

## LETTER TO INVESTORS

### MARKETABLES

**2H 2022**PERIOD ENDING  
DECEMBER 31, 2022

Dear Makena Investors,

This is the fifth installment of our semi-annual Marketables portfolio letter. Our annual Makena Endowment Portfolio (MEP) letter will be sent out in May, after we have received all of our private valuations.

### **Summary**

Last year was a difficult investing environment. With specific headwinds to several of our public equity themes, which we will detail shortly, the equity market, as measured by the S&P 500, had its worst calendar year return since the Global Financial Crisis (2008). The market grappled with the combination of a rapid shift in monetary policy, geopolitical disruptions, an increasing risk of global recession and high inflation emerging from COVID normalization. To tame inflation, the U.S. Federal Reserve raised interest rates at its fastest pace in history, driving down stock prices in the face of higher bond yields and hence higher discount rates for future cash flows. Bonds were particularly hard hit. The Global Aggregate was off 11% (a rare double-digit decline) while the risk-free U.S. 30-year treasury bond lost a staggering third of its value. Few assets were spared except for the energy industry which benefited from the spike in inflation. In fact, last year marked the only year on record in which both the S&P 500 and the U.S. Aggregate Bond index both declined more than 10%, underscoring the difficult environment and lack of diversifying options.<sup>1</sup> Bond returns have been positively correlated with equity returns over the past couple of years, reducing the diversifying benefits of bonds we saw for the prior two decades.

In prior communications, we judge our own and our managers' performance through cycles and over the long-term, but we are cognizant of the lessons learned during a challenging 2022. We reflect and provide detail on our portfolio changes below. We will also provide an update on our views of the investment landscape and dive into our Hedge Fund portfolio, about which we are particularly excited given the current environment.

### **Marketable CY 2022 Review**

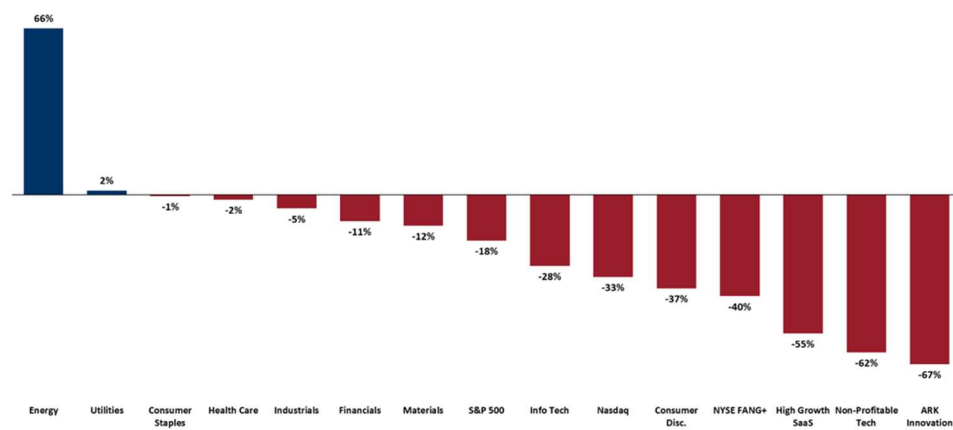
Calendar year 2022 proved to be one of the most challenging investment environments of the last couple decades. Very few assets were spared from the carnage, and even headline indexes mask the repricing at the security and sector levels. The following graph lays out equity sector and fixed income returns during 2022.<sup>2</sup> The energy sector was the positive outlier on the year while interest rate sensitive sectors in technology and innovation declined by over 60%. Fixed Income markets were also severely impacted as higher interest rates led to declines across the board with long duration "risk free" U.S. Treasury bonds declining by -33%.

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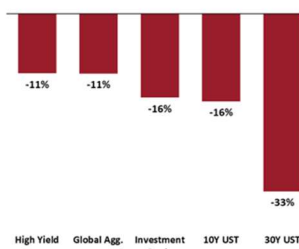
<sup>1</sup> Source: Bloomberg.

<sup>2</sup> Source: Bloomberg. Sectors represent S&P 500 sector indexes. High Growth SaaS represents UBS High Growth SaaS. Non-Profitable Tech represents GS Non-Profitable Tech.

