MJ HUDSON

London Borough of Bromley

Quarterly Report

Q2 2021

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Performance Summary

In market terms, the second quarter was positive for almost all asset classes with global equities up 7.9% in local currency terms and UK investment grade bonds up 1.9% over the quarter. Performance data is not available on the Multi-Asset Income or UK Property portfolios at the time of writing but given the market environment over the quarter I would expect these portfolios to have produced a small positive return.

Total Fund Performance

It is too soon after the end of the second quarter to have any information on the performance of the Fund or its managers for Q2. Given that the last meeting was also early, this report updates the estimated Q1 performance reported at the last meeting.

The Fund rose by 1.53% over the first quarter to a value of £1.332bn. The Fund underperformed the Strategic Asset Allocation (SAA) Benchmark by approximately 0.15% over the quarter. This was driven mainly by the underperformance of the Baillie Gifford High Alpha Global Equity portfolio causing approximately 60 basis points (bp) (0.60%) underperformance at the Total Fund level and from the two Multi-Asset Income portfolios which underperformed their 'cash+x' style benchmark causing approximately 25bp (0.25%) underperformance at the Total Fund level. This was countered by outperformance by the MFS global equity portfolio which contributed approximately 30bp at the Total Fund level; a small outperformance of their benchmarks by the two Fidelity bond portfolios (although they fell in absolute terms) and by the Fund's overweight exposure to Equities. The Baillie Gifford Global High Alpha Portfolio has outperformed substantially over the last 12 months.

Asset Allocation

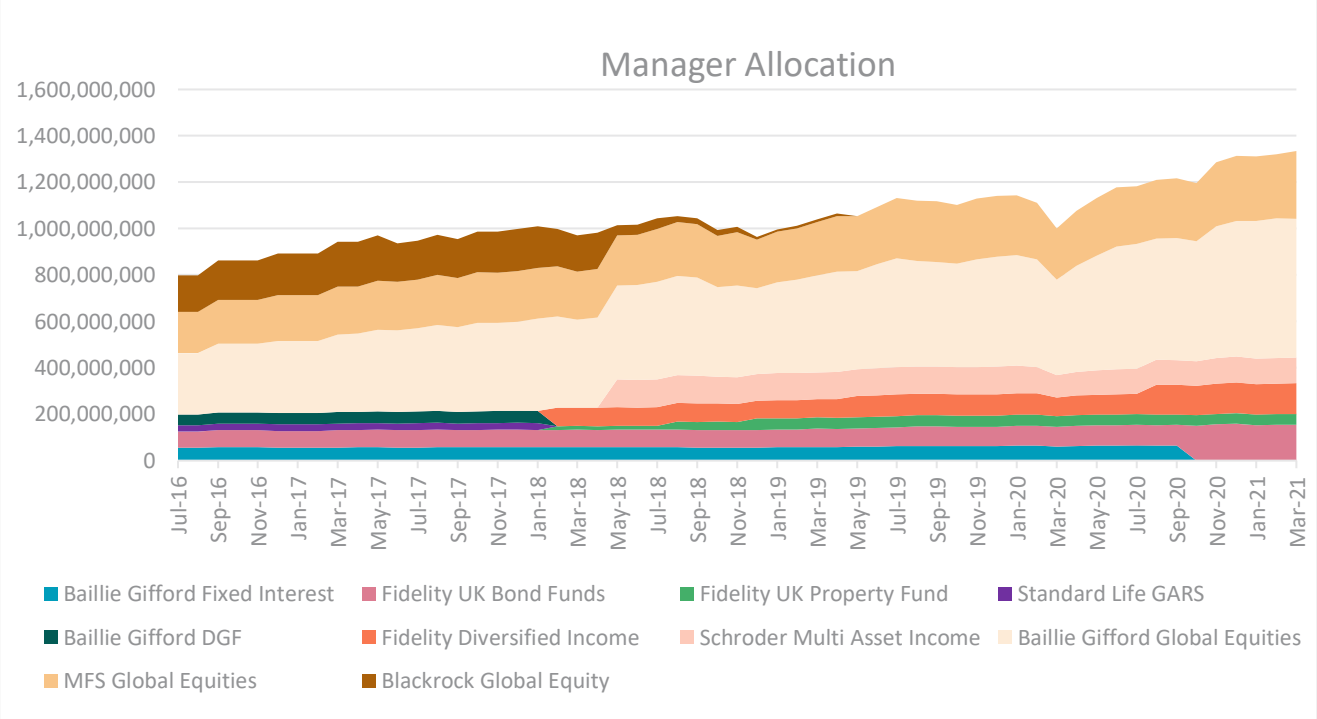
With equity markets continuing to rise over the first quarter and bonds falling, the Fund's tactical asset allocation has deviated further from the SAA Benchmark, this will have continued through the second quarter. In the short-term, the expectation of a strong recovery in earnings is pushing equities higher whilst also pushing bond yields up (prices down) which acts as a headwind on equity valuations. Market sentiment is at stretched levels suggesting investors are becoming over committed and the economic recovery increasingly priced in.

