London Borough of Bromley

Quarterly Report

Q2 2022

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Performance Summary

2022 remains a difficult year for investors as central banks across the globe raise interest rates to curb rampant inflation. Almost all asset classes were down in the third quarter, often by more than 10% and almost all are down year to date. The table below details the changes in the main asset classes to illustrate the scale of the downturn. The figures are in local currency. The scale of the fall in government bonds globally, but particularly in the UK, is unprecedented over such a short period.

	Index (Local Currency)	Q3 2022	Quarter-on-Quarter	YTD
Equities		**Index Value**	**Total Return**	
UK Large-Cap Equities	FTSE 100	6,894	-2.8%	-3.8%
UK All-Cap Equities	FTSE All-Share	3,763	-3.5%	-8.0%
US Equities	S&P 500	3,586	-4.9%	-23.9%
European Equities	EURO STOXX 50 Price EUR	3,318	-3.7%	-20.4%
Japanese Equities	Nikkei 225	25,937	-0.9%	-9.8%
EM Equities	MSCI Emerging Markets (USD)	876	-11.5%	-27.0%
Global Equities	MSCI World (USD)	2,379	-6.07%	-25.12%
Government Bonds				
UK Gilts	FTSE Actuaries UK Gilts TR All Socks	2,968	-12.8%	-25.1%
UK Gilts Over 15 Years	FTSE Actuaries Uk Gilts Over 15 Yr	3,764	-18.8%	-38.9%
UK Index-Linked Gilts	FTSE Actuaries UK Index-Linked Gilts TR All Stocks	4,256	-9.3%	-29.3%
UK Index-Linked Gilts Over 15 Years	FTSE Actuaries UK Index-Linked Gilts TR Over 15 Yr	5,231	-11.1%	-39.2%
Euro Gov Bonds	Bloomberg EU Govt All Bonds TR	213	-5.1%	-16.7%
US Gov Bonds	Bloomberg US Treasuries TR Unhedged	2,173	-4.3%	-13.1%
EM Gov Bonds (Local)	J.P. Morgan Government Bond Index Emerging Markets Core Index	115	-4.3%	-16.7%
EM Gov Bonds (Hard/USD)	J.P. Morgan Emerging Markets Global Diversified Index	743	-4.6%	-23.9%
Bond Indices				
UK Corporate Investment Grade	S&P UK Investment Grade Corporate Bond Index TR	310	-11.4%	-23.3%
European Corporate Investment Grade	Bloomberg Pan-European Aggregate Corporate TR Unhedged	209	-4.7%	-16.6%
European Corporate High Yield	Bloomberg Pan-European HY TR Unhedged	372	-0.9%	-15.1%
US Corporate Investment Grade	Bloomberg US Corporate Investment Grade TR Unhedged	2,864	-5.1%	-18.7%
US Corporate High Yield	Bloomberg US Corporate HY TR Unhedged	2,099	-0.6%	-14.7%
Commodities				
Brent Crude Oil	Generic 1st Crude Oil, Brent, USD/bbl	88	-23.4%	13.1%
Natural Gas (US)	Generic 1st Natural Gas, USD/MMBtu	6.77	24.7%	81.4%
Gold	Generic 1st Gold, USD/toz	1,662	-8.0%	-9.1%
Copper	Generic 1st Copper, USD/lb	341	-8.1%	-23.5%
Currencies				
GBP/EUR	GBPEUR Exchange Rate	1.14	-2.0%	-4.2%
GBP/USD	GBPUSD Exchange Rate	1.12	-8.3%	-17.5%
EUR/USD	EURUSD Exchange Rate	0.98	-6.5%	-13.8%
USD/JPY	USDJPY Exchange Rate	144.74	6.7%	25.8%
Dollar Index	Dollar Index Spot	112.12	7.1%	17.2%
Alternatives				
Infrastructure	S&P Global Infrastructure Index	2,411	-9.6%	-10.1%
Private Equity	S&P Listed Private Equity Index	144	-10.2%	-35.8%
Hedge Funds	Hedge Fund Research HFRI Fund-Weighted Composite Index	17,496	1.7%	-4.0%
Global Real Estate	FTSE EPRA Nareit Global Index TR GBP	3,599	-3.8%	-13.7%
Volatility			**Change in Volatility**	
VIX	Chicago Board Options Exchange SPX Volatility Index	32	10.1%	83.6%

In this hostile environment the Fund fell by only 0.5% which looks exceptionally good compared with the figures for asset class returns shown above but is explained by the weakness of Sterling which fell 8.3% against the US Dollar and 2.0%

against the Euro. The weakness of Sterling boosted the returns of all assets held overseas which includes almost all of the Global Equity exposure and much of the Multi-Asset Income exposure as well as the small holding in International Property and the US Dollar cash balance. The Fund's benchmark, which is also unhedged, fell 1% in the quarter. Given the weakness of Sterling against almost all major currencies so far this year, I am again reviewing the rationale for partially hedging Global Equities back to Sterling. This only makes sense if Sterling is currently undervalued on a long-term basis.

Over the last year the Fund has fallen by 12.5%, noticeably underperforming its benchmark by 7.8%. This has been caused by the underperformance of the Baillie Gifford Global Equity portfolio, the largest portfolio in the Fund which, following a period of exceptionally strong performance, has had a torrid last 12 months, and by the two Multi Asset Income portfolios which have a cash plus X style benchmark that will rise every quarter irrespective of market returns and, as such, will lead the two portfolios to show underperformance in falling markets. Over 3 and 5-year timespans the Fund is matching its benchmark return and even after the most recent market falls has returned 8.5% per annum over the last 35 years which remains substantially above inflation over that period.

The Fund is now valued at £1.22bn.

Comment

Although the last meeting of the Pensions Committee was cancelled due to the Queen's funeral, I believe the papers were sent out and will, therefore, assume my last report has been read.

