London Borough of Bromley

Quarterly Investment Report

Q1 2023

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Key Indicators at a Glance

	Index (Local Currency)	Q2 2023	Q2	YTD
Equities			**Total Return**	
UK Large-Cap Equities	FTSE 100	7,532	-0.4%	1.7%
UK All-Cap Equities	FTSE All-Share	4,096	-0.6%	1.1%
US Equities	S&P 500	4,450	8.7%	17.3%
European Equities	EURO STOXX 50 Price EUR	4,399	4.2%	17.2%
Japanese Equities	Nikkei 225	33,189	18.5%	30.5%
EM Equities	MSCI Emerging Markets	989	1.0%	5.0%
Global Equities	MSCI World	2,967	7.0%	15.2%
Government Bonds				
UK Gilts	FTSE Actuaries UK Gilts TR All Stocks	2,913	-5.4%	-3.5%
UK Gilts Over 15 Years	FTSE Actuaries Uk Gilts Over 15 Yr	3,481	-8.3%	-5.8%
UK Index-Linked Gilts	FTSE Actuaries UK Index-Linked Gilts TR All Stocks	3,897	-6.6%	-2.6%
UK Index-Linked Gilts Over 15 Years	FTSE Actuaries UK Index-Linked Gilts TR Over 15 Yr	4,298	-10.2%	-5.8%
Euro Gov Bonds	Bloomberg EU Govt All Bonds TR	214	0.0%	2.5%
US Gov Bonds	Bloomberg US Treasuries TR Unhedged	2,223	-1.4%	1.6%
EM Gov Bonds (Local)	J.P. Morgan Government Bond Index Emerging Markets Core Index	133	2.7%	7.6%
EM Gov Bonds (Hard/USD)	J.P. Morgan Emerging Markets Global Diversified Index	836	2.2%	4.1%
Bond Indices				
UK Corporate Investment Grade	S&P UK Investment Grade Corporate Bond Index TR	327	-3.1%	-0.8%
European Corporate Investment Grade	Bloomberg Pan-European Aggregate Corporate TR Unhedged	218	0.2%	2.2%
European Corporate High Yield	Bloomberg Pan-European HY TR Unhedged	408	1.8%	4.8%
US Corporate Investment Grade	Bloomberg US Corporate Investment Grade TR Unhedged	3,063	-0.3%	3.2%
US Corporate High Yield	Bloomberg US Corporate HY TR Unhedged	2,304	1.7%	5.4%
Commodities				
Brent Crude Oil	Generic 1st Crude Oil, Brent, USD/bbl	75	-6.1%	-12.8%
Natural Gas (US)	Generic 1st Natural Gas, USD/MMBtu	2.8	26.3%	-37.5%
Gold	Generic 1st Gold, USD/toz	1,929	-2.0%	5.7%
Copper	Generic 1st Copper, USD/lb	374	-8.6%	-1.8%
Currencies				
GBP/EUR	GBPEUR Exchange Rate	1.1637	2.3%	3.0%
GBP/USD	GBPUSD Exchange Rate	1.2703	3.0%	5.1%
EUR/USD	EURUSD Exchange Rate	1.0909	0.6%	1.9%
USD/JPY	USDJPY Exchange Rate	144.3100	8.6%	10.1%
Dollar Index	Dollar Index Spot	102.9120	0.4%	-0.6%
USD/CNY	USDCNY Exchange Rate	7.25	5.5%	5.1%
Alternatives				
Infrastructure	S&P Global Infrastructure Index	2,697	-0.1%	3.5%
Private Equity	S&P Listed Private Equity Index	175	7.7%	13.5%
Hedge Funds	Hedge Fund Research HFRI Fund-Weighted Composite Index	17,684	-0.8%	0.9%
Global Real Estate	FTSE EPRA Nareit Global Index TR GBP	3,433	-2.4%	-4.4%
Volatility			**Change in Volatility**	
VIX	Chicago Board Options Exchange SPX Volatility Index	14	-27.3%	-37.3%

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

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Performance

The Fund rose by 1.2% over the second quarter, 0.2% behind the benchmark. Global equities rose just over 3% in Sterling terms whilst UK Corporate Investment Grade Bonds fell just over 3% over the quarter. Both equity managers marginally underperformed in the quarter and the Multi-Asset Income funds failed to keep up with their 'cash +' benchmarks in a flat market, particularly with cash rates higher now. Offsetting this, the Fund remains overweight Equities against its Strategic Benchmark which aided the relative performance. The Fund has returned 5.65% per annum over the last 5 years but remains 0.5% per annum behind the benchmark mainly driven by the poor performance of the Baillie Gifford Global Equity portfolio over that period. Over the long-term the Fund has returned 8.5% per annum over the last 26 years, usefully above the actuarially assumed investment return and it is this that has driven the improved funding level over time. Much of this long-term performance has been driven by the Fund's high equity exposure with additional value added through the choice of managers.

Asset Allocation Recommendation

In the comment below I set out my own expectations for the direction of monetary policy and the global economy over the next few years. As a result of these views, my recommendation is that the Pension Committee consider transitioning 5% of the Fund from the Baillie Gifford Global Equity Fund currently managed through the LCIV to Fidelity to invest into their short-dated UK Corporate Bond fund. This Portfolio invests into short-dated UK Investment Grade bonds with some discretion to invest overseas, hedged into Sterling and invest off benchmark. It is slightly different from the existing two Fidelity bond funds the Fund currently holds, being shorter duration and, therefore, at the current time, higher yielding. The rationale for this is the high yield available in short-term UK bonds and some concern that equity markets and long duration bonds have yet to fully reflect an economic environment where interest rates remain higher for much longer than the current market consensus, particularly in the UK.

Why short duration? – because I am concerned that longer term bonds have yet to price in a higher for longer inflation and interest rate environment combined with the high level of Government debt.

Why not more that 5% of the Fund? – Because the Fund is an Open, Defined Benefit Pension Fund with a strong sponsor and therefore can invest over the ultra-long term which means global equities should continue to be the mainstay of the Funds investment strategy.

Why Fidelity? - Because they have managed the Fund's fixed Interest portfolios for over 25 years and have added 0.7% per annum over the benchmark over that time through periods of benign and stressed economic and market environment which leads me to believe that they are a strong asset manager who understands their investment process within this asset class and has the resources to enact that process. To select a different manager may require a procurement exercise which is costly and time consuming.

Thought should be given as to whether the Fund should alter the Strategic Asset Allocation benchmark to reflect this change in allocation. Given the Fund is currently overweight in Equities and underweight in Bonds it is not imperative to do this but, given that I expect bonds to remain relatively attractive for the medium-term it may make sense to alter the Strategic Allocation. If so, my recommendation would be to move 3% of the Strategic benchmark from Global Equities to Bonds to give the weightings shown in the table below. If only the investment switch is made and the benchmark not changed then the table below shows the position of the Fund on the left, against a white background, if both the investment and benchmark changes are accepted then the position of the Fund against the new benchmark is shown on the right of the table below against a grey background.

Table 1: Asset class weightings resulting from the recommendations above

Asset class	Fund as at 30/6/23	Current benchmark	Position against benchmark	New benchmark	Fund post switch	Position against new benchmark
Equities	58.5%	58%	+0.5%	55%	58.5%	+3.5%
Fixed Interest	15.6%	13%	+2.6%	16%	15.6%	-0.4%
Property	5.0%	4%	+1.0%	4%	5.0%	+1.0%
Multi-Asset Income	18.2%	20%	-1.8%	20%	18.2%	-1.8%
Int'l Property +US$	2.7%	5%	-2.3%	5%	2.7%	-2.3%

If the Fund makes the investment switch and moves the benchmark then the Fund remains overweight in Global Equities awaiting for that money to be drawn down into the International Property Fund. If the Fund makes the investment switch and does not move the benchmark then the money awaiting drawdown into the International Property Fund is, in essence, held in Bonds. It would make more sense, at the current time, to take the latter cause of action as there is now a lower probability of capital loss through holding short duration bonds making them a better place to hold capital awaiting drawdown.

