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REPORT PREPARED FOR

Worcestershire Pension Fund

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Independent Investment Adviser's report for the Pension Investment Sub Committee meeting

18 September 2019

Global overview

The winds of change are blowing, both for the UK's relationships with the rest of the world (Europe in particular), but also for the Fund. Over recent times it would have been fair to say that by and large business continued as normal, despite politics. That's certainly the view that seemed to be taken by our Emerging Markets managers! More recently one could take the view that politics has started to get in the way of business, trade issues stirred up by politicians (I'm not taking a view if that is right or wrong) certainly doesn't help. Interesting times lie ahead in many ways; let's hope the outcomes are positive.

I will attempt to keep this ramble around the world more focused on the underlying economic situation, because that is ultimately what matters. All still appears to be relatively rosy in the US at the headline level (GDP, employment/unemployment data, etc), but what we are all doing is watching the horizon for signs of bad economic weather approaching. Okay, the Fed didn't cut rates in June, but they did in July and there was an acknowledgement about concerns around global growth and trade. Rates are more likely to go down further than to rise in the near term, reflecting those concerns. So far so good, but confidence is weakening. No mention of the President there!

Here in the UK we have a new Prime Minister who has clearly laid out his stall about getting on with the job of the UK leaving the European Union and redefining our trading relationships with Europe and the rest of the world. I have often mentioned that uncertainty can create opportunities but in the meantime it can be quite disruptive, particularly with investment planning. The outlook for the economy is finely balanced and we are likely to see more volatility in the month by month statistics, as business tries to second guess what the implications of various different outcomes will be. On the plus side, weak sterling will continue to help our exports to be very competitive, so long as tariffs aren't imposed. Long term I am still positive about the prospects for UK plc. Now will there be yet another Prime Minister by the time I write my next report?

Elections for the European Parliament came and went, as predicted there was a rise in the representation of nationalist members, but not much seems to have changed, so far. At the economic level the focus seems to be increasingly on the health of each member state, and yes, I'm particularly thinking about Germany here. Europe needs a healthy Germany, actually even more so after the UK leaves. The ECB is clearly concerned, with declared intent to engage in further monetary easing if deemed necessary. Global trade issues seem to have eased for the moment, but could reappear on Twitter at any moment. I remain concerned about the future of the European Union and the implications for the member states.

Japan still seems to be caught up in the eddy currents of the ongoing “discussion” between China and the USA on trade issues, and to some degree Huawei. Economic data continues to be mixed, with many issues at play that could potentially tip the economy technically into recession. I was intrigued by one commentary on the quarter which concerned the annual general meeting season which stated, “Historically these have been tedious affairs but the growing focus on corporate governance, combined with greater shareholder activism, has begun to produce some fascinating results. This year, the greatest reversal of fortunes for incumbent managements occurred at Lixil and Nomura Holdings”. Something to raise with Nomura.

For Asia ex Japan and some Emerging Markets the main issue was the continuing gyrations of trade “talks” between China and the USA. Those markets involved are particularly sensitive to changes in sentiment as progress is made, or isn’t. An example of that is when talks unexpectedly broke down in May, markets fell sharply as a consequence and then recovered as the rhetoric eased. Elsewhere the outcome from elections in South Africa (no change) was received well. Russia also performed well as a result of an interest rate cut there, also helped by a strong rally in the share price of Gazprom.

Worcestershire Pension Fund Quarter to end June 2019

Summary and Market Background

The value of the Fund in the quarter rose to £2.87bn, an increase of £144m compared to the end March value of £2.72bn. The Fund produced a return of 4.0% over the quarter, which gave an underperformance against the benchmark of -0.6%. This was mainly attributable to a notional negative contribution from the equity protection strategy as markets continued their recovery from the falls seen in Q4 2018. The Fund would have been virtually in line with the benchmark if the equity protection strategy was excluded. Country allocation in equities also detracted from total Fund performance during this period, mainly due to an underweight position in Europe (ex UK) which performed well. Over a 12 month period the Fund also recorded a negative relative return against the benchmark of -0.8% (5.5% v. 6.3%). The Fund has outperformed over the three and five year periods, and is in line with the benchmark over ten years, details of which can be found in Portfolio Evaluation Limited's report.

As a continuing 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 2018, up until after the next Triennial valuation in April 2019 (covering an 18 month period). Approval has been given to extending the protection period until Q2 2020 to help manage the Fund's risk profile ahead of the new funding period. Preliminary work on the strategic asset allocation review has now commenced, which will be completed later this year. This will include a review of the risks associated with the Fund's relatively high allocation to equities and how that can be mitigated in the future, alongside consideration of a further switch to other asset classes that will seek to maintain returns while reducing risk. The Hymans report has highlighted some asset classes that could be considered in the future, but which are currently unattractive due to their high relative valuations.

We have reached farewell time for our two Emerging Markets managers, as the assets that they managed have now been transitioned to LGPS Central and their appointed managers (BMO, Vontobel and UBS). Following on from that will be the transition to the Corporate Bonds sub fund; the appointed managers are Fidelity and Neuberger Berman. Subject to final approval, transition is likely to take place in the near future.

World markets continued their recovery during the quarter after the horrors at the end of 2018, albeit not in the exuberant sort of way that was seen in Q1. All of the Fund's active managers outperformed their respective benchmarks during the quarter, if not necessarily their performance targets. The two departing Emerging Markets managers finished well; Schroders (Emerging Markets) was the relative best of the pack, with an outperformance of 1.8%, with JP Morgan (Emerging Markets) at 0.7%. Nomura (Pacific) was just about in

positive territory, with an outperformance of 0.1%. JP Morgan (Bonds) joined in with an outperformance of 0.3% against their benchmark.
The alternative passive strategies outperformed the total passive benchmark by 0.7% (6.3% v. 5.6%). Passive equities outperformed the active equities group by 1.0% (5.6% v. 4.6%), which reflects in aggregate terms the regional market indices that they represent rising more than those in the active section of the Fund.

World markets enjoyed another good quarter, but with a high level of volatility during the period as concerns about trade wars, particularly US/China, waxed and waned. Sterling value gains exceeded those in the US$ and the Euro, as the pound weakened on "no deal" Brexit concerns, which haven't gone away. All of the main market groupings showed gains in the quarter, but those in Asia and Emerging Markets were more muted as the implications for trade war tariffs caused concern about future growth.

Over the quarter, using the sterling adjusted basis, the MSCI World Index rose by 6.5%. Europe ex UK achieved the biggest gain, having been one of the relative laggards last quarter, up 9.0%. The US again showed a strong performance, with a gain of 6.8%. The UK was up by just 3.3%, which to a large degree reflects the uncertainties surrounding Brexit, with the Deal/ No Deal outcomes being fiercely debated. Asia (ex Japan) was up 3.2% and Japan was up 3.5%. Emerging Markets rose just 3.1%, with the usual mix within that, on the upside the likes of South Africa, Indonesia, Russia and Turkey performed well, but China and South Korea lagged on trade concerns. Remember that what goes up one quarter is often down the next!

In sterling terms, bond markets as a whole had a positive quarter, with some strong gains seen in Emerging Market debt, Corporate Bonds and US debt in general. UK gilts were the main laggard, as political worries prevailed.