QUARTERLY
INVESTMENT REPORT

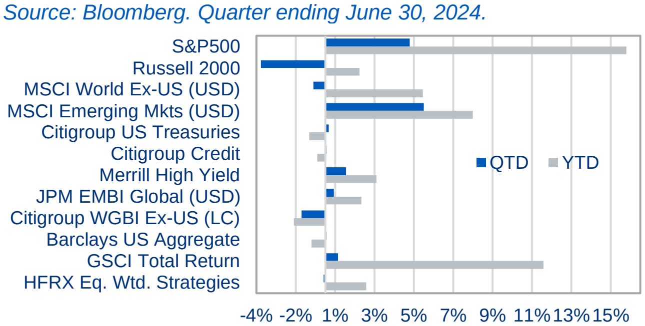
Q2 2024

Strategic Investment Group®

Global Market Review

Concentrated, overvalued, and AI-obsessed, the U.S. equity market extended its gains in the second quarter. NVIDIA, the chief object of the market's obsession, roared further ahead, briefly capturing the crown of most highly capitalized U.S. company. The Bank of Canada and the ECB cut their policy rates by 25 basis points in June, becoming the first G-7 central banks to do so. Advanced economy non-U.S. equity markets lost ground in the second quarter weighed down by a fall in the Japanese market and the lackluster performance of European bourses. A rally in Chinese equities sent emerging markets higher. U.S. Treasury yields rose marginally in the quarter, but expectations for a September Fed rate cut are firmly entrenched. Together with rising equity prices, narrowing credit spreads have eased financial conditions so far this year, mitigating the lagged effect of Fed rate hikes and contributing to steady economic growth as inflation moderates.

Exhibit 1
Performance of Major Market Indices
Source: Bloomberg. Quarter ending June 30, 2024.

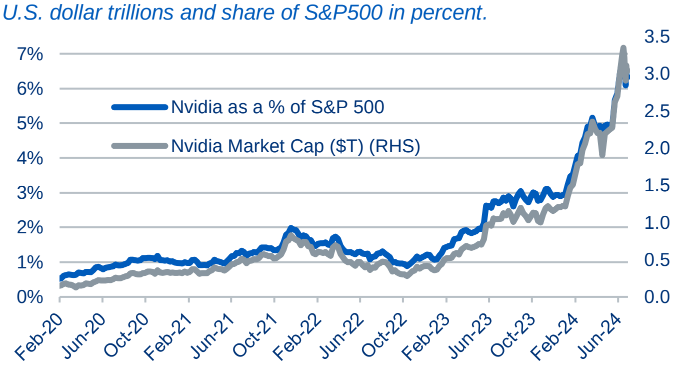


AI propels market higher.

U.S. Market's AI Obsession

The S&P 500 index gained 15.3% in the first half of 2024 as growth stocks outpaced value by a wide margin, rising 19.9% versus a gain of 6.2% by value. While the U.S. equity market's performance in the first half of the year has been strong, NVIDIA's gains have been stratospheric, rising 149.5%. NVIDIA is now valued at over $3 trillion, up from $144.5 billion at the beginning of 2020 (Exhibit 2). As a share of the total market capitalization of the S&P 500, NVIDIA has increased from 0.4% to 6.3% over the same period. It joins Microsoft and Apple as one of three U.S. companies with market capitalizations of over $3 trillion.

Exhibit 2
NVIDIA's Market Cap and Share of S&P 500 Soar
Source: Bloomberg and Strategic estimates. NVIDIA's market cap in U.S. dollar trillions and share of S&P500 in percent.



Although highly speculative, NVIDIA's vertiginous ascent is not baseless. Its earnings growth has also been spectacular, fueled by high operating margins and a seemingly insatiable demand for its chips which form the nucleus of AI platforms. However, analyst estimates of future earnings growth appear increasingly outlandish (Exhibit 3).

The extraordinary rise of AI-related stocks has contributed to the concentration of the U.S. equity market as well as rising valuations. The top 10 firms in the S&P 500 now account for over 35% of its total market capitalization, exceeding past peaks, including that of the 2000 tech bubble. This year's market gains thus rest precariously on a narrow foundation of stocks with elevated valuations and exuberant future earnings estimates.

