TO: The Greater Tacoma Community Foundation

FROM: Fund Evaluation Group, LLC

SUBJECT: Portfolio and Market Update

DATE: February 12, 2016

PORTFOLIO OBSERVATIONS

Performance as of 12/31/2015

	3 months	One Year	Three Year	Five Year	Seven Year
Foundation	2.3%	-3.7%	4.5%	5.3%	8.7%
Benchmark	1.4%	-2.3%	4.3%	4.7%	8.4%

The past 18 months have proven challenging for institutional portfolios with any measure of diversification. Since 2014 the markets have rewarded investments in large companies here in the United States, despite attractive valuations elsewhere. While it is difficult to maintain discipline in times like now, history shows that the principles of diversification and buying low and selling high are the bedrock requirements for long-term performance. It is times like now that an evaluation of the portfolio and its performance drivers are required. Fundamentally, the key components of the Foundation's investment philosophy have not changed. The belief that diversification matters, and that undervalued assets have greater return potential versus overvalued assets, and that downside protection at the sacrifice of potential underperformance in momentum driven up markets remains the cornerstone of decision making.

There are five specific issues over the recent months, however, that have proven to be a headwind. Below we discuss each of those as well as our opinion.

1. **A very narrow band of stocks outperforming-** While the S&P 500 has been the single best stock performer over the past 18 months, it is important to examine the drivers of return. For 2015, the top ten stocks of the S&P 500 returned 17% while the remaining 490 stocks returned -5%. So while the S&P 500 has done well, it is a very small handful of stocks truly driving performance. This thin line of strong performing stocks has skewed the index and, as a result, benchmarks.

2. **Value versus Growth-** Historically value stocks outperform growth stocks over a full market cycle. As a result, FEG's philosophy is for portfolios to have a bias toward value stocks. During the past 18 months, however, growth has significantly outpaced value stocks. To illustrate the divide between value and growth, in 2015 US large company value stocks were negative 3.8% while US large company growth stocks were positive 5.7%. A 950 basis point difference between value and growth stocks within the US large company space! We do not believe this trend can continue and we believe a return to historic

outcomes of value outperforming growth. When this does occur (and we do believe it will) the Foundation should stand to benefit from this value overweight.

3. **The strength of the US Dollar-** The Foundation has currently allocated approximately 20% of the portfolio to non-US stocks under the belief there is adequate growth as well as attractive valuations compared to the US market. Despite this, the returns of international managers in the portfolio have lagged the US market due in no small part to the impact of currency. Over the past 18 months the US Dollar has appreciated nearly 24% versus other major currencies. In 2015 international investments took a 6 percent hit due to currency as investments were converted from foreign currency to the US Dollar. International investors have been the beneficiary as well as the victim of currency over time. For example, coming out of the Great Recession as the US Dollar was losing value to other currencies (anyone who took a trip to Europe in 2008 may well remember the increase in cost due to the strength of the Euro) international investments increased in value due to the conversion back to the dollar. We are seeing the other side of the equation playing out over the past 18 months. This, we believe, is an event and not a trend. We further believe that over time the impact of currency reaches equilibrium and the Foundation will stand to benefit as the US Dollar cools relative to other currencies.

4. **Emerging Markets -** Investor sentiment is historically negative on Emerging Markets due to the economic slowdown in China. The prevailing narrative is that the impact to China's economy will be far reaching and all of the Emerging zone will decline. While it is true that China's economy has slowed, it has not declined to negative territory and still stands to benefit as China re-invents the key drivers of economic expansion from industrial to consumer factors. This will not happen overnight, however, and while FEG still is bullish on Emerging Markets in the long-term, there could be continued weakness in the intermediate term. As such FEG is recommending a modest reduction in Emerging Markets from approximately 7% to 5%.

5. **The collapse in the price of oil-** As has been discussed considerably, oil has reach multi-year lows and is now trading at a fraction of the price it was a few years ago. This impact has been a drag on energy-related investments in the portfolio (Energy sector, Master Limited Partnerships, Commodity Futures, etc.) due to an inventory overhang. In other words, supply is far in excess of demand presently. Again, we view this as an event and not a trend and believe in some return to normal asset pricing within the energy sector. Master Limited Partnerships (MLPs) at ~2.5% of the portfolio present attractive pricing, yields in excess of 600 basis points of Treasuries and offer a diversifier from rest of the portfolio. While returns have been challenging, we do believe the investment of 2.5% is warranted and should stand to benefit from energy pricing increase in the intermediate-term.

While the performance has been challenging for all investors, the past 18 months have proven particularly challenging for diversified portfolios with a bias toward undervalued assets. The Foundation recognizes these challenges and has made adjustments to correct portions of the portfolio where risk is outsized relative to the potential return. But the Foundation further believes that investments should be made for the long-term and recognizes that increased volatility may be the price to pay for potential reward down the road. It is times like now that patience is rewarded. The portfolio is not flawed and recent events have challenged but not changed what we believe to be the keys to success. While the returns are challenging and the Foundation is making every effort to correct what needs correcting, no long-term decisions should be made based upon short-term events.