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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

Market sentiment started Q4 trending downwards, as rising COVID-19 cases globally led to increasing restrictions in Europe and the US. However, it took a marked upturn in the second half of Q4, as the efficacy results of several vaccine trials were published, and as the US presidential election resulted in a clear, albeit disputed, win for Joe Biden. Global equities returned +14.1% in Q4, ending the year up +16.5%, while government bonds had a lacklustre quarter (though a strong year as a whole), as interest rates levelled off or even rose in the US, and markets anticipated some inflationary pressure from the expected Biden stimulus. The UK-EU Brexit negotiations eventually culminated in the "Trade and Cooperation Agreement", a deal on goods, which was positively received but had little impact on asset or currency markets.

In the UK GDP grew by 1.0% in Q4, while GDP for the EU (-0.7%) was negative over the quarter. The US (+3.4%) and Japan (+0.8%) are forecast to have positive GDP growth. While vaccination programmes are now underway throughout the developed world, it is clear that COVID-related restrictions are likely to be in place well into 2021, resulting in a "W-shaped" recovery in many markets, and estimates of the timelines to reaching pre-COVID levels of output are stretching outwards towards 2023. It is also clear that there are likely to be material regional differences in the long-term impact of the virus, with Europe and the UK worst affected, and Asian economies the least.

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

Policy has, and is likely to continue, to support asset markets: EU leaders were able to agree to a €1.8 trillion budget package (including a €750 billion recovery fund), despite the initial objections of Hungary and Poland, whilst US Congress were able to finally pass a new $900 billion fiscal stimulus package to support the economy and its citizens, having been gridlocked for months. Monetary support has also been extended across the US, Europe, and the UK, with central banks keeping interest rates near all-time lows and the continuation of their quantitative easing programmes to soften the economic fallout. This has maintained investors' appetite for risk, albeit on somewhat nervous foundations, given the uncertainties in the real economy.

Dispersion of returns: The announcement and approval of vaccines against COVID-19 resulted in a strong rally in "value" style, economically sensitive sectors (notably sectors most impacted by COVID, like energy, transport, and hospitality). The MSCI ACWI Value index rose by +16.8% in Q4, versus the MSCI ACWI Growth index +13.1%, reversing the wide dispersion observed in the opposite direction over the year to Q3. The dispersion in country returns

reflected the impact of the virus to a greater extent, with Japan and Emerging Markets outperforming both Europe and US equity markets.

Inflation: With the market's attention now focussed on the recovery and on the potential for increased US stimulus, coupled with the Democrat's winning control of the US Senate, there has been an uptick in near term inflationary expectations. Commodity stocks have performed very strongly, while Bitcoin has reached new peaks. However, longer term measures of inflationary expectations have remained steady over the last 12 months (3.3% for UK 20-year RPI).

The outlook for investment income has stabilised, albeit at lower levels: UK gilts yields have stabilised (0.2% for 10 year), while the hit to property rental income has been less than some feared (-10% expected medium term, though more in some sectors and over the short term), and equity dividend payments are resuming. UK dividend pay-outs are likely to be -40% in 2020 but are expected to recover to around half that reduction, while the impact globally is considerably less.

Worcestershire Pension Fund

Quarter to end December 2020

Summary and Market Background

The value of the Fund in the quarter rose to £3.22bn, an increase of £220m compared to the end September value of £3.0bn. The Fund produced a return of 7.2% over the quarter, which was -0.5% behind the benchmark. The main reasons for the underperformance were the significantly underweight UK equity position and the relatively low returning alternative passive assets, both of which have served us well for some time prior to this quarter. Property also produced a negative contribution against the new composite benchmark. Over a 12 month period the Fund recorded a positive relative return against the benchmark of 3.8% (6.9% v. 3.1%). 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). As an example of this, during the quarter an opportunity arose to re-set the US cover at higher market levels on advantageous terms, which was taken.

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. An update on this will be provided at the PISC meeting on 2 March. Further work is also being undertaken to seek appropriate means to bring the actual allocation to fixed interest closer to the strategic allocation (10%), again working with LGPS Central. Alongside the possible use of LGPS Central sub funds, follow on funds from BSIF (infrastructure) and Bridgepoint (private debt) are being evaluated.

