Meeting: **Local Pension Committee**

Date/Time: **Friday, 23 February 2018 at 9.30 am**

Location: **Guthlaxton Committee Room, County Hall, Glenfield.**

Contact: **Mr. M. Hand (Tel. 0116 305 2583)**

Email: **matthew.hand@leics.gov.uk**

AGENDA

Item		Report By	Marked
1.	Minutes of the meeting held on 19th January 2018.		(Pages 5 - 8)
2.	Question Time.		
3.	Questions asked by members under Standing Order 7(3) and 7(5).		
4.	To advise of any other items which the Chairman has decided to take as urgent elsewhere on the agenda.		
5.	Declarations of interest in respect of items on the agenda.		
6.	Pension Benefits for Co-Habiting Partners - Brewster Ruling.	Director of Corporate Resources	(Pages 9 - 16)
7.	Summary Valuation of Pension Fund Investments and Performance of Individual Managers.	Director of Corporate Resources	(Pages 17 - 22)
8.	Funding Update as at 31 December 2017.	Director of Corporate Resources	(Pages 23 - 24)
9.	Risk Management and Internal Controls.	Director of Corporate Resources	(Pages 25 - 32)

10.	Market Update	Independent Investment Advisor, Kames Capital	(Pages 33 - 58)
11.	Formation of LGPS Central update. *There will be a PowerPoint presentation for this item.*	LGPS Central	
12.	Any other items which the Chairman has decided to take as urgent.		
13.	Exclusion of the press and public The public are likely to be excluded during consideration of the remaining items in accordance with Section 100(A)(4) of the Local Government Act 1972 (Exempt Information).		
14.	Kames Capital Quarterly Report (Exempt under paragraphs 3 and 10 of Schedule 12A)	Fund Manager	(Pages 59 - 70)
15.	Aspect Capital Quarterly Report (Exempt under paragraphs 3 and 10 of Schedule 12A)	Fund Manager	(Pages 71 - 76)
16.	Kleinwort Quarterly Report (Exempt under paragraphs 3 and 10 of Schedule 12A)	Fund Manager	(Pages 77 - 82)
17.	Ruffer Quarterly Report (Exempt under paragraphs 3 and 10 of Schedule 12A)	Fund Manager	(Pages 83 - 88)
18.	Pictet Quarterly Report (Exempt under paragraphs 3 and 10 of Schedule 12A)	Fund Manager	(Pages 89 - 100)
19.	Millennium Global Quarterly Report (Exempt under paragraphs 3 and 10 of Schedule 12A)	Fund Manager	(Pages 101 - 132)
20.	IFM Investors Quarterly Report (Exempt under paragraphs 3 and 10 of Schedule 12A)	Fund Manager	(Pages 133 - 144)
21.	Delaware Investments Quarterly Report (Exempt under paragraphs 3 and 10 of Schedule 12A)	Fund Manager	(Pages 145 - 150)

22.	Legal and General Investment Manager Quarterly Report (Exempt under paragraphs 3 and 10 of Schedule 12A)	Fund Manager	(Pages 151 - 182)
23.	Ashmore Quarterly Report (Exempt under paragraphs 3 and 10 of Schedule 12A)	Fund Manager	(Pages 183 - 212)
24.	Kempen Capital Management Quarterly Report (Exempt under paragraphs 3 and 10 of Schedule 12A)	Fund Manager	(Pages 213 - 240)
25.	Stafford Timberland Quarterly Report (Exempt under paragraphs 3 and 10 of Schedule 12A)	Fund Manager	(Pages 241 - 332)
26.	Aviva Investments Quarterly Report (Exempt under paragraphs 3 and 10 of Schedule 12A)	Fund Manager	(Pages 333 - 352)
27.	JP Morgan Quarterly Reports (Exempt under paragraphs 3 and 10 of Schedule 12A)	Fund Manager	(Pages 353 - 356)
28.	KKR Quarterly Reports (Exempt under paragraphs 3 and 10 of Schedule 12A)	Fund Manager	(Pages 357 - 382)

TO:

<u>Leicestershire County Council</u>

Mr. P. C. Osborne CC (Chairman)
Mr. L. Breckon JP CC
Dr. S. Hill CC
Mr. Max Hunt CC
Mrs. R. Page CC

<u>Leicester City Council</u>

Cllr Deepak Bajaj and Cllr Dr Lynn Moore

<u>District Council Representatives</u>

Cllr Chris Frost and Cllr. Malise Graham MBE

<u>University Representative</u>

Ms. M. Holden

Staff Representatives

Mr. R. Bone
Mr. N. Booth
Ms. J. Dean

Leicestershire County Council

Minutes of a meeting of the Local Pension Committee held at County Hall, Glenfield on Friday, 19 January 2018.

