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REPORT PREPARED FOR

Worcestershire County Council Pension Fund

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

13 March 2018

Global overview

You will find references in this report to various items that you would find in parks and fun fairs. They are pieces of equipment that tend to go up and down and round and round. World markets are making me feel as if I have been on a ride on some of these, a bit giddy. Volatility is back, and with it greater risk. Let's hope that we enjoy the ride, rather than looking down the slide with trepidation.

So is the US on the helter-skelter, and what lies at the end of the ride? Certainly the positive economic data and the enthusiasm around the Republican tax reforms has helped to drive US markets higher, as has solid corporate earnings growth. Possibly this rising economic tide will make the process of Quantitative Tightening (QT) less likely to harm the economic outlook. However there are the signs of late in the cycle stresses appearing, such as capacity issues and inflation. Investors should be wary. I am drawn to an older definition of "helter-skelter" which long pre-dates the fairground ride, "disorderly haste or confusion".
I haven't mentioned the President.

In my last report I suggested that future growth in Britain may be reduced, and so it turned out to be in Q4, with expectations going forwards being adjusted downwards. Although demand for exported goods has remained strong, domestic consumption has been subdued, as illustrated by dull Christmas trading figures from retailers. Uncertainty about the outcome from the Brexit negotiations will continue to overshadow the economy until the key issues are agreed. The prospect of inflation remaining as a threat is real, with the consequent implications for base rates moving slightly higher sooner rather than later.

Over the other side of the Channel things may be ticking along nicely from an economic view point, but political storm clouds still swirl around. If I was a cartoonist, I would draw a picture of various European leaders in dodgems as they try to steer their way around each other, with a few bruisers trying to liven things up! During the quarter there was hardly a dull moment, ranging from the Catalan referendum issue, through Angela Merkel trying to form a workable coalition, with the Italians providing us with another opportunity to see how they vote; will it be anti or pro EU and the Euro? With regards to Brexit, their lead negotiator, Michel Barnier, is doing his best to be seen to do a great deal for Europe (ex UK), but economic reality means that he has to avoid doing more harm than good by alienating the UK. They still need us as a major trading partner.

Japan enjoyed a surge of improved sentiment following Prime Minister Abe's election victory. This was reinforced by an encouraging corporate results season, with earnings expectations being revised upwards. Overall economic data in December added to confidence, and as you will see later, Nomura has turned more positive! Rocket ride?

Asia (ex Japan). Following on from the Chinese National Congress, President Xi seems to have been quietly working to calm the Korean situation, bearing in mind that he does not wish to see the US embroiled in destabilising activity in "their" region. There is also continued emphasis on developing their internal market, with less reliance on being an export led economy. The Indian government is also continuing in their focus on developing their economy on a wider basis, which has included plans to significantly recapitalise the state controlled banks (to ease the burden of non-performing loans).

Emerging Markets, as usual there's never a dull moment. Probably the bucking bronco is the most appropriate analogy here. What is in favour one quarter is off the next quarter. So it is with South America, particularly Mexico and Brazil. The rides of the quarter included South Africa as hope for a better future rose with the election of Cyril Ramaphosa as leader of the ANC, with prospects of economic reform. Greece enjoyed a better time, as they reached agreement with international creditors over reforms, opening up the way to further funding. However will this be a short lived return to favour?

Worcestershire County Council Pension Fund Quarter to end December 2017

Summary and Market Background

The value of the Fund in the quarter rose to £2.79bn, an increase of £131m compared to the end September value of £2.66bn. The Fund produced a return of 5.0% over the quarter, which gave an outperformance against the benchmark of 0.6%. This was attributable to good returns from equities and being underweight in bonds, although it should be noted the asset mix in the passive portfolio provided a slight drag on performance due to the underweight position in Europe. Over a 12 month period the Fund recorded a positive relative return against the benchmark of 2.0% (15.4% v. 13.4%). 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.

Following approval from the Pension Committee work has been undertaken to implement the agreed down-side equity protection strategy mandate with River & Mercantile. In summary 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. In addition to this, and being cognisant of the fact that the current actual allocation to equities remains higher than the strategic benchmark level of 75% of the total Fund assets, work has also been undertaken to ensure a full allocation to Alternatives (15%) and to investigate the means of reducing the underweight position to Bonds (6% v.10%) while recognising that this asset class is deemed to be relatively expensive. A search is therefore been undertaken to identify a manager for a private debt mandate.

It was good to see 2017 end on a positive note after an excellent year for the Fund. With one exception the Fund's active managers again outperformed their benchmarks in the quarter, and all of the equity managers fully justified their existence over the year by exceeding their performance targets and are in positive territory on their three year rolling objective. Even the active bond manager only missed the outperformance target by a whisker. Schroders (Emerging Markets) was this quarter's star performer, with an outperformance of 1.0%, followed by Nomura (Pacific) outperforming by 0.6%. JP Morgan (Emerging Markets) rather let the side down with an underperformance of -0.8%. JP Morgan (Bonds) also outperformed, by 0.25%.
The alternative passive strategies performed in line with their benchmark, and outperformed the total passive index benchmark by 0.5% (4.9% v. 4.4%). Active equities outperformed the passive index equities by 4.0% (7.4% v. 4.4%).

At the risk of repetition, 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 4.8%. The strongest returns came from Japan (up 7.9%),

Pacific ex Japan (up 7.4%), and Emerging Markets (up 6.6%), Not far behind was the USA, gaining 5.8% and the UK 5.0%. The laggard was Europe ex UK up just 0.4%.
Bond markets continued the appearance of being on swings and roundabouts, with a mixed experience over the quarter on a sterling adjusted basis, against the continuing background of anticipated rate increases and the implications of quantitative tightening (QT). Again in general terms Corporate bonds outperformed Government Bonds, with some corporates gaining in value against the trend of falls seen elsewhere. Possibly as a reflection about the outlook, investment grade bonds fared better than some higher yielding issues.