Asset class	Asset Allocation as at 31/12/2019	Benchmark as at 31/12/2019	Position against the existing benchmark	Asset Allocation as at 31/3/2021	New benchmark going forward	Position against the new benchmark
Equities	64.6%	60%	+4.6%	66.7%	57.5%	+9.2%
Fixed Interest	12.7%	15%	-2.3%	11.6%	12.5%	-0.9%
Property	4.2%	5%	-0.8%	3.5%	5%	-1.5%
Multi-Asset Income	18.5%	20%	-1.5%	18.2%	20%	-1.8%

Int'l Property	n/a	n/a	n/a	0%	5%	-5.0%

Since the quarter end £20m has been sold from the Baillie Gifford Global Equity portfolio and reinvested into the Fidelity UK Commercial Property portfolio. This follows the presentation by the Fidelity property team at the last meeting where they set out the high void rate at present within the portfolio being mainly due to four planned major renovations which were nearing completion. The manager has a strong belief that the redeveloped properties would be relet at a premium to their past levels resulting in a rise in the valuation of these properties over time. This provided strong reassurance that this portfolio would add value over the next 24 months and given the high level of valuations within Equities; the recent exceptional performance of the Baillie Gifford Global Equity portfolio and the Fund's overweight position against its Strategic Benchmark in Equities (see table above); £20m or approximately 1.5% of the Fund's assets was switched from Global Equities to UK Property.

The chart below shows the Fund's assets by manager/mandate



Because the Fund's investment return has surpassed the level assumed by the actuarial discount rate at the 2019 actuarial revaluation (3.65%), the funding level would have improved, all else being equal. Of course, everything else has not stayed constant and the Fund's liabilities will have increased slightly due to the McCloud judgement and a number of other legislative issues. In addition, falling yields on UK Government Gilts may also have affected the actuaries' calculation of the discount rate. These calculations are for the Fund as an open, on-going Defined Benefit Scheme. If the Scheme was to close, less risk could be taken within the investment portfolios and the discount rate would be lower.

Cash Flow

Currently, the Fund can cover pension and lump sum payments as well as its manager fees and admin costs from pension contributions and the investment income received. Investment income is reinvested within the Global Equity and Fixed Income portfolios and paid out from the Multi-Asset Income and UK Property portfolios.

My understanding from discussions with your officers is that the Fund should end this financial year (2020/21) with around £7.5m in cash and currently has a positive cash flow of around £1m per annum being the net figure of pension contributions and income taken from the Multi-Asset Income and UK Property portfolios set against pension payments and administration costs. It would seem sensible to increase the physical cash coming into the Fund to ensure this figure remains positive. In addition, the allocation to the Morgan Stanley International Property Fund has yet to commence drawdown. This can initially be funded from the £8m of cash held by the Fund at present but thereafter will be funded by the sale of global equities.

Recommendation 1: To convert the Fidelity Bond portfolios to income distribution rather than reinvestment as at present.

The Fund currently has £150m invested in these two bond portfolios and taking the income from these should bring approximately £2.5m of cash per annum into the Fund. Given the low level of Government Gilt and Investment Grade Credit yields at present and that we expect only a very limited increase in value over the next 10 years from these assets, stopping reinvestment into this area makes sense.

Taking this action will mean that the two global equity portfolios are the only remaining portfolios where dividends are reinvested within the portfolio rather than paid out to the Fund. The effect of this is that the global equity portfolios will tend to grow over time (depending on performance). The Fund is already overweight global equities against the SAA but I note that the $80m committed to International Property will be financed from here reducing this overweight.

International Property

The Fund has committed US$80m (£57.5m) to International Property via the Morgan Stanley managed New Haven 10 fund and this amount will be drawn down over the next 4 years. The committed capital is an absolute US Dollar cash figure and will not alter even if the value of the Fund falls. Morgan Stanley has now made 8 acquisitions within this fund, investing approximately US$400m out of the funds approximately US$3bn of committed capital. They initially finance these acquisitions from bank debt and then call money down from investors when the sum is significant rather than call down a stream of small amounts. The manager has confirmed to me that they intend to call down approximately £10m (£7.2m) from the Fund during the third quarter. The Fund currently has sufficient cash to cover this but it would leave the Fund with close to zero cash going forward.

