MJ HUDSON

REPORT PREPARED FOR

Worcestershire Pension Fund

November 2021

Philip Hebson
MJ Hudson

philip.hebson@mjhudson.com

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

24 November 2021

Global overview

The drivers of markets in Q3 included weakening market confidence, due to the Coronavirus Delta variant, supply chain issues, persisting inflation expectations, and the concern that GDP growth rates had peaked. Developed market equity performance was modest, while Emerging Markets performed poorly due primarily to Government actions and high corporate debt in China. Growth orientated stocks modestly outperformed Value stocks (+0.84% against -0.67%). Supply shortages led to sharp price increases across energy commodity markets, whilst metal prices fell. Bond performance was mixed: index-linked gilts performed well on rising inflation expectations, with European and US high yield bonds also positive. Investment grade bonds generally performed weaker, as expectations of rate rises in the US and UK hardened. Credit spreads widened during the first half of the quarter, though much of this was retraced by quarter end.

GDP growth remained positive in Q3 for developed markets; the US posted +0.5% quarterly growth[1], the EU +2.1%, Japan +0.5% and the UK is forecast to be +1.5% (not published at the time of writing). However, growth rates are lower than in Q2 and forecasts suggest that tight labour markets, supply constraints and the withdrawal of Government stimulus will result in more sluggish growth through 2022.

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

Tapering and interest rate increases: It is expected that the Federal Reserve ("Fed") will begin to slow its asset purchases in Q4 2021, with expectations that "tapering" will complete by mid-2022. The most recent Fed guidance is that interest rates will increase to 1.75% by the end of 2024, with the potential for the first rise in 2022. Other central banks have been indicating similar shifts in policy: the Bank of England ("BoE") is expected to end its quantitative easing programme and raise interest rates to 0.75% by end 2022. However, there are some expectations that Chinese monetary and fiscal policy, which has been tightening, could become more supportive of economic growth in Q4, 2021.

Inflation may be looking less transitory: As demand has recovered from mid-pandemic lows, and supply chains remain disrupted, shortages of goods and labour continued into Q3. In particular, energy prices have spiked, and, with climate transition pressures increasing, it is possible that the market remains undersupplied for some time, increasing price volatility. Market implied 20 year inflation has risen by 0.7% YTD, to 3.9%, while the Bank of England is forecasting that CPI will reach over 4% by this year end, before declining to 2-3% in 2022.

[1] Note: US GDP has been de-annualised to be consistent with the other regions.

Investors have become increasingly worried that inflation may last longer than previously thought, and there are some outlier concerns of potential stagflation.

Risk Appetite: While gently rising rates may prove no more than a gentle headwind for risk assets, taking the edge off the forecast economic growth, there is some risk of more rapid rate increases unsettling investors and driving more of a correction. At the same time, rising inflation and negative real rates limit the attraction of bonds, especially Government bonds. In this environment, investors may consider taking some risk off the table, and increasing allocations to more stable, income producing alternative assets (e.g. real estate, private debt, infrastructure).

Value vs Growth: Although the valuation gap between Value style and Growth style narrowed somewhat at the beginning of this year, it is widening again, and remains very high by historical standards. Growth style equities, typically "longer duration" may see their valuations under pressure if interest rates (discount rates) rise, while financial sectors, typically with a more "Value" style signature, usually benefit from steepening yield curves. On the other hand, ongoing disruption of numerous industries, accelerated by the pandemic, is likely to favour new business models, typically found in actively managed "Growth" portfolios. At the same time, the dispersion in valuations between different markets (e.g. US vs UK and Emerging Markets) is also near historic highs. The relative performance of different equity styles and regions looks as if it may be volatile over the next few years, and it would be wise to continue to have an appropriate balance between these styles / geographies.

Worcestershire Pension Fund

Quarter to end September 2021

Summary and Market Background

The value of the Fund in the quarter rose to £3.46bn, an increase of £28m compared to the end June value of £3.43bn. The Fund produced a return of 1.0% over the quarter, which was -0.2% 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, including a negative contribution from Emerging Markets. Property also produced a negative contribution against the new composite benchmark, which has a listed property equity bias. Over a 12-month period the Fund recorded a negative relative return against the benchmark of -2.25% (15.0% v. 17.2%). The Fund has performed ahead of 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 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. It was agreed at the PISC meeting on 21st September to allocate £50m to the First Sentier and £75m to the Stonepeak follow on funds, subject to fee negotiations. A provisional allocation of £30m was also made to the LGPS Central Infrastructure Fund, subject to detailed proposals being approved. Research has been undertaken into a possible investment of £150m with Gresham House Forestry Fund spread over three years, which would be held within the property portfolio. The due diligence included your independent advisor receiving an absolute soaking in the midst of a Scottish forest! At least he caught a haggis that was running in the wrong direction.

