London Borough of Bromley

Quarterly Report

Q4 2022

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Performance Summary

Market Indicators

Index (Local Currency)		Q1 2023	Quarter-on-Quarter	YTD
Equities			**Total Return**	
UK Large-Cap Equities	FTSE 100	7,632	2.1%	2.1%
UK All-Cap Equities	FTSE All-Share	4,158	1.7%	1.7%
US Equities	S&P 500	4,109	7.9%	7.9%
European Equities	EURO STOXX 50 Price EUR	4,315	12.4%	12.4%
Japanese Equities	Nikkei 225	28,041	10.0%	10.0%
EM Equities	MSCI Emerging Markets	990	4.0%	4.0%
Global Equities	MSCI World	2,791	7.7%	7.7%
Government Bonds				
UK Gilts	FTSE Actuaries UK Gilts TR All Stocks	3,080	2.0%	2.0%
UK Gilts Over 15 Years	FTSE Actuaries Uk Gilts Over 15 Yr	3,797	2.8%	2.8%
UK Index-Linked Gilts	FTSE Actuaries UK Index-Linked Gilts TR All Stocks	4,172	4.3%	4.3%
UK Index-Linked Gilts Over 15 Years	FTSE Actuaries UK Index-Linked Gilts TR Over 15 Yr	4,786	4.9%	4.9%
Euro Gov Bonds	Bloomberg EU Govt All Bonds TR	213	2.5%	2.5%
US Gov Bonds	Bloomberg US Treasuries TR Unhedged	2,254	3.0%	3.0%
EM Gov Bonds (Local)	J.P. Morgan Government Bond Index Emerging Markets Core Index	130	4.8%	4.8%
EM Gov Bonds (Hard/USD)	J.P. Morgan Emerging Markets Global Diversified Index	818	1.9%	1.9%
Bond Indices				
UK Corporate Investment Grade	S&P UK Investment Grade Corporate Bond Index TR	338	2.4%	2.4%
European Corporate Investment Grade	Bloomberg Pan-European Aggregate Corporate TR Unhedged	217	2.0%	2.0%
European Corporate High Yield	Bloomberg Pan-European HY TR Unhedged	400	2.9%	2.9%
US Corporate Investment Grade	Bloomberg US Corporate Investment Grade TR Unhedged	3,072	3.5%	3.5%
US Corporate High Yield	Bloomberg US Corporate HY TR Unhedged	2,264	3.6%	3.6%
Commodities				
Brent Crude Oil	Generic 1st Crude Oil, Brent, USD/bbl	80	-7.1%	-7.1%
Natural Gas (US)	Generic 1st Natural Gas, USD/MMBtu	2.2	-50.5%	-50.5%
Gold	Generic 1st Gold, USD/toz	1,969	7.8%	7.8%
Copper	Generic 1st Copper, USD/lb	409	7.5%	7.5%
Currencies				
GBP/EUR	GBPEUR Exchange Rate	1.14	0.7%	0.7%
GBP/USD	GBPUSD Exchange Rate	1.23	2.1%	2.1%
EUR/USD	EURUSD Exchange Rate	1.08	1.3%	1.3%
USD/JPY	USDJPY Exchange Rate	132.86	1.3%	1.3%
Dollar Index	Dollar Index Spot	102.51	-1.0%	-1.0%
USD/CNY	USDCNY Exchange Rate	6.87	-0.4%	-0.4%
Alternatives				
Infrastructure	S&P Global Infrastructure Index	2,741	3.6%	3.6%
Private Equity	S&P Listed Private Equity Index	165	5.3%	5.3%
Hedge Funds	Hedge Fund Research HFRI Fund-Weighted Composite Index	17,820	1.7%	1.7%
Global Real Estate	FTSE EPRA Nareit Global Index TR GBP	3,519	-2.0%	-2.0%
Volatility			**Change in Volatility**	
VIX	Chicago Board Options Exchange SPX Volatility Index	19	-13.7%	-13.7%

Source: Bloomberg

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

The rebound across all asset classes since the October 2022 lows can be seen in the table above. I would note the heavy fall in oil and gas prices, which has been instrumental in inflation passing its peak, and the relatively strong performance of Gold in the face of continued economic uncertainty, both of these factors have continued since the quarter end.

Performance

The Fund rose by 2.2% over the first quarter of 2023, the Fund benchmark rose by 3.2% over the quarter. The 1% underperformance was driven by one of the Fund's managers MFS who underperformed their benchmark by 3.8% in the quarter and account for 28% of the Fund's assets. The Fund benefited from remaining overweight Global Equities against the Strategic Benchmark. This overweight was reduced late in the first quarter as the portfolio was partially rebalanced back towards the Strategic Benchmark weightings. Longer-term, the poor performance of the Baillie Gifford Global Equity portfolio during 2022 and difficult market conditions during this period of rapidly rising interest rates has taken the Fund performance below that of its Strategic Benchmark over 3 and 5 year period. Nonetheless the Fund has still returned 8.5% per annum since 1987 and it is this strong investment performance which has driven the improvement in the Fund's funding ratio.

Comment

Are we likely to enter a recession? My answer remains yes, we will find out over the next two quarters. (Probability 80%). Central banks are raising interest rates to slow demand and hence contain inflation. Historically, we have never seen central banks raise interest rates to just the right level to bring demand down to a non-inflationary level, that is why we have economic cycles and, across the globe, it usually takes longer than 5 years to bring inflation down to target levels after an inflationary spike, not 9 months.

