MJ HUDSON

London Borough of Bromley

Quarterly Report

Q4 2021

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Performance Summary

With global equities, as measured by the MSCI world Index, returning 7.9% in local currencies over the fourth quarter and UK Investment Grade bonds returning 0.6%, it has been a positive quarter for the Fund. However, whilst the benchmark rose 4.73%, the Fund only rose 1.87% to £1.43bn , underperforming by 2.86%. The reason for this underperformance was a downturn in the Ballie Gifford portfolio which fell by -0.08% against a rise in its benchmark of 6.29% in Sterling terms in the fourth quarter. The Baillie Gifford portfolio has now underperformed its benchmark by 11.35% over the last year but has still out-performed by 4.54% per annum over the last 3 years and by 4.42% per annum over 5 years as well as out-performing its benchmark by more than 1% per annum since inception in 1999. This remains an exceptional performance over the long-term and can only be achieved by taking investment risk.

Baillie Gifford invests in high growth companies, looking for businesses which can more than double sales over a 5-year period. The fourth quarter has seen a continuation of the repricing of a large swathe of high growth stocks. In theory, the current price of a share equals the current value of all future dividend flows. This current value changes as assumptions about the individual companies growth, profitability or cash flows change altering the expected dividend outlook but, it also changes for all companies if we change the rate at which those future dividends are discounted back to today's value. Given the repricing of interest rate expectations which has occurred with increasing pace through the fourth quarter of 2021 and into 2022, it is this increase in the discount rate that investors are applying to the future which is leading growth stocks to fall. Growth stocks have more of their valuation in the future, value stocks have a more mature and stable business where much of the value is in cash flows over the near term. This rotation has been compounded by a majority of investors being influenced by short-term momentum.

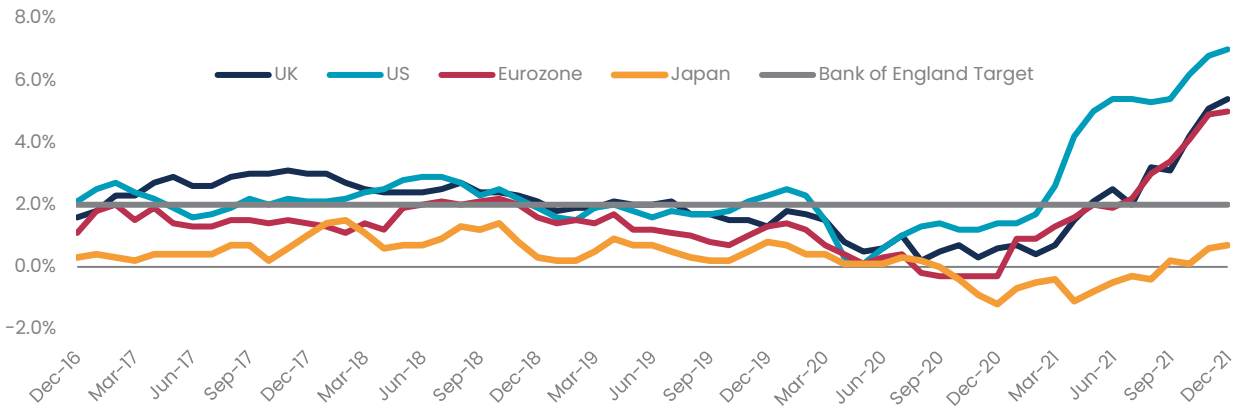
The Fund has divested £75m from the Baillie Gifford global equity portfolio since September 2020, taking advantage of the exceptionally strong performance. The current period of underperformance is not outside of the risk profile of this portfolio and I continue to have confidence in the manager adding value over the longer term.

Inflation

Looking forward, the concern remains about inflation. The Consumer Price Index (CPI) has continued to pick up globally through the year end with US CPI hitting 7.0% in December and 5.4% in the UK (RPI up 7.5%). This rise in inflation was initially driven by energy prices and supply disruptions but has now broadened to include food and housing costs. We have not seen these levels of inflation for well over thirty years.

Central banks now accept that the increase in inflation is not as transitory as they hoped and have started to move from Quantitative Easing (QE) to Quantitative Tightening (QT) and raising interest rates, QT is where a central bank's holding of bonds are sold back into the market increasing supply and potentially pushing bond yields higher.

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



With CPI inflation above wage inflation in many countries, consumers are going to feel a squeeze on their ability to spend, the Bank of England (BoE) is now forecasting the weakest growth in post-tax incomes in the UK for more than 70 years with a fall of 2% this year and 0.5% in 2023,which will be felt most by those on lower incomes. This squeeze on incomes will slow consumer spending and the economy just as central banks are raising interest rates. The combination of slowing spending and rising rates increases the possibility of a policy mistake from central banks if they tighten too aggressively in the face of high inflation, pushing the economy into a recession.