PRESENT:

Leicestershire County Council

Mr. L. Breckon JP CC (Chairman)	Mr. Max Hunt CC
Dr. S. Hill CC	Mrs. R. Page CC

Leicester City Council

Cllr Deepak Bajaj
Cllr Dr Lynn Moore

District Council Representative

Cllr. Malise Graham MBE

Staff Representatives

Mr. N. Booth	Ms. J. Dean

Independent Advisers and Managers

Mr. S. Jamieson	Independent Investment Advisor
Mr. A. Green	Hymans Robertson

94. Minutes of the previous meeting.

The minutes of the meeting held on 10 November were taken as read, confirmed and signed.

95. Question Time.

The Chief Executive reported that no questions had been received under Standing Order 35.

96. Questions asked by members.

The Chief Executive reported that no questions had been received under Standing Order 7(3) and 7(5).

97. Urgent items.

There were no urgent items for consideration.

98. Declarations of interest.

The Chairman invited members who wished to do so to declare any interest in respect of items on the agenda for the meeting. No declarations were made.

99. Market Outlook.

The Committee received a report concerning global market conditions which was presented by the Fund's Independent Investment Advisor. A copy of the report, marked '8' is filed with these minutes.

The Committee noted that the Fund had benefited from favourable investment conditions during 2017 thanks to various factors including strong US and Asia economies and a distinct lack of volatility across trading markets.

RESOLVED:

That the report be noted.

100. Strategic Investment Benchmark and Portfolio Structure of the Fund.

The Committee considered a report of the Director of Corporate Resources which was accompanied by appendices produced by the Fund's Independent Investment Advisor and Investment Consultants Hymans Robertson. The report recommended a small number of changes to the Leicestershire Fund's strategic investment benchmark and portfolio structure. A copy of the report and appendices marked '7 'are filed with these minutes.

Arising from discussion, the following points were noted:

- The proposed changes to the Fund's strategic benchmark, whilst modest, would improve the overall structure of the portfolio. The extremely encouraging asset returns achieved since March 2016 were expected to reduce slightly as market conditions changed and as a result the strategies' medium term return had been reduced to 3.6% above CPI, lower than the previously require return target of 3.9% above CPI;

- The revised strategic benchmark included a slight increase in the Fund's opportunity pool, moving the upper limit from 6% to 8% of the Fund's total assets. Whilst the increase was minimal in relation to the overall portfolio, it would allow for additional investments to be made where suitable opportunities were identified and approved by the Investment Subcommittee. The recommended allocation of an additional total 1% of assets, with the potential of splitting the increase between the Fund's existing infrastructure managers, through the sale of a small amount of equity investments, would enable additional exposure to less volatile asset class with similar medium-term return expectations;

- The recommended change to the Fund's neutral hedging currency position to 50% (from 70%) followed a period in which sterling had generally recovered from the worst of its falls following the UK's decision to leave the European Union. The change would help to protect the profits generated during the last year;

- During 2018 the Investment Subcommittee would be asked to consider the Fund's approach to its geographical balance of equity investments and the indices that it tracked as part of its passive equity exposure to fossil fuels would also be carried out:

- Several Local Government Pension Schemes had purchased portfolio insurance, at a considerable cost, to protect against significant falls in equity markets following their rise during 2017. Whilst a fall in equity value could not be ruled out, and should it fall in the region of 15% or greater those with insurance would be protected, it was considered reasonable for the Leicestershire Fund not to purchase portfolio insurance but be prepared to consider its exposure to equity assets should valuations become more stretched.

RESOLVED:

a) That the revised strategic benchmark for the Fund as shown on page 20 of Appendix A of the report be approved;

b) That the Director of Finance ,following consultation with the Fund's investment consultants, be authorised to split the increase in the Fund's strategic asset allocation to infrastructure between the Fund's existing infrastructure managers;

c) That the revised portfolio split within the Fund's targeted return portfolios as set out below, be approved:

Ruffer	6.0% of total Fund assets
Aspect Capital	3.5% of total Fund assets
Pictet	2.0% of total fund assets

d) That a change in the neutral hedging position in respect of the Fund's currency exposure created by its overseas equity benchmark position to 50% be approved;

e) That an additional £25m investment into the Kames Active Value Property Unit Trust II, in order to close some of the Fund's current underweight position in property, be approved;

f) That the Investment Subcommittee be asked to consider over the course of 2018 the issues of the regional equity split, the appropriate benchmarks against which the Fund's passive equities should be managed, and the potential impact of climate change onto benchmark returns.

09.30 – 11.30am
19 January 2018

CHAIRMAN

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Leicestershire County Council

LOCAL PENSION COMMITTEE – 23RD FEBRUARY 2018

REPORT OF THE DIRECTOR OF CORPORATE RESOURCES

PENSION BENEFITS FOR CO-HABITING PARTNERS – BREWSTER RULING

Purpose of the Report

1. The purpose of this report is to inform the Committee about the recent decision of the Supreme Court in the case of Brewster and the implications for the Leicestershire Pension Fund. The Local Pension Board has requested that this matter be brought to the Committees attention.

