MJ HUDSON

London Borough of Bromley

Quarterly Report

Q3 2021

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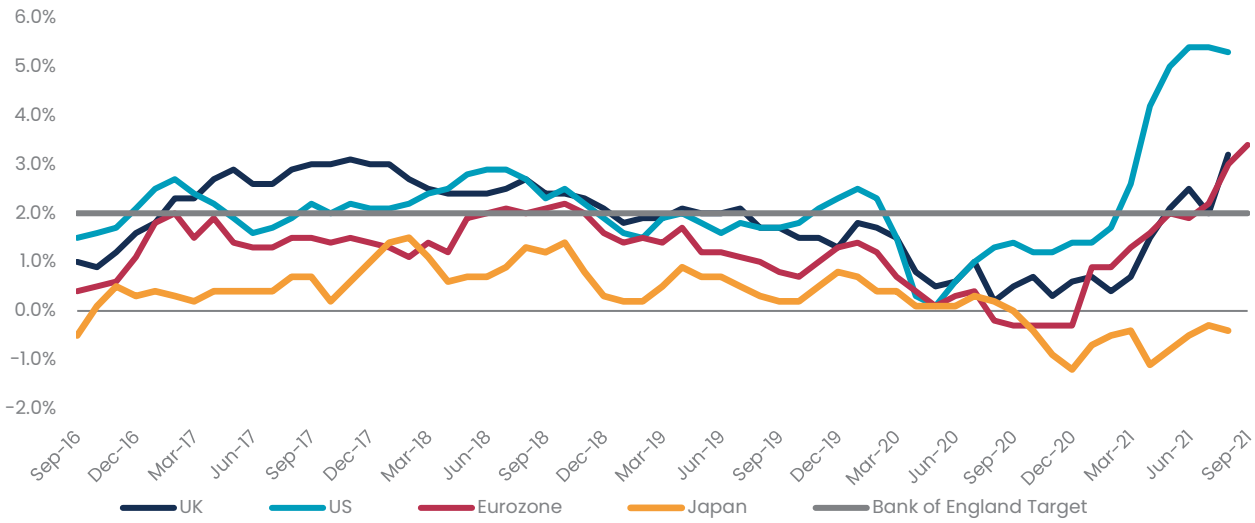
Performance Summary

Although equity and bond market returns were generally mixed, showing little change over the quarter, this stagnation was driven more by conflicting data on growth, inflation and corporate earnings rather than any investor apathy. Over the third quarter the MSCI World Index of developed market equities rose 0.1% whilst Emerging Market Equities fell -8.0%. In bonds, UK Government Index-Linked Gilts provided the best returns finishing the quarter up 2.3% whilst conventional UK Government Gilts fell (yields rose) by -2.0%. Elsewhere, Euro and US Dollar Government Bonds were flat but Emerging Market Bonds fell. In Credit, UK Investment Grade Bonds followed UK Gilts marginally low whilst the extra yield available in High Yield Bonds produced a small positive return despite some widening of credit spreads.

Post quarter end equity markets have moved higher as central banks have talked of raising interest rates on both sides of the Atlantic whilst avoiding actually doing so.

The difference in performance between UK Index-Linked Gilts (up 2.3%) and conventional UK Gilts (down -2.0%) underlines that it is inflation which is a concern to investors.

The Chart below shows the pick-up in inflation as measured by CPI.



Inflation, as measured by the Consumer Price Index (CPI) has continued to pick up in October with US CPI hitting 6.2% in October and 3.8% in the UK. (RPI up 6.2%) mainly driven by energy prices, particularly Natural Gas which was up 60% in the quarter. We have not seen these levels for well over a decade.

The question remains whether this increase in inflation is transitory, as suggested until recently by all the major central banks, driven by supply chain disruption, or likely to become more entrenched by feeding through to wage expectations plus the added cost of decarbonising the global economy. If the latter is correct then interest rates will need to rise from current levels and central banks, particularly in the US and UK, are starting to recognise this. In the US the rate of bond purchases (QE) will be reduced on a monthly basis with a view to interest rates rising in the first half of next year. In the UK, rate rises could come before the year end. However, markets are getting fixated on the timing of this initial rise whilst, in my opinion, it is more important to look 3-5 years out. If inflation settles around 3-4% then interest rates will need to move towards that level. That will be a substantial move from the current depressed levels of below 0.25%.

Whilst inflation may peak early in 2022, I expect it to fall back more slowly than central bank expectations and to remain above central bank inflation targets of around 2%.