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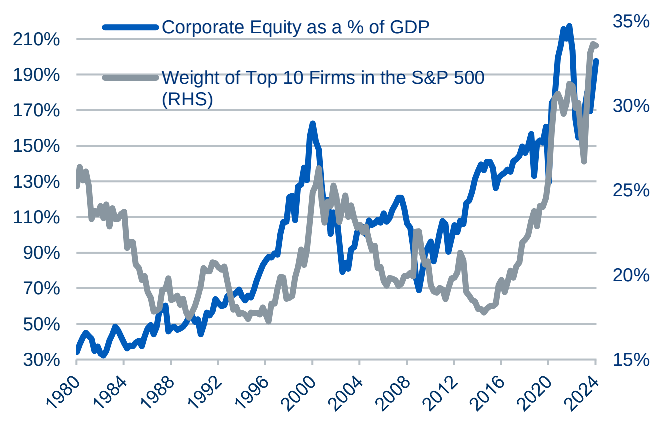
Outlook & Strategy

Rates, the Economy, and the Markets

We appear to be at a watershed in the economy and the markets. A long period of easy money and negative real interest rates initiated in the wake of the 2007-09 great financial crisis (GFC) and intensified following the pandemic shock has come to an end. In response to a spike in inflation across most advanced economies, global central banks have undertaken the most intense and concerted tightening of monetary policy in 40 years. We now appear to be entering a sustained period of higher real rates and tighter liquidity.

The legacy of the long period of ultra-low interest rates and abundant liquidity has been a large increase in the size of the financial sector and an overvaluation of risky assets. Although shy of its 2021 peak, the size of the U.S. equity market relative to GDP is well above long-term averages pointing to the growing financialization of the economy (see blue line in Exhibit 1). The increase in the size of the equity market has been accompanied by its increased concentration (gray line), reflecting the market's current obsession with a small number of AI-related firms.

Exhibit 1
Increasing Size and Concentration of the US Equity Market
Sources: FRED and Bloomberg. Non-financial corporation equity as a percent of GDP (LHS) and the weight of the 10 largest firms in the S&P 500 in percent of total market capitalization (RHS).



The immediate consequence of high asset prices has been to sustain household consumption. Buoyed by higher equity and home prices, household net worth is now hovering around 8-times disposable income, just below its all-time high in 2022. Although now helping to sustain economic growth, the equity market's size, overvaluation, and concentration raise concerns over future financial stability. The constellation of higher interest rates and richly valued assets also has important investment implications.

Investment Implications of Higher Rates

Investment returns can be broken down into the risk-free rate, usually proxied by three-month Treasury bills, market beta, and the value added generated through active management. During the post-GFC period of negative real yields, investors could expect no boost to return from the risk-free rate. However, low yields flattered asset valuations boosting market beta, especially across equity and property markets. High beta more than compensated for the unremunerative risk-free rate and made the search for alpha seem less pressing.

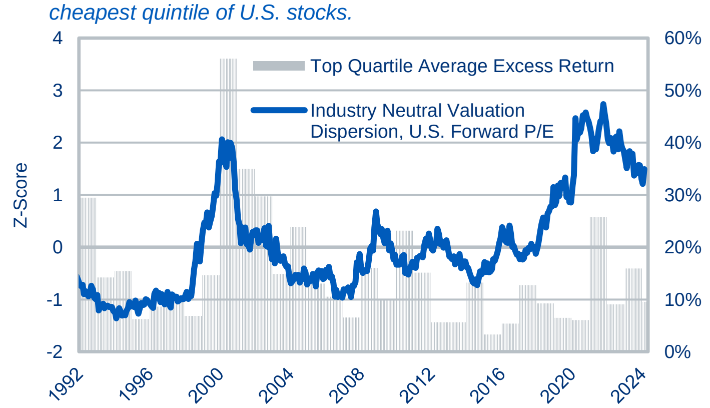
Now, however, with higher rates apparently well entrenched and the valuation of risky assets looking stretched, risk control and the sustained generation of alpha have become paramount. After a strong run for beta, we expect that portfolio construction and alpha will be the critical drivers of investment returns. The search for sustainable sources of alpha that contribute to portfolio diversification and resilience has been and remains our main focus.