## CY 2022 Equities



## CY 2022 Fixed Income



As we discussed in prior letters, challenging periods like 2022 reveal a lot about our underlying managers – reinforcing strengths, revealing weaknesses, and stress testing investment processes – which in turn leads us to evolve our views about their respective competitive advantages. Reflecting on the past 12-18 months, we find it instructive to separate our managers into outperformers and underperformers. There are managers who performed ahead of expectations, navigating the environment well, (re)positioning portfolios adeptly, and/or delivering on strong security selection capabilities. Even considering their recent outperformance, many of these managers warrant increased conviction and therefore additional capital.

Of managers who detracted from performance, we can further segment them. One set of managers we assess as having acted sensibly and on strategy with investments in companies with increasing intrinsic value, but due to market sentiment, prices deviated (sometimes materially) from that intrinsic value, driving underperformance. We have maintained or even increased our positions with such managers as we view their recent underperformance as temporary mark-to-market losses.

The final set of managers can be characterized as managers who made mistakes and underperformed our expectations of navigating the recent environment, ultimately leading us to develop concerns about their edge and thus future return prospects. This group includes certain L/S managers with inadequate risk management, value managers who failed to participate in the value rebound and select growth managers who succumbed to the free money environment losing valuation discipline. We exited many of these managers, while seeking to maximize the value of portfolios and manage term structures as warranted. While we will always make mistakes, last year we had more in this third group than we find acceptable (in Public Equity in particular). Consistent with our belief that challenging periods being informative periods, we have subsequently fully redeemed from six managers across Marketable representing above average redemption activity.

Specific to our Public Equity performance, it is important to underscore that to drive long-term outperformance we maintain a concentrated portfolio that deviates materially from benchmarks. As further detailed in our 2020 annual letter, our Public Equity strategy favors fundamental managers who take a private equity approach to public markets, leaning into concentration and long-term portfolios. We believe this approach will be rewarded over time with superior results, but it necessitates a tolerance for variability versus benchmark returns. We believe sticking to our knitting and proven strategy while culling mistakes will lead to prior levels of outperformance.

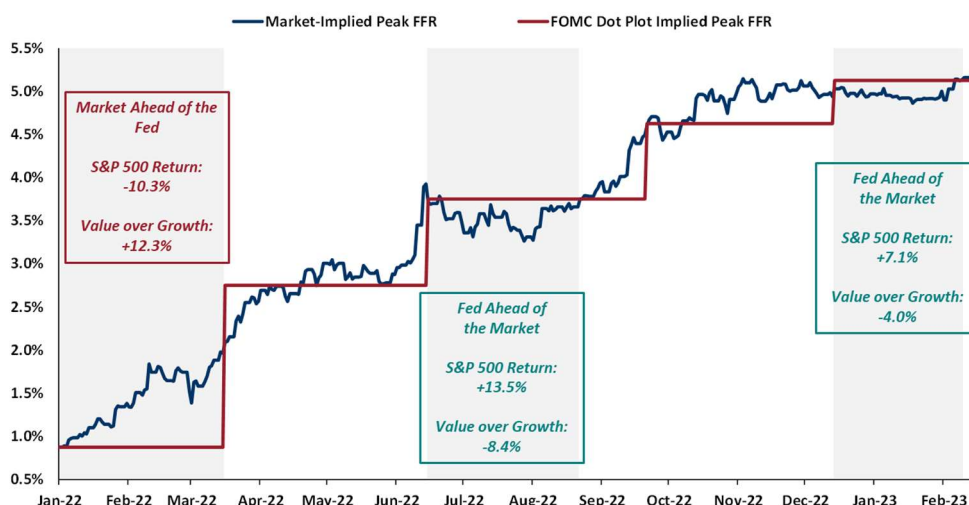
In previous letters, we offered lessons learned on minding investment patience, the impact of macro especially in Emerging Markets, and the importance of increased temporal diversification in our Hedge Funds. We appreciate the relative recency and duration of this challenging period and are mindful of the temptation to overreact. While we will continue to adjust the portfolio as necessary, we remain excited about our manager roster and underlying portfolio as it stands today.

