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Appendix 1

REPORT PREPARED FOR

Worcestershire Pension Fund

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

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Global overview

Brexit is done, bar the shouting, of which there will inevitably be a fair amount. At least on this side of the Channel we have a sort of stability, not sure about those to the south of it! Coming up, US Presidential elections and the shouting is just starting. The sad business of Coronavirus is making the headlines; it is too early to tell if this will have anything more than a short term impact on GDP in the region and elsewhere.

Global economic data was better than expected in Q4 but remained mixed. Aside from the Federal Reserve, which cut interest rates for the third time in the year, central banks declined to cut rates but remained committed to loose monetary policy. Meanwhile, pressure has been mounting on governments to loosen fiscal policies, most notably in the Eurozone, where extended quantitative easing and the continued slowing of the economy have raised questions over the amount of capacity left for monetary policy to stimulate growth. The announcement of a 'Phase One' US-China trade deal and a new majority government in the UK helped to ease global political uncertainty.

GDP: US GDP is expected to grow 2.2% in Q4, whilst last quarter's GDP was revised up from 1.9% to 2.1%. The US consumer confidence index grew from 125.1 in August to 126.5 in December; however this was a slight decline from 126.8 in November. US-China trade tensions continued to cause concern.

In the UK, Q4 GDP growth is expected to be around 0.1%, due to continuing long-term Brexit uncertainty, the running down of supplies ordered by businesses as part of no-deal Brexit contingencies, and political uncertainty leading up to the December election. The British Chamber of Commerce Quarterly Economic survey pointed to a worsening service sector, continuing negative indicators for manufacturing and export orders, and the lowest manufacturing investment for eight years. In the Eurozone, GDP growth is predicted to be 0.2% for Q4, as growth in the region continued to remain weak, especially in Germany.

CPI: In Q4, inflation levels in the US rose from 1.7% at the end of the previous quarter, to 2.3%. The majority of price rises were due to housing, medical care, and gasoline, whilst used cars and trucks, household furnishings and operations, and airlines fares declined.

In the UK, the consumer price index fell from 1.7% at the end of Q3 to 1.3%; this is below the 2.0% target set by the Bank of England (BoE). The decline was driven primarily by accommodation services and clothing, while the greatest increases came from water, electricity, gas and other fuels.

Central Banks: In Q4, central banks continued with dovish policies but the pace of interest rate cuts slowed. Whilst the Fed cut rates once more, the BoE, the European Central Bank (ECB), and the Bank of Japan (BoJ) all held rates steady. The Fed stated that while it does not plan to reduce rates further in the near future, it would be ready to step in. This was shown with its involvement in the Repo market at the end of Q4, with the aim of halting a repeat of September's Repo interest rate spikes. In her first months as ECB president, Lagarde reiterated Draghi's loose stance on monetary policy, and continued to press for governments to loosen fiscal policy. It was also announced that Andrew Bailey, head of the FCA, would take over from Mark Carney as Governor of the Bank of England on 16th March 2020.

Political Headlines: In the UK, Boris Johnson was elected as Prime Minister with a significant majority. In the US, the main headline was the impeachment of President Donald Trump, with the Senate voting against his removal. The new team of EU Commissioners were put in place on 1 December. In Germany, the new SDP leadership unexpectedly announced that they would keep their party in coalition with Angela Merkel's CDU. Meanwhile, in France, Macron was under pressure as protests against his proposed pension reforms set him in conflict with French unions.

Worcestershire Pension Fund

Quarter to end December 2019

Summary and Market Background

The value of the Fund in the quarter rose to £2.94bn, an increase of £12m compared to the end September value of £2.93bn. The Fund produced a return of 1.7% over the quarter, which was -0.3% below the benchmark. The equity protection strategy provided a small positive contribution to returns, with the main detractor being relatively underweight in the traditional market cap. passive indices and a relatively low return from the alternative benchmark passive portfolio. Over a 12 month period the Fund recorded a negative relative return against the benchmark of -3.9% (13.5% v. 17.3%). The Fund has performed close to benchmark over the three, five and ten year periods, details of which can be found in Portfolio Evaluation Limited's 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). This protection has now been extended until Q3 2020 to help manage the Fund's risk profile ahead of the new funding period. The strategic asset allocation review has been completed and was approved at the Pensions Committee meeting in December. An increase in allocation to the alternatives portfolio (up to 20% from 15%) was sanctioned, work has commenced on implementation. Further work will be undertaken to seek appropriate means to bring the actual allocation to fixed interest closer to the strategic allocation (10%). The main allocation continues to be in equities (70%) and the focus will be to ensure that risk and reward continues to be managed in a balanced manner, using a blend of passive and active management on a regional basis. An equity protection overlay will form part of the overall risk management strategy, with the objective of continuing to provide some protection to the funding level in the event of significant falls in equity markets.

The asset allocation review has also highlighted the need for the Fund to manage Environmental, Social and Governance (ESG) issues in a more proactive manner, assisted in part by LGPS Central. To enable the Fund's stakeholders to gain an understanding of the issues that are involved and actions that need to be considered a training programme has been initiated, starting with a presentation from Karen Shackleton from Pensions for Purpose. This provided valuable guidance about what should be considered and how to set objectives for the Fund in terms of how and to what extent ESG standards will be implemented and monitored.