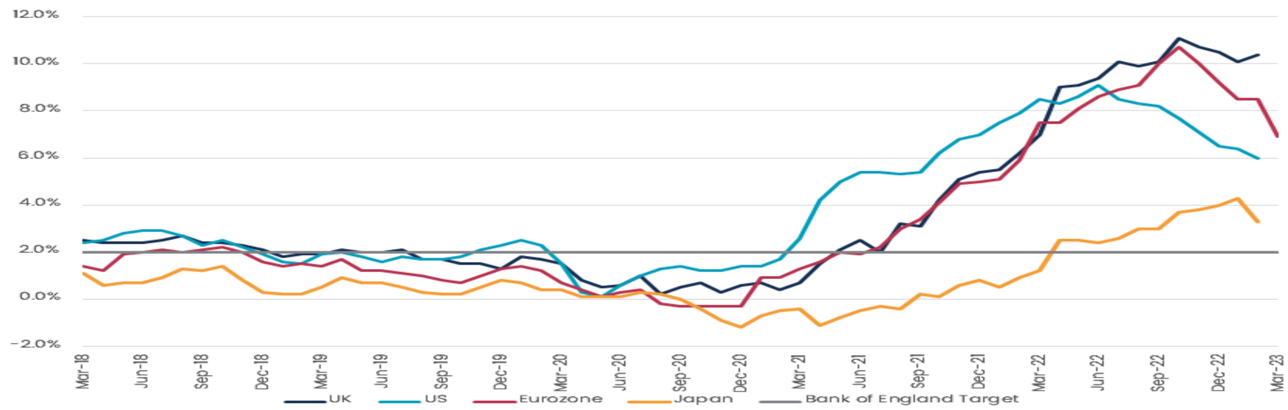
Will this be a shallow recession of a couple of quarters or a deeper longer lasting recession? The answer here is more balanced. Many developed economies continue to be driven by the consumer who still appears to have excess savings built up during the Covid pandemic. (Probability of a deep recession 50%; mild recession 30%).

Will the recent banking issues develop into a much more fundamental undermining of the banking industry? No, but the run on a number of US regional banks will have the effect of tightening credit conditions further and could be approximately equivalent to a 0.25-0.5% increase in interest rates. Banks borrow short-term money and lend it for a longer duration, When interest rates rise rapidly, as they have done, the cost of short-term deposits rises whilst it takes time for medium-term loans (e.g. mortgages) to roll off the books and reprice to reflect higher interest rates. If a bank has a concentrated and mobile deposit base and cannot realise their loan book or investments quickly and profitably, they are in danger of seeing a run on their deposits. Banks become more cautious and reticent about growing their lending book if they fear a loss of deposits, this leads to tighter credit conditions.

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 past 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 the headline inflation rate below 5% quite quickly in some regions.

As can be seen from this chart, US and then EU inflation have now peaked with the UK to follow.

Chart 1: CPI – Annual rate of Inflation - Five Years to March 2023



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)

Already noted in the previous quarterly, other commodities and food prices are starting to fall and supply lines look to be functioning better as shown by falling shipping rates.

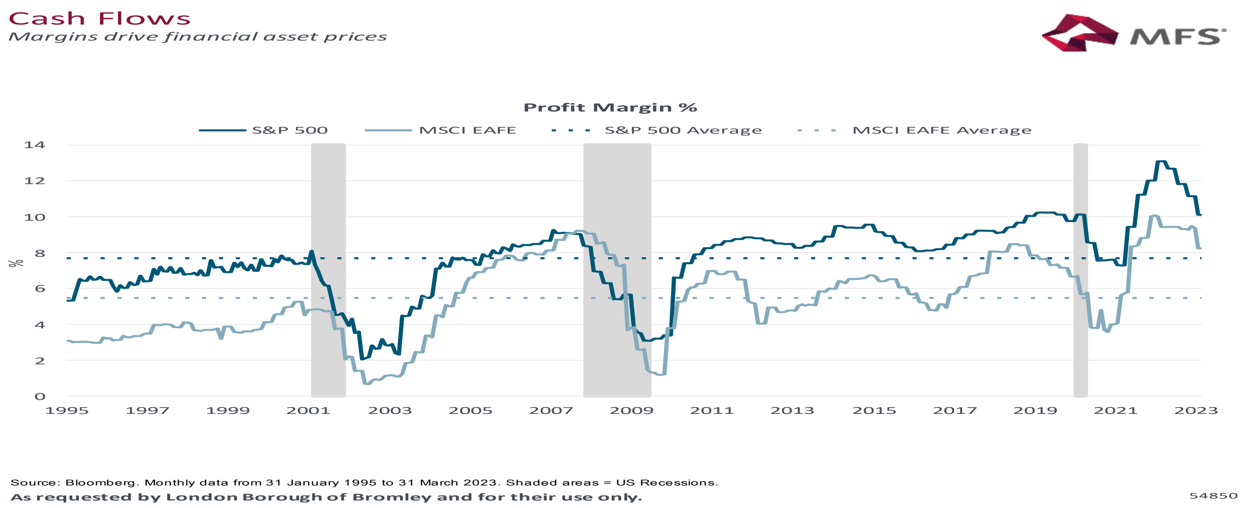
It is the consumer globally who is keeping the economy afloat at present as they work through the excess savings built up during the Covid pandemic but it is very difficult to understand how long this will last as the savings rate in any economy is not a fixed figure but varies considerably over time and, therefore, it is impossible to accurately calculate the level of excess savings and how long this will last at current spending rates. It is noticeable that spending on credit cards in the US has picked up recently suggesting current spending is starting to increase household debt rather than reduce savings.

