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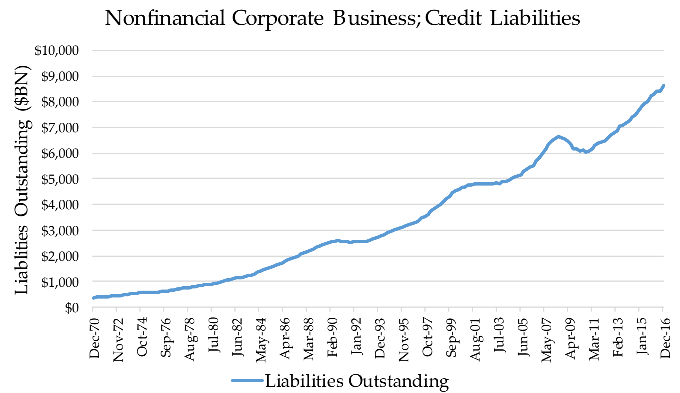
Disciplina Capital Management
June 2017 Quarterly Update

"The reports of my death are greatly exaggerated." – Mark Twain

Second Quarter 2017 Update

Legend has it that during a trip to London, an American newspaper published Mr. Twain's obituary. Upon hearing this, he uttered the now famous quote, which is regularly paraphrased to this day. Today, similar conversations are taking place around the potential death of the "endowment model" which subscribes to allocating to a broad range of strategies that entail growth, diversification and inflation protection. Additionally, there are a myriad of articles in the financial press citing the death of active management, the virtues and migration to passive investing, the woes associated with hedge fund performance and the cost/complexity associated with private market investments. This begs the question, "*Is the endowment model dead?*" If so, why shouldn't institutions simply invest their portfolios in a passive mix of stock and bond funds?

As is quite often the case, the true story is much more nuanced than what is presented in the public arena by the popular press. You need to drill down to see what the trends really are. Admittedly, active equity management has faced significant headwinds for a number of years, and the combination of low interest rates and volatility exacerbated by accommodative central bank policies across the globe has not relaxed the headwind faced by many active managers. While the U.S. Federal Reserve (the "Fed") reversed its stance late last year on rate policy, other countries continue with easing. It is also hard to argue that the absolute level of interest rates in the U.S., Europe and Japan could be viewed as restrictive. This in turn has fueled an expansion of corporate credit that has led to a record increase in stock buybacks. Thus, equity markets have been largely driven by fund flows and macro forces versus fundamentals at the individual company level, which makes security selection difficult for even the best fund managers.



Source: Federal Reserve Bank of St. Louis

Another reality that is often buried in nuance is the law of averages. For example, when those in the press cite the "average" hedge fund return, this number often captures the performance of a variety of hedge fund strategies. This average often includes very different strategies like long/short equities, fixed income relative value and macro strategies to name a few. It's a bit like walking into Baskin Robbins and ordering a scoop of all "31 flavors." So, the average may not be tailored to an institution's specific portfolio or investment objective.

Finally, the proverbial tombstone for the death of the endowment model would read, "Cost." Cost associated with private market investments is often lamented by investors in the press, "*how dare managers charge so much*." Yet, when one looks deeper, they would observe that private market investments have been the best performing asset class **on a net of fee basis**, by a sizeable margin for the ten-year period ending December 31, 2016, with an annualized benchmark return of 10% annualized.

