



Appendix 1

REPORT PREPARED FOR **Worcestershire County Council Pension Fund**

June 2018

Philip Hebson

MJ Hudson Allenbridge

philip.hebson@mjhudson.com

This document is directed only at the person(s) identified above on the basis that they are a professional investor or professional customer. It is issued by MJ Hudson Allenbridge. MJ Hudson Allenbridge is a trading name of MJ Hudson Investment Advisers Limited and MJ Hudson Investment Consulting Limited which are both appointed representative of MJ Hudson Advisers Limited which is Authorised and Regulated by the Financial Conduct Authority (FCA).

We understand that your preference is for your advisers to issue investment advice in the first person. We recognise that this preference is a matter of style only and is not intended to alter the fact that investment advice will be given by MJ Hudson Investment Advisers Limited, an exempt person under FSMA as required by the Pensions Act. We further note that you have requested that our focus in these reports is on recent short term performance notwithstanding that the FCA Rules would generally require us to place less emphasis on past performance and provide performance numbers over the longer term.

MJ Hudson Investment Advisers Limited is a subsidiary of MJH Group Holdings Ltd.

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

5 June 2018

Global overview

I would like to start my report by confirming that your new Director of Finance and S151 Officer, Michael Hudson, has no connection with the parent company of Allenbridge, MJ Hudson. Pure coincidence.

In my last report I referred to movements in some markets to be akin to a trip on a fairground ride. As it turned out the Big Dipper was the most appropriate analogy. Commentators were talking about this being a good year to "sell in May and go away", but that would have probably been a mistake earlier in the month. However it may yet turn out to be a good move for those who held on until later in the month. Volatility is likely to remain higher than we saw through 2017, or put another way it will probably be a bumpy ride. This can be applied to currency markets as much as equity markets.

There is a certain honesty in Trump "diplomacy". It is definitely different. The snag is that the stakes are high, as is potentially the risk. In the meantime the immediate consequence is that oil prices are rising to levels that we haven't seen for a while, which will start to have a negative impact on economic activity through higher input inflation. This notion of higher inflation fed through to the markets during the quarter with some substantial falls as risk appetites fell, although the Fed hasn't changed their guidance on the likely number of rises in interest rates during 2018. The ongoing issue of US/China trade sanctions doesn't help confidence, but maybe the nettle of the nature of the trade imbalance does need to be grasped.

Across to the UK. Hands up those who are getting bored with the subject of Brexit. Some progress has been made, but the list of issues that remain to be resolved, including that of "borders", shows that we won't escape from the topic anytime soon. Although the economy has been performing slightly better than the relatively low forecasts for growth, concerns are growing that the protracted nature of the Brexit negotiations will have a negative impact on our economic prospects, until there is greater certainty about the outcome.

Last quarter I referred to the potential threat of political bruiseurs in Europe, so enter what is likely to be just that in Italy. Developments will have to be watched closely, as the alliance formed following their election could be quite a challenge for the "establishment" at the heart of the EU. The posturing has already started, and is presumably an unwelcome "add on" to the issues that the UK has already filled up their Inbox with. It doesn't help that Germany cannot realistically provide a picture of stability, given their far from solid coalition. I think that the term "propped up" can be well applied to Angela Merkel's

position. At the economic level, it is "steady as it goes", but forward looking surveys indicate slower future growth. This feeling about lower growth on a wider basis is in part a reflection about the outlook for global trade, given the switch in US policy towards protectionism.

Looking now at Japan, Prime Minister Abe still seems to be struggling to shake off the whiff of controversy, which is somewhat ironic for a country that has historically had a different take on governance issues. At the economic level growth slowed a little in the first quarter, but the longer term improving trend appears to be intact. An improvement in the general situation with North Korea will help investor sentiment, even though the high level game of cat (Trump?) and mouse (Kim Jong Un?) continues.