At the current time, economists are forecasting inflation to peak in the first half of 2022 and for a rapid slowdown in growth in 2023. Current BoE forecasts are for UK inflation (CPI) to peak at 7.25% in April (!) with growth slowing from 7.5% in 2020 to an estimate of 1.25% in 2023 and 1% in 2024. This scenario is mimicked in the US and EU to varying degrees. In this environment of subdued growth, companies with fast growing sales will once again be at a premium and growth stocks may again look attractive to investors. This is part of the reason why I believe the Fund should continue to support Baillie Gifford as one of their global equities manager.

The question is: what is the right level of interest rates once the recovery for Covid has been established? I am concerned that some of the factors pushing inflation higher are not transitory (climate change, decarbonising the global economy, changing supply chains) and, as such, raising interest rates may not squeeze inflation out of the system as easily as in the past.

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% over the medium term.

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 on bringing it under control.

This, combined with high levels of government indebtedness and a fear of derailing the economic recovery, will mean that governments are prepared to see inflation settle higher that the 2% targets of the past and interest rates are highly likely to rise from here but may remain below inflation for the foreseeable future.

Asset Allocation

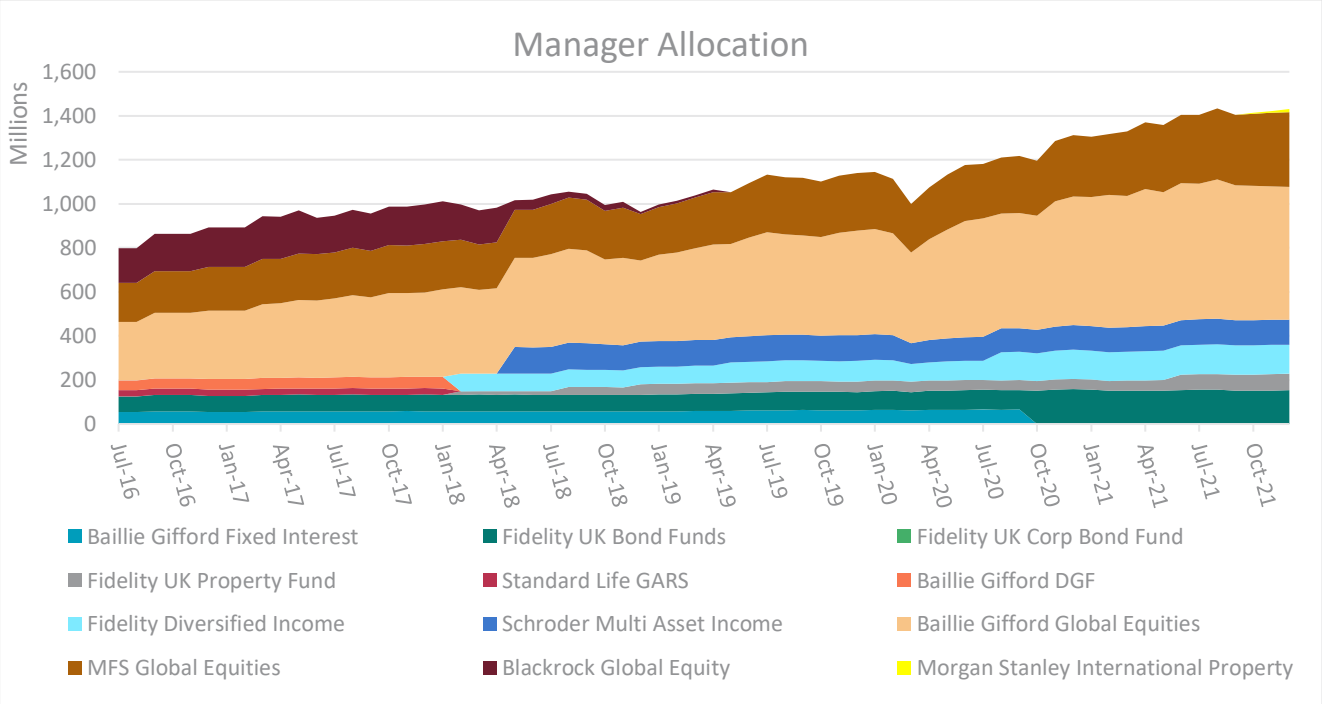
The Fund's tactical asset allocation continues to deviate from the Strategic Asset Allocation (SAA) Benchmark, being overweight equities, as shown in the table below. The Fund has commenced drawdown into the International Property Fund during the quarter and has allocated money to US$ cash to cover the next 9 months of drawdowns. 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 31/12/2021	New benchmark going forward	Position against the new benchmark
Equities	64.6%	60%	+4.6%	65.8%	57.5%	+8.3%
Fixed Interest	12.7%	15%	-2.3%	10.7%	12.5%	-1.8%
Property	4.2%	5%	-0.8%	5.3%	5%	+0.3%
Multi-Asset Income	18.5%	20%	-1.5%	17.2%	20%	-2.8%
Int'l Property +US$	n/a	n/a	n/a	1.0%	5%	-4.0%

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.

