MJ HUDSON 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

28 February 2019

Global overview

In my last review I mulled over the exuberance we had seen in world markets during the summer months of Q3, wondering if and when it would all end. A while ago I likened the market behaviour (and that of our managers) to a variety of fairground rides. In Q4 it was definitely a ride on the Big Dipper, but with an entrance at the top of the dip! As the ride has continued into 2019, things have calmed down (recovered) a bit, but I wouldn't undo the seat belt yet. This ride could be far from being over. Although in the short term market falls can be painful, they do at least provide opportunities to acquire assets at cheaper prices, to state the obvious. However they might get cheaper!

Markets wise, the party certainly stopped in the US. The list of reasons is quite long, and in many ways predictable. Apparently part of it is about a wall, but surely President Trump has studied some history (or maybe not) and realised that walls don't work. Whatever, it has caused some chaos, particularly within government. As predicted the Fed raised interest rates again, but has flagged that the pace of future increases may slow, as concerns about longer term economic prospects grow ever darker. Then we have trade talks, political issues rumbling on, and fears that the seemingly unstoppable IT/Media companies (the FAANGs*) might be fallible after all. What goes up eventually comes down (like walls).

* = Facebook, Amazon, Apple, Netflix and Google

Do I really have to write about Brexit again? I would love to think that next time I sit at the keyboard typing the review that it will be all over, bar the shouting. Well, I can but hope. In reality, this is an enormous distraction in the business world, particularly for those that have to consider the consequences of the various scenarios that exist. I am optimistic about the future for the UK economy, but we have to get over many hurdles first. As for politics, I'll leave that to others, but it is hardly surprising that voters are disenchanted. That isn't just in the UK, by the way.

At the risk of sounding like a stuck record, those comments about disenchanted electorates certainly applies in Europe. Personally I'm not keen on Yellow Vests, preferring orange ones (railway hi viz!). I don't think that President Macron is keen on them either, and he has good reason. I fear that the economic issues that have dogged Europe (I do blame the Euro) aren't going away quickly enough and that the demonstrations of discontent will become more widespread. The Brexit negotiations are as much to do with keeping the lid on their internal problems as they are on winding Mrs May up, and the rest of us Brits. Once we are out of it, they will have to focus on more pressing matters.

In market terms Japan had a grim time in Q4, with mixed economic data due to a series of natural disasters causing a slowdown in economic activity. There was little corporate news except for the completion of the Softbank IPO, and the former CEO of Nissan making national headlines as he was arrested on suspicion of misusing company assets. Corporate miscreance is an issue in Asia that will keep recurring until business culture changes, not that Western companies are completely immune to that.

Rather conversely it could be said that Emerging Markets had a relatively benign time in Q4, but as the chart below shows they had been suffering on a relative basis through much of 2018. China first, well they did have issues, as trade tensions continued with the US and their economy carried on slowing down. At the time of writing the clock is ticking on tariff/trade issues being resolved, but the Chinese are at least making pragmatic noises. Elsewhere Mexican equities fell to a three-year low over the quarter, as worries over the administration's populist approach to economic policy rattled the Mexican market. The fall in crude oil prices, continued to pressurise oil-producing countries like Russia. By contrast, Brazil posted strong equities gains with the election of the far-right candidate, Jair Bolsonaro, as he promised economic reforms to boost growth and reduce the deficit by privatising state-run companies and signing bilateral trade deals.

I don't usually provide pretty pictures, but this does provide some perspective on the year that was 2018.

Global Equity Markets Performance 2018

Source: Bloomberg. All in local currency. FTSE All-Share Index (Ticker: ASX Index) S&P 500 Index (Ticker: SPX Index) Nikkei 225 Index (Ticker: NKY Index) MSCI World Index (Ticker: MXWO Index) MSCI Emerging Markets (Ticker: MXEF Index)

Summary and Market Background

The value of the Fund in the quarter fell to £2.63bn, a decrease of £195m compared to the end September value of £2.82bn. The Fund produced a return of -5.2% over the quarter, which gave an outperformance against the benchmark of 2.4%. This was mainly attributable to a positive contribution from the equity protection strategy as markets experienced some heavy falls in October and again in December. The positive performances from the infrastructure and property investments have also helped to reduce the overall volatility of total Fund performance during this period. Over a 12 month period the Fund also recorded a positive relative return against the benchmark of 1.1% (-3.8% v. -4.9%). The Fund has outperformed over the three and five year periods, and now also over ten years, 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, as seen in the fourth quarter, up until after the next Triennial valuation in April 2019 (covering an 18 month period), after which the position will 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, and in almost any other terms, it would be fair to say that world markets had a horrible fourth quarter in 2018, which with the exception of the US also caused all other main equity markets to record losses for the year as a whole. On the flip side, Bonds generally fared well, with the exception of Corporate High Yield ("Junk") Bonds, as there was a flight to relative safety and quality. The Fund's active managers all had a grim quarter, which probably isn't a surprise. Nomura (Pacific) was again the relative "best" of the active equity manager pack, with an underperformance of -1.0%. Schroders (Emerging Markets) had another difficult quarter, with an underperformance of -1.2%. JP Morgan (Emerging Markets) once again collected the wooden spoon with an underperformance of -1.6%. Sadly there isn't any good news from active bonds either; JP Morgan (Bonds) also struggled in the volatile markets, recording an underperformance of -0.6% against their benchmark. The alternative passive strategies outperformed the total passive benchmark by 1.3% (-9.5% v. -10.8%). The active equities group also outperformed passive equities by 2.1% (-8.7% v. -10.8%), as despite the relative underperformance of the active managers the market indices they represent fell less than those in the passive section of the Fund.

World markets slammed into reverse gear in the fourth quarter of 2018, the falls seen wiped out all the gains seen in the middle months of the year. Sterling value falls were

muted in comparison with the US$ and the Euro. Only the US (S&P 500) showed an increase over the year on a sterling adjusted basis, by 1.6%, but fell by -4.4% in US$ terms.
Over the quarter, using the sterling adjusted basis, the MSCI World Index fell by -11.4%. Japan experienced the biggest fall amongst developed markets, -12.2%, followed by the USA at -11.5%. Europe (ex UK) was down by -10.9%, with the UK faring slightly better at -10.3%. Asia (ex Japan) did relatively well amongst developed markets, down just -6.6%. “Top” of the leader board was Emerging Markets at -5.2%, but with the usual very mixed experience on a country by country basis, some helped by the significant fall in the oil price. Our managers clearly got caught out by that!

Bond markets as a whole had a generally positive quarter, again so long as you look on a sterling adjusted basis. There was a distinct “flight to quality”, as Government bonds outperformed Corporate debt, and within that “Junk” bonds (non investment grade) performed poorly.