At some stage in the future, when the inflation outlook is clearer, it may make sense to lengthen the maturity of the Fund's Bond portfolio to take advantage of any decline in yields but I expect that to be 2-5 years away. In the intervening period it would be sensible for the Fund to review the fixed interest portfolios managed by Fidelity and consider moving to a segregated portfolio to replace what would become three separate Fidelity bond mandates each with a slightly different benchmark. I have discussed this with Fidelity and believe such a move would give greater flexibility to manage the fixed interest exposure of the Fund with no increase in cost. However, thought needs to be given to what benchmark should be considered for such a mandate. Fixed interest investments are held for diversification purposes as they tend to rise in value when investors seek security during times of market stress when equities may be falling, but that diversification benefit is usually best at the longer duration end of the bond market. They are also held for yield which, at present, is most attractive at the short end of the duration curve.

The Fund's current fixed interest exposure is low compared to the LGPS sector and stands at 10.5% against 13% in the Strategic Asset Allocation.

The Fidelity short dated Corporate Bond Fund currently has a yield to maturity 6.8% with a duration of 2.5 years.

The table below compares the Fidelity Short Dated Bond fund with the Fund's existing Fidelity bond portfolios. Note the lower duration, this means that the bond prices are less exposed to interest rate rises.

Table 2: Comparison of Fidelity Sterling Bond Funds

Asset class	Current yield to maturity	Duration	Allocation to Govt bonds	Allocation to IG bonds + cash
Short Dated Corporate Bond Fund	6.8%	2.8 years	7.0%	96.8%
UK Aggregate Bond Fund	6.2%	7.9 years	43.2%	97.1%
Sterling Corporate Bond Fund	6.0%	6.0 years	9.4%	96.0%

These yields are above the investment return assumed by the actuary and so the Fund can lock in these returns at low risk whilst still boosting their funding level.

Recommendation 1 – To switch 5% or £65m from the Baillie Gifford Global Equity portfolio currently managed through the LCIV into a Short-Dated UK Corporate Bond fund managed by Fidelity.

Recommendation 2 - To consider altering the Strategic Benchmark to reflect this change.

Recommendation 3 – To discuss with Fidelity the costs and benefits of moving the Fund's fixed interest investments to a single segregated portfolio.

This switch would incur transition costs but the ongoing management fee would be lower.

Possible alternatives to this move, which would take advantage of higher bond yields, would be to invest the money into the PIMCO portfolio offered by the LCIV although this does not specifically target short duration bonds so the yield would be lower and potentially more volatile. The rationale for taking this route could be coming pressure from the Government over pooling. However, I would rather see the result of the current consultation on pooling and confirm the Government's ability to enact legislation before allowing this issue to trump investment rationale. Given the competitive fees offered by Fidelity I do not see much in the way of fee saving from this route.

A second approach would be to invest into direct lending, which is lending to small to medium companies at floating rates and so taking advantage of higher short-term interest rates. The positive here is that current rates and fee income are high in this space with a number of direct lending funds showing returns of 11%-12% at the current time but the investment would be illiquid via a close-ended fund similar to the international property fund with potentially a four-year commitment window meaning that current high returns may have fallen by the time the money is invested. Additionally, I am concerned about recession risk and, as such, nervous about taking concentrated credit risk in smaller companies at the current time.

Comment

My comments in the last quarterly report were pretty gloomy about the global economic outlook and yet the data reported during the second quarter continued to convince many investors that we are heading for a soft landing in the US with the Federal Reserve (US Fed) raising interest rates to just the right level to slow inflation which would benignly fall back to the 2% range that existed before the Covid pandemic struck whilst economic growth will clip along at 2% per annum with high rates of employment and moderate wage inflation. So why do I remain concerned?

1) We have never seen central banks bring inflation down over a short period of time, to exactly their target level, through the raising of interest rates to slow demand and cool the economy. Interest rates are a very blunt tool which acts on the economy with a variable and indeterminable time lag. There are reasons to believe that, on this occasion, interest rates will affect the economy with a longer time delay than usual due to the savings built up during Covid for the majority of the population and a higher percentage of corporate debt and mortgages being fixed at low rates for a longer duration than in the past. However, as the market begins to understand that interest rates will stay higher for longer to combat stubborn inflation, even 3–5-year mortgages will eventually have to be renewed at much higher interest rates. Consumers, in particular, had a real propensity to spend post covid and became noticeably price insensitive in the immediate aftermath of the Covid induced economic lockdowns. It appears from credit card data that much of the Covid induced savings have now been spent.
2) Interest rates will stay higher for longer as wage expectations have risen. For employees who have accepted a 6% wage increase whilst inflation was 10%, they will expect to reclaim that loss of real purchasing power at a later stage. This expectation will only be lowered through the destruction of demand and therefore jobs with the increased unemployment undermining wage demands. We have yet to see this happening. US jobs' data shows the economy creating 185,000 new jobs in June and July, down from earlier this year but still above the !00,00 level which would

be consistent with 2% inflation. US wage growth is rising and now at 6% per annum, this again is not consistent with 2% inflation. The situation in the UK is similar with a shrunken workforce unable to fill current vacancies. Europe looks better on this metric with sufficient levels of unemployment to stop higher wage demands becoming entrenched but will still need to raise interest rates above current levels.

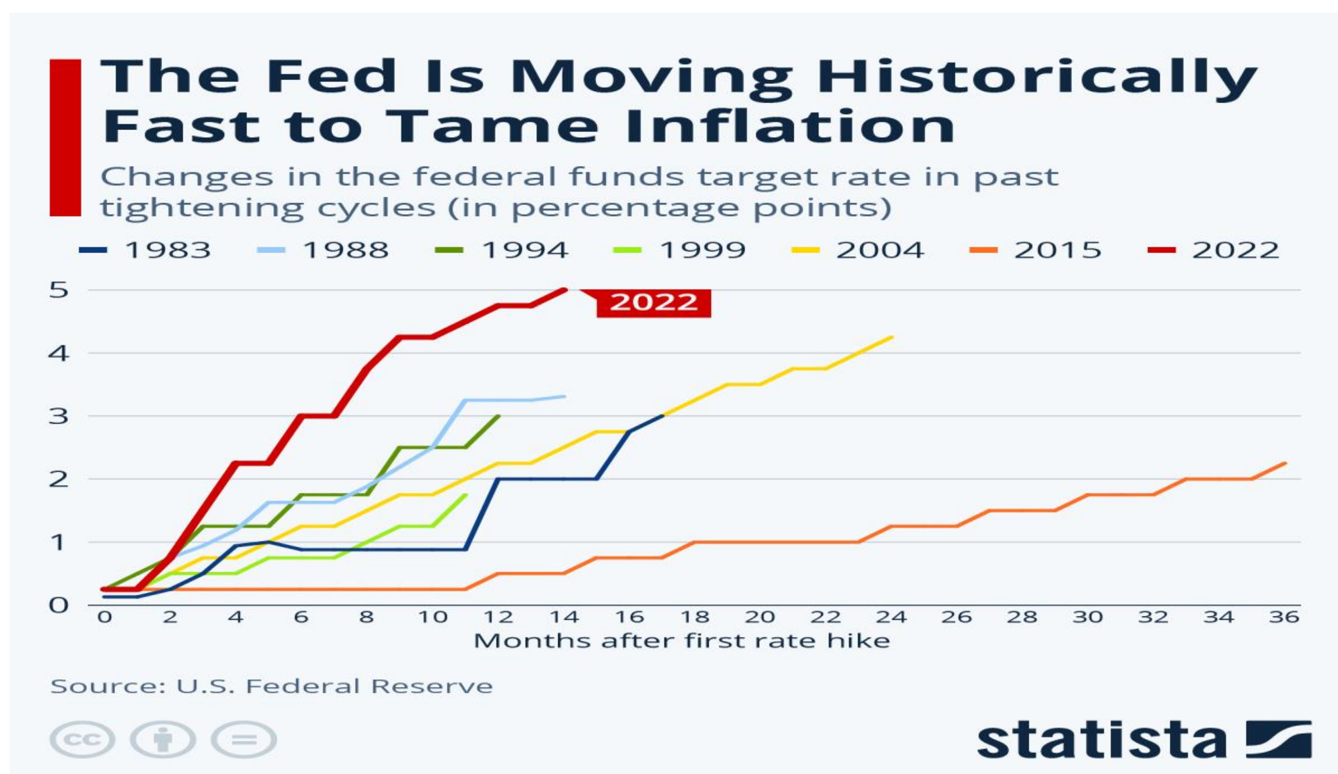
3) Inflation is a year on year measure, the massive rise in energy prices post the Russian invasion of Ukraine in spring 2022 has now fallen out of the inflation calculation and the effect of energy on the yearly inflation number has switched from being a major upward pressure to a negative, that reverts to a more neutral to positive push to inflation as we move through the second half of the year particularly as oil prices have been rising through the summer as we hit the peak US demand over the summer driving season. Headline inflation is falling as high inflation numbers of a year ago fall out of the equation. US inflation could get to 3% during the Autumn before picking up but this is not the same as stable 2% inflation.

