Coronavirus Response – UPDATE

Remaining disciplined

March 2020

March 13, 2020 (update to March 3rd letter)

As the COVID-19 pandemic continues to expand its geographic and economic reach, we will continue to provide you with regular updates from Makena. Each day brings more uncertainty about the health and economic impacts of the pandemic. As governments, industries, schools, and daily life grind to a halt, the implications for global growth continue to worsen. Although bad news is accelerating, our team is actively managing our portfolio and is prepared for a variety of outcomes.

This note provides a brief update on our portfolio, the market, and our business.

Portfolio Update

During times of market distress, it is important to circle back to our core investment principles. Two important principles stand out at this time: maintaining our long-term focus and maintaining balanced diversification. Although we have no edge predicting the progression of the pandemic, our approach to balanced diversification is designed and managed to withstand the short-term risks that prevent many investors from achieving their long-term goals. The statement "patience is a virtue" is perhaps never truer than during times of market volatility. Overreacting to short-term news in search of quick profits or avoiding losses is a losing long-term investment strategy. Investors' biggest mistakes involve overreacting: being overly bullish in the good times and overly bearish in bad times. Our long-term approach requires patience, discipline, and a constant search for how we can position the portfolio to achieve the best long-term risk-controlled returns. Our investment team has managed through prior stressful environments, including 9/11 and the Global Financial Crisis ("GFC"). Although every "black swan" event is different, the market reactions share many similarities. We have seen this type of market environment before, and we know how to navigate it. The market panic yesterday (March 12) felt very much like the panic at the height of the GFC on October 15, 2008. Although the market declined another 25% from that date through the March 9, 2009 low, the return for long-term investors was exceptional. The S&P 500 returned over 20% for the one-year period following the October 15, 2008 close.

We have a risk management system and process in place to know where our portfolio is exposed at all times. Normally, our Risk Committee meets every other week. During market distress, like now, our Risk Committee meets every day to review the latest risk reports and to discuss portfolio actions. This process, along with constant, open dialogue with our managers, helps inform what actions we should take. At the portfolio level, we have modestly rebalanced, but remain under-risked. Many of our managers are excited about the valuations of their underlying portfolio companies. One of our long-time managers exclaimed that the deviation of their portfolio from fair value is larger than it was during the GFC (i.e., it is very cheap). We are prepared to patiently rebalance further into risk assets. A diversified portfolio includes having allocations not only to adequate sources of liquidity, but it also includes having allocations to asset classes as hedge funds and real estate and portfolio management tools such as tail hedges and currency hedges. While a tail hedging program will cost the portfolio in times of lower volatility, it provides liquidity during times of market distress to help rebalance into equities when others are selling in fear. This additional liquidity helps maintain a long-term mindset.

In addition to opportunities that many public equity and long/short managers are monitoring, there may finally be interesting opportunities in absolute return. Although there is no forced selling yet, absolute return managers are starting to see some interesting credit opportunities beyond low-quality energy companies, which they will continue to avoid. A commitment to active management means that during market turbulence, a portfolio has a greater chance of surviving short-term risks while allowing the portfolio to compound at a higher return over the long-term. Active managers have experienced other distressed market environments and are now able to invest in quality companies at cheaper prices.

Market Update

As of Thursday, March 12, global equity markets had officially entered bear market territory. The S&P 500 lost 23% year-to-date, being down 27% from its all-time high on February 19th. Through Friday, March 13, year-to-date losses for other global markets are comparable; the MSCI ACWI is down 19%, the FTSE 100 is down 29%, and the Nikkei 225 is down 26%. Treasury yields have continued to hit historic lows, with the 10-year Treasury yield bottoming out at 57 basis points on March 9, before bouncing back to its current yield of 98 basis points. The 9.5% decline in the S&P 500 on March 12 was the fifth largest decline of all-time, with the 20.5% decline on October 19, 1987 being the largest and the other three occurring during the fall of 1929. The March 12 decline exceeded the largest one-day decline during the GFC of -9.1% on October 15, 2008. Market volatility (CBOE Volatility Index) spiked to a high of 75 on March 12, nearing the highs experienced during the 2008 GFC. Lastly, agreement on supply cuts between OPEC members Saudi Arabia and Russia fell apart, which, combined with falling demand, has led to a sharp decline in crude oil prices (WTI) to $33/bbl., down nearly 50% year-to-date.

Business Update

The only update from our March 3rd letter is that we have implemented a work-from-home policy for all Makena team members. Our IT and Cybersecurity systems provide us with the capability to work remotely. We continue to evolve our approach as the situation unfolds in order to protect our business and our people.

As always, we thank you for your partnership. We remain committed to providing transparency around the portfolio and our business. Please let us know if you have any questions.

Sincerely,

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