REPORT PREPARED FOR

Worcestershire County Council Pension Fund

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Independent Investment Adviser's report for the Pension Investment Advisory Panel meeting

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Global overview

You've heard this one before, but a week can be a long time in politics. We certainly got a very sharp reminder of how true this can be at the end of June, following the outcome of the EU referendum and the decision to "Brexit". A week may appear to be a long time, but the implications of that week will rumble on for many years to come. In the immediate aftermath markets were understandably turbulent, in brief the UK equity and bond markets rose, but sterling fell sharply.

I have sometimes regaled you with observations from my holidays, so this time I can include the discovery of a considerable number of laid up exploration rigs and associated support vessels amongst the Canary Islands. I am sure that across the world there are many similar scenes. The low oil price is fantastic news in many ways, but there is a sting in the tail. How long will these vessels be waiting for their next assignment, if indeed the call ever comes? Economically does every silver lining have a cloud?

We now know the confirmed contenders in "The US Presidential Election Show", which rather beggars belief. The American electorate will have a choice to make between two radically different policy agendas, which if we are led to believe the rhetoric from the Trump camp, could result in a very different relationship with the rest of the world than seen in recent times. In the meantime it is hard to see much change in economic and fiscal policy, which would also make it highly unlikely that we see a rise in interest rates between now and January. By the time I write my next report, we should have the answer about the outcome!

If someone had asked me six months ago to bet against Philip May becoming the next Prime Minister's consort, I would have lost another fiver. With the fallout from Brexit, Britain has a new Prime Minister, who will take us through some uncertain times. The short term implications are already well aired, the Bank of England has moved to address the perceived threats to the economy, so now the hard bargaining has to begin with our European partners. I take heart from the fact that historically Britain is Great at trading, so while I know that I am sticking my neck out, I am quietly optimistic about the outlook. When Britain joined the European Economic Community in 1973, we turned our backs on many of our former trading partners, predominately other members of the Commonwealth. Many of those countries have been quick to welcome the opportunity to help build new relationships, and indeed our European friends have acknowledged that it would not be in their best interests to not continue trading with us on appropriate terms. The challenge for

Mrs May will be to strike the right balance, with that comes risk. I am not sure that the markets have priced that risk appropriately in the short term.

In Europe, GDP growth slowed during Q2, mainly as a result of weaker growth in Germany. However all eyes were on the UK and the outcome of the referendum. Political risk has inevitably increased following the Brexit decision, which many populist parties throughout Europe will take heart from with a number of critical elections due over the next year or so. Having said that, the general election in Spain immediately after the UK referendum saw victory for the moderate centre-right Popular Party, even though an overall majority was not achieved. It will be interesting to see if the member countries of the EU can actually present a united front in their forthcoming UK exit negotiations.

There isn't much to add on Japan from previous comments. Economic data continues to provide little evidence of a sustained recovery. The 30 month delay in increasing consumption tax confirms that demand remains weak, which would be further damaged by a rise at this time. Prime Minister Abe is going to have to look for some new innovative ways to stimulate the economy.

Within Emerging Markets commodity prices and exchange rate movements continue to drive sentiment, with some of the trends seen in Q1 continuing through into the second quarter. One of the biggest features in weighting terms was an easing of concerns about the Chinese market. South American markets continued to recover strongly, as did Asian markets. However some of the European markets suffered from "Brexit" related concerns, such as Poland and Greece.

Worcestershire County Council Pension Fund   Quarter to end June 2016

Summary and Market Background

The value of the Fund in the quarter rose to £2.066bn, an increase of £138m compared to the end December value of £1.928bn. The Fund produced a return of 7.1% over the quarter, which gave an outperformance against the benchmark of 0.7%. This was attributable to both asset allocation (0.5%) and stock selection (0.2%). Over a 12 month period the Fund recorded a positive relative return against the benchmark of 0.4% (8.6% v. 8.2%).

Amongst the active mandates, Nomura (Pacific) and Schroders (Emerging Markets) outperformed their benchmarks, by 0.8% and 0.5% respectively. JP Morgan underperformed on both of their mandates, by -1.1% on Emerging Markets and by -0.1% on Bonds. The specifics concerning JP Morgan are discussed later in this report.
The alternative passive strategies have continued to produce a return ahead of their respective benchmarks (0.2% in aggregate), and ahead of the traditional passive index benchmark.

Despite the turbulence seen in the immediate aftermath of the Brexit vote, the quarter ended with equity markets showing some good returns. Because of the sharp fall in sterling at the end of the quarter, there is an unusually large divergence between performance at local currency levels against sterling valuations. For example, the MSCI World Index shows a total return of 1.2% (USD), but the sterling adjusted return is 8.8%. The UK FTSE All-Share rose 4.7%, the US S&P was up 2.5% (sterling adjusted up 10.2%). Emerging Markets rose 0.8% (USD), with the sterling adjusted return of 8.4%.