4) Whilst the price of oil and gas has fallen back to pre-Covid levels, the situation in Ukraine and stressed relations with Russia still mean we could see further price volatility in the future. Whilst great efforts have been made to wean Europe off Russian gas there is still scope for further disruption.

Whilst I do expect headline inflation to dip through the summer, wage inflation shows that Central Bank targets of 2% inflation are out of reach at the current time. Because of this either interest rates will rise further to slow the economy or the rate rises to date will begin to have a greater impact on economic activity, either way I would still expect to see a recession across much of the developed world in 2024/5 and remain sceptical of a soft landing.

The current rise in interest rates is the fastest in recent history and has come after a period of prolonged ultra-low rates. We have never seen rates rise this quickly and not cause a recession. But what if the changes in corporate and consumer behaviour mean the effect of the interest rate rises are hitting spending with a much-delayed response? Is this giving corporates and consumers more time to react and get ready for higher interest rates or is it just delaying the inevitable?

Chart 1: US Fed interest rate tightening cycles



The chart above shows the extent and unprecedented speed with which the US fed has raised interest rates compared to past cycles.

Inflation

It is worth revisiting why inflation will be stickier in the future and why we are unlikely to return to the ultra-low interest rates of the past. There are a number of long-term trends which have held inflation down in the past but which are now changing as well as new inflationary factors to be considered.

1) Demographics – Global demographics are predictable as we know approximately how many people are alive and an estimation of their age and mortality. That the population is aging in most parts of the developed world is recognised, but, whereas over the past 40 years, an increasing percentage of the population in the developed world was of working age with more women entering the workforce due to a lower childcare burden, now the baby boomers are retiring and will need increased care in their old age removing more people from the workforce. This will not just lower the available workforce but also reduce the level of savings in the economy as baby boomers draw on their savings to fund their retirement and later life care. This will lead to less money being available for investment, lowering potential economic growth (as seen in Japan). The economic solution to this could be to accept greater immigration but that seems to be politically unacceptable at present in many countries but, without this, the bargaining power of the remaining workforce increases forcing up wages and thus inflation and interest rates. Chinas' own demographics are now also negative with a shrinking working age population.

2) Energy supply – The weaponization of energy supply is not new, the OPEC cartel was formed in the 1970's to force oil prices higher and redistribute economic wealth towards oil producers, mainly the middle east. President Putin has now followed the same playbook with Russian gas but, as the western world looks to switch away from carbon-based energy sources, it should be remembered that China produces over 50% of the world supply of car batteries and over 80% of solar panels as well as having a near monopoly on a number of metals vital to decarbonising the global economy. China's avowed intention to reunite Taiwan into the Chinese fold could again lead to the weaponization of critical energy supply chains even as the world moves to renewable energy.

3) Decarbonising the economy – The cost of moving towards a decarbonised economy will have to initially be borne by the consumer. Rethinking business methods may eventually lead to efficiency gains but the initial cost will need to be passed through the system.

4) Geopolitics – Politics are rarely important to investment markets with very few political leaders capable of having the vision and political longevity to really make a marked difference in how the world works. One notable exception would be Deng Xiaoping and his decision to shift China towards being an export-oriented, market-tolerating economy in the 1980s. This released a very sizable fresh workforce onto the world economy which drove down unskilled and semi-skilled wages and hence inflation for a 40-year period. It seems any geopolitical consensus is now fraying at the time when climate change demands just such a consensus.

5) Globalisation of trade – undoubtedly in the 40 years to 2010 global trade expanded as companies took advantage of the opening of China and other markets with their cheap labour force to bear down on the cost of manufacture, but rising geopolitical tensions mean that globalisation, while not in retreat, has stalled; in 2022, exports were slightly lower, as a proportion of global GDP, than they were in 2008. The move from 'just in time', low-cost production, to 'just in case' production with multiple supply chains located in, hopefully, more stable areas of the world must mean a higher overall cost of production.

The five points above have all worked to reduce inflation for a prolonged period of time but their long-term dynamic looks to have changed. However, going forward, there is one factor which continues to bear down on inflation and that is the speed of technological change. Artificial Intelligence (AI) is being touted as having similar potential to the introduction of the Internet to alter the way we live and how the corporate world works. I see this as having a simpler economic impact. For all

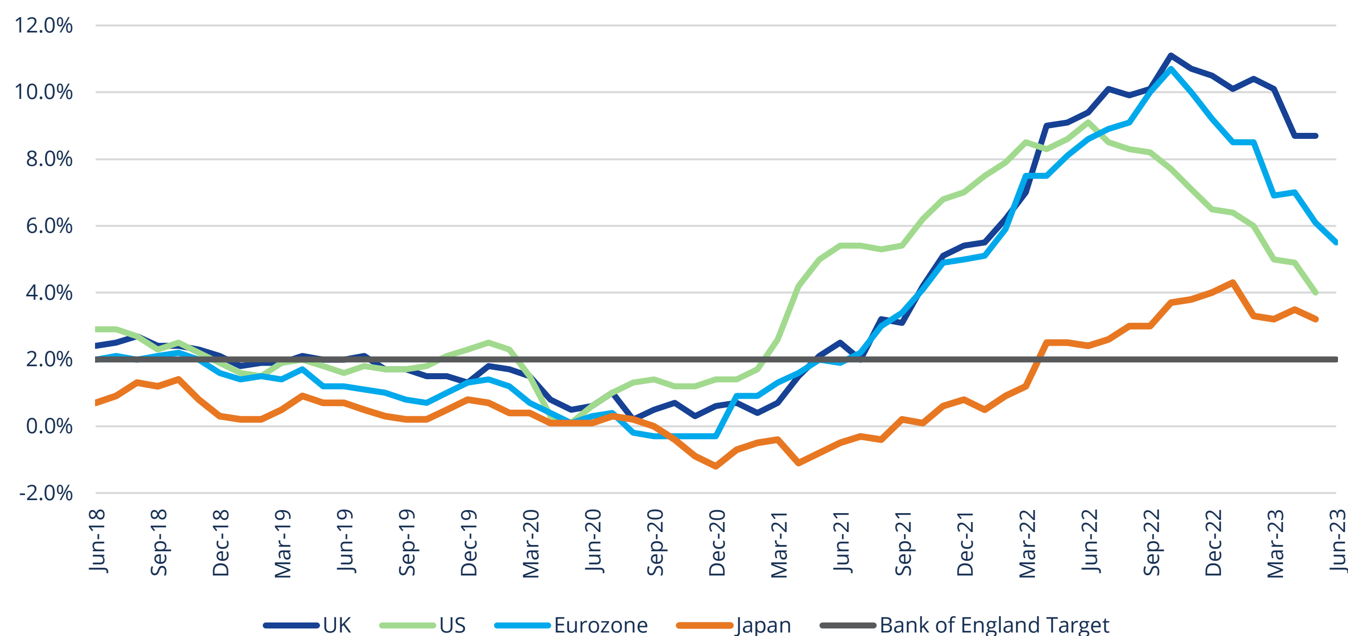
my working career, technology has advanced, altering the way I work, removing one competitive edge and opening up opportunities to create others. I see AI as a continuation of this trend. It pushes the substitution of labour by computing power up the value chain from skilled and semi-skilled work to highly skilled and professional work and will have the ability to drive the price for certain jobs lower whilst creating new roles in the monitoring and managing of AI itself as well as challenging its assumptions and results.