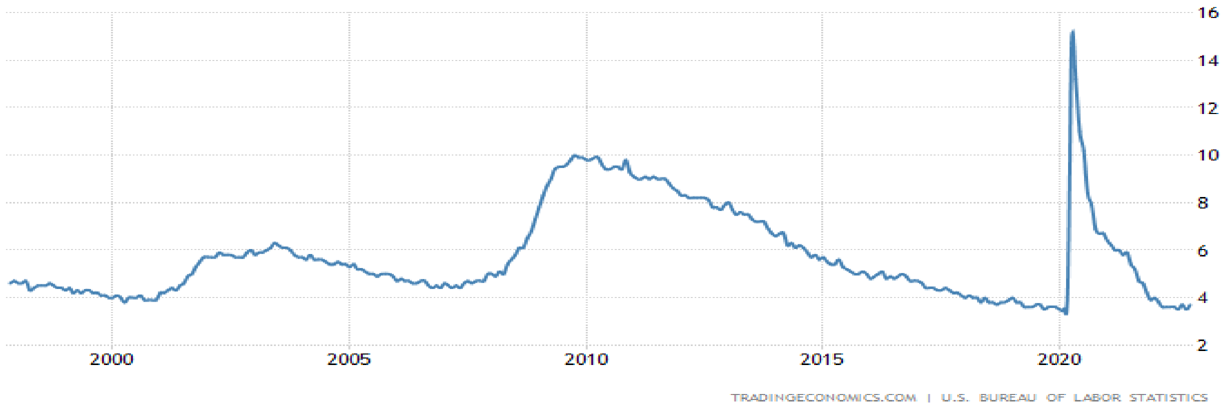
Interest rates continue to rise and will do so for at least another quarter across the US, UK and EU. The questions are:

- Has inflation peaked
- How quickly it will come down
- Will the rise in interest rates cause a recession

The answer to these questions will set the tone for markets globally because all asset classes are, to some extent, priced off the expected government bond yield (theoretical risk free rate).

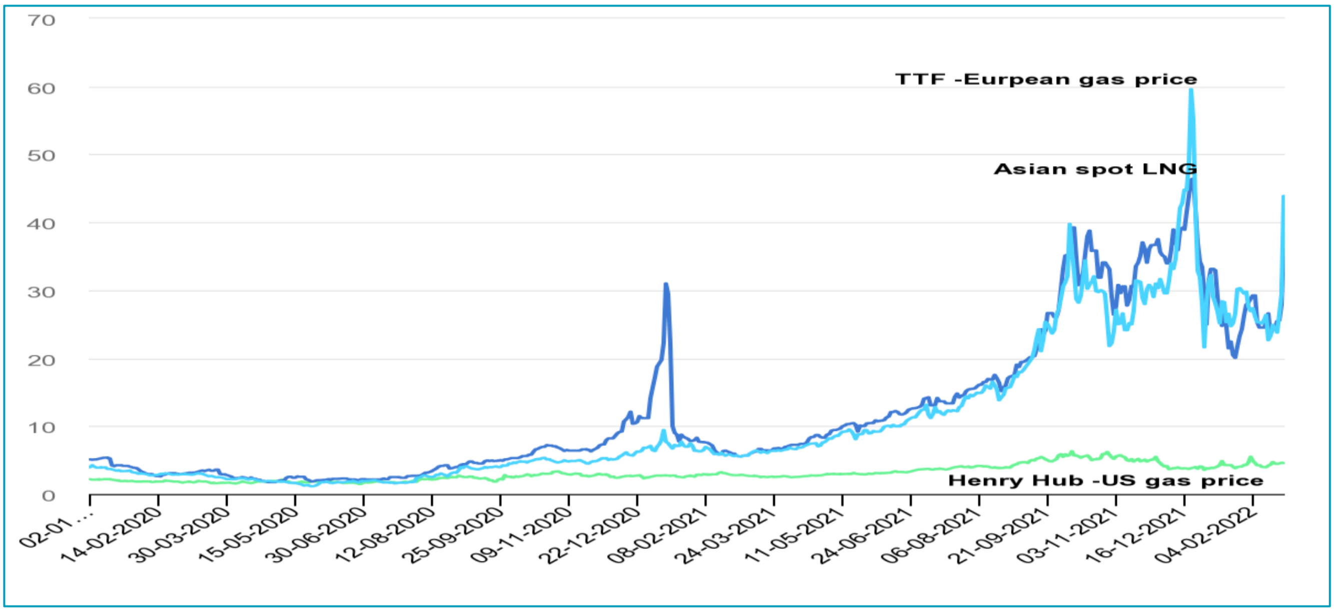
The common factor behind the rise in inflation is the pent up consumer demand post Covid hitting a disrupted supply chain, particularly whilst China follows a zero Covid policy which can shut down whole economic regions affecting millions of people. I would expect much of this supply chain disruption to ease as we enter the new year and we are already seeing some fall in shipping costs. Because inflation is measured as a year on year change, a number of factors will move from being large positive contributors to rising inflation (e.g. energy) to becoming a negative influence over the next few months as past year price rises drop out of the equation and more recent price falls are included. This could lead to inflation falling from its peak faster than many commentators expect. However, as discussed in my previous quarterly reports, there are now a number of long-term inflationary tailwinds which are likely to keep core inflation above the central bank targets of 2% per annum going forward. Outside of these effects, each region has different factors behind the rise in inflation. In the US, it is the tight labour market driven by record low unemployment which is pushing up wages.

The chart below shows the US unemployment rate as a percentage of the working age population.