Background

2. Attached as an appendix is a report on this matter that was produced for the Local Pension Board for consideration at its meeting held on 4th December 2017.

Recommendation

3. It is recommended that the report be noted.

Appendix

4. Report to the Local Pension Board.

Equal Opportunities Implications

None specific.

Background Papers

None.

Officer to Contact

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Chris Tambini, Director of Finance
Corporate Resources Department
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Leicestershire County Council

LOCAL PENSION BOARD

4 DECEMBER 2017

REPORT OF THE DIRECTOR OF CORPORATE RESOURCES

BREWSTER RULING

Purpose of the Report

1. The purpose of this report is to inform the Board about the recent decision of the Supreme Court in the case of Brewster and the implications for the Leicestershire Pension Fund.

Background

2. The Local Government Pension Scheme provides pension benefits for co-habiting partners, should their partner die whilst a member of the Local Government Pension Scheme, if a co-habiting partner's nomination form is complete.

3. Denise Brewster was the co-habiting partner of a member of the Local Government Pension Scheme in Northern Ireland, which has slightly different rules to England, but principally are the same.

4. A Supreme Court ruling earlier this year found in favour of Denise Brewster who claimed, the requirement for the completion of the co-habiting partner's nomination form constituted unlawful discrimination and a breach of the European Convention on Human Rights. The Court agreed this constituted unlawful discrimination. A nomination form was not required for married or civil partner survivors.

5. Following the Supreme Court ruling the Department for Communities and Local Government (DCLG) issued a letter dated 17 August 2017 to all Local Government Pension Managers detailing the implications on the Local Government Pension Scheme. This is attached as Appendix A.

Implications

6. In 2014, recognising the need for a change in Regulations to deal with the position of cohabiting partners, the Local Government Pension Scheme Regulations in England changed, withdrawing the need to complete a partner's co-habiting form. This however left a position of inequality for those

co-habiting partners, whose partner died between 2008 and 2014, where the requirement for completion of a co-habiting partner's nomination form still existed. The DCLG's letter dated 17 August 2017 now considers it reasonable for Funds to make retrospective payments to cases in this category.

7. While the DCLG's letter makes it clear that it is for individual Pension Funds to determine their approach in respect of claims arising from situations they find arising that are similar to the Brewster case, the letter states that in the DCLG's view it would be reasonable for Pensions Funds to rely on the judgement as well as the wider provisions of the Human Rights Act (HRA) to make retrospective payments.

8. Section 3 of the HRA provides that legislation (including Pension Regulations) must be read and be given effect in a way that is compatible with human rights.

9. It is to be noted that the HRA also has provisions (Section 6) which effectively justifies a public authority not acting unlawfully in a human rights sense if a statutory provision could not be read or be given effect to in a way which would be compatible with human rights. It is surprising that Section 6 is not discussed in the Brewster Supreme Court and this Authority takes the view that given the fact DCLG have sought legal advice and concluded as a result the relevant 2007 Pensions Benefits Regulations do not require amendment and have written to Pensions Funds and have written the letter previously referred to, reliance on Section 6 to justify not make a payment would be disproportionate.

Leicestershire Pension Funds Actions

10. Following the Brewster ruling and the Department of Communities and Local Government's letter, the Leicestershire Pension Fund has discussed the situation with other Funds in the East Midlands region who were in agreement that in principle Funds could now make retrospective payments.

11. The County Council has investigated how many cases in the period between 2008 and 2014 fall into this category, where no co-habiting partners form has been completed. Whilst the Pension Fund cannot be absolutely certain of the historic facts of all previous cases, it has only positively identified one case which has now been resolved following legal advice.

12. Whilst the Regulations no longer require the need to complete a partner's co-habiting nomination form to gain entitlement, the Pension Section still asks for the form to be completed. This is to assist the Pension Section with the administration and so the scheme member is confident in the knowledge the Pension Section knows their personal wishes.

13. Without completion of the form, the Pension Section does not know if a co-habiting partner exists and does not know the deceased members wishes.

14. However, in the rare event that a co-habiting partner does exist and no form has been completed, the Pension Section will still allow payment of the co-habiting partner's pension if all other criteria are met.

Recommendation

14. It is recommended that the Board notes the report.

Equality and Human Rights Implications

None specific

Appendix

DCLG letter dated 17 August 2017

Officers to Contact

Ian Howe – Pensions Manager - telephone (0116) 305 6945
Chris Tambini – Director of Finance - telephone (0116) 305 6199
Lauren Haslam – Director of Law and Governance (0116) 305 6240

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Department for Communities and Local Government

17 August 2017

Dear Pensions Manager

Implications for the Local Government Pension Scheme of Brewster Decision

A number of funds have been in touch now regarding the implications of the Supreme Court's ruling earlier this year in the case of Brewster. This letter is intended to provide some guidance to those managing funds. It is not statutory guidance, as we have no power to issue statutory guidance on this point, and neither is it intended to be, and should not be construed as, legal advice. As you will appreciate, the correct interpretation of LGPS regulations is a matter for the courts and not government departments.