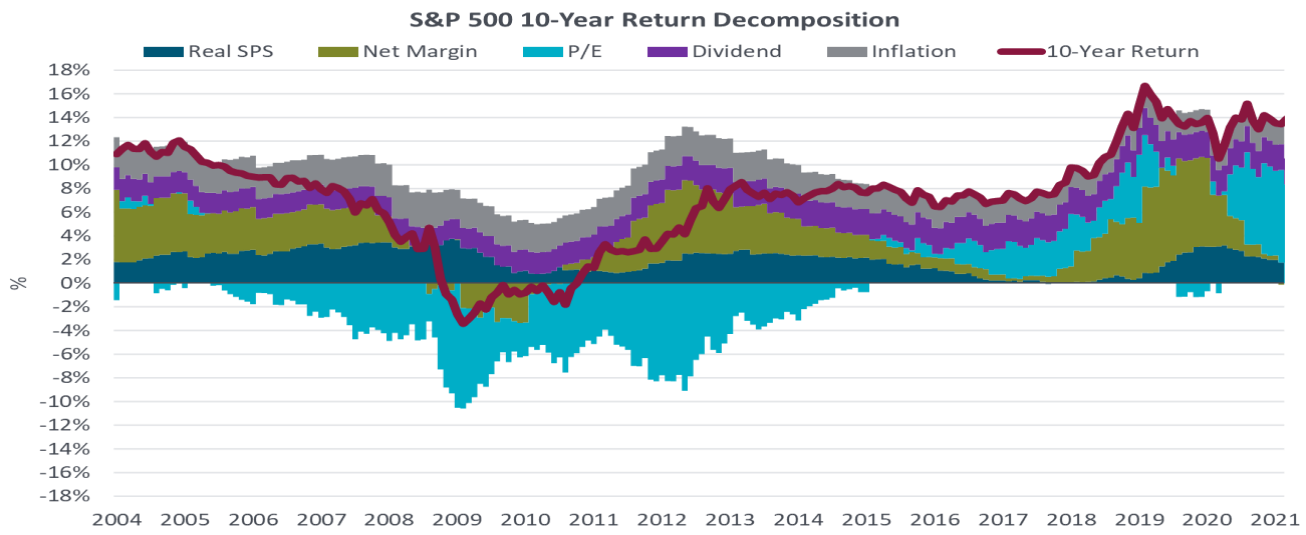
Because some of the rise in inflation will become structural (e.g. the cost of complying with increasing environmental legislation) raising interest rates may have limited effect.

This, combined with high levels of government indebtedness and a fear of derailing the economic recovery, will mean that interest rates are highly likely to rise from here but will remain below inflation for the foreseeable future.

In this environment government bonds for the developed world are forecast to return on average close to 0% p.a. over the next 10 years and Investment Grade Credit 1-2% p.a. which is approximately equal to their yield.

The outlook for equities is more complex. The chart below attempts to attribute equity market performance for the US S&P 500 index between the main factors influencing 10-year equity market returns. It suggests that much of the recent performance has been driven by a rise in the Price/Earning (P/E) multiple, i.e. by increasing valuations. As can be seen from the 15-year history of the chart, valuations do not rise forever and can contract for long periods. During the next few years we may see rising sales per share (SPS in the chart) and rising inflation plus a short term recovery in net margins. However, longer-term, net margins are already near all-time highs as are valuations suggesting these could become negative forces going forward.

It is not inflation itself which is bad for equity markets, it is usually the change in inflationary expectations which undermines the valuation of equity markets. The fact that we seem to be in just such a period at the current time is a cause for concern.



Source: MFS using data from Factset

On the positive side, experience gained during the Covid pandemic in the way businesses work may lead to productivity gains going forward which suggests economic growth could surprise slightly on the upside supporting equity valuations. Indeed, the whole mix of the global economy is becoming far less capital intensive enabling businesses to grow far faster on a lower capital base. Business disruption and innovation will undoubtedly continue providing fertile ground for stock selection by active asset managers to add value.

With returns from Government and Investment Grade Bonds forecast to remain low into the future, these assets are fulfilling only investment two roles; diversification and liquidity. As a Defined Benefit Pension Fund still open to new members, the Fund takes a long-term investment approach and can set its exposure to risk in terms of its cash flow requirement for paying pensions plus a highly liquid buffer which can be converted into cash in case of emergencies rather than the traditional approach of looking for bonds to provide returns whilst adding diversification and short-term protection during equity market downturns. This may lead to a lower allocation to bonds at the next review of the Strategic Benchmark. However, they still act as a liability hedge and will help to add stability to contribution rates as set at each actuarial revaluation.