Bond markets, both Government and Corporate, also saw strong performance in total returns, but with yields being driven even lower. Again the sharp depreciation in sterling has amplified returns. The 12 month sterling adjusted returns are even more astonishing, typically around the 25% level.

Active North America

The assets have been transferred to passive management, pending the outcome of the 2016 Strategic Asset Allocation review.

Nomura- Pacific

Performance objective is to outperform the benchmark by 1.5% annually over rolling 3 years

Nomura outperformed by 0.8% against their benchmark over the quarter (9.1% v 8.3%). Their performance over 12 months is now in line, (9.0% v 9.0%).

Their three year performance against their performance target has improved marginally, at -0.7% annualised against benchmark, and is -1.7% over 10 years.

Both the Japanese and ex Japanese elements of the mandate outperformed their respective benchmarks over the quarter.

JP Morgan – Emerging Markets

Performance objective is to outperform the benchmark by 2.0% annually over rolling 3 years

While Emerging Markets had another good quarter in absolute terms, JP Morgan underperformed against their benchmark again, by -1.1% (8.4% v. 9.5%). Their one year performance against their benchmark is at 0.6% (4.3% v. 3.7%), which including their performance target leaves them -1.4% behind the objective level.

Over three years they remain behind their performance target, currently by -2.4% annualised, since inception the picture has deteriorated slightly this quarter, at -1.7% against performance target.

Schroders – Emerging Markets

Performance objective is to outperform the benchmark by 2.0% annually over rolling 3 years

After a very poor Q1, some of the lost ground has been recovered in Q2, with an outperformance against their benchmark of 0.5% (10.0% v. 9.5%). On a 12 month view they have outperformed by 1.3% (5.0% v. 3.7%). Over the three year period they are ahead of benchmark by 1.7% per annum, so although showing an improvement, they are still behind their performance target.

Country allocation and stock selection both contributed to performance in Q2.

JP Morgan – Bonds

Performance objective is to outperform the benchmark by 1.0% annually over rolling 3 years

Underperformance of this mandate continued in Q2, albeit less so than Q1, with an underperformance of -0.1% (3.0% v 3.1%). This has further damaged their performance against benchmark over the last 12 months, now at -0.5% (6.0% v 6.5%), which is clearly well behind their performance target.

Relative to their performance target, they are behind by -0.6% over three years, and -1.2% over ten years, which is an unchanged position from last quarter.

Fund Officers have engaged with JP Morgan concerning the continued underperformance against benchmark and their performance target. Along with a change in the lead manager responsible for the portfolio, they have also now indicated that they consider that their performance target of 1.0% annually over rolling 3 year periods is no longer attainable. The new lead portfolio manager, Andreas Michalitsianos, will be attending the PIAP meeting on 9 September.

Legal and General – Passive equity

The absolute value of the passive mandate in total rose over the quarter by 6.95%.

In relative terms the alternative indices performed well versus the traditional benchmark indices (9.7% v 6.6%), and in absolute terms performed just ahead of their own indices or comparators.

Q2 2016	Fund %	Benchmark %
Fundamentally weighted	8.23	8.22
Low volatility	13.27	13.24
Quality companies	7.23	7.20

Property and Infrastructure Investments - commitment and drawdown updates

Although it is too early to be focusing on performance numbers with these long term investments at this stage, consideration has been given to possible methods of benchmarking beyond an absolute return basis. Conversations with Portfolio Evaluation Limited (PEL), the successor to WM, and the asset managers concerned will aim to provide a means of measuring progress against an anticipated returns profile over the life of the investments.

Hermes (Officer meeting 16 September 2016)
Commitment: £49m
Net Assets Available For Plan Benefits £38.1m
Income: £2.0m
Period Closing Balance: £38.1m

Green Investment Bank (GIB) (Officer meeting 16 September 2016)
Commitment: £40m
Net Assets Available For Plan Benefits £34.2m
Income: £1.1m
Period Closing Balance: £34.9m

Venn
Commitment: £27.5m
Net Assets Available For Plan Benefits: £22.8m
Income: £1.2m
Period Closing Balance: £24.2m

Invesco
Commitment: EUR 56m
Net Assets Available For Plan Benefits £61.0m
Income: £0.5m
Period Closing Balance: £63.9m

Walton Street
Commitment: £27.5m
Net Assets Available For Plan Benefits: £6.6m
Income: £0.1m
Period Closing Balance: £7.0m