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

Markets continued in a positive trend in Q2. Major equity regions produced returns of between +5.1% (MSCI Emerging Markets) and +8.5% (US S&P 500) with only Japan lagging at -1.2%. Growth style regained the lead over Value style, as rates fell, but commodities continued to be strong, with oil up over 18%. Bonds also produced positive returns, as the first quarter's inflation-inspired rise in yields reversed somewhat: UK Gilts produced returns of +1.8%, reducing their losses for the year, while long-dated index-linked bonds bounced 4.7%. Credit spreads narrowed marginally over the quarter, as the economic recovery continued.

GDP growth for Q2 is positive across the board; the US has followed a positive Q1 with +1.6% quarterly growth[1]. The UK (+4.8%), EU (+1.9%) and Japan (+0.3%) have returned to growth, having contracted in Q1. This large uptick is due to the re-opening of the global economy with pent-up demand from deferred purchases combined with continued government fiscal stimulus and expansionary monetary policy. Despite the unequal access to vaccines, the World Bank now predicts global growth to reach +5.6% in 2021, its fastest pace in 80 years. However, many are now fearing that increasing inflation, and the risk of subsequent increases in interest rates to tackle it, now pose the greatest threat to a sustainable recovery.

Labour force dislocation: As economies have reopened, and service industries look to hire, strains have emerged in many labour markets. Though unemployment rates remain elevated (estimated to be 6.6% for the OECD)[2], employers have reported difficulty in filling vacancies. Potential reasons range from a lack of workers, ongoing COVID relief, childcare difficulties created by at-home schooling, and workers having changed industry.

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

Expectations on monetary policy have started to shift: Central banks gave divergent policy signals in Q2. Despite markets coming to broadly accept the Federal Reserve's argument of transitory inflation (US bond yields actually fell slightly over Q2), Federal Open Market Committee members signalled potential for earlier than previously expected interest rate rises (two rate rises are now expected in 2023, up from zero). Outside of the US, the Bank of Japan reduced the scale of its ETF and REIT purchases, however the Bank of England and the European Central Bank did not signal similar changes, although improving expectations of

[1] Note: US GDP has been de-annualised to be consistent with the other regions.
[2] OECD, "Labour: Labour market statistics", July 2021.

near-term growth in Europe led to rising European government bond yields, and a strengthening Euro. In contrast, Gilt and Treasury yields fell, whilst the performance of the Dollar and Sterling was weaker than in Q1.

Inflation continues to be a concern: As the recovery, driven by expansionary monetary and fiscal policy, combined with pent-up demand and increased savings rates, lifts both output and markets and drives down unemployment across much of the world, focus has now shifted from growth to inflation. The dislocation of supply chains and pent-up demand has pushed inflation indicators to heights not seen since the run-up to Global Financial Crisis of 2008. With commodity prices near highs, disrupted semiconductor supplies causing shortages ranging from games consoles to cars, and low but volatile bond yields, investors are asking two questions: is inflation transitory or structural, and where are bond yields going to go from here?

While the strong recovery in demand post pandemic is likely to be transitory, the effects on supply (e.g., reduced labour force participation) may be longer lasting. And underlying this, long term demographic trends (reducing global working age population) and the maturing of the Chinese economy (the shift from investment to consumption, reducing the growth rate in aggregate supply) are likely to add longer term upward pressure to global inflation. Forecasters expect inflation of 3+% in US and 2+% in UK by the end of the year. While consensus has been that this is transitory, the path inflation takes is likely to continue to be a key driver of markets.

The consensus expects a 0.5% rise in US interest rates next year (less in UK and Europe), but there is increased uncertainty, and risk that short term complacency could result in sharper interest rate rises later.

While both equities and real estate typically provide some insulation against inflation over the longer term (5-10 years), both may suffer if inflationary expectations and interest rates rise sharply. For bonds and cash, of course, even modest inflation is pernicious: 5 years of 2.5% inflation represents a 13.1% erosion of purchasing power, while 10 years represents a 28% erosion!

Worcestershire Pension Fund

Quarter to end June 2021

Summary and Market Background

The value of the Fund in the quarter rose to £3.43bn, an increase of £150m compared to the end March value of £3.28bn. 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).

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. LGPS Central will be providing an update on their infrastructure investment plans at the PISC meeting on 21 September. In the meantime, an allocation of £75m to BSIF II (infrastructure) has been approved by the PISC as a follow on to our existing investment. Consideration is also being given to the First Sentier and Stonepeak follow on funds, who will be presenting their proposals to the PISC meeting on 21st September. Research is also being undertaken into a possible investment with Gresham House Forestry Fund, which would be held within the property portfolio.

With the excellent performance seen from our equity investments over the last few years, some rebalancing between portfolios has become desirable, with positions now outside of the ranges contained in the strategic asset allocation. The reorganisation of the Nomura portfolio provided an appropriate opportunity to release £75m, of which £60m has been added to the LGPS Central Corporate Bond Fund investment. The balance has been retained to meet near term drawdowns from our alternatives managers and the Bridgepoint debt Fund. Within the LGIM passive equity portfolios, £120m has been switched from North America to the UK.