However, the Fund still needs to diversify away from the risk inherent in equity investment to reduce the potential for volatile returns, this diversification can be found to some extent within Alternative Assets with Private Debt yielding 5% acting as an illiquid substitute for the role previously played by quoted bonds and infrastructure providing the long-term, inflation-linked return. In both cases valuations can be affected by short-term market disruptions but, provided the credit quality of the underlying investment is sound, long-term return forecasts remain attractive.

The risk to this outlook is from markets losing confidence in the central banks' ability to control inflation. In this environment investors stop buying bonds until yields are significantly higher undermining the valuation of equities and there is a correlated fall in both Equities and Bonds. Such a fall would affect the valuation of many Alternative Assets and may impact the global economy undermining corporate returns. In this environment true diversification away from 'market risk' is required. This is not easy to find but it may be worth looking closer at highly regulated sectors with contractual cash flows such as the affordable/social housing sector.

Total Fund Performance

The Fund rose by 0.37% over the first quarter remaining valued at just over £1.4bn. The performance figures appear to exclude the USD cash holding and the Morgan Stanley International Property fund. Including these would increase the valuation to £1.42bn and affect the Total Fund return marginally. This issue will be rectified during the next quarter. The Fund underperformed the Strategic Asset Allocation (SAA) Benchmark by -0.83% over the quarter, this was mainly driven by the underperformance of the Baillie Gifford High Alpha Global Equity portfolio which cost 97 basis points (0.97%) at the Total Fund level, partly offset by a positive performance from the MFS Global Equity portfolio which added 31 basis points (0.31%) at the Total Fund level. The overweight in equities against the Strategic Benchmark was a further marginal positive to performance.

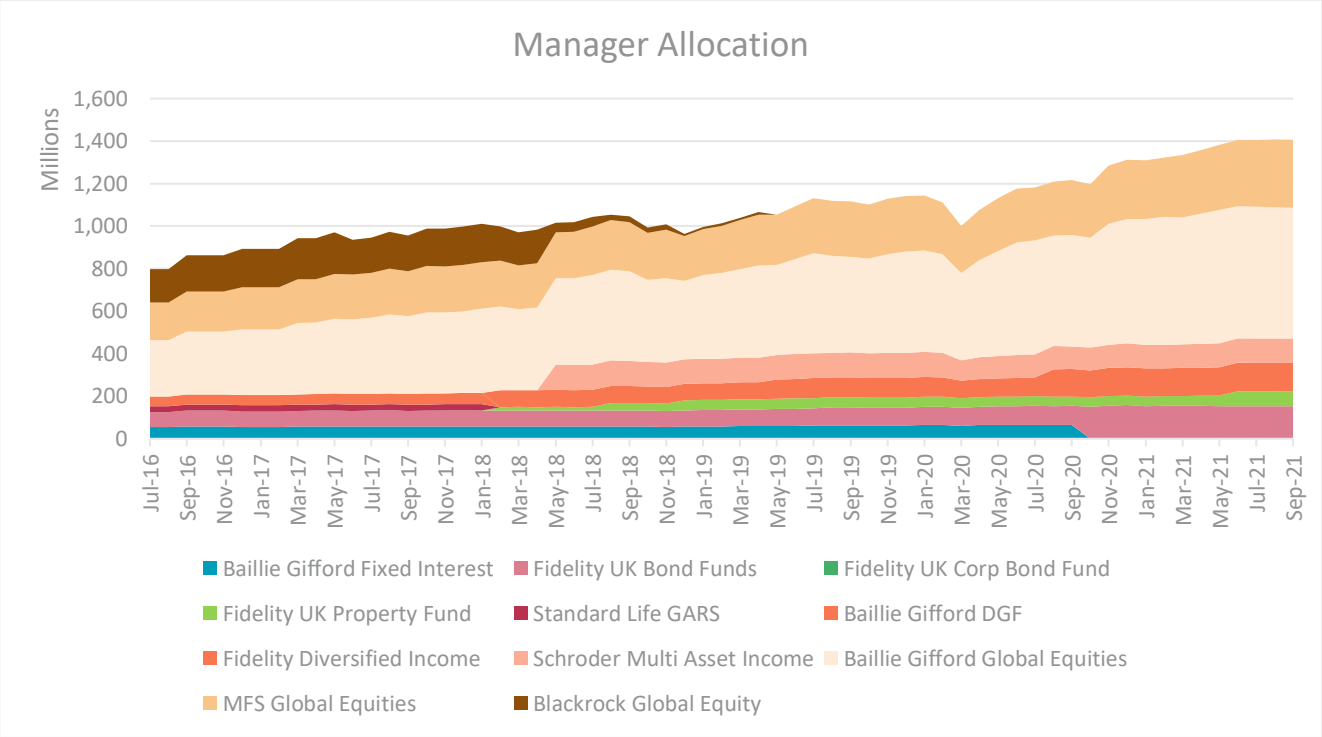
UK Property was the best performing asset over the quarter with the benchmark up a surprising 6.7%. Over 3 years the UK Property benchmark is up 6.6%per annum against a 3.9% return for the Fund's Fixed Interest benchmark which is mainly made up of Sterling Investment Grade Credit.