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



Cash Flow

Your officers have recently updated their cashflow forecasts for the Fund. These show that the Fund is forecast to have received £34m in contributions but to have paid out £41m in benefits in 2020/1. This shortfall in cashflow, as well as administrative and investment manager costs, is covered by income received from the Fund's investments. Income is

currently taken from the two Multi-Asset Income portfolios, the UK Property portfolio and now the Fixed Interest portfolio. Income from the two Global Equity portfolios continues to be reinvested by their investment managers.

Medium Term, the cashflow shortfall (benefits paid less contributions received) is forecast to increase but not exceed the amount of income generated by the portfolio until later this decade.

The Fund currently holds a small element of £ cash as well as the allocation to US$ cash awaiting drawdown into the International Property portfolio. This and cash currently taken from the investment portfolio should cover the next 9 -12 months of drawdowns into the International Property portfolio.

Funding level

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	£1,431m	£1,045m	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 125% 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 2019 revaluation. This will affect the assumptions used for pension increases and salary increases.

Environmental, Social and Governance (ESG)

During the quarter the Chair, Finance Director and I again held meetings with four of the Fund's investment managers to delve further into their Environmental, Social and Governance approach and how this impacts the investments they hold for the fund. (A meeting with Baillie Gifford was held in Q4 2021). We were pleased with the information obtained and continue to believe that the underlying managers understand our expectation that ESG and climate change issues are an integral part of their analysis while still focusing on delivering investment performance. Because the Fund is a long-term investor and appoints managers, who invest over the long-term (as noted by 5-8 year average holding periods and low turnover of investments within the equity portfolios in particular) integrating climate change and ESG factors into the analysis of all investments should improve the long term performance of the Fund.

Taskforce for Climate Related Financial Disclosure

The Financial Stability Board established the TCFD to develop recommendations for more effective climate-related disclosures that could promote more informed investment, credit and insurance underwriting decisions and, in turn, enable stakeholders to understand better the concentrations of carbon-related assets in the financial sector and the financial system's exposures to climate-related risks. The required reporting disclosure has four core elements:

- Governance: The organization's governance around climate-related risks and opportunities.
- Strategy: The actual and potential impacts of climate-related risks and opportunities on the organization's businesses, strategy and financial planning.

- Risk Management: The processes used by the organization to identify, assess and manage climate-related risks.
- Metrics and Targets: The metrics and targets used to assess and manage relevant climate-related risks and opportunities.

Each of these sections will require the Committee to think through its current approach to climate change, how this will evolve into the future and what metrics and targets it will monitor to hold itself to account. In essence, it will need to describe and quantify its existing practice and understanding and think through how this might change into the future. There will be a requirement for analysis on two climate change scenarios – one aligned with the Paris climate change agreement and one "at your choice"; there will also be a requirement to choose three metrics, including absolute carbon emissions and carbon intensity and set a target based on one of these metrics for the future.

TCFD reporting has already commenced for large, private sector pension schemes with the LGPS sector expected to follow using 2022/3 data.

Examples of TCFD reporting

The link below is to the Derbyshire LGPS Fund's TCFD report (25 pages).https://www.derbyshirepensionfund.org.uk/site-elements/documents/pdf/derbyshire-pension-fund-climate-related-disclosures-report-march-2020.pdf

Asset managers are also required to produce TCFD reports and the link below is for the 2020 report produced by Fidelity (54pages).https://eumultisiteprod-live-b03cec4375574452b61bdc4e94e331e7-16cd684.s3-eu-west-1.amazonaws.com/filer_public/5f/ea/5fea757c-f1dc-4ba7-a6e0-e6378e17c7f4/fidelity_tcfd_report_2020_v15.pdf

Carbon Emissions 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 sales (tCO2e/£m) aggregated to the portfolio level. This gives a comparable carbon footprint for each portfolio and their respective index where possible. These figures relate to scope 1 & 2 emissions only.

