REPORT PREPARED FOR

Worcestershire County Council Pension Fund

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Independent Investment Adviser's report

12 June 2017

Global overview

When political historians look back on 2016 and 2017, they will be able to report that politics became exciting again, if not somewhat unnerving! So far this year we have got over some of the more potentially unsettling hurdles, including the fact that Marine Le Pen was NOT elected as the next President of France. However the big surprise, (or is it?) is that we now face a General Election in the UK, the result of which we will know by the time of our meeting. Still to come; the German elections.

In the US, the now not so new President Trump is still being controversial and rather as anticipated he isn't getting everything his own way. The "system" is working. At least some of the rhetoric hasn't been followed through, he seemed to get on well with President Xi, he made the right noises to Muslim leaders in the Middle East, and he appears to be trying to be statesmanlike, when not on Twitter. The implications and detail of his anticipated tax structure changes continue to be worked out, alongside a gently tightening fiscal policy. There are still many "what ifs" about US politics and economic strategy, but to a large degree business continues as normal in the meantime.

The UK government overcame the obstacles to triggering Article 50 and then did so, thus starting the process of leaving the European Union. There will be a lot of bluster during the negotiations, with a lot of uncertainty until that is completed. In the meantime the post period end, post Easter surprise, was the announcement of a General Election. It appears that the Prime Minister is attempting to strengthen her negotiating position by ensuring she has the right "group" in Parliament, backed by a renewed mandate from the UK electorate. Although it hasn't been said as such, there is also clearly some attraction in attempting to sort the "Scottish" issue (aka Nicola Sturgeon) at the same time. Oh, and George Osborne is gone, at least for the time being. Presumably he couldn't do electioneering and start a new job at the same time. Very convenient.

You might recall the comments in the last report about inflation, and how I was flagging that my belief was that the signs were that we would see inflation rise faster and higher than was being forecast at the time. That has happened, so what next? The current consensus seems to be that inflation will peak quite rapidly, and then settle at a slightly higher level than we have seen in recent times, but that there is nothing to worry about. Economic history doesn't really support that benign scenario. Inflation remains a risk, and while currency and commodity pricing threats tend to work out over time, inflation can cause permanent damage to the value of some assets unless appropriate protective action is taken.

Europe is actually treading water quite well at the moment. Economic data looks reasonable, politically the Dutch and French elections have come and gone without major upsets (still trying to work out who President Macron is though!), and the outlook looks reasonable. The ECB is maintaining fiscal stimulus for the time being, but a tailing off is being flagged. Next up, the German elections......

Another meeting that seemed to go well, after previous negative rhetoric, was that between Prime Minister Abe and President Trump. Mr Abe has also received the backing of the Liberal Democratic Party to continue in office, so apart from a small local scandal, he appears set to remain for a while longer, presumably alongside his economic policies. Corporate results are indicating good earnings prospects, which is encouraging for the wider economy. However for a sustained recovery to be seen, domestic consumption needs to consistently improve.

Asia (ex Japan) and Emerging Markets again had one central driver of sentiment; the US. To a large extent this was a bounce back from the negative sentiment seen in Q4 2016, as fears of a doomsday trade scenario evaporated. As usual on a country by country basis local events impacted on sentiment and consequently markets.

India enjoyed a return to favour, following the demonetisation shock last year, with Prime Minister Modi's party, the BJP, performing well in state elections. This has provided reassurance about the sustainability of his economic strategy.

China also saw an improvement in sentiment, with currency pressures easing. Clearly an easing of trade restriction fears after the meeting between Presidents Trump and Xi has a major part to play. Cynically one could say that President Trump needs President Xi's help to keep the lid on the erratic behaviour of the "Dear Respected Comrade" (Kim Jong Un) before things in North Korea get really out of hand.

Sadly the world continues to be an uncertain place, and the fortunes of many emerging markets are driven by external influences which far outweigh the strengths of their own internal economic performance.

Worcestershire County Council Pension Fund — Quarter to end March 2017

Summary and Market Background

The value of the Fund in the quarter rose to £2.45bn, an increase of £133m compared to the end December value of £2.31bn. The Fund produced a return of 5.6% over the quarter, which gave an outperformance against the benchmark of 0.6%. Asset allocation (0.2%) and stock selection (0.4%) both contributed to this positive outcome. The positive asset allocation was as a result of being overweight in equities and underweight in bonds. Over a 12 month period the Fund recorded a positive relative return against the benchmark of 2.0% (26.7% v. 24.7%). The average performance of 60 LGPS Funds for 2016/17, as compiled by PIRC, was a return of 21.4%. 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.

As an update to the comments in the last report concerning the improvement in the funding level, this continued increase in value that the Fund has enjoyed over recent months has improved the funding level further to approximately 96%* (assets as a percentage of liabilities). It should be noted that part of this improvement is as a result of £110m in prepaid deficit contributions being received in April 2017, which is not included in the quarter end Fund value. As a reminder, the 2016 Triennial Valuation showed a funding level of 76%. Given the improvement in the Fund's funding level, further consideration could be given to strategies to protect that position.

*This calculation is an estimate, with liabilities based on the assessment date of 31 March 2016, but with assets valued as at 18 May 2017.

The Fund's active managers generally had a positive first quarter of 2017. Nomura (Pacific) was this quarter's star performer, with an outperformance of 1.7%, followed by JP Morgan (Emerging Markets) outperforming by 1.3%. Schroders (Emerging Markets) let the side down, with an underperformance of -0.6%. JP Morgan (Bonds) also outperformed, by 0.1%. The alternative passive strategies performed in line with their total benchmark, but outperformed the traditional passive index benchmark by 0.4% (5.2% v. 4.8%).

World markets once again enjoyed a good quarter, on a sterling adjusted basis. The MSCI World Index showed a rise of 5.8%. In contrast to the previous quarter the strongest returns were seen from Pacific ex Japan at 11.5% and Emerging Markets up 10.2%. Europe ex UK gained a very respectable 7.4%, with the "laggards" being the USA up 5.0%. the UK up 4.0%, and Japan was up just 3.4%.

Bond markets were a bit of a mixed bag in the first quarter. Emerging Market debt was the "stand out" performer; up 5.2% (local currency index). UK long dated conventional gilts enjoyed a good recovery over the last quarter, and Index Linked had a relatively good quarter again. US long dated bonds fell, reflecting the expectation of tighter monetary policy going forwards. Global corporate high yield bonds outperformed investment grade bonds, reflecting an increased risk appetite.