Appendix 5

London Borough of Bromley

Quarterly Report

Q2 2021

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Performance Summary

This report is an update of the report delivered at the Pension Committee meeting on 14th July 2021. At the previous meeting the Fund performance from the custodian had not been received and so the performance figures quoted were my estimations. It includes an appendix on Private Equity.

In market terms, the second quarter was positive for almost all asset classes with global equities up 7.9% in local currency. Fixed Interest reversed a part of last quarter's decline with UK investment grade bonds up 1.9% and UK Index-Linked Gilts up 3.9%. UK commercial property rose 6.1% in the quarter as confidence returned to real estate markets. Currencies were fairly stable over the period.

The recovery in fixed interest markets was probably the surprising feature of the quarter given the strong economic background and rising inflation. The recovery was driven by calming comments from central banks, particularly the US Federal Reserve, on the current inflation surge being transitory and a decoupling of the economic recovery around the globe as the Delta variant of the Covid-19 virus took off in some areas pushing a number of economies back into partial lockdown. There also appears to be a technical element to the recovery in government bonds which may unwind in the fourth quarter leading to weaker bond prices in the short-term.

Total Fund Performance

The Fund rose by 5.75% over the first quarter to a value over £1.4bn. The Fund outperformed the Strategic Asset Allocation (SAA) Benchmark by 0.59% over the quarter. This was driven mainly by the positive market environment leading to strong returns within the two Multi-Asset Income portfolios against their 'cash+x' style benchmark which added approximately 40 basis points (0.40%) to Total Fund performance. The overweight in equities against the Strategic Benchmark added a further 10 basis points (0.10%). The MFS global Equity portfolio was the main detractor to Total Fund performance over the quarter.