Recommendation 2: For the Committee to delegate to the Officers and Chair the timing of raising up to £10m between PISC meetings from the global equity portfolios into cash to cover expected future drawdowns to this fund. The timing of this cash raising should take account of the expected level of drawdowns to the Morgan Stanley fund and the state of global equity markets.

Recommendation 3: For the Committee to discuss the desired balance between the two global equity portfolios (Baillie Gifford and MFS) so as to inform the sales. My suggestion would be to target a 60/40 split.

The current split between Baillie Gifford and MFS within global equities is 67%/33%.

Funding level

The table below was included in the slides for the recent Pensions Seminar held on the 14th June.

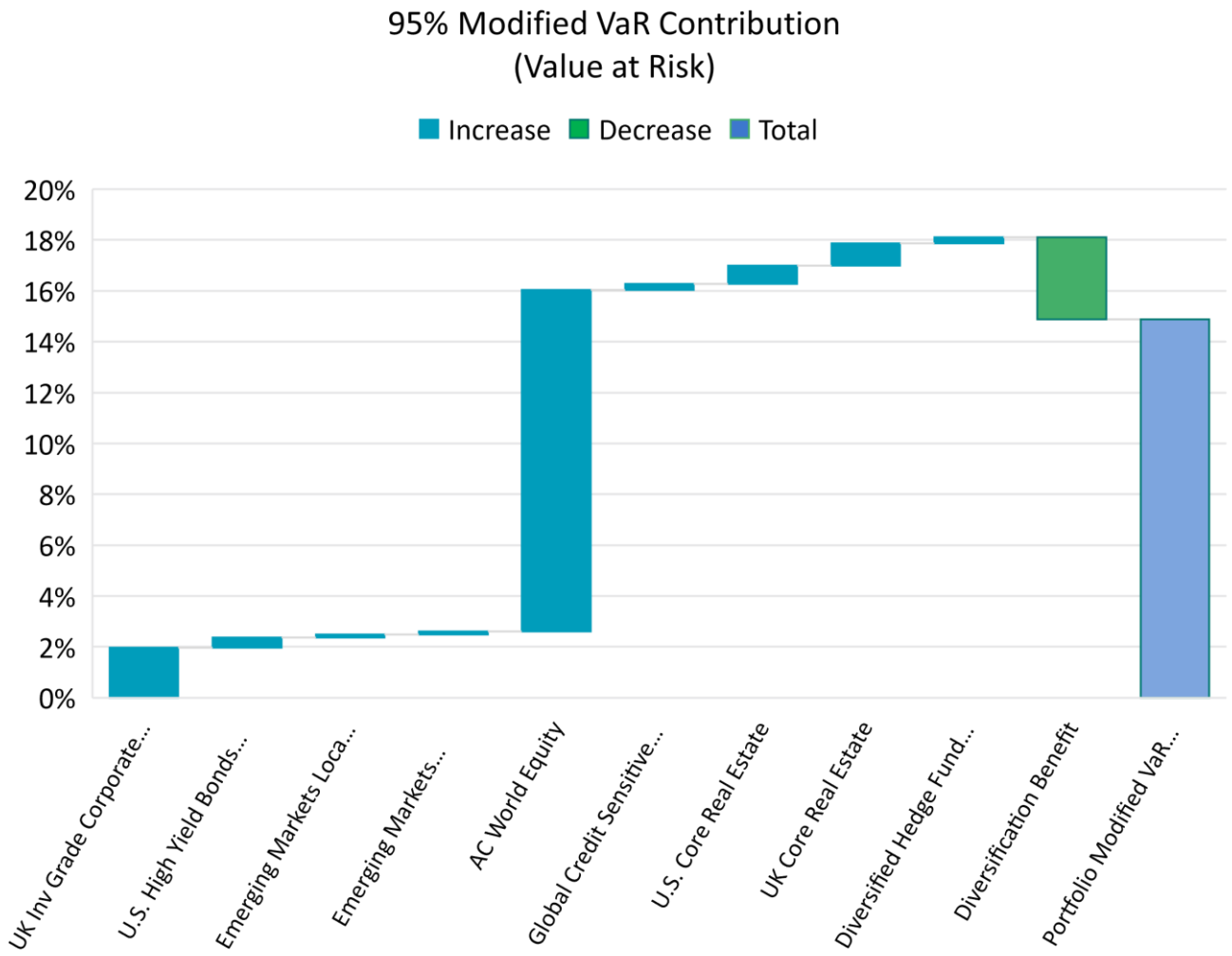
Date	Assets	Current Liabilities	Funding Level	Discount rate
31/3/10	£429m	£511m	84%	6.9%
31/3/13	£584m	£712m	92%	4.95%
31/3/16	£748m	£818m	91%	4.2%
31/3/19	£1,039m	£945m	110%	3.65%
Current	£1,335m	£1016m	131%*	?

