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REPORT PREPARED FOR

Worcestershire Pension Fund

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Independent Investment Advisor's report for the Pension Investment Sub Committee meetings

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Global overview

The Q4 2020 themes of a resurgence in COVID-19 cases and optimism that vaccines can bring an economic recovery continued and intensified in Q1 2021; the resurgence has led to renewed restrictions in some regions, while vaccines are now being rolled out across the developed world, albeit unevenly. In the US, following the Georgia Senate run-offs, the Democrats now have de facto control of the Senate. Along with the Democrat President and Congress, this provides scope for the implementation of Democrat policies, as seen with the $1.9 trillion stimulus package (which, at 6% GDP, represents around twice the negative shock caused by COVID-19). This resulted in some fears of overheating the US economy: government bond yields jumped for most developed markets, with bond prices falling significantly, spurring an equity rotation in the favour of value stocks. Oil and copper prices continued to rebound due to increased demand.

GDP growth for both the UK (-1.5%) and EU (-0.4%) were negative over the quarter, and a sharper contraction was experienced in Japan (-5.1%) following a renewed state of emergency. The US "advanced" forecast is to have positive growth (6.4%). While Asian nations have maintained low COVID-19 caseloads over the quarter, and high levels of economic normality, the speed of the vaccine rollout in the UK and USA is expected to provide tailwinds going into Q2. New lockdown restrictions being implemented in mainland Europe due to a "third wave" are expected to limit growth in the short-term. However, overall expectations of an economic rebound in 2021 have increased - S&P Global have revised their forecast of 2021 global GDP growth up from +5.0% to +5.5%.

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

Policy is expected to remain loose (with the balance shifting from monetary to fiscal support). Despite the recent rise in government bond yields (see below), central banks have generally recommitted to keeping interest rates near historic lows. Likewise, governments continue to pursue supportive policies, such as a $1.9 trillion stimulus package in the US, along with a proposed $2.25 trillion infrastructure plan; the UK 2021 budget was broadly supportive in the short-term; and the EU recovery fund continues to progress to implementation.

An accelerating but uneven recovery. Differential rates of COVID vaccination and differing amounts of government fiscal stimulus are likely to make the recovery uneven across regions, with the US and Chinese economies in the lead, the UK leading Europe, and challenges for some emerging economies (notably in LATAM).

Inflation continues to be a concern. As the prospects of an economic recovery combine with central banks acceptance for higher inflation levels as the cost for such as recovery, markets continue to be wary of potential rising inflation and economies overheating. Whilst central banks are currently committed to low interest rates, investors may have less appetite than previously for low yielding government bonds, especially during a post-COVID-19 recovery.

Growth to Value style rotation. Expectation of rising rates, inflation and GDP recovery led value equities to outperform growth by 9.5% over Q1, reversing a long trend in the opposite direction. While the market may now have discounted the short-term uptick in inflation caused by year-on-year comparisons, it probably has not yet fully discounted a longer-term increase (20-year UK inflation expectations have only increased by 0.25% year-to-date).

Falling bond prices help with the search for yield and Pension Fund funding ratios. The increase in government bond yields in Q1 (+65 bps for 10-year UK Gilts) has taken yields back to pre-COVID levels in the UK and US. However, as the Fund approaches the next triennial valuation in 2022, it is worth remembering that UK yields are still some 30 bps below their level at the last valuation in March 2019.

Worcestershire Pension Fund

Quarter to end March 2021

Summary and Market Background

The value of the Fund in the quarter rose to £3.28bn, an increase of £59m compared to the end December value of £3.22bn. The Fund produced a return of 1.7% over the quarter, which was -0.7% behind the benchmark. The main reason for the underperformance was due to asset allocation within the total equity portfolio, in particular the significantly underweight UK equity position and the relatively low returning actively managed equity assets. Property and infrastructure also produced a negative contribution against the new composite benchmark. Over a 12-month period the Fund recorded a negative relative return against the benchmark of -1.5% (22.1% v. 23.6%). The Fund has performed in line with the benchmark over the three-year period and ahead of benchmark over the 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 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). During the quarter the European cover was re-set at the higher market levels. Reference is made in the PEL report to the UK Govt. bonds that are held as collateral within the protection strategy underperforming equities. This should be benchmarked against the appropriate bond index, not equities, so this will be corrected.