The above economic outline leaves scope for short-term interest rates to be nearing a peak in the US and UK and soon Europe whilst long-term bond yields may still exhibit some volatility as markets come to realise that inflation is not beaten yet; that interest rates will stay higher for longer; that high government debt levels will lead to higher interest charges with greater government bond issuance and that Quantitative Tightening removes a major buyer from the bond markets as central banks let their existing holdings of bonds bought during Quantitative Easing mature and fall off their balance sheet.

US inflation should bottom above 3%, quite possibly rising into the year end back towards 4% due to tougher year-on-year comparisons and continued high wage growth. This will not be an environment where US interest rates can be cut. The only alternative to this is a more obvious slowdown in the US economy and increased unemployment but any negative data will initially be used by the US Fed to pause interest rate increase rather than cut them. A reacceleration of the US economy seems unlikely from here. Whilst the time scale for the effect of higher interest rates may have lengthened, rates have still risen and, as such, eventually corporates and consumers will be paying higher debt servicing costs, the effect of which is to redirect free cash-flow generated by the business from growth towards interest payments.

Outside of the US, Europe does not have the same tight labour market and is, therefore, more able to bring inflation under control especially as economic growth is slow across much of the EU. The outlook here is for a mild recession but falling inflation. The UK remains the problem child, it has many of the same problems as the US with a tight labour market and inflation now built into many employees' wage expectations. The Bank of England (BoE) may still need to raise interest rates further into a sluggish economy and any indecision or tailing off in the inflation fight will undermine investor confidence in the UK and be felt through weaker Sterling and rising long-term bond yields which again emphasises my preference for the shorter duration bonds particularly in the UK.

Chart 2: CPI – Annual Rate of Inflation - Five Years to June 2023



All central banks in the western world would like to drop their 2% inflation targets but feel unable to do this until there are, at least short-term, signs that inflation will hit the 2% level. They will have to row back on their 2% target from a position of strength and credibility or lose the confidence of investors in their anti-inflationary stance.

China

China has not seen the same economic rebound from ending the Covid era economic lockdowns as the developed world. There seem to be two main reasons for this. Firstly, the Chinese property market has over expanded and become over indebted. This needs to be worked through but more importantly, if the government lowers interest rates it will just reignite the property sector and exacerbate the existing issues. Secondly, the consumer seems to have been scarred by their experience through Covid and is responding to what they see as the unpredictability of central government in the imposition of severe economic lockdowns over a multi-year period by increasing their propensity to save and storing more money away, this has negated the post lockdown consumption boom which we have seen in most other countries and is an interesting side effect of a totalitarian regime which can have an immediate and high impact on a populations' daily lives. This should be a transitory impact and consumption should pick up in time.

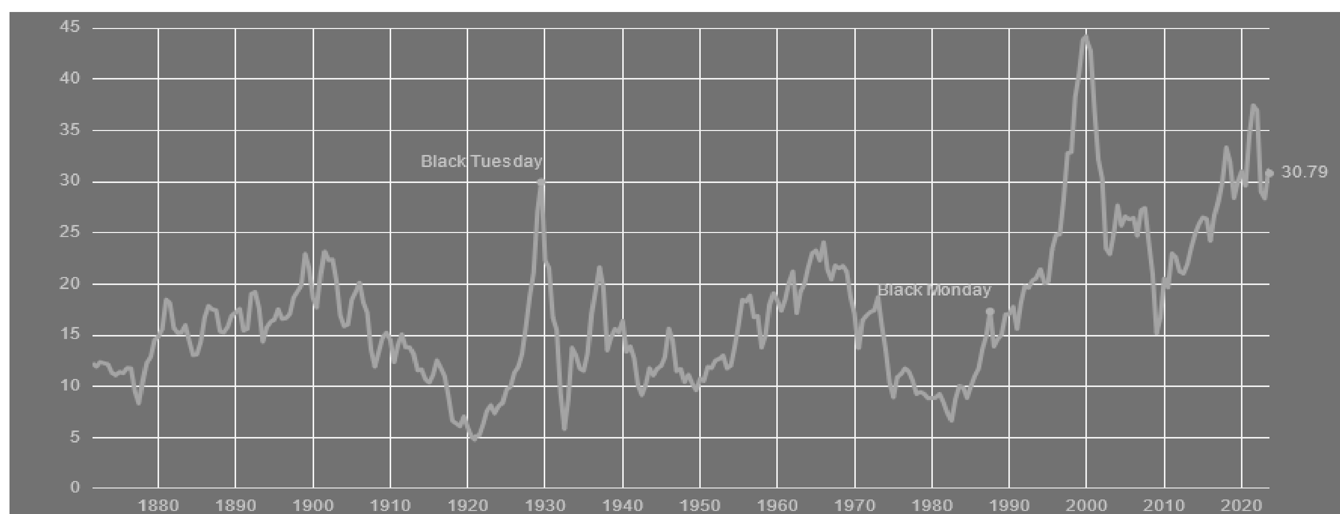
Markets

Given the above my expectation is for interest rates to stay high for the remainder of 2024 with any attempts to cut rates needing to be reversed quite quickly as inflationary pressures remain nearer the surface than in the recent past. This makes current yields quite attractive, particularly the shorter duration end of the yield curve as short rates are higher than long rates at present. A negative yield curve, where short duration yields are higher than longer duration yields, is traditionally seen as a sign of an impending recession. If interest rates stay higher for longer, short-term bond yields will remain high whilst longer duration bond yields may have to rise further leading to some price weakness in 5–20-year bonds.

In this higher rate environment, I would not expect equities to perform that well, on the one hand they are a partial inflation hedge but when the risks are of a slowing economy and stubborn inflation, the ability to pass costs on to consumers may become constrained. Earnings expectations have fallen back for this year but remain unaltered for 2024 and have, therefore, yet to recognise any impending economic slowdown.

The chart below shows the Shiller or CAPE price/earnings (P/E) ratio for the S&P 500 using average 10-year earnings and can be used as an indicator of long-term value for equity markets. It makes sense for equity markets to trade more expensively when interest rates, and thereby the cost of capital, is low but the recent rise in bond yields should lower valuations in the medium term. This suggests that equities are not particularly cheap at the present time.