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 considering 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 agreed on 21st September to switch the Fundamentally Weighted (Value) element into the LGIM Quality companies portfolio and to transition the Low Volatility element of the LGIM Alternative Factors portfolio to the LGPS Central All World Climate Multi Factor Fund. These elements contained the highest exposures to carbon within the Fund, so this clearly demonstrates that that decisive action is following on from the research and discussions that have taken place over the last two years. 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, an update on progress will be provided at the PISC meeting on 24th November.

Performance during Q3 2021 has again 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 continued to perform well in comparison to other asset classes, the detail within equity allocation has been challenging despite the partial rebalancing of regional weightings. World equity markets had a very mixed performance experience during Q3 as described below, with Emerging Markets as a whole being hit by political control being applied in China, but other EM countries performed well. Our active managers had a lacklustre quarter in relative performance terms with Nomura (Pacific) showing an underperformance of -0.9% in their new guise, LGPS Central (Emerging Markets) just about in positive territory by 0.1% and LGPS Central (Corporate Bonds) also achieving just 0.1% ahead of their benchmark. The total property fund showed an underperformance against our own benchmark of -2.7%, which reflects to some degree the cautious approach to valuations that is still prevalent in the Covid-19 environment.

The passive equities outperformed the alternative passive strategies benchmark by 0.2% (2.3% v. 2.1%). Passive equities outperformed active market equities by 3.2% (2.3% v. -0.9%), which reflects the good performance from the passive index markets in comparison

to Emerging Markets. Out of the passive geographies, Europe lagged this time, up just 0.7% over the quarter, while North America was up 2.6% and the UK up 2.3%.

Equities

Global equities had a mixed Q3, with modest gains across developed markets, excluding the 10bp decline in Europe, while emerging markets suffered. There were underlying concerns around economic growth peaking, but various news stories in China dominated the headlines. There were successive rounds of regulatory crackdown. First, the Chinese Government moved to turn private tutoring companies into non-profit organisations, and this was followed by regulations limiting children's access to online gaming and tighter regulation around technology. Finally, the potential default on the offshore debt of China's second largest property developer Evergrande contributed to market anxiety at the end of the quarter. The VIX index increased substantially by +46.2% over the quarter, from 15.8 to 23.1. Growth continued to outperform Value (+0.84% against -0.67%).

US equities, measured by the S&P 500, posted modest gains over Q3 (+0.6%). Despite the quarter-on-quarter growth, September (-4.65%, total return) was the worst month for US equities since March 2020 (-12.35%), as the market sold off from its previous highs. Fears around financial instability in China along with the Federal Open Market Committee signalling that they could begin tapering as early as November 2021 dragged on returns.

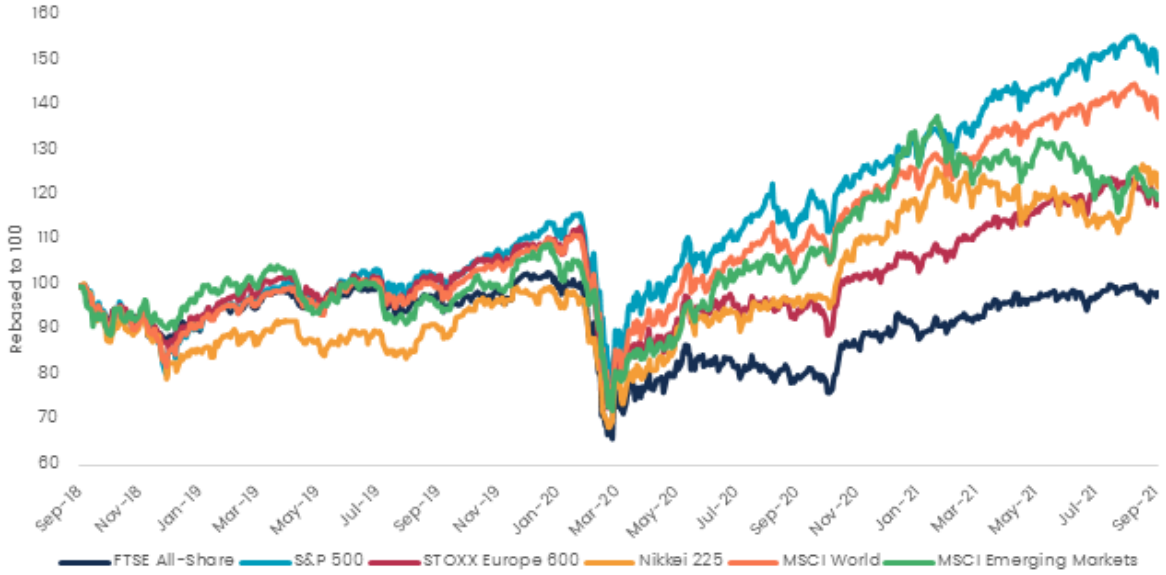
UK equities performed well over Q3, despite continued supply chain disruption and a more hawkish tone from the BOE, with both the FTSE 100 (+1.9%) and FTSE All-share (+2.2%) indices delivering positive returns. Energy producers (accounting for 10.2% of the FTSE 100) have benefitted from the aforementioned increase in commodity prices, along with supermarkets; takeover bids for Morrisons have seen the stock appreciate over 50% on pre offer prices and lifted the wider sector.

