First Quarter 2023

MARKET COMMENTARY

MARCH MADNESS

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The annual NCAA Men's Division I Basketball Tournament, colloquially known as "March Madness," has once again come to an end. The nickname is the result of the unpredictable nature of the tournament, which boasts surprising outcomes nearly every year. This year's tournament was no exception, with several upsets and a 4-seed-ranked team being the highest ranked team in the final four. The markets also offered their own version of "march madness" this year. They were relatively calm through February, working to digest the Federal Reserve's (Fed's) swift increase in interest rates, but March was a different story.

Most notably, the month saw stress in the banking system, as Silicon Valley Bank (SVB) declared bankruptcy, Credit Suisse and rival UBS were forced to merge, and First Republic Bank required a $30 billion rescue package to stay afloat. This rapid deterioration in the banking system led to an initial sharp sell-off in risk assets. The month also witnessed a flight-to-quality rally, with core bonds returning 2.5% in March and gold up nearly 8% on the month. During the banking system turmoil, the ICE BofA MOVE Index, a measure of implied volatility on Treasuries, spiked to levels not seen since the global financial crisis of 2007 to 2009.

Within the private markets, while first quarter performance is not available, rising interest rates slowed merger and acquisition (M&A) activity across buyout sectors, and valuations for late-stage venture investments – much like the hopes of many a Final Four contender – faced a sobering fall back to reality. Fallout from the SVB collapse remains to be seen but liquidity for the venture and growth sector has declined, which will continue to pressure valuations at least for the near term.

The dust settled relatively quickly, with broad equity finishing in the black for the first quarter, and the MSCI All Country World Index (ACWI) returning 7.3%. Bonds also ended the quarter in positive territory with a 3.0% return. Real assets, broadly speaking, eked out a modestly positive 1.4% gain as measured by the S&P Real Assets Equity Index, while the first cut of hedge fund performance as proxied by the HFRX Global Hedge Fund Index reflected a flat performance on the quarter.

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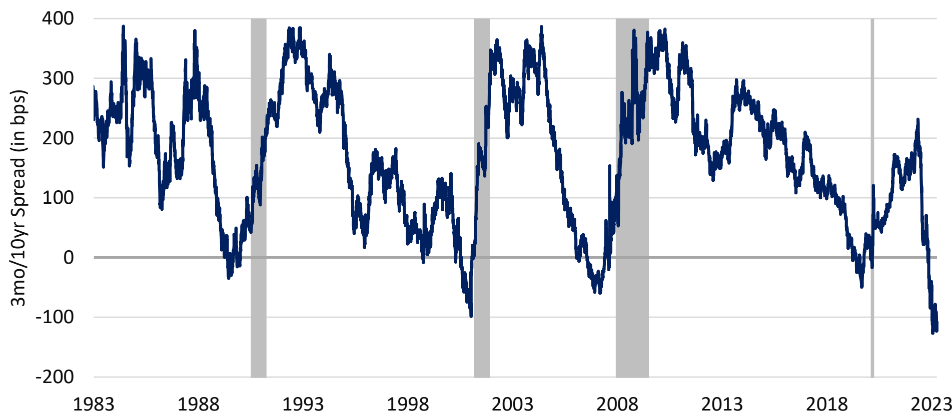
KEY MARKET THEMES & DEVELOPMENTS

PUMPING THE BRAKES UNTIL SOMETHING BREAKS

Since late 2021, the Fed has carried out its most aggressive tightening campaign in 40 years in a bid to restore price stability and tame inflation. These tightening measures—including a 5% policy rate, ongoing quantitative tightening through an approximately $100 billion per month reduction in the size of the Fed's balance sheet, and a dramatic reduction in banking system liquidity—have helped to drive a sharp increase in financial market volatility.

Consequences of the Fed's tightening of monetary conditions have included both a nearly $1 trillion reduction in banking system reserve liquidity since the end of 2021 and the most inverted yield curve since the early 1980s. Historically, the negative slope of the Treasury term structure has placed downward pressure on the profitability of banking institutions through a reduction in their net interest margin, leading occasionally to excessive risk-taking to help fill the void.