Finding Alpha in Concentrated Markets

The U.S. equity market is concentrated, overvalued, and AI-obsessed. The current prices of some of the largest firms in the market, including those that have contributed disproportionately to recent overall market return, are predicated on heroic future earnings assumptions. We consequently maintain an underweight to U.S. equities and continue to favor equity strategies that use active security selection to take advantage of valuation anomalies.

Against the backdrop of the market's overvaluation and concentration, the valuation dispersion of rich and cheap securities, although down from its peak, remains quite wide relative to history (Exhibit 2). These high levels of valuation dispersion increase the opportunity set for value added.

Exhibit 2
Wide Valuation Dispersion Boosts Alpha Potential
Sources: Bloomberg and Strategic estimates. Z-score measures the standard deviation of the valuation dispersion of the richest and cheapest quintile of U.S. stocks.



By constructing each client's equity portfolio to encompass a wide range of highly diversified and complementary sources of return and value added, we aim to optimize risk-adjusted returns and enhance portfolio resilience. Accordingly, we have constructed the U.S. equity portfolio to comprise active long-only managers using a combination of quantitative and fundamental techniques as well as extension and portable alpha strategies. We have found extension strategies to be an efficient way to capture alpha by allowing skilled active managers to express their outperform and underperform insights on particular securities through both long and short positions. We round out the equity portfolio with portable alpha strategies that combine a rich source of diversified alpha streams with market beta. These strategies have the potential to generate higher risk-adjusted returns and more consistent value added than a single active manager.

We are currently considering the merits of further diversifying the various sources of equity value added using industry-focused specialist managers. We are looking in particular at the value added and diversification potential of strategies focusing on the biotech sector. We believe that the sector's current valuation, large universe of small- and mid-cap companies, and the highly idiosyncratic risk factors driving each firm's earnings make the biotech sector especially fertile ground for specialist managers to add value.

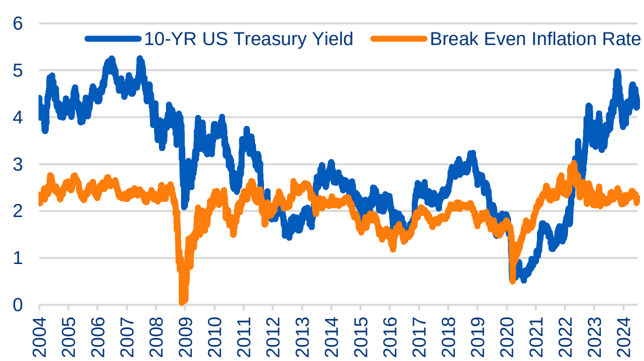
We remain overweight advanced and emerging non-U.S. equity markets which are much more favorably valued than the U.S. We continue to consider the Japanese market to be especially attractively valued. Shareholders in Japanese firms are also likely to benefit from corporate reform initiatives aimed at improving governance. Moreover, the eventual recovery of the highly depreciated yen would compound the gains to foreign investors. European and Emerging equity markets also remain attractively valued relative to the U.S. Emerging markets have on the whole become more resilient and have weathered the recent global tightening cycle without accident.

Rising Real Yields, Tight Credit Spreads

Exhibit 3

Real Yields Rise as Inflation Expectations Remain Stable

Source: FRED. U.S. Treasury yield and expected average 10-year inflation rate in percent.



Real U.S. Treasury yields have risen sharply since the Fed initiated a shift to a tighter monetary policy stance in March 2022. Inflation expectations, however, have remained well anchored (Exhibit 3). A sustained return to higher real yields will require a reassessment of valuations across asset classes. In the fixed income markets, the prospect of higher funding costs raises the possibility of deteriorating credit quality as debt service burdens increase.

Against the backdrop of higher real yields, narrow credit spreads, and the prospect of higher debt service burdens as borrowers refinance, we are holding a neutral duration position and an underweight position in credit. U.S. Treasury securities appear to be fairly valued. Investment grade and high yield credit spreads, in contrast, remain near the lowest levels since the GFC and there are signs of gently rising rates of delinquency and default. Despite these incipient pressures and tight spreads, we see continued opportunities to add value through security selection in the credit markets. Mortgage asset-backed securities, for example, have a particularly attractive yield and risk profile. We are also continuing to expand our allocation to direct lending to take advantage of opportunities opened up by the retrenchment of bank lending.