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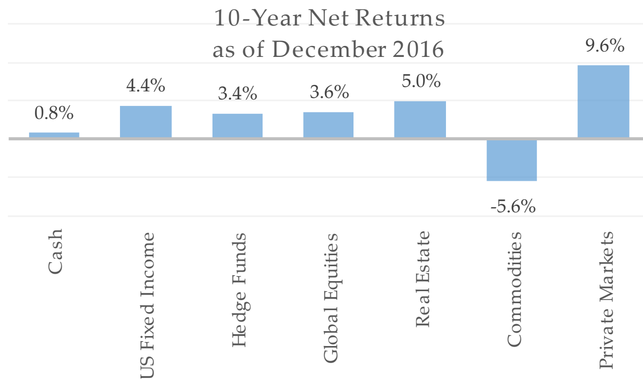
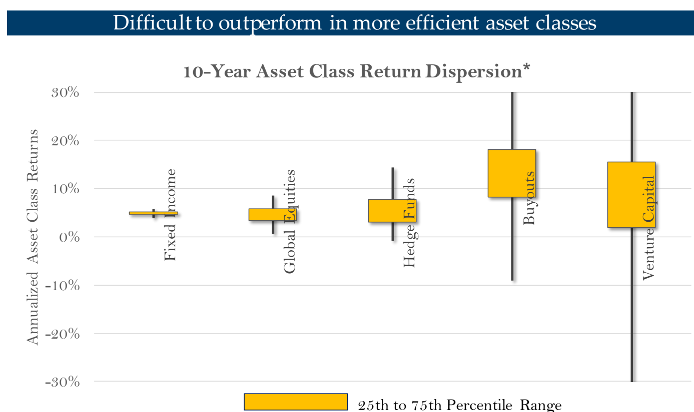


By comparison, global equities rose 4%, despite U.S. and other equity markets achieving record highs.

Within what context should the "endowment model" be applied? Absent clairvoyance and assuming a long-term investment horizon, Disciplina believes a multi-asset class and multi-investment manager approach should be applied in order to achieve an institution's long-term return objectives. For many institutions, this equates to a long-term nominal return (including inflation) of 6 – 8% percent, with an annual spending rate 4 – 6% percent and a current inflation rate of 2%.

The exhibit below highlights the return disparity between investment managers within the top and bottom percentiles across several asset classes from the most efficient: fixed income and equities, to the least efficient: hedge funds, buyout and venture capital.



*10-year returns per various eVestment universes through December 2016. Buyouts and Private Equity are represented by 2007 vintage year IRRs as reported by Preqin.

Return disparity between the most efficient asset classes such as fixed income and equities is very narrow. This implies that fixed income, in particular core fixed income, and developed market equity managers' ability to provide differentiated returns is a relatively more difficult proposition. Thus, an investor's ability to select investment managers that will outperform on a net of fee basis within these asset classes is equally challenging. Confirming passive management within these strategies may be a preferable approach. Conversely, subject to an institution's access to appropriate resources, Disciplina believes alternatives should be included as part of a long-term investment strategy, providing access to differentiated, hard to replicate strategies not available to many investors. Alternative investments employed within an "endowment model" may also provide a better opportunity to generate value-add performance through manager selection, thus increasing the potential range of returns for investors.

At the end of the day, the "endowment model, which includes actively managed alternative investment strategies, is still very viable, but extensive homework is required. Clearly, the growth in the space over the last few years has led to many pretenders rising on the coat tails of the successful history of other well-established investment franchises. Fortunately, at Disciplina we have a long history of roughly 20 years of working together sourcing, evaluating, and allocating capital to investment managers within both the public and private markets. This affords our clients a greater opportunity to realize competitive returns within their endowment, regardless of size, and thereby enhancing their ability to sustain their mission, attract capital, and continue the legacy of their respective institutions.

