MJ HUDSON

London Borough of Bromley

Quarterly Report

Q3 2022

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Performance Summary

The fourth quarter showed some rebound from the poor performance of the first 9 months as, although central banks continued to raise interest rates, markets began to look forward to a period of falling inflation. The table below shows that whilst many asset classes recovered in the fourth quarter, they were still down over 2022 as a whole.

	Index (Local Currency)	Q4 2022	Quarter-on-Quarter	YTD
Equities			**Total Return**	
UK Large-Cap Equities	FTSE 100	7,452	8.7%	4.6%
UK All-Cap Equities	FTSE All-Share	4,075	8.9%	0.2%
US Equities	S&P 500	3,840	7.5%	-18.1%
European Equities	EURO STOXX 50 Price EUR	3,794	14.9%	-8.5%
Japanese Equities	Nikkei 225	26,095	0.7%	-9.0%
EM Equities	MSCI Emerging Markets	956	9.6%	-19.9%
Global Equities	MSCI World	2,603	9.9%	-17.7%
Government Bonds				
UK Gilts	FTSE Actuaries UK Gilts TR All Socks	3,018	1.7%	-23.8%
UK Gilts Over 15 Years	FTSE Actuaries Uk Gilts Over 15 Yr	3,694	-1.8%	-40.1%
UK Index-Linked Gilts	FTSE Actuaries UK Index-Linked Gilts TR All Stocks	4,000	-6.0%	-33.6%
UK Index-Linked Gilts Over 15 Years	FTSE Actuaries UK Index-Linked Gilts TR Over 15 Yr	4,564	-12.8%	-46.9%
Euro Gov Bonds	Bloomberg EU Govt All Bonds TR	208	-2.1%	-18.5%
US Gov Bonds	Bloomberg US Treasuries TR Unhedged	2,188	0.7%	-12.5%
EM Gov Bonds (Local)	J.P. Morgan Government Bond Index Emerging Markets Core Index	124	7.8%	-10.2%
EM Gov Bonds (Hard/USD)	J.P. Morgan Emerging Markets Global Diversified Index	804	8.1%	-17.8%
Bond Indices				
UK Corporate Investment Grade	S&P UK Investment Grade Corporate Bond Index TR	330	6.4%	-18.4%
European Corporate Investment Grade	Bloomberg Pan-European Aggregate Corporate TR Unhedged	213	1.7%	-15.1%
European Corporate High Yield	Bloomberg Pan-European HY TR Unhedged	389	4.7%	-11.1%
US Corporate Investment Grade	Bloomberg US Corporate Investment Grade TR Unhedged	2,968	3.6%	-15.8%
US Corporate High Yield	Bloomberg US Corporate HY TR Unhedged	2,186	4.2%	-11.2%
Commodities				
Brent Crude Oil	Generic 1st Crude Oil, Brent, USD/bbl	86	-2.3%	10.5%
Natural Gas (US)	Generic 1st Natural Gas, USD/MMBtu	4.48	-33.9%	20.0%
Gold	Generic 1st Gold, USD/toz	1,826	9.9%	-0.1%
Copper	Generic 1st Copper, USD/lb	381	11.7%	-14.6%
Currencies				
GBP/EUR	GBPEUR Exchange Rate	1.13	-0.8%	-5.0%
GBP/USD	GBPUSD Exchange Rate	1.21	8.2%	-10.7%
EUR/USD	EURUSD Exchange Rate	1.07	9.2%	-5.8%
USD/JPY	USDJPY Exchange Rate	131.12	-9.4%	13.9%
Dollar Index	Dollar Index Spot	103.52	-7.7%	8.2%
Alternatives				
Infrastructure	S&P Global Infrastructure Index	2,658	11.0%	-0.2%
Private Equity	S&P Listed Private Equity Index	159	11.8%	-28.2%
Hedge Funds	Hedge Fund Research HFRI Fund-Weighted Composite Index	17,520	1.7%	-3.9%
Global Real Estate	FTSE EPRA Nareit Global Index TR GBP	3,590	-0.3%	-14.0%
Volatility			**Change in Volatility**	
VIX	Chicago Board Options Exchange SPX Volatility Index	22	-31.5%	25.8%

Source: Bloomberg
All return figures quoted are total return, calculated with gross dividends/income reinvested.

The Fund rose by 2.1% over the quarter which looks poor given the equity market recovery shown in the table above but the asset class returns quoted above are in local currency. The recovery in Sterling from the Truss/Kwarteng debacle has

been reasonably rapid but has actually been driven more by the weakness of the US Dollar than by Sterling strength. US domiciled stocks account for over 60% of the MSCI Global Equity index.

The quarterly return of 2.1% is above the Fund benchmark return of 1.2%. Over 2022 the Fund fell by -12.3% against a benchmark return of -7.6%. The vast majority of the fall was driven by the underperformance of the Baillie Gifford Global Equity portfolio. Despite the tough market conditions of the last year, the Fund has still returned over 8.5% per annum over the last 35 years. It is this long-term performance which has driven the improved funding ratio.

Following on from the review of managers forecast risk and return expectations for major asset classes and the Strategic Asset Allocation Review conducted by MJ Hudson earlier this year, No major changes to the Strategic Asset Allocation benchmark are proposed. However, given the considerable deviation of the current portfolio from that Strategic Benchmark, I do recommend reducing the Fund's Equity exposure by £70m via a sale from the Baillie Gifford portfolio, reinvesting the money £20m into the US Dollar account supporting the Morgan Stanley International Property portfolio; £20m into the Fidelity Fixed Interest portfolio and £15m into both of the Fund's Multi-Asset Income portfolios. This will increase the diversification within the Fund, use the currently strong equity markets to replenish the cash awaiting drawdown into the International Property portfolio and bring the Fund more into line with the Strategic Benchmark. £20m accounts to approximately 1.6% of the Fund.