The work commissioned by the Pensions Committee to manage Environmental, Social and Governance (ESG) and Climate issues in a more proactive manner across all of the Fund investments has continued, by investigating 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. The PISC have had several sessions to explore some of the options, particularly focusing on those currently available, or in development, from LGPS Central and LGIM. Consideration is also being given to some active Sustainable Investment management options, both with LGPS Central and through the West Midlands Sustainable Equities framework of managers.

Performance during Q2 2021 has clearly been a bit of a mixed bag, as demonstrated by the underperformance against the total Fund bespoke benchmark. While the Fund’s relatively high allocation to equities has done well in comparison to other asset classes, the detail within equity allocation has been challenging. World equity markets had a good performance experience again during Q2, but the Far East and Emerging Markets were relatively subdued. Our active managers had a poor quarter in relative performance terms with Nomura (Pacific) showing an underperformance of -1.9%, LGPS Central (Emerging Markets) underperforming by -1.8% and LGPS Central (Corporate Bonds) just about in line with benchmark. The total property fund showed an underperformance against our own benchmark of -0.7%, which reflects to a large degree the cautious approach to valuations that is still prevalent in the Covid-19 environment.

The alternative passive strategies outperformed the passive equities benchmark by 0.2% (7.6% v. 7.4%). Passive equities outperformed active market equities by 5.9% (7.4% v. 1.5%), which reflects the good performance from the passive index markets in comparison to the Far East and Emerging Markets, and to some extent the poor performance of the active managers. Out of the passive geographies, the UK lagged this time, up 5.6% over the quarter, while the overweight position in North America will have enhanced performance, given the return of 8.7%.

Equities

Global equities had a very strong Q2 overall, with gains higher than those observed over Q1. Equities were supported by an accelerating vaccine rollout and strong economic data, with strong purchasing managers index (“PMI”) measures across the UK, US, and Europe. Most regions delivered good returns over Q2, with the MSCI World up +7.9%. Volatility, measured by the VIX index, fell -18.4% over the quarter, from 19.4 to 15.8.

US equities, measured by the S&P 500, performed strongest over Q2, gaining +8.5%. The S&P 500 continued its trend of reaching new all-time highs in late June, driven by strong economic data and the prospect of more fiscal stimulus. In particular, the technology giants made strong gains, driving the rebound of growth stocks, though most sectors gained.

Growth stocks outperformed value in Q2, a reversal in trend from what was seen previously, with undervalued discounts largely disappearing. Sector-level performance was also a big factor in the outperformance of growth stocks, with technology leading the way, in addition to communication services and healthcare. The MSCI World Growth index gained +11.0% over the quarter, compared to +4.9% for the MSCI World Value index.

UK equities performed well over Q2, with both the FTSE 100 (+5.6%) and FTSE All-share (+5.6%) indices delivering positive returns. Over April and May, value stocks continued to perform well, alongside small and mid-caps. However, concerns over the COVID-19 delta variant led to a fall to these equities that had experienced strong gains, leading, at the end of the quarter, to a rotation towards defensive large-cap stocks – which increased as Sterling fell against the Dollar in June.

The Euro Stoxx 50 gained +5.2% over Q2, supported by an increase in vaccine rollouts, loosening of restrictions, and a strong corporate earnings season from strong global goods demand. Rotations between growth and value stocks led to a mixed group of sectors outperforming including consumer staples, and information technology. Meanwhile, the utilities and energy sectors lagged.

Japanese equities underperformed other developed markets in Q2, having the weakest quarter overall, returning -1.2%. This is a reversal from the previous quarter, due to the slow vaccination campaign and a state of emergency that lasted much of the quarter.

Emerging market equities returned a solid +5.1%, measured by the MSCI Emerging Markets index, but performance between regions was mixed. Despite a sell-off in May resulting from US inflation concerns, as the outlook for economic recovery improved, regions such as Poland, Hungary and Czech Republic outperformed. Surging oil prices, and commodity prices in general, helped Russia and Saudi Arabia as large exporters, but hindered others. Regulatory concerns in China began to extend outside of the technology sector, which impacted China’s performance, and Asia’s as a whole.

Global Equity Markets Performance

Fixed Income

Bonds, in general, had a good quarter, reversing some of the losses in Q1 as yields fell and bond prices increased. Despite the sharp rise in inflation indicators, we did not see an accompanying sell-off in the bond market that would be expected if moving to a high inflation regime, implying markets expect the inflation to be transitory. In a reversal of last quarter, US investment grade bonds outperformed US high yield. In terms of regions, the US outperformed both UK and the Eurozone.