*This is an informed estimate!

The Funding level may deviate from this current forecast due to the impact of legislative changes e.g. the McCloud judgement; changes to the actuarial discount rate or changes to inflation expectations which would alter the current valuation of future liabilities.

As stated at the Pensions Seminar, MJ Hudson has recently updated the work they undertook in the SAA review conducted during 2019. In particular, they have recalculated the Fund's risk and return forecasts using updated Long-Term Capital Market assumptions provided by JP Morgan.

The table below shows the Value at Risk (VaR) of the Fund. Value at Risk is expressed as the percentage of the Fund that could be lost in adverse market conditions over a one-year time horizon. Because markets do not exhibit a normal distribution of returns, the calculation is modified to take into account the asymmetry (upward bias) and kurtosis (fat tail) of the assumed distribution. The calculation is done to a 95% confidence level so there is an assumed 5% probability that the Fund's value could fall by at least this amount.



This chart above shows that the vast majority of the Fund's market risk is within the global equity portfolios. If the Committee wishes to reduce the level of risk within the Fund it will need to reduce the equity exposure. This calculation suggests that there is a 5% chance that the Fund could fall by at least £200m over the next 12 months. The diversification benefit is because returns from bonds and equities have tended to be negatively correlated in the past. I would question whether that will continue into the immediate future.

The long-term return forecast at the Total Fund level was 4.6% per annum at the time of the 2019 review. Because of the Fund's heavy exposure to Global Equities and Fixed Interest, where return forecasts have fallen slightly, this may have fallen towards 4.2% per annum but will still be above the Actuarial Discount rate of 3.65% per annum which is the return required to retain the current funding position.

Environmental, Social and Governance (ESG)

My next quarterly report will include a section on impact investing which attempts to generate a positive social impact whilst still targeting the best level of financial return and will cover social housing as an example of this.

The annual meeting of the Chair and Vice Chair of the committee and your officers with MJ Hudson and invited fund managers will cover the reporting requirements from the Taskforce for Climate Related Financial Disclosure (TCFD) recommendations and a presentation on ESG issues from MJ Hudson's ESG consultancy.

The Inflation Question – for discussion

I set out in the previuos quarterly report my concern about inflation.

As noted previously the economic and monetary stimulus currently underway across the developed world far outweighs the cost of the Covid-19 pandemic. In the US, the economic stimulus packages enacted or under discussion account for 20-25% of annual GDP and to over 10 times the estimated hit to personal finances from the pandemic. This comes at a time when the US Personal Savings Rate is estimated to have increased from 7.6% in 2019 to 13.7% in 2020 amounting to an extra £1tn of enforced savings.

This is leading to a rapid recovery in US GDP as the economy reopens and lockdown measures are eased. US GDP growth is now forecast to hit over 7% in 2021, far above anything experienced since the 1970's. Nonetheless, this will only take US GDP back above the pre Covid-19 level in early 2022.

US annual GDP growth

This assumes that the US economy is not derailed by the Delta varient of Covid-19 or by any future mutations.

This rapid economic recovery is undoubtedly hitting some supply constraints as companies themselves struggle to reopen post lockdown. We are seeing labour wages rising as shown by the chart below which shows US wage growth.