Comment

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

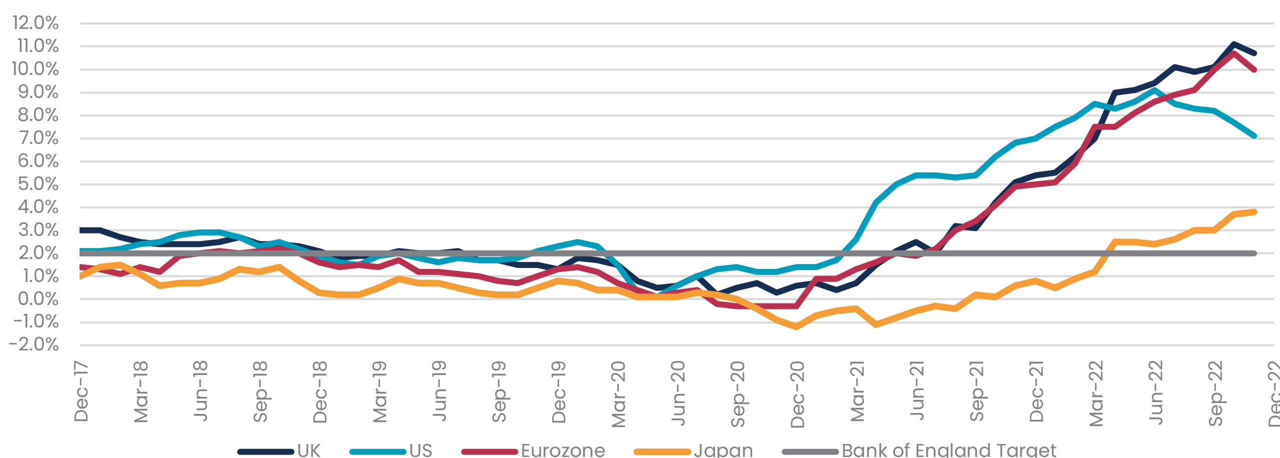
- Has inflation peaked?
- How quickly it will come down?
- Will the rise in interest rates cause a recession?

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 chart below shows the Consumer Price Inflation (CPI) rate for the major economies. This is a year on year comparison and measures how much prices have changed against this time last year. We are now at the stage where the rapid rise in energy prices following the Russian invasion of Ukraine will fall out of the year on year comparison and be replaced by falling prices for energy as gas and oil prices have fallen back from their peak. This will push inflation lower at quite a pace and has the potential to push inflation below 5% quite quickly in some areas.

As can be seen from this chart, US inflation looks to have peaked and this should be followed by Eurozone and hopefully UK inflation.

Chart 1: CPI – Annual rate of Inflation - Five Years to December 2022



Source: Bloomberg

Notes: UK: UK CPI EU Harmonised YoY NSA (Ticker: UKRPCJYR Index); US: US CPI Urban Consumer YoY NSA (Ticker: CPI YOY Index); Eurozone: Eurostat Eurozone MUICP All Items YoY Flash Estimate (Ticker: ECCPEST Index); Japan: Japan CPI Nationwide YOY (Ticker: JNCPIYOY Index)

In addition to falling energy prices due to a warm winter in the northern hemisphere lowering demand and enabling Europe to replace Russian gas with gas from other sources, the common thread on inflation is that the global supply chain disruptions post Covid are being solved as shown by falling shipping rates. The chart below shows the cost of shipping a standard container from China to the US west coast.

Chart 2: Container shipping rates

This chart is echoed in second hand car prices which are now falling and further evidenced by the recent cut in the list price of Tesla's model Y by 20% amongst other data point,s all indicating that supply chains are becoming efficient again.

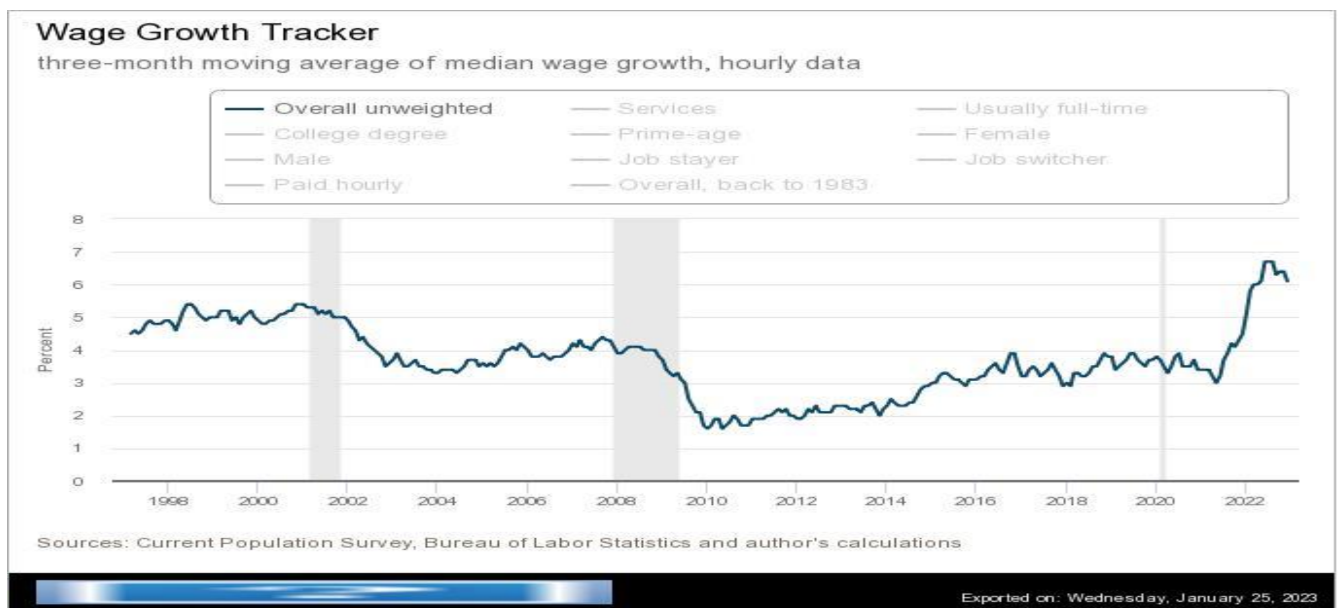
However, in the US, part of the inflationary problem is a very tight labour market which has been pushing up wages. This will only change when the economy slows, reducing the demand for labour and raising unemployment. Arguably, this can only be achieved by causing a recession. Historically, we have not seen an increase in US interest rates of the current magnitude, over a such a short period of time, without it causing a recession.