The Euro Stoxx 50 declined by -0.1% over Q3. Energy stocks again performed positively alongside technology stocks, particularly those involved in the semiconductor sector. Conversely consumer discretionary stocks performed negatively. Inflation and supply chain disruption continued to be a headwind to growth.

Japanese equities reversed the Q2 underperformance (-1.2%), now outperforming other developed markets in Q3, returning +2.9%. Bucking the wider trend, September was the strongest month in the quarter, despite the sudden resignation of Yoshihide Suga as prime minister on September 3rd; the news had no noticeable negative effect on markets. Optimism over potential future stimulus and economic reopening drove returns.

Emerging market equities suffered a -8.0% contraction, measured by the MSCI Emerging Markets index. China (accounting for 34.0% of the index) suffered heavily due to its government's regulatory crackdown, fears over Evergrande's default, and electricity shortages, while rising inflation and subsequent rate increases in some countries (notably Brazil) also weighed on returns. Despite the overall EM losses, brighter spots were seen in the major energy exporting nations, such as Russia, while India also performed well due to a strong vaccine led recovery and increased IPO activity lifting sentiment.

Global Equity Markets Performance



Fixed Income

Bonds had a mixed quarter, with government bond yields across the US and Europe initially declining, before ending the quarter flat. Gilts experienced rising yields and so falling prices. Yield increases for Treasuries and Gilts followed a hawkish shift among monetary policymakers later in the quarter as inflationary pressures continued. Corporate investment-grade bonds failed to match last quarter's good performance, whilst corporate high-yield bonds outperformed corporate investment grade bonds in the US and Europe.

The 10-year US Treasury yield ended the quarter one basis point higher at 1.49%, with Treasuries as a whole providing a total return of +0.1%. Yields initially fell due to concerns over economic recovery due to the Delta variant and inflation concerns, before returning to original levels as the Federal Reserve struck an increasingly hawkish tone. Jerome Powell (chairman of the Fed) suggested that tapering of asset purchases could commence as early as the next meeting in November, although markets were more surprised by the indication that tapering could finish as soon as mid-2022, which would subsequently pave the way for rate hikes earlier than expected. The median rate expectation moved up to three hikes from two for 2023, with three additional hikes expected in 2024. Fed officials were evenly split 9 against 9 on a potential hike in 2022. Additionally, the impending debt-ceiling showdown prompted fears, albeit extremely unlikely, of a default on national debt, with Treasury Secretary Yellen warning that the US will reach its ceiling by the 18th October. A deal between the democrats and republicans since appears to have been agreed, allowing the debt ceiling to be raised until early December.

10-year UK Gilt yields increased from 0.72% to 1.02% over Q3, with Gilts delivering a total return of -1.9%. The yield move occurred towards quarter-end, as the BoE matched the hawkish tone of the Fed. Inflationary pressures once again surpassed expectations, with August CPI reaching 3.2%. This has contributed to growing concerns that rate rises may be

needed before the end of the year, although current BoE guidance suggests no rise until quantitative easing is wound up in early 2022. Index-linked Gilts had another strong quarter following continued inflation, with the over-5 year and over-15-year index-linked bonds both returning +2.3%.

The strong year-to-date performance of high yield bonds persisted in Q3, as European and US high yield bonds returned 0.6% and 0.9% respectively. UK investment-grade bonds returned -1.0% over the quarter, while performance was flat for the equivalents in Europe and the US.

Currencies

In the third quarter, Sterling weakened against the Dollar (-2.5%) but held steady against the Euro (-0.1%), as the UK faced ongoing supply-side pressures and a worsening growth outlook. The Dollar had a solid quarter (Dollar Index Spot rose +1.9%), with most of the gains coming in the last few weeks of September following expectations of an earlier rate hike after the FOMC meeting. The Euro weakened notably against the Dollar in Q3 (-2.3%), as the market reacted to the uncertainties caused by the energy crisis. The ECB's decision to slightly slow quantitative easing was not equivalent to tapering and had limited impact on the Euro.

