Appendix 5

MJ HUDSON
Allenbridge

London Borough of Bromley

Quarterly Report

Q2 2020

Contacts:

John Arthur	Joanne Job
Senior Analyst	Head of Research
+44 20 7079 1000	+44 20 7079 1000
John.Arthur@mjhudson.com	Joanne.Job@mjhudson.com

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Performance Summary

The first quarter of the new decade ended with a crisis the like of which we had not seen for a century. Equities were in free fall and globally governments were acting to shut down their economies to stop the onward transmission of the Covid-19 virus. By end March, investors were selling all assets, even government debt, in the desire to hold US Dollar cash. In this unprecedented environment, central banks, led by the US Federal Reserve (US Fed) stepped in to provide almost unlimited liquidity and ensure markets continued to function. They reintroduced Quantitative Easing (QE) on an unprecedented scale, far surpassing the operation during the Global Financial Crisis (GFC) of 2008/9. This wall of liquidity and promise of market support via QE helped underpin prices and set the scene for a major market recovery during the second quarter. All risk asset performed strongly, although in most cases they remain below pre covid-19 levels.

The economic damage from Covid-19 is obvious but the central assumption remains that it will be transitory and relatively short lived. However, there will be long-term impacts on human behaviour going forward. Most of these effects are accelerations of existing trends, the adoption of online shopping, the move to home working etc. From the asset owner's viewpoint this acceleration of existing trends will be important. Bond yields will stay lower for much longer, maybe 10 years or so, accelerating the hunt for yields. A return of 4% with low volatility and risk now looks attractive, 3% anyone?

The requirement for companies to act in a socially acceptable manner and for investors to pressurise them to do so is another trend which this crisis has accelerated. This is a challenge for a capitalist system, put bluntly, either environmental and social damage is fully priced, and companies bear this cost as part of their business, or shareholders accept that a company has a much broader set of responsibilities than maximising returns. This means a greater acceptance that the shareholder can no longer be the primary focus and a broader group of stakeholders which will undoubtedly include broad society and the environment will be the focus going forward. Either approach would seem likely to alter return expectations into the future but change appears to be inevitable.

Performance

The Fund rose by 17.7% over the quarter, to an all-time high of £1.177bn. This increase was far in excess of the benchmark which returned 12.3%. The outperformance was driven by three factors: the performance of the Baillie Gifford Global Equity portfolio; the performance of the Multi Asset Income portfolios against their cash+X style benchmark and by the Fund's tactical asset allocation against the Strategic Benchmark, being overweight Global Equities and underweight all other asset classes. The table below sets this relative performance in context. The figures are an approximation and my own calculations.

		Relative Performance Contribution		
Asset Class	Portfolio	1Q2020 (bp)	2Q2020 (bp)	1H2020 (bp)
Global Equities	Baillie Gifford	110	356	466
	MFS	2	-91	-89
Fixed Interest	Fidelity	-7	10	3
	Baillie Gifford	-15	13	-2
Multi Asset Income	Fidelity	-131	70	-61
	Schroders	-186	90	-96
UK Property	Fidelity	0	5	5
Asset Allocation		-34	87	53
Total Fund		**-261**	**540**	**279**

The asset allocation figure is calculated as the remainder once the individual portfolio performances have been calculated.

The performance of the Total Fund is driven by the weightings in the Strategic Asset Allocation Benchmark, but the table above does illustrate how important the Baillie Gifford Global Equity portfolio has been to the relative performance of the Total Fund against this benchmark. This performance is increasing the weighting of the Fund's Global Equity position against the Strategic Benchmark and of its weighting to the Baillie Gifford Global Equity portfolio in particular.

Asset Allocation

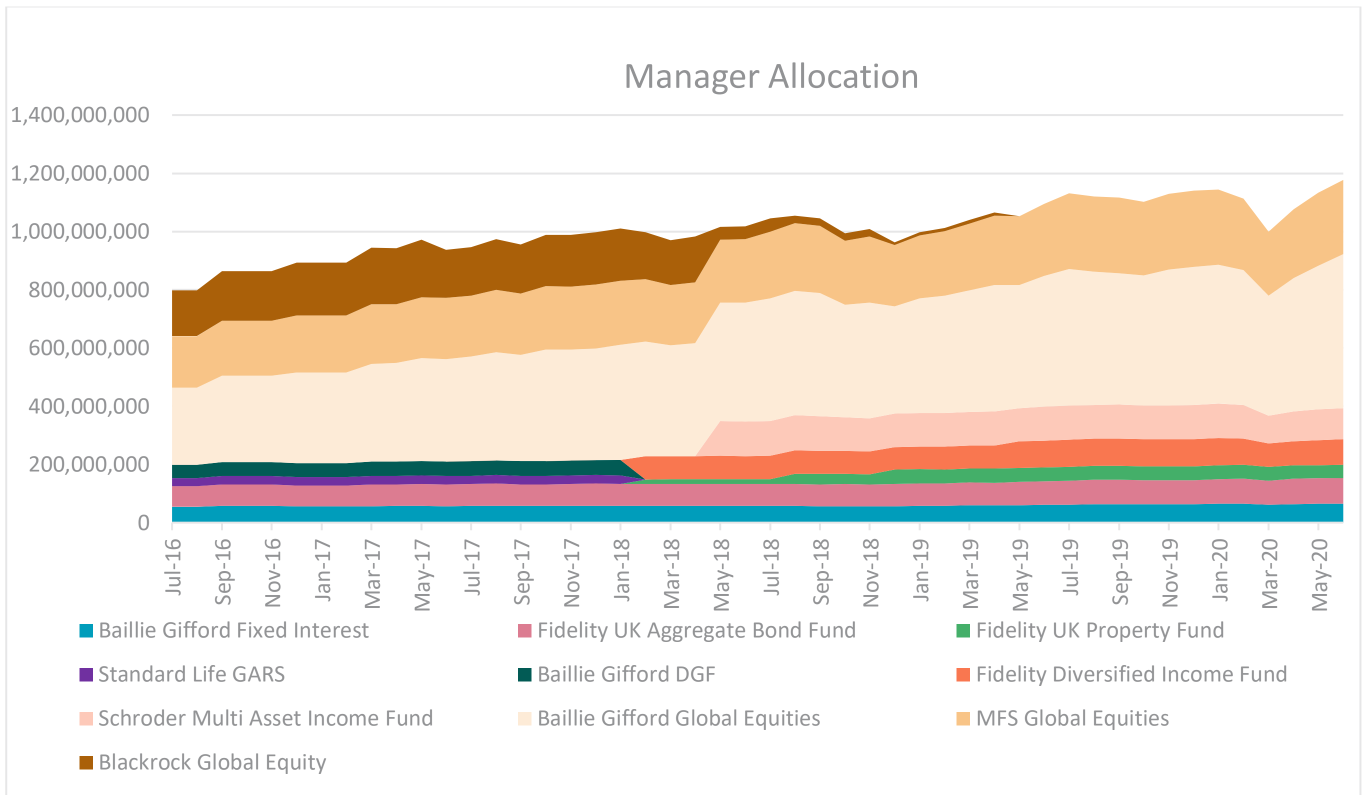
Asset class	Asset Allocation as at 31/12/2019	SAA as at 31/12/2019	Position against the existing SAA	Asset Allocation as at 30/6/2020	New SAA going forward	Position against the new SAA
Equities	64.6%	60%	+4.6%	66.6%	57.5%	+9.1%
Fixed Interest	12.7%	15%	-2.3%	13.0%	12.5%	+0.5%
Property	4.2%	5.0%	-0.8%	3.9%	5%	-1.1%
Multi-Asset Income	18.5%	20%	-1.5%	16.5%	20%	-3.5%
Int'l Property	n/a	n/a	N/a	0%	5%	-5.0%

Funding Position

The Fund has risen in value by 14.5% since the actuarial valuation on the 31/3/19, this is nearly 10% in excess of the market return requirement and, all other things being equal, will have pushed the Funding Ratio up from the 110% recorded at that time. In addition, I would expect inflation to be below expectations for the next year or so (a positive as it will feed through to lower salary and pension increases). Against this UK Gilt yields have fallen and future return assumptions may now be lower. Nonetheless the Fund remains well Funded and in a position to reduce the scale investment risk currently being taken, particularly via the overweight in Equities against the Strategic Asset Allocation benchmark.

From a manager perspective, the strong performance by the Baillie Gifford Global Equity portfolio is increasing the weighting of this portfolio and manager within the Fund. The Baillie Gifford Global Equity portfolio now accounts for 45% of the Fund's assets and Baillie Gifford as a manager over 50%.

The chart below shows the changing allocation by manager over time for the Fund, including the switch from Global Equities and Multi-Asset portfolios to Multi-Asset income and UK Property in early 2018 post.



Recommended Action

Given the Fund's overweight position in Global Equities and underweight in Multi-Asset Income against its Strategic Benchmark and the need to maintain income generation for the Fund, I recommend switching 3.5% of the Fund (£40m) from Global Equities to Multi-Asset Income. Specifically, given the very high weighting of the Baillie Gifford Global Equity portfolio, I would recommend taking £40m from this portfolio and reinvesting this into the Fidelity Multi-Asset Income portfolio as my preferred Multi-Asset Income manager. The effect of this change will be to reduce the funds exposure to Global Equities to 63% against the Strategic Benchmark weighting of 60% and to increase the weighting to Multi-Asset Income back up to the Strategic Benchmark weighting of 20%.

Cash Flow

Currently, the Fund can cover pension and lump sum payments as well as it's manager fees and admin costs from pension contributions and the investment income received. Excess investment income is reinvested within the Global Equity and Fixed Income portfolios and paid out from the Multi-Asset Income and UK Property portfolios. With a number of companies cutting dividends to conserve cashflow, income for the Global Equity portfolios is predicted to fall this year. In addition, rental income from the UK Property portfolio will be reduced and UK Gilt yield have fallen further. Investment income coming into the Fund is, therefore, expected to fall this year and only recover slowly going forward.