Even as inflation slows in the US, it is energy and food inflation which is coming down. Wage inflation and service sector inflation will be much harder to squeeze out of the system and I am concerned that the US Federal Reserve (US Fed), which sets US interest rates, may hold interest rates higher for longer than the market now expects.

The chart below shows the US unemployment rate which is still at multi decade lows suggesting little slack in the economy and a continuation of wage inflation.

Chart 3: US Unemployment rate

The level of job vacancies continues to run at a multiple of those looking for work and wage pressures are only slowly rolling over..



Within Europe, energy prices have had a much more direct effect on inflation due to the reliance of the region on Russian gas prior to the invasion of Ukraine. The fact the energy prices are now well below the level hit last year will mean that their effect on inflation will fall out of the calculation very rapidly and we will see falling inflation for the region going forward. Nonetheless, I would expect the European Central Bank to continue to raise interest rates for a while yet. Europe does not have such a tight labour market as the US and hence wage growth is likely to come under control much faster in this region providing the Russian war in Ukraine does not cause further disruptions.

Unfortunately, the problem child is the UK where our energy prices are linked to the European gas price and we have a labour shortage in a number of sectors, in part caused by Brexit. When I wrote about Brexit 5 years ago, my expectation was that there would be a short-term cost as regulations changed but that over the long-term, the UK's innovative and entrepreneurial spirit would eventually shine through, the problem was I was unsure of how long that would take, potentially a couple of years or potentially a generation! Unfortunately, not one of the string of governments we have had post Brexit has really thought through how to reorganise the UK economy and to enact detailed regulation to take advantage of leaving the EU. There appears to be no long-term planning and little intellectual foresight at present. The UK is predicted by the International Monetary Fund (IMF) to have the slowest economic growth of all G7 developed countries for both 2023 and 2024 and be the only G7 country where the economy has failed to recover to pre Covid levels over this period.

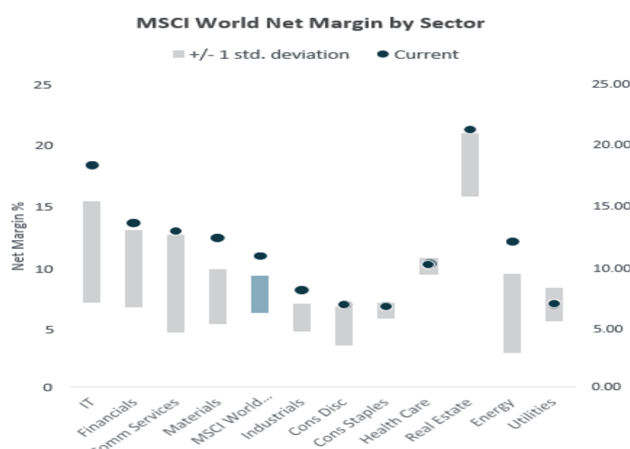
For Investors, there has been a substantial rally in global equity markets from the October lows, with the MSCI global equity index up 17% by end January 2023, investors now seem to be predicting that the US and EU will not enter a recession this year, inflation will fall back below 5% and that central banks will stop rising interest rates soon and start cutting by year end. Whilst this is possible it does not seem the most likely scenario for the future to me. If either the economy weakens into a recession or stays strong forcing central banks to raise interest rates further, then markets may struggle to make further progress for much of this year. The US will remain the lead economy and therefore the actions of the US Fed are likely to set the market tone.

There are three potential economic outcomes for the future to my mind, listed below. I have added my own thoughts on the probability of each outcome.:-

1) A 'Soft Landing' with the US Fed hiking rates from the current 4.5% up to 5% over the spring and then pausing during which time US inflation slows allowing the US Fed to cut interest rates into a slowing economy during the second half of this year. In this scenario, Equities would rise further as we would revert to a low interest rate environment (Likelihood 10%).
2) A quick 'Hard Landing' as the effect of the recent rises in interest rates finally impacts the consumer, the economy slows rapidly allowing the US Fed to step in and cut rates. In this scenario Equities would fall as corporate earnings expectations take a hit but short-dated bonds would do well as interest rates are cut in the second half of the year. (Likelihood 20%).
3) Persistent underlying inflation and a longer recession. In this scenario, the US Fed raises rates to 5% over the next few months and then pauses as inflation is falling. However, because the fall in inflation is driven by falling energy prices and other more transitory factors rather than falling wage growth, inflation bottoms in the summer but then rises back towards 5% forcing the US Fed to recommence raising interest rates in the Autumn, this would drive both equities and bonds lower. (Likelihood 70%)

I would note that corporate profit margins are at extreme levels at present, as shown in the charts below. It may be that corporates will allow profit margins to reduce in the interest of retaining labour, but the chart suggests there should be little further upside in profit margins from current levels and the potential for earnings downgrades during a recession is high. This would undermine current earnings valuations.

Profit Margins Are Near Peak Levels
Last 20 years



Source: LHS, FactSet. Monthly Data from 31 December 2002 through 30 December 2022. Trailing¹ = Last twelve months RHS, Monthly data from 31 December 2002 through 31 December 2022. Due to data availability Real Estate data is from 30 September 2016 through 31 December 2022. Trailing Net Margin¹ = Previous 12 months.
Index data source: MSCI. MSCI makes no express or implied warranties or representations and shall have no liability whatsoever with respect to any MSCI data contained herein. The MSCI data may not be further redistributed or used as a basis for other indices or any securities or financial products. This report is not approved, reviewed or produced by MSCI.

Declining margins potentially impacting earnings growth in 2023

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53921

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 over the last 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 is a function of relative performance of these asset classes over the year to date. Despite the fall in global equity markets over 2022, the fall in other asset classes was greater. This has lead to the overweight in global Equities increasing over the last year.