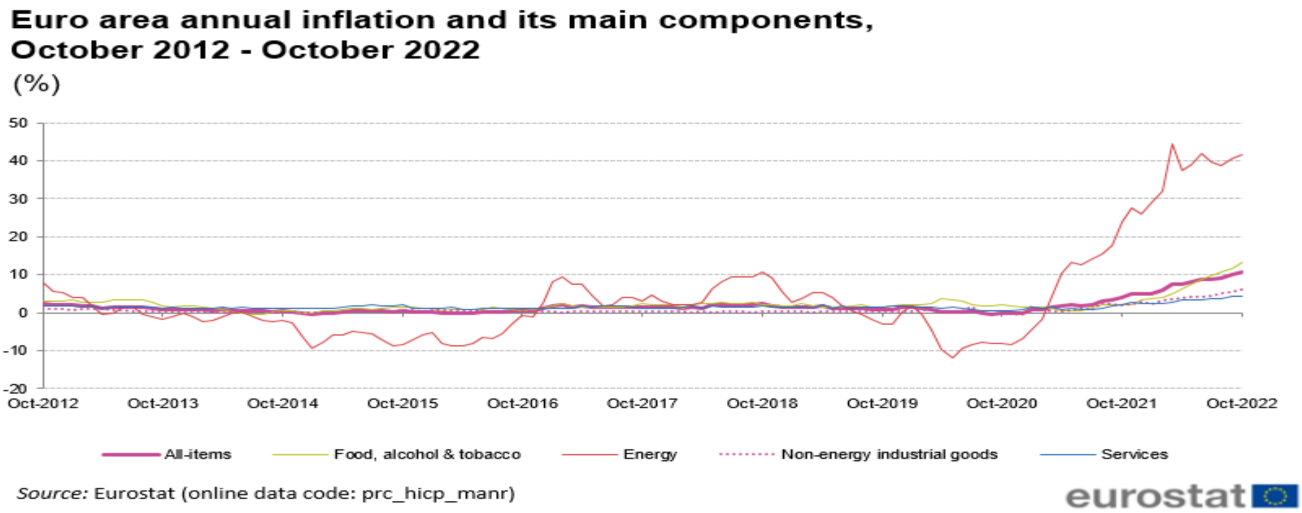
A tight labour market causing inflationary pressures can be rectified by rising interest rates to a level where demand slows and unemployment therefore rises. The ability of a central bank to raise interest rates to just the right level to slow future demand without causing a recession is very debateable and history suggests this would be a highly unlikely outcome but it is made even harder this time because Covid lockdowns have left many companies and consumers with a raised savings rate and a greater ability to sustain spending, even as the economy slows. In addition, gas prices in the US are a fraction of those in the rest of the world because the country is self-sufficient in oil and gas. This gives the country a competitive advantage in any industry where gas is a feedstock, e.g. fertiliser. We are seeing whole industries in Europe and the UK shut down as customers switch to buying product from the US, again supporting US growth.

$/mmbtu



After 6 interest rate hikes this year, the last 4 being of 0.75% each time, the US Federal Fund's rate (interest rate) has now risen to 3.75%-4.25%. The market expects interest rates to continue to increase, albeit at a slower pace, and to peak at 4.75%-5.0% around the middle of 2023 before falling back as a mild recession takes place. US inflation peaked at 9.1% and has now fallen for 4 consecutive months to 7.7%. If you exclude food and energy, which can be volatile and where the Russian invasion of Ukraine has had a direct impact, core US inflation is running at near 5%. My personal expectation is that whilst the headline inflation figure will continue to fall back, allowing the US Fed to slow the pace of interest increases in line with market expectations, the underlying economy will prove rather resilient and therefore the tight labour market will persist and this will force the US Fed to eventually raise interest rates above the expected peak of 5% later in the year.

In Europe, the effect of the massive rise in gas prices is much more central to the inflation debate.



This makes predicting the future much harder. Whilst gas prices have fallen from recent peaks, they are still high. Raising interest rates will have a much more delayed effect on energy prices as many industries and consumers have relatively fixed energy requirements and altering these takes time (think housing insulation). It also makes EU inflation much more dependant on the outcome of Russia's war in the Ukraine. The positive is that if this reached an acceptable conclusion that allowed both sides to resume trading with each other, then gas prices could decline rapidly solving much of the short-term EU inflation problem. On the negative side, the EU remains susceptible to further disruption in gas flows and parts of the gas infrastructure e.g. undersea pipelines from Norway to the UK are exposed to sabotage. A conclusion to the Russia/Ukraine war seems unlikely whilst Putin remains in power and on the assumption that he remains then the effects of high energy prices, high inflation and rising interest rates is likely to take the EU into a recession during 2022.

The UK is a mix of the issues confronting the US and EU with both a tight labour market and exposure to high global gas prices. The situation is made more precarious by a budget deficit which requires the country to borrow to meet its spending requirements and a current account deficit which means we export less than we import and therefore require overseas investors and lenders to invest in the UK and purchase UK assets to support the currency. Whilst it is not unusual for a country to run a current account and budget deficit it does mean that it is, to some extent, reliant on lenders and particularly overseas lenders to finance these deficits. The lenders need to believe their loans will be paid back in a stable currency. These issues, whilst simple, were not understood by the Truss/Kwarteng government with their actions leading to a major disruption in lender's views of the UK as a credit risk, forcing Gilt yields higher and Sterling lower. Whilst both UK Gilts and Sterling have now recovered, the reputation and competence of the UK Government has been brought into question and now needs to be restored by showing a much more believable path to lowering government debt levels hence the highly restrictive recent Autumn Statement released by Jeremy Hunt as UK chancellor. The UK remains in a poor position with low growth predicted going forward and whilst many of these problems seem to be of the Government's own making we have yet to see a credible plan to raise the long-term growth rate of the UK economy. Fortunately, the UK is not a major part of the global economy and market direction will be set by how inflation plays out in the US and globally.

Asset Allocation

The Fund's tactical asset allocation continues to deviate from the Strategic Asset Allocation (SAA) Benchmark, being overweight equities. The table below shows the changes to the asset allocation so far this year. There was a further small drawdown into the International Property fund during the last quarter, this was financed from the US Dollar cash holding. The increasing underweight in Bonds and overweight in property are a function of relative performance of these asset classes over the year to date.

Asset class	Asset Allocation as at 31/12/2021	New benchmark going forward	Position against the benchmark	Asset Allocation as at 30/6/2022	Position against the benchmark
Equities	65.8%	57.5%	+8.3%	65.8%	+8.3%
Fixed Interest	10.7%	12.5%	-1.8%	9.5%	-3.0%
Property	5.3%	5%	+0.3%	6.4%	+1.4%
Multi-Asset Income	17.2%	20%	-2.8%	17.0%	-3.0%
Int'l Property +US$	1.0%	5%	-4.0%	1.4%	-3.6%

Figures may not add up due to rounding

In early Novermber your officers and the Chair held their triennial meeting with the Fund's asset managers to discuss expecations for future investment returns. There was a consensus on the major change in asset valuations driven by the rising Government Bond yields and, whilst a number of managers saw some attraction in various of the alternative asset classes such as Infrastructure, the main improvement in expected returns is in the liquid asset classes of equities and bonds partly because these have been the fastest to reprice lower as interest rates have risen.

Below is printed a table of forecast asset class returns produced by J.P. Morgan, I find these the most comprehensive. Whilst there was some difference between the forecast returns set out here and those forecast by the Fund's individual asset managers, the actual numbers were not dissimilar and, in particular, the relative returns forecast between the various asset classes was fairly consistent.