Inflation, like the pandemic, does not affect everyone equally. Both tend to have a more detrimental effect on the least well off. Businesses tend to be able to rise prices faster than workers can force wages higher, this can be particularly true in the public sector and those on benefits. In the UK, whilst average wages rose by 6.9% in the year to February 2023, that was a fall of 3.2% p.a in real terms given 10% annual inflation. The Rowntree Foundation estimates that UK unemployment benefit has fallen by 12% in real terms between March 2021 and March 2023. But even this underestimates reality for claimants as it is the basic food stuffs and necessities which have seen the steepest price rises in many cases. This unequal effect on individuals and countries of the Covid pandemic and then inflation is what is making it particularly difficult to understand when and how quickly the global economy will slow given the rise in interest rates. Inflation is often said to be a tax on the poor and whilst the effect of Covid and inflation on differing segments of society may be hidden within most economic figures it will have an effect on socio-economic factors and, in all likelihood, the political environment.

It is also noticeable that corporate profit margins remain high and many companies seem to be able to put through price rises and maintain margins at the current time, this will only last whilst the consumer continues to spend.

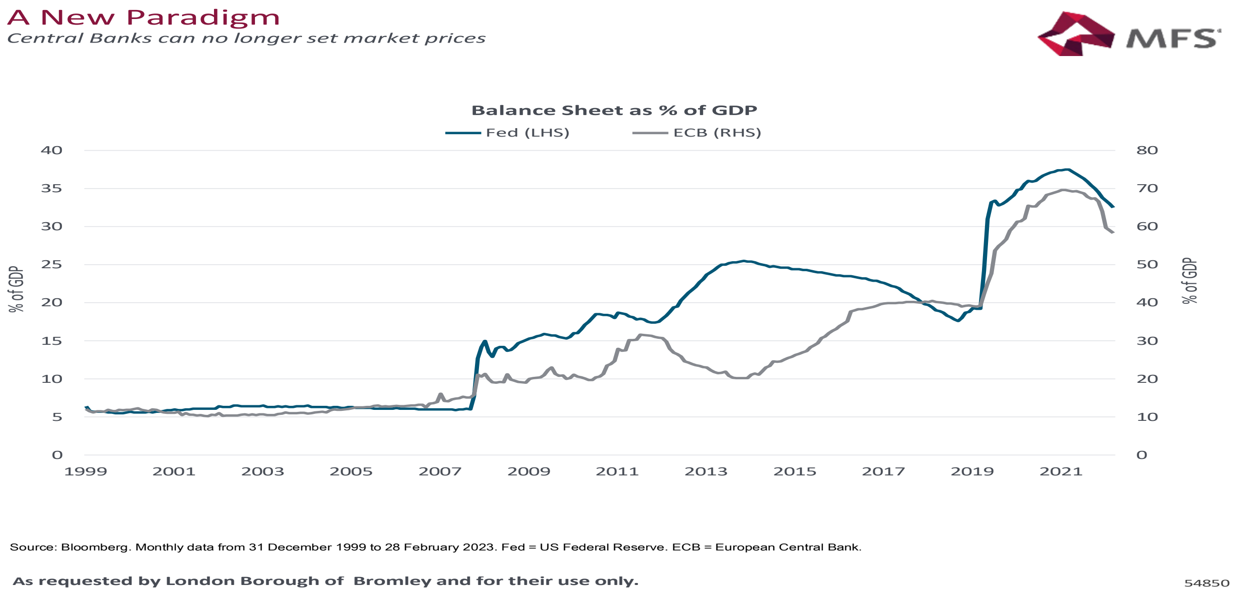
My expectation is for a pause to interest rate rises in the US and, potentially, elsewhere during the summer and for inflation to fall, but that the central banks will become concerned when they see that whilst headline inflation is falling, core inflation (excluding energy and food prices) is slower to respond and will require interest rates at current levels or higher for a considerable time. Markets are currently pricing in cuts to US interest rates by year end and I continue to see this as very unlikely with any attempt to cut rates into a slowing economy later in the year likely to be reversed during 2024 to combat stubbornly higher inflation.

Corporate profit margins are at extreme levels and suggests many companies have used inflation to push prices up in excess of costs. Some of this will be from the energy sector which had a bumper 2022 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 equity valuations. Note the collapse in margins during previous recessions as shown by the shaded areas in the chart below.



In the US there are signs of companies resorting to exceptional items to maintain profits with an increasing divergence of Generally Accepted Accounting Principles (GAAP) earnings and reported earnings. This again is a sign of coming stress in corporate earnings.

The last unknown is the effect of quantitative easing on the balance sheets of central banks. We have seen an unprecedented expansion of central bank balance sheets across the developed world as economies flirted with deflation during the 2010's. and again during the response to the economic impact of the Covid pandemic. Central banks would like to reduce their balance sheets and have started to sell off some of the accumulated bonds they have bought but this has only just begun and the effect of this is unlikely to be fully understood at the current time. We now recognise that quantitative easing inflated asset prices, it would therefore seem logical that quantitative tightening and the removal of cash from the monetary system will do the opposite?



