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REPORT PREPARED FOR

Worcestershire County Council Pension Fund

November 2017

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

24 November 2017

Global overview

I am confused. That isn't anything new, but I am struggling to come to terms with the fact that world markets are at, or near, all time highs, yet looking at economic data (including monetary tightening) and the general view of the world that just doesn't seem to make much sense. There have been many times that markets have been called irrational, so maybe that is my rational explanation!
What with President Trump charging around as if he owns the place, and the posturing going on around Brexit, it hardly feels like a great backdrop to global growth going forwards. Maybe I need to get out more and see the world from other angles.

In the US, the economy chugged happily onwards, with a healthy growth rate of 3.1% recorded in Q2. New terminology keeps appearing, the latest being Quantitative Tightening (QT), so despite the likely negative economic impacts of two particularly unpleasant hurricanes, this is likely to be a feature going forwards, albeit gently. The political "Trump Show" continues on its madcap run, but "the system" does seem to be coping rather well, so far.

In the UK Brexit jitters are increasing, as the process of negotiation with the EU includes some rather bizarre public posturing. In addition, the Prime Minister's perceived position of weakness doesn't exactly help business sentiment. Despite that the economic outlook remains relatively stable. Sterling's weakness against the US$ seems to have run out of steam now, indeed September saw a reversal of that as the Bank of England indicated a likely rise in base rates (which then happened). These are uncertain times, and future growth may well be reduced as a result of that.

Over the other side of the English Channel, gentle GDP growth continued, but the outlook remains fragile. Politically the main hurdles seem to have been overcome as the year has progressed, although Mrs Merkel has lost some of her authority with a weaker than expected performance in the German election (shades of the other Mrs M?). This is important, as with continuing issues elsewhere in Europe the lead provided by Germany and France remains critical. After some uncertainty, the ECB has extended quantitative easing, but at a reduced level, into next year. The end of that is probably within sight.

Japan was another market where economic progress continued while politics swirled around creating uncertainty. At the geo-political level the tensions created by North Korea certainly were unhelpful, while at home Prime Minister Abe called a snap general election towards the end of the quarter, a gamble that we now know paid off.

Asia (ex Japan) was really about China and commodity prices. Certainly markets took a lot of cheer that Chinese GDP growth is maintaining a good pace, and sentiment has changed considerably since a year ago. More recently we have seen the Chinese National Congress take place, with President Xi effectively tightening his grip on power. Globally he seems to be regarded as a safe pair of hands and his regime does appear to be open to addressing some long standing issues, such as climate change and business practices. It shouldn't be forgotten that the Chinese wish to assert themselves as the dominant force in Asia, so the re-emergence of US interest in the region will not be welcomed.

Within Emerging Markets, the Latin America region was boosted both by the improvement in commodity prices but also the swing in political sentiment away from the issues that have dogged them in recent times. As usual there were losers as well, featuring this time Pakistan, Greece and Turkey in particular.

Worcestershire County Council Pension Fund   Quarter to end September 2017

Summary and Market Background

The value of the Fund in the quarter rose to £2.66bn, an increase of £170m compared to the end June value of £2.49bn. The Fund produced a return of 2.6% over the quarter, which gave an outperformance against the benchmark of 0.5%. This was attributable to good returns from equities and being underweight in bonds, although it should be noted that the equity asset mix provided a small drag on performance with an overweight position in the Far East which underperformed Europe, an area in which the Fund is underweight. Over a 12 month period the Fund recorded a positive relative return against the benchmark of 1.2% (13.8% v. 12.6%). It should be noted that the Fund has also outperformed over the three and five year periods as well, details of which can be found in Portfolio Evaluation Limited's report.

Since the last Pension Committee meeting, the Fund officer has analysed the appropriate methods by which the Fund could implement a down-side equity protection strategy to the funding level, that has increased to c.100% (assets as a percentage of liabilities) since the last actuarial valuation at 31 March 2016. This has been largely driven by a significant rise in equity markets, in which the Fund has a strategic allocation of 75% of total assets. The objective has been to secure protection against a relatively significant fall in equity values, up until after the next Triennial valuation in April 2019 (covering an 18 month period), after which the position can be reviewed. A single hedge strategy is considered to be simpler to manage and more economic in cost terms rather than a more complex and costly dynamic hedging strategy.

In a continuation of the encouraging theme seen throughout 2017 so far, the Fund's active managers had a positive third quarter, the difference this time being that they all outperformed their benchmarks. JP Morgan (Emerging Markets) was this quarter's star performer, with an outperformance of 3.1%, followed by Nomura (Pacific) outperforming by 2.3% and Schroders (Emerging Markets) by 1.3%. JP Morgan (Bonds) also outperformed, by 0.3%.
The alternative passive strategies performed in line with their benchmark, but underperformed the total passive index benchmark by -0.9% (1.3% v. 2.2%). Active equities outperformed the passive index equities by 2.4% (4.6% v. 2.2%).

World markets once again enjoyed a good quarter, and again rather better in US dollar terms than on a sterling adjusted basis. Using the sterling basis, the MSCI World Index showed a rise of 1.6%. The strongest returns came from Emerging Markets (up 4.6%), Europe ex UK (up 3.6%) and Pacific ex Japan (up 2.7%). The UK gained 2.1% and the USA 1.1%. Although Japan had a good quarter in local currency terms, they were the laggard this time on the sterling adjusted basis, up just 0.8%.

Most bond markets finished down over the quarter on a sterling adjusted basis, against the background of anticipated rate increases and scaling back of quantitative easing (QE). Like last quarter the exceptions were Euro Government bonds (up 1.0%) and UK Corporate bonds (up 0.1%). Again in general terms Corporate bonds outperformed Government Bonds, with some corporates gaining in value against the trend of falls seen elsewhere.