These are 10 year forecasts and given that interest rates are still rising and we may be about to enter a recession, forecast returns may be back end loaded from here with the next two years remaining difficult.

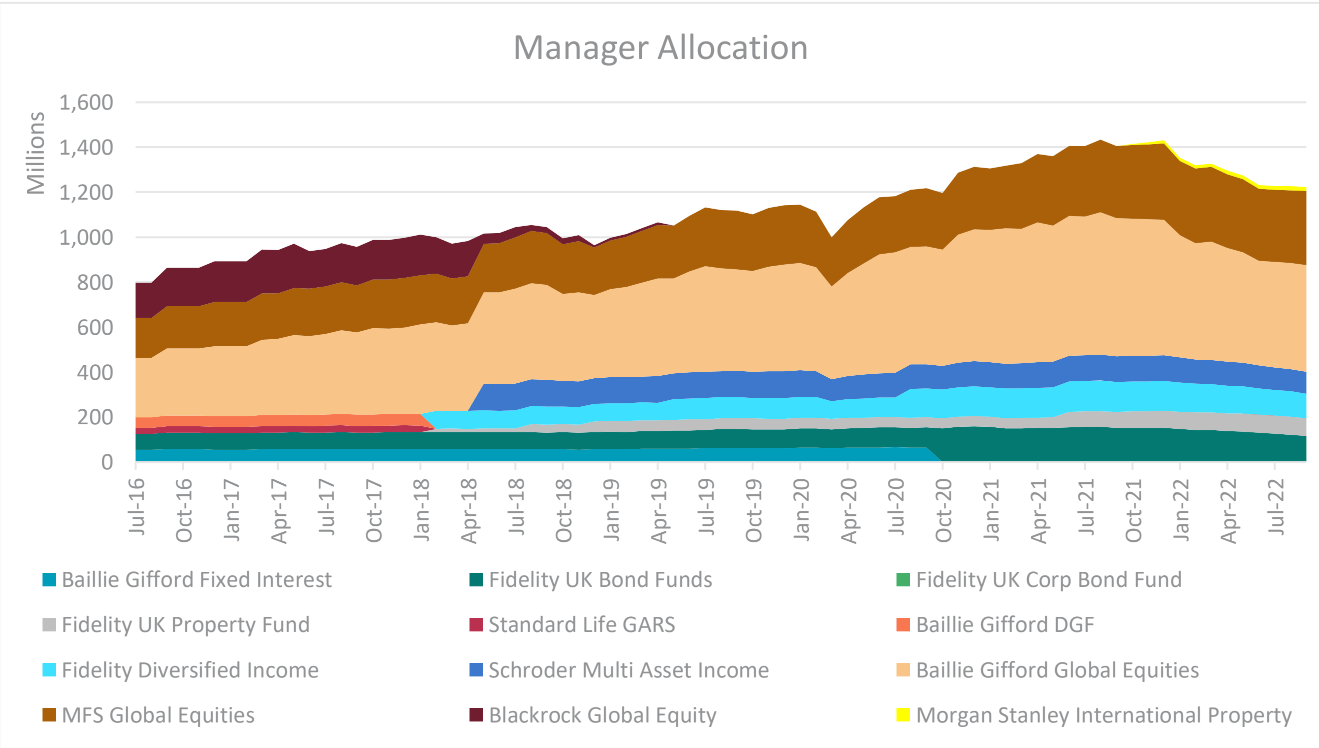
The table below sets out the LTCM forecast produced by JP Morgan in 2021 and 2022.

Asset Class	Index	2021 10 year return forecast	2022 10 year return forecast	2022 volatility forecast
Global Equities	MSCI AC World	5.2%	6.7%	13.9%
Fixed interest	UK Gilts	0.0%	4.2%	7.6%
	Global Investment Grade Bonds	2.5%	5.1%	5.4%
	UK Investment Grade Bonds	2.2%	4.2%	7.6%
Property	UK Core Real Estate	6.6%	5.5%	13.0%
	US Core Real Estate	5.6%	3.9%	10.2%
Alternatives	Global Core infrastructure	5.8%	4.5%	10.8%
	Private Equity	8.2%	8.1%	17.5%
	Direct Lending	7.4%	6.0%	15.8%
	Social housing	4.0%	4.0%	10.8%

As can be seen in the table above, the largest increase in expected returns is in the Fixed Interest markets and is as a direct result of expecting interest rates and thereby bond yields to remain higher into the future. The expected return on UK Gilts is approximately equal to the current yield. Return expectations for Global Equities have also risen which makes sense given the lower starting valuation post market falls. There has been no real increase in return expectations across alternative investment sectors and many of these areas have yet to see prices fall following the rise in bond yields due to their illiquid nature and therefore scarce pricing points.

A more detailed discussion of market return assumptions and the effect this should have on the Fund's investment strategy can be found in the recent Strategic Asset Allocation Review conducted by MJ Hudson.

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



Cash Flow

Your officers have again stress tested their cashflow assumptions for more persistently high inflation. Even under this scenario, the cash outflow (pension payments > pension contributions) from the Fund is covered out to 2026/7 using investment income which is currently distributed from the underlying portfolios. At present, the income from Global Equities is reinvested and if this was distributed to the Fund it would cover the cash outflow for at least a further year. Income is currently taken from the two Multi-Asset Income portfolios, the UK Property portfolio and the Fixed Interest portfolio. Income from the two Global Equity portfolios continues to be reinvested by their investment managers. The Fund does not, therefore, need to alter the strategic asset allocation of the Fund to generate more income at the current time.

The Fund currently holds £5m in US Dollar cash to cover future drawdowns into the International Property portfolio. This will cover the next quarter of potential drawdowns. Further to this the Fund is forecast to hold £16m in cash by the end of the 2022/3 financial year and this should cover the drawdown requirements for this portfolio into next year. The International Property portfolio is expected to drawdown approximately £20m per annum for the next 3 years.

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	£1,222m	£1,073m	114%*	?

*This is an estimate!

The Funding level may deviate from the current assumption used in the table above due to the impact of legislative changes e.g. the McCloud 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 estimate that the Fund currently has in excess of 110% 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 and is likely to increase the cash outflow out of the Fund.

Environmental, Social and Governance (ESG)

Your officers recently circulated a response to the Government consultation on the introduction of Taskforce for Climate Related Financial Disclosure (TCFD) reporting and we await the announcement from the Government regarding the timescale for LGPS funds to prepare this. This will be a major task for the Fund as it requires the Committee to set out the following:

- 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.