## Market Environment and Opportunity Set

As discussed above, last year proved to be a very challenging investment environment, where macro factors were the dominant narrative in determining asset pricing. Having been deemed transitory by officials as recently as late 2021, inflationary pressures took center stage driving market focus on the Fed's battle against inflation and the consequential rise in interest rates. As shown below, the markets underestimated the Fed's resolve in the fight against inflation, leading to episodic periods of pain as investor expectations caught up to the Fed's messaging.<sup>3</sup> The most significant of these events was the Jackson Hole speech on August 26, 2022 where Chairman Powell channeling his inner Volcker, reinforced his resolve to restore price stability and "keep at it until the job is done."<sup>4</sup>

FOMC Dot Plot Peak FFR vs. Futures-Implied Peak FFR and Equity Returns

Jan. 2022 – Feb. 2023, Daily



Importantly, we resist the temptation to position the portfolio to bet on a particular macroeconomic forecast, but rather construct a durable and diversified portfolio designed to withstand a wide array of macroeconomic scenarios. That said, we do believe that inflation has likely peaked. With annual CPI reaching a high of above 9% in June of last year, recent 3-month CPI readings are running at an annualized rate of 3% with further leading indicators in the weighty housing component showing further softening.<sup>5</sup> The labor market, however, remains stubbornly hot with unemployment reaching a 60-year low of 3.4% after the blowout jobs report to end the year.<sup>6</sup> Certain measurements of wage inflation like the Employment Cost Index are also starting to slow though still at levels likely above comfort for policy makers. Market futures pricing remains volatile but as of year-end, expectations pointed to a Fed pivot to rate cuts this year. Rhetoric from policy makers, however, continues to support restrictive monetary policy for 2023 albeit reserving optionality to see how their actions play out in data on the real economy.

<sup>3</sup> Source: Bloomberg. Note: Value over Growth return calculated as the difference between Russell 1000 Value and Russell 1000 Growth performance over the periods shown.

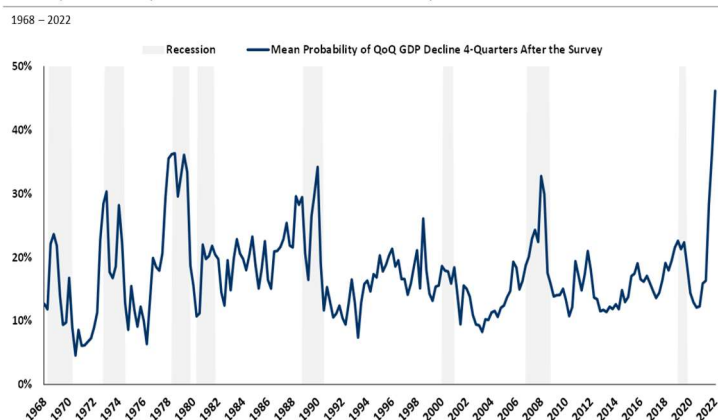
<sup>4</sup> <https://www.federalreserve.gov/newsevents/speech/powell20220826a.htm>

<sup>5</sup> Source: U.S. Bureau of Labor Statistics.

<sup>6</sup> Source: U.S. Bureau of Labor Statistics.

The focus for market participants has partially shifted away from Fed tightening and higher rates to the impact on economic growth with the consensus view calling for a mild recession over the next year. In fact, the Philadelphia Fed survey has odds of a GDP decline in the next year at an all-time high (chart below)<sup>7</sup> though more recently possibilities of a “soft(ish) landing” have increased with pundits even introducing the concept of a “no-landing” scenario where the U.S. avoids a recession entirely. U.S. GDP growth remains positive, yet some leading indicators

Philadelphia Fed Survey of Professional Forecasters: Mean Probability of GDP Decline



are suggesting slowing growth. Europe has fared far better than expected aided by a mild winter. China seems to be shifting back to growth after abandoning their Zero-Covid Policy and easing up on anti-business policies and rhetoric. However, geopolitical tension between the U.S. and China remains a risk. The U.S. consumer is still quite strong, with consumer spending supporting economic growth. Layoffs, however, continue to increase, with mentions of job cuts in earnings calls rising fourfold since the beginning of 2022, led by technology companies. Interestingly, some stocks are starting to react positively upon these announcements, particularly in tech companies, as a rationalization of cost structures is viewed favorably by equity holders. Analysts generally think stocks will go sideways, weighed down by rates and a potential recession. The average Bloomberg projection for the S&P at the end of 2023 is 4,009 points (+4.4% from the close of 2022 of 3,839.50). Another down year would be rare as the S&P 500 has declined for two consecutive calendar years in just four instances since 1928.