Asset Allocation

The Fund's tactical asset allocation continues to deviate from the Strategic Asset Allocation (SAA) Benchmark, being overweight equities. This has reduced following the rebalance last quarter with a £70m sale from the Baillie Gifford Global Equity portfolio transacted just before the collapse of Silicon Valley Bank and increased stress across the US regional banking sector. The money was reinvested into the Fidelity Fixed Interest portfolio (£20m); both the Fidelity and Schroders Multi-Asset Income portfolios (£15m each) and into US Dollar cash (£20m) awaiting drawdown into the Morgan Stanley International Property Fund. This approximately halved the deviations from the Funds Strategic Benchmark. With the sale coming from the Baillie Gifford Global Equity portfolio the split between the two Global Equity managers is now 55/45

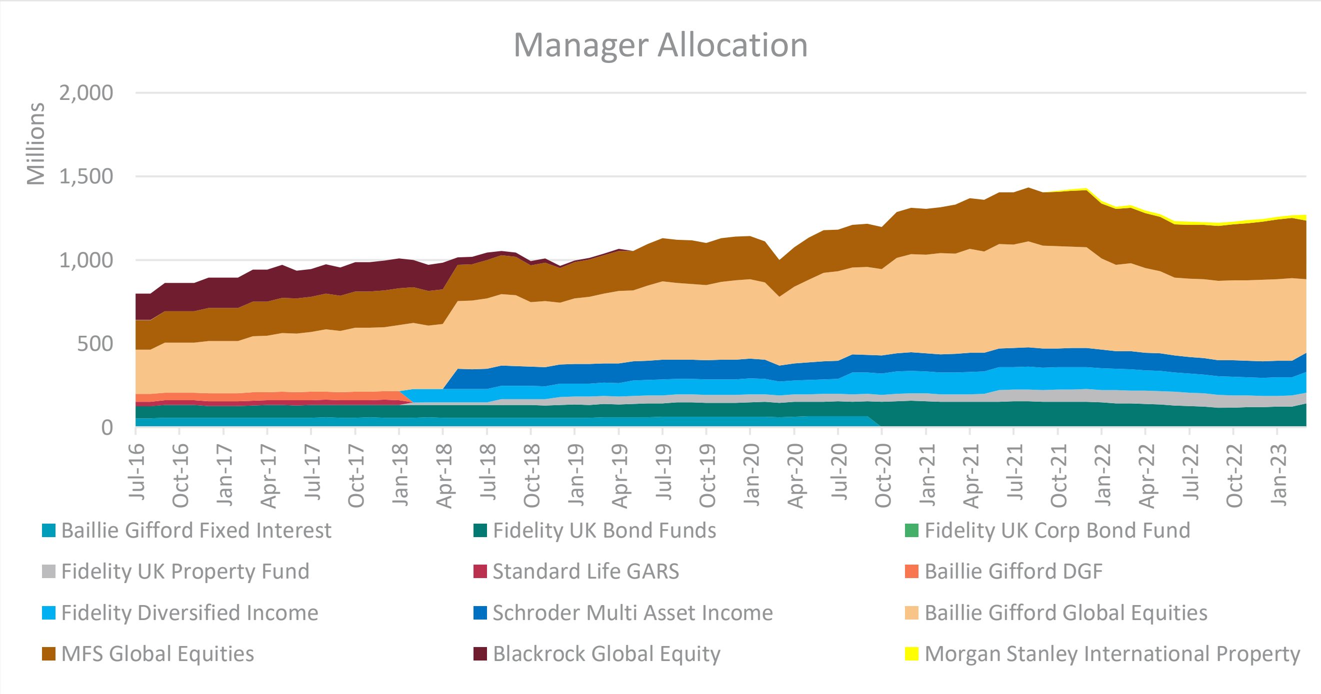
Given my comments above I would be happy to see a further reallocation to reduce the overweight in Global Equities and to reinvest into Fixed Interest as I see this as a more defensive asset class given my concerns about a pending recession.

Asset class	Asset Allocation as at 31/12/2022	New benchmark going forward	Position against the benchmark	Asset Allocation as at 31/3/2023	Position against the benchmark
Equities	67.0%	58%	+9.0%	62.1%	+4.1%
Fixed Interest	9.7%	13%	-3.3%	11.2%	-1.8%
Property	5.3%	4%	+1.3%	5.1%	+1.1%
Multi-Asset Income	16.7%	20%	-3.3%	18.8%	-1.2%
Int'l Property +US$	1.3%	5%	-3.7%	2.7%	-2.3%

Figures may not add up due to rounding

In early November your officers and the Chair held their triennial meeting with the Fund's asset managers to discuss expectations 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 was 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.

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%

31/3/22	£1,244m	£1,163m	115%	4.1%

The Funding level may deviate from the current assumption used in the table above due to the impact of legislative changes, changes to the actuarial discount rate or changes to inflation expectations as well as the level of investment returns achieved. The actuary assumes that future investment returns will cover the accrual of future pension liabilities. The actuarial revaluation from 31/3/2022 assumes CPI +2.0% to fund future accruals. I would expect the main challenge to be the assumptions used for long-term inflation which may have to rise from the 3.1% used in the 2022 revaluation. This will affect the assumptions used for pension increases and salary increases and is likely to increase the cash outflow from the Fund.

Cost Transparency Initiative (CTI)

In 2018, the CTI was tasked by the FCA with designing a standardised CTI template for asset managers to report all costs associated with managing an institutional client's money. The CTI is supported by Pensions and Lifetime Savings Association (PLSA), Investment Association (IA) and Local Government Pension Scheme - Scheme Advisory Board (LGPS SAB).

The CTI has now launched a standard template for managers to complete which details all costs borne by the investor, including management fees; admin and custody fees and transaction costs. The LGPS SAB has set up an LGPS Cost Transparency Compliance and Validation System with a company called BYHIRAS https://lgps.byhiras.com/ which can be accessed by LGPS Funds. The CTI Template is to be completed annually by investment managers but is voluntary.

I last reported on the CTI templates for the Fund in Q3 2020. This a repeat of that exercise.

All of the Fund's asset managers are a member of the CTI and I have reviewed the CTI templates for all the Fund's mandates with the exception of the International Property portfolio and regard them as fit for purpose. Because the International Property portfolio is in build-up phase, comparing costs to AuM will provide limited useful information at the current time. The management fees shown for each mandate are competitive and in line with the agreements that I am aware of and the transaction costs borne by each portfolio are acceptable. The two global equity portfolios, in particular, have low transaction costs compared to the industry average because both managers invest for the long-term and have a low turnover of holdings. Within the less liquid portfolios, the CTI templates are of less value and the reporting of the transaction cost much less detailed. This should improve going forward and the information in these reports should get more standardised over the coming years. Some of the managers have already provided these reports to Bromley, others are happy to do so upon request.