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 was 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. Regrettably it has transpired that some of the sub fund proposals being put forward by LGPS Central do not match up with our asset allocation requirements in an appropriate manner. Consequently, an allocation of £120m has been made to the Bridgepoint (private debt) follow on fund and BSIF (infrastructure) will be presenting their further proposals at the PISC meeting on 10th June. Consideration is also being given to the First Sentier and Stonepeak follow on funds.

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 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 were presented to the PISC meeting on 2 March and next stages were considered at the Pensions Committee meeting on 16 March. It was agreed to investigate possible alternatives to the current passive mandates that would incorporate a greater focus on ESG considerations, while maintaining or enhancing returns in a risk-controlled manner.

In some ways Q1 2021 has been quite a frustrating period from a performance perspective. While the Fund's relatively high allocation to equities has done well in comparison to other asset classes, the detail within equity allocation has effectively seen us on the wrong foot across the board. So, the big picture was right, the detail less so! This explains to a large degree the Fund's underperformance against the bespoke benchmark. World equity markets had a good performance experience again during Q1, but the Far East and Emerging Markets were relatively subdued. Our active managers had a rather dull quarter in relative performance terms with Nomura (Pacific) showing an underperformance of -0.2%, LGPS Central (Emerging Markets) underperforming by -0.3% and LGPS Central (Corporate Bonds) in line with benchmark.

The passive equities benchmark outperformed the alternative passive strategies by 1.2% (4.5% v. 3.3%). Passive equities outperformed active market equities by +2.8% (4.5% v. 1.7%), which reflects the good performance from the passive index geographies in comparison to the Far East and Emerging Markets. Out of the passive geographies, Europe (ex UK) lagged this time, up 2.5% over the quarter, while the underweight position in the UK again detracted from performance, given the return of 5.2%.

Equities

Global equities had a strong Q1 overall, although gains were not as substantial as those observed over Q4 2020. Vaccine rollouts, the US fiscal stimulus package, and a rebound in global goods demand supported equities throughout the quarter, despite market volatility due to a rotation from growth to value shares. Equity markets performed well in Q1 and all regions delivered solid returns, with the MSCI World up +5.0%. Volatility, measured by the VIX index, fell -15% over the quarter, from 22.8 to 19.4.

US equities, measured by the S&P 500, gained +6.2% over Q1, supported by the approval of the stimulus package. Expectations of social normality in the latter half of the year is expected to lead to an earnings recovery for companies hit hardest by the pandemic, which has helped "value" sectors such as industrials, energy and financials to outperform this quarter.

Growth stocks underperformed in Q1, with valuations in sectors such as technology and healthcare being impacted heavily by rising yields. Bond yields are often used as the discount rate for future earnings. Growth company valuations are based on long-term earnings growth and so are very sensitive to changes in bond yields. In contrast, value company valuations tend to be based more on shorter-term earnings. In addition, value sectors tend to be those that benefit from cyclical economic recovery. The MSCI World Growth index gained only +0.3% over the quarter, compared to the +9.8% of the MSCI World Value index.