Work done by your officers assumes Global Equity dividends fall by 50%. In addition, there will be a fall in rental income from the Property portfolio of 20% or so. On these, very cautious, assumptions the Fund will need to receive a greater percentage of the investment income as cash to cover the cash outflow going forward. It would make sense for the Fixed Interest portfolio to distribute investment income as a first step to cover this shortfall, but this may have to be the case for the Global Equity portfolios as well. I do not expect Global Equity dividends to rebound to the pre-crisis levels quickly. In particular, those companies which have accepted Government support in the form of furloughing staff or guaranteed business loans will feel an obligation to focus cashflow on maintaining the business and supporting employment rather than paying shareholders, making it now acceptable to cut the dividend. As we recover from this crisis, property rental payments should catch up with past expectations.

I have discussed income payments with the two Multi-Asset Income managers, and they feel the current target of a 4% yield remains achievable but the rapid recovery in markets has pushed many yields down to new lows.

From the work conducted by your officers, it does appear that the Fund is capable of covering the forecast monthly cash outflow from investment income going forward and does not need to alter the Strategic Asset allocation to focus more on higher yielding assets at this time. I would, however, encourage the Committee to retain 20% of the Fund invested into the Multi-Asset Income portfolios and thereby sustain the investment income being received by the Fund.

I suggest that the cashflow position is monitored quarterly going forward and will endeavour to include this in my quarterly reports.

Currency Hedging

Currency hedging is the conversion of the return from an overseas asset into your domestic currency. It is done using exceedingly liquid, 3-month forward futures contracts to sell the currency of the overseas asset and purchase the domestic currency, this insulates the price of the overseas asset from any currency movement over that 3-month period. The futures contract is rolled every 3 months to maintain the hedge with the profit or loss on the expiring contract being born by the asset owner and used to offset the currency move in the underlying asset, leaving only the investment return in the domestic currency.

An Example:
A manager has a £100 million investment in US equities. The exchange rate is $1.60, which equates to a dollar value of $160 million. If sterling appreciates to $1.70 (and assuming the equity market stays flat), the sterling value of that portfolio now falls to £94.1 million. By hedging the currency exposure, the portfolio would still be worth £100 million, because the sterling loss on the portfolio would be offset by a gain on the forward foreign exchange contract. However, if sterling were to depreciate to $1.50, the sterling value of the holding would increase to £106.7 million. In this case, the currency hedging strategy would make a loss, offsetting the gain in the equity portfolio.

From an investor's point of view there are two reasons to consider currency hedging:

1. To reduce the volatility of the return stream from an overseas asset
2. In the belief that your domestic currency is undervalued, will appreciate and thereby reduce the value of any overseas assets held.

Current position

Currently the Fund's Fixed Interest and Multi-Asset Income portfolios are hedged back into Sterling. The UK Property portfolio consists of only UK assets and therefore is valued entirely in Sterling with no currency risk. This means that 40% of the Strategic Asset Allocation Benchmark is Sterling based. The unhedged element consists of the two Global Equity portfolios.

In Fixed Interest, particularly high-quality Government or Investment Grade bonds, the volatility of the currency is likely to be greater than the volatility of the price of the underlying bond. This means that moves in the currency will dominate the returns achieved by the overseas bond. Given that bonds are often used by investors to reduce the volatility of a portfolio, it is recognised investment practice to hedge high quality bond portfolios back to the domestic currency of the asset owner. The has the added advantage of allowing the asset manager to concentrate on analysing the credit quality of the bond issuer rather than the likely direction of the currency.

A similar argument can be made for the Multi-Asset Income portfolios. Here the underlying requirement is the provision of a 4% yield and a low level of volatility achieved through holding a diversified set of international assets. Again, hedging the currency will reduce the volatility of future returns and ensure that the yield remains at the target rate in the domestic currency.

Hedging Global Equities is a more complex discussion. In theory, if a company is producing in one currency and selling or has competitors in another, then a weakness in the base currency they are producing in will increase their competitive advantage and therefore their profitability leading the share price to rise. From the investors point of view, this is shown by an element of negative correlation between a currency and the local equity market. If this held true it would make sense not to hedge global equity portfolios. However, this relationship is not constant, some currencies have a safe haven characteristic in investor's minds, e.g the US Dollar, Japanese Yen and Swiss Franc. In

these cases, the currency can appreciate during periods of market stress leading to a more consistently negative correlation with the local equity market, particularly during periods of market turmoil and, thereby, reducing volatility over these periods. Hedging overseas assets in these currencies makes sense. The quid pro quo of this is that those currencies outside of this group, including Sterling, will weaken during periods of market turmoil taking the correlation between equity market and currency positive at the very moment investors are most worried about volatility. This element is covered well by the paper Schroders provided in response to your officers call for evidence from the Fund's asset managers on this matter. Other currencies may be linked to a particular commodity, e.g. oil. If one commodity is a major part of the country's earnings then any price change in the commodity will alter the outlook for the domestic economy, leading to a positive correlation between the currency and that commodity.

An analysis of the volatility of Global Equities would suggest that, for Sterling, the volatility of returns is reduced by hedging 50% of the currency exposure. But because the correlation between currency and the local equity market is not constant over time, this can be a positive or negative influence on investment returns for a long period and not hedging the Global Equity portfolio's has undoubtedly aided the investment return of the Fund over the last 10 years as Sterling has weakened over this period. In addition, it is uneconomic to hedge Emerging Market currencies and so these are left unhedged.

This takes us to the second element, is Sterling undervalued or not. If the view is that Sterling will appreciate going forward, then it makes sense to hedge the Global Equity portfolios. The response by the Funds asset managers to this question is "perhaps, slightly" and this fits with my own view, but, this question undoubtedly rests, in part, on the sort of trading nation the UK will become post BREXIT. This means that the question has become politicised, if the view is that the UK economy flourishes post BREXIT as an unencumbered, innovative trading nation then Sterling may appreciate. If the view is that the UK will lack economic scale and political clout and has now burdened itself with extra cost and red tape in its dealings with its biggest trading partner (the EU) then the medium term outlook for the UK economy may be more sclerotic and Sterling continue to weaken. The polarisation of views over the BREXIT process makes it difficult to have a discussion on this topic that is truly objective. Either way, the level of conviction over whether Sterling is undervalues is low and it is difficult to argue that a decision on hedging should be taken purely on this basis. There appears to be a slightly higher conviction that the UD Dollar is overvalued at present.

Conclusion

There is academic evidence that hedging 50% of a Global Equity portfolio reduces the volatility of future returns but there is some dissension on this. There is general agreement that Sterling is undervalued at the current time but the conviction on this is low. My personal view mimics this in that I am mildly in favour of hedging 50% of the Global Equity portfolios but do not have a strong enough view to recommend this as a course of action. I do believe that this is something the Committee should review periodically, however.

How can strategic currency hedging be implemented by a pension fund?

There are several ways a pension fund can introduce a strategic currency hedging programme into the portfolio:

- **Passive hedging.** In this case, an investment manager, or the pension fund's custodian, routinely hedges a pre-agreed, fixed percentage of the currency exposure in the portfolio, typically by entering into forward foreign exchange contracts with rolling three-month periods. At the end of each three months, the changes in currency values are cash settled and new currency forward positions are put in place.

  If sterling appreciates, the cash settlement on the forward currency is positive (this offsets the loss on the underlying portfolio of overseas assets). If sterling depreciates, the forward exchange contract settles at a loss and this is offset by the gain in the value of the underlying portfolio.
  Note that this means that there are occasions when the Fund will be asked to pay across cash. Although this is offset by an equivalent book gain in the underlying portfolio, in periods of continued sterling depreciation, the cash calls could become significant.

- **Dynamic hedging.** In this case, the fund manager will vary the amount hedged according to sterling's strength or weakness. The more the foreign currency appreciates, the less the manager hedges, and vice versa. The effect of this strategy is to generate an option-like payoff that captures most of the benefits of foreign currency strength but offers some protection in periods of domestic currency strength.

Note that this strategy has similar cash payment flows as for a passive hedging approach (although the amounts will differ).

- **Active currency overlay management.** This is where a fund manager uses active skills and judgement to anticipate when currencies are appreciating and when they are weakening. Managers use fundamental and/or quantitative analysis to assess whether currencies are over- or under-valued and position the portfolio accordingly.

  Arguably this is not a strategic currency hedging approach, as such, yet in the past some funds have argued that this approach offers them the twin benefits of both reducing portfolio risk and increasing potential return (because of the active selection decisions). Unfortunately, the poor performance of many active currency managers during the credit crunch earned active currency overlay management a bad name and has led to a considerable number of pension funds withdrawing from this approach.

- **Tactical currency hedging as part of the underlying portfolio.** A final option is to delegate responsibility for currency hedging to the investment manager responsible for the overseas investments. Some asset managers will be happy to take tactical decisions to hedge currencies in the short term, as part of their investment decisions. Bond managers are more inclined to do this than equity managers. A major advantage of this approach is that the cash settlement on any forward foreign exchange contract must be dealt with by the investment manager as part of their portfolio administration. This is the situation within the Fund's Fixed Interest and Multi-Asset Income portfolios.

What do other LGPS Funds do?
According to WM research, less than a quarter of LGPS funds in their universe now have a strategic currency hedging mandate in place. Active currency mandates remain relatively few and far between, and have fallen significantly from around twenty mandates, in 2010, to just two as at year end in 2014.

If the Committee wished to move forward with currency hedging, my recommendation would be for a simple approach, passively hedging a set percentage of the Global Equity portfolios using the major currencies of only the US Dollar, Japanese Yen and Euro. This can probably be done by the custodian but would require some internal resource to manage the cashflows from the currency contracts.