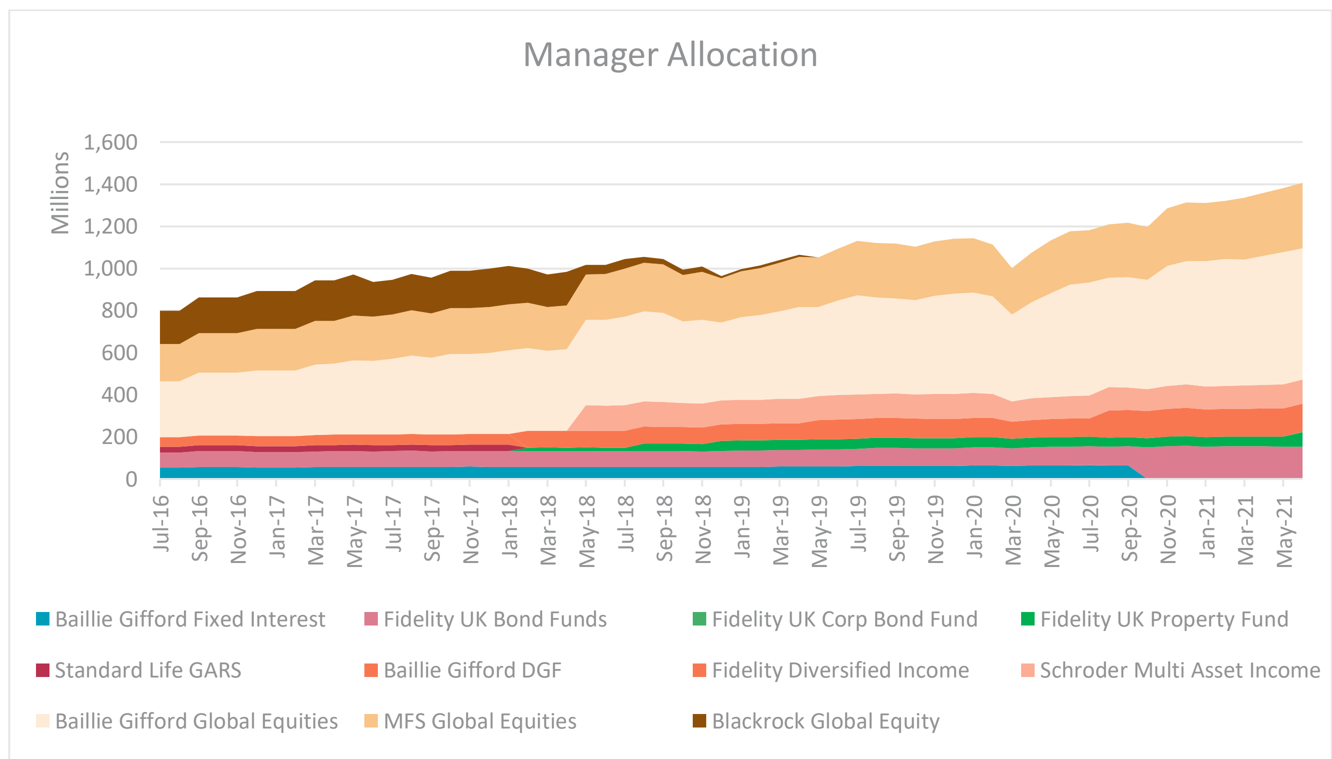
Asset Allocation

With equity markets continuing to rise over the second quarter and bonds falling, the Fund's tactical asset allocation has deviated further from the SAA Benchmark. In the short-term, the expectation of a strong recovery in earnings is pushing equities higher but inflation continues to surprise on the upside which, if interest rates rise, will act 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%	66.6%	57.5%	+9.1%
Fixed Interest	12.7%	15%	-2.3%	10.9%	12.5%	-1.6%
Property	4.2%	5%	-0.8%	4.9%	5%	-0.1%
Multi-Asset Income	18.5%	20%	-1.5%	17.7%	20%	-2.3%
Int'l Property	n/a	n/a	n/a	0%	5%	-5.0%

During the second quarter £20m has been sold from the Baillie Gifford Global Equity portfolio and reinvested into the Fidelity UK Commercial Property portfolio bringing this portfolio up to weight. This followed 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 re-let 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. 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 were switched from Global Equities to UK Property. It is pleasing to see that the return form UK Property increased to 6.1% this quarter and that the Fidelity UK Property Fund returned above that at 6.8%.

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 actuary's 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

In the 2020/1 financial year the Fund had sufficient cash to cover the expected pension payments and costs after receiving pension contributions and the income from the two Multi-Asset Income portfolios plus the UK Commercial Property portfolio. In addition to this, approximately £10m of income generated within the two Global Equity portfolios and two Fixed Interest portfolios was reinvested within those portfolios by their manager. At the last Pensions Committee meeting in July, the committee agreed to take the investment income from the two Fixed Interest portfolios managed by Fidelity to increase the net cash flow of the Fund.

Updated forecasts provided by your officers show a continued deterioration of the net cash flow of the Fund and as such it will be necessary to take some of the investment income from the Equity portfolios going forward. In addition to this the Fund is currently commencing the drawdown of cash into the Global Property portfolio managed by Morgan Stanley. This is expected to amount to approximately $20m (£17.4m) per annum for the next four years. Following the decision at the last committee meeting the Fund now holds $20m to cover a part of this drawdown.

Going forward, if the Fund takes all the investment income generated by the portfolio it will cover its cash flow and by utilising the $20m of cash now held, also be able to cover much of the expected drawdowns into the International Property portfolio. This will reduce the need to raise cash from the Global Equity portfolios by selling investments to finance drawdowns into the International Property portfolio. It is also a cheaper method of raising the cash. At the end of four years, the International Property portfolio should be starting to repay capital and therefore returning cash to the Fund as opposed to drawing cash down. Nonetheless the cash flow position will need to be reviewed at that time.

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 fund's 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. During September the manager issued the first drawdown notice to Bromley for £2.4m and confirmed to me that they expect to call down a further £10m (£7.2m) approximately by year end.

Funding level

The table below was included in the slides for the recent Pensions Seminar held on the 16th 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	£1,406m	£1026m	137%*	?