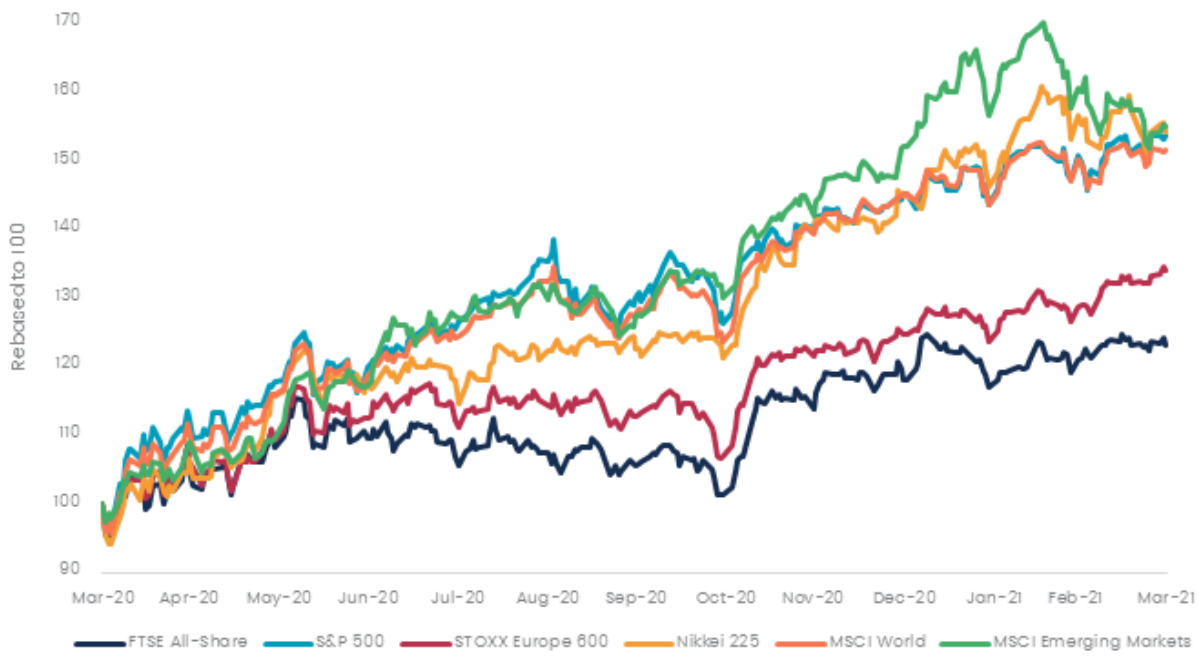
While UK equities lagged other developed markets, both the FTSE 100 (+5.0%) and FTSE All-share (+5.2%) indices delivered positive returns. Value stocks, such as financials, which make up a large proportion of the FTSE 100, performed strongly.

The Euro Stoxx 50, performed strongest over Q1, returning +10.8%. Attractive valuations and the approval of a coronavirus recovery plan outweighed concerns surrounding the slow vaccine rollout.

Japanese equities had another strong quarter, with a return of +7.7%. Strong corporate results and the outperformance of cyclical and value stocks led the market rally.

Emerging market equities returned only +2.2%, measured by the MSCI Emerging Markets index. The rise in US Treasury yields and the strengthening US dollar restricted returns, despite rises in commodity prices aiding many emerging market economies.

Global Equity Markets Performance



Fixed Income

Bonds, in general, had a poor quarter as yields jumped across the board, and bond prices fell substantially. The extent of the price drop was such that Q1 2021 was the one of the worst quarters for US Treasuries since 1980. In general, relatively higher risk fixed income indices outperformed lower risk indices. In terms of regions, Eurozone bonds outperformed both US and UK bonds.

10-year US Treasury yields started the quarter at +0.91% and ended the quarter at +1.75%. While yields are still low from a historical standpoint, the change was sharp and significant in size. It impacted other asset classes and sparked further discussions on government deficit spending and the loose monetary policies of central banks, though the Federal Reserve reaffirmed its commitment to low rates.

10-year UK Gilt yields rose from +0.20% to +0.85%. At the start of the quarter, market concerns around the Bank of England policy were focused on the risks of negative rates; by the end, concerns focused on when rates would rise.

Most explanations for the yield increases centre on higher inflation due to the new US stimulus package, COVID-19 vaccination drives and a general view of a post-COVID economic recovery. These increases were concentrated at the longer end of the curve –Treasury yields remained flat or even fell at the short-end (sub 1-year maturities).

High Yield bonds outperformed Investment Grade bonds. European High Yield bonds returned +2.1%, and US High Yield bonds returned +0.8% in Q1. European Investment Grade bonds returned -0.6%, while the US and UK equivalents returned -4.6% and -4.4% respectively. While bond total returns were in general greater for higher risk bond indices, it should be noted that US Treasuries returned -4.3%, marginally above US Investment Grade.