Asset Allocation

The Fund's tactical asset allocation continues to deviate from the SAA Benchmark as shown in the table below. The Fund did have the first drawdown of $2.6m into the International Property Fund during the quarter with a further $3.4m drawn down post quarter end. During the fourth quarter the Fidelity Fixed Interest mandate will start distributing interest payments back to the Fund. This will increase the cash flow into the Fund by about £2m p.a. rather than this amount being reinvested into the Fixed Interest portfolio..

Asset class	Asset Allocation as at 31/12/2019	Benchmark as at 31/12/2019	Position against the existing benchmark	Asset Allocation as at 30/9/2021	New benchmark going forward	Position against the new benchmark
Equities	64.6%	60%	+4.6%	66.5%	57.5%	+9.0%
Fixed Interest	12.7%	15%	-2.3%	10.8%	12.5%	-1.7%
Property	4.2%	5%	-0.8%	5.1%	5%	+0.1%
Multi-Asset Income	18.5%	20%	-1.5%	17.6%	20%	-2.4%
Int'l Property	n/a	n/a	n/a	0.1%	5%	-5.0%

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 legisaltive issues. In addition, falling yields on UK Government Gilts and rising inflation will also have affected the actuary's calculation of the Fund's pension liabilities. 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 increasing the current valuation of the Fund's liabilities.

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, the Fund is currently commencing the drawdown of cash into the International Property portfolio managed by Morgan Stanley. This is expected to amount to approximately USD20m (£17.4m) per annum for the next four years. Following the decision at the last committee meeting the Fund now holds USD20m as USD cash 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 USD20m 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.

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	£1,035m	135%*	?

*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. The next actuarial revaluation will commence using the figures from 31/3/2022. I would expect the main change to be the assumptions used for inflation which will have to rise from the 2.4% used in the 2-19. This will affect the assumptions used for pension increases and salary increases.

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!)

Environmental, Social and Governance (ESG)

Measuring carbon exposure within the Fund

That greenhouse gas emissions are a major cause of climate change is, I believe, undeniable. There are now an increasing number of stock market indices which focus on only investing in low carbon emitting companies and many passively managed portfolios have been constructed by asset managers to mimic these indices. However, in my opinion, focusing purely on environmental issues when investing is as erroneous as focusing purely on financial issues has been in the past and I would far rather have my investments managed by asset managers who analyse companies in depth by looking at all potential variables including both financial and environmental. The Fund invests purposely through asset managers who adopt a long-term investment philosophy and who place a very strong emphasis on analysing their investments in depth and then buying and holding those investments which fit that investment philosophy for the long-term. The average holding period for a stock in both of the Fund's global equity portfolios is between 5 and 8 years. By investing on this timescale, environmental issues such as climate change have to be considered as part of the investment thesis.

I have held meetings with each of the Fund's asset managers, as have the Chair, Vice Chair and Officers, over the last two years on ESG issues and believe, in each case, that the manager has embedded climate issues into their investment analysis. The investment philosophy used by Baillie Gifford to manage the Fund's High Alpha Global Equity portfolio, focusses on fast growing companies which tend to have a small asset base and concentrate on intellectual capital rather than fixed assets and, therefore, the portfolio has a low exposure to manufacturing and hence carbon emissions. The global equity portfolio managed by MFS, whist having a greater exposure to manufacturing, is again managed to an investment philosophy which is less likely to focus on carbon intensive industries. The Fidelity Fixed Interest and Property portfolios also analyse the environmental impacts of their investments. In each case the resultant portfolio should be expected to produce less carbon emissions than the comparative index. It is slightly harder to show this issue for the Fund's two Multi -Asset Income portfolios because they both invest partly via third party funds where it is harder to collect the data.

In order to illustrate the carbon intensity of the Fund I have asked each manager to provide the CO2 equivalent (CO2e) of six recognised greenhouse gases covered by the Kyoto protocol (CO2, CH4, N2O, HFC's, PFC's and SF6) and to show these as tonnes of CO2 equivalent per £m of turnover aggregated to the portfolio level. This gives a comparable carbon footprint for each portfolio and their respective index where possible.