Overall, we think the consensus view is probably correct. We will likely experience a mild recession this year, with some volatility on the path of inflation and rates. We expect a return to positive real interest rates and normalized cost of capital will separate winners from losers and rationalize industries plagued by overspending. Geopolitical uncertainty will probably remain an overhang with risks like the debt ceiling standoff front and center. Investors are in search of the proverbial market bottom – history tells us that most market bottoms occur after the peaking of inflation and/or the pivoting of central bank cuts. Relative to prior tightening periods, our current episode has much in common except valuations. Today, equity valuations are roughly in-line with to slightly above long-term averages with forward S&P multiples at 17.4x (last 20-year average is 17.8x) and S&P 500 equity risk premium using CAPE at 2.4% (vs. average since 1980 of 2.5%).<sup>8</sup> If one were to extrapolate consensus earnings estimates for the S&P 500 for five years and apply long-term average valuation assumptions, the resulting average annual S&P 500 return with dividends would be approximately 8%. Historical long-term realized returns for U.S. equities over the last century have been 10.1% annualized. While it is hard for us to see a repeat of the prior decade’s bull market, something slightly below long-term average returns (mid to high single digits) seems more reasonable to us. Above all, it does appear that higher volatility should persist given the increased geopolitical risks and potential range of economic outcomes.

In this lower returning equity environment, opportunities that are less reliant on market beta and thus more heavily geared towards idiosyncratic outcomes are particularly attractive. We highlight a few areas that have increasingly become areas of focus for our Marketable portfolio which include biotech, public equity activism, and credit.

Biotech and healthcare have been long-term investment themes for Makena yet with the sector severely out of favor, we took the opportunity to scale our allocation. We are attracted to biotech for its inefficiency as one of the

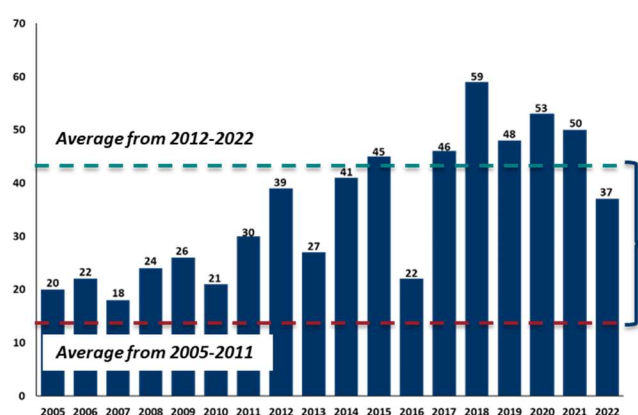
<sup>7</sup> Source: Philadelphia Fed.

<sup>8</sup> Source S&P, Shiller. As of: 12/31/2022.

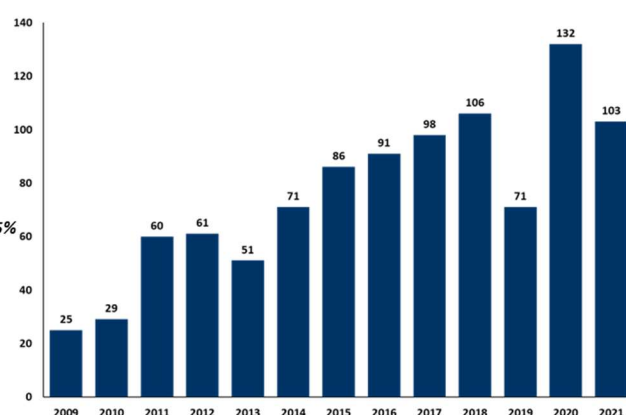
sectors with the highest observed dispersion in broader equity markets. This inefficiency, combined with high barriers to entry given the specialized knowledge required for scientific analysis, create an opportunity for specialist managers to gain a sustainable competitive advantage by focusing on scientific understanding and complex probabilistic assessments. There is also a true societal need for advancements in life sciences and a long-term innovation opportunity that provide tailwinds for the sector more broadly. After outperforming during the pandemic, the sector had its worst drawdown in history, and many biotech companies now trade at or below balance sheet cash levels.