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 undertaken the 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 have been presented to the stakeholders who have been involved throughout the process at a workshop session in January. This will be covered in the strategic asset allocation review section of the PISC meeting on 2 March and next stages will be considered at the Pensions Committee meeting on 16 March.

World markets had a good performance experience during Q4, but UK and Europe were still relatively subdued. Our active managers all had a good quarter in relative performance terms with Nomura (Pacific) the winner, with an outperformance of 1.9%, LGPS Central (Emerging Markets) outperforming by 1.4% and LGPS Central (Corporate Bonds) by 0.55%. All active mandates therefore exceeded their expected performance targets, which is delightful to see.

The passive equities benchmark outperformed the alternative passive strategies by 4.2% (9.5% v. 5.3%). Active equities outperformed passive market equities by +5.6% (13.7% v. 8.1%), which reflects the good performance from the Far East (14.7%) and Emerging Markets (12.6%). North America lagged this time, up 6.8% over the quarter, while the underweight position in the UK detracted from performance, given the return of 12.7%.

Equities

Global equities had a strong Q4, with all regions delivering double digit returns. As mentioned above, this performance was primarily driven by the release of the vaccine trial data, followed by the gradual regulatory approval and the start of the rollout in December. In addition, equity returns were further boosted in Q4 with the positive reaction to the US election (the resolution of which was faster than many had feared) and the subsequent announcement of new fiscal stimulus packages. As such, US equities gained +12.1% over the quarter, with the S&P 500 recording its best November performance in its 63-year history.

The positive vaccine data led to a substantial momentum shift away from growth stocks, with investors allocating instead to value stocks in sectors that had been most impacted by the pandemic. Despite this momentum shift, growth stocks continued to perform well.

Japanese equities were one of the strongest performers over the quarter, returning +18.5%. The style reversal seen in most markets has not yet materialised in Japan, with only a brief outperformance for value stocks.

European equities returned +11.4%, whilst the UK also lagged other developed markets. the FTSE 100 returned +10.9%, despite the announcement of the Brexit trade deal.

As mentioned above, this has resulted in a large divergence in yearly performance, with the S&P 500 in the US gaining +18.4% over 2020 (largely driven by big-tech stocks) compared to the FTSE 100 declining by -11.4%. This was the weakest year for the FTSE since 2008.

Global Equity Markets Performance

Source: Bloomberg. All in local currency.
FTSE All-Share Index (Ticker: ASX Index) S&P 500 Index (Ticker: SPX Index) STOXX Europe 600 (Ticker: SXXP Index)
Nikkei 225 Index (Ticker: NKY Index) MSCI World Index (Ticker: MXWO Index) MSCI Emerging Markets (Ticker: MXEF Index)

Fixed Income

On the fixed income front, bond yields diverged during the quarter, with US Treasury yields rising, compared to European sovereign yields, which fell, as prices rose due to the European Central Bank increasing their quantitative easing programme. Despite the resurgence of COVID-19, and renewed lockdowns, the proportion of companies with negative credit outlooks has remained steady compared to last quarter, although S&P Global expects default rates to rise next year.[1]

US Treasury yields rose, with the 10-year yield rising 25bps to 0.91%, meaning that prices fell. Yields peaked at 0.98% in November, their highest level since March. The total return for US Treasuries over Q4 was -0.8%. In contrast, German 10-year Bund yields fell 5bps, Spanish yields fell by 20bps, and Italian 10-year yields fell by 32bps.

[1] S&P Global "Global Credit Outlook 2021: Back on Track?", December 2020

The 10-year Gilt yield was little changed at 0.20% (with a total return over the quarter of +0.6%) due to promising vaccine news balancing Brexit uncertainty. This stability was maintained despite a credit rating downgrade to Aa3 by Moody's.

US corporate bonds outperformed government bonds, reflecting vaccine-related optimism that spurred investor positioning for a post-COVID world. US corporate spreads have declined further and are now at a similar level to what they were at the start of 2020, while UK credit spreads are now narrower than a year ago. While issuance dipped in October, this rebounded in November.

Out of the companies monitored by S&P Global, just over a third of these have been rated with negative outlook, with 9% of non-financial companies rated 'CCC' (a rating level indicating current vulnerability to default). The ratings agency expects US corporate defaults to rise from 6.3% in September 2020 to 9% by September 2021, and in Europe an increase from 4.3% to 8% is forecast.[1]