Portfolio	tCo2e/£m	Benchmark equivalent.	Benchmark
Baillie Gifford Global Equity	140.0	201.0	MSCI All Countries World
MFS global Equity	148.36	184.9	MSCI World (Developed Markets only)
Fidelity Multi-Asset Income	224.69	n/a	
Schroders Multi-Asset Income		n/a	
Fidelity Fixed Interest	93.4	172.1	Composite Fixed Interest benchmark
Fidelity UK Property	?	n/a	

I believe these figures to be comparable, they are expressed as a carbon equivalent per million pounds of turnover at the company level. Where there is a comparable index figure the Fund's assets are managed with a noticeably lower carbon intensity that the index. Because of the multi-asset nature of the Multi-Asset Income portfolios it is not possible to provide a benchmark figure for carbon emissions for these two portfolios. In addition, due to a miss communication on my part, I have not received the figures from Schroders for their portfolio at the time of writing and Fidelity are unable at present to provide this data for the UK Property portfolios but are inserting clauses in all new leases which require tenants to report such figures. Each manager has also noted a small number of companies where they are currently unable analyse this data, this is mainly for emerging market companies and where the portfolio is invested in third party funds.

I will continue to discuss with each manager the best way to report this data going forward and suggest it should be reviewed at least annually with the intention of seeing the Carbon intensity of the Fund's portfolios fall over time. This may be hampered in the short term by filling out the missing data.

COP 26 and action on climate change

A number of new commitments were made during the recent COP26 summit in Glasgow which will affect the global economy and the way the Fund invests going forward. In the main they will create more data which the Committee should expect their asset managers to analyse and report on.

- Deforestation – over 130 counties have pledged to end deforestation by 2030. This is the first time issues outside of carbon emissions have been included within the COP agenda. Investors are likely to scrutinise a company's entire supply chain to ensure action is being taken where necessary. (Note draft EU legislation to ban beef, palm oil, cocoa and other products linked to deforestation from entering the EU under landmark legal proposals that attempt to help prevent the felling of the world's great forests.)
- Methane emissions – more than 100 countries have pledged to reduce methane emissions by 30% by 2030. Unfortunately this did not include China, Russia or India.
- Coal for power usage - Over 20 countries have committed to phase down coal usage for power generation and phase out inefficient fossil fuel subsidies. (The original text used the phrase to phase out coal but was watered down in the final version by China and India.) Whilst the final text did not fully meet expectations it is progress none the less.
- Financing - USD100bn commitment to finance developing countries' ability to adapt to climate change. (Previous pledges on this financing have fallen short.)
- Corporate disclosure – The UK Government plans to mandate the reporting of net zero transition plans by financial institutions in 2023. Financial reporting worldwide is likely to include an increasing element of climate risk disclosure going forward. At COP 26 all parties agreed to progress on carbon emissions accounting and international carbon trading mechanisms and, whilst these fall short of the UK's Taskforce for Climate Related Financial Disclosure (TCFD) requirements, they will increase the focus on these issues within company reports.

All of the above will increase the focus on sustainability within investment and provide a greater detail of data to be analysed. It remains important that the COP agenda is supported by all countries. Any fracturing of this hard won consensus could end in trade disputes as different countries adopt differing rules based on their own circumstance.

Of interest this quarter was the announcement from Rio Tinto, the mining giant, who announced that it planned to spend USD7.5bn to halve its carbon emissions by 2030. Investors response to this announcement was to mark the shares down almost 10% which suggests that the true cost of decarbonising the economy is still not fully understood by investors.