Key Indicators at a Glance

Market Indicators

Index (Local Currency)		Q2 2020	Quarter-on-Quarter	YTD
Equities				
UK Equities	FTSE 100 Index	6169.74	9.57%	-16.78%
UK Equities	FTSE All-Share Index	3410.93	10.54%	-17.43%
US Equities	S&P 500 Index	3100.29	20.54%	-3.09%
European Equities	EURO STOXX 50 Price EUR	3234.07	17.78%	-11.97%
Japanese Equities	Nikkei 225	22288.14	17.97%	-2.88%
Emerging Markets Equities	MSCI Emerging Markets	995.10	18.14%	-9.70%
Global Equities	MSCI World	2201.79	19.57%	-5.47%
Government Bonds				
UK Govt Bonds	Bloomberg Barclays UK Govt All Bonds TR	436.39	2.62%	9.64%
UK Govt Bonds Over 15 Years	FTSE Actuaries Govt Securities UK Gilts TR Over 15 Yr	6741.77	3.85%	15.49%
UK Govt Bonds Over 15 Years	FTSE Actuaries Govt Securities UK Index Linked TR Over 15 Yr	8382.65	14.85%	16.87%
Euro Govt Bonds	Bloomberg Barclays EU Govt All Bonds TR	257.09	1.73%	2.01%
US Govt Bonds	Bloomberg Barclays US Treasury TR Unhedged USD Index	2576.30	0.48%	8.71%
Bond Indices				
Pan-European Investment Grade	Bloomberg Barclays Pan-European Aggregate Corporate TR Index Value Unhedged	240.66	5.40%	-1.60%
Pan-European High Yield	Bloomberg Barclays Pan-European HY TR Index Value Unhedged	388.87	10.87%	-5.82%
US Corporate Investment Grade	Bloomberg Barclays US Corporate Investment Grade TR Index Unhedged	210.54	8.99%	5.02%
US High Yield	Bloomberg Barclays US Corporate High Yield TR Index Value Unhedged	2099.86	10.18%	-3.80%
UK Corporate Investment Grade	S&P UK Investment Grade Corporate Bond Index TR	395.43	9.03%	3.31%
UK Index Linked Bonds	FTSE Actuaries Govt Securities UK Index Linked TR over 5 Year	6472.33	11.54%	13.65%
Commodities				
Brent Crude Oil	Generic 1st Crude Oil, Brent, bbl.	41.15	80.96%	-37.65%
Natural Gas	Generic 1st Natural Gas, MMBtu	1.75	6.77%	-20.01%
Gold	Generic 1st Gold, 100oz	1800.50	13.71%	18.21%
Copper	Generic 1st Copper, lb	271.35	21.79%	-2.99%
Currencies				
GBP/EUR	GBPEUR Spot Exchange Rate	1.10	-2.17%	-6.89%
GBP/USD	GBPUSD Spot Exchange Rate	1.24	-0.33%	-6.62%
EUR/USD	EURUSD Spot Exchange Rate	1.12	1.92%	0.27%
USD/100JPY	USDJPY Spot Exchange Rate	107.83	0.27%	-0.72%
Dollar Indez	Dollar Index Spot	97.39	-1.67%	1.04%
AUD/USD	AUDUSD Spot Exchange Rate	0.69	12.38%	-1.87%
USD/CAD	USDCAD Spot Exchange Rate	1.36	-3.17%	4.82%
USD/CNY	USDCNY Spot Exchange Rate	7.06	-0.26%	1.45%
USD/CHF	USDCHF Spot Exchange Rate	0.95	-1.46%	-2.00%
Alternatives				
Infrastructure	S&P Global Infrastructure Index	2211.44	13.83%	-19.38%
Private Equity	S&P Listed Private Equity Index	136.48	27.49%	-16.16%
Hedge Funds	Hedge Fund Research HFRI Fund-Weighted Composite Index	14030.31	7.13%	-5.16%
Property				
Global Real Estate	FTSE EPRA Nareit Global Index TR GBP	3229.30	10.57%	-15.38%
Volatility				
VIX	Chicago Board Options Exchange SPX Volatility Index	30.43	-43.16%	120.83%

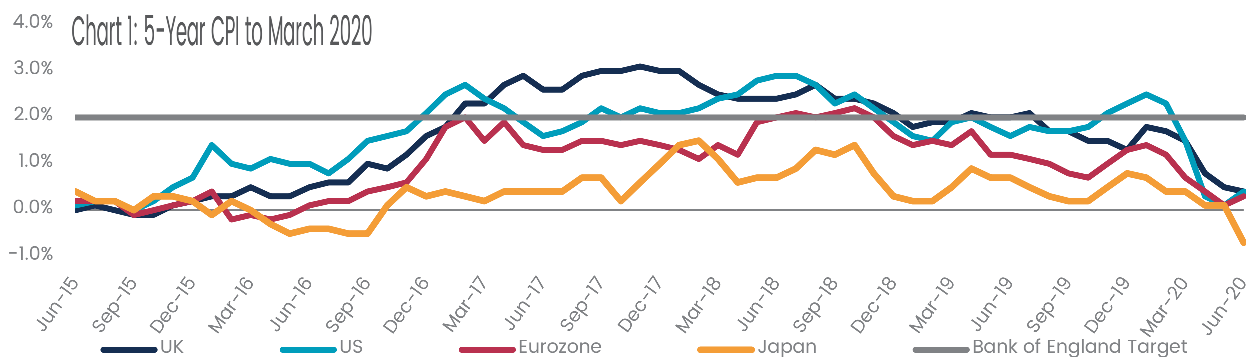
* All return figures quoted are Total Return, calculated with gross dividends reinvested.

Source: Bloomberg.

Executive Summary

The relatively short "Act 1" of the Covid-19 recession (as pronounced by the US National Bureau of Economic Research) is now over. Liquidity has been restored and market stress is back to neutral levels. Markets are guessing how speedily growth will bounce back, but indications suggest a much longer "Act 2", with many sectors under severe pressure and unemployment likely to stay higher for the foreseeable future.

- The COVID-19 outbreak and the enormous government support packages put in place to counter the effects of the ensuing economic lockdowns continued to be the dominant global theme driving markets over the quarter. This is likely to remain the case until a vaccine is developed, or the number of new cases significantly decreases.
- Europe and Asia have started to re-open their economies as their outbreaks have been brought under control, whilst the United States, having focused on a speedy economic recovery, is seeing a resurgence in cases, with some States starting to reverse their re-openings. Virus hotspots are now the United States, Russia, India and Latin America but localised virus hotspots are appearing across the globe in countries which had worked hard to eradicate the virus.
- Unprecedented policy support has accelerated through the second quarter: Central bank Quantitative Easing (QE) programmes have been expanded and broadened in the scope of asset classes they target. On the fiscal front, most developed economies have continued the employment support packages put in place in Q1, and an important EU-funded support package for the worst-hit member states has been agreed suggesting this crisis is strengthening ties within the EU even whilst economic conditions across the EU diverge.
- In general, higher risk asset classes, such as equities and high yield bonds experienced strong gains over the quarter, as a more general risk-on attitude prevailed, driven largely by the scale of economic support from governments and central banks around the world. Investors wavered somewhat towards the end of the quarter, as they looked ahead to the phased withdrawal of fiscal support and the consequences of the high levels of government debt built up through this period.
- Income from investments has also come under renewed pressure, with UK gilts joining the ranks of low/negative yielding government bonds. In addition, both equity dividends and property rental income has suffered material cuts in Q2. In both cases we do not see an immediate recovery to pre-crisis levels.
- Looking at global economic growth, according to the World Bank[1], the world is experiencing the worst global recession since the Second World War. Q2 annualised GDP growth estimates were negative across the board, with the US economy contracting the most of the major economies (-34.5%), followed by Japan (-22.4%), the UK (-17.0%), and then the Eurozone (-12.0%). These contractions, whilst substantial, were not unexpected given the widespread economic lockdowns for much of the quarter. The shape of any economic recovery is as yet uncertain, expectations of a rapid, 'V' shape, recovery rely on those consumers who have accumulated wealth during the lockdown (by not spending) reopening their purse strings but, anecdotally, many businesses are finding consumers remain cautious. Any second wave of infections will further exasperate this attitude and led to a slower, more drawn out recovery.
- Inflation levels over the quarter were substantially below recent levels for all major economies reflecting the downturn in demand and the fall in the oil price. In the UK, CPI went from 0.5% in March to an estimated 0.2% in June, US CPI fell from 1.5% in March to an estimated 0.4% in June, whilst Eurozone CPI fell from 0.7% in March to 0.3% in June. The chart below shows inflation rates for the major economies, underlining the fall in the Q2.

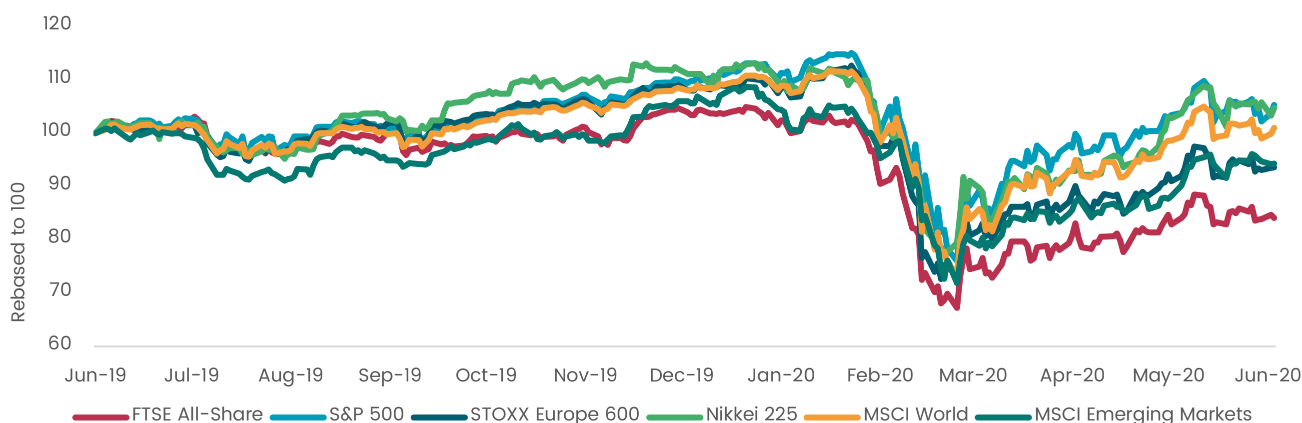


[1] World Bank, "June 2020 Global Economic Prospects", June 2020.