Portfolio	tCo2e/£m	Benchmark equivalent.	Benchmark
Baillie Gifford Global Equity	62.0	196.7	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	186.8	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 sales at the company level. Where there is a comparable index figure the Fund's assets are managed with a noticeably lower carbon intensity than 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, 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 to provide this data, this is mainly for emerging market companies and where the portfolio is invested in third party funds. We, and the industry, continue to push for greater disclosure.

I will continue to discuss with each manager the best way to report this data going forward and suggest it should be reviewed 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. Personally, I regard carbon reporting as similar to performance reporting for the Fund, the quarterly data is just a point in time and of itself is of limited use, what is more important is the direction of travel and level of volatility within the figures, each of which can lead to further discussion.

Carbon reporting is still developing and for many of the metrics relies on reporting three scopes of emissions:

- Scope 1 covers direct emissions from owned or controlled sources.
- Scope 2 covers indirect emissions from the generation of purchased electricity, steam, heating and cooling consumed by the reporting company.
- Scope 3 includes all other indirect emissions that occur in a company's value chain.

Whilst progress is being made by companies to quantify all three of these scopes, it is the last, covering the whole of the value chain, which is by far the most complex. The majority of carbon reporting available at present covers only scope 1 & 2 emissions.

Executive Summary

- Markets continued their positive trend in Q4, despite surging inflation and the resurgence of Covid as the Omicron variant pushed daily infections to new hights in December as investors were reassured that central banks would increase interest rates to contain the inflationary uptick. Corporate earnings continued to beat expectations in Q4 and the growing evidence that the likely impact from Omicron would be less than initially feared, helped provide tailwinds in most equity markers through December. Developed market equities were generally strong with the S&P reaching fresh all-time highs and only Japanese equities retreating, as concerns for Chinese growth continued. Emerging Markets suffered over the quarter caught between a strengthening US Dollar and weak Chinese equities, following the summers' technology crackdown and ongoing concerns over the level of property debt and the potential for further covid related lockdowns. 'Growth' orientated stocks modestly outperformed 'Value' stocks (+8.1% against +6.7%). Bond performance was mixed: index-linked gilts returned 5.4% on the continued concern over rising inflation, while returns on shorter dated credit were more muted (US high yield bonds slightly up, European high yield bonds slightly down) as investors priced in a faster pace of rate hikes. Energy commodities lagged, in contrast to metals.
- GDP growth remained positive in Q4 for developed markets; the US is expected to post +1.5% quarterly growth[1], the UK +1%, the Eurozone +0.7% and Japan +1.5%. With the reopening upswing now behind us and inflation continuing to run far above target all eyes will be on the effectiveness of central bank policy to bring inflation back in line with its target without causing a recession. This has led the World Bank to expect global GDP growth to slow from 5.5% in 2021 to 4.1% in 2022.
- Although year-on-year S&P500 corporate earnings for Q4 are expected to grow by 21.7%, this is the first quarter that more companies are issuing negative guidance than positive since Q2 2020. Energy is the sector with the greatest increase in estimated earnings, whilst consumer discretionary and industrials have the largest decreases in estimated earnings.
- **Omicron:** The discovery of this variant initially caused widespread market selloffs, particularly in the travel, leisure and hospitality sectors, and a risk-off attitude in markets. Following the implementation of new travel restrictions and partial lockdowns across the globe, renewed vaccine booster campaigns and further information on the variant, markets reassessed the likely impact of the variant. A broad-market recovery followed in December, with risk appetite increasing. China's continuing zero Covid policy has meant renewed lockdowns, potentially further impacting the domestic economy and global supply chains which suggests that inflation will continue to be a problem.
- **It is worth highlighting the following themes, impacting investment markets:**
    - **Time to retire the word "transitory"; inflation is likely to be sustained over the next two to three years:** As inflation has continued to surge globally, central banks have moved away from their previous position that the price rises are transitory. In the US, December CPI hit a multi decade high of 7.0% while the UK and Eurozone reported 4.6% and 4.9%, respectively, for November. Critically, core inflation (excluding food/energy) in December hit 5.5% in the US and is expected to hit 4.0% in UK, indicating more widespread/persistent effects. While most economists expect inflation to return to modest levels (2-3%) over the next couple of years, there is increased risk that central banks may have difficulty bringing inflation in line with their target without causing economic harm.

