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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

17 & 18 September 2018

Global overview

At this time of year I usually share some insights from my summer holiday, when I get the chance to view the world from a slightly different angle. I had high hopes this year of getting something a bit different when my wife booked a holiday with an American cruise line, albeit sailing out of Southampton. Now don't laugh, but it turned out that only 7% of the passengers were actually American, of the US variety! So having played the game of hunt the American, I discovered that they probably weren't typical, as they had actually left their homeland. Their mindset therefore played to the angle that they could see the clear dangers and potential cost of pursuing an isolationist policy on trade, but could also see the point in trying to level the playing field somewhat to help native US industry. All disturbingly rational. We visited Spain, Italy and the southern coast of France, at all ports of call the impact of large numbers of immigrants from Africa was both saddening (deprivation) and worrying (crime, and native populations being forced out of some areas).

In the US itself, performance of US equities was driven by strong corporate earnings and economic data, although the growing threat of a trade war between the US and China raised concerns over future performance. It does bother me that when the music eventually stops, there could be a big correction. That day is getting closer.

Onwards to what is happening at home, or not as the case maybe. Sorry to mention it, Brexit, or now Chequers. The brinkmanship is growing, hopefully towards some form of resolution this autumn. It just feels like Deal or No Deal at the moment. In the meantime the weakness of sterling has helped markets, and hopefully the economy.

On the other side of the Brexit debate, political uncertainty increased significantly in Europe in Q2. The Italian elections resulted in a coalition of two populist parties. However, instability subsequently declined, and support for the euro was steady or increasing across the Eurozone by the end of the quarter. Stock market returns were positive, boosted by more promising economic data, although financial stocks, in particular Italian banks, weighed on overall performance.

The Asian region, alongside the Emerging Markets on a wider basis, had a challenging quarter, but as usual some fared better than others. The two main issues revolved around the strength of the US dollar, and the looming threat of a trade war with the US. At the moment there is a lot of noise, and there are clearly some real issues that need sorting to balance trade more equitably, but hopefully common sense will prevail. The alternative is genuinely worrying. In Japan, markets were boosted by a weaker yen, following a disappointing Q1. Corporate earnings broadly met expectations, and unemployment declined further.

For China trade tensions with the US led to falls in their markets. Growth slowed somewhat, as expected, but remained solid as the transition from an investment-led model to one based on consumer spending continued.

Elsewhere emerging markets had a difficult quarter, due to the strength of the dollar, trade tensions, and an increase in risk aversion.
In Brazil, political instability and strikes hit output. Turkey and Argentina also suffered, with the former raising interest rates sharply to shore up the lira, and the latter forced to approach the IMF for assistance.

As a tailpiece, on a calm evening in the middle of the Mediterranean Sea, with the sun low on the horizon, I couldn't help noticing the sheer amount of rubbish floating around that I could see from my balcony. It did make me think about the reality of pollution, and the potential harm it causes.

Worcestershire County Council Pension Fund

Quarter to end June 2018

Summary and Market Background

The value of the Fund in the quarter rose to £2.761bn, an increase of £79m compared to the end March value of £2.682bn. The Fund produced a return of 2.9% over the quarter, which gave an underperformance against the benchmark of -2.0%. 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. Elsewhere the underperformance of Emerging Markets as a sub asset class, alongside poor relative performance from JP Morgan (Emerging markets) and Nomura (Pacific), also impacted on performance. Over a 12 month period the Fund recorded a small negative relative return against the benchmark of -0.1% (7.1% v. 7.2%). 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 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. Given that the risks associated with the Fund's relatively high allocation to equities may no longer be justified, consideration of a switch to some other asset classes will be included in the strategic asset allocation review.

With the definite exception of Emerging Markets, in sterling terms all world markets enjoyed a good second quarter this year. Bonds didn't fare so well, but against a background of real and suggested rate increases some volatility was to be expected. With a concentration in the regions that struggled in Q2, some of the Fund's active equity managers had a challenging quarter, to put it politely. The good news was that Schroders (Emerging Markets) enjoyed another good quarter, with an outperformance of 1.4%. That's the end of the good news, with JP Morgan (Emerging Markets) collecting the wooden spoon with an underperformance of -3.7%, followed by Nomura (Pacific) with an underperformance of -1.1%.
JP Morgan (Bonds) also underperformed slightly again, by -0.15%.
The alternative passive strategies underperformed the total passive benchmark by -0.65% (7.34% v. 7.99%). Not surprisingly the passive index equities also outperformed active equities by 8.8% (-0.5% v. 8.3%).

Markets generally shook off the malaise of the first quarter of 2018 during the Spring months, with particularly strong performances from the US and the UK. Markets fared better on a sterling adjusted basis, reflecting the strength of the US dollar. Using the sterling adjusted basis, the MSCI World Index rose by 8.1%. The USA (S&P) topped the leader board at 9.9%, followed by the UK at 9.2% (which hurt the Fund, due to our underweight position).

They were followed at some distance by Europe ex UK at 3.8%, Japan (3.3%), Asia ex Japan (2.5%). Emerging Markets was the clear laggard at -2.1%, in large part attributable to China and growing trade issues with the US.

Bond markets as a whole had a 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). In trying to establish a pattern, performances to some degree were driven by local issues, so for some (UK) the impact of rising base rates weighed, while Emerging Market debt was driven lower by the general connectivity to the strength of the US dollar. On the flip side, US treasury and corporate issues performed well, again on a sterling adjusted basis