In the case of Denise Brewster, she successfully challenged the requirement in the Local Government Pension Scheme (Northern Ireland) that a surviving adult partner had to be formally nominated in order to be entitled to payment of survivor benefits. The Court ruled that this administrative requirement constituted unlawful discrimination and a breach of the European Convention on Human Rights. As the other underlying scheme conditions were met then it should be disapplied.

Most public sector pension schemes that have, or have had, such a nomination requirement for unmarried partners, are now taking the view that scheme managers can rely on this judgment and section 3 of the Human Rights Act 1998 as the legal basis for not requiring that a surviving adult partner be nominated in order to receive survivor benefits. This section of the Act provides that, as far as possible, regulations such as those covering the LGPS must be read and given effect in a way which is compatible with the European Convention on Human Rights. This approach is also being applied to applications which have previously been rejected. In these circumstances, schemes are also being encouraged not to require survivors to claim within any specific limitation period.

We consider that this approach is reasonable in the circumstances and that LGPS funds should give careful consideration to adopting a similar approach to relevant cases. In adopting this approach a fund accepts that a power to pay these benefits already exists in the LGPS regulations when read and given effect in a way which is compatible with Convention rights and that the tax status of them is no different from any other payments made under the scheme.

Chris Megainey
Local Tax and Pensions
Department for Communities and Local Government

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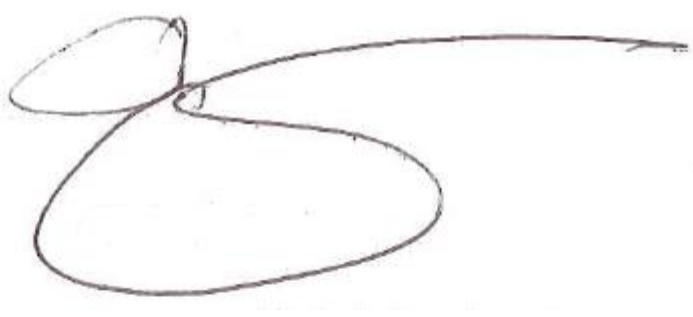
Tel : 0303 444 3145

We suggest that LGPS funds should consider the following:

- Relevant cases will be those in the period between 2008 and 2014 when a "nominated cohabiting partner" test was applied to restrict survivor benefits. Any relevant case presenting now for a survivor's pension, who can demonstrate that they were, at the point of their partner's death, in a relationship with an LGPS member and met all the underlying conditions apart from the nomination requirement, should be awarded a survivor's pension, appropriately backdated;
- Funds should take reasonable steps to identify cases where an application for a survivor's pension was rejected for want of a nomination. Such cases should be reviewed to check whether there is evidence that the underlying conditions may have been met at the time and whether a survivor's pension should now be considered;
- Where a new claim for a survivor's pension is accepted but a child's pension was being paid at the higher rate (due to an adult survivor's pension not being paid) the fund should advise as soon as possible the recipient of the child's pension that its intention would be to reduce it once the adult survivor pension is being paid;
- In these circumstances, technically there will have been an element of overpayment in the child's pension. Decisions on whether to attempt recovery should be handled sensitively, having regard to the need to avoid hardship or injustice, the fund's own policy on overpayments and general guidance on the appropriate use of public money;
- We expect that funds will not be able to offset overpayments of a child's pension against the adult survivor's benefits given that they are separate individual entitlements.

Some cases will inevitably raise complex issues and it is not possible to provide guidance on the application of the judgment in all circumstances. Accordingly, scheme managers should seek their own independent legal advice if they are in any doubt as to how to proceed.

Yours sincerely,



Chris Megainey

Chris Megainey
Local Tax and Pensions
Department for Communities and Local Government

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Leicestershire County Council

LOCAL PENSION COMMITTEE – 23RD FEBRUARY 2018

REPORT OF THE DIRECTOR OF CORPORATE RESOURCES

SUMMARY VALUATION OF PENSION FUND INVESTMENTS AND INVESTMENT PERFORMANCE OF INDIVIDUAL MANAGERS

Purpose of the Report

1. The purpose of this report is to present to the Committee a summary valuation of the Fund's investments at 31st December 2017 (attached as an appendix to this report), together with figures showing the performance of individual managers.

Summary Valuation

2. The total market value of investments at 31st December 2017 was £4,146.0m compared to £3,999.1m at 30th September 2017, an increase of £146.9m. In the three month period non-investment related net cash inflows amounting to £8.4m were received. After adjusting for non-investment related cash flows the Fund value increased by 138.5m, or 3.5%, due to changes in the value of investments.