Like other world markets, Asia (ex Japan) saw a spike in market volatility during the quarter, flowing through from late January onwards, once again not helped by concerns about the future of world trade. The negative impact of the rising oil price is also starting to rear its ugly head in consuming countries. Again China's economic data was resilient, but as they are at the heart of the trade concerns with the US, this might serve to temper longer term growth expectations. As mentioned above, sorting the long running trade imbalance with the China has been on President Trump's "to do" list since taking office, it's just that his negotiating methods could be deemed to be unusual!

As ever Emerging Markets always has something of interest to report, this time Brazil providing the drama as the former president Luiz da Silva had his criminal conviction upheld, which may well rule him out of the presidential elections later this year. Despite Russia being increasingly seen as a pariah state, their sovereign bonds were upgraded to investment grade by S&P. I'll try to work that one out. India had another of their wobbles, this time caused in main part by the ruling BJP showing a weak showing in two state by-elections in March. In most countries that would be considered normal at midterm by-elections, but that does serve to illustrate the fragility of sentiment in Emerging Markets.

Summary and Market Background

The value of the Fund in the quarter fell to £2.676bn, a decrease of £118m compared to the end December value of £2.794bn. The Fund produced a return of -3.5% over the quarter, which gave an outperformance against the benchmark of 0.7%*. This was mainly attributable to the implementation of the equity protection strategy, with some contribution from the active equity managers. Over a 12 month period the Fund recorded a positive relative return against the benchmark of 1.9% (5.4% v. 3.5%). 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. It is particularly pleasing to be able to note that the ten year performance figure has now moved to an in line position against the benchmark, after a long period of showing an underperformance.

During the quarter under review the equity protection strategy mandate with River & Mercantile has been implemented. This was done on a multi stage basis through February, reflecting the scale of the programme. As a reminder, the objective has been to secure some protection to the funding level 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. Given that the risks associated with the Fund's relatively high allocation to equities may no longer be justified, consideration should be given to starting the background work now on the next strategic asset allocation review. The search to identify a manager for a private debt mandate to supplement the existing allocation to bonds was undertaken, with EQT being appointed.

Following on from the period of excellent real returns from markets throughout 2017, 2018 started in a similarly positive manner. However that came to an end towards the end of January, when we experienced some major falls in equity markets, with a period of enhanced volatility running on from that. Despite the turmoil, the Fund's active equity managers fared relatively well against an uncertain background. JP Morgan (Emerging Markets) was this quarter's star performer, with an outperformance of 1.7%, followed by Schroder (Emerging Markets) at 0.7% ahead. Nomura (Pacific) were marginally in negative territory, with an underperformance of -0.1%.

JP Morgan (Bonds) also underperformed slightly, by -0.1%.

The alternative passive strategies performed in line with their benchmark, and outperformed the total passive index benchmark by 1.1% (-4.9% v. -6.0%). Active equities also outperformed the passive index equities by 3.2% (-2.8% v. -6.0%).

As referred to above the relentless upward progression of equity markets finally faltered during the first quarter of 2018, with markets experiencing a considerable increase in volatility, something not seen for quite some time. Markets fared better in US dollar terms than on a sterling adjusted basis, with sterling strengthening on the expectation of interest rate rises. Using the sterling adjusted basis, the MSCI World Index fell by -4.8%. Emerging Markets fared the best, with a fall of just -2.2%, followed by Japan (-2.6%) and Asia ex Japan (-2.9%). The USA (S&P) was down -4.3%, Europe ex UK -4.7% and the UK -6.9%.

Bond markets had a difficult quarter with a mixed experience on a sterling adjusted basis, against the continuing background of anticipated rate increases and the implications of quantitative tightening (QT). In general terms Government Bonds outperformed Corporate Bonds, with some gains being seen, particularly at the local currency level. Another example of the continuing rotation of fortunes quarter by quarter, High Yield bonds tended to fare better than investment Grade bonds in Q1 2018.

*At the time of writing, the performance attributed to River & Mercantile by PEL is being discussed between the two parties, to ensure that this is an accurate portrayal of the performance of the Fund. The objective is to be able to show the notional position of the Fund, with or without the equity protection strategy in place.