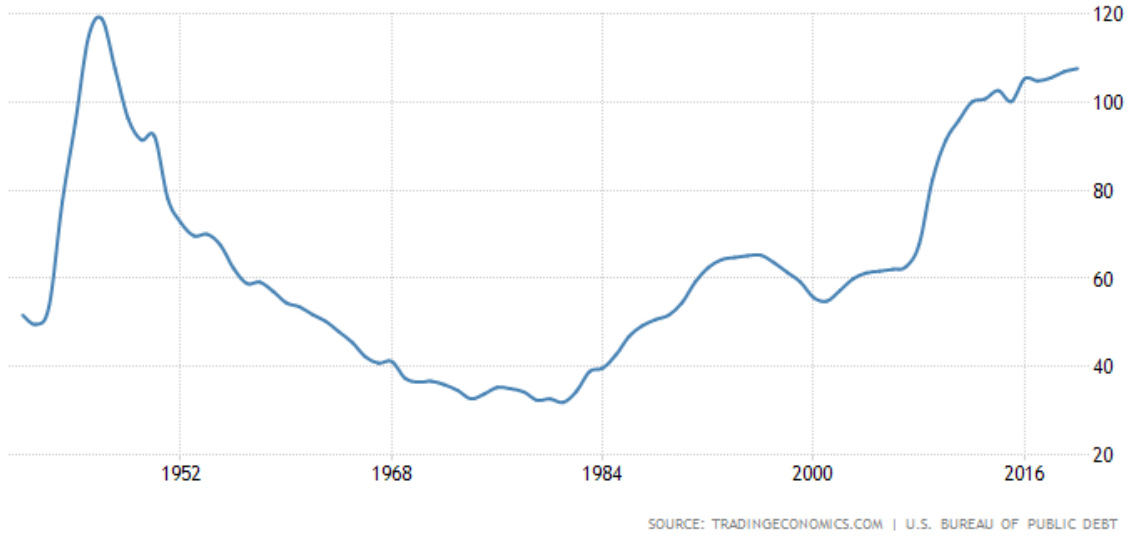
The unknown is whether this recovery is the start of a new economic cycle. Post pandemic there is ample room for unemployment to fall; the pandemic itself has altered the way we work and may well have accelerated the adoption of new technology potentially improving productivity. In this scenario US GDP growth reverts to the 5% nominal level with inflation remaining muted and interest rates can be raised slowly to a more neutral level over the next 2 years.

However, I noted in my last report that interest rates have remained above inflation throughout the majority of the last 40 years with the rate of inflation falling throughout this period until the Global Financial Crisis of 2008/9. Since then inflation has been subdued and often below central bank targets of around 2%. Over the last ten years the inflation concern has shifted from it being too high to it being too low. The fear of stagnation and disinflation has taken hold. Put simply, central banks now fear disinflation and falling prices more than they do rising inflation and therefore policy risks will be bias to overshootiing inflation targets not undershooting.This has the added advantage of inflating away the high level of Government debt over time.

This shift in thinking has occurred in tandem with a policy shift around the acceptable scale of government indebtedness and spending across many of the developed economies. The support provided by governments to the Global Economic Crisis of 2008/9 is seen, in hindsight, as too little too late. Policy markers and market participants now believe you need to respond to a crisis by hitting early and hitting hard. This risk again has shifted with the accepted wisdom now being that under spending to counteract a crisis is the mistake, not over spending. With an electorate unaccepting of austerity, governments are content to accept the new, higher spending, wisdom.

We have seen no reduction in US Government debt to GDP levels following the increased spending post the Global Financial Crisis in 2008/9 and the scale of economic stimulus now proposed is highly likely to increase this ratio still further, taking it to levels not seen since the aftermath of the second world war.

US Government Debt to GDP.