Executive Summary

- The drivers of markets in Q3 included weakening market confidence, due to the Coronavirus Delta variant, supply chain issues, persisting inflation expectations and the concern that GDP growth rates had peaked. Developed market equity performance was modest, while Emerging Markets performed poorly due primarily to Government actions and high corporate debt in China. Growth orientated stocks modestly outperformed Value stocks (+0.84% against -0.67%). Supply shortages led to sharp price increases across the energy commodity markets with natural gas rising 60% in the quarter, whilst metal prices fell. Bond performance was mixed: index-linked gilts performed well on rising inflation expectations, with European and US high yield bonds also positive. Investment grade bonds generally performed weaker, as expectations of rate rises in the US and UK hardened. Credit spreads widened during the first half of the quarter, though much of this was retraced by quarter end.
- GDP growth remained positive in Q3 for developed markets; the US is expected to post +1.5% quarterly growth[1], UK (+1.5%), EU (+3.2%) and Japan (+1.5%). However, growth rates are expected to be lower than in Q2 and forecasts suggest that tight labour markets, supply constraints and the withdrawal of Government stimulus will result in more sluggish growth through 2022.
- **It is worth highlighting the following themes impacting investment markets:**
    - **Tapering and interest rate increases:** The Federal Reserve (US Fed) has announced that it will begin to slow its asset purchases in Q4 2021, with expectations that "tapering" will complete by mid-2022. The most recent US Fed guidance is that interest rates will increase to 1.75% by the end of 2024, with the potential for the first rise in 2022. Other central banks have been indicating similar shifts in policy: the Bank of England (BoE) is expected to end its quantitative easing programme and raise interest rates to 0.75% by end 2022. However, there are some expectations that Chinese monetary and fiscal policy, which has been tightening, could become more supportive of economic growth in Q4, 2021.
    - **Inflation is looking less transitory:** As demand has recovered from mid-pandemic lows and supply chains remain disrupted, shortages of goods and labour continued into Q3. In particular, energy prices have spiked, and, with climate transition pressures increasing, it is possible that supply constraints will continue for some time, increasing price volatility. Market implied 20-year inflation has risen by 0.7% YTD, to 3.9%, while the BoE is forecasting that CPI will reach over 4% by this year end, before declining to 2-3% in 2022. **Investors have become increasingly worried that inflation may last longer than previously thought and there are some outlier concerns of potential stagflation**.
    - **Risk Appetite**: While gently rising rates may prove no more than a mild headwind for risk assets, taking the edge off the forecast economic growth, there is some risk of more rapid rate increases unsettling investors and driving a deeper correction. At the same time, rising inflation and negative real rates limit the attraction of bonds, especially Government bonds. In this environment, **investors may consider taking some risk off the table and increasing allocations to stabler, income producing Alternative Assets (e.g. real estate, private debt, infrastructure).**
    - **Value vs Growth:** Although the valuation gap between Value style and Growth style narrowed somewhat at the beginning of this year, it is widening again and remains very high by historical standards. Growth style equities, which are typically "longer duration" may see their valuations under pressure if interest rates (discount rates) rise, while financial sectors, typically with a more "Value" style signature, usually benefit from steepening yield curves. On the other hand, ongoing disruption of numerous industries, accelerated by the pandemic, is likely to favour new business models, typically found in actively managed "Growth" portfolios. At the same time, the dispersion in valuations between different markets (e.g. US vs UK and Emerging Markets) is also near historic highs. **The relative performance of different equity styles and regions looks as if it may be volatile over the next few years and investors would be well advised to ensure they have an appropriate balance between these styles/geographies**.