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.

Carbon reporting is still developing and for many of the metrics it relies on the reporting of 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.

Portfolio	tCo2e/£m	Benchmark equivalent.	% of portfolio covered	Benchmark
Baillie Gifford Global Equity	159.06	196.96	99%	MSCI All Countries World
MFS global Equity	tbc	tbc		MSCI World (Developed Markets only)
Fidelity Multi-Asset Income	243.9	n/a	46%	
Schroders Multi-Asset Income	145	n/a	67%	70% Global Equity 30% Global Bond
Fidelity Fixed Interest	99	104	68%	Sterling Corporate FI benchmark
Fidelity UK Property	n/a	n/a	70%	Insufficient data
Morgan Stanley Intl Property	n/a	n/a		Insufficient data

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. Fidelity and Morgan Stanley are unable at present to provide this data for the Property portfolios but are inserting clauses in all new leases which require tenants to report such figures. Each manager has also noted a 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 but I have included in the table the percentage of each portfolio which is producing the required figure.

Executive Summary

- Q3 was challenging for most investors, with only temporary optimism as central banks continued their rate hikes. Markets are challenged by a combination of high inflation, slowing economic growth, a strong US dollar and, accelerated interest rate hikes. Equity markets rose for the first half of the quarter, in the hope that rate hikes would finish in early 2023 but disappointing inflation figures turned expectations of monetary policy more hawkish one again and led to repricing in light of persistent high inflation. Similarly, long-term bond yields fell until late July as markets viewed recession risk as taking precedence over inflation, however, with policymakers tightening monetary policy further with additional rate hikes, the tide turned mid quarter with yields rising to quarter end. Global equities fell again, declining by -6.1% over the course of the quarter. Emerging markets detracted the most within equity markets (-11.5%) facing the headwinds of slowing growth from China and a strong US dollar. US equities fell -4.9%; followed by European and UK equities (-3.7% and -3.5% respectively). Growth stocks fell less (-5.2%) than value stocks (-7.8%) for the first quarter in a while. Corporate and government bond indices also fell sharply (with UK Gilts and UK investment grade credit falling by -12.8% and -11.4% respectively), while emerging market bonds in hard currency terms fell by -4.6%. Real assets such as commodities and real estate generally also fell and the US dollar strengthened against most currencies, benefiting from broad risk aversion and increasing interest rate differentials in its favour.

- **GDP growth:** Despite the ongoing recovery from the pandemic, the impact of the war in Ukraine on high inflation resulting in rising interest rates globally will slow growth in the UK and Europe in particular likely to enter a recession next year. As the Russian war continues, commodity prices will remain high and volatile and supply chains disrupted. The US is forecasting a GDP growth rate of 0.3% for Q3, following declines in both Q1 and Q2. China's growth has been disrupted by ongoing COVID-19 lockdowns and a real estate slump - its GDP growth is expected to slow sharply to 2.8% in 2022.
- The new UK Government's September "mini-budget", which in part attempted to boost growth, was poorly constructed and badly misjudged: markets were spooked by the risk which the unfunded tax-cuts, on top of a universal energy support package posed to the UK's fiscal position, resulting in a rapid rise in long-term interest rates and a sharp fall in Sterling. Gilt markets have stabilized following the BoE's intervention, but the increased volatility does represent a risk factor to UK pension funds, whilst those with "Liability Driven Investment" (LDI) portfolios have had to source liquidity in order to meet significant margin calls.
  - **It is worth highlighting the following themes, impacting investment markets:**
  - **Inflation – the end is not yet in sight.** While YoY CPI inflation appears more or less to have plateaued near double digit levels (in the US, August CPI increased to 8.3% YoY, Eurozone inflation rose to 10.0% and the BoE expects UK inflation to be in double digits for the next few months) there are clear indications of inflation becoming more entrenched. Euro core inflation rose to a new high at 4.8%, highlighting the stickiness as it shifts from goods to service prices, while average earnings are starting to rise faster (average hourly earnings rose to 5.2% in the US in August, 5.5% in the UK in July). 10-year inflation break-evens are well above Central Bank targets (e.g. c. 4% in UK), suggesting inflation is likely to remain "higher for longer".
  - **Inflation vs Recession – the monetary policy conflict.** To combat this, monetary policy continued to tighten in most major developed countries, with the US Fed, the BoE and the ECB all raising rates several times in Q3. In addition, the Fed is expected to increase the pace of reducing its balance sheet ("Quantitative Tightening", QT), while the BoE was planning to start QT at the end October before the mini-budget necessitated a reversal. Markets now expect rates to peak in the 4.5-4.75% range in the US and around 5.5% in the UK. But 10-year real rates are still only barely positive, suggesting further rises may be needed to quell inflation; central banks remain very focussed on the latter. As a result the likelihood of a "hard recession" is increasing, particularly in the UK and Europe.
  - **Liquidity risk rising:** While higher rates increase the attractiveness of cash, the tighter monetary policy (particularly QT) increases the risk of liquidity stresses appearing in financial markets. The spiral in UK Gilt yields, which caused UK pension funds with LDI exposure to sell other assets in order to meet margin calls is symptomatic of this. Investors may want to take this opportunity to examine the liquidity profiles of their portfolios, and ensure they are comfortable.
  - **Valuations – looking more attractive if earnings are sustained:** With global equities over 25% off their peak and credit markets 15-20% down, valuations are looking more in line with long-term averages. US equities are trading on 15x forward P/E, while most other regions are nearer 10x, and global investment grade indices yield c.4-5%. Corporate profits have so far remained broadly resilient, and expectations for 2023 earnings are still strong despite the strong US dollar which historically has a negative impact on S&P 500 earnings. US profit margins have declined to 10.9% for Q2, down from 11.9% for Q1, but still above the long-term trend and recessionary levels. Similarly, credit spreads have widened only slightly beyond their long-term average, signalling investors' views that economic recession may well occur, but widespread defaults are less likely. This potentially indicates that earnings forecasts and default expectations may still be too sanguine and a more severe recession could undermine valuations.
- Global equities fell sharply in Q3, continuing the year-to-date trend. In addition to the ongoing war in Ukraine, the impact from slowing economic growth, rising interest rates, and high inflation have all significantly hit markets. Given the selloff in equity markets, the VIX increased by 10.1%, from 28.7 to 31.6.
  - In the US, the S&P 500 fell by -4.9% and the NASDAQ fell by -3.9% in response to interest rate hikes. Communication services and REITs were the hardest hit in the quarter, down -12.7% and -11.0% respectively. Energy and consumer discretionary were the only positive sectors in the quarter, although consumer discretionary had fallen significantly in Q2.
  - UK equities continued to be impacted by the war in Ukraine and subsequent volatility in energy prices. The BoE raised the base rate to 2.25% in September. New fiscal policies from the new Government resulted in markets falling sharply and Gilt yields

rising dramatically at the end of the quarter. However. On a relative basis the UK somewhat outperformed global equities, declining by -2.8% (FTSE 100) and -3.5% (FTSE All-Share).