Chart 3: Shiller P/E



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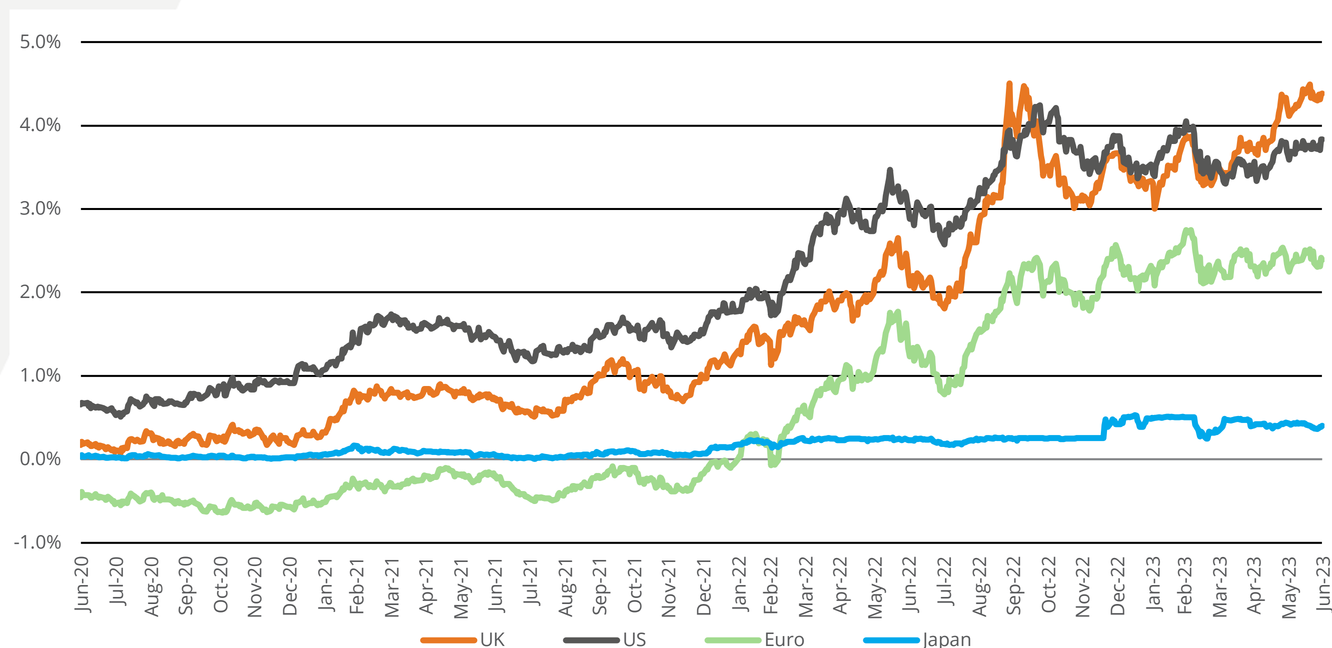
Asset Allocation

At The Strategic Asset Allocation review, conducted by MJHudson in 2022, little change was suggested to the current asset mix of the Fund. At the time bond yields were rising (prices falling) and looked unattractive and lower equity markets suggested they could generate higher returns in the near future. What has now changed is that there is more confidence that inflation has at least peaked and that higher interest rates will reduce inflation over time, interest rates in the US and UK are nearing their peak making short duration bonds more attractive to investors, whilst equities have risen over the last year making them more expensive.

Chart 4: Government 10-year Bond Yields



In that Strategy review MJHudson used forward looking risk and return assumptions for all the major asset classes, these assumptions showed Equities as one of the most attractive asset classes on a 10-year view with a return assumption of 6.7% per annum. Since then, equities are up 15% year to date whilst bonds yields have continued to rise (prices fall) and are now, in the UK, surpassing the yield levels reached in autumn last year when the Truss/Kwarteng budget brought the UK Gilt market into a panic.

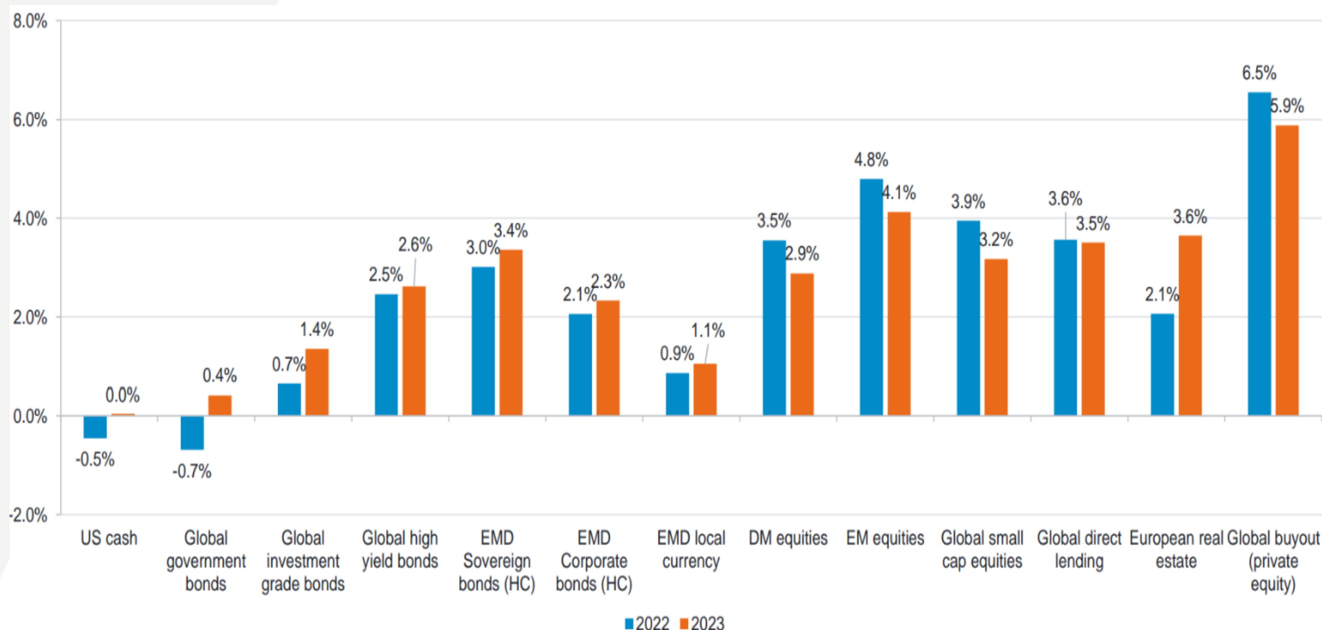
Given the move in markets so far this year, I would set the assumed return on UK cash equal to current interest rates of 5.25% (previously 2.2% reflecting interest rates at the time). Consensus is for UK interest rates to reach 5.5-5.75% during the Autumn although I suspect the peak may need to be over 6%. UK Gilt return expectations should reflect the current 10-year Gilt yield so 4.5% with UK Investment Grade and Global Bond returns also looking slightly higher at 6.0% (UK Gilt return plus credit risk premium).

Against this I would argue All Country World Equity returns lower to around 6.0% per annum for the next 10 years. I would also argue for a lower assumed return on Private Equity as I do not believe higher interest rates have been realistically fed through into valuations at present, yet deal flow and sales or flotations have fallen markedly, giving limited pricing points to check valuations against. (It will not just be a few UK water companies which bear the scars of the private equity industries desire to boost short-term returns by increasing the level of indebtedness within businesses.).

Direct lending is an area where returns are currently very attractive with yields currently over 10% with fee income on top. Given this high current return, 10-year returns could easily reach 7.5% or more. This remains an attractive area but is illiquid

and takes time to invest into meaning that it would need to be seen as a long-term allocation rather than a move to take advantage of higher current bond yields

Chart 5: Forecast Real returns by asset class, comparing 2023 with 2022 forecasts