3. The total returns of various indices since 30th September 2017 were as follows:-

	Local Currency %	**Converted to Sterling %**	**Return with 70% hedge %**
UK Gilts	+2.0	+2.0	+2.0
UK Index-Linked	+3.5	+3.5	+3.5
UK Equities	+5.0	+5.0	+5.0
North American Equities	+6.5	+5.6	+6.2
European Equities	+0.3	+0.4	+0.3
Japanese Equities	+8.9	+7.9	+8.6
Pacific (Ex Japan) Equities	+6.5	+7.8	+6.9

4. The current split of investments over sectors is as follows:-

	31st December 2017		**30th September 2017**
	£m	**%**	**%**
UK Equities	327.5	7.9	7.9
Overseas Equities	1643.2	39.6	40.1
Targeted Return/Credit/Opportunity Pool	977.0	23.6	22.4
Private Equity	144.4	3.5	3.5
Property	358.7	8.6	8.2
Cash	121.4	2.9	3.1
Inflation-Linked Assets	578.9	14.0	13.8
Active and Passive Currency	(5.1)	(0.1)	1.0
	4146.0	**100.0**	**100.0**

5. The investment performance of the individual managers is laid out in the tables below, over various periods. For most managers the benchmark performance quoted is based on indices, for targeted return managers the benchmark is cash + 4% p.a. and for Millennium the benchmark is 1.5% p.a.

3 months

Manager/Portfolio	Actual (%)	B/mark(%)	Relative (%)
Legal & General (passive global equities)	+4.9	+4.9	-
Aviva Investors (property)	+3.4	+3.1	+0.3
Aspect Capital (managed futures)	+9.6	+1.1	+8.5
Delaware (emerging market equities)	+2.0	+6.5	-4.5
Kleinwort Benson (equity dividend)	+5.6	+4.8	+0.8
Kempen (equity dividend)	+4.7	+4.8	-0.1
Ruffer (targeted return)	+3.1	+1.1	+2.0
Pictet (targeted return)	+3.2	+1.1	+2.1
Ashmore (emerging market debt)	+0.2	+0.4	-0.2
Millennium (currency)	-0.1	+0.4	-0.5

Financial year to date (9 months)

Manager/Portfolio	Actual (%)	B/mark(%)	Relative (%)
Legal & General (passive global equities)	+7.6	+7.6	-
Aviva Investors (property)	+8.8	+8.0	+0.8
Aspect Capital (managed futures)	+5.0	+3.4	+1.6
Delaware (emerging market equities)	+16.1	+13.9	+2.2
Kleinwort Benson (equity dividend)	+6.3	+7.2	-0.9
Kempen (equity dividend)	+9.2	+7.2	+2.0
Ruffer (targeted return)	+1.9	+3.4	-1.5
Pictet (targeted return)	+4.4	+3.4	+1.0
Ashmore (emerging market debt)	-0.5	-2.0	+1.5
Millennium (currency)	-0.1	+1.2	-1.3

One year

Manager/Portfolio	Actual (%)	B/mark(%)	Relative (%)
Legal & General (passive global equities)	+13.3	+13.3	-
Aviva Investors (property)	+11.6	+10.2	+1.4
Aspect Capital (managed futures)	+3.9	+4.4	-0.5
Delaware (Emerging market equities)	+31.8	+25.4	+6.4
Kleinwort Benson (equity dividend)	+11.2	+13.2	+2.0
Kempen (equity dividend)	+14.1	+13.2	+0.9
Ruffer (targeted return)	+2.1	+4.4	-2.3
Pictet (targeted return)	+6.0	+4.4	+1.6
Ashmore (emerging market debt)	+3.8	+1.2	+2.6
Millennium (currency)	-1.5	+1.5	-3.0

Three years (performance per annum)

Manager/Portfolio	Actual (%)	B/mark(%)	Relative (%)
Legal & General (passive global equities)	+14.1	+14.1	-
Aviva Investors (property)	+9.4	+8.4	+1.0
Aspect Capital (managed futures)	+1.0	+4.4	-3.4
Delaware (Emerging market equities)	+18.0	+14.4	+3.6
Ruffer (targeted return)	+5.8	+4.4	+1.4
Kleinwort Benson (equity dividend)	+13.8	+14.6	-0.8
Kempen (equity dividend)	+16.4	+14.6	+1.8
Ashmore (emerging market debt)	+9.3	+4.8	+4.5
Millennium (currency)	-0.1	+1.5	-1.6

Five years (performance per annum)

Manager/Portfolio	Actual (%)	B/mark(%)	Relative (%)
Legal & General (passive global equities)	+14.4	+14.4	-
Aviva Investors (property)	+11.6	+10.3	+1.3
Aspect Capital (managed futures)	+5.5	+4.4	+1.1
Delaware (Emerging market equities)	+12.2	+8.2	+4.0
Ruffer (targeted return)	+7.2	+4.4	+2.8
Kleinwort Benson (equity dividend)	+14.7	+14.9	-0.2
Kempen (equity dividend)	+14.0	+14.9	-0.9
Millennium (currency)	+0.9	+1.5	+0.6