    - The Euro Stoxx 50 fell by -3.7% in Q3 as the ECB ended its long period of negative rates. Concerns over the higher cost of living and the possibility of recession saw the European Commission's consumer confidence reading fall to -28.8 in September, a level lower than during the peak fear of the pandemic.
    - Japanese equities fell by -0.9% in Q3. While inflation has been trending higher and above the target range, it remains well anchored relative to peers, at only 3.0% for August. The BoJ has steadfastly kept monetary policy stable, but was forced to intervene in currency markets as the yen has fallen particularly sharply against the US dollar, reaching 144.
    - Emerging market equities fell more (-11.5%) than global equities, with US dollar strength the main headwind as well as marked weakness in Chinese economic data.

- Bond yields rose in Q3 amid elevated inflation and rising interest rates. Yield's initially fell in July/August due to rising recession concerns; but ended the quarter higher on Central Banks' comments and rate hikes. In corporate bonds, high-yield credit outperformed as spreads were largely unchanged and have less duration sensitivity. Emerging market bonds fell -4.3% in local currency, and -4.6% in hard currency.
    - The US 10-year Treasury yield rose from 2.98% to 3.83% and the 2-year from 2.93% to 4.22%. Treasuries provided a total Q3 return of -4.3%. The unemployment rate rose slightly to 3.7% in August, indicating a still strong labour market, and supporting the Fed's case for further policy tightening. The Michigan Consumer Sentiment index rose to 58.6 in September but remains well below pre-pandemic levels.
    - The UK 10-year Gilt yield increased from 2.23% to 4.09% and 2-year rose from 1.88% to 4.30%. Much of the increase occurred in August/September due to the proposed tax cuts and borrowing by the new government, which caused sterling to slump and yields to spike, and for the BoE to announce emergency gilt buying. The yield spike is understood to have also resulted in forced selling to meet margin calls from some pension funds with LDI strategies.
    - European government bonds had a total return of -5.1% in Q3. The selloff in European government bonds took place as the ECB raised rates by 125bps in Q3 with further rises expected to try and reduce inflation, following the same path as the BoE and Fed. The German 10-year bund yield increased from 1.37% to 1.87% with Italy's up from 3.19% to 4.17%, although hitting as high as 4.75% in September.
    - US high-yield bonds outperformed the global bonds market, returning -0.6%, and European high-yield bonds returned -0.9%. Investment-grade bonds returned -11.4% in the UK, -4.7% in Europe and -5.1% in the US.
- Energy prices fluctuated in Q3 2022, with the continuation of the war in Ukraine, and tension regarding the Nord Stream pipeline. Natural gas prices rose, while crude oil prices fell as recession fears (and expectations of falling oil demand) weighed on sentiment. Precious metals fell, negatively impacted by the rise in rates.
    - US gas prices rose 24.7% over Q3, influenced by concerns over global supply. The increase in exports from the US to Europe, due to Europe seeking to replace Russian gas, has led US prices to rise. Prices in Europe climbed over Q3 (Dutch TTF Gas Futures +33%) due to the aforementioned Nord Stream issues. Prices spiked round 330 €/MWh in August when Russia announced a 3-day shutdown of Nord Stream 1, but subsequently retreated to end the quarter at 188.
    - Brent crude oil fell -23.4% in Q3. Prices have been volatile as fears of a fall in demand from a global recession and structural trends toward renewable energy have clashed with supply side disruptions. Oil prices fell through the quarter except a small jump prior to the OPEC+ meeting in early September where the group agreed a marginal but symbolic cut in production. Brent closed the quarter at $88 per barrel.
    - Gold and Copper fell -8.0% and -8.1% respectively in Q3, with gold falling on rising interest rates, and copper falling on concerns of slowing economic growth, Chinese economic growth in particular. Gold and Copper closed Q3 at 1,662 USD/toz and 341 USD/lb, respectively.
- Global listed property had a weak quarter, with the FTSE EPRA Nareit Global Index falling -3.8% in Q3.
    - Property prices in the UK have begun to decline recently, with the Green Street Commercial Property Price Index down by -4.9% this quarter. The all-property index is now down -5.9% since the start of the year.
    - The rise in the Nationwide House Price Index in the UK slowed slightly to up 9.5% YoY in Q3, from up 10.7% in Q2. Expectations indicate a slowdown, with mortgage approvals falling back towards pre-pandemic levels and rising mortgage rates. However, the housing market has retained some momentum given rising inflation and further stamp duty cuts.
- In Q3, sterling weakened sharply against the US dollar (-8.3%) and the euro (-2.0%). The principal driver came late in September as the new Chancellor proposed cutting taxes and increasing government borrowing. Existing fears of a UK recession and inflation uncertainty had already placed relatively low confidence in the UK economy and currency. Overall, the US dollar (Dollar index +7.1%) had a strong Q3 and strong YTD (+17.2%). Notably the US dollar also strengthened against the Japanese yen by 6.7% despite the intervention by the BoJ, reflecting the attractive mix of a high interest rate and "safe haven" status that the dollar currently offers.

Performance report

Asset Class/ Manager	Global Equities/ Baillie Gifford
Fund AuM	£474m Segregated Fund; 38.8% of the Fund
Benchmark/ Target	MSCI All Countries World Index +2-3% p.a over a rolling 5 years
Adviser opinion	Short-term performance has been poor, acceptable longer term.
Last meeting with manager	John Arthur/John Carnegie by phone
Fees	

The Baillie Gifford Global High Alpha portfolio rose by 1.7% over the quarter against a benchmark rise of 1.5%. The portfolio is now behind the index over the last year by -17.6%. Long-term performance is mixed with the portfolio underperforming marginally over 5 years but adding 0.5% per annum since inception in 1999.