- There are still concerns on the political front as we move towards the US elections in November and the end of the UK's BREXIT transition period. In the US, Democrat Joe Biden has emerged as the frontrunner in the US presidential election, against incumbent Donald Trump, as the electorate questions the competency of the president's handling of the Covid-19 crisis. The two candidates espouse strongly divergent policies and although both are in favour of increased infrastructure expenditure and seek to pressure China to operate fairly on the international stage, key differences between the candidates include attitudes to climate change (including fossil fuels usage), healthcare, immigration, and free trade. A win for Joe Biden would likely mean higher corporate taxes and potentially, a less business friendly environment.

  With Trump behind in the opinion polls we would expect a more bellicose attitude to trade policy and international relations in the run up to the election. We have already seen elements of this with Trump referring to Covid-19 as the Chinese virus and placing sanctions on Huawei the Chinese telecom equipment company. In addition, the US has also threatened to impose tariffs on those countries (Britain and the EU) that institute a digital tax on internet-based companies (Google, Amazon etc).

- **Equities** had an outstanding quarter with all the main equity indices gaining ground strongly. The S&P 500 index was the strongest performer, with a total return of +20.5% over the quarter; the EURO STOXX 50, Nikkei 225, MSCI Emerging Markets, and MSCI World also rose sharply, whilst the UK FTSE All Share was the weakest performer rising 10.5%. The rebound faltered somewhat in June as the number of COVID-19 cases in the US began to rise again. All the main equities indices remain in negative territory YTD (at the time of writing). Volatility, as measured by the VIX, remains elevated, reaching 30.4 at the end of Q2 (from 13.8 at the beginning of the year).
  - The best performing equity sectors globally were technology companies, including online retailers, and healthcare, and those sectors exposed to the global economy (particularly the Chinese economy), such as mining stocks, whilst the more consumer focused areas of airlines, hotels, Real Estate, and bricks-and-mortar stores, as well as consumer staples and utilities, lagged in the rally.
  - Investors' preference for high quality assets has continued with 'Growth' as an investment style continuing to outperform 'Value'. Investment Grade Credit spreads over Government bonds have regained most of their losses in Q1. This does leave valuation dispersion between perceived high and lower quality assets at very high levels.
  - Emerging market equities experienced their strongest quarter of the last decade[2], as the strength of the dollar abated, markets re-opened, and oil-exporting countries such as Saudi Arabia, Mexico, and Russia benefiting from a partial rebound in oil prices in the second half of the quarter.



- In **Fixed Income**, all major bond indices posted a positive total return. High yield corporate bonds performed best, followed by investment grade corporates, and then sovereign bonds, matching the risk-on attitude of investors, despite the rise in credit downgrades.
  - US corporate bond spreads declined across the quarter, (Corporate bonds outperforming Government bonds) due to liquidity provided by central bank's QE programs and government stimulus. However, they remain above pre-COVID levels.
  - The strength of corporate bond total returns is in contrast to the trend in credit ratings. S&P Global downgraded the ratings of 21% of non-financial corporates between the beginning of the pandemic, and the end of Q2. Investors have been driven instead by the direct buying from QE programmes and

[2] Schroders, "Quarterly Markets Review – Q2 2020", July 2020.

government economic stimuli. A number of notable companies have lost their investment grade credit rating including Ford, Occidental Petroleum, Kraft Heinz, and Renault.
    - Sovereign bonds were supported by substantial central bank quantitative easing. Short-term Gilt yields turned negative due to speculation on negative interest rates, and Brexit concerns. US Treasury and German Bund yields remained steady during the quarter as can be seen with the +0.48% total return provided by US Treasuries, this is in contrast to the strong gains seen in Q1 as the economic environment deteriorated.
- **Commodities** had a strong but volatile quarter, with significant price shifts across many commodity indices.
    - Oil was particularly volatile during the quarter, being impacted heavily by the demand changes due to the lockdowns and re-openings, as well as an oil price war between Russia and Saudi Arabia. In April, Brent Crude prices fell precipitously. However, prices rebounded strongly, with Brent Crude Oil prices finishing the quarter at $41.115/bbl. a decline of -37.7% YTD.
    - Gold prices rose +13.7% in the quarter, marking the first-time gold futures have risen above $1800/oz since 2011, supported by long term inflationary concerns and a slightly weaker US Dollar.
    - Copper, seen as an indicator of economic activity, rebounded as countries began to loosen economic restrictions.
- **Property** had a mixed quarter. Listed property rebounded strongly, with the FTSE Global property Index rising +10.6% in Q2, though it is still down -15.4% YTD. The US property index performed the strongest, followed by Asia Pacific, Europe, and then the UK.
    - In the US, according to Green Street Advisors, a real estate focused research and advisory firm, unsurprisingly, retail properties have seen the greatest falls in value, followed by residential, then offices, and finally logistics. Many UK open-ended property funds remain suspended due to an uncertainty over real estate valuations, this is due to very limited transactions taking place and therefore no real price guide to value individual properties.
    - One of the main drivers of the poor performance was the reduced rent collection, particularly from leisure and consumer facing tenants. In the UK, late- and none-payment of commercial rents was high in both Q1 and Q2 as the economic lockdowns came into place.

The major currencies also reflected the risk-on attitude adopted by investors this quarter. The dollar lost strength over the period, as the market swung in favour of higher risk assets. The euro gained 1.9% against the dollar. Sterling was generally a weak performer, ending the quarter down -0.3% against the dollar and -2.2% against the euro, due to resurgent concerns over Brexit and speculation that interest rates would be cut below 0% (i.e. being charged to deposit money in the bank).

Global Outlook 2020 Q1

Investment markets have rallied very strongly from the Covid-19 induced collapse late in the first quarter due to the unprecedented scale of government and central bank action across the globe aimed at insulating the economy from the effects of the lockdown and to protecting employment. QE is being conducted by all major central banks on a scale which is a multiple of that used post the Global Financial Crisis (GFC) in 2008/9 and introducing it over a much shorter timescale.

We are also seeing governments globally shift away from the austerity drive designed to reduce government debt levels post the GFC. The desire to act quickly and protect employment such that the economy can recover far outweighs the need to correctly target where financial support is required. This is a major difference from the GFC in 2008/9 when it was the banks which needed support yet because they had limited desire to lend, little of that money reached the consumer. This time governments are targeting money directly at companies and individuals and whilst each will look to rebuild their personal balance sheets, more of this money is likely to be spent aiding an eventual recovery.

Where possible, central banks have cut interest rates, but it is noticeable that neither the EU nor Japan followed this route as both have interest rates close to zero. Because of this, the total return on EU government bonds has been 2% YTD against 8.7% for US Treasuries and 9.6% UK Gilts. This is important from a portfolio construction point of view. In the past, when equity and risk assets fell, investors would buy Government debt as a safe haven and with the view that

governments would cut interest rates to ward off whatever risk investors were concerned about (usually a recession). With interest rates near zero and QE pushing bond yields down to this level 5 to 10 years out, there is no difference between holding government debt and holding cash. This suggests that, in the absence of interest rates going negative, government debt will not perform in the same way during an equity downdraft as in the past. In particular, UK Government Gilts may not give a positive return in the next equity market panic. They will still provide some diversification by not falling in value as equities fall but will not provide the same level of portfolio protection.

Taking this a stage further, if central banks are reticent about cutting interest rates into the next economic slowdown then they will have to rely more heavily on QE and government fiscal stimuli. This increases the probability of inflation in the future as the cost of credit is suppressed and money printed to cover increased government indebtedness. In addition, it reduces a central banks ability to act independently of its government thereby reducing its independence and, in all likelihood, shortening its time horizon.

The outlook for inflation remains the most debated issue within the investment industry. Inflation has fallen over the last two quarters, as demand has collapsed, and oil prices fallen and is now below central bank targets where they explicitly target this measure. However, longer-term, the scale of fiscal stimulus currently being applied within the developed world and the ensuing increase in government borrowing is a concern. There appears to be no appetite for further austerity within the electorate in most regions yet in the 10 years since the GFC government borrowing has done little more than stabilise post the increased borrowings from that period. Budget deficits may reach 10% this year taking debt/GDP ratios over 100% in a number of developed economies.

In my report last quarterly report, I noted the likely effects of this debt burden going forward and reiterate that comment below.

Governments will likely, therefore, take three actions:

- Increasing taxes. The obvious targets (which appear to be acceptable to the electorate) are internet-based companies which appear to be avoiding tax; increased taxes on wealth rather than income and a thorough pricing of carbon emissions with taxes levied on the extent of emissions.
- Encouraging central banks to continue their QE programmes and thereby keep interest rates at ultra-low levels well into the future. This keeps the cost of servicing the governments' debts low.
- Accepting a level of inflation that remains above interest rates and thereby depreciates the stock of debt. We have already seen this happen with interest rates at or below the rate of inflation for much of the last 10 years. I suspect the differentiation between these two rates will widen going forward.

In this environment investors are forced to hold risk assets because cash and government bonds do not provide a yield which matches inflation. This is likely to keep the valuation of risk assets high and introduce increase price volatility as investors are forced to remain invested and collect a yield above inflation whilst they can but will not wish to lose money and will therefore rush for the exit en masse when this becomes a concern.

This increased volatility and the reduced portfolio protection provided by government bonds mentioned earlier makes portfolio diversification more important and I would continue to recommend that the Fund look to acquire real assets over the medium term to help mitigate the inflation risk.

In the short term, the current earnings season in the US will underline the extent for which this crisis has been a disaster for some businesses and a boom for others. The US elections are also likely to create a certain amount of noise and distraction which may unsettle markets as could the BREXIT negotiations in the UK/EU. The Covid-19 virus does not seem to be under control in a number of regions including the US and further economic disruption cannot be ruled out. Balancing this the news on potential vaccines and partial treatments for Covid-19 remains encouraging.

