REPORT PREPARED FOR

Worcestershire Pension Fund

November 2020

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

25 November 2020

Global overview

Following the strong bounce back witnessed across major markets over Q2 and early Q3, markets appeared to somewhat run out of steam in September as evidence emerged of a resurgence in European COVID-19 cases and investors anticipated the recessionary effects of the ramping-down of stimulus packages, as well as the uncertainty of a close US presidential election.

While most major economies had reopened by mid-way through the quarter, forecasts for 2020 global real GDP growth are around -5% (nearer -10% for UK). While daily COVID cases had been declining in the United States (now appear to be rising again), cases in Europe have been rising rapidly. Some restrictions are likely to be in place well into next year, and global GDP may not reach pre-COVID-19 levels before 2021/22.

It is worth highlighting the following themes, impacting investment markets:

o Policy has, and is likely to continue, to support asset markets. Whilst many governments have pulled back on their fiscal stimulus programmes, the European Union was a notable exception, with the 27-member bloc agreeing to a pandemic recovery package worth €750bn in July. Equally, central banks have continued with their unprecedented levels of monetary support: speculation continues on the possibility of negative interest rates in the UK, while the Federal Reserve has shifted its mandate to target an average inflation rate of 2% pa to give itself more monetary flexibility. This has maintained investors' appetite for risk, albeit on somewhat nervous foundations, due to relatively high valuations in US equities notably.

o With today's low interest rates, it is hard to see government bonds delivering a good return, especially in real terms. However, they may still provide some (though limited) diversification of equity risk; potential investors need to think if they can accept the increased volatility of not holding government bonds.

o Increasing dispersion of returns. The gap between the winners and losers from COVID-19 restrictions continues to grow, as manufacturing has demonstrated by recovering more quickly than services. Sectors benefitting from the changes have continued to outperform strongly. For example, the global tech sector is up 23% YTD, while energy is down -40% YTD. This partly explains the continued outperformance of growth-style equities (up +16% YTD) over value-style (down -15% YTD), and also the wide dispersion of regional equity returns (US and emerging markets up nearly 10% in Q3, compared to the UK down -3% and Europe flat. These extreme dispersions highlight the importance of managing portfolios' risk in asset allocation and consideration should be given to rebalancing.

o Warning lights on currency risk. The extraordinary amount of policy support in addition to the vast debt being accumulated provides fertile ground for investor nervousness, as the weakness in the US dollar over Q3 has shown. A contested US presidential election and, for Sterling-based investors, Brexit, help explain some of the enthusiasm for other currencies, including some emerging markets currencies. Other safe havens, including gold, have also benefitted.

o Inflation. While further COVID-19 restrictions are clearly deflationary in the short-term, markets still expect sustained moderate (3% to 4% pa in UK) inflation in the medium term. However, clearly these expectations are likely to be pushed further out, the longer restrictions bite.

Political Headlines: Many of the geopolitical themes from Q2 had continued into Q3. The US presidential election has come and gone, but concerns remain over the contested election result which increased uncertainty. VIX options have increasingly priced in election-related volatility spreading into December, with lower equity volatility expected once the election issues calm down.

o Sino-centric tensions have continued, with escalations in the US-China trade war (including a new emphasis on technology firms), as well as renewed tensions with both India and Taiwan. It will be interesting to see how the Biden administration handle trade issues in the post Trump era, including with the UK.

o Negotiations between the EU and UK on a post-Brexit trade deal have intensified, with political rhetoric and tensions increasing due to the UK Internal Market Bill and the corresponding legal action that the EU has launched to enforce the Withdrawal Agreement. Expectations of a “No-Deal” Brexit have risen, although this is still not regarded as the most likely scenario.

o Shinzo Abe announced his intention to resign as Prime Minister of Japan in August, stepping down on 16th September. Expectations of tighter monetary policy boosted the Yen and put pressure on equities in the aftermath of the news. His former right-hand man, Yoshihide Suga, was elected as his replacement.