The table below shows the charges borne by the Fund for each mandate for the fiscal year 2019/20 as reported by the managers:

Mandate	AuM	Management Fee (inc VAT)	Transaction Costs	Comment
Baillie Gifford Global Equity	£438m	0.4513%	0.0518%	
MFS Global Equity	£350m	0.4369%	0.1091%	
Fidelity Fixed Interest	£142m	0.2303%[1]	-0.1484%	The manager added value by dealing within the spread when buying or selling securities.
Fidelity Multi-Asset Income	£124m	0.4193%[2]	0.1147%	Pooled fund so the transaction cost not fully included
Schroders Multi-Asset Income	£115m	0.554%	0.2685%	Management fee is 0.35% + VAT. Fees incurred within the pooled fund structure is 0.215%
Fidelity UK Property	£65m	0.89%	0.57%	Property, as an illiquid asset is more expensive to trade.

[1] Includes 40% fee discount for aggregation with Multi-Asset Income Fund
[2] Includes 33% fee discount for aggregation with Fixed Interest

I would treat these figures with care, there is plenty of scope for managers to interpret the requirements differently particularly around transition costs and the treatment of pooled funds. The management fees will not correspond exactly to fee rates agreed within your contracts as the CTI template presents annual information with costs calculated as a percentage of the period end Assets under Management (AuM) whereas the fees will be calculated and charged on a monthly or quarterly basis.

Environmental, Social and Governance

We are still awaiting a Government pronouncement on their Levelling-up agenda for LGPS Schemes and would expect that during this quarter. We are also awaiting comment on Taskforce on Climate-Related Financial Disclosure (TCFD) reporting for LGPS funds but it seems increasingly likely that this will slip into next year.

The Fund has commissioned Mercers to report on carbon emissions, I understand this report will look at the Fund's asset allocation and assume each portfolio is invested inline with the index for each asset class in order to produce an estimated carbon weighting for the entire Fund. Whilst this is of value, it will not take account of the actual managers used by the Fund. In the case of the Global Equity portfolios, in particular, the investment philosophy and process used by both Baillie Gifford and MFS leads them to invest away from carbon intensive industries and the figures they produce for the carbon intensity of their Bromley Global Equity portfolios are below the figures for the associated index which Mercers will be using in their calculation. In addition, both Schroders and Fidelity take carbon intensity into account when building their Multi-Asset Income and (for Fidelity) the Fixer Income portfolios. Again this has the effect of their portfolios showing a lower carbon intensity than the underlying index. Because of this, my assumption is that the figures produced by Mercers will overestimate the carbon intensity of the Fund but I will comment more on this report once it is published.

Executive Summary

- Q1 was a strong quarter for equities and bonds, however, the headline numbers obscure some dramatic market events that took place. Macroeconomic data was generally resilient in the quarter, as inflation continued to decline (with the exception of the UK), employment data generally showed tight labour markets and central banks continued their rate hikes, albeit at a slower pace. The focus on inflation and central bank outlooks took a backseat in early March, as a confidence crisis, which started with US-tech focused Silicon Valley Bank (SVB), spread to other similar US lenders (Signature Bank, First Republic), and then to struggling Swiss bank, Credit Suisse (CS). Central bank regulators acted swiftly to restore confidence: US Federal Reserve (US Fed) opened swap lines (providing liquidity to banks) and guaranteed depositors in the afflicted banks, while the Swiss National Bank (SNB) organised a rescue bid for CS from rival Swiss bank UBS. While these actions have restored confidence in the short-term, the underlying causes of the stress (mark-to-market losses on balance sheets combined with competition for deposits, both driven by the sharp rise in interest rates) remain, and are likely to have medium term repercussions.
- Despite the banking crisis mentioned, equity markets rose over the quarter and, in particular, were led by growth-oriented stocks (+14.9% for growth, +0.2% for value). However, the quarterly gain of +7.7% for the MSCI World (c. +6% in GBP terms) was not a smooth ride with the index up sharply in January, before declining in February and early March as the banking crisis unfolded and then rallying strongly to end the quarter up +7.7%. European and Japanese equities performed particularly strongly (around +12% and +7% in GBP terms respectively). The US Fed providing large amounts of liquidity led to long bond yields falling sharply in March despite a small upward move in short-term rates, resulting in performances between +2% and +5% for most fixed income and interest rate-sensitive alternative asset classes (except real estate, which continued to decline -2%). Index-linked gilts and EM debt performed particularly well. Energy prices softened (oil down -7%) and the US Dollar continued its weakening trend (-1%).
  - **It is worth highlighting the following themes, impacting investment markets:**
  - **Tighter credit conditions following the banking crisis makes recession more likely.** Keen competition between banks for deposits, together with the reaction to the SNB imposing losses on contingent "AT1" bondholders in the CS rescue, have put significant pressure on bank funding. This has fed quickly through to tighter credit conditions, which, by some measures, are as tight as they were following the 2008 financial crisis. So, while it is important to note that consumption and employment are still relatively strong in most developed economies, they are trending weaker, and the tight credit conditions will make survival tougher for any struggling businesses. This is likely to put pressure on corporate earnings in the second half of 2023, and increase defaults in credit portfolios.