Performance report

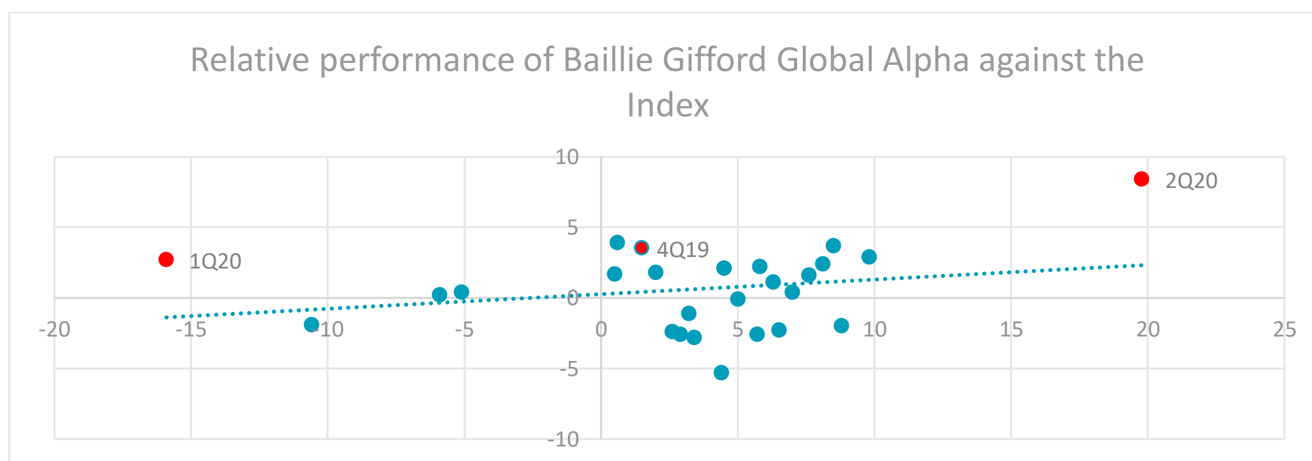
Asset Class/ Manager	Global Equities/ Baillie Gifford
Fund AuM	£530m Segregated Fund; 45%% of the Fund
Benchmark/ Target	MSCI All Countries World Index +2-3% p.a over a rolling 5 years
Adviser opinion	Manager continues to exceed their performance target
Last meeting with manager	No meeting this quarter
Fees	0.65% on first £30m; 0.5% on next £30m; 0.35% thereafter

The portfolio rose by 28.5% over the quarter, outperforming the benchmark by 8.6%. This is certainly the strongest quarterly outperformance by this portfolio since the reorganisation on 31/12/13 and probably in the portfolio's 20-year history. The portfolio is up 18.1% over the last 12 months, outperforming its benchmark by a huge 12.3%, has outperformed by 5.2% over 5 years, well in excess of its challenging performance target of 2-3% per annum and by 1.6% since inception over twenty years ago.

Turnover within the portfolio has picked up marginally but the average holding period remains in excess of 6 years. Given the volatility in markets, an increase in portfolio turnover is not surprising and, undoubtedly, this crisis has altered the dynamics of many businesses. The Baillie Gifford portfolio focuses on holding stocks which they believe can double sales over the next 5 years. This gives the portfolio a 'Growth' style bias and a beta greater than one, meaning that the portfolio will rise or fall by more than the market over any given period.

The chart below shows the quarterly relative returns of the portfolio (y-axis) against the returns of the index (x-axis) since this portfolio was restructured at the end of 2013. The dotted line is the line of best fit (trend line). The chart supports the comment made above regarding a beta of greater than one. The portfolio tends to outperform as markets rise and vice versa. Given that equity markets tend to produce positive returns over the long-term, the fact that the dotted line is above zero for all positive returns suggests the manager is adding value, which is indeed the case.

The dots highlighted in red are for the most recent three quarters. The chart shows how extreme the index return has been for the most recent quarters, but also the scale of the portfolio's outperformance, it being surprisingly resilient in the precipitous market fall in 1Q20 and then recovering very strongly in2Q20.



The relative outperformance of this portfolio, so far this year, has added £51m to the value of the Total Fund over the benchmark return. This is driven by the scale of the portfolio's outperformance against its benchmark and by the high weighting of this portfolio within the Fund.

The chart below shows the performance of Growth as an investment style as against Value, using the US S&P index. It shows there have been periods when each of Growth and Value have outperformed but the recent trend has been

increasingly heavily in Growth's favour. The periods when value has outperformed have been following the tech bubble in 2000 and in the run-up to the GFC in 2008-9 when global economic growth was strong.

The outperformance of Growth against Value as an investment style so far this year has been one of the strongest on record. The disparity between the valuation of Growth stocks and Value stock is also at a multi-decade high. This trend has been of benefit to the portfolio, fitting well with Baillie Gifford's investment philosophy. It also makes sense from an economic perspective in that global growth is slowing, making strong growth harder to find and pushing these stocks to an increasing premium. We are also going through a period of tremendous commercial disruption with new companies with new ways of doing business abounding.

The conclusions I would draw from this are as follows

- That Baillie Gifford are an exceptional manager;
- That the current focus of investors suits Baillie Gifford's investment philosophy;
- That this portfolio is likely to underperform any sharp economic recovery as this will be led by a recovery in Value stocks;
- That I would still expect this portfolio to outperform over the long term.

In addition, I would note that this portfolio now accounts for 45% of the Total Fund. This compares with 41.6% at the beginning of this year and 40.5% when the last actuarial valuation was conducted at 31/3/19.

Despite having a high regard for this manager and believing they will continue to outperform their benchmark over the long-term, my recommendation would be to trim this holding as I am concerned about the concentration risk at the Total Fund level. The relative performance of this portfolio is highly likely to be the main determinant of the performance of the Total Fund against its benchmark going forward.

Asset Class/ Manager	**Global Equities/MFS**
Fund AuM	£254m Segregated Fund; 21.6% of the Fund
Benchmark/ Target	MSCI World Index
Adviser opinion	meeting long term performance targets, underperforming short-term
Last meeting with manager	22/7/20 Elaine Alston/John Arthur
Fees	0.6% on first £25m; 0.45% on next £25m; 0.4% thereafter

The MFS portfolio rose by 15.5% during the quarter, underperforming its benchmark by 4.1%. This poor performance has bought the longer-term performance figures down and the manager is now below the benchmark over 1 and 3 years but has still outperformed over 5 years and by 1% per annum since inception on 1/12/13. Given the managers

Value style bias and the pressure this style has been under in performance terms recently (as noted above) the longer-term outperformance is important.

The MFS philosophy is to invest in quality companies with an above average return on capital but at a below average price. This focus on valuation means they tend to fall into the Value style category and have seen this approach struggle somewhat, particularly during the rapid market recovery seen in the second quarter which was led by a small number of high growth technology stocks. In addition, during a period of such rapid change in many industries, a number of previously stable and highly regarded businesses now find their operating model under threat. It is noticeable that the turnover within this portfolio has increased as the manager has recognised that some, previously stable, business models are under threat and that the market collapse during March presented an opportunity for the manager to buy a number of favoured holdings at a price they were comfortable with. Whilst MFS remain under-exposed to the kind of high growth business disrupter favoured by Baillie Gifford, they have bought a number of suppliers to the technology sector recently including Intel (semiconductors) and Quest Diagnostics.

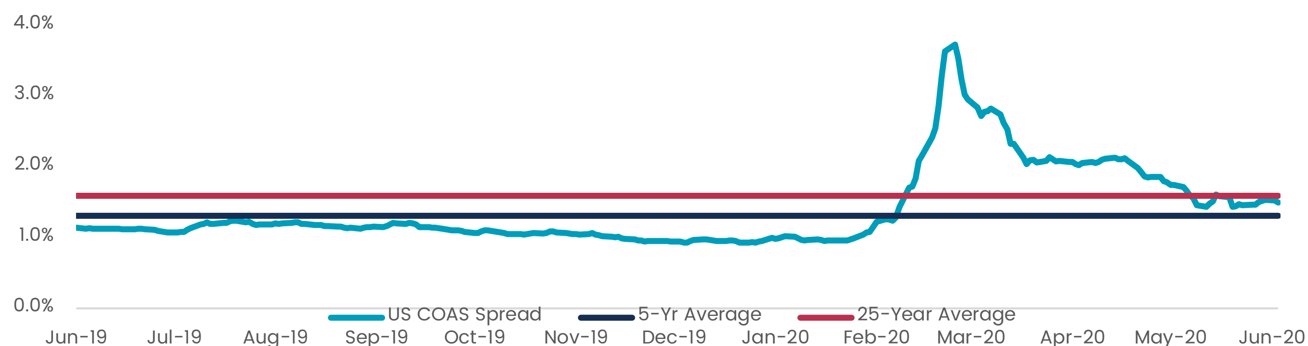
Similar to the Baillie Gifford portfolio discussed above, MFS invest over the long term and the portfolio has a high Active Share which means it deviates significantly from the index in its holdings. The two managers should be seen in tandem with their investment styles balancing each other and thereby lowering the risk of the combined global equity portfolio. MFS will tend to have a below market beta, meaning their portfolio will rise or fall by less than the market over any given time period.

Asset Class/Manager	**Fixed Interest/ Fidelity**
Fund AuM	£88m Unit Trust; 7.5% of the Fund
Performance target	50% Sterling Gilts; 50% Sterling Non-Gilts; +0.75 p.a rolling 3 year
Adviser opinion	Manager continues to meet long term performance targets
Last meeting with manager	6/5/19; 8/7/19 John Arthur/Paul Harris/Suzy Fredjohn
Fees	0.35% on first £10m; 0.3% on next £10m; 0.21% on next £30m; 0.18% thereafter

The portfolio returned 5.9% over the quarter, ahead of the benchmark return of 4.8%. The return over one year is an exceptional 9.8%, again ahead of the benchmark (by 0.6%). The portfolio is ahead of its benchmark over all time periods and is meeting the performance target over the longer term including since inception 22 years ago. This is a strong performance.

Whilst UK Gilt prices rose (yields fell) during the quarter, the recovery from the Covid-19 induced sell-off in Investment Grade Credit was the main impact and contributed strongly to performance. In relative terms the portfolio has fully recovered the underperformance experience in Q1 suggesting the manager has managed to take some small advantage form the recent volatility and market see-off in March.

The chart below shows US Corporate Bond spreads (the interest rate premium over the equivalent Government Bond) and highlights the massive impact of the Covid-19 pandemic and ensuing economic lockdown.



