MJ HUDSON Allenbridge

REPORT PREPARED FOR

Worcestershire Pension Fund

11th June 2019

Philip Hebson
MJ Hudson Allenbridge

philip.hebson@mjhudson.com

We understand that your preference is for your advisers to issue investment advice in the first person. We recognise that this preference is a matter of style only and is not intended to alter the fact that investment advice will be given by MJ Hudson Investment Advisers Limited, an exempt person under FSMA as required by the Pensions Act. We further note that you have requested that our focus in these reports is on recent short term performance notwithstanding that the FCA Rules would generally require us to place less emphasis on past performance and provide performance numbers over the longer term.

Independent Investment Adviser's report for the Pensions Investment Sub Committee meetings

11/12 June 2019

Global overview

Those of us of a certain vintage will remember a very popular film, "It's a Mad, Mad, Mad, Mad World". It used to be classified as comedy, but now it should be under the description of current affairs. That Big Dipper? Replace it with the acrobatics aeroplane, soaring and diving all over the place. The falls of Q4 2018 turned out to be Much Ado About Nothing as we turned into 2019, but the same threats still remain. The main issues were easing of concerns about a China/USA trade war (since heightened again) and central banks stepping back from quantitative tightening, at least for the time being.

The term "Shouty politics" has been used to describe how President Trump goes about his business. Nothing new about that; just look at how Prime Minister's Questions used to be conducted. However it would be true to say that US politics is certainly noisy these days, what with calls for the President to be impeached simply not going away and trade negotiations seemingly being conducted with the aid of a megaphone. However what is going on beneath the surface is where we should focus our attention, and with the Fed lowering its projections for growth and inflation the spectre of recession reappeared. That, linked to the renewed concerns about trade with China (and possibly Europe), is something that should be taken seriously. Frankly impeachment talk is just a side show, for now.

Oh dear Mrs May, this really is a rather long goodbye. Goodbye to Europe and goodbye to her. I am not brave enough to predict what the outcome(s) will be, but almost any way it does not make Britain look exactly Great in the eyes of the rest of the world. Under the surface here, mixed messages; growth and anticipated growth is slowing on one hand, while on the other employment statistics remain robust with wages gently picking up. I've said it before, markets do not like uncertainty, but it can provide opportunities for the savvy investor. See, I haven't mentioned the "B" word!

Elections for the European Parliament loom and by the time you read this we will know the outcome. I'm not sure that the word "fascinating" is one that I would readily attach to the EU, but I am awaiting the outcome of this election with interest. As one who will probably be a detached observer at some stage before long, I will be watching to see how the balance between traditional politics and the rise of populist parties across Europe plays out at this level, rather than just at the nationalistic level. While the polls predict that the traditionalists will still have the upper hand, the future direction of travel of the EU is up for grabs. Continued progress with federalism, or ultimately a disintegration of the Union? In the meantime, trade issues loom, not just with the UK but also the USA. What will the summer bring?

In contrast to other countries the bounce back in Japanese markets was distinctly muted. This seemed to be more to do with a series of negative surprises which then started to undermine confidence. Observations of economic news in the USA and resulting interest rate trends caused some reassessment of the outlook. Including China in particular, there is an expectation of lower external trade, including cars and electrical items, which when coupled to higher wage costs working through are serving to depress the corporate earnings outlook. All this may turn out to be overly pessimistic, but possibly explains the impact on sentiment.

Looking at Asia ex Japan and Emerging Markets together two main issues were at play. For the Asian region the more benign tone of the China/USA trade issues settled some nerves (since rattled again) helped sentiment. For China the technical change in weighting of their listed shares in MSCI benchmark indices also helped markets recover, however artificial that seems. Elsewhere geopolitical tensions in the region didn't help, including the spat between India and Pakistan, and the abrupt end to the USA/North Korea summit. The other factor was the strong rally in the oil price which helped some of the producer nations, such as Russia and Columbia. With increasing tension between the USA and Iran, that recovery may be sustained.

There seems to be a common theme in this overview, wherever the USA is mentioned there is increased tension. Food for thought.

Worcestershire Pension Fund Quarter to end March 2019

Summary and Market Background

The value of the Fund in the quarter rose to £2.72bn, an increase of £98.1m compared to the end December value of £2.63bn. The Fund produced a return of 4.8% over the quarter, which gave an underperformance against the benchmark of -2.7%. This was mainly attributable to a notional negative contribution from the equity protection strategy as markets experienced a significant recovery from the falls seen in Q4 2018. The underperformance from the active equity managers and the underweight position in UK equities also detracted from total Fund performance during this period. Over a 12 month period the Fund also recorded a negative relative return against the benchmark of -2.3% (4.4% v. 6.7%). 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, up until after the next Triennial valuation in April 2019 (covering an 18 month period), after which the position will be reviewed. Consideration is being given to extending the protection period until Q2 2020 to help manage the Fund's risk profile ahead of the new funding period. Hymans Robertson has completed a review of the Fund's current asset allocation strategy, which will help guide the decisions that will be made when the strategic asset allocation review takes place 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.

This quarter saw some significant developments in the process of transitioning the day to day management of Fund investments to LGPS Central. LGPS Central announced the appointment of their selected three managers for the Emerging Markets sub fund; BMO, Vontobel and UBS. They have also announced the two managers selected for the Corporate Bonds sub fund; Fidelity and Neuberger Berman. Subject to final approval, transition is likely to take place in Q3 this year.

World markets bounced back strongly in the first quarter after the horrors at the end of 2018. That bounce back up until the end of March is very welcome, given that the values then form the basis of the English and Welsh Funds' triennial valuation, which in turn helps determine the required employer contribution rates for the next funding period. The Fund's active equity managers all saw the value of their mandates recover, but sadly not by enough

to help their relative performances. Schroders (Emerging Markets) was the relative "best" of the pack, with an in line performance, then it's downhill from there with Nomura (Pacific) underperforming by -0.4% and JP Morgan (Emerging Markets) tail end Charlie again with an underperformance of -0.5%. A small glimmer of good news from active bonds; JP Morgan (Bonds) managed to save some house credibility with an outperformance of 0.7% against their benchmark.
The total passive benchmark outperformed the alternative passive strategies by 0.3% (9.8% v. 9.5%). Passive equities outperformed the active equities group by 3.3% (9.8% v. 6.5%), which reflects a combination of the relative underperformance of the active managers with the regional market indices that they represent rising less than those in the passive section of the Fund.

World markets roared away as we entered the New Year, such as by the end of the quarter virtually all of the ground lost in Q4 2018 had been made up. Sterling value gains were muted in comparison with the US$ and the Euro. All of the main market groupings showed good gains in the quarter, and with the exception of Emerging Markets were also ahead on a 12 month basis again. It is difficult to fathom out the sanity of markets at times!
Over the quarter, using the sterling adjusted basis, the MSCI World Index rose by 9.9%. The USA achieved the biggest gain, having been one of the biggest fallers in Q4 2018, up 11.1%. The UK was up by 9.4%, which to some degree reflects the fact that the falls had opened up some good relative value. Asia (ex Japan) was up 8.9% and Europe was up 8.0%. Emerging Markets rose 7.4%, with the usual mix within that, particularly after the fall in the oil price rapidly reversed as tensions in the Middle East increased. Japan struggled, having been one of the biggest fallers in Q4 2018 it was also the laggard in terms of gains in Q1 2019, rising just 4.4%.

In sterling terms, bond markets as a whole had a muted quarter, with a reversal of fortunes compared to Q4 2018. In general terms corporate bonds, particularly global high yield issues, outperformed government bonds, although UK gilts enjoyed a good quarter.