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

- **Monetary policy is tightening and interest rates increasing, but rates are still negative in real terms:** The Federal Reserve indicated at the end of the year, that it would start to unwind the US$120 billion monthly asset purchase programme, which is likely to have ceased entirely by mid-2022, while the market is now discounting up to 5 x 0.25% interest rate increases in 2022. Equally, the BoE voted to increase the base rate to 0.5% from 0.1% in two steps, becoming the first major central bank to raise its benchmark interest rate. UK 10-year Gilt yields declined from 1.04% to 0.97% over the quarter suggesting a belief that rising interest rates would successfully subdue inflation in the medium-term. In contrast, the ECB is likely to continue with expansionary monetary policy, despite surging inflation.
- **Increased volatility expected:** Given the increased risk of policy errors/overshoots as central banks tackle inflation; the volatility due to an inflection point in the interest rate cycle and uncertainty as to the impact of Omicron, particularly on China with its zero Covid policy, there is likely to be volatility in markets. As this comes on top of extended valuations, investors should ensure their portfolios are well diversified.

- Global equities had a mixed Q4, there was strong performance across most of the developed markets, while Japan and Emerging markets suffered declines. Over the quarter, renewed COVID fears due to the Omicron variant and increased restrictions, along with a shift to hawkish central bank policy to combat surging inflation dominated the headlines. However, markets rebounded in December, as markets reassessed the level of severity of the Omicron variant, with the MSCI World Index finishing the quarter at its highest end of year close. The VIX decreased by -25.6% in Q4, from 23.1 to 17.2. Growth continued to outperform Value (+8.1% against +6.7%).
  - US equities, measured by the S&P 500, posted strong gains over Q4 with the S&P 500 rising +11.0% and the tech heavy NASDAQ rising +11.3%. Despite the many headwinds, including lingering supply chain disruption, surging inflation and a move to more hawkish monetary policy, the US was the best performing region over the quarter. US companies continued to beat analysts' expectations and Biden signed the long-awaited infrastructure bill, whilst the Federal Reserve acted in line with market expectations in announcing QE tapering. This propelled markets in October and early November. However, markets were hit by a more hawkish stance from the Federal Reserve along with fears of the Omicron variant. Markets ended Q4 strong, despite surging infection rates, with the US implementing limited new Covid restrictions and markets reassessed the likely economic impact of the new variant. The S&P 500 ended year at an all-time high. The technology and real estate sectors were the best performing, while energy and financials lagged.
  - UK equities performed well over Q4, with both the FTSE 100 (+4.7%) and FTSE All-share (+4.2%) indices delivering positive returns. While there was strong performance through October concerns around Omicron caused a broad market selloff, particularly in the energy, travel and leisure sectors. However, these fears had largely abated over December with bright spots amongst banks and internationally diversified consumer staples groups. On-going supply chain disruptions have continued to cause pain for the retail sector, despite robust consumer demand backed by falling unemployment.
  - The Euro Stoxx 50 increased by +6.5% over Q4. Much like the US, performance was supported by strong corporate earnings, outweighing the impact on travel and hospitality of renewed Covid restrictions imposed by some nations. The communication and real estate sectors lagged the index while utilities and IT were some of the strongest performers.
  - Japanese equities underperformed other developed markets in Q4, declining -2.1%. Despite the Liberal Democratic Party's election success in retaining a majority and the subsequent passing of a US$490 billion stimulus package, including direct handouts, December's gains were not enough to offset losses in October and November.
  - Emerging market equities were negative over the quarter (-1.4%), and the only market we track to suffer a decline over 2021, equal to -2.5%. Turkish equities, as measured by the Borsa Istanbul 100, suffered heavily, due to inflation hitting a 19 year high of 36% and increasingly dovish monetary policy; an approach President Erdogan is belligerently sticking to. Chinese equities continued to perform poorly, both those listed within mainland China and those listed on foreign exchanges; technology related stocks were particularly disappointing, especially when compared to their western counterparts. Furthermore, ongoing concern around the Chinese property market and the effects of a potential slowdown on the broader economy were another worry. Despite the overall EM losses, Egypt, UAE and Peru all had a positive quarter. Taiwan benefited from its IT and semiconductor sector despite escalating tensions with China.