Asset class	Asset Allocation as at 31/12/2021	New benchmark going forward	Position against the benchmark	Asset Allocation as at 31/12/22	Position against the benchmark
Equities	65.8%	57.5%	+8.3%	67.0%	+9.5%
Fixed Interest	10.7%	12.5%	-1.8%	9.7%	-2.8%
Property	5.3%	5%	+0.3%	5.3%	+0.3%
Multi-Asset Income	17.2%	20%	-2.8%	16.7%	-3.3%
Int'l Property +US$	1.0%	5%	-4.0%	1.3%	-3.7%

Figures may not add up due to rounding

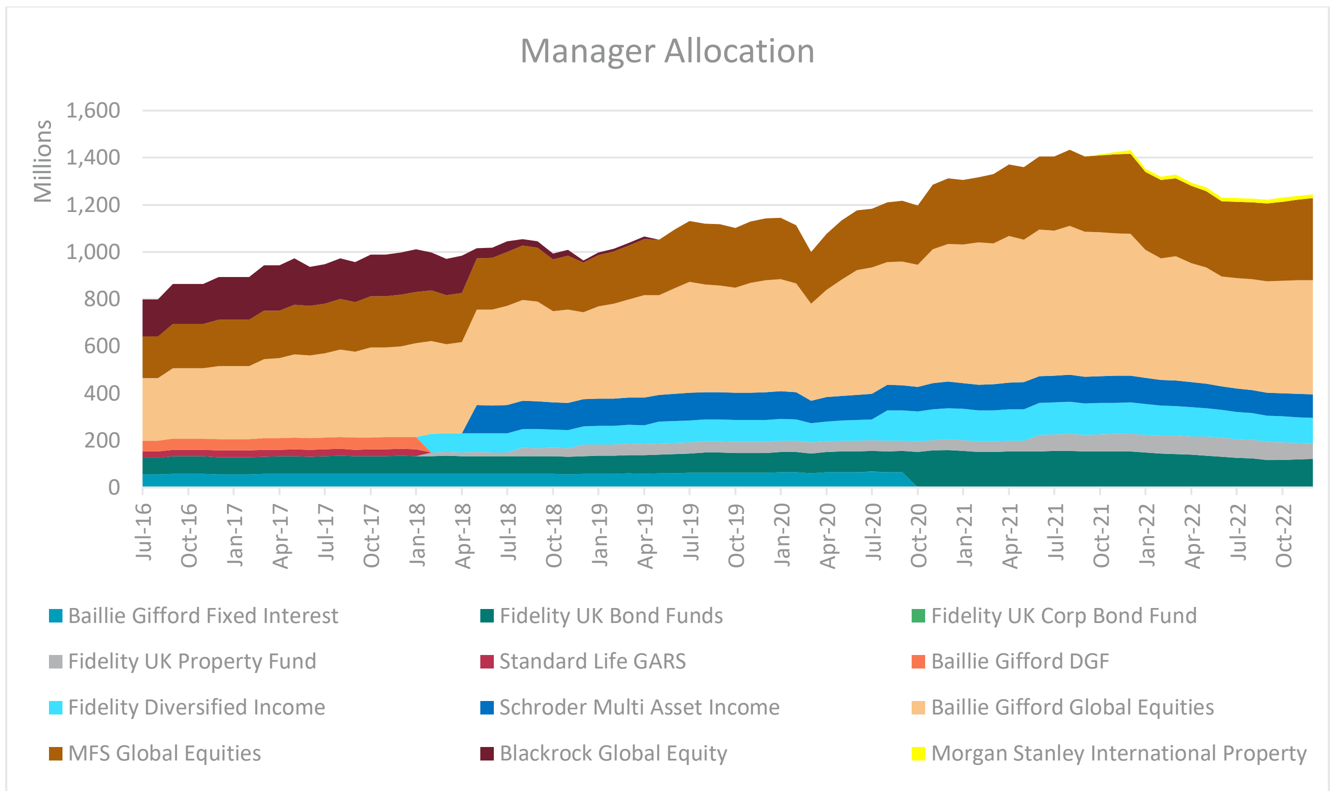
In early Novermber your officers and the Chair held their triennial meeting with the Fund's asset managers to discuss expecations for future investment returns. There was a consensus on a major change in asset valuations driven by the rising Government Bond yields and, whilst a number of managers saw 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. Because of this, and as discussed at the last Pensions Committee meeting, I do not propose any changes to the Fund's Strategic Asset Allocation benchmark at this time. However, as noted above, the Fund continues to exceed the weighting of the SAA towards global equities by a considerable margin.

Since the last Committee meeting equity markets have risen strongly, and, as described above, I see limited further upisde to justify the current overweight position in global equities against the Fund's Strategic Asset Allocation (SAA).

Recommendation – To reduce the Fund's global equity exposure by approximately 5% (£80m) using the proceeds to replenish the cash account supporting the International Property portfolio (£20m) which will cover the expected drawdowns over the next 12 months. Use the remaining proceeds to replenish the two Multi-Asset Income portfolios to the tune of £20m each and add £20m to theFixed Interest portfolio which is focused on investment grade credit. This will increase the yield and cash distribution of the Fund slightly.

The effect of this adjustment is to bring the Fund's actual asset allocation closer into line with the Fund's SAA targets. The split of the global Equity portfolio between Baillie Gifford and MFS was 58/42 as at year end. If the £60m was divested from the Baillie Gifford portfolio this balance would move to 55/45. Whilst the Baillie Gifford portfolio has underperformed over the last 18 months, in absolute terms it had fallen by only 14% over the last year and this will be less given the continued strength in equity mmarkets since the year end.

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



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	£1,244m	£1,083m	115%*	?

*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 has commenced using the figures from 31/3/2022. I would expect the main change to be the assumptions used for long-term 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 from the Fund. I will update this table for the next meeting once the valuation report has been received from the actuary.