U.S. TREASURY YIELD CURVE SLOPE & CYCLES



Note: Shaded areas represent recessionary periods.
Data sources: Bloomberg, L.P., NBER; data as of 3/31/2023

The effect of the dramatic shift in Fed policy is now ripping through the economy, with the banking system as a prime example. At its core, banking is a simple business; banks take in deposits (liability), then create loans and purchase securities (assets) and earn the spread between the two. Provided depositors are confident in the bank's ability to manage this process prudently, all is well. Of late, banks have felt pressure from the one-two punch of deposits leaving their coffers, and some have also been saddled with longer duration assets containing paper losses given the sharp rise in rates. When depositors become skittish, a run on a bank may follow, forcing the bank to reduce its balance sheet, perpetuating the spiral towards insolvency.

In terms of the recent banking crises, there are issues on both sides of the balance sheet. On the asset side, some banks bought assets with longer duration profiles versus their short-duration deposit base. In March, a number of well-established financial institutions succumbed to the severely negative operating conditions. In the U.S., SVB and Signature Bank failed, with First Republic Bank looking to be the next domino to fall, while brokerage giant Charles Schwab defended its financial standing on numerous occasions amid severe downside volatility on its share price. Abroad, Credit Suisse's multi-year struggles came to an unfortunate end, with Swiss authorities forcing a merger with rival UBS on March 19.

On the deposits, or liability, side of the balance sheet, banks have been slow to increase their rates, leading to large outflows of cash as investors move their assets into money market funds offering higher yields. This is evidenced by the chart showing the large differential between the average bank savings account rate and a simple 1-month T-Bill yield—a proxy for money markets.

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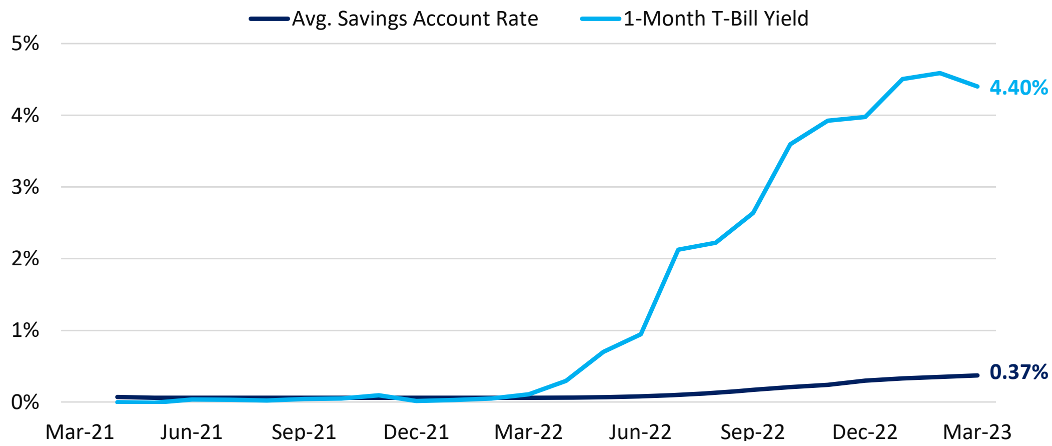
NATIONAL AVERAGE SAVINGS ACCOUNT INTEREST RATE & 1-MONTH T-BILL YIELD



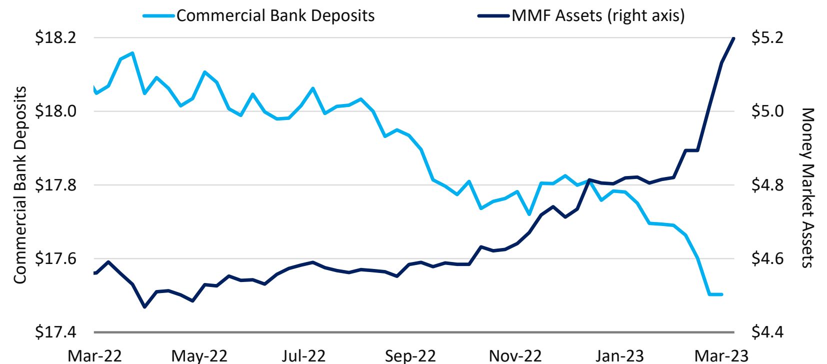
Data sources: FDIC, Bloomberg, L.P.; data as of March 2023

Therefore, even before there was concern with the asset side of the balance sheet at banks such as SVB, this disparity prompted significant capital outflows in the search for income. This started in earnest in March of last year when the Fed began hiking rates. The commercial bank deposit chart shows that deposits have declined by three quarters of a trillion dollars over the past year, while money market fund (MMF) assets have increased by nearly the same amount.

