REPORT PREPARED FOR

Worcestershire Pension Fund

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

16 & 17 September 2020

Global overview

Overall, the COVID-19 outbreak and the enormous government support packages put in place to counter the effects of lock-downs, continued to be the dominant global theme driving markets, and they are likely to continue to do so until a vaccine is developed, or the number of new cases significantly decreases.

Europe and Asia have started to re-open as their outbreaks have been brought under control, whilst the United States is seeing a resurgence in cases, with some States starting to reverse their re-openings. Hotspots are now the United States, Russia, and Latin America.

Unprecedented policy support has continued through the second quarter: Central bank "quantitative easing" programmes have continued, and broadened the scope of asset classes they target (for example, US corporate debt): and on the fiscal front, most developed economies have continued the employment support packages put in place in Q1, and the important EU-funded support package for worst-hit member states was agreed.

In general, higher risk asset classes, such as equities and high yield bonds experienced strong gains over the quarter, as a more general risk-on attitude prevailed, driven largely by policy support. This wavered somewhat towards the end of the quarter, as markets looked ahead to the phased withdrawing of fiscal support and the consequences of the high levels of debt built up.

Income from investments has also come under renewed pressure, with UK gilts joining the ranks of low/negative yielding government bonds, and both equity dividends and property rental income have suffered material cuts in Q2, some of which may have lasting impacts.

Political Headlines: On the geopolitical front, globally the picture remains mixed. In the US, Biden has emerged as the frontrunner in the US election against incumbent Donald Trump, with each representing strongly divergent policies. Though both are in favour of infrastructure expenditure, and seek to pressure China (though methods differ), key differences include attitudes to climate change (including fossil fuels usage), healthcare, immigration, and free trade, with Biden taking a more liberal stance on each as well as being in favour of increased taxation.

US-China tensions have restarted, threatening a renewed trade war. The US has also threatened to impose tariffs on those countries (Britain and the EU) that institute a digital tax.

In Europe, Brexit has come back into focus as trade negotiations continue ahead of the end of the transition period at the end of the year.

GDP: Looking at the global economy, according to the World Bank[1], based on the extent of impact on output and GDP, the world is experiencing the worst global recession since the Second World War. Q2 annualised GDP growth estimates were negative across the board, with the US economy contracting the most out of the economies that we track (-34.5%), followed by Japan (-22.4%), the UK (-17.0%), and then the Eurozone (-12.0%). These contractions, whilst substantial, were not unexpected given the widespread economic shutdowns for much of the quarter. Some market surveys indicate that analysts are expecting a "W-shape" recovery, compared to previous expectations of a "V-shaped" recovery.

CPI: Inflation levels over the quarter were substantially below recent levels for all major economies, which was broadly expected given the unprecedented situation and its impact. In the UK, CPI went from 0.5% in March to an estimated 0.2% in June; US CPI fell from 1.5% in March to an estimated 0.4% in June, whilst Eurozone CPI fell from 0.7% in March to 0.3% in June. The main underlying driver in falling inflation rates was the decline in oil prices, with a rebound in oil prices likely to reverse this.

Holiday reflections

All of us have experienced considerable upheaval in what we used to consider as "normal" life prior to the dramatic lock down back in March. Over the last couple of months, exact timing depending on whether you live in England, Scotland or Wales, those restrictions have been eased somewhat. My son returns to school and my daughter goes off to university. Both will be in new environments, even though he goes back to his existing school. Prior to this we very much felt that if possible we should try to get away somewhere for a short holiday, if only to get a sense of perspective back. So off we went in the last week of August to Fort Augustus, at the south end of Loch Ness, really as far away as we could get from the Madding Crowds on the south coast! Sadly Nessie has been put on furlough! Apart from just being in a wonderful place, we clearly ended up seeing their Covid-19 existence. Normally the area relies heavily on coach (or bus, in Scotland) tours, there is a virtual total absence of that traffic. Most B&B's and guest houses remained closed, which makes up a large percentage of the normal accommodation up there. The few places that were offering Eat Out to Help Out were inundated, but as one landlord showed us they were busy then but the bookings diary was empty for September. Frankly they face a long and difficult winter, after an all too short respite in late July and August. One telling story; back last October the Loch Ness Cruise boats hosted a party booking from Wuhan. They were all wearing masks. They retained a Chinese guide to provide a commentary for their considerable tour business from China. Having not done so before; she started wearing a mask afterwards and told a tale of an unexplained illness in Wuhan. Some people in the local area were ill afterwards. Possibly we now have an explanation for their illness.....