GDP: After the unprecedented slump to global GDP in Q2, most major economies are announcing record rebounds in Q3 following the lifting of national lockdowns. However, it is becoming apparent that the previous forecasts of a steep “V-shaped” recovery are levelling off towards what economists are referring to as a “reverse-square root sign”. To date the US economy has announced the highest Q3 GDP growth out of the economies that we track (+33%), followed by the UK (+15%) and Japan (+5%), with a forecast for the Eurozone (+7.5%). However, these rebounds need to be considered in the context of the falls in GDP during Q2: the US experienced the greatest slump in GDP (-31.4%), followed by the UK (-19.8%), the Eurozone (-11.8%) and then Japan (-7.8%). More interesting than the bounce back is perhaps the build-up of government debt to finance it. The FY2020 budget deficit in

the US alone is projected to reach $3.3 trillion, with US government debt set to exceed the size of the economy for the first time since the Second World War.

CPI: Current inflation remains well below recent levels among the major economies. In the UK, CPI growth fell from 0.6% in June to an estimated 0.2% in September, while Eurozone CPI fell from 0.3% in June to 0.1% in September. In contrast, US CPI increased from 0.6% in June to an estimated 1.4% in September, with large price increases for second-hand motor vehicles one factor for this change.

Worcestershire Pension Fund

Quarter to end September 2020

Summary and Market Background

The value of the Fund in the quarter rose to £3.0bn, an increase of £60m compared to the end June value of £2.94bn. The Fund produced a return of 1.0% over the quarter, which was -0.3% behind of the benchmark. The equity protection strategy provided a small negative relative return, due to the bonds collateral pool underperforming the underlying equities. Infrastructure and property also produced a negative contribution against their new composite benchmarks. Over a 12 month period the Fund recorded a positive relative return against the benchmark of 3.7% (1.4% v. -2.3%). 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 has been *implemented to secure some protection to the funding level* against a relatively significant fall in equity values. 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).

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. The LGPS Central alternatives team will be presenting their proposals to the PISC at the 25th November meeting for consideration, with the focus on their new infrastructure sub fund. Further work is also being undertaken to seek appropriate means to bring the actual allocation to fixed interest closer to the strategic allocation (10%).

In furtherance of the work commissioned by the Pensions Committee to manage Environmental, Social and Governance (ESG) issues in a more proactive manner across all of the Fund investments, Minerva have been selected to undertake work 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 a separate but timely exercise, LGPS Central has completed a Climate Risk review of the Fund's equity investments. In summary this was very encouraging in terms of the Fund investments having a much lower carbon exposure than the benchmark position, partially aided by our regional allocation mix and also from the stock selection profile of our active managers.
The findings of both reviews will be presented to the stakeholders who have been involved in the Pensions for Purpose led sessions that formed the brief for Minerva to work with, hopefully early in 2021.

World markets had a mixed performance experience during Q3, with some markets continuing the recovery seen in Q2, but UK and Europe were more subdued. Our active managers had what can only be described as a rather dull quarter in relative performance terms with Nomura (Pacific) performing in line with their benchmark, LGPS Central (Emerging Markets) underperforming slightly (by -0.15%) and LGPS Central (Corporate Bonds) just about on the positive side of benchmark performance. All active mandates therefore fell short of their expected performance targets.

The alternative passive strategies outperformed the passive equities benchmark by 0.35% (1.35% v. 1.0%). Active equities outperformed passive market equities by 2.0% (3.0% v. 1.0%), which reflects in main part the poor UK performance (-2.9%) and good performance from Emerging Markets (4.3%). North America was again a good performer, up 4.5% over the quarter.

Equities

Global equities generally had a strong Q3, although performance diverged as the US, Asia and Emerging markets enjoyed gains, while the UK and Europe lagged in comparison. Emerging markets were the frontrunner with a quarterly return of 9.7%, followed by the US, where the S&P 500 saw a return of 8.9%. In contrast, UK equities were the weakest performers with the FTSE 100 returning -4.0%, though this was partially due the strengthening of Sterling over the quarter. Volatility, as measured by the VIX index, fell from 30.4 on 30 June to 26.4 on 30 September.