Recommendation

6. It is recommended that the report be noted.

Appendix

7. Pension Fund Investments as at 31st December 2017.

Equality and Human Rights Implications

8. The matters referred to in this report have no identifiable equal opportunities implications.

Officer to Contact

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APPENDIX

PENSION FUND INVESTMENTS AS AT 31ST DECEMBER 2017

	Market Value £	Value %	Benchmark %	Variance %
Equities				
United Kingdom	327,542,313	7.90	7.50	0.40
Overseas:				
Global dividend-focused	343,100,416	8.28	8.00	0.28
North America	556,436,180	13.42	13.20	0.22
Europe (Ex UK)	239,624,325	5.78	5.70	0.08
Japan	117,197,531	2.83	2.80	0.03
Pacific (Ex Japan)	118,949,946	2.87	2.80	0.07
Emerging Markets	267,908,000	6.46	6.00	0.46
Total	1,643,216,398	39.63	38.50	1.13
Private Equity	144,385,753	3.48	4.00	-0.52
Property				
Direct Holdings*	101,494,000	2.45	3.30	-0.85
Indirect Holdings	257,238,777	6.20	6.70	-0.50
Total	358,732,777	8.65	10.00	-1.35
Alternative Investments				
Fauchier	424,457	0.01	0.00	0.01
Pictet	120,611,162	2.91	2.50	0.41
Ruffer	258,707,499	6.24	6.50	-0.26
Credit Opportunities	220,680,666	5.32	7.50	-2.18
Aspect	142,847,139	3.45	3.50	-0.05
Emerging Market Debt	106,688,588	2.57	2.50	0.07
Opportunity pool	127,025,282	3.06	3.00	0.06
	976,984,793	23.56	25.50	-1.94
Commodities	0	0.00	0.00	0.00
Inflation-Linked Assets				
Global Government Index-Linked Bonds	306,389,444	7.39	7.50	-0.11
Infrastructure	189,639,644	4.57	5.00	-0.43
Timberland	82,845,789	2.00	2.00	0.00
	578,874,877	13.96	14.50	-0.54
Cash on Deposit	121,390,833	2.93	0.00	2.93
Unrealised Profit On Currency				
Active	2,079	0.00	0.00	0.00
Passive	-5,152,361	-0.12	0.00	-0.12
Total	-5,150,282	-0.12	0.00	-0.12
TOTAL	**4,145,977,462**	**100.00**	**100.00**	**0.00**

Direct Property Holdings*		
Retail	14,155,000	13.95
Retail Warehouses	21,005,000	20.70
Offices	24,490,000	24.13
Industrials	18,815,000	18.54
Leisure (Hotels/Health Club)	20,235,000	19.94
Farms	2,794,000	2.75
	101,494,000	100.00

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Reliances and limitations

This report was commissioned by and is addressed to the Leicestershire County Council in their capacity as the Administering Authority and is provided to assist in monitoring certain funding and investment metrics. It should not be used for any other purpose. It should not be released or otherwise disclosed to any third party except as required by law or with our prior written consent, in which case it should be released in its entirety. **Decisions should not be taken based on the information herein without written advice from your consultant.** Neither I nor Hymans Robertson LLP accept any liability to any other party unless we have expressly accepted such liability in writing.

The method and assumptions used to calculate the updated funding position are consistent with those disclosed in the documents associated with the last formal actuarial valuation, although the financial assumptions have been updated to reflect known changes in market conditions. The calculations contain approximations and the accuracy of this type of funding update declines with time from the valuation; differences between the position shown in this report and the position which a new valuation would show can be significant. It is not possible to assess its accuracy without carrying out a full actuarial valuation. This update complies with Technical Actuarial Standard 100.

HYMANS ROBERTSON

Leicestershire County Council Pension Fund

Funding and risk report as at 31 December 2017

HEADLINES

31 December 2017	Ongoing funding basis
Assets	£4,144m
Liabilities	£5,152m
Surplus/(deficit)	(£1,008m)
Funding level	80.4%

Summary

This funding update is provided to illustrate the estimated development of the funding position from 31 March 2016 to 31 December 2017, for the Leicestershire County Council Pension Fund ("the Fund"). It is addressed to the Leicestershire County Council in its capacity as the Administering Authority of the Fund and has been prepared in my capacity as your actuarial adviser.

At the last formal valuation the Fund assets were £3,164m and the liabilities were £4,153m. This represents a deficit of £989m and equates to a funding level of 76.2%. Since the valuation the funding level has increased by c4% to 80.4% as detailed in the table above.

