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

So much has changed over the last three months. The short term impact of Coronavirus/ Covid-19 has been enormous, with a large negative impact on the economy in the UK and globally, but also sadly we have seen a huge human cost as well. The Pension Fund exists to provide financial security to the members in their retirement, much work has been undertaken to ensure that the Fund is protected to some degree from short term market falls, such as that which was seen in late February and early March.

There were two distinct halves that characterised Q1 2020: during the first half, the global outlook was slightly optimistic, albeit tentatively so. In January, the "Phase One" trade deal was signed between the US and China, and the UK officially left the EU. The latter half, however, saw a change of course as the Covid-19 became a global pandemic.
In the UK, the consumer price index rose for the first two months of the quarter (1.8% in January, and 1.7% in February) from 1.3% in December. It is expected to fall to approximately 1.2% in March. These were all below the 2.0% target set by the Bank of England (BoE).

GDP: The impact of COVID-19 pandemic is expected to be widely felt across all major economies. US GDP is expected to fall by -5.0% in Q1, compared to a rise of 2.1% in Q4. According to the Bureau of Labour Statistics, 10m people lost their jobs in America in the last two weeks of March. The US consumer confidence index fell from 126.5 in December to 120 in March.

In the UK, Q1 GDP growth is expected to be -1.8%. Despite substantial government stimulus, the economic fallout will likely push the UK economy into a recession. In the Eurozone, GDP growth is predicted to be -2.0%.

CPI: In Q1, inflation levels in the US fell from 2.3% in December to 1.5% in March. The inflation rate peaked in January at 2.5%, before falling back to 2.3% in February.

Central Banks: Central banks unveiled a raft of rate cuts and quantitative easing, supported by large-scale government stimulus, to counteract the damage to the economy of global actions taken to slow the spread of Covid-19. Mark Carney ended his time at the Bank of England (BoE) with an emergency rate cut of 0.5% down to 0.25%, the first reduction in the BoE's base rate since August 2016. This was followed up by another emergency cut by the new governor, Andrew Bailey, to 0.10%, a historic low. The Federal Reserve also cut rates twice, from 1.00% to 0.00%. Both the Bank of Japan, and the European Central Bank held

interest rates steady. All major central banks announced a wide range of quantitative easing programmes.

Political Headlines: The most notable political headlines came from January, with the coronavirus outbreak overshadowing other considerations for the rest of the month. Almost four years after voting to leave the European Union, Britain finally exited on 31 January, though a transition period runs until the end of 2020 as Britain negotiates trade relations with the European Union, and the rest of the world. At the same time, US-China trade tensions eased, the impeachment of Donald Trump did not proceed, and fears of a war between the US and Iran receded.

Worcestershire Pension Fund

Quarter to end March 2020

Summary and Market Background

The value of the Fund in the quarter fell to £2.61bn, a decrease of £333m compared to the end December value of £2.94bn. The Fund produced a return of -11.1% over the quarter, which was 3.6% ahead of the benchmark. The equity protection strategy provided the main part of the excess performance, helped by an underweight position in UK equities which underperformed other equity markets. Over a 12 month period the Fund recorded a positive relative return against the benchmark of 3.1% (-3.7% v. -6.9%). The Fund has performed ahead of the 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 originally *implemented to secure some protection to the funding level* against a relatively significant fall in equity values, as seen in the most recent quarter, up until after the Triennial valuation in April 2019 (covering an 18 month period). This protection was extended until Q3 2020 to help manage the Fund's risk profile ahead of the new funding period. Following the significant falls seen in equity market values, the options protecting the UK Equity market were exercised as values approached and achieved the lowest end of the protection range. The values of the European and US markets did not fall as far within their protection ranges, so therefore remain in place.
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. As part of this process a commitment to the British Strategic Investment Fund (an innovative infrastructure and housing fund managed by Gresham House) of £50m was agreed during the quarter. 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 future 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. Following further training and in consultation with the Fund's main stakeholders to establish the key issues, a procurement process will be undertaken to appoint an adviser to map the Fund's existing investments against the agreed objectives and to provide a framework by which future progress to achieve the Fund's aspirations can be measured.

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) took place during the quarter.

In extremely turbulent markets our two active equity managers had a divergent experience in the quarter with positions reversed from Q4, so while LGPS Central (Emerging Markets) managed an outperformance of 0.9%, Nomura (Pacific) underperformed during the quarter by -1.4%. The corporate bond mandate was in transition during the quarter, not helped by those turbulent markets, but up to the point of transition JP Morgan (Bonds) performed slightly ahead of their benchmark (0.2%). In the short time LGPS Central (Corporate Bonds) have been in charge of the mandate they have provided a performance in line with the benchmark. The transition process will have had a negative impact on returns, which will be covered in a separate report.
The alternative passive strategies outperformed the passive equities benchmark by 4.3% (-15.2% v. -19.5%). Active market equities outperformed passive equities by 2.2% (-17.3% v. -19.5%), which reflects in aggregate terms the regional market indices that they represent falling less than those in the passive section of the Fund, despite a relatively strong performance from the US market within that. The UK was the laggard, down -25.1% over the quarter.

