Allenbridge

REPORT PREPARED FOR

Worcestershire County Council Pension Fund

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

6 March 2017

Global overview

So here we are, well into the New Year, Donald Trump is now President Trump and 2016 is fast vanishing into the wake. 2017 looks like it may well bring more challenges to "established order", as more disillusioned voters head to the polls.

As for the US, for the time being at least the new President is following through on his election pledges, but already coming up against resistance to his authority. He continues to communicate by Twitter, which does seem to illustrate graphically that he will not be constrained by tradition. Economists are running any number of "what if" scenarios against President Trump's declared trade and protectionist policies, with outcomes that range from concerning to downright scary. At least the UK seems to have "favoured nation" status, but only time will tell how we fit into the new order, and the impact on our own economy. In the short term, there is a desire to bring the economy out of the post financial crisis era, with not only implications for the pace of interest rate increases, but presumably for asset valuations as well.

In the UK, the focus remains on "Brexit", and is likely to be so for some time.
Common sense would suggest that negotiating trade arrangements outside of the single market should not place what are currently mutually beneficial terms at risk, but it is a very nervous EU that we are dealing with. It is difficult to do business with desperate people, when their own future is at risk.
Thankfully George Osborne's predictions of economic catastrophe haven't come true, at least not yet!
One major issue that may rear its ugly head sooner rather than later is inflation. In my experience watching prices in supermarkets provides an excellent bellwether as to how official data will look in a few months time. During January and early February I have observed some quite large price increases in a range of products, which are not usually subject to weather fluctuations or ostensibly related to currencies. I have also seen some increase in pricing on more service related items, which would suggest to me that after a long period when suppliers have not been able to increase prices, they are taking advantage of a more benign environment to play "catch up".

Europe is a conundrum. On one hand, the Eurozone is continuing a gentle economic recovery, with GDP rising and unemployment falling. On the other hand political uncertainty continues, with plenty more to come in 2017, which depending on the outcome of the various elections may well shape the future of the EU and could show that the UK Brexit vote was only the beginning of a period of significant change.

As with all world markets, Japan felt the impact of the outcome of the US Presidential election, in their case seeing a sharp fall in the Yen over the quarter and had a positive impact on market sentiment. The fall in the yen reflects the expectation that there will be an increase in the bond yield differential, as US rates rise, and the Bank of Japan are expected to maintain their target rate at or around zero. Back at local economic level, industrial production continued to improve, but domestic consumption declined. Recovery is still tenuous.

Asia (ex Japan) and Emerging Markets reflected the uncertainty over US trade and foreign policy, as well as the prospect of tighter US dollar liquidity. Those markets and currencies perceived as most sensitive to a tighter global interest rate environment posted the steepest declines. This included Turkey, Malaysia and Indonesia. Uncertainty around a potential change to US trade and foreign policy was a headwind to certain markets in particular. Mexican equities and the peso were directly impacted by these concerns. However it should be questioned how seriously the threat of a wall along the Mexican border should be taken. Even President Trump must know that history shows that walls ultimately aren't effective!

The Chinese market also lost value in part given concerns of protectionist policy implementation by the US. The potential for US monetary policy tightening has supported the US dollar and led the renminbi to devalue, increasing pressure on capital outflows from China.

By contrast, a recovery in energy and commodity prices was beneficial for a number of markets. Russia registered the strongest index return, boosted by a rally in Brent crude. This followed the agreement of production cuts by OPEC, with further agreements with ten non-OPEC members including Russia subsequently reached. Expectations for higher fiscal spending in the US triggered a strong rise in industrial metals prices, particularly iron-ore but also copper. This benefited Latin American equities with Peru, Chile and Brazil all registering positive returns and outperforming.

Summary and Market Background

The value of the Fund in the quarter rose to £2.312bn, an increase of £75m compared to the end September value of £2.237bn. The Fund produced a return of 3.6% over the quarter, which gave an underperformance against the benchmark of -0.1%. Asset allocation was a positive contributor (0.2%), but stock selection was negative (-0.3%). The positive asset allocation was as a result of being overweight in equities and underweight in bonds. Over a 12 month period the Fund recorded a positive relative return against the benchmark of 0.3% (21.7% v. 21.4%).

The significant increase in value that the Fund has enjoyed recently has improved the funding level to 88%* (assets as a percentage of liabilities). The 2016 Triennial Valuation showed a funding level of 76%, so this is a considerable change. The Strategic Asset Allocation review highlighted the risks associated with the Fund's high level of exposure to equities, and recognised the need to reduce the potential volatility associated with that by an increase into the allocation to alternatives (including property). Concerns about the Fund's exposure to currencies and the possible impact of inflation were addressed in the review, with the recommendation that this should be reviewed again ahead of the transition of Fund assets to LGPS Central. Given the improvement in the Fund's funding level, further mitigation of that risk may be appropriate to protect that position.

*It should be noted that this calculation is an estimate, with liabilities based on the assessment date of 31 March 2016, but with assets at current value.

The Fund's active managers had a mixed experience in the last quarter of 2016. Only one of the active equity mandates outperformed their benchmark in Q4, with JP Morgan (Emerging Markets) outperforming by 0.4%. Schroders (Emerging Markets) underperformed by -0.8% and Nomura (Pacific) by -0.9%. JP Morgan (Bonds) also outperformed, by 0.2%.
The alternative passive strategies slightly underperformed their total benchmark (-0.3% in aggregate), and also slightly underperformed the traditional passive index benchmark (-0.2%).

World markets enjoyed another good quarter, on a sterling adjusted basis. The MSCI World Index showed a rise of 7.2%. The break-down by regions and countries is of some interest. The "Trump" effect helped North America/USA to show a return of 8.9%. Europe ex UK gained 5% and the UK 4.2%. Japan was up 5%. The possible flip side of the Trump effect showed muted gains from Pacific ex Japan at 2.3% and Emerging Markets up just 0.8%. The stand out country was Italy, up 16.5%. Although the EU might have thought the referendum outcome was bad news, markets clearly didn't share that view.

Bond markets, both Government and Corporate, came under pressure during the quarter, with US interest rates seen to be on a rising trend, and the prospect of inflation rising in both the US and UK. Long dated gilts fared worst, with British Govt over 25 years falling -6.5%. The FTSE UK Govt All Stocks fell -3.4%. As expected, index linked fared rather better, as did corporate bonds. The flip side as always is that falling values mean higher yields. so at least that is welcome.