- Bonds had a mixed quarter as markets reacted to the impacts of the Omicron variant, rising inflation and tightening monetary policy. At the short end, yields moved higher in the US and the UK as investors priced in a faster pace of rate hikes despite the Omicron variant, whilst for longer dated bonds, a belief that central banks would overcome the inflationary spike lead to Government bond yields declining in Europe and the UK, but not in the US. Corporate investment-grade bonds performed broadly in line with government bonds over the quarter, while US high-yield corporate bonds were positive.
    - The 10-year US Treasury yield ended the quarter two basis points higher at 1.51%, with Treasuries as a whole providing a total return of +0.2%. Earlier in the quarter, the yield reached 1.7% as the US Fed turned increasingly hawkish amidst persisting inflation and a tightening labour market. US CPI jumped to 6.8% in November, the highest reading in 39 years. In response, the US Fed announced plans to accelerate the tapering of asset purchases from US$15 billion to US$30 billion per month, starting in January. However, the Committee voted to maintain the federal fund's target interest rate at the current level. Yields fell to a low of 1.34% in early December over Omicron fears, before recovering as emerging data from the UK and South Africa indicated a lower risk of severe infection. The impact of tightening policy and a weaker future growth backdrop led to a flattening of the US yield curve, with shorter-dated bond yields increasing significantly.
    - The 10-year Gilt yield declined from 1.04% to 0.97%, with Gilts delivering a total return of 2.6%. Yields dropped sharply in November when the Bank of England opted not to raise rates, against market expectations. Yields recovered in December however, as fears over Omicron faded and the BoE raised rates by 0.15% to 0.25%. Index-linked Gilts had another strong quarter following a further rise in inflation to 5.1%, with the over-5 year and over-15-year index-linked bonds returning +5.4% and +6.2% respectively. A record 1.2 million job vacancies reported in Q4 suggest price and wage increases have the potential to be sustained.
    - European government bonds provided a total return of -0.5%. The European Central Bank reaffirmed their dovish stance, despite Eurozone inflation reaching the highest level in 30 years. In stark contrast to the US and UK, the ECB have provisionally boosted their monthly bond purchases, aiming to create a more cushioned exit from its pandemic stimulus.
    - US high yield bonds continued their strong performance, returning +0.7%, despite a flat performance for European high yield. UK investment-grade bonds returned +0.6% over Q4, performance was flat in Europe and positive in the US (+0.2%).
- Energy commodities generally performed negatively in Q4, despite soaring prices over the course of 2021. In contrast, precious and industrial metals performed stronger.
    - US Natural gas prices declined substantially in Q4 (-36.4%) to US$3.7/MMBTU, reducing the year to date increase to +46.9%, from +131% in Q3. Weather forecasts predicted a relatively mild winter, reducing expectations of gas demand in the US. Conversely, European gas prices reached an all-time high on the 21st December due to artificial supply-constraints from Russia; this was alleviated by the arrival of Liquid Natural Gas (LNG) tankers from the US at the end of the Q4.
    - Brent crude oil also fell this quarter (-0.9%) but YTD appreciation remained significant at 50.2%. There was a sharp decline in response to the Omicron variant in late-November. This coincided with the US government's decision to release 50 million barrels of crude oil from the Strategic Petroleum Reserve (8% of the total reserve), in co-ordination with a number of other governments, putting downward-pressure on prices. As the Omicron variant has been linked with fewer hospitalisations than the Delta variant, concerns about declining aggregate demand subsided. However, the increase in oil output from OPEC+ in December undershot the targets initially agreed, owing to capacity constraints. This led to a full recovery in the oil prices through December.
    - Gold prices rose 4.2% in Q4, ameliorating a moderately poor performance for 2021 overall (prices rose +3.5% in 2021).
    - Copper also rose in Q4, by 9.2%, with appreciation of 26.8% overall for 2021. Industrial metals generally performed well.
- Global listed property, performed strongly: the FTSE EPRA Nareit index rose +8.7% in Q4.
    - Green Street Advisor's US Commercial Property Price Index rose by +5.7% over the quarter. This represents a 24% increase for 2021 with strong performance across the board and a 14.4% increase from pre Covid levels.
    - The Nationwide UK house price index rose once again across Q4 (+2.6%). Annual house price growth was +10.4% in December, up from +10.0% in September, which made 2021 the best performing year since 2006.

- In the fourth quarter, Sterling strengthened against the Dollar (+0.5%) and the Euro (+2.2%), as the BoE adopted an increasingly hawkish stance, especially when compared to the ECB. The Dollar had another solid quarter (Dollar Index Spot rose +1.5%), boosted by the US Fed's acceleration of tapering which will pave the way for more imminent rate hikes. The Euro weakened notably against the Dollar in Q4 (-1.7%), with the ECB's monetary stance continuing to lag the US Fed's.

Performance report

Asset Class/ Manager	**Global Equities/ Baillie Gifford**
Fund AuM	£602m Segregated Fund; 42.1% 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	John Arthur/John Carnegie by phone
Fees	

The Baillie Gifford Global High Alpha portfolio returned -0.08% over the quarter against the benchmark return of 6.29%. The portfolio is now behind the index over the last year returning 8.78% against 20.13% for the benchmark. Long-term performance remains very strong with both 3-year and 5-year returns over 4% per annum above the benchmark. The table below gives the recent calendar year returns for both the portfolio and the benchmark. As can be seen in the table, performance has varied markedly from the benchmark over the last 5 years and this is because Baillie Gifford have a very strong investment philosophy and process which leads them to build a portfolio which differs markedly from the benchmark index.