- **Inflation – continuing to grind lower, but rates likely to remain elevated for some time.** The UK was the outlier in the quarter with annual CPI rising in February to +10.4%, having fallen for the prior 3 months. However, headline UK inflation is expected to decline in the months ahead (current consensus c. +5% in 2023 and +3% in 2024) as energy prices have fallen from their dramatic highs last year. But, while labour markets remain relatively tight, central banks are likely to maintain high short-term rates and there is potential for the energy genie to return later in 2023. So rate cuts still look to be some way off.
- **Volatility has increased in "stabilising" asset classes (fixed income).** Concerns over the path of US rates and the fallout from the banking crisis has led to increased volatility in bond markets. The MOVE index, which measures the volatility of the US Treasury bond market, ended 2022 at an already elevated level of 122 but spiked in March to 199, well above the Covid-19 March 2020 levels, as bond yields fell dramatically in mid-March 2023. While this volatility has affected the rate-sensitive (long) government bond market in particular, the next phase of tighter credit is likely to see increased volatility in asset-classes exposed to credit risk (corporate bonds, private debt etc).
- **Equity valuations rise despite earnings risk.** While US equities rallied strongly in Q1, analysts have at the same time lowered their forecast earnings for Q1 2023 and for full year earnings 2023. If correct, this will mark consecutive quarters of declining earnings and, for Q1 2023, the expected decline is the largest quarterly decline since the Covid impacted Q2 2020. This combination has led the forward earnings ratio for the S&P 500 to rise to 17.8x, from 16.7x at year end 2022. Companies have generally been guiding that they expect minimal revenue growth for 2023 and slightly contracting profit margins (albeit still at historically elevated levels of c. 11.2%). This appears to leave scope for disappointment.

- Global equities rose sharply in Q1, as investors initially embraced cooling inflation data in the US before strong US economic data (jobs report, ISM survey) reminded investors that the US Fed is still in a rate hiking cycle. The VIX declined over the quarter from 22 to 19, although reaching 27 in the midst of the March banking crisis.
  - In the US, the S&P 500 rose by +7.9% and the NASDAQ soared by +21.6%. Markets rallied despite the turmoil in banks in the US and Europe in March, seemingly driven by support from the US Fed and this potentially signalling a near term end to rate hikes.
  - UK equities rose +2.1% in Q1 but underperformed global equities and ending below the February high. Earnings updates from large index constituents in energy and financials drove strong performance. Economic data has also proven more resilient than dire forecasts in late 2022, with a sharp decline in energy prices contributing, and the Bank of England noting that while it still expects a recession in 2023 it now expects a shallower one than previously. The BoE raised the base rate in both February and March, by 50bps and then 25bps, to 4.25%.
  - The Euro Stoxx 50 rose by 12.4% in Q1, to follow its strong gain last quarter. Economic data was better than expected with falling inflation and a strong purchasing managers index result in February indicating strong business activity. The ECB raised the deposit rate twice by 50bps in the quarter, to 3.5%.
  - Japanese equities outperformed global equity markets, rising by +10.0% in Q1. Japanese equities appeared to be catching up to global equities after a weak Q4 and were buoyed by comments from the incoming new Bank of Japan Governor that he supported the current easy monetary conditions. Inflation has been rising in recent months but in February declined to +3.3% from +4.3% the month prior. The yen was largely flat vs the USD over the quarter.
  - Emerging market equities rose +4.0%, lower than global equities due to an -8.9% decline in the relatively expensive Indian equities market.
- Medium- and longer-term bond yields fell over the quarter resulting in solid performance for bonds, while very short-term yields rose following various central banks rate hikes. The US yield curve inversion as measured by the 10 year yield –2 year yield ended the quarter at -58bps, close to the 2022 year end -61bps, but much steeper than a peak in March of -107bps. In corporate bonds, high-yield credit and investment grade performed roughly in line as credit spreads for the high yield index tightened slightly over the quarter. Emerging market bonds rose 4.8% in local currency and 1.9% in hard currency.
  - The US 10-year Treasury yield fell in Q1, ending at 3.48% from 3.88%. US rates rose initially until early March, at which point the banking crisis led the US Fed to introduce new liquidity provisions. US CPI data prints also declined during Q1 but remain uncomfortably high (6.0% as of February 2023). The US Fed raised their policy rate 0.25% twice in the quarter (to 4.75%-5.0%) despite the banking crisis.
  - The UK 10-year Gilt yield fell from 3.65% to 3.49% and 2-year from 3.60% to 3.44%. Since Q4, UK Gilts have returned to their approximate positioning relative to Bunds (UK approx. +120bps) following the sharp yield spikes due to the September/ October 'mini budget'. The BoE hiked rates by 75bps in the quarter which led only short term rates to rise, with maturities from 2 years onwards all falling in yield.
  - European government bonds had a total return of 2.5% in Q1. Yield curves flattened further over Q1, as short end rates rose in response to the ECB raising its policy rate to 3.5% while yields for medium and longer-term yields fell. The German 10-year bund yield fell from 2.44% to 2.29%, while Italy's fell from 4.55% to 4.09%.

- US high-yield bonds narrowly outperformed investment grade, returning 3.6% and 3.5% respectively. European high-yield bonds returned 2.9%, outperforming the 2.0% for European investment grade and 2.4% for UK investment grade.