Innovation within the biotech sector continues to accelerate in the face of the drawdown. Advancements in technology and a supportive FDA have helped increase the pace of novel new drugs approvals over the last decade. Novel device approvals equally continue to expand at an increasing rate. With technological innovation breeding further breakthroughs, the fundamentals of biotech innovation remain intact (as seen below). Furthermore, when these breakthroughs are announced to the market, stock prices have been reacting favorably. For example, Sarepta Therapeutics announced positive clinical data on its gene therapy program targeting Duchenne Muscular Dystrophy (a clinically unmet genetic disorder that significantly lowers life expectancy) in July 2022. Sarepta's clinical data showed significant functional improvements for patients with DMD across multiple studies, driving an intent to file for accelerated approval before final Phase 3 results. After the announcement of clinical results, the stock traded up over +60% through year-end, highlighting the favorable reaction of the market to these types of breakthrough innovations.

Novel New Drug Applications Approved by FDA



Number of Novel Device Approvals by Year



Source: FDA, Regulatory Focus.<sup>9</sup>

As further support for the biotech sector, traditional pharma is facing significant patent cliffs through 2030 that will result in a loss of over \$150 billion dollars of revenue across just the top ten companies. Pharma companies are well capitalized, with over \$500B in cash, and are actively looking for opportunities to replace sales impacted by a loss of exclusivity through M&A. We have seen this M&A start to occur in 2022 with several high-profile acquisitions from large pharma players with the largest 10 deals in 2022 totaling ~\$65 billion. The largest deal of the year was Amgen's acquisition of Horizon Therapeutics. Horizon Therapeutics has three key assets: thyroid eye disease drug Tepezza, gout therapy Krystezza and Uplizna, an approved drug focused on neuromyelitis optica spectrum disorder that touted \$10 billion in peak annual sales goals in aggregate. The deal valued Horizon at \$27.8 billion and represented a 48% premium over prior unaffected closing price. This deal is emblematic of 2022 M&A – significant emphasis on clinical-stage assets and approved drugs that could provide immediate revenue support for the vulnerable pharma acquirers as well as significant value accretion to small cap biotech equities and investors.

<sup>9</sup> Novel devices include original PMAs, panel track supplement PMAs, De Novos, HDEs, breakthrough 510(k)s, and specific Emergency Use Authorizations (EUAs) deemed novel. Most recent data as of January 2023.



We continue to be very positive about the state of the biotech market despite the broad market sell-off. The combination of strong underlying fundamentals with the significant number of companies with near-term liquidity needs and market volatility creates opportunity for active management.

Just like our long-standing investments in biotech, activism and engagement have consistently been a part of our portfolio strategy. Managers with concentrated portfolios can afford to go very deep on their companies and share insights and engage with their portfolio companies to drive value. During boom times, management teams often dismiss investor demands, but during downturns activism becomes increasingly powerful as investors' ability to influence corporate management expands during periods of stress. From a return perspective, these self-help stories are particularly valuable during sideways markets as managers can create alpha through their influence and subsequently unlock value independent of market or economic beta. As seen below, activist campaigns have increased significantly over the last decade and more recently have been led by campaigns in the once insulated technology sector.<sup>10</sup>

Activist campaigns target a variety of corporate behavior, ranging from improvements in product strategy to capital allocation to corporate governance. Some efforts driven by “constructivists” take place more behind the scenes. Other situations take place in the public arena through open letters or public presentations. For example, Alphabet was called upon in a public letter to rationalize their cost structure through addressing compensation practices while Spotify has been tasked in a public presentation with aligning operating expenses and content costs. Others escalate further, such as Disney managing a proxy fight for a board seat. The commonality of these campaigns is influential shareholders demanding corporate transformation intended to increase value for equity investors.



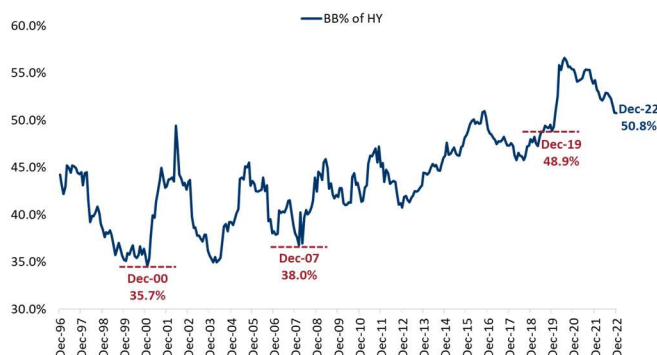
Perhaps the most directly impacted area of the capital markets last year were fixed income markets. Intuitively, we can appreciate that higher interest rates are likely better for credit investing – if we had been paid 1% interest and we now receive 5% interest, we are 4% better off. However, the impact is more nuanced especially in the corporate credit markets where investors earn both the treasury yield as well as a credit spread to compensate for additional credit risk.