	2017	2018	2019	2020	2021
BG Global Alpha	23.3%	-3.7%	28.4%	33.1%	8.9%
MSCI All Country World	13.8%	-3.3%	22.4%	13.2%	20.1%
Relative performance	+9.5%	-0.4%	+6.0%	+19.9%	-11.2%

Of the 2021 underperformance, about half relates to holdings in China where a Government regulatory crackdown has undermined the business case for a number of previously fast growing industries. Baillie Gifford do not see this crackdown as a u-turn by President Xi but more a commitment to greater prosperity for all rather than the privileged few. New antitrust regulations have been bought in to stop technology companies from blocking competition on their various platforms and to improve data protection and privacy laws. Private education was reformed with a ban on profit making enterprises teaching core school subjects; gambling laws were reformed and screen time for children limited. Many of these reforms are mimicking some of the dialogue we are having in the west about the power of large tech and the personal data they collect, the main difference with China is that, because it is a centrally controlled state, change can be introduced much more rapidly. Baillie Gifford were undoubtedly caught out by the speed of regulatory change in China but they have not panicked and believe these changes may well improve the business outlook for the longer term for a number of the companies they own.

About a quarter of the underperformance has been driven by disappointing developments in a number of holdings where market forecasts were too optimistic and companies misfired coming out of the pandemic or were caught out by supply issues. Where a highly valued growth stock disappoints against its revenue or profit forecasts the share price can fall rapidly. An example, held in this portfolio would be Peleton, the fitness operator where the share price halved in the last 6 months

following disappointing subscriber figures post a pandemic induced boost in 2020. Baillie Gifford have seen a number of their holdings hit such issues in the past before recovering. Tesla fell 80% after they invested into the company but has been one of the largest contributors to their outperformance over the last 5 years despite this. With these companies, Baillie Gifford will take time to reappraise the changes in business dynamics before deciding on whether to take any action.

The last part of the underperformance has come from the market repricing growth stocks in general even where the underlying businesses are hitting all their targets and forecast. For these stocks Baillie Gifford are likely to add to existing holdings where they have the scope to do that.

With a number of their portfolio holdings declining Baillie Gifford note the following:

'The current environment is unusual in that declines of this magnitude are usually triggered by companies experiencing operational challenges or a significant deterioration in the macroeconomic backdrop. However, over recent weeks, both in our conversations with company management teams and the earnings announcements which have been released by portfolio holdings, in the vast majority of cases there appears to be excellent operational momentum. With one or two exceptions, which you would always expect in a one hundred stock portfolio, the companies are continuing to grow strongly. Looking across the top 20, 15 of these businesses are seeing accelerating 12-month sales growth, versus their 5-year average growth rates (i.e. no evidence of a post-pandemic slowdown). The market is applying a higher discount rate against future cash flows, which is particularly impacting early stage growth companies, which have a greater proportion of their value further out into the future. While periods such as this are certainly uncomfortable in the short-term, the fact that the average investor's time horizon is shrinking in this way plays to our advantage as long-term, patient investors.'

With economic growth expected to slow markedly from current rates, it is understandable for investors to be pricing in lower growth expectation, but it may be that the style of investments made in the Baillie Gifford portfolio, of high growth, industry disrupting businesses, may be more defendable that the market currently believes.

Asset Class/ Manager	**Global Equities/MFS**
Fund AuM	£340m Segregated Fund; 23.8% 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 matched the benchmark in the fourth quarter, returning 6.1% against 6.2% for the benchmark. The portfolio has underperformed over the last 5 years but has outperformed since inception 9 years ago.

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 Manager believes that the companies they own have the ability to gain sustainable competitive advantage and have relatively strong pricing power. They should be able to withstand the impact of rising input costs better than many peers. The portfolio has limited exposure to rising interest rates as it is underweight bond proxy sectors (real estate and utilities) and notably underweight technology stocks where high valuations can come under pressure in a rising interest rate environment. It is for these reasons that when MFS presented at the last Committee meeting I noted my expectation for improved performance from this portfolio over the next few years when the Baillie Gifford portfolio may find the current investment environment more taxing.

Asset Class/Manager	**UK Aggregate Bond Fund and UK Corporate Bond Fund/ Fidelity**
Fund AuM	£153m pooled fund; 10.7% of the Fund
Performance target	25% Sterling Gilts; 25% Sterling Non-Gilts; 50% UK Corporate Bonds +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	

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. These two portfolios are combined for reporting.