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

- Global equities had a mixed Q3, with modest gains across developed markets, excluding the 10bp decline in Europe, while emerging markets suffered. There were underlying concerns around economic growth peaking, but various news stories in China dominated the headlines. There were successive rounds of regulatory crackdown. First, the Chinese Government moved to turn private tutoring companies into non-profit organisations and, this was followed by regulations limiting children's access to online gaming and tighter regulation around technology. Finally, the potential default on the offshore debt of China's second largest property developer Evergrande contributed to market anxiety at the end of the quarter. The VIX index increased substantially by +46.2% over the quarter, from 15.8 to 23.1. Growth continued to outperform Value (+0.84% against -0.67%) albeit marginally.
    - US equities, measured by the S&P 500, posted modest gains over Q3 (+0.6%). Despite the quarter-on-quarter growth, September (-4.65%, total return) was the worst month for US equities since March 2020 (-12.35%), as the market sold off from its previous highs. Fears around financial instability in China, along with the US Fed signalling that they could begin tapering as early as November 2021, dragged on returns.
    - UK equities performed well over Q3, despite continued supply chain disruption and a more hawkish tone from the BoE, with both the FTSE 100 (+1.9%) and FTSE All-share (+2.2%) indices delivering positive returns. Energy producers (accounting for 10.2% of the FTSE 100) have benefitted from the aforementioned increase in energy prices, along with supermarkets where takeover bids for Morrisons have seen the stock appreciated over 50% on pre offer prices and lifting the wider sector.
    - The Euro Stoxx 50 declined by -0.1% over Q3. Energy stocks again performed positively alongside technology stocks, particularly those involved in the semiconductor sector. Conversely consumer discretionary stocks performed negatively. Inflation and supply chain disruption continued to be a headwind to growth.
    - Japanese equities reversed the Q2 underperformance (-1.2%), now outperforming other developed markets in Q3, returning +2.9%. Bucking the wider trend, September was the strongest month in the quarter, despite the sudden resignation of Yoshihide Suga as prime minister on September 3rd; the news had no noticeable negative effect on markets. Optimism over potential future stimulus and economic reopening drove returns.
    - Emerging market equities suffered a -8.0% contraction, measured by the MSCI Emerging Markets Index. China (accounting for 34.0% of the index) suffered heavily due to its government's regulatory crackdown, fears over Evergrande's default and electricity shortages, while rising inflation and subsequent rate increases in some countries (notably Brazil) also weighed on returns. Despite the overall EM losses, brighter spots were seen in the major energy exporting nations, such as Russia, while India also performed well due to a strong vaccine led recovery and increased IPO activity lifting sentiment.
- Bonds had a mixed quarter, with government bond yields across the US and Europe initially declining, before ending the quarter close to flat. Gilts experienced rising yields and so falling prices. Yield increases for Treasuries and Gilts followed a hawkish shift among monetary policymakers later in the quarter as inflationary pressures continued. Corporate investment-grade bonds failed to match last quarter's good performance, whilst corporate high-yield bonds outperformed corporate investment grade bonds in the US and Europe.
    - The 10-year US Treasury yield ended the quarter one basis point higher at 1.49%, with Treasuries as a whole providing a total return of +0.1%. Yields initially fell due to concerns over economic recovery due to the Delta variant and inflation concerns, before returning to original levels as the US Fed struck an increasingly hawkish tone. Jerome Powell (chairman of the US Fed) suggested that tapering of asset purchases could commence as early as the next meeting in November, although markets were more surprised by the indication that tapering could finish as soon as mid-2022, which would subsequently pave the way for rate hikes earlier than expected. The market expectations for rate increases moved up to three hikes of 0.25% from two for 2023, with three additional hikes expected in 2024. US Fed officials were evenly split 9 against 9 on a potential hike in 2022. Additionally, the impending debt-ceiling showdown prompted fears, albeit extremely unlikely, of a default on national debt, with Treasury Secretary Yellen warning that the US will reach its ceiling by the 18th October. A deal between the democrats and republicans now appears to have been agreed, allowing the debt ceiling to be raised until early December.
    - 10-year UK Gilt yields increased from 0.72% to 1.02% over Q3, with Gilts delivering a total return of -1.9%. The yield move occurred towards quarter-end, as the BoE matched the hawkish tone of the US Fed. Inflationary pressures once again surpassed expectations, with August CPI reaching 3.2%. This has contributed to growing concerns that rate rises may be needed before the end of the year, although current BoE guidance suggests no rise until quantitative easing is wound up in early 2022. Index-linked Gilts had another strong quarter given the increased inflation, with the over-5-year and over-15-year index-linked bonds both returning +2.3%.

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

- Commodities performed positively in Q3. Energy prices are increasingly becoming a geopolitical touchpoint, as surging natural gas and coal prices have sent consumer and industrial energy costs soaring. This has led to the bankruptcy of multiple UK energy providers who are squeezed by rising wholesale gas and electricity prices set against a price cap on what they can charge the consumer. Furthermore, coal shortages in China, which accounts for over half of the world's coal consumption, have led to the temporary shutdown of some heavy industry, whilst coal reserves in India were also far below normal levels.
  - Natural gas prices soared (+60.7%) to USD5.9/MMBTU, a +131% YTD appreciation. A cold start to the year and a hot summer increased demand while supply was constrained by maintenance work that had previously been disrupted by the pandemic. This led to reduced summer injection into storage and consequently low inventory. Thematic trends that have seen nations pivot to gas as an alternative to coal for baseload power generation, alongside a faster than expected economic recovery, have exacerbated demand-side price pressures.

  Furthermore, while no entity is contractually obliged to stabilise European spot prices outside of their contractual supply obligations (which are believed to have been met) the International Energy Agency have highlighted that Gazprom have capacity to increase supply, which would help ease shortages.
  - Brent crude oil had another strong quarter (+4.5%), the continuing recovery in the global economy and the strong rebound in jet fuel demand helped further lift oil prices.
  - Copper suffered its first quarterly price decline since Q2 2020 falling by -4.8%, finishing the Q3 at USD4.1/lb.
  - Gold prices suffered a modest decline during Q3 (-0.9%), with prices falling to USD1,755 per troy ounce.

- Global listed property, whilst positive, underperformed previous quarters: the FTSE Global Nareit Index rose 1.0% in Q3. Widespread worries grew regarding the stability of Chinese property developers.
  - Green Street Advisor's US Commercial Property Price Index rose by +9.5% over the quarter. The index is now +9% above pre-COVID levels. In terms of sub-sectors, only malls, offices and lodging remain below pre-COVID levels.
  - The Nationwide UK house price index rose once again across Q3 (+1.7%), though it declined by 0.7% in July. Annual house price growth was +10.0%, down from +13.4% in Q2.