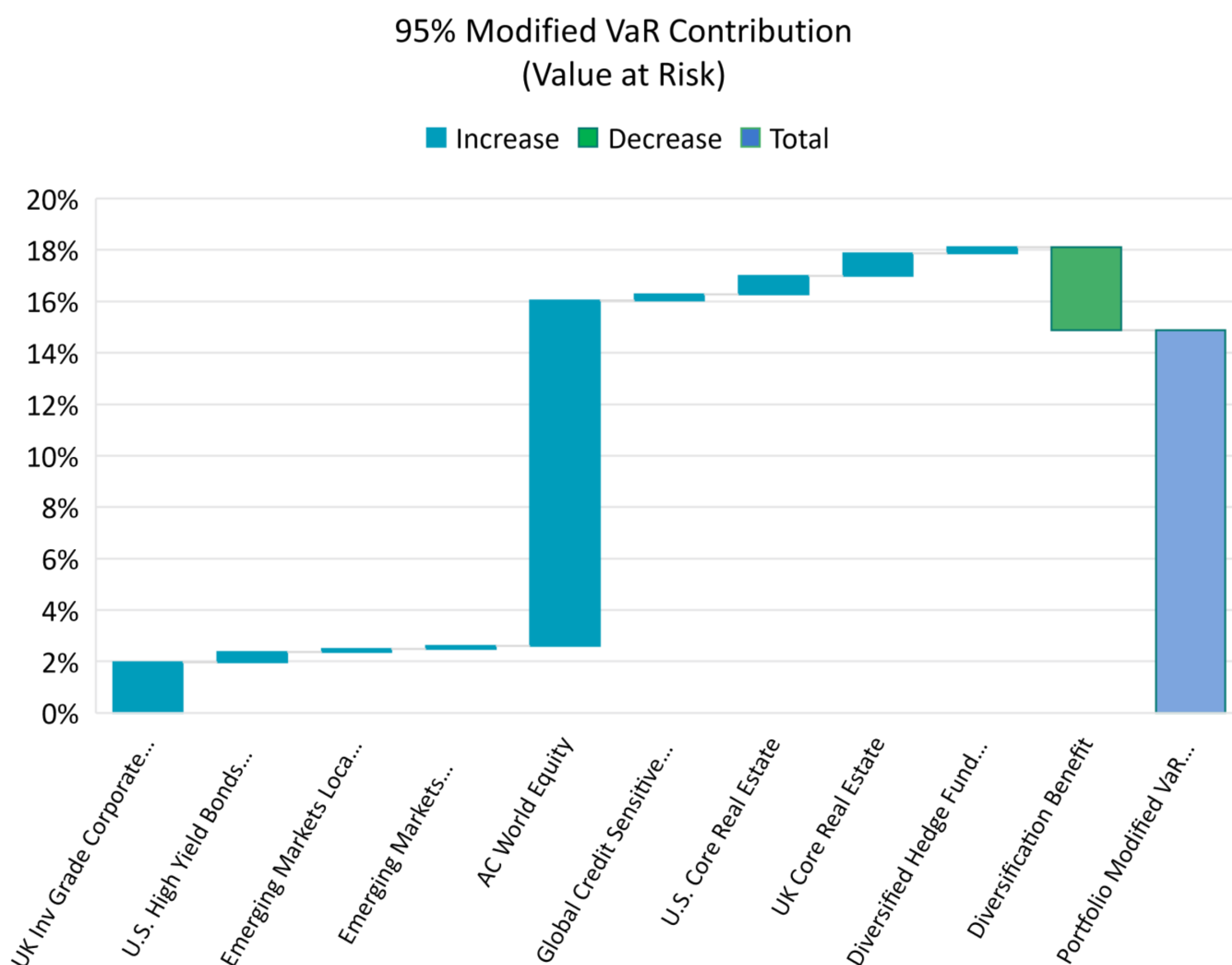
*This is an informed estimate!

The Funding level may deviate from this current forecast due to the impact of legislative changes e.g. the McLeod judgement; changes to the actuarial discount rate or changes to inflation expectations. All these issues should be expected to increase the current valuation of future pension liabilities: even so, I would guess that the Fund currently has in excess of 130% of the value of existing pension liabilities. The actuary assumes that future investment returns will cover the accrual of future pension 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 re-calculated the Fund's risk and return forecasts using updated Long-Term Capital Market assumptions provided by JP Morgan. The estimated future return of the portfolio remains above the actuary's discount rate which, if achieved, will lead to further increases in the funding level, all other variables remaining constant (which they won't!)

The table below shows the Value at Risk (VaR) of the Fund. VAR 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 (one year in 20) that the Fund's value could fall by <u>at least</u> this amount.

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



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.