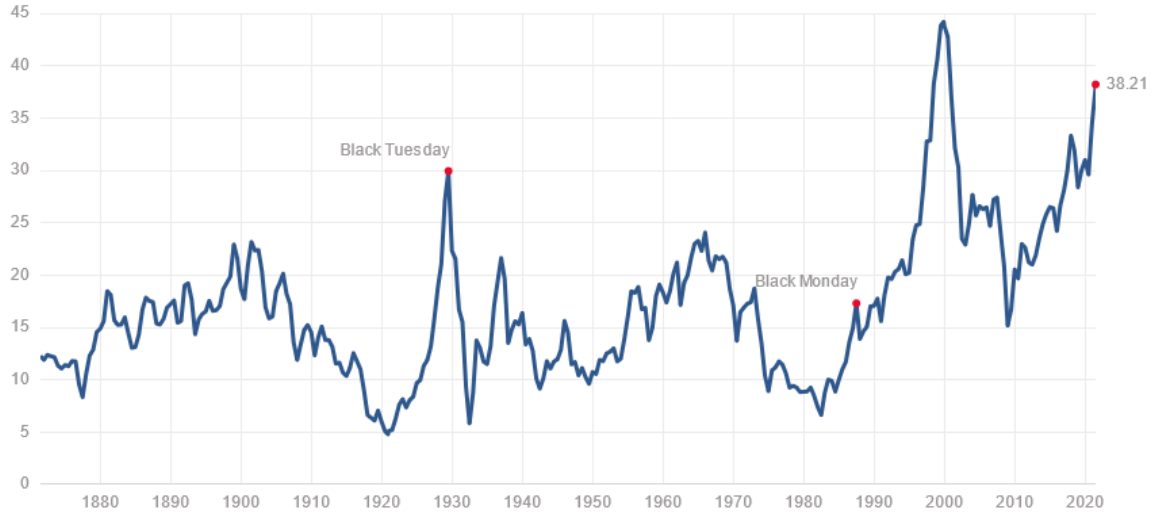


We are now in a world where central banks will take risks of an overshoot in inflation and Governments receive little criticism for raising their indebtedness and spending heavily. This is coming at a time when many consumers have built up savings and have a high propensity to spend. Economic theory tells us that high Government spending tends to crowd out private spending and is less optimal.

At the same time we are seeing a reversal of the trends of globalisation with supply chains moving from 'just in time' to 'just in case' to provide more security of supply but this will come at higher cost. In addition, we are seeing society demanding that companies pay a fair labour rate and are environmentally sustainable. Both of these issues are necessary but will embed higher costs into production.

It is very difficult to predict whether the current uptick in inflation will be a temporary phenomenon or is the start of a more long-term inflationary pressure which will require higher interest rates to combat it. We have found in the past that inflation can only be lowered by forcing an economy to grow below its productive capacity over a period of time. In this environment, interest rates would rise faster and this has the potential to undermine equity valuations.

Shiller Price/Earning (P/E) ratio -The Shiller P/E is based off 10 years of corporate earnings and thereby aims to smooth out the effect of the business cycle making the ratio more comparable over time.

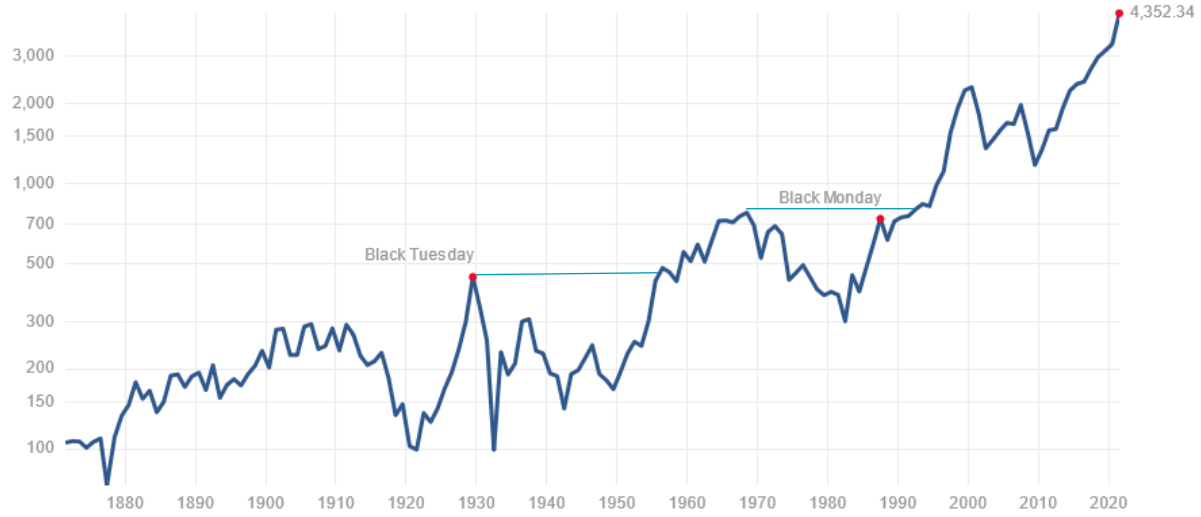


Whilst the Shiller P/E is not at the same extended levels seen during the dotcom bubble it is nonetheless high. The counter argument to this is that the modern economy relies far more on intangible assets and less invested capital leading to higher rates of return than achieved in the past which justifies a higher average P/E. It is only the US equity market which has such an extended Shiller P/E ratio at the current time, other developed markets are less stretched on this measure.

The conclusion of this is that equity market valuations may be stretched and inflation may be about to tick up longer-term. Does this matter?

The chart below shows the US S&P index in real terms (after adjusting for inflation) over time. The good news is that over the long-term equities rise in value (although this rise tends to be driven by a small subset of the overall market). The more concerning finding is that there have been two periods of over 20 years when US equity markets have produced returns at less than the rate inflation. Firstly, from immediately prior to the Great Crash of 1929 and secondly, and more pertinently, from the start of the inflationary awakening in the late 1960s.