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. There is only a 14% overlap between their portfolio and the index at present.

	2017	2018	2019	2020	2021	Last 12 months
BG Global Alpha	23.3%	-3.7%	28.4%	33.1%	8.9%	-21.3%
MSCI All Country World	13.8%	-3.3%	22.4%	13.2%	20.1%	-3.7%
Relative performance	+9.5%	-0.4%	+6.0%	+19.9%	-11.2%	-17.6%

The MSCI All Countries World index fell by 6% in US Dollar terms but with Sterling falling over 8% against the US Dollar, this led to a positive index return in Sterling. The US accounts for over 60% of the MSCI AC Word Index.

This is the first quarter of positive performance in over 12 months. It should be remembered that 12 months ago we were assuming the stella outperformance of the Baillie Gifford portfolio was coming to an end as rising inflation was expected to force interest rates higher which would undermine the valuation of high growth companies. In my 2nd quarter 2021 report I stated: '*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.*'

The difference between our expectation then and what has actually happened is the scale of the underperformance. In September last year inflation expectations were for a short-term peak of 4-5% during 2022 with US interest rates rising to 3-3.5%. In reality, we have seen inflation peak at over 10% with interest rates now heading for 5%. It is the change in long-term interest rates which has altered the valuation of equity markets. The price of an equity theoretically is the current value of future dividends, discounted back to today's value. One of the major determinants of that price is the discount rate used which is taken from bond yields. Post the Russian invasion of Ukraine, inflation forecasts and therefore bond yields rose rapidly, undermining the valuation of growth companies in particular. Baillie Gifford have made some mistakes over the last year, e.g. being caught out by the regulatory zeal against the free market in China and being slow to sell their Russian holdings as well as being invested in a small number of early stage businesses where higher financing costs have undermined the business rationale. However, for the majority of their holdings, progress in terms of sales and profitability over the last year have been in line with expectations, it is purely the valuation which has changed. I stick by my comment of last year that I still expect Baillie Gifford to add value over the long-term because the speed of technological change and resulting disruption of whole swathes of the economy has not slowed and so, in a slow growth environment, companies which can show rapid growth and are re-engineering the way an industry operates by undercutting the entrenched players, will still be a source of long-term growth and profitability and, hence, in time, share price performance.

Asset Class/ Manager	**Global Equities/MFS**
Fund AuM	£329m Segregated Fund; 26.9% of the Fund
Benchmark/ Target	MSCI World Index (Developed Markets)
Adviser opinion	This portfolio should outperform in a more inflationary environment
Last meeting with manager	Elaine Alston/John Arthur by phone
Fees	

MFS focuses on companies with a below market valuation but where returns are consistent and competitive positioning within their industry defensible. This makes them more stable in an environment where inflation is rising as they retain more pricing power. As previously noted and as specifically raised at the last Trustee meeting which the manager attended, it is my expectation that the performance of this portfolio should improve in the current inflationary environment. As such it is pleasing (although only short-term) to see the manager add value this quarter.

The MFS portfolio rose 3.3% against a rise in the benchmark of 1.4% in the third quarter, the portfolio has now outperformed its benchmark by 6.9% over the last year having previously struggled to add value during a period of falling inflation and low interest rates. The portfolio has added 1% per annum over the last 5 years.

In my 2nd quarter 2021 report I stated: '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.'

It is the strong and consistent investment philosophy and process of both the Fund's global equity managers which makes it easier to understand in what market environment each equity manager with out or under-perform the benchmark.

With investors remaining cautious in the second quarter, it was secure, and well positioned companies with strong cash-flow which outperformed, this suited the investment philosophy and process of the manager.

Asset Class/Manager	**UK Aggregate Bond Fund and UK Corporate Bond Fund/ Fidelity**
Fund AuM	£116m pooled fund; 9.5% 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	

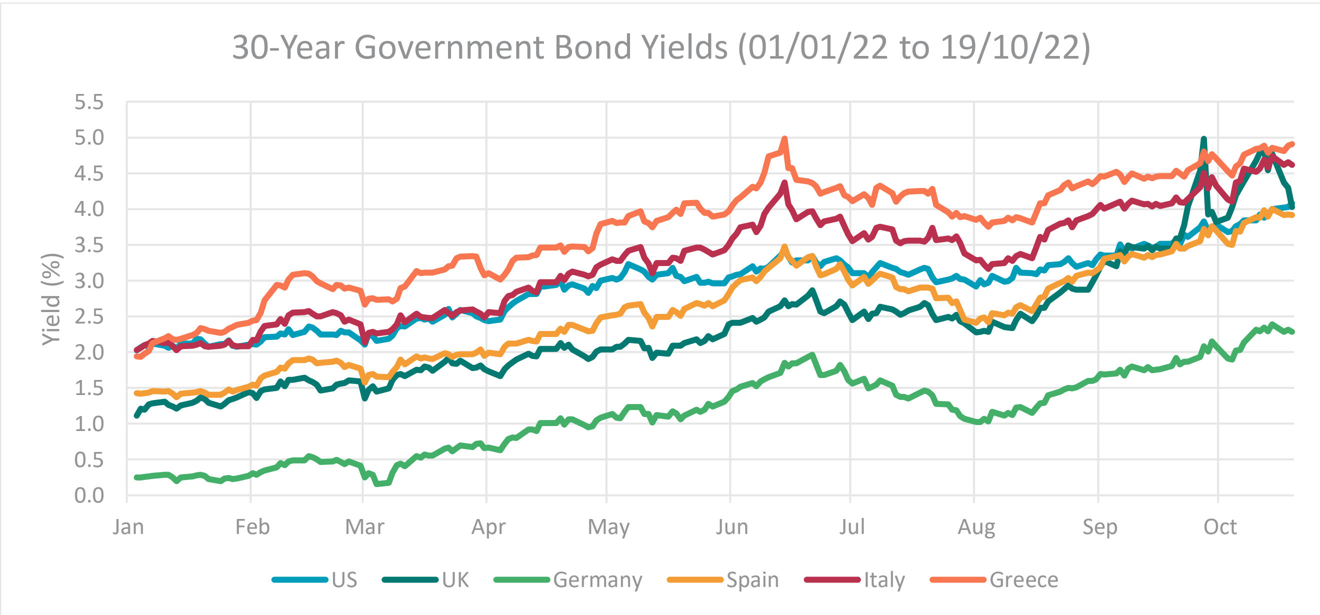
The Fund now has two similar Fidelity Fixed Interest portfolios. The UK Aggregate Bond Fund has a benchmark which is 50% UK Gilts and 50% UK non-Gilts; the UK Corporate Bond Fund which has a benchmark consisting entirely of UK Investment Grade Corporates and, as such, contains slightly higher credit risk and achieves a slightly higher yield. The manager can invest outside of these benchmarks with a proportion of the portfolio including into overseas investment grade bonds hedged back to Sterling and higher yielding bonds. These two portfolios are combined for reporting.