[1] World Bank, "June 2020 Global Economic Prospects", June 2020.

Worcestershire Pension Fund

Quarter to end June 2020

Summary and Market Background

The value of the Fund in the quarter rose to £2.94bn, an increase of £325m compared to the end March value of £2.61bn. The Fund produced a return of 11% over the quarter, which was 0.2% ahead of the benchmark. The underweight position in UK equities provided the main part of the excess performance, which underperformed other equity markets, helped by the equity protection strategy. Over a 12 month period the Fund recorded a positive relative return against the benchmark of 4.1% (2.8% v. -1.3%). 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, ahead of the 2019 triennial valuation and strategic asset allocation review. One of the key decisions within the asset allocation review was to continue to with a relatively high percentage of the Fund's assets (70%) being invested in equities. It was decided that 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 (as seen in Q1 2020). With the benefit of experience gained from the earlier stages of the equity protection strategy, the positioning of the strategy will be monitored more closely going forwards, looking in particular at the movements of the three individual regional markets covered by the strategy (US, Europe and UK). A discussion has also taken place between the Fund, PEL and River & Mercantile to link the performance reported closer to the underlying assets, thereby removing some of the volatility previously seen.

Work has continued towards increasing the allocation to the alternatives portfolio (up to 20% from 15%) in a cost effective manner. The Fund has been working with LGPS Central to identify what part they could play in this process and how that would work alongside the existing investments, ensuring that a suitable diversification of investments is maintained and as appropriate, enhanced. Further work is also being undertaken to seek appropriate means to bring the actual allocation to fixed interest closer to the strategic allocation (10%).

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 is now being 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. Hopefully we will be able share the detail of the appointment at the Sub Committee meeting on 16 September.

With the main markets continuing to recover strongly from the falls seen in Q1, we saw a further reversal of positions with our active equity managers in Q2, with Nomura (Pacific) outperforming by 3.0%, but LGPS Central (Emerging Markets) underperforming by -0.7%. It is pleasing to report that LGPS Central (Corporate Bonds) had a good inaugural quarter, with an outperformance of 1.3%. We can dare to hope that this will be the start of a consistent pattern and therefore cover the cost of transition sooner and provide a robust element of the Fund's investments.

The passive equities benchmark outperformed the alternative passive strategies by 0.6% (16.6% v. 16.0%). This is to be expected in the sort of market environment seen in the quarter. Passive equities outperformed active market equities by 5.5% (6.6% v. 1.1%), which reflects in main part the very strong performance from the North American portfolio (21.9%). The UK was again the laggard, up only 10.1% over the quarter.