US S&P 500 index in real terms



It is not inflation of itself that tends to undermine equity valuations, it is the change of inflationary expectations as, once these expectations change they are extremely hard to squeeze back out of the system.

Performance report This is an update of the comment from Q1 and does not include Q2 data

Asset Class/ Manager	**Global Equities/ Baillie Gifford**
Fund AuM	£598m Segregated Fund; 44.8% 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 significantly
Last meeting with manager	Presented at the Jan Committee meeting. John Arthur/John Carnegie by phone
Fees	0.65% on first £30m; 0.5% on next £30m; 0.35% thereafter

Although the portfolio underperformed by 1.5% in the first quarter it has still outperformed by 17.3% in the last 12 months which is a quite incredible achievement. With 'Growth' as an investment style underperforming 'Value' this quarter perhaps the underperformance was to be expected. With a rapid economic recovery now predicted, economically sensitive sectors of the economy like finance, manufacturing and consumer cyclicals should be expected to do well, this should lead to the continued recovery in 'Value' stocks. However, whilst this may provide a headwind to the Baillie Gifford's investment approach which focuses on high growth companies, I remain impressed by the intellectual rigour and thought leadership they show and their understanding of the market dynamics. The performance of the last 12 months will not be repeated but I do not expect this to be entirely unwound going forward.

Asset Class/ Manager	Global Equities/MFS
Fund AuM	£293m Segregated Fund; 22.0% of the Fund
Benchmark/ Target	MSCI World Index
Adviser opinion	meeting long-term performance targets, underperforming short-term
Last meeting with manager	Phone call during the quarter: Elaine Alston/John Arthur
Fees	0.6% on first £25m; 0.45% on next £25m; 0.4% thereafter

The MFS Global Equity portfolio outperformed in the first quarter by 1.5% but, following a very poor second quarter 2020 performance, as the pandemic struck, the portfolio is still behind its index over the last 12 months by -5.8%. I would expect some outperformance of this portfolio going forward and it acts as a useful counterweight to the Baillie Gifford Global Equity portfolio which helps reduce the level of risk taken by the overall Fund and hence volatility.

Asset Class/Manager	UK Aggregate Bond fund and UK Corporate Bond Fund/ Fidelity
Fund AuM	£86m Unit Trust; 6.4% of the Fund / £65m unit trust; 4.9% 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	Phone call during the quarter: Paul Harris/John Arthur
Fees	0.35% on first £10m; 0.3% on next £10m; 0.21% on next £30m; 0.18% thereafter

Following the transfer of the Baillie Gifford Fixed Interest portfolio across to Fidelity and the decision by the Committee not to invest all the Fund's Fixed interest assets into the Fidelity UK Corporate Bond portfolio, the Fund now has two similar Fidelity Fixed Interest portfolios.

The UK Aggregate Bond Fund has a benchmark which is 50% UK Gilts and 50% UK non-Gilts; the UK Corporate Bond Fund has a benchmark consisting entirely of UK Investment Grade Corporates and, as such, contains slightly higher credit risk.

Portfolio	4Q20 performance	Duration	Yield
UK Agg Bond	-5.9%	10.5 years	1.2%
UK Corp Bond	-3.9%	8.2 years	1.7%

10-year UK Government Gilts yield rose from 0.2% at the start of the first quarter to 0.8% by the end, an increase of 0.6% over the quarter. This back up in yields (fall in prices) impacted the performance of the two Fixed Interest portfolios. If you multiple the change in yield by the approximate duration of each portfolio you get the impact of the yield change on prices, i.e. for the Sterling Corporate portfolio with 8 years of duration a 0.6% rise in yields equates to a -4.8% fall in prices (0.6% x 8) for the Sterling Aggregate portfolio, which has a duration of 10 years the impact is higher at -6% (0.6% x 10). The Sterling Corporate portfolio recouped a part of the fall through credit selection. The Sterling Aggregate portfolio has a 50% weighting in UK Government Gilts and a higher credit quality and, therefore, less scope to add value through credit selection.

My central assumption remains that UK Gilts yields will rise further through the remainder of this year and, as such, I would expect both of these portfolios to add little value in the short-term. I believe the UK Corporate Bond portfolio is likely to outperform the UK Aggregate Bond portfolio over the long-term due to the higher yield available in UK Investment Grade Bonds over UK Government Gilts, more than compensating for the increased credit risk in the portfolio.