By the end of March, a general sense of calm filtered through the investment community, with market participants seeming to find comfort in the government's response to the banking system panic of mid-March. While the Fed has continued to raise rates, there has been a reversal in the shrinking of its balance sheet, and the Fed's assets rose to $8.7 trillion in March. This, in conjunction with actions taken by the Federal Deposit Insurance Corporation (FDIC) and more financially sound banks aimed at providing short-term liquidity, seems to have quelled the storm for now.

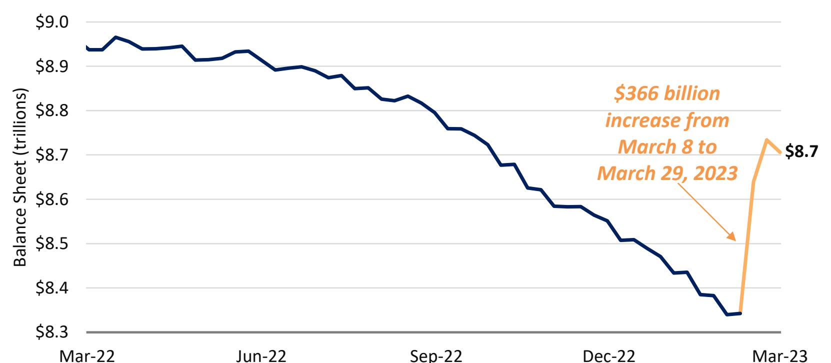
We are keenly aware of the Fed's difficult task and spotty historical track record. With inflation proving stubbornly resistant to returning to the Fed's 2% desired level, the risk of the Fed pumping the (monetary) brakes until something breaks remains a principal concern. While the fallout from the failure of SVB and Signature Bank appears contained, risk remains elevated in the markets. One might assume such risk would be reflected in asset prices; however, that has not been the case thus far.

COMMERCIAL BANK DEPOSIT LIABILITIES & TOTAL MONEY MARKET FUND NET ASSETS



Data sources: ICI, Federal Reserve, Bloomberg, L.P.; data as of 3/22/2023

FEDERAL RESERVE BALANCE SHEET ASSETS



Data sources: Federal Reserve, Bloomberg, L.P.; data as of 3/29/2023

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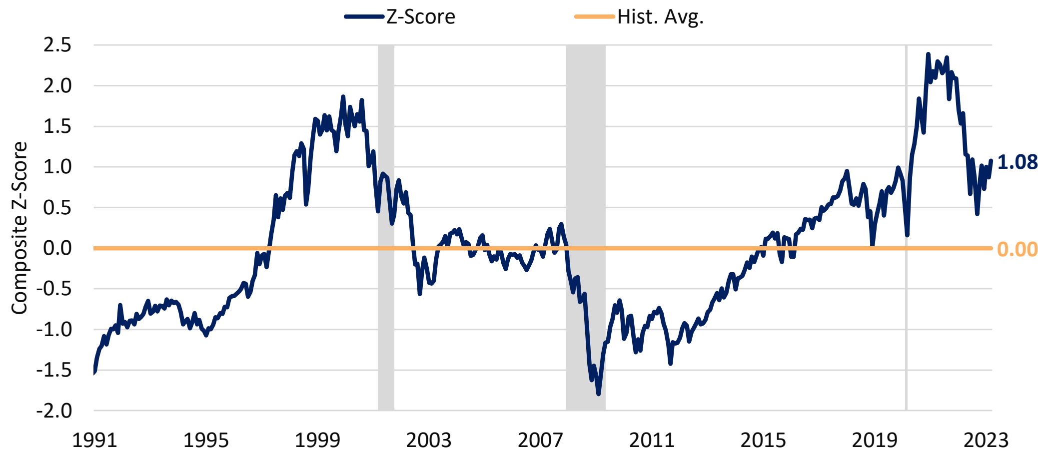
In the credit markets, high yield bonds spread over Treasuries stand below the long-run average, which implies a lack of a margin of safety, should the U.S. economic situation deteriorate further. At quarter end, the option-adjusted spread (OAS) on the Bloomberg U.S. High Yield Bond Index stood at just 455 basis points, 73 bps below the historical average and inconsistent with both the deceleration in economic activity and the recent banking system woes.