Equities

Equity markets had a very tough Q1. Whilst several indices hit all-time highs (such as the S&P 500, and the Dax 30) early in the quarter, the picture reversed dramatically towards the latter part of the quarter. This was driven by changing expectations regarding the economic impact of the response to the coronavirus outbreak and intensified by crashing oil prices. The quarter ended with a sharp rally in response to widespread stimulus measures, such that most indices declined by just under -25.0% by end March, having rallied from the much larger -35.0% fall to the trough in mid March. The energy sector was also hit by the oil price war between Saudi Arabia and Russia. The VIX Volatility Index spiked to recent highs of 82.69, from 13.78 in December, during the height of market uncertainty.

According to the MSCI ACWI factor indices, Momentum stocks had the strongest performance in Q1; however performance was still negative at -18.83%. Value stocks had the worst performance at -26.95%. In March, Quality stocks, that is those that have high and stable levels of financial strength, performed best, returning -11.58%, whilst Value was again the worst performer at -16.78%.

UK: The UK stock market followed the same trends as outlined above, except that the early, pre-coronavirus crash portion of the month was weaker than for other developed markets. In this period, UK markets traded sideways, in large part due to the release of weak economic data covering the period up to the election being released. Weak UK corporate earnings announcements for Q4 2019 also contributed. The FTSE 100 was down by -24.0%, whilst the FTSE All Share down by -25.11%.

EU: The Euro STOXX 50 was the worst performing index that we track, declining by -25.3% over the quarter. As Europe became the centre of the pandemic, the equities rebound in late March was weaker than in other markets.

US: The story of the US stock market in Q1 was similar to main overview outlined above. Whilst the Q4 2019 earnings reports were stronger than expected, Q1 earnings announcements were overshadowed by the coronavirus outbreak. S&P 500 earnings expectations for Q1 are of a -7.3% year-on-year decline, followed by a decline of -10% in Q2.

Japan: The Nikkei 225 was the strongest performing equity index that we track; however, it was still down -17.7% over the quarter. This strength was due to the expanded central bank ETF purchases, as well as reporting fewer cases of Coronavirus and the relatively resilient balance sheets of Japanese corporates.

China: Chinese markets fell earlier than others as the country was the first to face the epidemic. The closure of Chinese companies as part of the January Lunar New Year was extended, with the Chinese economy effectively shutting down; factories were still only starting to recover by the end of the quarter. As part of this, onshore stock exchanges were closed beyond the New Year holiday.

Emerging Markets: The MSCI Emerging Markets index was down -23.6% for Q1. While the oil price collapse helped countries that are large importers, such as India and South Africa, others which rely heavily on oil exports, such as Russia and Saudi Arabia were negatively affected. The strengthening US dollar presented another negative headwind.

Fixed Income

In Q1, with major global economies such as the US and the UK fearing a possible recession, central banks cut interest rates causing yields to fall and government bond prices to rise. In addition, a market-wide flight to safety increased investor demand for bonds at the end of the quarter. This reversed the mid-March bond sell-off when bond prices collapsed alongside most other asset classes due to the intensity of risk-off attitude. In the UK, the

Bank of England cut rates to a mere 0.1%, this led to gains in UK government bonds over the quarter. Meanwhile, high yield and investment grade corporate bonds performed significantly less well and saw broad falls across the markets, as investors factored in the risk of increased default rates driven by the anticipated recession.

Government Bonds: In Q1, government bonds generally performed well in most markets, as central banks responded to the pandemic by cutting rates, causing yields to fall and prices to rise. The Bloomberg Barclays US Treasury TR Unhedged USD Index gained 8.2%.

European sovereign bonds made slight gains over the quarter. The Bloomberg Barclays EU Govt All Bonds TR rose 0.3%. Meanwhile in Britain interest rate cuts led to gilt prices rising, with the Bloomberg Barclays UK Govt All Bonds TR gaining 6.8% over the quarter, this is despite the downgrading of the UK government credit rating to AA- by Fitch.

Investment Grade Corporate Bonds: In Q1, IG corporate bonds performed poorly across the board, in response to investor worries about business strength during the pandemic. The S&P UK Investment Grade Corporate Bond Index TR fell by -5.3% in Q1 and the Bloomberg Barclays US Corporate Investment Grade TR Index Unhedged fell by 3.6%. However, these rallied towards the end of March, as a number of central banks added high quality corporate bonds to the assets they can buy in their quantitative easing (QE) programmes, and as falling underlying interest rates increased the reward investors receive (the "spread") for taking the credit risk of buying corporate bonds.

High Yield Credit: Fears of a possible, imminent global recession and investors' decreased appetite for high risk investments caused high yield bond prices to fall significantly in Q1. In Europe, the Bloomberg Barclays Pan-European HY TR Index Value Unhedged Index fell by -15.1% while in the US the Bloomberg Barclays US Corporate High Yield TR Index Unhedged fell by -12.7% in Q1. US high yield spreads widened significantly, with US corporate option-adjusted spreads ending Q1 at 880bps, compared to 336bps at the start. For reference High yield credit spreads peaked at a bit below 20% in 2009.