From a risk perspective, the underlying credit quality of the high yield market has also improved meaningfully over the last decade. Relatively higher rated BB bonds comprise over 50% of the index for the first time, and the seniority and security (collateral) of the debt has improved drastically since the 2000's and financial crisis periods. Finally, as starting yields are akin to valuations in equity markets, they are a general leading indicator of prospective returns. Historically, when starting yields breach 9%, go-forward HY returns tend to be attractive.

<sup>10</sup> Source: Bloomberg.

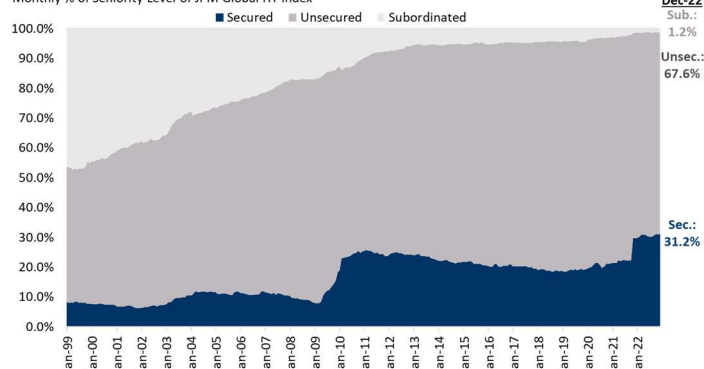
BB % of HY Index

Monthly BB % of ICE BofA US High Yield Index



Seniority of Global HY Index

Monthly % of Seniority Level of JPM Global HY Index



HY Index YTW and Forward 12-Month Total Returns

Daily ICE BofA U.S. High Yield Index Yield to Worst and Forward 12-Month Total Returns



In short, *bonds are back!* As a result, we have allocated to our first new credit hedge fund manager in a decade (highlighted below in the Hedge Funds section), have added capital with current managers, have built a robust pipeline of high probability credit managers across markets, and have opportunistically increased our bond duration in our Fixed Income portfolio slightly (from 2.6 years to 4.5 years in 2023).

Overall, we believe the current environment described above lends itself well to idiosyncratic opportunities, as the era of low rates and free money morphs into a regime of investor discernment and real cost of capital. This separation of wheat from chaff places a premium on alpha driven opportunities found in the types of active management strategies we pursue in the Makena Marketables portfolio. Many of these strategies will reside in our Hedge Fund portfolio, which we have chosen to highlight in this letter.

### Investment Topic Highlight: Hedge Funds

*“An illusion is that short selling is somehow more dangerous than buying a stock for a price. A stock can go up to infinity and down only to zero. There is no danger that cannot be provided for by adequate diversification.”*

— Alfred Winslow Jones

Alfred W. Jones is often regarded as the father of the hedge fund industry. Originally an editor for Fortune magazine, Jones’s research led him to believe he could compete with professional investors. In 1949, Jones launched what is believed to be the first “hedged” fund with \$100,000 of which 40% was his own capital. He would go on to have immense success with a cumulative return of nearly 5,000% in his first two decades while only losing money in three of his 34 years -- speaking to the power of his hedged approach.<sup>11</sup> Jones’s success was aided by two key innovations. First, in addition to buying stocks long, he would sell stocks short to profit independent of market

<sup>11</sup> <https://www.valuwalk.com/alfred-winslow-jones/>

direction. Shorting stocks was unheard of 75 years ago – Jones had to convince investors of its merit as seen in the above selection taken from a letter to his partners. Secondly, he pioneered a method of analyzing stock behavior which he called “velocity” – a decade before Sharpe, et al. had introduced the world to the CAPM model and beta – which allowed him to adeptly manage his strategy’s increased complexity.