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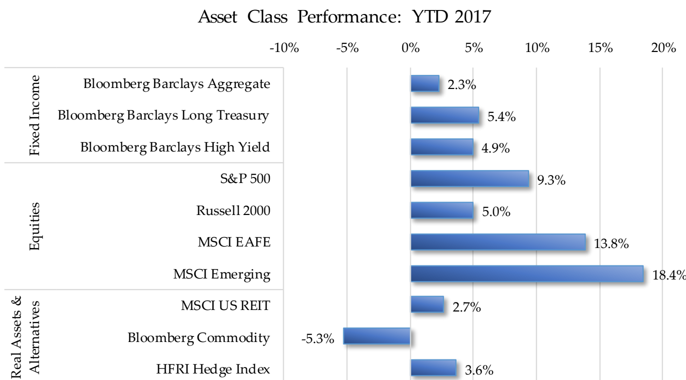
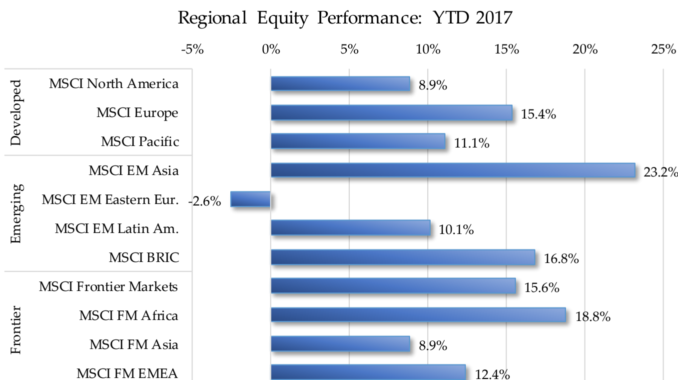
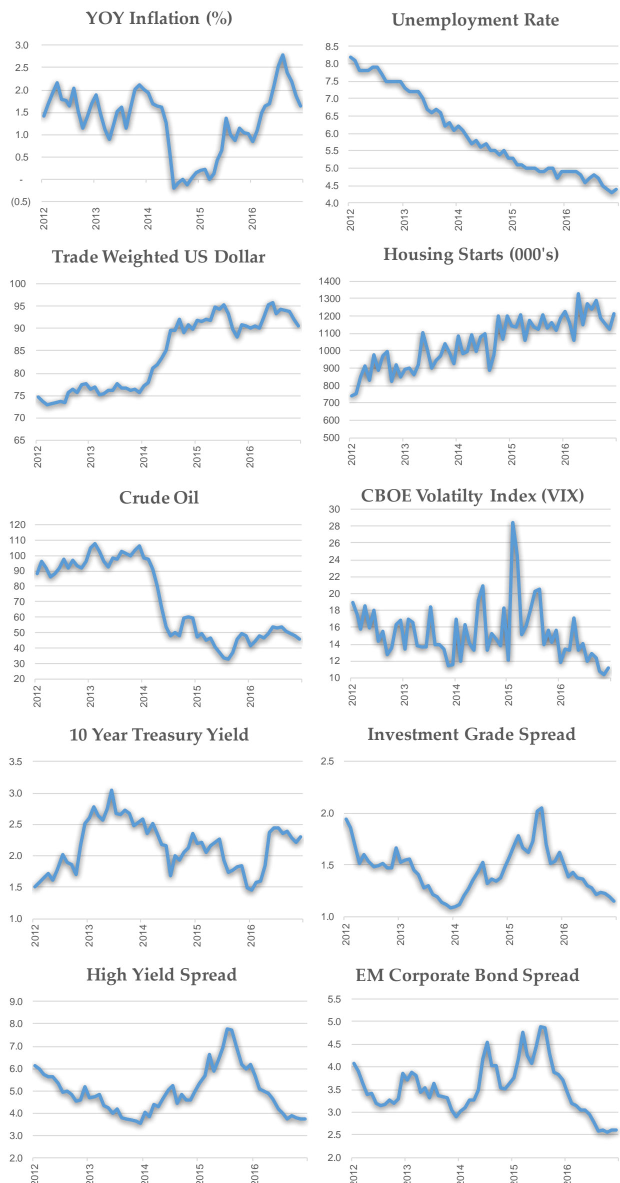
Market Update - Equity markets surpassed their 2016 annual returns, with global equities gaining 11.5% year to date, led by emerging market equity gains of 18.4% and international returns of 13.8% on a year-to-date basis. Fixed income rates declined, as did credit spreads, which led to 2.3% gains in the Barclays US Aggregate and 4.9% gains in high yield. Real assets in commodities and real estate saw the lowest returns for the six-month period while hedge funds gained 3.6%.



International and emerging market equities greatly outperformed U.S. equity markets in the year to date period as the U.S. dollar fell about 5.5% versus a trade-weighted basket of currencies. Additionally, valuations were generally supportive of an international equity rally.



Firm Update - We are honored to have the privilege of stewarding our clients' portfolios with ultimate goal of advancing their respective missions. For the six-months ending June 30, net returns for our client's long-term mandates ranged between **7%** and **9%**, while reserve portfolios posted a **2%** net of fee return. As we continue to gain momentum in the marketplace, we are grateful to our existing clients and supporters.



* Sources: BofA Merrill Lynch; US Departments of Labor, Commerce & Energy; CBOE; Federal Reserve Bank of St. Louis, Board of Governors of the Federal Reserve System

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