Hedge Funds Remain a Key Diversifier

We retain a neutral allocation to hedge funds. Our focus, as always, is on creating hedge fund portfolios with highly diversified streams of value added from security selection that minimize market beta. Constructed in this way, our hedge fund portfolios provide important diversification benefits that are central to constructing robust multi-asset class portfolios with strong value-added potential.

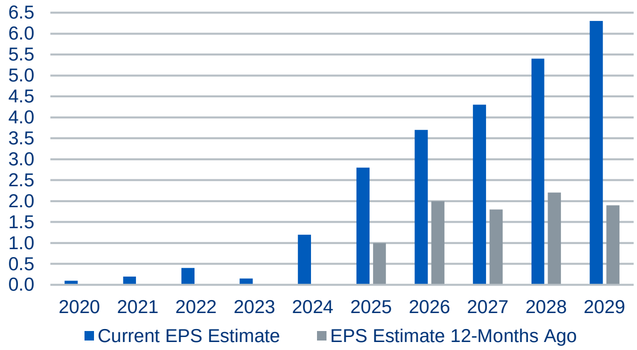
Selective Opportunities in Real Estate

The real estate sector remains challenged by changing patterns of work and consumption as well as more costly and less abundant financing. The office sector has been particularly hard hit by stubbornly high vacancy rates and plummeting prices. Despite these challenges, we are seeing attractive real estate investment opportunities. We are therefore gradually moving to a neutral allocation to real estate, although we are avoiding new investments in the office sector. Select industrial, retail, residential, and alternatives such as storage and data centers are benefiting from high demand and rental income growth, providing an inflation hedge. We are also retaining a neutral allocation to TIPS as a source of real yield and a further inflation hedge.

Steady Approach to Private Equity

In addition to higher funding costs, the private equity (PE) sector is still digesting the aftershocks of a rapid influx of funds which in some cases reduced investment discipline and artificially increased valuations. Despite these challenges, we have maintained a deliberate approach to vintage year diversification. Private firms represent a large, growing, and dynamic segment of the U.S. economy that offers attractive opportunities for strong returns and added value. During the boom-induced period of reduced investor discrimination, we remained focused on investments in firms in the industrial, technology and consumer sectors with solid earnings growth. We believe that these prudent investments will continue to be relatively resilient to more costly and less readily available funding and will prosper as investor discrimination is restored.

Exhibit 3
NVIDIA's Evermore Exuberant Earnings Estimates
Source: Financial Times. NVIDIA's earnings per share (EPS) in U.S. dollars per share.

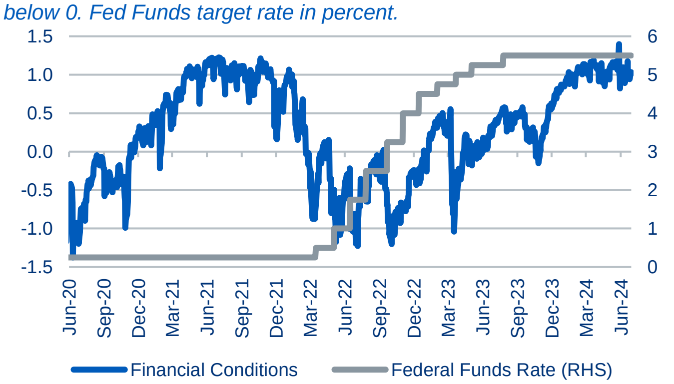


Mixed Non-US Equity Market Performance

Advanced non-U.S. equity markets lost ground in the second quarter weighed down by declines in the Japanese market and uncertainty across Europe created by a snap French election whose result ultimately proved inconclusive, raising doubts about the future of policies. So far this year, the MSCI World ex-U.S. index of advanced equity markets is up 5%. Emerging equity markets outperformed their advanced economy counterparts, rising 5% in the second quarter. They are up 7.5% so far this year. A rebound in Chinese equities in the second quarter was the main catalyst for these gains. The Chinese economy nevertheless continues to face near-term headwinds in the form of a deflating property market that is depressing consumer sentiment, overall economic activity, and investment. Over the longer term, the Chinese economy's prospects are clouded by an aging population, declining labor force, rising dependency ratios, and high debt.