Asset Class/Manager	Multi Asset Income / Schroders
Fund AuM	£111m Pooled Fund; 8.5% of the Fund
Performance target	LIBOR +5% including a yield of 4% per annum
Adviser opinion	Slightly disappointing to date
Last meeting with manager	By phone during the quarter: John Arthur/ Russel Smith/Remi Olu-Pitan
Fees	0.35% of Fund value

The portfolio was flat over the first quarter with Equities and High Yield Credit providing a positive return and Investment Grade; Government Bonds and Emerging Market debt falling. The expectation is for Government Bond yields to rise further (prices fall) during the next 12 months and are, therefore, unlikely to provide a significant return, even during periods of market stress. With this in mind, the portfolio manager has been increasing exposure to Real Estate, Infrastructure and Insurance linked assets, which, whilst they do not provide the natural hedge in a falling equity market that Government debt has done in the past, they are a stable source of income and should support the portfolio through periods of higher market volatility.

Asset Class/Manager	Multi Asset Income / Fidelity
Fund AuM	£133m Pooled Fund; 10.1% 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	By phone during the quarter John Arthur/Paul Harris
Fees	0.4% on first £20m; 0.3% on next £30m; 0.25% on next £100m; 0.18% thereafter

The Fidelity Multi-Asset Income portfolio fell by 0.4% over first the quarter with Equity positions adding value and defensive assets falling. The manager continues to take a selective approach to adding to risk assets, focusing on UK Equities and Global Financials whilst selling down the holding in Investment Grade Bonds in the belief that yields have further to rise as the global recovery becomes more entrenched.

Fidelity have a lower return target at Cash +4% to Schroders Cash +5%. This means that the Schroders portfolio is likely to have a higher Equity weighting and Equity risk as it chases a slightly higher return. Both portfolios are currently yielding above the target 4% per annum and this yield is distributed to the Fund each month to cover any cash outflow.

Asset Class/Manager	UK Commercial Property / Fidelity
Fund AuM	£46m Pooled Fund; 3.5% 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	Phone calls during the quarter John Arthur/Paul Harris
Fees	0.75% of Fund value

The manager presented to the Committee at the last meeting and covered the current market environment and wide dispersion of returns from different sub-sectors of the UK property market and the outlook for the four major redevelopments currently occurring within the portfolio. These redevelopments account for 16% of the asset value of the portfolio at the current time and the manager retains a high conviction that each of these properties can be re-let upon completion at a higher yield than

prior to the redevelopment. Once this has been achieved, the independent valuer should revalue each property upwards to reflect the higher ongoing cashflow thus underwriting the value of the portfolio for the next couple of years.

The UK Commercial Property portfolio managed by Fidelity rose by 2.7% over the quarter and has returned 2.4% over the last 12 months. The portfolio has a low exposure to retail and hospitality assets and has achieved rental collection of over 90% since the pandemic struck which is well above the industry average with all outstanding rents being actively managed with each individual tenant. The current vacancy rate is very high at 21% but over 16% of this relates to the four properties commented on below.

The four properties currently undergoing refurbishment are as follows:

- Industrial Units in Wigan – valued at 5% of the portfolio. Refurbishment completed in August 2020 and currently being marketed although this is being delayed due to the lockdown. The targeted rent is above the previous level.
- Office in Cardiff – The client exercised a break clause in the lease enabling them to vacate the property earlier than expected. This property has now being refurbished with completion at end November 2020. The energy efficiency of the property has been improved and the expectation is to achieve a rental level 10%+ above the previous rent.
- Office in Southampton – This was a planned redevelopment due to lease expiry. Planning permission has been granted to add a fourth floor and infill the atrium with completion expected in mid-2021. The manager is targeting an uplift in rent of over 25% upon completion of the refurbishment.
- Barley Wood where the manager is looking for change of use from Office to Industrial.

Asset Class/Manager	International Property / Morgan Stanley
Fund AuM	US$80m(£57.5M)/ Limited Partnership; 0.0% of the Fund
Performance target	Absolute return
Adviser opinion	
Last meeting with manager	Phone calls during the quarter John Arthur/Gareth Dittmer
Fees	

I would expect an initial drawdown this quarter of up to £8m for the Fund as the fund manager has acquired 8 investments costing $400m to date, currently purchased with bank debt. These include a distribution site in the US; an hotel in Vienna, logistics sites in Japan and India and other assets in Europe. I intend to circulate more details on the individual transactions at the meeting. The Fund currently is estimated to have sufficient cash to cover this investment. The first Shareholders Advisory Committee meeting for this fund will not be until the Autumn of this year and the Fund has an observer seat on this committee.

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