- Energy prices fell over Q1 which has supported recent headline inflation figures. Warmer weather over winter in Europe has resulted in a sharp downward repricing in natural gas, while for oil, markets continue to grapple with the trade-off between potential economic slowdown from tighter monetary policies vs a boost in demand from China re-opening and OPEC+ production cuts.
  - US gas prices fell -50.5% over Q1, reversing the sharp rise that occurred through 2021 and 2022 and are now back to 2020 levels.
  - Brent crude oil fell -7.1% over Q1, to US$80 per barrel at quarter end, although this was up from the mid-March price of US$73. Prices have continued to be volatile as fears of a recessionary fall in demand have clashed with supply side dynamics relating to Russia's invasion of Ukraine, OPEC+ production cuts and China's reopening from Covid restrictions.
  - Gold and Copper rose +7.8% and +7.5% respectively over Q1, with gold rising as investors sought a safe haven asset amidst the banking turmoil. Copper rose with a boost from China, a significant copper importer, loosening regulations on its stricken real estate sector which has been hampered since the 2021 property deleveraging policies. Gold and Copper closed Q1 at 1,969 USD/toz and 409 USD/lb, respectively.
- Global listed property continued to decline, with the FTSE EPRA Nareit Global Index falling -2.0% in Q1 2023.
  - The Nationwide House Price Index in the UK has continued its decline, with the price index down -1.8% for the quarter, and down -1.0% for the year. While only a modest decline, this is a considerable deterioration from the 9.5% YoY growth in Q3 2022, and 10.7% in Q2 2022.
  - European commercial property has also continued to decline in the face of higher interest rates, with the Green Street Commercial Property Price Index down by -2% this quarter and -15% for the past 12 months.
- In currencies, sterling strengthened against the US Dollar (+2.1%) and the euro (+0.7%) over the quarter, as the ongoing high and uncertain inflation in the UK is viewed as requiring a more lengthy period of tighter monetary policy. The US Dollar fell in Q1 (Dollar index -1.0%), continuing to reverse some of the prior 2022 Dollar strength.

Special Note: Anatomy of the Banking Crisis

While much has already been written about the banking crisis witnessed to date in 2023, a brief summary is: deposits at US banks rose sharply in 2020 and 2021 following the Covid social security payments, and perhaps due to a decline in spending following Covid restrictions, as well as large amounts of capital raised by venture capital firms which flocked to SVB. Interest rates fell to near zero given the extremely loose monetary policy. Banks then needed to use this capital to provide loans, or to invest in securities (commonly US Treasuries). Due to strict risk based capital requirements, many banks invested in Treasuries and engaged in interest rate hedging. SVB was particularly exposed due to: reducing its interest rate hedging ratio on securities leading to large unrealised losses, having an undiversified depositor base largely of Venture Capital firms, and having a large proportion of deposits above the US$250kFederal Deposit Insurance Corporation (FDIC) insured limit. Depositors and investors became alarmed that SVB would not be able to sell its securities to provide cash to depositors if required (essentially a 'bank run'). SVB's depositors then, en masse, began withdrawing cash, leading SVB to attempt to raise equity capital which proved unsuccessful. Signature Bank also had a very high proportion of uninsured deposits (90%) and was rapidly closed by the FDIC 2 days after SVB. Investors then turned their attention to CS, despite very different underlying issues, with CS more troubled by legacy profitability and compliance issues, leading to outflows of assets under management and deposits. With unfortunate timing, in early March CS announced an Stock Exchange Commission (SEC) assessment of issues in its financial reporting in 2021 and 2022 which triggered a share price drop. The following day, large investor Saudi National Bank declared it would 'absolutely not' invest further prompting a collapse in the share price and subsequent forced sale to UBS.

Performance report

Asset Class/ Manager	Global Equities/ Baillie Gifford
Fund AuM	£438m Segregated Fund; 34.5% 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

The Baillie Gifford Global High Alpha portfolio rose by 5.1% over the quarter against a benchmark rise of 4.5%. Long-term performance is mixed with the portfolio underperforming over 5 years by -1.3% per annum and therefore failing to achieve its performance target, but has outperformed its benchmark by 0.6% per annum since inception in 1999.

This is now the third consecutive quarter when Baillie Gifford has marginally outperformed its benchmark. The overriding effect on the portfolio performance in 2022 was rising bond yields which 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.

Unfortunately Baillie Gifford did invest into Signature Bank, a US regional bank, earlier this year, only to see the recent turmoil in the US regional banking sector result on a run on the deposits of this bank and the business was shut down by the regulator in March 2023. The portfolio lost 0.55 basis points (0.55%) in Signature Bank but, despite this, the Baillie Gifford portfolio outperformed the benchmark this quarter.

Asset Class/ Manager	**Global Equities/MFS**
Fund AuM	£350m Segregated Fund; 27.6% 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/Robert Almeida/John Arthur 10/5/23

MFS focuses on companies with a below market valuation but where the business returns are consistent and the company has a strong competitive positioning within their industry which is defensible. This makes the business more stable in an environment where inflation is rising as they retain more pricing power.

The MFS portfolio rose 0.6% against a rise in the benchmark of 4.4% in the quarter. However, the portfolio outperformed its benchmark by over 10 % in 2022 having previously struggled to add value during a period of falling inflation and low interest rates. The portfolio has added 1.4% per annum over the last 5 years and 1.5% per annum since inception in 2013.

There was a noticeable switch back into growth stocks during the quarter with 'Growth' as a style outperforming 'Value' by over 15% in the quarter according to MSCI indices in US Dollars. MFS believe they invest in companies with a defensible business model which enables them to retain pricing power. During 2022, with inflation rising, many companies found it easy to raise prices in consumer facing businesses and much of the strong performance from MFS came from being in the right sectors e.g. Financials, Industrials and Consumer staples. Going forward, with inflation falling but still above central bank targets, the environment will become harder for MFS and their stock picking ability will be more closely examined as corporate margins come under pressure.

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.