Financial Conditions and the Fed

Exhibit 4
Financial Conditions Ease as Fed Raises Rates
Source: Bloomberg. Financial conditions are easier above 0 and tighter below 0. Fed Funds target rate in percent.



An inverted U.S. Treasury yield curve is normally a harbinger of impending recession. Yet, the slope of the U.S. Treasury yield curve between 2-and 10-years has been inverted for over two years and the U.S. economy still powers on. The U.S. remains in a macroeconomic sweet spot of continued economic growth and falling price pressures. Although fiscal stimulus and COVID-related savings had previously supported economic activity despite rising rates, the U.S. economy's resilience is now largely reliant on easier financial conditions. The stimulative impact of rising equity prices and narrowing credit spreads have muted the lagged effect of a 525-basis point increase in the Fed funds rate since March 2022 (Exhibit 4).

With inflation on a downward trend, the Fed is widely expected to make its first rate cut of the cycle in September. This first cut, if it indeed is made in September, will come notwithstanding solid economic growth, a tight labor market, and easy financial conditions. Loosening monetary policy in these circumstances will likely further increase the overvaluation of equity and credit markets, thus raising the risk of a destabilizing correction in the future.

Against this backdrop, U.S. Treasury securities have lost 0.8% so far this year, led by the 4.4% decline of securities with maturities of 10+ years. Investment grade credit has also declined. The lower duration high yield sector, in contrast, has benefited from narrowing spreads to gain 2.8%.

Hedge Funds Generate Modest Gains

So far this year, the HFRX equal-weighted hedge fund index is up 2.1%, notwithstanding a small decline in the second quarter. Equity hedge, global macro, and equity market neutral strategies have been the strongest performers in the first half of 2024. Alpha accounted for a large share of these gains as the industry took advantage of wide valuation dispersions to add value through security selection. Performance was also helped by the industry's bias toward growth stocks. Across strategies, only merger arbitrage fell in the first half of the year. This underperformance largely reflects a lack of corporate actions.

Office Sector Remains Challenged

Real estate, as measured by the NCREIF Open-End Funds Core Index (reported with a delay), lost 12% in the 12 months through March 2024. The office and apartment sectors (down 17.4% and 6.3%, respectively) posed the largest drags on performance, although the industrial and retail sectors also lost ground. Shifting work and consumption patterns and tighter credit conditions drove the generalized decline. The hotel sector, continuing to benefit from a resurgence in travel, was the sole property sector to enjoy gains.

Private Equity Faces Continued Headwinds

The Thomson Reuters/Cambridge Index of U.S. private equity (reported with a delay) rose 6% in 2023. Venture capital strategies continued to lag, falling 3.4% last year reflecting late-stage venture markdowns. Buyout and growth equity strategies, in contrast, rose 10.4% and 6.1%, respectively. Across all strategies, transaction activity remains limited. Fund raising is also down, although firms remain flush with record levels of dry powder. Tighter credit and a weak exit market are likely to continue to weigh on private equity valuations.

Special Topic

Diversity, Equity, and Inclusion

In a time when many firms are stepping back from their initial promises, Strategic stands firm in our commitment to, and initiatives toward, a more inclusive and diverse investment industry.

Our Firm

Since our founding, Strategic has been committed to fostering a rich environment of diverse perspectives and experiences. Our commitment was further strengthened with the establishment of our Diversity, Equity, and Inclusion (DEI) Committee in the summer of 2021. This initiative marked a pivotal step in our ongoing journey to enhance and broaden our firm's diversity. While we have made strong progress in increasing the representation of women and underrepresented racial groups across various areas of our firm, including our Board of Managers, Equity Holders, Director level and above positions, and Investment Professionals, we recognize that this is a continuous and evolving process. Our efforts are grounded in our belief that a diverse and inclusive workplace not only enriches our team but also drives superior outcomes for our organization as a whole. We understand that achieving true equity and inclusion requires ongoing effort and dedication. We are committed to this journey, knowing that the path will involve both challenges and achievements.

This past fall, Strategic was named one of three finalists for the 100 Women in Finance (100WF) Americas Industry DEI Award[1]. The 100WF Americas Industry DEI Award recognizes organizations that are driving forward and shaping the future of women in the finance industry. We are both humbled and energized by this recognition.