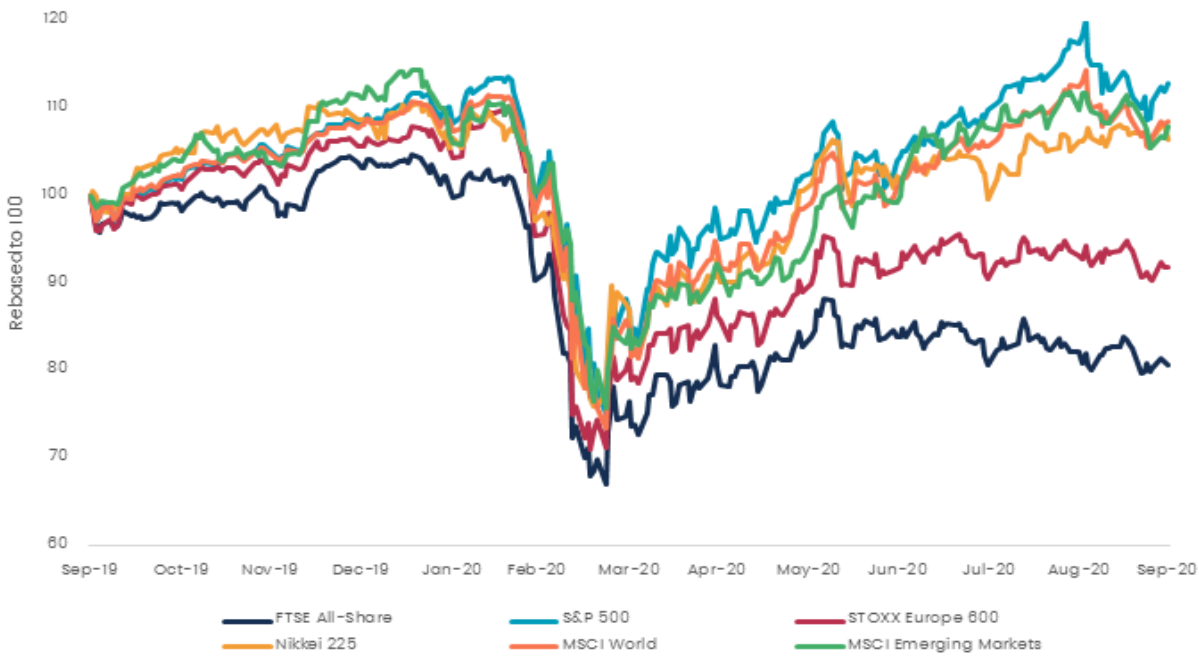
o In the US, consumer discretionary and materials companies were boosted as the economy re-opened, while aviation and energy companies have continued to perform poorly. Meanwhile technology, the standout sector during the pandemic, experienced a tough September with significant selloffs.

o The UK and Europe saw similar trends to the US in terms of consumer discretionary and materials sector performance. However, for the UK in particular, the outsized exposure to stocks in the financial services and oil sectors hampered performance.

o Emerging market equities recorded the strongest returns over Q3 as Asian manufacturing-led economies recovered, helped also by the relative weakness of the dollar. Markets such

as China, Taiwan and India performed well, in contrast to the likes of Turkey, Thailand, Russia, and Brazil.

Global Equity Markets Performance



Fixed Income

On the fixed income front, risk appetite remained strong. Defaults have continued at lower than average levels, given fiscal support packages. However, it is likely that they will increase markedly next year as stimulus is withdrawn. As investors continue to hunt for yield in the all-time low interest rate environment, high yield credit performed the best over Q3, followed by investment grade credit. Government bonds yields were generally unchanged over the quarter.

o US high yield credit spreads fell by around 1.1% in Q3. Most of this occurred in July, due to strong investor inflows along with default and downgrade rates slowing in pace. The inability for Democrats and Republicans in the US to agree on refreshed stimulus measures pushed up yields in September.

o US Treasuries and investment grade credit yields were broadly stable over the quarter. The impact on Treasuries of the change in the Federal Reserve's inflation policy in August was muted. Likewise, high levels of corporate issuance over the quarter has had limited effect on corporate bond yields.

o UK Gilts yields rose slightly over the quarter (meaning prices fell) as fears renewed around a disorderly Brexit transition weighed on investor sentiment, while investors increasingly expect UK interest rates to drop below zero during 2021.

o The positive performance of corporate bonds continues to contrast with credit rating trends. 37% of the companies rated by S&P now have downgrade warnings. Between 70% and 85% of energy, transport, media, and automotive firms have either experienced a credit downgrade, or a downgrade warning since the start of the COVID outbreak.