During this period the survival of many businesses came into question. Spreads have narrowed in the second quarter as governments globally have moved to shore-up their economies to prevent large scale bankruptcies and central banks have re-instigated and broadened QE programmes which, in the case of the US Fed, now includes specifically buying corporate bonds in order to contain the cost of borrowing for the corporate sector. Corporate Bond spreads remain above the pre-crisis level although defaults are expected to rise, and a large number of bonds have had their credit rating downgraded.

UK Gilt yields are likely to remain very low into the future as the Bank of England (along with all other major central banks) looks to use QE to anchor yields at ultra-low levels. In addition, the use of QE to purchase corporate bonds (hence avoiding bankruptcies and aiding the eventual economic recovery) makes the Investment Grade Corporate Bonds attractive for the foreseeable future although security selection will remain important.

With bond yields set to remain low, the manager is currently taking no position relative to the benchmark on interest rate duration or positioning, preferring to take investment risk in security selection within the Corporate Bond space where they continue to believe they can add value.

Asset Class/Manager	**Fixed Interest/ Baillie Gifford**
Fund AuM	£65m consists of holdings in three separate funds; 5.5% of the Fund
Performance target	44% Sterling Gilts; 44% Sterling Non-Gilts; 6% Emerging Market debt; 6% High Yield. Index +0.75 p.a rolling 3 year
Adviser opinion	Manager continues to meet long term performance targets
Last meeting with manager	No meeting this quarter
Fees	0.35% on first £10m; 0.3% on next £10m; 0.21% on next £30m; 0.18% thereafter

The Fixed Interest mandate managed by Baillie Gifford has slightly more credit risk in it than the Fidelity portfolio commented on above. The benchmark for this fund includes small allocations (6%) to both Emerging Market (EM) Debt and High Yield Credit. These elements recovered from the sell-off in the first quarter returning 10% plus in Q2. This boosted the benchmark return for this portfolio to 5.1% against 4.8% for the Fidelity Fixed Interest benchmark. Both managers can invest outside of their Sterling based benchmark, but overseas bonds are hedged back to Sterling and so produce a Sterling return without the foreign exchange risk.

The portfolio returned 7.2% over the quarter, outperforming its benchmark by 2.1% however, this was not enough to recover the underperformance in Q1, and the fund has underperformed its benchmark by -0.7% over the last year. It is marginally behind the benchmark over 3 and 5 years and matches the benchmark return since inception and so has failed to reach its performance target.

The manager made heavy usage of Credit Default Swaps (CDS) during the crisis, these allow the buyer of the CDS to benefit from any increase in the credit spread for that security without the cost of trading in the underlying bond and can be used to protect a portfolio during a market downturn. Much of this position was unwound during the second quarter as the manager found attractive priced corporate bonds within the Investment Grade Credit space.

Similar to the Fidelity portfolio commented on above, the manager has very little interest rate duration and positioning exposure versus the benchmark at present, believing that interest rates and UK Gilt yields will remain anchored at the current low level by the Bank of England's QE programme. Portfolio risk is concentrated in the selection of individual credit's, therefore. Over the long term there does seem to be some indication that the manager can add value through security selection, but this is balanced out by a loss of value at the macro, asset allocation level between the sub-asset classes.

UK IG Corporate Credit looks reasonably attractive now that spreads against UK Government Gilts have widened slightly from pre-crisis levels, especially as central banks are targeting this area as part of their QE programmes and therefore supporting prices by buying these bonds directly in the market.

Asset Class/Manager	Multi Asset Income / Schroders
Fund AuM	£107m Pooled Fund; 9.1% of the Fund
Performance target	LIBOR +5% including a yield of 4% per annum
Adviser opinion	Slightly disappointing to date
Last meeting with manager	8/6; 18/6 John Arthur/ Russel Smith/Remi Olu-Pitan
Fees	0.35% of fund value

The portfolio has continues to deliver the 4% yield requirement but the rise in risk assets during the quarter has taken the yield back down to 4% gross and the manager may struggle to maintain the 4% yield target if markets rally much further if they are to retain the level of diversification and reduced volatility of the portfolio. Both of the Fund's Multi-Asset income portfolios are hedged back to Sterling, removing the currency risk of holding overseas assets.

The portfolio returned 10.6% in the second quarter following the -16.7% fall in Q1 and is still down over the last year by -5.2%. This is 4% below the returns delivered by the Fidelity Multi-Asset Income portfolio over the one-year period. In addition, the Schroders portfolio has exhibited more volatility and appears to be taking slightly higher investment risk which fits with the target return of cash +5% to Fidelity's Cash +4%.

The manager increase risk slightly during the quarter as central bank QE policies supported markets and removed the risk of a prolonged and severe economic recession. (The expectation now is for only a short term, severe economic recession!). The focus has been on increasing the exposure to Investment Grade Credit where QE programmes are supportive and in Quality Equities but, with the manager remaining concerned about the growth outlook, they are continuing to hold US Treasuries and US cash as safe haven assets and a hedge against a second market fall.

The manager does raise the issue of diversification. Developed government bonds now offer such low yields that they are unlikely to provide a positive return in a risk-off market environment as they have done in the past. The manager is therefore biasing the portfolio to quality assets and taking some currency positions which should prove defensive in a market setback (e.g. holding the Japanese Yen and Swiss Franc). I need to understand the effect of the currency positions given the hedged nature of the portfolio more fully but agree that diversification is becoming more of an issue.

Asset Class/Manager	Multi Asset Income / Fidelity
Fund AuM	£87m Pooled Fund; 7.4% of the Fund
Performance target	LIBOR +4% including a yield of 4% per annum
Adviser opinion	Too early to make any assessment
Last meeting with manager	6/5; 15/6/20 John Arthur/ Paul Harris
Fees	0.4% on first £20m; 0.3% on next £30m; 0.25% on next £100m; 0.18% thereafter

Again, this portfolio is hedged back into Sterling.

The portfolio returned 9.7% over the quarter against a fall of -12.6% in the first quarter and has therefore regained the majority of the Q1 fall. This was possible due to the strong recovery in risk assets driven by central bank intervention and government economic support measures across the globe. The manager remains cautious preferring debt to equities and Investment Grade Credit in particular where they value the support provided by the central bank QE programmes.

Both the Multi-Asset Income portfolios have a 'cash+X' style benchmark which will increase slightly each quarter irrespective of the movement in markets. This style of benchmark is of very limited value as a comparison in the short-

term but does match the Funds requirement of these portfolios over the long-term. Because the yield from these portfolios is distributed to the Fund each quarter (to help cover the Fund's cash outflow), the value of these portfolios will not grow in the same way as Global Equity portfolios. The target for these portfolios is to provide 1-2% of capital growth and 4% yield and to provide diversification away from the Fund's predominantly equity based investment risk.

Asset Class/Manager	UK Commercial Property / Fidelity
Fund AuM	£45m Pooled Fund; 3.9% of the Fund
Performance target	IPD UK All Balanced Property Index
Adviser opinion	Has outperformed the peer group during the recent market turbulence
Last meeting with manager	No meeting this quarter
Fees	0.75% of fund value

I have not received the managers quarterly report at the time of writing.

I noted in my previous report that the first quarter performance for this portfolio was overstated due to a lack of transactions in the UK property market and, therefore, pricing comparisons, making it impossible for property valuers to correctly value existing assets. I saw the first quarter fall in the portfolio value of -0.8% as an under-estimate of the Covid-19 impact and predicted a further fall of approaching -10% over the coming quarters. The portfolio fell -2.9% in the second quarter and whilst it may fall slightly in Q3, my previous expectation of a 10% fall in values now appears exaggerated.

Importantly, the portfolio has proved reasonably resilient in what has been a difficult period and appears to be outperforming the peer group both in rental collection and valuation terms at the present time. This is supported by the manager's approach of focusing on tenant creditworthiness and affordability at all times, aided by a low exposure to retail and leisure properties.

The portfolio has a higher void (unlet properties) rate than would be expected at present due to the planned refurbishment of two properties and, whilst these refurbishments will have been delayed slightly by the economic lockdown and requirement for social distancing within the workplace, reletting them over the coming months will be a good test of the current UK market and should boost valuations going forward.

Rent collection across the UK portfolio for Q2 is currently at 90% against a historic 99%+ and expectations of 70% for this period. The manager does expect Q3 to be slightly worse as the effect for many companies of reopening has been to increase operating costs whilst revenues have remained subdued, therefore cashflow has deteriorated even from the lockdown period.

Where rents have been postponed or passed the manager has looked to agree lease extensions where appropriate to offset the value loss. Nonetheless there will be a very small level of debt write-off over the coming quarters. The yield from this portfolio will also fall slightly due to rental payment delays and the level of voids within the portfolio. Q2 yield was 90% of Q1 (pre covid-19) levels and the Q3 yield will fall slightly further. The yield for the portfolio should then recover as the refurbished properties are re-let and rents currently being postponed are recovered.

A number of tenants are taking advantage of the UK Government's restriction on landlords taking action against unpaid rent and have not paid their rent, but discussions with them are continuing, with the majority requesting deferrals, meaning that rent will be delayed but not lost. Retail tenants, in particular, are pressing hard for agreements to defer rents or for rent free periods, but these discussions have recently been developing into more sophisticated lease restructuring negotiations, with tenants prepared to offer concessions (such as lease extensions) to landlords in return.

The portfolio is well positioned with low exposure to Retail and Shopping sectors and contains a number of properties with a flexible design where change of use is a possibility, helping the portfolio to remain flexible and cope with changing demand in the future.

Fixed interest mandate

The balance between generating investment return and the requirement for diversification from Global Equities, which remain the majority of the Fund's assets

The recent review of the Fund's Strategic Asset Allocation (SAA) conducted by MJ Hudson Allenbridge included a table of expected long-term (10 year) investment returns for the main asset classes and a table showing the correlation between asset classes based on historic data. I have reproduced elements of these tables below and used a heat map to show positive attributes in blue and negative in orange.