Our Investment Program

Strategic has remained committed to lifting the visibility of diverse investment managers. Over the past year, Laurie Bonello, Managing Director and Head of Strategic's Hedge Fund asset class, took part in the inaugural Fellows and Forum Program hosted by the Institutional Allocators for Diversity, Equity, and Inclusion (IADEI). IADEI is a consortium of asset owners seeking to drive DEI within institutional investment teams and portfolios and across the investment management industry. Laurie shared resources to contribute to many of IADEI's initiatives including IADEI's Diverse Manager Database, which has grown to become the largest open-source database of diverse-owned and diverse-led investment firms.

Amplifying visibility is an important step toward increasing investment in diverse-owned managers, but actual investment is crucial. Strategic recently completed the fourth year of our effort to measure the diversity levels of the managers included in our clients' portfolios. While we continue to materially outperform the averages set out by the Knight Foundation's most recent study, we are not satisfied by outperformance versus a very low benchmark.

In July of 2023, Strategic launched an optional commingled vehicle for clients seeking to invest in funds managed by high potential sub-advisers owned or led by individuals from groups that historically have been less widely represented in institutional portfolios due to barriers unrelated to investment skill. The fund has had a threefold positive impact:

- An expanded opportunity set for potential client investment returns, as qualified diverse managers may be missed in searches that rely on traditional due diligence standards.
- Both capital and operational support can serve as a basis for future AUM growth for emerging diverse managers through investment in the managers coupled with Strategic's operational due diligence expertise.
- A vehicle that allows Strategic clients who wish to express DEI as part of their missions to combine capital for maximum impact.

Our Community

Strategic has expanded our multi-pronged effort to encourage diverse talent to consider the financial industry as a career path over the past year.

We pursued numerous opportunities to reach and encourage women and people of color, including:

- Nikki Kraus, Chief Executive Officer, served on the U.S. Impact Committee for 100 Women in Finance, continued her service as a mentor for Girls Who Invest, and was a speaker at the 2024 Notre Dame Women's Investing Summit.

[1] The 2023 recipient of the 100WF Americas Industry DEI Award was announced November 8, 2023 and finalists were notified in advance of the Award Ceremony. Strategic is a Global Corporate Sponsor of 100WF and paid an annual $10,000 sponsorship fee that provides for free membership for Strategic employees. The criteria for judging applicants are quantitative numbers, qualitative initiatives, and overall application. Each applicant is given a score out of 5 for each of these areas. The totals are added and compared. Each initial application is read and scored by 2 selection committee members with different committee members scoring different applications (no consistent pairing of judges) to avoid personal bias. After the first round, applications are shortlisted and then the process is repeated. Shortlisted applications are read and scored by all selection committee members. The aggregated scored usually highlight the winner and finalists. In the case of a tie, the selection committee will conduct a silent vote on the order of their choices of first, second, and third place.

Note: Opinions expressed herein are current as of the date appearing in this material and are subject to change at the sole discretion of Strategic. This document is not intended as a source of any specific investment recommendations and nothing discussed herein constitutes an offer of, or solicitation or invitation to subscribe for or purchase, an interest in any fund or any security.

- Valentina Glaviano, Managing Director, Co-Head of Global Client Development, joined the Black Owner and Women's (BOW) Collective Advisory Board to provide guidance and advance the mission to empower and promote Black women business owners.
- Nathalie Cunningham, Managing Director, joined as a member of the Woman's Advisory Board of the Girl Scouts of the Nation's Capital, and serves as an Ambassador in the Girls Who Invest mentorship program.
- Jeff Nasser, Managing Director and Deputy CIO, continued his work on the Advisory Investment Committee for Women of the World Endowment.

We committed to another year of scholarship support with the Thurgood Marshall College Fund (TMCF), the nation's largest organization exclusively representing the Black College Community. With TMCF we have sponsored the Strategic Investment Group Alpha Scholarship program since February of 2020, which is offered to eligible, need-based students who attend TMCF member-schools.

We completed the third year of our high school mentorship program. Business Academy students spent the day at Strategic's offices learning about institutional investment management, as well as careers and opportunities within the financial industry to spur interest and future participation.