Environmental, Social and Governance (ESG)

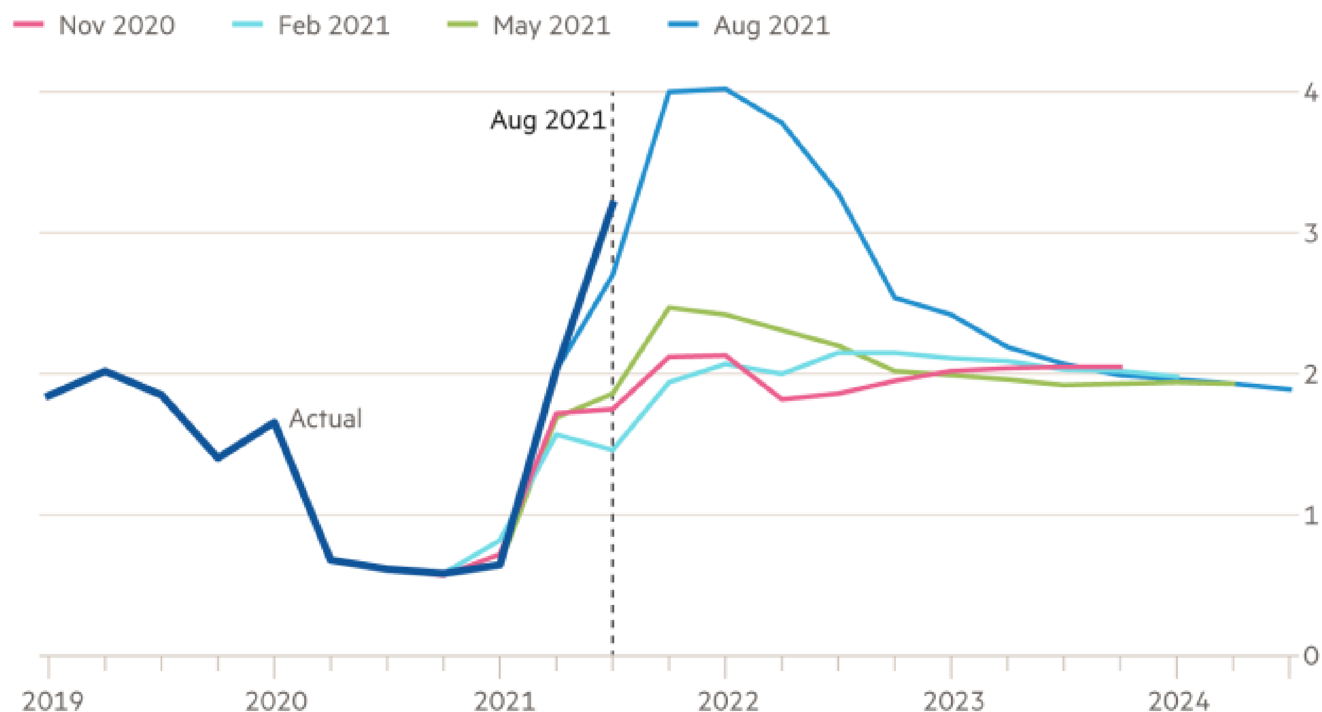
Please see the separate report on impact investing.

It is intended to produce carbon emissions data and a comment on TCFD reporting at the next committee meeting in December.

The Inflation Question – for discussion

In the last quarterly report I set out a thought piece on inflation, noting my concerns that the pick-up we are currently seeing will be less transitory and more 'sticky' than many commentators expect.

The chart below shows the Bank of England's current and past inflation forecasts, it shows that they have underestimated the pick-up in inflation for the last 9 months. My own expectation is for inflation in the UK to peak above 4% by year end and for the rate to remain above 3% through 2022. The question is whether this will lead to higher interest rates. Historical evidence is an unequivocal yes. However, whilst interest rates may move higher by the end of 2022, this time may be different.



The supply disruptions forcing prices higher will be solved at some stage, but the costs being put onto companies in the form of environmental costs and consumers/investors' expectations regarding environmental and social behaviour are not coming from restricted supply, so slowing the economy will not suppress these costs. Likewise, a desire by governments in both the US and UK to raise the wages of the lowest paid will also push costs higher. This would suggest that the future could be one of mediocre growth but somewhat higher inflation without the need for significantly higher interest rates. This would be a boon for heavily indebted governments allowing inflation to eat away at outstanding debt levels without higher rates increasing the interest cost of such debts. Note a 1% raise in the UK Government's interest cost is approximately equal to the tax raised form the recently announced rise in National Insurance!!! But not for asset owners for whom the rise in inflation eating away at their capital.