Asset Class	Sub-Asset Class	Expected Annual Return	Expected Annual Volatility	Correlation with Global Equities
Cash	UK Cash	1.80%	0.68%	-0.11
Bonds	UK Gilts	0.00%	6.64%	0.00
Multi Asset Income	UK Investment Grade Corporate Bonds	2.00%	7.38%	0.37
	US High Yield Bonds Hedged	5.20%	8.27%	0.61
	European High Yield Bonds Hedged	4.80%	8.54%	0.53
	US Leveraged Loans Hedged	4.90%	7.55%	0.40
	Emerging Markets Sovereign Debt Hedged	5.00%	8.44%	0.54
	Emerging Markets Local Currency Debt	4.40%	11.16%	0.57
	Emerging Markets Corporate Bonds Hedged	4.80%	8.16%	0.51
	Global Credit Sensitive Convertible Hedged	4.30%	7.11%	0.28
	Diversified Hedge Funds Hedged	4.40%	7.28%	0.56
Multi Asset Credit	US High Yield Bonds	3.70%	9.38%	0.62
	US Leveraged Loans	3.50%	10.54%	0.35
Equity	AC World Equity	5.50%	13.39%	1.00
	Emerging Markets Equity	7.70%	18.46%	0.84
Alt's	UK Core Real Estate	4.30%	10.43%	0.10
	US Core Real Estate	5.50%	16.19%	0.29
	Global Infrastructure Equity	4.50%	9.48%	0.15
	Private Equity	7.30%	16.22%	0.67
C'dities	Commodities	1.00%	13.94%	0.41
	Gold	1.50%	18.31%	0.03

These forecasts were made prior to the Covid-19 pandemic and subsequent gyrations in investment markets but given the recovery in most asset prices at the current time they would still seem to be a good guide. Note: In adverse markets all correlations tend to increase in the short term.

You will see from the table that those asset classes with higher forecast returns also have high forecast volatility and the highest historic correlation to equities i.e. there is no easy solution to increasing returns whilst diluting the exposure to equities.

Currently our forecast 10-year return for UK Government Gilts is 0%, Fidelity are forecasting 0.3% p.a. Our forecast for UK Corporate Investment Grade Bonds is 2% p.a., Fidelity forecast 1.7% p.a.

As at 30/6/20 the Fund had 13% of its assets invested in Fixed Interest across the two mandates against the current SAA benchmark of 15% and the new SAA benchmark of 12.5%. This weighting has fallen from 14.15% at the end of the first quarter given the recovery in equities over the second quarter.

The alternatives for the investment committee to consider are as follows:

1. Do nothing. Accept that the allocation to UK Government Gilts is forecast to add no value over the next 10 years but, particularly during periods of heightened market uncertainty, this exposure will help to contain the volatility within the value of the Fund's assets.
2. Increase credit exposure by moving UK Government Gilts to Sterling Corporate Investment Grade Credit. This will increase returns slightly and raise yield but does, via the heightened correlation to equities, increase the likely volatility at the Total Fund level.
3. Move into the higher yield credit market via a Multi-Asset Credit (MAC) portfolio, this will raise returns but will further increase the correlation to equities and so the level of risk and expected volatility within the Fund will rise further.

It should be recognised that the Fund is currently well funded with a long-term investment horizon and so can cope with heightened levels of short-term volatility.

Comment

1) Doing nothing fits with having only just completed the SAA and is a justifiable solution.
2) Moving UK Gilts to UK Investment Grade Credit. This will boost returns slightly and increase the yield on the portfolio (but the return from this part of the portfolio is still forecast to remain below the actuarial assumed discount rate). It has the advantage of being achievable relatively simply and may not require a formalised OJEU process for the manager selection.
3) Moving to a MAC portfolio raises both the Fund return and risk. It is likely to require a formalised manager selection process. In addition, I would be uncomfortable making this move in isolation and would suggest the move should be made in tandem with a further allocation away from Global Equities (my suggestion would be to infrastructure) to add further diversification and contain the increased risk. This mimics the discussion the committee had when receiving the SAA report from MJ Hudson Allenbridge, where the decision was not to move to a MAC mandate at that time, although I do believe that the Covid pandemic and subsequent rise in Government debt has altered the economic and market outlook going forward.

Recommendation – To move all the Fund's exposure in UK Government Gilts to UK Investment Grade Credit by switching both existing mandates into the Fidelity Sterling Corporate Bond Fund. To retain the Fund's exposure to Multi Asset income in line with the Strategic benchmark at 20% via a sale from Global Equities if required. This latter move will help restrain any increase in risk within the Total portfolio.

Global Equities have recovered since the onset of the pandemic, yet the economic outlook remains cloudy. Currently the Fund is overweight both the existing SAA in Equities (60%) as well as the new target allocation of 58.5% and is underweight in Multi-Asset Credit, partly because this is where the income is paid out and therefore the return on these portfolios does not compound in the same way.

Exiting Fixed Interest Mandates

Both mandates are invested in a comingled fund rather than in a segregated mandate. The Baillie Gifford mandate is invested via three funds, the majority is in a UK Gilt and Investment Grade Credit fund with small percentages invested into Emerging Market and High Yield debt funds to match the makeup of the benchmark.

The table below shows the Funds existing Fixed Interest mandates. Both mandates are invested in open ended fund's rather than in a segregated mandate.

Manager	Fidelity UK Aggregate Bond Fund	Baillie Gifford
Benchmark	50% Iboxx UK Govt Gilts; 50% Iboxx UK Investment Grade Credit	44% UK Govt Gilts All Stock; 44% Merrill Lynch £ Non-Gilt; 6% Barclays global Credit; 6% JP Morgan Emerging Market Credit
Performance 5Y	4.8% p.a	3.3% p.a.
Relative Performance 5Y	0.7% p.a	-0.7% p.a.
Inception	1/5/98	1/12/13
Relative Performance since inception	0.8% p.a.	0.0% p.a.
% of fund owned by LBB	8.2%	Spread across three funds

The Fidelity fund has a benchmark of 100% in UK Gilts and UK Investment Grade Credit but can invest off benchmark to some extent. It has a performance target of benchmark +0.75% per annum which it has achieved since inception 22 years ago. I regard this as a very strong performance which has shown good consistency and low volatility over the long term. The majority of the outperformance has come from security selection which fits with the managers investment process of analysing the creditworthiness of individual bonds rather than relying on macro positioning on interest rates to drive performance.

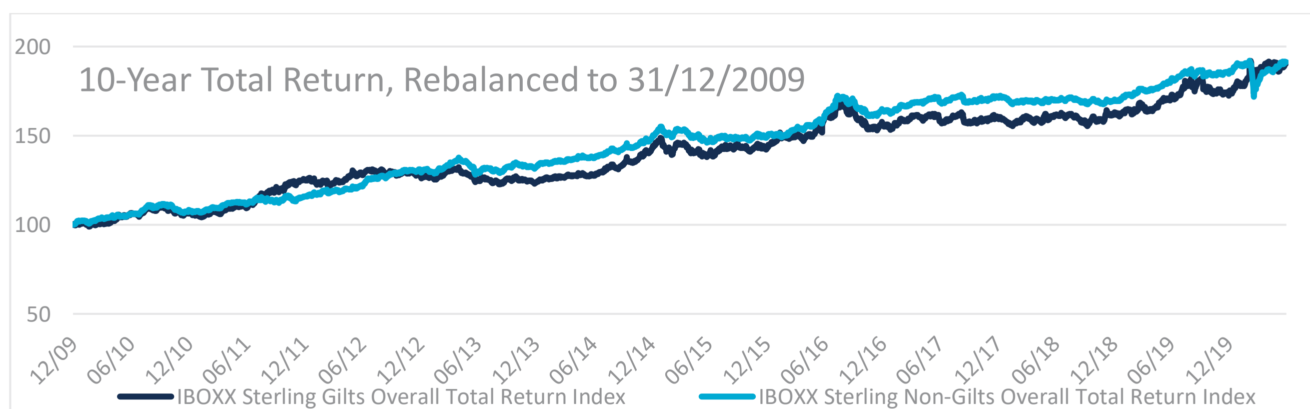
The Baillie Gifford benchmark is 88% in UK Gilts and UK Investment Grade Credit with 12% invested into a combination of High Yield and Emerging Market debt. Despite this broader remit, this fund has failed to match its benchmark over the last 5 years or since inception over 6 years ago and lags the Fidelity fund by around 1.5% per annum. In particular, the underperformance is most noticeable in difficult market conditions when credit spreads are widening. The manager has made personnel hires to bolster the investment team, particularly in the macro-economic area but again in 1Q 2020 this fund underperformed noticeably. The exposure is gained through holdings in three separate Baillie Gifford funds covering UK Gilts and Investment Grade; High Yield and Emerging Market debt respectively.

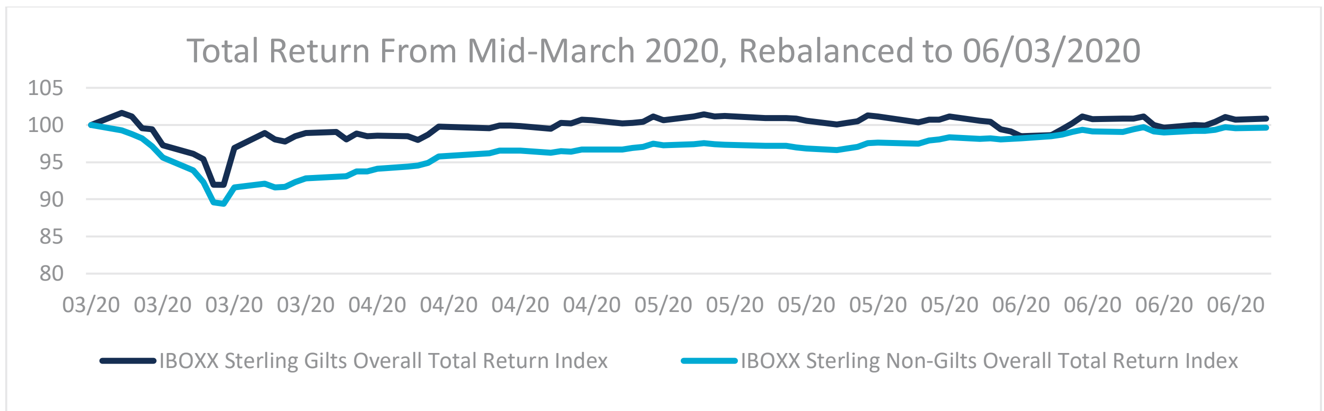
Both mandates may well have outperformed during the second quarter as Investment Grade Credit spreads have narrowed.