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

Performance report

Asset Class/ Manager	**Global Equities/ Baillie Gifford**
Fund AuM	£615m Segregated Fund; 43.3% 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	

The Baillie Gifford Global High Alpha portfolio returned -0.7% over the quarter against the benchmark return of 1.5%. The portfolio is now behind the index over the last year returning 21.3% against 22.7%. Long-term performance remains very strong with 5-year returns at 5.4% per annum above the benchmark. I have noted previously that this portfolio is less likely to add significant value during a period of rising interest rates and, as such, I would expect the exceptional performance of

the last 5 years to fade slightly but I remain impressed by how Baillie Gifford approach investment and would expect this portfolio to continue to add value over the longer-term.

Asset Class/ Manager	**Global Equities/MFS**
Fund AuM	£321m Segregated Fund; 22.6% of the Fund
Benchmark/ Target	MSCI World Index (Developed Markets)
Adviser opinion	meeting long-term performance targets, underperforming short-term
Last meeting with manager	Phone call during the quarter: Elaine Alston/John Arthur
Fees	

The MFS Global Equity portfolio outperformed in the first quarter by 1.3% returning 2.7% against the benchmark return of 1.4%. 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 which should give some protection in a more inflationary environment. The MFS portfolio acts as a useful counterweight to the Baillie Gifford Global Equity portfolio which helps reduce the level of risk taken by the Fund and hence overall volatility.

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	3Q21 performance	Duration	Yield
UK Agg Bond	-0.5%	10.0 years	1.7%
UK Corp Bond	-1.1%	7.7 years	1.8%

Asset Class/Manager	**UK Aggregate Bond Fund and UK Corporate Bond Fund/ Fidelity**
Fund AuM	£152m pooled fund; 10.7% 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	

10-year UK Government Gilts fell over the quarter (yields rose) in response to persistent concerns over inflation both in the UK and globally. At its September meeting the BoE indicated that it was considering rising interest rates but then failed to act in the November meeting. The comments have, however, led to markets discounting an earlier rise in interest rates than previously. The manager remains cautious on credit and marginally short on duration recognising the persistent inflationary dynamics being offset by a reduced pace of economic growth. I continue to expect these two portfolios to add little in terms of returns over the longer-term but they are the Fund's most liquid and are therefore important as a source of available cash in extremis.

Asset Class/Manager	Mult-Asset Income / Fidelity
Fund AuM	£134m Pooled Fund; 9.4% 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	By phone during the quarter John Arthur/Paul Harris
Fees	

Asset Class/Manager	Multi-Asset Income / Schroders
Fund AuM	£113m Pooled Fund; 8.0% 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	

With limited price movements in all asset classes over the quarter, the two Multi-Asset Income portfolios produced minimal returns with the Fidelity portfolio up 0.3% and the Schroders portfolio flat over the period. Both portfolios moved slightly more defensive over the period but continue to target a 4% yield and remain well diversified.

Asset Class/Manager	UK Commercial Property / Fidelity
Fund AuM	£72m Pooled Fund; 5.1% 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	

For the second quarter in succession the UK Commercial Property market returned over 6% in the period. The portfolio lagged this rapid rise in the benchmark returning 3.9% against a 6.7% return for the benchmark. Longer term the portfolio has underperformed it's benchmark returning 4.5% per annum since inception in 3/18 against a 6.1% return for the benchmark. This is partly due to the costs involved in buying and selling properties in the UK (Stamp duty etc) but also because the portfolio is currently only part way through refurbishing a number of large holdings at present which has depressed rental levels. These buildings are now being re-let or nearing completion of the refurbishment and should add to value to the portfolio over the next few quarters. Fidelity continue to collect over 90% of rental income due from tenants despite the effects of the Covid pandemic and expect to recover all unpaid rents going forward.

Asset Class/Manager	International Property / Morgan Stanley
Fund AuM	US$80m(£57.5M) committed / USD2.4m drawn. 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 second quarter (£2.4m) with a further drawdown of USD3.4m due on the first of December. Following the last committee meeting a USD20m dollar cash fund has been put in place to cover part of the potential future drawdowns and reduce the currency risk. The fund has invested in a number of properties in both the logistics and residential markets in the US, UK, Japan and India. At present, performance will be negative as the manager incurs costs in analysing and buying properties but has done little to increase each individual property's value. This situation may well continue for much of the next 12 months.

The Fund has committed USD80m (£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.