Equity valuations also appear blissfully unaware of growing macro headwinds from the Fed's actions, inflation, and declining earnings. For example, the S&P 500 Index is trading at well above average valuations. FEG monitors closely an equal-weighted composite of traditional valuation measures which is reflecting levels more than 1 standard deviation above the historical average.

S&P 500 VALUATION COMPOSITE (EQUAL WEIGHTED)

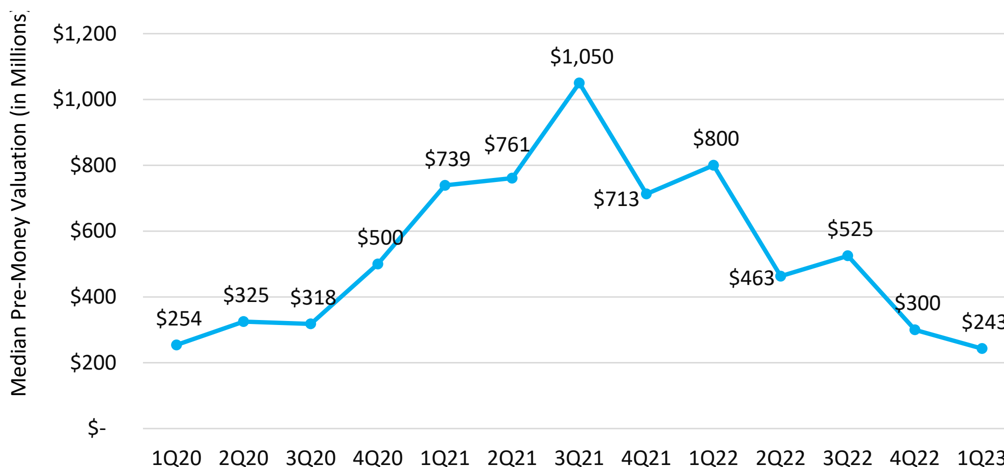


Note: Valuations used: EV/EBITDA, P/E (fwd), P/B, P/S, P/CF; shaded areas represent recessions.
Data sources: FEG, Bloomberg, L.P., NBER; data as of March 2023

Finally, although private market valuations have declined somewhat, they typically occur on a lag versus public markets. The primary area of focus and concern for valuation has been venture capital, in particular later-stage financing rounds. As shown in the graph, series D valuations skyrocketed from $254 million at the beginning of 2020 to over $1 billion by the third quarter of 2021. The market environment has come full circle back to levels in line with the first quarter of 2020. While it is healthy to see the nosebleed valuations of 2021 come down to Earth, it is worth remembering that the current valuations may be more rational, but are still not cheap.

THE SERIES D VALUATIONS WATERSLIDE

Median pre-money valuation for Series D companies by quarter



Source: eShares, Carta; data shown for 1Q2020 - 1Q2023

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Reflections and Outlook

"The key is not the will to win…everybody has that. It is the will to prepare to win that is important." —Bob Knight