The hedge fund industry has evolved materially since Jones first launched his fund nearly three quarters of a century ago. Today, the industry manages over \$3.7 trillion in assets across over 9,000<sup>12</sup> registered funds with strategies spanning Long/Short Equity, macro, event-driven, systematic strategies, relative value, and other arbitrage strategies. Institutional investors’ Hedge Fund portfolios can take many shapes and play different roles in their portfolios. This Section describes the role that Hedge Funds play within the MEP and details our approach to building and managing a Hedge Fund portfolio.

The role of any asset class at Makena is rooted in our core principles – invest where there is manager skill or edge that can exploit inefficiencies and where the sourcing and evaluation of managers play to our strengths (this last principle may rule out certain strategies). Jones’s edge in the 1950’s was being the only short seller in town, creating a sustainable inefficiency he exploited for decades. Today, the inefficiencies that could be exploited by Hedge Funds range from short selling (still) given its degree of difficulty to opaque credit market opportunities like restructurings to event-driven strategies with hidden catalysts. Our portfolio of Hedge Funds is constructed such that exploiting these inefficiencies leads to risk-adjusted alpha after accounting for the lower market risk of the program.

Risk management also plays a key role in Hedge Fund strategies given their increased complexity and use of leverage. Jones dealt with higher complexity in his “hedged” fund by developing his new measurement of stock price “velocity” and designing a system to balance longs and shorts on their measured “velocity” (very similar to market beta). Hedge Fund managers today are armed with far more sophisticated models, yet they must constantly adapt and improve their risk management capabilities as markets evolve. For example, the Reddit fueled “Meme Stock” short squeeze in January of 2021 created a new risk for short sellers that must be accounted for in current portfolio construction. Risk management can in fact be a distinct competitive advantage for certain managers. We assess both an individual manager’s risk management capabilities in the context of their strategy as well as applying our own risk principles on diversification (sector, geography, style), leverage tolerance (shying away from strategies requiring excessive leverage) and market beta for our total portfolio risk management. These efforts aim to provide capital protection during broader equity drawdowns, which in turn allow us to rebalance into the market.

From an MEP portfolio perspective, Hedge Funds also aid in achieving our beta target. While we could achieve this profile with a higher allocation to Fixed Income and Cash to offset equity strategies and manage risk in a highly liquid way, our returns would suffer. Additionally, the Hedge Fund portfolio provides diversification in a rising rate environment that acutely impacts bonds. In addition to the risk management and diversification benefits of the Hedge Fund portfolio, we have taken meaningful strides to improve the underlying liquidity of this portfolio. HFs are the next line of liquidity defense after ample levels of Fixed Income and Cash, should we experience a deeper and extended market decline.

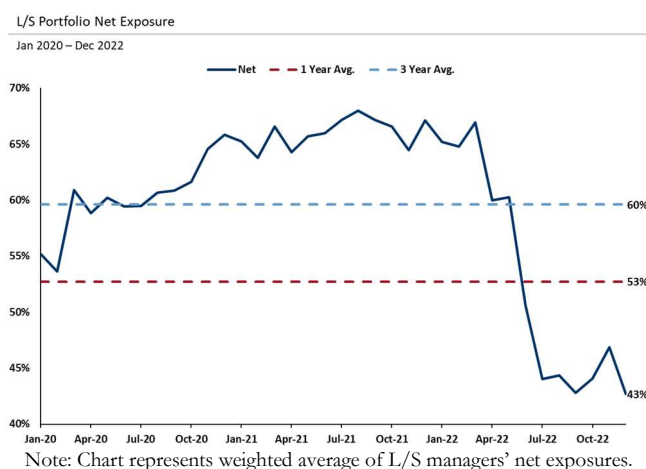
Our Long/Short Equity portfolio is the major driver of the Hedge Fund portfolio. We are currently invested in active relationships with a focus on specialist managers, who have an edge in a particular sector (like biotech, TMT or cyclicals) or geography, balanced with select generalist managers who can move opportunistically across sectors and geographies that offer the most compelling reward. Our managers are fundamentally oriented in their assessment of businesses with a strong emphasis on shorting stocks. We believe our managers have manageable

<sup>12</sup> Source: HFR.



asset bases, which balances the benefits of scale in attracting and retaining talent with the detrimental impact of size on short returns.