Cash Flow

The current actuarial review, using March 2022 figures, will confirm the expected cashflow forecasts into the future. As previously stated, your officers have stress tested the current cashflows for the Fund to take into account the potential for higher pension payments given the currently elevated level of inflation (CPI). I do not expect the figures produced by the actuary to differ wildly from the forecasts created by your officers. The Fund can currently cover any increased cash outflow from a temporary jump in inflation through taking the income from the global Equity, Multi-Asset Credit and UK Commercial Property portfolios.

Executive Summary

- Q4 was a very positive quarter for risk assets generally, with equities and credit rebounding from losses in Q3 as investors have grown more optimistic that inflation may have peaked and central banks will soon have reason to end their rate hikes. Inflation still remains uncomfortably high however, and central bank rhetoric has so far remained hawkish. Long-term bond yields showed little overall movement (with the exception of UK gilts returning to normality), while short-term yields generally rose as monetary policy was tightened further. Additional positive impetus was provided by China's relaxing of its zero-COVID policy, improving the outlook for growth in its economy and by the surprising resilience of European gas supplies, reducing oil/gas prices and easing fears of recession: oil and gas finished the year only 10% and 20% above their end-2021 levels. Equity markets rallied this quarter, especially beleaguered European and Emerging Markets, although global equities are overall unchanged from June 2022 levels, despite volatile price moves in this period. The UK was one of the best-performing equity markets and Sterling recovered some of its earlier losses vs the US Dollar. Value stocks (+14.2%) outperformed growth (+4.6%) by a wide margin this quarter.
- **GDP growth and labour markets:** Despite the on-going recovery from the pandemic, the impact of tight monetary policy and the war in Ukraine are expected to slow growth, particularly in the UK and Europe. Labour markets have, to date, remained strong with unemployment at very low levels historically for the US, UK and Europe (3.5%, 3.7%, and 6.0% respectively from the most recent data).
- The 'new' UK Government under Rishi Sunak has restored order to gilt markets and Sterling by promising fiscally conservative plans. Markets have so far looked favourably on this and returned bond yields to their former positions relative to peer yields although this has not entirely fed through to mortgage rates yet.
- **It is worth highlighting the following themes, impacting investment markets:**
  - **Inflation – the story after the peak.** While CPI inflation appears to have now peaked for the US, UK and Europe, concern remains over how rapidly and to what level inflation will fall. There are indications of inflation becoming more entrenched, but investors appear to be pricing in a more rapid cut in rates than that which central banks are currently forecasting. Euro inflation reached 10.6% in October, a fresh high, however this fell in November to 10.1%. Similarly for the UK, a high of 11.1% was reached in October before falling in November. For the US, the high in CPI appears to have been reached in June at 9.1% and has since declined to 7.1%.
  - **Inflation vs Recession – the next stage for monetary policy.** Monetary policy continued to tighten in most major developed countries, with the Fed, the BoE and the ECB all raising rates several times in Q4. Markets now expect rates to peak at ~4.5% for the UK, ~5% for the US, and a little over 3% for the ECB which indicates hiking cycles are coming towards their end. In addition, the Bank of Japan (BoJ) surprised markets by lifting the yield ceiling for their 10-year bond to 0.5% from 0.25%. The BoJ noted this was to restore proper market function, but as the BoJ owns over half of the bonds in issue, investors have questioned if there is another rationale for the change. Prime Minister Kishida has also announced they will discuss the BoJ's inflation target approach when a new BoJ Governor starts his term in April.
  - **A return to fixed income?** The repricing of debt of all forms, following the rapid rises in interest rates last year, has increased yields on many fixed interest asset classes, potentially increasing long-term returns. Interest rates are now in a more volatile phase, in marked contrast to the repressed volatility of the past decade of QE, so this potential for improved returns is likely to come with increased volatility.
  - **Equity valuations reflect "mild" recession – earnings on watch in 2023.** Following the 18% decline in US equities in 2022, they are now trading at 16.5x forward earnings, below the 10-year average of 17.2x, but up from 15x in

Q3. Over the course of Q4, expectations for 2023 earnings fell by -4.4% with much of the negative impact expected in the first half of 2023 and, some of the leading economic indicators (e.g. ISM survey data) are starting to signal a recession. Investors appear willing to look through any potential decline in earnings, but clearly there remains a risk to earnings as corporate profit margins remain elevated by historical standards and inflating costs may yet impact these.

  - **Energy crisis: off the boil, but not gone**. While the immediate threat of blackouts in Europe this winter has probably been avoided and gas storage levels are high, the problem is not over. Furthermore. China's reopening is likely to increase demand pressure on global supplies.