Source Fidelity

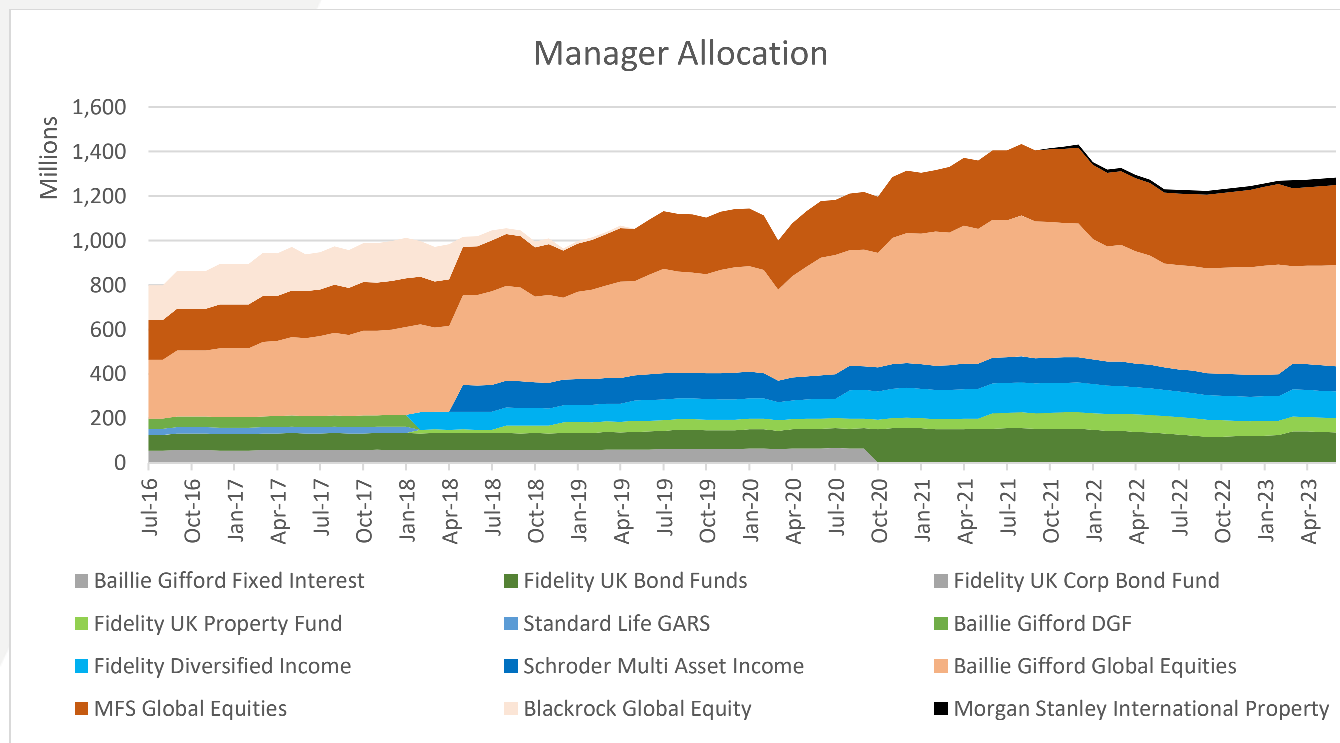
The chart above shows the forecast asset class real (post assumed 10-year inflation) returns for 2023 compared with those forecast a year ago. These are from Fidelity International. The exact numbers are less important than the change between 2022 and 2023. In particular, note the rise in forecast return for bonds as interest rates and yields have risen and the fall in expected returns from equity markets.

Table 3: The Funds current asset allocation against the Strategic Benchmark

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%	63.5%	+5.5%
Fixed Interest	9.7%	13%	-3.3%	10.6%	-2.4%
Property	5.3%	5%	+0.3%	5.0%	+0.0%
Multi-Asset Income	16.7%	20%	-3.3%	18.2%	-1.8%
Int'l Property +US$	1.3%	5%	-3.7%	2.7%	-2.3%

The change in the asset weightings since 31/12/22 reflects market moves plus sale of 5% of the Fund from equities to other asset classes completed earlier this year.

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



Executive Summary

- Macroeconomic data was generally resilient globally in the quarter, with headline inflation falling in the US and Europe, and remaining steady in Japan. Labour markets remained surprisingly robust and GDP growth remains below trend, but generally positive. Chinese and European manufacturing data has softened in recent months leading to some concern over the anticipated post-COVID rebound for China. The UK was an exception to the disinflation trend, with inflation at an uncomfortably high 8.7% in May. Despite falling inflation, the US Fed and ECB continued to hike rates and maintain a hawkish posture because of tight labour markets and stubborn core inflation data. The Q1 banking crisis appears to have been contained, but there are signs of consumer credit card defaults starting to tick up, and it is likely that the effects of the interest rate increases will take time to filter into real economies.
- Q2 was another strong quarter for equities, with global equities (MSCI World) rising around +7% in local currency (+4% in GBP terms). Equity markets were led by growth-oriented stocks (+10.1% for growth, +2.2% for value) as investors jumped on board the new innovation of Artificial Intelligence (AI). Japanese equities performed particularly strongly (+18.5% in local currency, and up +5.9% in GBP terms), as the Bank of Japan has maintained a more accommodative policy than its peers. The Tokyo Stock Exchange has also urged listed companies to become more focused on value creation, such as using cash stockpiles to remedy the low book values to market capitalisations. The combination of the very weak JPY and potential corporate governance improvement has attracted investors to the region. US equities returned just under +5%, though gains have been very concentrated in a few large tech stocks, leaving the rest of the index flat. UK equities, on the other hand, have lagged peers (slightly down in Q2) after a relatively strong 2022 and markets view more risk of recession and negative impacts to employment than for some other developed markets. Bonds, too, faced headwinds as interest rates continued to rise with central banks not yet ready to signal a shift in direction in the fight to reduce inflation. Global

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investment grade credit was flat over the quarter, but UK long index-linked gilts fell around -10% as yields jumped higher in light of stubborn inflation and investors now expect UK rates to peak above 6%. Energy prices softened further (oil down -6%), while GBP has continued to strengthen against both JPY and USD, retracing a fair amount of its weakness during 2022.

It is worth highlighting the following themes impacting investment markets:

- **Credit spreads indicate a sanguine sentiment to risk.** Credit spreads have tightened since the March banking crisis with US investment grade credit spreads ending Q2 at 120bps, having reached a year to date high of 165bps in March. US high yield bonds spreads have similarly tightened, from a high of 516bps, to 392bps at quarter end, despite incipient signs of rising delinquencies. In the first half of 2023, for example, US Chapter 11 bankruptcies have risen sharply on the same period last year.
- **Inflation – heading towards target, but core inflation proving sticky.** The UK was again the outlier in the quarter with annual CPI only falling to 8.7% in the quarter, compared to 4.0% for the US and 5.5% for Eurozone. However, core inflation (excluding energy and food prices) has been telling a different story. UK core inflation has worryingly risen to a new high at 7.1% in Q2, while US core inflation is now above headline inflation at 5.3% and has only slowly decreased from 6.0% 12 months prior. Similarly, Eurozone core inflation rose in June to 5.4% and is well above the 3.8% figure of 12 months ago. This all suggests the high inflation / high rates environment may last for rather longer than currently discounted.
- **A narrow range of stocks is driving global equities performance.** In May, Nvidia announced a vastly improved earnings forecast (50% above Wall Street consensus for Q2) driven by the demand for high specification chips used by entities pursuing AI efforts. This prompted a 52% rise in the share price over Q2, and has been emblematic of the recent attention investors are paying to companies with any form of potential for AI products. Indeed, Nvidia, Tesla and Meta have risen by 196%, 142%, and 130% respectively over the year to date. This characteristic, of performance being concentrated in a narrow number of stocks can be symptomatic of the late phases of equity bull markets.
- **Equity valuations rise despite earnings risk.** Equities rose for another quarter, despite analysts' forecasting S&P 500 Q2 earnings declining 7.2% on the year prior. This has led the forward earnings ratio for the S&P 500 to rise to 18.9x, from 17.8x in Q1, and comfortably above its 10-year average of 17.4x. Profit margins for US equities have declined to c.12%, from 14% in 2021 but remain above longer term averages and equity markets appear to be looking past the potential effects of high interest rates and discounting a "soft landing" scenario. This would seem to leave the asset class exposed to disappointment.

- Global equities rose sharply in Q2, led by US and Japanese equities for varying reasons. The VIX declined over the quarter from 19 to 14, well down on its average level of 21 for the 5 calendar years 2017 to 2022.
    - In the US, the S&P 500 rose by +8.7% and the NASDAQ soared by +15.2%. Markets rallied as enthusiasm for AI boosted a number of some stocks and an upward adjustment to the Q1 annualised GDP figure (from 1.3% to 2.0%) provided support to the view that the US economy may avoid a recession or 'hard landing' despite the sharp rise in interest rates.
    - UK equities fell -0.4% and underperformed global equities. Inflation has remained too high in the UK for the BoE, resulting in the base rate being raised to 5.0%, from 4.25% at the end of Q1. The BoE had slowed the pace of rate rises from 50bps to 25bps, but moved back to a 50bps rise in Q2. UK CPI was 8.7% in May, well above the 6.1% figure for the Eurozone.
    - The Euro Stoxx 50 rose by 4.2% in Q2. Economic data was better than expected with inflation continuing to move downwards, although the ECB has maintained a hawkish rhetoric. The composite PMI has, however, been declining in Q2 and in June fell just into contractionary territory at 49.9.
    - Japanese equities continued their strong run, rising by +18.5% in Q2. A weakening JPY has boosted exporters, as the BoJ maintains very accommodative monetary policy with core inflation currently at 3.2%, as well as the mentioned prospective corporate governance reform. The JPY yen fell 8.6% vs the USD over the quarter.