Equities

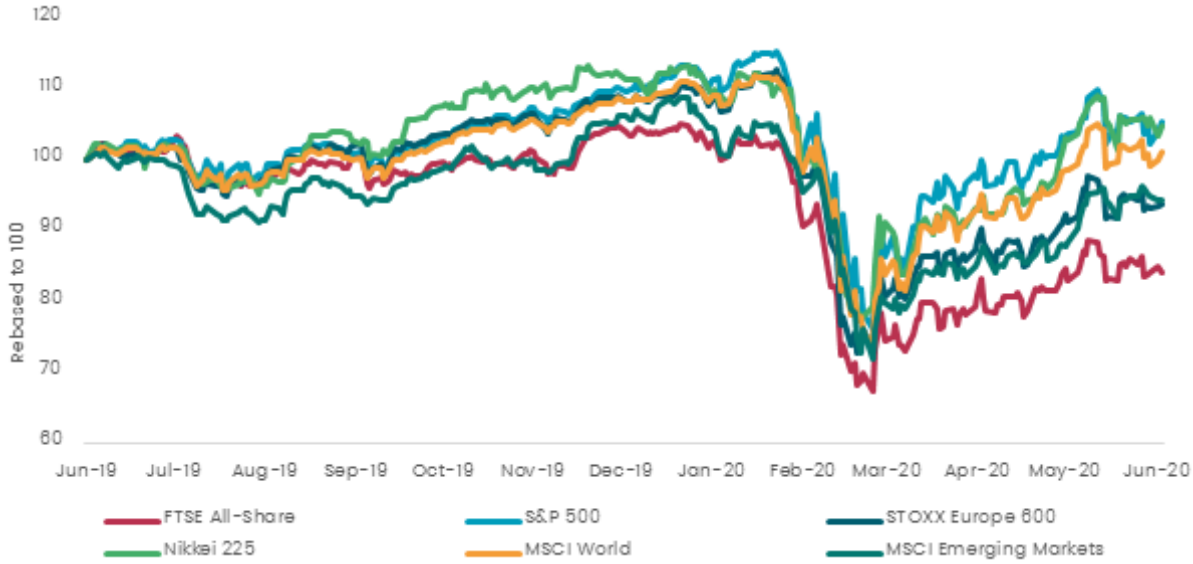
Equities had an outstanding quarter with all main equity indices gaining strong ground from a total return perspective. The S&P 500 index was the strongest performer, with a total return of +20.54% (Q-o-Q); the EURO STOXX 50, Nikkei 225, MSCI Emerging Markets, and MSCI World all followed close behind, whilst the FTSE was the weakest performer. However, the rebound faltered in June as the number of COVID-19 cases in the US began to rise again, and all equities indices that we track remain negative YTD. Volatility, as measured by the VIX, remains elevated, reaching 30.4 at the end of Q2 (from 13.8 at the beginning of the year).

The best performing equity sectors globally were technology companies, including online retailers, and healthcare, and those sectors exposed to the global economy (particularly the Chinese economy), such as mining, whilst the likes of airlines, hotels, REITS, and bricks-and-mortar stores, as well as consumer staples and utilities, experienced a poor quarter. This trend was also seen with UK and US equities.

Investors' preference for high quality assets has continued. Growth style has continued to outperform Value, and investment grade credit spreads have regained most of their losses in Q1. This does leave valuation dispersion between perceived high and lower quality assets at very high levels.

Emerging markets equities experienced their strongest quarter of the last decade[2], boosted by a weakened (though still strong) dollar, market re-openings, and oil-exporting countries such as Saudi Arabia, Mexico, and Russia benefiting from a partial rebound in oil prices in the second half of the quarter, though prices continued to be low in comparison to pre-COVID levels.

Chart: Global Equity Markets Performance



Fixed Income

On the fixed income front, the picture was positive, with all of the main bond indices posting positive total returns. High yield corporate bonds performed best, followed by investment grade corporates, and then sovereign bonds, matching the risk-on attitude of investors, despite the rise in credit downgrades.

US corporate spreads declined across the quarter, though remained above pre-COVID levels, due to liquidity provided by central banks, government stimulus, and investors.

The strength of corporate bond total returns is in contrast to the trend in credit ratings. S&P Global downgraded the ratings of 21% of nonfinancial corporates between the beginning of the pandemic, and the end of Q2. However, government stimulus has acted to limit to the scale of defaults thus far. Notable fallen angels include Ford, Occidental Petroleum, Kraft Heinz, and Renault.

Sovereign bonds were supported by substantial central bank quantitative easing. Short-term Gilt yields turned negative due to speculation on negative interest rates, and Brexit concerns. US Treasury and German Bund yields remained steady during the quarter; this can be seen with the +0.48% total return provided by US Treasuries.

[2] Schroders, "Quarterly Markets Review – Q2 2020", July 2020.