Asset Class/Manager	UK Aggregate Bond Fund and UK Corporate Bond Fund/ Fidelity
Fund AuM	£142m pooled fund; 11.2% 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: David Barber/John Arthur

The Fund has two similar Fidelity Fixed Interest portfolios. The UK Aggregate Bond Fund which has a benchmark that 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	1Q23 performance	1 Year performance	Duration	Yield
UK Agg Bond	3.0%	-22.8%	7.8 years	5.3%
UK Corp Bond	5.8%	-18.4%	6.0 years	6.1%

The combined portfolio rose by 1.5% over the quarter but has fallen by -14.1% 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 0.4% 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 in-line with their benchmark during the current bond market retrenchment.

Asset Class/Manager	Mult-Asset Income / Fidelity
Fund AuM	£124m Pooled Fund; 9.8% 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	£115m Pooled Fund; 9.0% 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 0.1% over the quarter whilst the Schroders portfolio rose by 2.6%. Over 12 months the Fidelity portfolio has returned -9.1% and the Schroders portfolio -4.9%. Over three years the Fidelity portfolio has risen by 1.4% per annum and the Schroders portfolio by 4.7% 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 become 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 month's 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.

During 2022 there was some divergence between the performance of the two portfolios with Schroders managing the fall in bond prices and general market de-risking better than Fidelity who did not seem to recognise the potential for a correlated fall in bonds and equities which is what happened during 2022.

Asset Class/Manager	UK Commercial Property / Fidelity
Fund AuM	£65m Pooled Fund; 5.1% of the Fund
Performance target	IPD UK All Balanced Property Index
Adviser opinion	
Last meeting with manager	12/4/23 Alison Puhar/David Barber/ John Arthur

The Fidelity UK Property portfolio fell by 15.8% in the last quarter of 2022 as UK commercial property prices repriced to take account of the higher bond yields available. The first quarter of 2023 was a more stable affair with the Fund rising 0.3% against a benchmark fall of 0.2% Over three years the portfolio has risen by 2.8% 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.

Over the last 5 years the UK Commercial Property benchmark has returned 2.5% per annum against 10% per annum for Global Equities and -2% per annum for the Fund's fixed Interest benchmark.

Asset Class/Manager	International Property / Morgan Stanley
Fund AuM	USD80m(£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

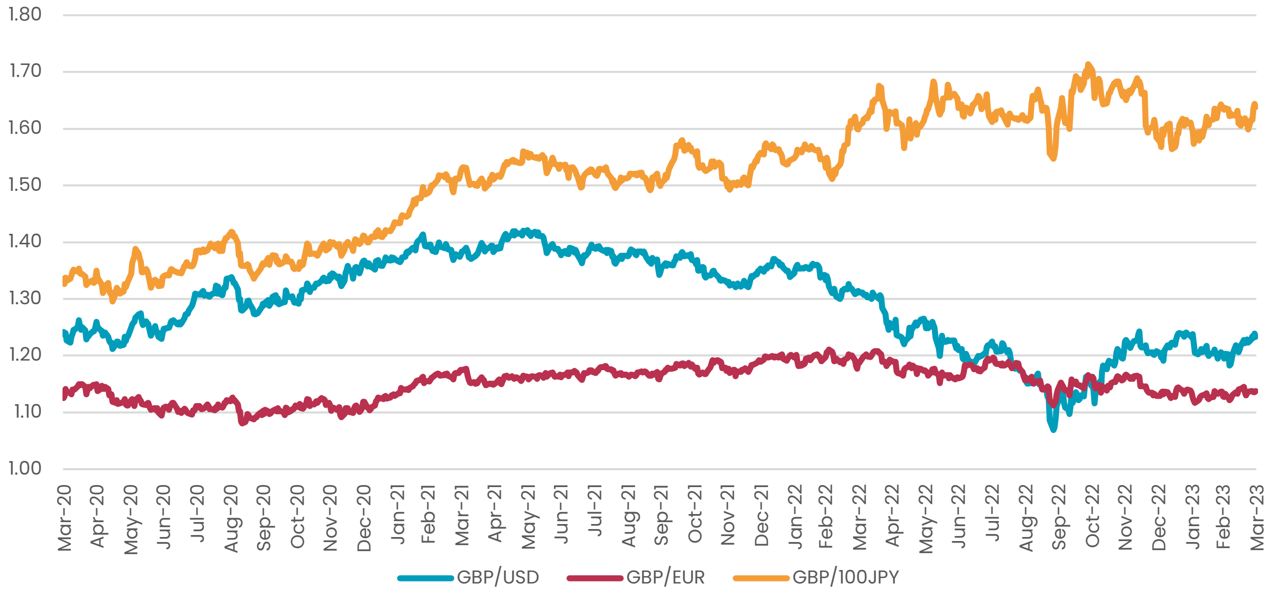
The International Property portfolio is now valued at £20m following further drawdowns this quarter. The Fund currently holds £15m in US Dollar cash to cover further drawdowns following the additional purchase of USD cash towards the end of this quarter. The manager expects to speed up the rate of investment through 2023 as prices are beginning to look more attractive although this may be back end loaded over the year.

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 assets 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.

Currency

Please note the recent strength of Sterling against the US Dollar. This is more US Dollar weakness than Sterling strength, Sterling has been relatively stable against the Euro and the Japanese Yen. The effect of a weakening US Dollar will be to lower the Fund's returns in Global Equities where the currency is unhedged as well as to reduce the value of the US Dollar cash holding supporting the International Property allocation.

Chart 7: Three-Year Currency Rates of Major Currencies vs Pound Sterling



Source: Bloomberg

Notes: GBPEUR Spot Exchange Rate (Ticker: GBPEUR Currency); GBPUSD Spot Exchange Rate (Ticker: GBPUSD Currency); GBPJPY Spot Exchange Rate (Ticker: GBPJPY Currency)