Performance report

Asset Class/ Manager	Global Equities/ Baillie Gifford
Fund AuM	£622m Segregated Fund; 44.2% 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	*See Part 2 Appendix*

The Baillie Gifford Global High Alpha portfolio returned 7.3% over the quarter similar to the benchmark return of 7.4%. Long-term performance remains exceptional with 5-year returns at 21.3% per annum against the benchmark return of 14.5% per annum for this period. This portfolio is 44% of the Fund's assets.

In the last quarter £20m has been sold from this portfolio to finance a purchase of the Fidelity UK Property portfolio and £17.4m to finance a US dollar cash portfolio to help fund the international property portfolio as it is drawn down. As growth picks up and as we recover from the Covi-19 pandemic, I would expect this portfolio to match or slightly lag the benchmark return. However, looking further forward, I do believe Baillie Gifford will continue to add value in a low growth, higher inflationary environment.

Asset Class/ Manager	Global Equities/MFS
Fund AuM	£312m Segregated Fund; 22.2% 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	*See Part 2 Appendix*

The MFS Global Equity portfolio underperformed in the first quarter by 1.1% returning 6.2% against the benchmark return of 7.3%. The portfolio has underperformed over the last 5 -years but has outperformed since inception 8 years ago. I would expect some outperformance of this portfolio going forward as the manager focuses on defendable businesses where price pressure can be passed through to consumers. The MFS 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	£154m pooled fund; 10.9% 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	*See Part 2 Appendix*

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	2Q21 performance	Duration	Yield
UK Agg Bond	0.5%	10.2 years	1.2%
UK Corp Bond	1.5%	7.6 years	1.9%

10-year UK Government Gilts yields fell slightly over the quarter (prices rose) in a marked reversal of the first quarter. Concern over the Delta version of the Covid-19 virus leading to localised economic shutdowns and thereby a slower economic recovery across the globe leading to a slightly more pessimistic outlook for global growth and hence interest rates. This accompanied with strong vocal comments from central banks over the transitory nature of the current inflation uptick left markets happy to push bond yields lower. The manager has slightly lowered the duration of the portfolio in the belief that interest rates are at the low end of their range.

Asset Class/Manager	Multi-Asset Income / Schroders
Fund AuM	£114m Pooled Fund; 8.1% of the Fund
Performance target	LIBOR +5% including a yield of 4% per annum
Adviser opinion	Slightly disappointing to date
Last meeting with manager	By phone during the quarter: John Arthur/ Russel Smith/Remi Olu-Pitan
Fees	*See Part 2 Appendix*

Asset Class/Manager	Mult-Asset Income / Fidelity
Fund AuM	£135m Pooled Fund; 9.6% 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	*See Part 2 Appendix*

In a strong quarter for asset prices you would expect the Multi-Asset income portfolios to outperform their cash+x style benchmarks. The Schroders portfolio rose by 3.8% and the slightly more conservatively managed Fidelity portfolio by 3.5%. Both portfolios have been part of the Fund for over three years now with the Schroders portfolio returning 3.1% p.a. over this period and the Fidelity portfolio 5.1%. Part of the performance difference seems to be from the Fidelity portfolio holding up better in more difficult market conditions.

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	UK Commercial Property / Fidelity
Fund AuM	£69m Pooled Fund; 4.9% 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	Phone calls during the quarter John Arthur/Paul Harris
Fees	*See Part 2 Appendix*

It was pleasing to a strong quarterly return from the UK Commercial Property portfolio this quarter having injected a further £20m towards the end of the last quarter. The portfolio returned 6.8% against a 6.1% return for the benchmark. The portfolio remains slightly behind the benchmark since inception in January 2018 reflecting the high cost of investing in this sector with UK stamp duty at 5%. 3-Year return has been 3.5% p.a. against 3.7% for the benchmark.

Asset Class/Manager	International Property / Morgan Stanley
Fund AuM	US$80m(£57.5M) committed / 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	

The Fund received the first drawdown of cash into this portfolio towards the end of the quarter (£2.4m) with a further drawdown currently expected before year end. Following the last committee meeting a $20m dollar cash fund has been put in place to cover part of the potential future drawdowns and reduce the currency risk.

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