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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

15 November 2018

Global overview

As we move from summer firmly into autumn, market jitters have returned. During July, August and September most world markets seemed to be in holiday mood, moving ever higher, with the exception of the UK that is. Only time will tell if that exuberance was ill conceived and was actually the end of a very long bull market, fuelled by asset price inflation brought on by quantitative easing. Mind you, where would we be now without that?

Starting off as usual with the USA, things, as in political noise, seem to have calmed down somewhat. Mr Cynic might suggest that the upcoming midterm elections might have something to with that, the outcome of which we will know by the time we next meet. Is the President bothered? Probably not. As for their economy, it powers onwards, in major part helped by domestic consumer spending. It is good to see trade deals being struck, but not with China, yet. There is a line of thought that suggests that the main issue for the US is the continuing practice of intellectual property being "stolen" by the Chinese. Indeed the suggestion by the Chinese that if they bought 4 Ford class aircraft carriers that would sort the trade gap had me chuckling, as that encapsulates a huge package of the most technically advanced equipment in the world!

I am so bored with the Brexit subject, but it can't be avoided until it is sorted. So much now seems to revolve around it, including politics and economics. I have said all along that it is the uncertainty that is damaging sentiment, not the actual reality. The fact that the Bank of England increased interest rates confirms that, due to the strengthening economy, underpinned by low unemployment levels, increasing consumer spending, and wage inflation. Now the real issue is possibly on the other side of the Channel....

....who may well consider that Brexit is the least of their worries? The fact that there is an immense amount of political unrest virtually throughout Europe means that in many individual countries their leaders are more concerned about domestic issues than they are about the UK leaving Europe. Merkel looks to be on her last legs, Macron's popularity is turning out to have been a flash in the pan, the Spanish and Italians are revolting and even Sweden is in turmoil. I could go on, and although at the moment the eurozone economic picture appears reasonable, the future looks very uncertain. We are best off out of it.

In the Asian region, the Japanese market performed well, helped by the Yen falling against the US Dollar. Economic growth rebounded strongly as corporate earnings continued to improve in line with market expectations. Some other Asian markets experienced a difficult

quarter, such as Hong Kong and Singapore, as trade worries spread. For China, the ongoing trade tensions with the US caused the Chinese Index to fall quite sharply. The US implemented tariffs on Chinese goods and, in September, announced a 10% tariff on $200 billion of Chinese goods, which resulted in the Chinese retaliating by enforcing their own tariffs on US imports. The central bank also introduced measures to try to stabilise the Renminbi. As mentioned elsewhere the real issue may be more about how China does business, rather than the trade imbalance as such.

Emerging markets had another volatile quarter, due to the strength of the US dollar, global trade tensions, and an increase in risk aversion. South Africa and Turkey under-performed, the latter suffering the most with the sell-off in the Lira, as geopolitical tensions escalated with the US. However, Mexico outperformed following a decisive Presidential election result and an agreement with the US on the renegotiation of NAFTA. Russian equities benefited from strength in crude oil prices.

Worcestershire County Council Pension Fund Quarter to end September 2018

Summary and Market Background

The value of the Fund in the quarter rose to £2.82bn, an increase of £61m compared to the end June value of £2.76bn. The Fund produced a return of 2.1% over the quarter, which gave an underperformance against the benchmark of -0.2%. This was mainly attributable to a negative contribution from the equity protection strategy as markets rose above the upside limits, although the Fund still enjoyed an overall increase in value from other assets outside the strategy. Clearly if markets fall (specifically UK, US and Europe) the equity protection strategy will have a positive impact on performance. Elsewhere the poor relative performance from JP Morgan and Schroders (Emerging Markets) also impacted on performance. However the Fund's underweight position in UK equities and overweight position in other equity markets benefited performance. Over a 12 month period the Fund also recorded a negative relative return against the benchmark of -1.0% (6.5% v. 7.5%). The Fund has outperformed over the three and five year periods, details of which can be found in Portfolio Evaluation Limited's report.

As a reminder, particularly to the wider external readership of this report, the equity protection strategy mandate with River & Mercantile was *implemented 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. Alongside a review of the risks associated with the Fund's relatively high allocation to equities and how that can be mitigated in the future, consideration of a further switch to other asset classes will be included in the strategic asset allocation review.

In sterling terms most world markets enjoyed a good third quarter this year, with the UK being the main exception. Government Bonds generally didn't fare so well, but against a continuing background of real and suggested rate increases this isn't surprising. The Fund's active equity managers all had a challenging quarter, but it wasn't disastrous. Nomura (Pacific) was the "best" of the pack, with an underperformance of -0.1% (but remember that is well behind their performance target). After a good run over recent times, Schroders (Emerging Markets) had a subdued quarter, with an underperformance of -0.6%. JP Morgan (Emerging Markets) again collected the wooden spoon with an underperformance of -0.7%. There is some good news; JP Morgan (Bonds) found some outperformance this time, of 0.25% ahead of benchmark and in line with their performance target. It's just a shame they can't make that a habit.
The alternative passive strategies outperformed the total passive benchmark by 2.2% (6.4% v. 4.2%). Not surprisingly the passive index equities also outperformed active equities by 1.4% (3.2% v. 1.8%).

With the exception of the UK, Developed Markets pretty much carried on upwards during the third quarter, with the US once again leading the way. Currency movements were more muted this time, so less benefit from a sterling perspective. Using the sterling adjusted basis, the MSCI World Index rose by 5.7%. The USA topped the leader board at 8.9%, with Japan following at 5.1% and Europe ex UK at 3.1%. Asia ex Japan (-0.1%) had a muted quarter, with Hong Kong and Singapore being the main negative influences on performance. The weakest performance of the main market groups was the UK at -0.8% (which in a reversal of last quarter will have helped the Fund's performance, due to our underweight position). Emerging Markets just about held their own, at 0.3%, but there was a wide range of performances on a country by country basis with China and Turkey falling significantly, but others (such as Thailand, Mexico and Taiwan) performing well.

Bond markets as a whole had another volatile and varied 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). Unusually the pattern seen in Q2 looks very similar to that in Q3, again performances to some degree driven by local issues; so for some (UK) the impact of rising base rates weighed (and Brexit concerns), while Emerging Market debt was driven slightly lower by the general connectivity to the strength of the US dollar. On the flip side, US Treasury and corporate issues performed well, but not with the same magnitude as in Q2.