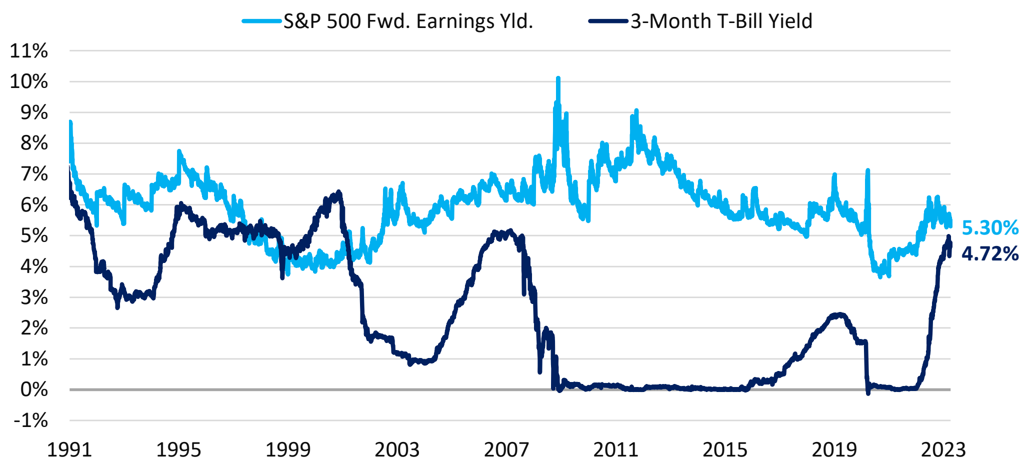
Legendary college basketball coach Bobby Knight is one of the winningest coaches in history, with 902 career wins as a head coach. In viewing markets today, we believe now is the time to prepare to win. There is plenty of uncertainty in markets which does not appear to be priced in yet. Without many obvious easy "layups"—to continue the basketball analogy—FEG is focused on sound defense and being ready to go on the offensive when better opportunities present themselves.

Preparing to win in investing requires a sound long-term plan. This culminates in a strategic asset allocation codified in an investment policy statement (IPS). Reviewing your IPS on a periodic basis is a best practice, and there is no time like the present to review and affirm or tweak as needed based upon your risk and return objectives.

Within the IPS, consider how much liquidity is needed in the portfolio and whether target allocations to private capital can be included or increased to drive long-term returns. Bear in mind that any good idea can be taken too far, and that it is important to manage private capital programs to ensure the portfolio does not become too illiquid. Now is a great time to update commitment budgets to ensure any private capital commitments are being sized appropriately. Factoring in the impact of potential write-downs in valuation in certain pockets of the private markets—as well as slowing deal activity—is reasonable in the current environment.

Tactically and within the parameters of IPS targets and ranges to various asset classes, we are currently cautious on equities. Bonds now offer some yield, downside protection, and liquidity to re-deploy capital quickly when opportunities arise. One simple way to see this is with the equity risk premium, which is the earnings yield of the stock market less the risk-free rate.

EQUITY FORWARD EARNINGS YIELD HAS NEARLY CONVERGED WITH THREE MONTH T-BILL YIELD



Data source: Bloomberg, L.P.; data as of 4/3/2023

Looking ahead, the areas of potential opportunity FEG is monitoring are vast. This opportunity set includes small and micro cap stocks, non-U.S. stocks, asset-backed securities, distressed debt, secondary private equity transactions, and increasing equity exposure—just to name a few. Patience is key, however, as wonderful entry prices for investing in higher-risk areas of capital markets have yet to present themselves. Unlike in basketball, there is no "shot clock" in investing, so focus on preparing to win with a sound long-term plan and be patient until the market offers you some layups.

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The HFRI Monthly Indices (HFRI) are equally weighted performance indexes, compiled by Hedge Fund Research Inc., and are utilized by numerous hedge fund managers as a benchmark for their own hedge funds. The HFRI are broken down into 37 different categories by strategy, including the HFRI Fund Weighted Composite, which accounts for over 2000 funds listed on the internal HFR Database. The HFRI Fund of Funds Composite Index is an equal weighted, net of fee, index composed of approximately 800 fund of funds which report to HFR. See www.hedgefundresearch.com for more information on index construction.

The MSCI ACWI (All Country World Index) Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed and emerging markets. The MSCI ACWI consists of 47 country indexes comprising 23 developed and 24 emerging market country indexes. The developed market country indexes included are: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, the United Kingdom and the United States. The emerging market country indexes included are: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Korea, Kuwait, Malaysia, Mexico, Peru, Philippines, Poland, Qatar,Saudi Arabia, South Africa, Taiwan, Thailand, Turkey, and United Arab Emirates.

The S&P 500 Index is a capitalization-weighted index of 500 stocks. The S&P 500 Index is designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

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