Portfolio	2Q22 performance	1 Year performance	Duration	Yield
UK Agg Bond	-11.4%	-22.6%	8.6 years	6.0%
UK Corp Bond	-12.5%	-24.1%	6.4 years	6.8%

The combined portfolio fell 11.1% over the last quarter and has fallen -23.6% over the last 12 months. The portfolio has continued to add incremental value against the benchmark over longer time periods and has outperformed the combined benchmark by 0.6% p.a. over 5 years and 0.8% p.a. since inception in 1998. This 25-year outperformance is a good indicator of the value added by the manager. It is often easy to add value in rising bond markets when yields fall as the manager can take on extra credit risk, creating a higher yield in the portfolio. It is far harder for a manager to outperform when bond prices are falling and yields rising as any credit exposure is likely to fall by more than the index. Fidelity have performed roughly inline with their benchmark during the current bond market retrenchment.

The chart below shows the moves in Government bond yields so far this year. The volatility in UK Gilts post the Truss/Kwarteng mini budget is clear to see (late September, dark green line) and caused major stress for many corporate pension schemes resulting in a real loss of investment performance for many.

Government Bond yields.



Globally, the scale of the fall in bond prices and the rise in yields has been extreme and whilst we were expecting an inflation problem the Russian invasion of Ukraine has altered the inflation outlook and lead to a much greater sell-off than was expected a year ago.

Asset Class/Manager	Mult-Asset Income / Fidelity
Fund AuM	£110m Pooled Fund; 9.0% 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	£98m 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 fell -5.4% over the quarter whilst the Schroders portfolio fell -2.2%. Over 12 months the Fidelity portfolio has returned -14.6% and the Schroders portfolio -11.0%. Over three years the Fidelity portfolio has fallen by -3.6% per annum and the Schroders portfolio by -2.0% per annum. Both these returns are below their benchmark for each period. As previously noted, the benchmarks for these portfolios are of a cash +x style and, as such, will increase by a margin over cash each quarter irrespective of market moves. Whilst both portfolios have underperformed their respective cash benchmarks they do serve an important purpose in that they distribute dividends back to the main Fund which helps cover the cash outflow as pension payments are greater than employer and employee contributions. By removing the need to constantly divest assets from the Fund to cover this cash outflow the Fund is more secure and does not have to sell assets during a period of market stress.

Returns from these two Multi-Asset Income portfolios have been slightly disappointing and are a close match for the returns delivered by mainstream Multi-Asset portfolios which do not concentrate on delivering income. My expectation was for the income requirement to push the managers to analyse the balance sheet strength of their chosen investments more fully, selecting more financially sound holdings which should have fared better in turbulent markets. In reality, what appears to have happened, is that during the period of ultra-low yields, both managers were forced to take greater investment risk to meet the portfolios' yield requirement of 4% per annum. Both managers were challenged on whether the yield requirement was achievable but both were comfortable with it when questioned. Now, will yields much higher, the managers can, hopefully, be more selective and produce a stronger performance.

Asset Class/Manager	UK Commercial Property / Fidelity
Fund AuM	£78m Pooled Fund; 6.4% 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	

The Fidelity UK Property portfolio fell by 3.0% over the quarter outperforming its benchmark by 0.9%. Over three years the portfolio has risen by 8.6% p.a. outperforming its benchmark by 1% per annum. This has mainly been driven by the redevelopment of almost a quarter of the portfolio over the last few years with each redeveloped property returning to the market with a higher rent roll and therefore valuation.

Whilst the performance of this portfolio has been in line with expectations I would treat current valuations with caution. Property is an illiquid asset class and takes time to reprice following sudden market moves as we have seen in the bond market during the last few months. Quoted UK property companies are trading at substantial discounts to their current net asset value and it is very likely this portfolio will show a negative return for the next quarter. The manager does not currently have a queue of investors waiting to buy the fund and so any attempt to sell will be priced at a discount to the current NAV.

Asset Class/Manager	International Property / Morgan Stanley
Fund AuM	US$80m(£57.5M) committed / £11.8m drawn. Limited Partnership; 0.6% of the Fund
Performance target	Absolute return
Adviser opinion	
Last meeting with manager	Phone calls during the quarter John Arthur/Gareth Dittmer
Fees	

The International Property portfolio is now valued at £11.9m following a drawdown this quarter. The Fund currently holds £5.3m in US Dollar cash to cover further drawdowns and has some UK Sterling cash and is cash positive when distributions from other portfolios are taken into account.

The Morgan Stanley fund held its annual meeting in London this year which I attended in October. The day long meeting showcased the global resources Morgan Stanley have in place to manage this portfolio as well as the flexibility of approach, both of which are elements that led the Fund to appoint this manager.

With the repricing of bond yields across much of the globe, property valuations should be expected to fall. Whilst this does lead the manager to be more optimistic about the potential returns of this portfolio over the next 5-8 years, I did challenge the manager about the valuations at which current holdings already in the portfolio have been made.

Of the 17 investments made to date, the manager views 5 as unaffected by the changed interest rate environment; of these, 4 are in Japan where bond yields and interest rates have not risen because the Japanese economy is still fighting a period of prolonged deflation and one is on the US where the property has already been sold at a decent premium to the purchase price and is , therefore, not at risk. The manager classes 11 of the properties as at having no major issues, with increases in rental demand offsetting any rise in achieveable yields and only 1 property, in the UK, where there is some risk of a fall in valuation as the increased price of debt is affecting the market. I regard this as a decent outcome given the dislocation in markets this year and am pleased with the level of detail the manager is sharing with investors.