- Global equities rose sharply in Q4, as inflation appears to have now peaked and investors expect that central banks will not need to maintain restrictive monetary policies for as long as they have been guiding. Given the rise in equity markets, the VIX which measures equity volatility and can be read as a "fear" gauge decreased by -31.5%, from 32 to 22, although this level is above the pre-COVID-19 average.
  - In the US, the S&P 500 rose by 7.5% and the NASDAQ fell by -1.0% as markets rallied due to falling inflation data, but investors remain wary of growth and tech stocks. A number of tech companies have announced staff layoffs and cost cutting measures in a response to investor concerns.
  - UK equities rallied in Q4, rising 8.7% as investors welcomed the government leadership change and return to a normal market functioning of gilts following the Truss/Kwarteng debacle and subsequent BoE intervention in the Gilt market. Energy price declines amid warmer temperature and rising inventories of natural gas also helped temper inflation expectations. The BoE raised the base rate to 3.5% in December, however two committee members voted to keep rates unchanged which could signal the start of a shift toward more dovish policy. The BoE also expects Q4 GDP at -0.1%, a 0.2% improvement from its November report.
  - The Euro Stoxx 50 rose by 14.9% in Q4 as investors were cheered by inflation data declining in the quarter, albeit it is still at high levels. Inflation in Europe has been particularly high due to the impact of energy prices following Russia's invasion of Ukraine and their consequent impact on European energy supply.
  - Japanese equities underperformed other equity markets, rising by only 0.7% in Q4. Japanese equities performed well in the quarter until core CPI in December was announced at a 40-year high and the BoJ increased the ceiling of the trading range for the 10-year bond to 0.5% (from 0.25%) which proved a headwind for equities. While inflation remains well below other major economies, investors are wary of a hawkish pivot at upcoming BoJ meetings due to the impending retirement of Governor Kuroda. The Yen reached a high (i.e. a weak Yen) of 150 vs the US Dollar during Q4 but ended the year at 131 following the inflation peak and yield curve adjustment.
  - Emerging market equities performed strongly (+9.6%) with sentiment improving in China following the announcement of COVID-19 restrictions easing. US Dollar weakness also provided a boost.
- Medium and longer term bond yields were largely rangebound in Q4 as investors weighed expected declines in inflation against central banks' desires to ensure inflation is stamped out. Additionally, employment data generally has remained strong which provides the impetus for central banks to hike rates now while labour markets are viewed as strong enough to withstand it. In corporate bonds, high-yield credit outperformed as spreads tightened over the quarter but remain around their long-term average level. Emerging market bonds rose 7.8% in local currency and 8.1% in hard currency.
  - The US 10-year Treasury yield rose marginally in Q4 ending at 3.88% from 3.83%. The 2-year yield rose in Q4, from 4.22% to 4.41%, as the yield curve inverted further. US rates rose initially in the quarter as core inflation data continued to be strong and the US Fed speakers maintained the narrative that hawkish policy needed to be maintained. Later in the quarter rates fell though, as markets took the view that the US Fed will pivot and cut rates in 2023 as inflation falls, spurred by recent falls in monthly CPI data. The US Fed raised short term rates to 4.25-4.5% as at end of Q4..
  - The UK 10-year Gilt yield fell from 4.09% to 3.67% and the 2-year from 4.30% to 3.56%. The declines largely reflected markets returning to normal following the spike in yields in Q3 following the disastrous Truss government 'mini budget' and occurred despite the BoE hiking rates by 125bps. While Gilt rates fell sharply over the quarter, UK Gilts now trade in a similar relative position to peer Government bonds as they did before Q3.
  - European Government Bonds had a total return of -2.1% in Q4. Yield curves flattened or inverted during the quarter, as short end rates rose in response to the ECB raising its policy rate to 2.5% during the quarter and noted

it expects to hike rates further based on its inflation outlook. Long-end rates rose less, as investors view inflation as likely to fall steadily. The German 10-year Bund yield increased from 2.11% to 2.57%, and Italy's went up from 4.51% to 4.70%.

   - US high-yield bonds outperformed investment grade, returning 4.2%, and European high-yield bonds returned 4.7%. Investment-grade bonds returned 6.4% in the UK, 1.7% in Europe and 3.6% in the US.

- Energy prices fluctuated during Q4 as investors mulled over China re-opening, risk of looming recessions in Europe, UK and USA and warmer weather than expected reducing near-term demand for natural gas. Precious metals rose as the US Dollar declined and also received a boost from falling interest rates.
   - US gas prices fell -33.9% over Q4, reversing some of the sharp gains earlier in 2022 as winter weather has been warmer than expected (reducing demand) and inventories have been higher than previously expected.
   - Brent crude oil fell -2.3% in Q4. 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 dynamics relating to Russia's invasion of Ukraine, OPEC production and the US releasing oil from its Strategic Petroleum Reserve. Brent closed the quarter at US$86 per barrel.

Asset Class/ Manager	Global Equities/ Baillie Gifford
Fund AuM	£485m Segregated Fund; 389.0% 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

   - Gold and Copper rose 9.9% and 11.7% respectively in Q4, with gold rising as interest rates and the US dollar declined, as well as reports of central banks including China and Turkey increasing their purchases. Copper rose as China, a significant copper importer, announced the start of COVID-19 re-opening. Gold and copper closed Q4 at 1,826 USD/oz and 381 USD/lb, respectively.
- Global listed property had another weak quarter, with the FTSE EPRA Nareit Global Index falling -0.3% in Q4.
   - The Nationwide House Price Index in the UK fell sharply over the quarter, with YoY growth at 2.8% for December. This is markedly down from 9.5% YoY growth in Q3, and 10.7% in Q2. The performance by region showed a smaller variance than prior years as the macro environment of high inflation and high mortgage rates are impacting affordability as real wages struggle to keep up.
   - European commercial property remained under pressure in Q4, with the Green Street Commercial Property Price Index down by -7% this quarter and -12% for the 2022 full year.

In currencies, Sterling strengthened sharply against the US Dollar (+8.2%) but fell against the Euro (-0.8%) over the fourth quarter. The principal driver was the appointment of Rishi Sunak as Prime Minister who is viewed as likely to pursue a more fiscally conservative agenda and the BoE's intervention in gilt markets to stabilise yields. Overall, the US Dollar fell in Q4 (Dollar index -7.7%) reversing much of the Q3 gains. Over the year 2022, the Dollar Index rose +8.2%. Notably, the US Dollar also fell against the Japanese Yen by -9.4% in Q4 as the BoJ shocked markets in December by increasing the top range at which the 10-year bond could yield.

Performance report

The Baillie Gifford Global High Alpha portfolio rose by 2.5% over the quarter against a benchmark rise of 2.0%. The portfolio is now behind the index over the last year by -7.6%. Long-term performance is mixed with the portfolio underperforming over 5 years by -0.6% per annum but outperforming its benchmark by 0.6% per annum since inception in 1999.

This is now the second consecutive quarter when Baillie Gifford has marginally outperformed its benchmark. The overriding effect on the portfolio performance has been rising bond yields which have raised the discount rate used to value future cash flows and dividends and hence lowered the valuation of equities, particularly those where much of the value is in the future because they are fast growing. This corresponds to the area where Baillie Gifford invest ('Growth' as a style). Bond yields peaked in the 3rd quarter of 2022 and so this valuation effect has not been a negative drag on the valuation of 'Growth' style equities over the last 6 months. The underperformance of high growth companies, driven by the rising discount rate has been pretty indiscriminate and whilst Baillie Gifford have made a number of errors over the last few years, I would hope that their skill in analysis and idiosyncratic stock selection will now add value as the major dislocation in bond yields should now be behind us.