Potential for Manager outperformance

With interest rates now potentially flat for five to ten years and increasingly driven by politics via fiscal policy rather than monetary policy, I believe it will be increasingly difficult for a manager to add value through positioning within the interest rate yield curve or by duration as these will be driven more by sentiment and risk appetite rather than long term economic outlook. A good manager focusing on credit selection in the Investment Grade space should still be able to add value in a market more driven by credit selection than interest rate positioning. This is a minor point, but I believe it is, and will continue to be, more difficult for a manager to add value within a Gilt portfolio than within an Investment Grade Credit portfolio.

The chart below shows the returns of both Investment Grade Bonds and UK Government Gilts over the last 10 years and since the start of the global pandemic.



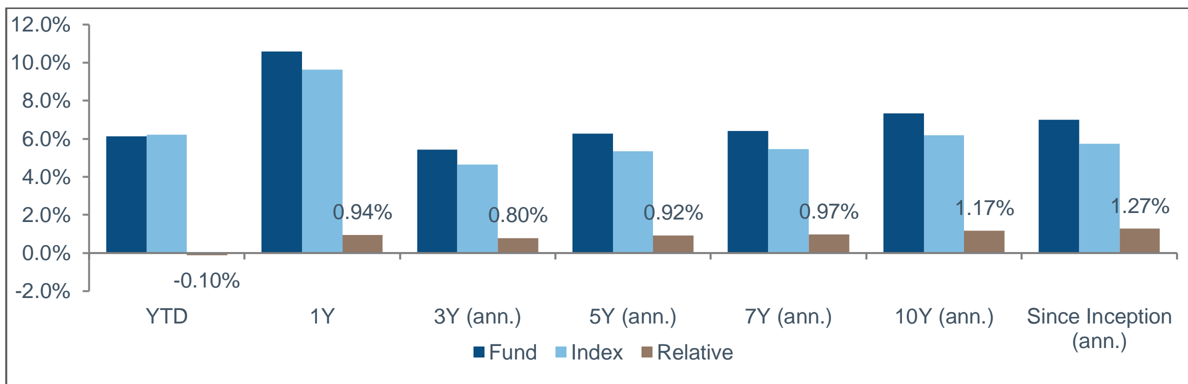


The top charts show that over the long-term the return from both UK Gilts and IG credit returns have been strong. The returns have been positively correlated (0.54%) over the last ten years. This makes sense as much of the return has been driven by falling interest rates. This is unlikely to be the main driver of returns into the future. The bottom chart shows the performance of both assets since the start of the market turbulence in March 2020. Post the initial fall, Investment Grade Credit under-performed Government Bonds in an unprecedented manner, but have now recovered almost all of this lost performance. I expect Returns from both asset classes to be lower going forward and the correlation between the asset classes to fall slightly (but remain positive) as more of the return is driven by credit selection rather than interest rate direction.

Fidelity as a manager of Fixed Interest mandates

- Bromley's experience over the last 22 years has been positive with the manager achieving their performance target over both short and long-term timescales, with acceptable levels of investment risk.
- The outperformance has been driven by Credit Selection which fits with the managers description of their investment approach.
- Work produced by Mercers shows the Fidelity fund as outperforming the benchmark and the peer group and with a lower risk profile than the peer group and thereby a higher Sharpe ratio.
- The client service provided by Fidelity has been good since inception with no major issues that I am aware of. The team are well regarded by myself and your officers.

The chart below shows the performance of the existing Fidelity fund over a variety of time periods



Returns are gross of fees.

Attribution of returns (bps) for the existing Fidelity Aggregate Bond Fund

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	10-year Average	Average incl. GFC
Attributed Return	-404	1000	192	43	268	84	102	47	119	202	-1	101	116	146
Yield	76	208	97	100	52	35	40	71	76	65	29	24	59	73
Currency	-2	24	-7	-5	1	0	7	12	2	-7	-9	-7	-1	1
Term Structure	39	97	14	26	2	-4	35	-21	0	-6	4	39	9	19
Credit	-518	668	86	-75	207	49	19	-15	41	151	-25	44	48	53
- Security Selection	-161	436	63	-23	84	33	14	56	78	-1	-57	76	32	50
- Sector Allocation & Beta	-357	231	24	-52	123	16	5	-71	-36	152	32	-33	16	3

The table above shows that, historically, the majority of the added value in returns (outside of portfolio yield) has come from credit selection and that this has be a consistent source of added value over the long-term.

Given the consistency of Fidelity's performance over a substantial time period in this mandate; the low risk profile; stability of the investment team and, most importantly, that the manner of outperformance which fits with their stated investment process, I believe that this manager would likely be shortlisted by MJHudson Allenbridge in a manager selection process within this asset class.

Fidelity Sterling Corporate Bond Fund

In addition to the existing fund that Bromley is invested in, Fidelity also manage a Sterling Corporate Bond fund which, rather than being benchmarked to a 50/50 mix of UK Gilts and UK Investment Grade Credit, is benchmarked purely against UK Investment Grade Credit. It is managed by the same team as the existing mandate and the same individual, Ian Fishwick as lead manager, has managed both funds since 2007. This gives confidence that the strong track record of the existing Fidelity mandate can be attributed to the latter fund. The actual track record of the latter fund does indeed mimic the strong track record and generation of added value through credit selection of the existing mandate.

Comparison between the Fund's existing Fidelity mandate and the Fidelity Sterling Corporate Sterling Bond Fund.

	Aggregate Sterling Bond Fund	Sterling Corporate Bond Fund
Benchmark	ICE Euro Sterling Index [3]	50% Iboxx Sterling Gilt index; 50% Iboxx Sterling non-Gilt index
Max off benchmark	30%	30%
Max Gilt holding	30% (off benchmark)	~55%
Max High Yield (<BBB)	10%	10%
Max unhedged Currency	10%	10%
Max Gross derivative exposure	75%	75%
Benchmark duration	10.9 years	8.1 years
Duration	Index +/- 1 Year	Index +/- 1 Year
Current yield to maturity	1.7%(fund) 1.1% (index)	2.6% (fund) 1.9% (index)
Average credit rating	A+	A
Total Cost[4]	17.8bp (AMC); 24.8bp (TER)	bp[5]
Size of Fund	£972m	£327m

[3] The Ice Euro Sterling index and the Iboxx Sterling non-Gilt index are very similar, consisting of much the same assets

[4] AMC- Annual Management Charge. TER – Total Expense Ratio, this is the nearest we can currently get to a total cost charge.

[5] Fidelity currently offer Bromley a relationship discount of 20% via a fee rebate which is included in these figures

, this would continue in the new fund.

If the long-term return forecasts for Investment Grade Credit, of 2% per annum over the next 10 years, is correct, switching the existing mandates to this new Fidelity Corporate Bond mandate will correspond to moving approximately 6% of the Fund out of UK Government Gilts and into UK Investment Grade Credit with a 2% uplift in returns. This could add 0.12% p.a. to returns per annum over the long term, mainly through a higher yield. The risk in the portfolio would increase marginally as well but this can be mitigated by reducing the current overweight in Global Equities in favour of Multi-Asset Credit (which also raises the yield fractionally at the Total Fund level).

The effect of these changes looks small however:

- I expect Fidelity to continue to add value within Corporate Credit against a potential fall off in outperformance in the existing portfolio;
- I expect the correlation between UK Gilts and UK Investment Grade Credit to fall slightly;
- Even post a recovery in Investment Grade Credit in the second quarter, yields still appear to fully compensate for the expected default risk over the long term;
- the move raises the yield on the Fund marginally which is an additional benefit;
- in a low return environment, the little gains matter;
- the lower duration in the Corporate Bond fund lowers interest rate sensitivity marginally;
- I believe that Fidelity would be shortlisted for any manager selection in this product area and therefore, a full OJEU process may not be required;
- the transition costs of moving between the two Fidelity funds should be low, there will be a transition cost for moving across from the Baillie Gifford fund, this fund may have to be realised and reinvested but trading costs within UK Gilts and Investment Grade Credit are low.

The cost of transitioning between the two Fidelity funds should be low because the Investment Grade element of the existing portfolio (~50%) can be transferred in specie at zero cost and the cast of selling UK Gilts is low because they are extremely liquid and easy to trade. The transition cost of moving from the Baillie Gifford Fixed Interest portfolio to the new Fidelity portfolio will be higher. Because the current investment and target investment is in funds a bid/offer spread would apply, this could equate to approaching 1% on the £60m in the Baillie Gifford portfolio. I estimate that total transition costs should be around £800,000.

Asset return correlations

Will the future mimic the past, are the correlations, which are based on historic data, a good guide into the future? Not exactly but I do believe the core correlation between equities and Government bonds will stay low over the next 5 to 10 years.

Given the massive debt issuance and future spending commitments made by Governments across the world, they now require interest rates to stay low for the foreseeable future, central banks will therefore continue to purchase government and investment grade debt to achieve this.

With interest rates set to remain near zero for 5-10 years, the determinant of economic growth will no longer be the outlook for rates but, I believe, is likely to depend on the outlook for government stimulus; if growth slows, governments will spend more and central banks will purchase the debt, if growth rises, governments will slow spending. Under these circumstances, the core correlation between Equities and Government Bonds is likely to stay around zero.

But what if inflation rises? Initially this will be very poor for both equities and government bonds and they could become positively correlated as they both fall. But government response to persistently rising inflation will eventually be to lower spending and slow growth, positive for bonds and negative for equities. (The seeds of the next crisis may well be from governments not reacting to rising inflation and bond markets having to force governments' hand by raising bond yields, the government response to this could include capital controls and forcing some institutional asset owners, including LGPS Funds, to hold a percentage of their assets in government bonds!).

8 Old Jewry, London, EC2R 8DN, United Kingdom | +44 20 7079 1000 | london@mjhudson.com | mjhudson.com | mjhudson-allenbridge.com

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