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Should you have any queries please contact me.
Anne Cranston AFA

Agenda Item 8

Leicestershire County Council Pension Fund | Strategy and Risk Management dashboard

CURRENT POSITION

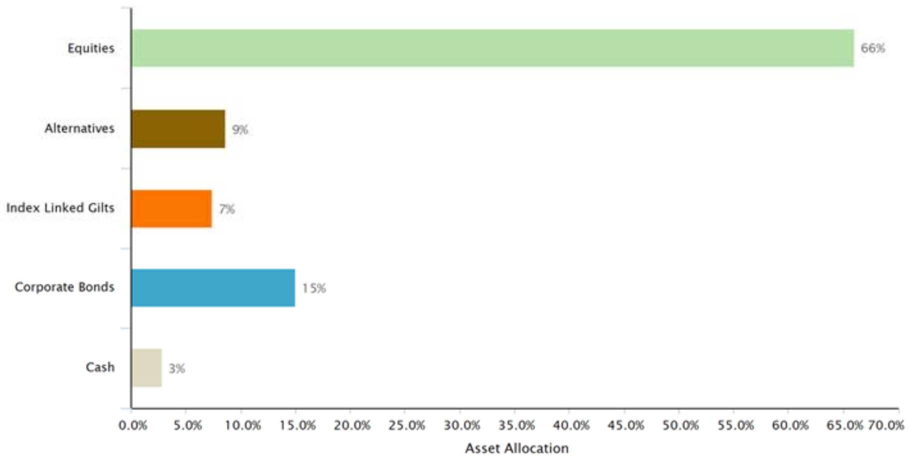
31 December 2017	Ongoing funding basis
Assets	£4,144m
Liabilities	£5,152m
Surplus/(deficit)	(£1,008m)
Funding level	80.4%

Surplus/(deficit)	£m
Surplus/(deficit) as at 31/03/2016	(989)
Contributions (less benefits accruing)	(47)
Interest on surplus/(deficit)	(70)
Excess return on assets	686
Impact of change in yields & inflation	(588)
Surplus/(deficit) as at 31/12/2017	(1,008)

	31 March 2016	30 September 2017	31 December 2017
Market Yields (p.a)			
Fixed Interest Gilts	2.17%	1.84%	1.68%
Index-linked Gilts	-0.96%	-1.49%	-1.64%
Implied Inflation	3.16%	3.38%	3.38%
AA Corporate Bonds	3.36%	2.64%	2.44%
Price Indices			
FTSE All Share	3,395	4,050	4,222
FTSE 100	6,175	7,373	7,688

PROGRESS

ASSETS AND RISKS



Sensitivity Matrix as at 02 February 2018 for basis Ongoing funding basis

	5210 -30%	5955 -20%	6699 -10%	7443 0%	8188 10%	8932 20%	9676 30%
0.6	(£1,428m)	(£1,122m)	(£815m)	(£509m)	(£202m)	£104m	£411m
0.4	(£1,565m)	(£1,259m)	(£952m)	(£646m)	(£339m)	(£33m)	£274m
0.2	(£1,711m)	(£1,404m)	(£1,098m)	(£791m)	(£485m)	(£178m)	£128m
0.0	(£1,865m)	(£1,559m)	(£1,252m)	(£946m)	(£639m)	(£333m)	(£26m)
-0.2	(£2,030m)	(£1,723m)	(£1,417m)	(£1,110m)	(£804m)	(£497m)	(£191m)
-0.4	(£2,205m)	(£1,899m)	(£1,592m)	(£1,286m)	(£979m)	(£673m)	(£366m)
-0.6	(£2,392m)	(£2,086m)	(£1,779m)	(£1,473m)	(£1,166m)	(£860m)	(£553m)

less than 50% | 50% - 85% | 85% - 95% | 95% - 100% | 100% - 105% | 105% - 115% | greater than 115%

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Leicestershire County Council

LOCAL PENSION COMMITTEE

23 FEBRUARY 2018

REPORT OF THE DIRECTOR OF CORPORATE RESOURCES

RISK MANAGEMENT AND INTERNAL CONTROLS

Purpose of the Report

1. The purpose of this report is to inform the Committee of any concerns relating to the risk management and internal controls of the Pension Fund, as stipulated in the Pension Regulator's Code of Practice.

Background

2. In April 2015 The Pension Regulator (TPR) published its code of practise on governance and administration of public service pension schemes. This introduced a number of areas pension administrators need to record and members be kept aware of.

3. One area within the code is risk, more specifically 'risk management and internal controls', which the code states should be a standing item on each Pension Board and Pension Committee agenda.

4. The Leicestershire Fund already manages risk and has a risk register in place that is regularly reviewed by officers and presented to the Local Pension Board annually. Internal and external audit also consider risks within Pensions and highlight any risk concerns. However, in order to comply with the code the Director of Finance has agreed to have this as a standard item on both agendas.

Risk Register

5. A revised Risk Register, which was amended to include investment risk, was approved by the Local Pension Committee on the 10 November 2017. The register is appended to this report to allow members the ability to ask questions about the current situation in respect of any of the risks highlighted.

