to rise much and could continue to moderate next year. This and a commensurate cooling of the jobs market could allow the Fed to soften its "higher-for-longer" approach aimed at cooling the economy. Whether we see a recession or not, the economy should be on more stable ground after the tumult that could surround the election cycle. Although a few turbulences are possible in the first quarters of 2024, we should see better times, even if we must wait until after markets discount a possible recession along the way. In our view, we continue moving back toward normal markets where asset returns will trend up and to the right.

As always, we very much appreciate the opportunity to help manage your capital and to help you achieve your organization's goals. We are here to assist you in any way possible, so please reach out and let us know how we can help. Finally, we wish each of you a happy, healthy, and safe New Year.

Your TIFF Investment Team

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