Asset Class/ Manager	**Global Equities/MFS**
Fund AuM	£348m Segregated Fund; 28.0% 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 26/1/23

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.

The MFS portfolio rose 5.8% against a rise in the benchmark of 1.9% in the fourth quarter, the portfolio has now outperformed its benchmark by 10.5% over the last year having previously struggled to add value during a period of falling inflation and low interest rates. The portfolio has added 2% per annum over the last 5 years and 2% per annum since inception in 2013.

With inflation continuing to be an issue I would expect the MFS portfolio to continue to perform well as it is concentrated on companies who are better able to pass cost pressures on to their customers due to their strong market position. The portfolio has been very underweight in technology stocks for a long time as they did not feel the valuations justified investment. With the market fall, a number of stocks in this area now fit with their investment philosophy of strong brands with a defensible franchise and they are looking more closely at both Microsoft and Alphabet (owner of Google).

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 will out or under-perform the benchmark.

I have always asserted that the Fund's two global equity managers were very different in their investment philosophy and process and because of this, the occasions when they outperform and underperform their benchmarks would be fundamentally different making their relative performance against the benchmark negatively correlated. If that is the case then by combining the two portfolios the Fund should achieve long-term outperformance of the benchmark but with a lower volatility than investing in either manager separately.

I have now analysed 5 years of quarterly performance data and the correlation coefficient between the performance, relative to the benchmark, of Baillie Gifford against MFS is -0.5%. This supports my view, stated above.

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, non-investment grade bonds. These two portfolios are combined for reporting.

Portfolio	2Q22 performance	1 Year performance	Duration	Yield
UK Agg Bond	3.0%	-22.8%	8.6 years	5.6%
UK Corp Bond	5.8%	-18.4%	6.4 years	6.1%

The combined portfolio rose by 3.8% % over the last quarter but has fallen by -21.2% over the last 12 months. The portfolio has continued to add incremental value against the benchmark over longer time periods and has outperformed its combined benchmark by 0.5% 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

Asset Class/Manager	**UK Aggregate Bond Fund and UK Corporate Bond Fund/ Fidelity**
Fund AuM	£120m pooled fund; 9.7% 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

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 in-line with their benchmark during the current bond market retrenchment.

Bond markets remained volatile over the fourth quarter but focused on the expectation of falling inflation. Against this China has reopened post COVID following mass demonstrations against long running and draconian lock-down measures and this will support global growth over the next few quarters.

Markets now appear to be pricing a severe credit default risk in the expectation of a major recession, this does not fit with the mood in global equity markets which seem to be assuming a more gentle slowdown with limited recession risk and with a number of indicators suggesting that inflation has now peaked, the environment should be more supportive for bond yields.

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	Meeting 26/1/23

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

The Fidelity Multi-Asset Income portfolio rose by 2.1% over the quarter whilst the Schroders portfolio rose by 1.4%. Over 12 months the Fidelity portfolio has returned -12.8% and the Schroders portfolio -11.2%. Over three years the Fidelity portfolio has fallen by -3.1% per annum and the Schroders portfolio by -2.3% 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. This enables the Fund to run a slightly higher risk investment strategy (more equities) which has boosted returns over the long-term.

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. I have spoken with the investment team at Fidelity in some depth and reiterated the expectation that, going forward, the portfolio will be less exposed to general market risk and potentially take more independent, idiosyncratic risk. Both portfolios require a months' notice of dealing and, as such, this should give the managers some comfort for holding some less liquid investment positions which provide a decent yield but are less volatile than the general market.

Asset Class/Manager	UK Commercial Property / Fidelity
Fund AuM	£66m 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

The Fidelity UK Property portfolio fell by 15.8% over the quarter as valuations caught up with the rise in bond yields. Over three years the portfolio has risen by 2.4% p.a. outperforming its benchmark by 0.2% 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.

Despite the weaker market environment, tenant demand has remained resilient and, with UK Gilt yields stabilising, liquidity is re-entering the market and giving a greater degree of conviction over pricing.

Asset Class/Manager	International Property / Morgan Stanley
Fund AuM	US$80m(£57.5M) committed / £12.3m drawn. Limited Partnership; 1.0% of the Fund

Performance target	Absolute return
Adviser opinion	
Last meeting with manager	Phone calls during the quarter John Arthur/Gareth Dittmer

The International Property portfolio is now valued at £12.3m following a drawdown this quarter. The Fund currently holds £1m in US Dollar cash and £3.8m in Sterling cash to cover further drawdowns and is cash positive when distributions from other portfolios are taken into account. However, the manager expects to speed up the rate of investment through 2023 as prices are beginning to look more attractive although this may be back end loaded over the year. I would plan for drawdowns of £30m for 2023 and as such there is a requirement for additional cash to cover this (see earlier recommendation on raising cash via a sale of part of the Baillie Gifford Global Alpha portfolio).

Your manager believes that there will be opportunities to acquire assets from, or provide capital solutions to, public companies, funds and owners in need of liquidity as prices reset to reflect higher bond yields giving the potential to provide attractive risk adjusted returns relative to prior years within the portfolio. The existing assts are still performing well with an expected Internal Rate of Return (IRR) of 16% against a forecast of 18% at the time of investment with some assets in Japan (around Tokyo) approaching sale post partial rebuilds.

Meadowship Homes

This comment is based on my understanding of the information I have received.

Whilst I do see some value in the Index-Linked Gilt market for the first time in many years as real yields return to positive territory, I have some concerns with the pricing of the deal as I see it.

The investment would be illiquid and the terms if accepted now would remain for the entirety of the contract term. There would be no secondary market in the Bond.

I see the credit spread as low for a business of this size. At 125bp over the relevant gilt. Senior corporates can borrow around the 50-80bp with smaller companies borrowing at much higher rates.