10-year US Treasury yields fell from +1.74% to +1.47% over the quarter, delivering a return of +1.7%. In addition, the 2- to 10-year curve flattened, with the spread decreasing by 36 bps. The closely watched Federal Reserve meeting in June kept short-term borrowing costs at near-zero levels and agreed to continue the same rate of bond purchases. While recognising that inflation has risen, they attributed this mainly to "transitory factors". However, the Committee surprised the market with an updated “dot plot” showing that their median expected pace of interest rate rises had increased, with two increases expected in 2023, up from zero, and an acceleration of expectations by one year.

10-year UK Gilt yields fell from +0.85% to +0.72% over Q2 with the curve flattening, a departure from the pronounced rise in Q1, providing a total return of +1.8%. In June the Bank of England’s nine monetary policymakers again voted 8 to 1 in favour of keeping stimulus at full throttle and hold steady the government bond-buying programme at £875 billion pounds. Rising inflation concerns led to strong index-linked gilt returns (+4.7% for over 15-year index-linked bonds, and +3.9% for over 5-year), though performance is still negative year-to-date.

High yield bonds continued to perform strongly while investment grade bonds eroded Q1 losses. European high yield bonds returned +1.4%, and US high yield bonds returned +2.7%

in Q2. European investment grade bonds returned +0.5%, while the US and UK equivalents returned +3.5% and +1.9% respectively.

Currencies

In contrast to previous quarters, Sterling weakened against the Euro (-0.8%) but held steady against the dollar (+0.0%), as the UK vaccine rollout was already priced in. The Dollar had a weak quarter, with the Dollar Index Spot falling -0.9%, as markets reacted to heightened inflation measures in April and May, though a shift in interest rate guidance in June caused the dollar to gain back some of its losses. The Euro performed strongly in April and May, due to an accelerating vaccine rollout pushing growth expectations higher, catching up with the US and UK.

Holiday reflections

As Covid-19 restrictions eased, as a family we took full advantage of my son finishing his GCSE assessments by the end of May. This enabled us to do some detailed research into what is loosely called the "hospitality industry" around the UK. What we discovered is a virtual perfect storm created by the impacts of Covid-19, Brexit and increasingly supply issues. We started our travels in mid-June, heading down into the West Country. The area was already very busy, much more so than would normally be the case. At that time some Covid-19 restrictions were still in place, limiting the capacity at some tourist attractions (but not all; Longleat Safari Park has a natural separation!) and at pubs and restaurants. Some had not reopened, citing lack of space to economically operate along with labour shortages. In the South, this labour shortage is in part due to the lack of Europeans being available to supplement locals, but as we realised later this isn't the only issue. Certainly my daughter was offered a job on a number of occasions! Prices being charged ranged from steep to eye-watering, which to be fair is a function of supply and demand, but also reflected the limited capacity at many venues.

Just before the school holidays started in July we had a short trip to Coniston in the Lake District. Again, it was very busy, but apparently nothing like the real hot spots, like Bowness, Ambleside and Grasmere. However it was clear that there was simply not enough pub and restaurant capacity to match demand, again with many operators juggling how to manage with a limited number of staff. Those we spoke to were not looking forward to the following week, with the start of school holidays quite a number of "pop up" camp sites would be opening, thereby increasing the pressure on already stretched services. There was already some talk of supply issues surfacing, with quite restricted menus as a consequence.

To me the real thought provoking wrap up on this came from the trip we made to South West Scotland (near Stranraer) in late August. Here we stayed at a hotel/pub in a small town. The restaurant was closed on Sundays and Mondays due to a lack of a chef, other places had similar evenings with no food service. This is not a usual mass tourism area, which has seen a large influx of visitors and they are struggling to cope. The hotel is operating with half their “usual” staff level yet are constantly fully booked. The nearest available room the weekend before we were there, according to Booking.com, was at Inverness. The manager explained to me that they don’t normally have staff from outside of the area, and seasonal cover is usually supplied by students at home for the vacation. However students are now tending to stay in their University accommodation more, as off campus rentals are now generally annual, so they lacked that resource. More telling was that when they shut down last year, many of their staff got work elsewhere, such as van driving, and have not been inclined to return to the sometimes hard world of the hospitality industry (long hours, low pay, stroppy customers). They were turning away casual diners, so as to ease the pressure on their few remaining staff. While the manager appreciated having a full hotel, he knew that without more staff he was ultimately likely to lose more staff due to the relentless pressure. The developing situation was supply problems. He was already struggling with intermittent beer and wine supplies, but said that some food items and housekeeping materials would now be missing from deliveries.

There are some fundamental issues here that need to be fixed before the hospitality industry can return to anything like normal. There is a similarity between this and what we were hearing from some of infrastructure managers concerning renewable energy. Prices and demand may have recovered, but without wind and without sunshine, they cannot benefit. Similarly for the hospitality industry demand is there and people will reluctantly pay the price, but at the moment they can’t take advantage of that. Until they can, this area of the economy will see a stunted recovery at best.