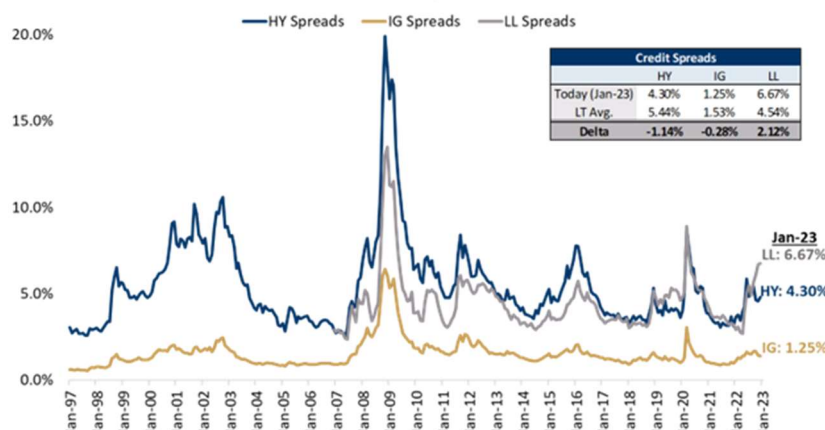
Two main themes emerged from our managers' short portfolios in 2022. The first was a focus on COVID beneficiaries, where the market assumed a long-term acceleration of growth for businesses that benefitted from the global shutdown. In many cases, these companies had experienced a significant pull-forward in demand that was being under-appreciated by the market, allowing managers to take advantage of mispricing. This dynamic existed across sectors and industries, including healthcare (telemedicine and remote therapy), industrials (companies that manufacture PP&E and related materials), electronics (desktop monitors and web-cameras), and home and auto (RVs and HVAC systems). The second short theme involved capital intensive companies that do not generate free cash flow, which includes firms in immature and crowded industries like the electric vehicle and autonomous vehicle industries. Many of these companies took advantage of open capital markets to go public via SPAC or IPO in 2020 and 2021 but are still in the process of finalizing products. As funding windows closed, these companies' share prices were hit hard, generating strong alpha for managers who had been active in the space throughout the year. Given our managers' core competency in shorting and the wide range of future economic outcomes, we remain optimistic about the outlook for shorting. We believe we have partnered with a wide range of managers that can take advantage of a more robust opportunity set for shorting and positive industry tailwinds to continue to generate excellent risk-adjusted returns over the long-term.



The other portion of the HF portfolio is allocated to Opportunistic Hedge Funds (OHF). True to its name, these managers and strategies are quite idiosyncratic and opportunistic in their mandates, though the majority of the portfolio has been allocated to credit related opportunities. We currently have active managers in this portfolio spanning distressed/credit, multi-strategy, liquidations and other arbitrage opportunities. Notably, our OHF portfolio is geared more towards non-U.S. geographies than our L/S portfolio given some of the material and structural inefficiencies in the European credit markets in particular (half of OHF NAV is in managers focused on the European Opportunity set). As mentioned, we had been steadily reducing our allocation to credit given the relative risk/reward **until very recently**. As seen below, credit spreads have increased meaningfully recently particularly in High Yield and Leveraged Loans. These are the exact type of markets where our managers find value when risk/reward becomes compelling.

## Historical Credit Spreads

U.S. HY Index OAS, U.S. Corporate Index OAS, and JPM Leveraged Loan Index Summary Spreads



In conclusion, we believe our Hedge Fund portfolio has played a valuable role within the MEP and has met our objectives for the strategy. We believe a well-constructed Hedge Fund portfolio that generates risk-adjusted alpha will continue to play an important role in our endowment portfolio. Managers who sustainably exploit market inefficiencies can drive attractive returns, provide downside protection, and offer a unique source of diversification for the MEP. We close by tipping our cap to the father of hedge funds, the legacy of Alfred Jones, and his first “hedged” fund. Upon converting to a fund-of-funds in 1984, Jones made perhaps his most impactful investment in Julian Robertson’s Tiger Management who became a household name in the investing community and a titan in the hedge fund industry.<sup>13</sup> Mr. Robertson passed away in 2022, but his impact on the investment world will be felt for years to come, as he spawned countless “Tiger Cubs” and “Tiger Grand-Cubs” – a few with which Makena is fortunate to be partnered with.

**Conclusion**

As always, we are grateful for your long-term support. Our aligned, long-term investors are foundational to our endowment model of investing.

Sincerely,  
Jackson Garton on behalf of the Partners of Makena Capital

<sup>13</sup> <https://www.valuwalk.com/alfred-winslow-jones/>

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