  - Emerging market equities rose +1.0%, underperforming global equities as Chinese stocks fell. Investors had previously pinned hope on a rebound in Chinese stimulus and growth which had propelled Chinese equities in late 2022 and early 2023; however, the country has not yet provided meaningful policy stimulus.

- Medium- and longer-term bond yields rose over the quarter, generally rising with rate hikes from central banks resulting in negative performance for government bonds. The US yield curve inversion as measured by the 10 year–2 year ended the quarter at -106bps, as short and mid-term rates rose more so than longer bond yields. In corporate bonds, high-yield credit outperformed as credit spreads tightened over the quarter. Emerging market bonds rose 2.7% in local currency and 2.2% in hard currency.
  - The US 10-year Treasury yield rose in Q2, ending at 3.81% from 3.48%. US rates rose steadily through the quarter, with US GDP being revised upwards for Q1 and job openings (JOLTS) at a strong 9.8 million, compared to 7.2 million in January 2020. The US Fed raised their policy rate by 0.25% just once in the quarter (to 5.0%-5.25%).
  - The UK 10-year Gilt yield rose sharply from 3.49% to 4.39% and 2-year from 3.44% to 5.27%. Over the quarter, the spread between UK and German 10-year bond yields widened, reflecting the increased stress viewed on the UK economy (UK approx. +200bps now vs +120bps in Q1, and close to the +228bps in September 2022 during the 'mini budget'). The BoE hiked rates by 25bps two times in the quarter.
  - European government bonds returned flat in Q2. Yield curves steepened further over Q2, as short end rates rose with rate hikes, with the main refinancing rate now at 4.0% (up from 3.5%), while longer term bond yields were little changed. The German 10-year Bund yield rose to 2.39% from 2.29%, while Italy's fell from 4.09% to 4.07%.
  - US high-yield bonds outperformed investment grade, returning +1.7% and -0.3% respectively. European high-yield bonds returned 1.8%, outperforming the 0.2% for European investment grade and -3.1% for UK investment grade.
- Energy prices were mixed over Q2, as gas prices rebounded somewhat although still sharply down from the pre-winter figures. Oil prices have traded down driven by concerns over global growth and oil demand.
  - US gas prices rose 26% in Q2. Prices have fallen dramatically from their 2021/ 2022 peaks.
  - Brent crude oil fell -6.1% over Q2, to US$75 per barrel. Falling prices since 2022 triggered various OPEC+ announcements of production cuts which have thus far only resulted in small reactions from the market. The US released oil from its Strategic Petroleum Reserve in 2021/ 2022 to meet demand and address high prices, but has yet to restock the inventory.
  - Gold and Copper fell -2.0% and -8.6% respectively over Q2. Gold fell as investors returned to risk assets and with high yields available on cash alternatives. Copper fell over the quarter from a high in April, with the growth outlook for China a headwind. Gold and Copper closed Q2 at 1,929 USD/toz and 374 USD/lb, respectively.
- Global listed property continued to decline, with the FTSE EPRA Nareit Global Index falling -2.4% in Q2.
  - The Nationwide House Price Index in the UK has continued its decline, with the price index down -0.3% for the quarter, and down -3.5% on an annual basis.
- European commercial property has also continued to decline in the face of higher interest rates, with the Green Street Commercial Property Price Index down by -2.3% this quarter and -15.9% over the past 12 months.
- In currencies, sterling strengthened against the US$ (+3.0%) and the Euro (+2.3%) over the quarter, as the ongoing high and uncertain inflation in the UK is viewed as requiring a lengthier period of tighter monetary policy. The US$ rose modestly in Q2 (Dollar index +0.4%).

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Performance report

Asset Class/ Manager	Global Equities/ Baillie Gifford via the LCIV
Fund AuM	£455m 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

During the quarter this portfolio was transferred to the LCIV. It continues to be managed by Baillie Gifford and is an exact replica of the historic Global High Alpha fund. The cost of transitioning the portfolio across to the LCIV was very low as agreement was reached with the UK Government to avoid stamp duty and Baillie Gifford contributed towards the remaining costs. The Fund will now benefit from the slightly lower fees negotiated by the LCIV due to the economies of scale they are able to demand from pooling the assets of the 32 LCIV member funds.

The portfolio marginally underperformed during the quarter but is now showing positive performance over the last 12 months and the revaluation of growth style equities due to rising bond yields seems to be in the past. Whilst the manager has underperformed the benchmark over the last 5 years and therefore failed to achieve their performance target of index +2% over a 5-year time frame, their long-term performance remains positive and I continue to expect them to add value over a full economic and market cycle. Since inception in 1999 the manager has added 0.6% per annum over benchmark performance.

I remain confident that Baillie Gifford is a good asset manager with a strong investment philosophy and process and the resources to follow that process. They encourage challenge to their views and have a thirst for understanding which I find admirable. More particularly, I noted earlier that technological change was the one long-term factor which continued to be deflationary. The speed of the technological change does not seem to be slowing and we may be at the start of a new era of business disruption through advances in artificial intelligence. Given this, I see value in continuing to invest via a manager who spends a considerable amount of time, effort and money in looking to understand technological change and how it will affect the business environment. Baillie Gifford work closely with a number of leading educational institutions and individuals at the forefront of these development.

Asset Class/ Manager	Global Equities/MFS
Fund AuM	£359m 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/Paul Fairbrother/John Arthur 9/8/23

MFS underperformed by 0.6% over the quarter returning 2.6% but has outperformed their benchmark over 1, 3, 5 and 10 year periods as well as by 1.3% per annum since inception in 2013. The last 18 months have been a strong period for MFS as their whole investment philosophy is around investing in companies which have pricing power and are defensible businesses. In an inflationary environment the ability to push price rises through becomes vitally important and MFS have

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shown that their portfolio has that ability. The challenge going forward is that pricing pressure is still strong through wage growth but the ability to pass these costs on to the end consumer is waning. I expect many companies to see margin compression over the coming year and the managers' ability to continue to outperform over the next few years will be a testimony to the thoroughness of their research and understanding of the pricing and business dynamics of the companies they invest in.

It is possible that both the Fund's equity managers could outperform over the next few years as both seem to have an investment approach that fits well with current market dynamics.

Asset Class/Manager	**UK Aggregate Bond Fund and UK Corporate Bond Fund/ Fidelity**
Fund AuM	£136m pooled fund; 10.6% 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	Tom Jeffery; Jessica Miley/John Arthur 30/8/23

The Fund hold 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	2Q23 performance	1 Year performance	Duration	Yield
UK Agg Bond	-4.2%	--8.7%	7.7 years	6.4%
UK Corp Bond	-2.9%	-8.1%	5.8 years	7.0%

During the quarter the portfolio returned -4.1% outperforming a falling benchmark by 0.5%. The combined portfolio has continued to outperform its benchmark through this period of market turmoil adding 1.1% against the benchmark over the last year and 0.5% against the benchmark over the last 3 & 5 years. Since inception in 1998, the manager has added 0.7% per annum and outperformed through a variety of market and economic conditions. I regard this as a strong investment performance. The manager continues to hold shorter duration bonds and less credit risk than the benchmark believing that the outlook for the UK remains unstable.

Looking back at past reports, at the end of Q2 2021, two years ago, the yield on this portfolio was 1.5%. The dramatic rise in interest rates and thereby bond yields has radically altered the outlook for this asset class but whilst the yield now looks attractive, especially against the actuarial assumed investment return of 4.5%, both I and the manager have concerns that bond yields in the UK could rise further (prices fall) as the market recognises the weak financial position of the UK Government which will be compounded by much higher interest costs going forward. An outlook of poor growth in the UK with stubborn inflation and quantitative tightening by the BoE means that returns from this asset class may remain low and subject to volatility despite the attractive yield. Any perceived weakness by the BoE in its anti-inflation fight could see investors lose confidence and both Sterling and longer duration bonds weaken. I have a preference for shorted dated bonds at the current time.