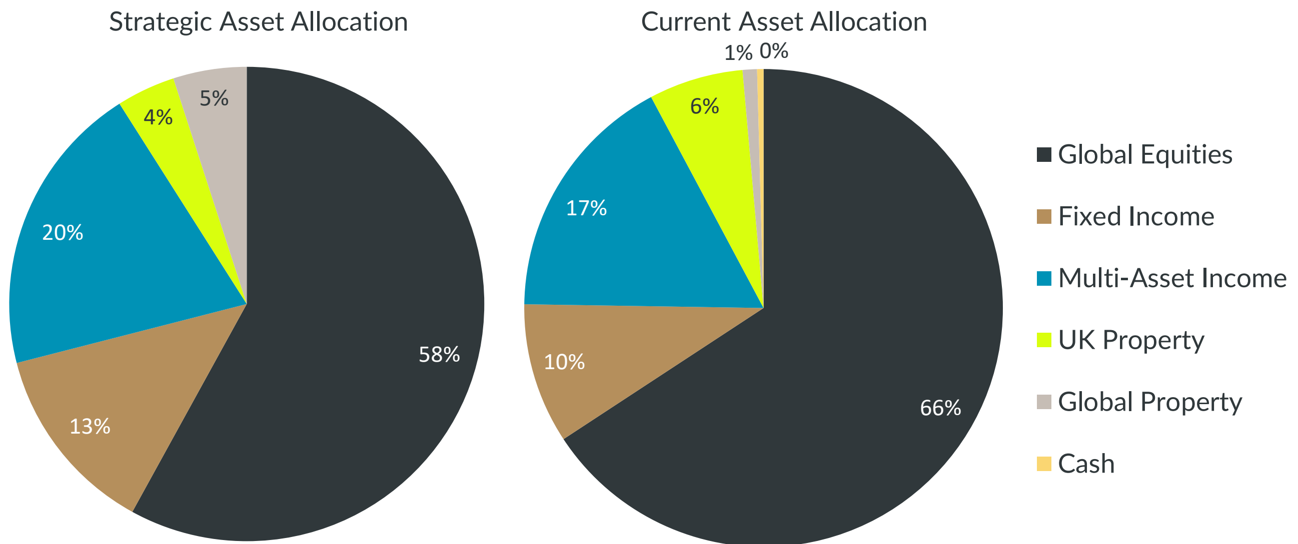
Is there any collateral supporting the bond? If not then the Fund has no protection if there is a fall in rental yield or any other negative impact on the borrower.

The assumed inflation rate is 2.5% for the next 22 years, Whilst this may be in line with current market pricing my own expectation is that we are entering an era of slightly higher inflation over the longer term and I certainly see a transition period of 5-10 years before inflation is stable at a sustainably low level.

Summery – I see the terms as relatively poor value from an investment viewpoint compared to other alternatives available to the Fund at the current time.

Currency Hedging

Figure 1: SAA and Current Asset Allocation (as at 30 September 2022)



The pie charts above set out the Fund's Strategic and current Asset Allocation. Of the asset classes the Fund is invested in, only the Fixed Interest and UK Commercial Property investments are held in Sterling. In addition, about a third of the Fund's investment into Multi-Asset Income will be in Fixed Interest and therefore held in or hedged back to Sterling. In particular, the exposure to global equities is unhedged which means the currency exposure mirrors the country breakdown of the index. (over 60% US Dollar exposure) within the Fund's Strategic Asset Allocation. Against this the liabilities, in terms of current and future pension payments, are all Sterling based. Insight, the investment manager, estimates that the Fund has £820m of unhedged currency risk, a 10% rally in the value of Sterling would therefore reduce the value of the assets of the Fund by £82m, if nothing else changed. Of course, no one factor influencing asset prices acts in isolation and it is fair to argue that, for those companies manufacturing in a country with a weakening currency, the terms of trade improve, giving the business a competitive boost.

Does this matter?

No - because the Fund is an open Defined Benefit Pension Fund and therefore any currency swings will even out over time and over the long-term – 20 years plus, Sterling has tended to weaken consistently over the last 150 years.

Yes – Sterling has been very weak over the last 5 years and currencies have a habit of mean reverting (trending towards the average). The currency looks cheap on purchasing power parity (it cost more to buy the same goods in the US particularly, than the UK, even for a fairly standard product e.g. a Big Mac burger or cheese sandwich).The scale of the benefit to the Fund of the recent weakness of Sterling is large and could be reversed.

As an example of the currency effect on global equity portfolios, the recovery in Sterling against the US Dollar in Q4 2022 reduced performance of a global equity portfolio from a 7% return when hedged back to Sterling to a 2% return when unhedged over that period.

It is important to recognise that the Fund does have currency risk due to the impact of holding non Sterling assets against Sterling based liabilities, therefore, the volatility of future performance would be reduce by hedging back to Sterling a percentage of the global equity portfolio.

Operationally, the effect of including a currency hedge creates cashflow considerations. To hedge a currency a manager would purchase 3 month forward currency contracts locking in the predicted exchange rate for that time. This exchange rate would be the current rate plus or minus any interest rate differential. When these currency contracts expiry and change

in the exchange rate will be settled in cash with the Fund either paying to or receiving from the investment manager the profit or loss on the currency contract. If the Fund hedged 50% (£410m) of the global equity portfolio back into Sterling and Sterling weakened by a further 10% from current exchange rates then the Fund would have to pay the investment manager £41m in cash. This would require selling assets to settle the payment. Obviously if Sterling appreciated then the payment would be from the investment manager to the Fund and the Fund would be £41m better off.

One of the strengths of the Fund at the present time is that it can cover its forecast cashflows into the future. In order to avoid becoming a forced seller of assets as Sterling weakens one solution would be to have the currency manager run a portfolio of £40m short dated bonds (yielding currently around 4%). This then becomes the collateral backing the currency hedge and would only require the fund to replenish this portfolio when Sterling had fallen from current levels. Of course, f Sterling appreciates then money would flow into this portfolio and the buffer covering any future Sterling weakness would increase.

In terms of cost Insight, as an example, would charge 2bp on the value of the hedging portfolio plus a fee to manage any short dated bond portfolio acting as collateral.

I believe approximately 50% of LGPS Funds hedge an element of their global equity portfolios back to Sterling (usually 50%) and 50% do not.

I believe this topic needs further consideration by the Committee but give no recommendation at the current time.