As previously reported Emerging Markets assets have now been transitioned to LGPS Central and their appointed managers (BMO, Vontobel and UBS). The monitoring of this mandate will need to focus on how LGPS Central manages it on a Fund of Funds basis, along

with scrutiny of the individual managers as necessary. The transition of the Corporate Bonds mandate, currently managed by JP Morgan, to the LGPS Central sub fund (the appointed managers are Fidelity and Neuberger Berman) is in process at the time of writing.

Our two active equity managers had a very divergent experience in Q4 2019 Nomura (Pacific) enjoyed another good quarter, with an outperformance of 1.5%, whereas LGPS Central (Emerging Markets) underperformed during their second quarter by -0.4%. Hardly an auspicious start. JP Morgan (Bonds) nearly performed in line with their benchmark (6bps under!).
The alternative passive strategies underperformed the total passive benchmark by -1.1% (0.7% v. 1.8%). Active market equities outperformed the passive equities group by 0.4% (2.8% v. 2.4%), which reflects in aggregate terms the regional market indices that they represent rising more than those in the passive section of the Fund, despite a strong performance from the UK market within that, with Europe being the laggard.

Equities

Over the course of Q4 2019, equity markets performed well; as political uncertainty and concerns regarding the global economy subsided, to some extent investors' risk appetite increased, and thus so did allocations to equities. Concerns over the trade war continued to weigh on markets, with mixed messages throughout the quarter. Whilst a trade deal was agreed in mid-December, alleviating some uncertainty, the trade war endures. Nonetheless, continued central bank support helped spur-on markets globally. Generally, fears of a recession calmed, as economic data proved better than expected, although typically such data was either negative or neutral.

UK: UK markets were slightly up in Q4 with the FTSE 100 up by 2.7% and the FTSE All-Share by 4.2%, bringing year to date returns to 17.2% and 19.1%, respectively. However, the FTSE 100 was the worst performing equity market of those that we monitor. Domestic stocks, and economically sensitive areas of the market outperformed; however, oil and gas lagged despite increasing crude oil prices. UK small and mid-cap stocks performed well over the quarter. In contrast, the retail sector performed poorly, with retail sales declining by 1% in the quarter, with many retail companies posting lower profits as a result. Wider earnings reports were broadly mixed.

EU: The Euro STOXX 50 increased by 5.2% in Q4. Like other developed markets, the EU region made strong positive gains over the quarter, boosted by the ECB's re-start of quantitative easing. Sectors that performed well included IT, consumer discretionary and materials.

US: The US stock market made strong gains over the quarter. The S&P 500 index reached record highs in Q4, finishing the quarter up 9.1%. Over the year, the S&P 500 rose 31.5% and was the strongest performing equity index that we track. Well-performing sectors included energy stocks, which rose as the oil price increased, whilst real estate and

industrials performed below market average. For Q4, it is estimated that S&P 500 earnings would be down by -2.1% year-on-year, whilst revenues were expected to grow 2.7% year-on-year; this would mark the fourth continuous quarter of net profit margin declines. However, it should be noted that Q4 2018 represented the fourth highest net profit margins since 2008.

Japan: The Japanese equity market had a very strong quarter; the Nikkei 225 was up 8.9% during Q4, pushing returns to 23.5% over the course of 2019. Japan had a good start to the quarter, with textiles & apparels the only sector on the Tokyo Stock Exchange to decline. Abenomics restarted and the BoJ continued with loose monetary policies. However, the Japan-South Korea trade war, the typhoon and the consumption tax weighed on the economy.

China: The MSCI China Index rose by 14.0% over the quarter. The Chinese government continued to support its economy as it experienced slower growth. Despite continued instability in Hong Kong, the Hang Seng increased by 8.4% over the quarter.

Emerging Markets: The MSCI Emerging Markets index was up 11.7% for Q4, bringing returns in 2019 to 18.6%, which is at the lower end of returns for the indices that we track. Civil unrest across emerging markets held down equity returns, along with continued uncertainty over the US-China trade war. Despite this, emerging markets performed well. The increase in oil prices helped to boost the stock market returns of some emerging market countries, including Russia, Colombia and India.

Fixed Income

Government Bonds: In Q4, bond yields rose as the impact of accommodative central bank policies was felt, and progress was made in US-China trade deal talks. The 10-year US Treasury yield rose by 25 bps, and the US yield curve steepened. This was driven by optimism over a potential end to the trade war, and better than expected US economic data.

While the leadership of the ECB has changed, policy has not, so far. Loose monetary policy continues, although bond yields have been rising throughout the Eurozone. French government 10-year yields turned positive, whilst 10-year German bond yields rose from -0.6% to -0.2%. Japanese government bond yields also rose but remained negative. In Britain, increased confidence in a Brexit deal was balanced with increased spending proposals by the new government, but overall the UK 10-year yield rose by only 33 bps.

Investment Grade Corporate Bonds: In Q4, IG corporate bonds outperformed government bonds but underperformed US high yield bonds. US investment grade corporate bonds outperformed both pan-European, and UK corporate investment grade bonds.

The Bloomberg Barclays US Corporate Investment Grade TR Index Unhedged returned 1.2%, bringing the year to date return up to 14.5%. US corporate bond spreads tightened due to strong foreign and domestic demand.

High Yield Credit: Better than expected economic data allayed fears of a recession, and reduced global tensions helped to propel US high yield bonds which outperformed developed market government bonds, as well as US IG Corporate Bonds. The Bloomberg Barclays US Corporate High Yield TR Index Unhedged returned 2.6% in Q4. US high yield spreads continue to be tighter than the historical average, tightening 27bp over Treasuries.