Portfolio	4Q21 performance	Duration	Yield
UK Agg Bond	1.5%	10.2 years	1.7%
UK Corp Bond	0.3%	7.9 years	2.1%

Over 5 years the both the UK Aggregate Bond portfolio and the UK Corporate Bond portfolio have outperformed their respective benchmarks by 1.2% per annum both returning 4.1% per annum.

The fourth quarter of 2021 finally saw central banks globally admit that the current rise in inflation was not transitory and that they would need to raise interest rates to slow demand. The roll off of various employment protection schemes along the lines of the UK's furlough scheme is not resulting in rising unemployment, quite the opposite, as job vacancies remain unfilled and unemployment is falling.

Rising interest rate expectations led to the front end of the yield curve seeing the largest falls as markets realised that interest rates were going to rise in the short term. This lead to a fall in short duration bonds and a widening of interest rate spreads between Gilts and corporate bonds. Because these interest rate rises, combined with high inflation eroding consumer spending, markets expect the economy to slow markedly over the next two years and, as such, have less concern over longer term inflation and so there was less pressure on longer term bond yields..

Asset Class/Manager	Mult-Asset Income / Fidelity
Fund AuM	£132m Pooled Fund; 9.2% of the Fund
Performance target	LIBOR +4% including a yield of 4% per annum
Adviser opinion	
Last meeting with manager	By phone during the quarter John Arthur/Paul Harris
Fees	

Asset Class/Manager	Multi-Asset Income / Schroders
Fund AuM	£114m Pooled Fund; 8.0% of the Fund
Performance target	LIBOR +5% including a yield of 4% per annum
Adviser opinion	
Last meeting with manager	By phone during the quarter: John Arthur/ Russel Smith/Remi Olu-Pitan
Fees	

The fidelity Multi-Asset Income portfolio was flat over the quarter and has returned 5% per annum over the 3 years since inception. This includes dividends distributed back to the Fund of approaching 4% per annum. The Schroders Multi-Asset Income portfolio returned 1.65% over the quarter and has, similarly, returned 5% per annum over three years including a dividend distribution of approaching 4% per annum. These 3- year returns and dividend distributions are inline with expectations at the time of inception. The Schroders portfolio has a slightly higher performance target of cash +5% against Fidelity at cash +4% and, as such, the Schroders portfolio takes slightly higher investment risk and should be expected to perform slightly better over the long-term. Both managers remain defensive in their positioning, forecasting some market volatility as interest rates rise.

Asset Class/Manager	UK Commercial Property / Fidelity
Fund AuM	£76m Pooled Fund; 5.3% of the Fund
Performance target	IPD UK All Balanced Property Index
Adviser opinion	
Last meeting with manager	Phone calls during the quarter John Arthur/Paul Harris
Fees	

For the third quarter in succession the UK Commercial Property market returned over 6% in the period returning 6.3% over the quarter and is now up 21.2% over the year and 7.1% over three years. This compares to a 3- year return of 4.9% from the Fund's fixed interest portfolios.

The portfolio is shown as lagging its benchmark quite markedly in the custodian's performance report but I have raised a question with your officers regarding the accuracy of this benchmark. I believe the benchmark the custodian is using is the IPD UK All Properties index. IPD was purchased by MSCI some years back and all the indices have been rebranded at MSCI, I am, therefore, unsure what the IPD benchmark quoted by the custodian is referring to. Fidelity benchmark the portfolio to the rebranded MSCI index with the portfolio showing useful outperformance of this benchmark over the longer term.

As previously reported, the portfolio is currently only part way through refurbishing a number of large holdings 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. The vacancy rate within the portfolio has now fallen from a peak of over 20% to 14% as these refurbished properties are being re-let and this rate is expected to fall further. 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 has now made two drawdowns of cash into this portfolio with the portfolio now valued at £3.3m after fees and expenses. The fees are charged on committed capital, i.e. the US$ 80m, not invested capital and so, at this stage, the performance of monies invested will look poor as it bears the full cost of the fees. The manager continues to expect to drawdown approximately $20m per annum over the next four years but, given the current strong market is not increasing the pace of investment at the current time.

The Fund currently holds £10m in US Dollars to finance part of this year's drawdowns and has a cash balance of a further £8m at the current time. This suggests that the Fund will not need to realise any cash from other portfolios for the next 12 months to finance the expected drawdowns.

The portfolio remains diversified globally with investments in the US, UK, Europe, Japan and India and is invested in industrial warehouses and residential at the current time. It will become more diversified by geography and sector as further investment are made.

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