COP 26

While COP 26 was still in progress while this report was being written, some clear themes have already emerged. There has been a lot of commentary surrounding these issues from investment management firms, but I am going to draw on a useful piece written by Columbia Threadneedle looking at the **investment implications of COP 26.**

Corporates

A successful COP26 outcome could provide more clarity on the future trajectory of policy and regulation and accelerate opportunities for green investments. Although agreements are high-level sovereign commitments, these have to filter down into policy in order to be achieved.

More ambitious net-zero targets underpinned by tangible measures and plans will help gauge future climate policy and regulation, providing certainty for businesses. Current ambiguity and uncertainty is delaying investment and increasing the risk of stranded assets. Businesses should therefore pay attention to the outcomes of COP26 as they will provide an insight into the conditions in which they will be operating over the next few decades.

Firm agreement around Article 6 could help set a legal framework and scale a voluntary carbon market. Barclays estimates the voluntary carbon market could reach $250 billion a year by 2030 compared to just $500 million today, and $1 trillion a year by 2050. Industries providing nature-based solutions will see growth opportunities, as well as energy, finance, agriculture and agricultural tech, and companies devoted to monitoring and verification processes. However, market awareness around greenwashing for all these options is growing quickly, so these solutions need to be well managed or risk consumer backlash.

We should also expect a wave of firmer announcements from the private sector in the wake of COP26. The summit will bring together a great number of business leaders and corporations and could be a catalyst for them to formulate firmer climate strategies independently or through industry-specific working groups, for example steel, fashion or finance, or to join organisations such as Race to Zero.

Race to Zero is a UN-backed global campaign aimed at encouraging non-state actors – including companies, cities, regions and financial and educational institutions – to take rigorous and immediate action to halve global emissions by 2030 and deliver a healthier, fairer zero-carbon world. The campaign is seeking to align net-zero targets among industries and set minimum standards of what a net-zero target should incorporate.

The financial sector

The financial sector in particular is in the spotlight at COP26. The Glasgow Financial Alliance for Net Zero brings together existing and new net-zero finance initiatives in a sector-wide coalition which aims to accelerate the transition to net-zero emissions through the alignment of lending and investment portfolios, as well as other areas of the financial system. These commitments will have implications for the broader economy as they will favour capital availability for those companies in decarbonisation mode and could begin to restrict it to those that are not aligning with net zero.

Investors should therefore be mindful about different sectors' decarbonisation strategies as they could provide guidelines on how competition will play out, how finance will be geared and which decarbonisation solutions will be implemented, which could allow early identification of winners and losers. COP26 is also relevant for investors that are members of the Net Zero Asset Managers Initiative, which consists of 128 signatories representing $43 trillion of assets under management, as they have committed to aligning their portfolios with net-zero emissions by 2050. Signatories need to announce 2030 portfolio emission targets, and for those members who joined at launch this needs to be done by COP26.

Non-financial sectors

The transportation sector is expected to be a focus at COP26 with the UK, the host nation, setting an ambitious 2030 target for ending the sale of internal combustion engine vehicles. Prime Minister Boris Johnson has said his focus is on "coal, cars, cash and trees" and announced £1 billion of additional electric vehicle incentives in the two-week run up to the start of the conference in order to appeal to other world leaders to make "bigger commitments". As yet it is unclear what the announcements might be during the summit.

Another area of attention going into the summit was methane. In August 2021 the Intergovernmental Panel on Climate Change (IPCC), the world's leading group of climate scientists, released an updated report on the physical basis of climate change. This is the first update since 2013 and outlined some concerning developments around methane. The report found that methane emissions over the last reporting period were tracking the high emission scenario published in the previous release. Although methane doesn't remain in the atmosphere for as long as carbon dioxide does, it is a much more potent greenhouse

gas: 84 times worse than carbon dioxide on a 20-year timeframe and 28 times worse on a 100-year timeframe. High levels of methane pose a real risk to reaching 2050 net-zero emissions targets, and in some estimates the gas accounts for just under a quarter of the climate change (officially called radiative forcing) observed to-date.

All of this is relevant to the private sector because the oil and gas and agricultural industries are the biggest drivers of methane emissions. Although methane is seen as a transition fuel because it has roughly half the emissions intensity of coal when burnt, any leakage in the exploration and production of the gas quickly diminishes this benefit – again, because of the global warming potential versus carbon dioxide.

Conclusion

This climate conference is the most widely anticipated since Paris in 2015, so the stakes are high. However, signs in the lead up to it have been mixed at best. An unsuccessful summit would mean more uncertainty which would delay progress on the energy transition and the mobilisation of finance towards green investments. It could also impact progress on climate policies at national level, for example any signs of failure at COP26 could diminish President Biden's efforts to implement his climate goals and pass climate legislation in the US.

And finally, another asset manager posed the question, "What can investors expect after COP 26?". Presumably that will be COP 27.