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Asset Class/Manager	Mult-Asset Income / Fidelity
Fund AuM	£121m Pooled Fund; 9.4% of the Fund
Performance target	LIBOR +4% including a yield of 4% per annum
Adviser opinion	
Last meeting with manager	Meeting Eugene Philalithis; Tom Jeffrey; Jessica Miley/John Arthur 8/8/23

Asset Class/Manager	Multi-Asset Income / Schroders
Fund AuM	£113m Pooled Fund; 8.8% 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

These portfolios are designed to provide yield which is paid back to the Fund each quarter. By guaranteeing that the Fund always has enough cash to pay pensions, under any circumstances, the Fund never becomes forced to sell into unfavourable market conditions but can continue to invest for the long-term.

During the quarter both portfolios underperformed. Fidelity falling -1.8% and Schroders falling -0.5%. Over the last year a noticeable performance gap has opened up between the two portfolios with Fidelity down –5.2% and the Schroders portfolio up 1.2%. This is during a period when the Fund's UK Bond portfolios fell by -8.7% and Global Equities were up over 10% in Sterling terms which makes the Schroders performance relatively impressive over the last 12 months.

Longer term the Fidelity portfolio has fallen -2.4% per annum over 5 years whilst the Schroders portfolio has risen 0.2% per annum over this period. Much of this divergence has occurred in the last 12 months when Schroders have been more fleet of foot and equity biased whilst Fidelity have remained wedded to some longer duration bonds in the belief that these will provide diversification through periods of market stress when, in reality, they became the focus of the market stress as inflation and interest rates rose.

The Fidelity portfolio has a return target of 4% per annum against 5% per annum for the Schroders portfolio, this means that the Schroders portfolio is always likely to be taking slightly higher risk.

Without the income support from these portfolios, I would be recommending a lower level of risk at the Total Fund level and less equity exposure. This makes it complex to review the performance of these portfolios separately from the Total Fund. Nonetheless, the performance of the Fidelity portfolio has been disappointing and I have held discussions with the manager around diversifying the portfolio outside of long duration bonds and accepting a slight increase in illiquidity.

Because interest rates have risen over the last 18 months, the benchmark return for these portfolios, which is a 'cash + X' benchmark, has also risen. With Fidelity now targeting 9.25% returns and Schroders 10.25 % return per annum at current interest rates. I suspect these targets are too high but given the higher yields achievable, a return above cash should be achieved going forward.

Asset Class/Manager	UK Commercial Property / Fidelity
Fund AuM	£64m Pooled Fund; 5.0% of the Fund
Performance target	IPD UK All Balanced Property Index
Adviser opinion	
Last meeting with manager	9/8/23 Alison Puhar; Tom Jeffery; Jessica Miley/ John Arthur

After a very poor UK property market in the Q4 2022 when the UK property market caught up with higher interest rates and repriced downwards by 15% on average, the last two quarters have been much less volatile. The portfolio fell by -1.8% in the quarter against a rise in the benchmark of o.4%. This was, in part, due to valuers still being cautious and valuing down any property currently being refurbished or not completely let. The Fidelity UK Property portfolio has been going through a large, planned refurbishment with work completed or nearing completion on over 25% of the portfolio over the last 2 years. Not all of these properties are completed or fully relet at the current time. In discussion with the manager I have confidence that once relet these properties will get revalued upwards because the refurbishment is bringing the individual properties up to a high environmental specification with such properties achieving higher rents than the market at the current time. A number of these refurbishments are in the office sector where valuers are particularly aggressive on values but it appears that the office market is bifurcating as high quality, environmentally leading properties are in demand and older, less energy efficient offices are difficult to let or sell. The work Fidelity has done over the last few years in bringing its offices up to amongst the best available in their region seems to have been a sound investment decision for the longer term.

Over the last three years the Fidelity UK Property portfolio has returned 3.1% per annum, slightly below the benchmark. This compares with a return of 10.5% per annum for Global Equities and -8.7% per annum for UK Bonds as measured by the Fund's fixed interest benchmark.

I continue to see this portfolio as well managed and providing an element of diversification from the Fund's heavy global equity exposure.

Given the current state of the UK Commercial property market, the Fund does have a number of investors looking to sell their holdings at the current time. These are predominately corporate defined benefit pension schemes who are looking to move to buyout and therefore need their investments to be liquid and easily valued. I will continue to monitor this going forward to ensure that the manager does not come under undue pressure to realise assets in difficult market conditions.

Asset Class/Manager	International Property / Morgan Stanley
Fund AuM	USD80m(£57.5M) committed / £14.1m drawn. Limited Partnership; 1.0% of the Fund
Performance target	Absolute return
Adviser opinion	
Last meeting with manager	30/8/23 John Arthur/Gareth Dittmer

When the Pensions Committee decided to invest into International Property it was to provide diversification from the Equity and Bond holdings which made up the majority of the Fund. To achieve this the Committee agreed for the mandate to be opportunistic rather than invest in core international property, selecting a manager in Morgan Stanley/New Haven who would be able to adapt to changing market circumstance and who would work with a total return target rather than a formal property index as its benchmark. Given the disruption caused to property markets globally over the last two years by rising interest rates and higher debt costs I believe this to have been a good decision.

The New Haven fund has now drawn down 32% of the commitments of US$3.08bn to the fund and is just under halfway through its four-and-a-half-year investment period. As can be seen from these figures, the rate of drawdown has been on the slow side reflecting the managers concern about rising interest rates causing a deterioration in the global property market which is what we have seen over the last 18 months.

So far, the fund has made 18 investments located in the US (59%); Japan (24%); UK/Europe (13%) and India (3%). These have mainly been into the Industrial (52%) and residential (30%) sectors with one asset each into the hospitality, office and senior living sectors. Of these 18 investments 1 IN Japan has already been sold with a good return.

Of the remaining properties, the expected return has dipped slightly as the global property market has deteriorated with an internal Rate of Return (IRR) now forecast at 16.2% in Sterling for these investments against an original expectation of achieving a 17.6% IRR. This would still mean the overall portfolio returning 1.5X the initial investment at the close. The main factors causing this slight drop in predicted IRR is an increase in the cost of construction, partly offset by rising rents but with sales now taking place at higher yields (lower prices) due to the rise in interest rates. The Japanese properties are trading investments by nature and because we have not seen such a large increase in Japanese interest rates and thereby borrowing costs, these investments look stable. The US industrial and residential investments have, in the main, seen minor drops in expected returns with only one investment, in the industrial sector in the UK showing any notable deterioration but this is still expected to produce a positive return.

Given the rapid change in dynamics within the global property market, the manager has now shifted attention towards providing debt into the sector rather than purchasing assets outright. This is because yields on high quality property debt now appear to be in double digits making them attractive and by investing into the debt rather than the equity the investment is more secure an element of collateral protection.

Since quarter end the manager has made an investment of Euro240m into a portfolio of Swedish residential assets via preferred equity giving the investment a debt like characteristic. This investment has been made at a yield of 13% for a two-and-a-half-year period. This has led to a further call being made on the Fund and the commitment will now be over 40% drawn.

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Short-term cash

Following the rise in interest rates the Fund is receiving more investment income with the yield on the Multi-Asset Income funds having risen from 4% to between 5% - 6% and the yield on the Bond portfolio rising from 1.5% to 6%. At a guess this will increase the income distributed back to the Fund by approximately £8m per annum. Against this pension payments will have risen following the inflationary rise last September and will rise again this September.

The Fund should be able to operate with cash on hand of less that 1% of assets, so at present £13m.

Recommendation 4

Any accumulation of cash above that level should be lent out in short term money deposits potentially piggybacking on LB Bromley's treasury operation or, if the cash is not required for 6 months or more, invested into the Fidelity Short-duration corporate bond fund where the current yield is 6.8%.