Newly Identified Risks

6. There are currently no new identified risks or changes to existing residual risk. scores

Recommendation

7. The Committee is asked to note the report.

Appendix

8. Risk Register

Equality and Human Rights Implications

None specific

Officers to Contact

Colin Pratt, Investments Manager, Corporate Resources Department
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Chris Tambini, Director of Finance
Corporate Resources Department
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APPENDIX – Pensions Risk Register December 2017

Pensions

Risk no	Service	Risk	Causes (s)	Consequences (s)	Risk Owner	List of current controls	I	L	Current Risk Score	Risk Response; *Tolerate Treat Terminate Transfer*	Further Actions / Additional Controls	I	L	Residual Risk Score	Action owner	
1	**Pens**	If we fail to reconcile HRMC GMP data with the Pension Section data there is a risk of overpayment of Pensions Increase	Government changes to end contracting out legislation. Contracting out ended April 2016. Between 2015 and December 2018 Pensions need to reconcile GMP data. From 2018 we take responsibility for GMPs so we need to ensure we pay Pensions Increase. (e.g. no GMP means we pay full PI and if there is a GMP we pay less PI)	Overpaying pensions Reputation	Ian Howe	Checking of HMRC GMP data to identify any discrepancies	**3**	**3**	**9**	**Treat**	Working through cases Developed reporting tools to assist Recruitment taking place for a full time person to join the project	**3**	**2**	**6**	Ian Howe	Managed at Service level
2	**Pens**	**If we fail to implement a pension administration system the Pension Section will fail to deliver its statutory duties for both LGPS and the 3 Fire Authorities**	The current pensions administration system contract ends in April 2019	Failure of the Pension Section Unable to meet statutory requirements Manual calculations Huge increase in administration time causing delays Increased appeals	Ian Howe	Currently use a successful pension administration system Currently use a separate member self-service facility	**5**	**2**	**10**	**Treat**	Tender document completed Working in partnership with another Fund Working closely with internal IT, ESPO, internal audit and others	**5**	**1**	**5**	Ian Howe	Managed at Service level

3	**Pens**	**If we fail to meet the service requirements of the three Fire Authorities we may lose their business**	Changes in legislation on the Firefighters pension scheme has significantly increased the scheme's complexity. Only limited knowledge in the Section in this area.	Reputation Potential loss of business	Ian Howe	Quarterly meetings take place with the Fire Authorities to resolve issues Membership of the Midlands Fire Officer Group enables us to identify and resolve issues early Resource on the team increased SLA and contracts produced	**3**	**2**	**6**	**Treat**	Continue to monitor and develop improvements to work processes, guiding all three Fire Authorities to similar processes and decisions (where possible). Set up a joint pension board for the 3 Fire Authorities	**2**	**2**	**4**	Ian Howe	Managed at Service level
4	**Pens**	**If we fail to receive accurate and timely data from employers scheme members pension benefits could be incorrect or late**	A continuing increase in Fund employers is causing administrative pressure in the Pension Section. This is in terms of receiving accurate and timely data from these new employers who have little or no pension knowledge	Late or inaccurate pension benefits to scheme members Reputation Increased appeals Greater administrative time being spent on individual calculations	Ian Howe	Training provided for new employers Guidance notes provided for employers Communication and administration guide provided to employers	**3**	**3**	**9**	**Treat**	Implement IConnect with employers so they provide monthly data in a secure and timely manner Review the SLA and communication and administration guide (for IConnect)	**2**	**2**	**4**	**Ian Howe**	Man
5	**Invs**	**If employer and employee contributions are not paid accurately and on time**	Error on the part of the scheme employer	Potentially reportable to The Pensions Regulator as late payment is a breach of The Pensions Act	Colin Pratt	Receipt of contributions is monitored and late payments are chased quickly	**2**	**4**	**8**	**Treat**	Late payers will be reminded of their legal responsibilities.	**2**	**3**	**6**	Colin Pratt	Managed at Service level

6	**Invs**	**If assets held by the Fund are ultimately insufficient to pay benefits due to individual members**	Ineffective setting of employer contribution rates over many consecutive actuarial valuations	Significant financial impact on scheme employers due to the need for large increases in employer contribution rates.	Chris Tambini/ Colin Pratt	Input into actuarial valuation, including ensuring that actuarial assumptions are reasonable and the manner in which employer contribution rates are set does not bring imprudent future financial risk	**5**	**2**	**10**	**Treat**	Actuarial assumptions need to include an element of prudence, and Officers need to understand the long-term impact and risks involved with taking short-term views to artificially manage employer contribution rates	**4**	**2**	**8**	Chris Tambini/ Colin Pratt	Managed at Service level
7	**Pens/Invs**	**If the sub-funds of Community Admission Bodies were not monitored to ensure that there is the correct balance between risks to the Fund and fair treatment of the employer**	Changing financial position of both sub-fund and the employer	Significant financial impact on employing bodies due to need for large increases in employer contribution rates, which may ultimately lead to insolvency and a deficit that has to be met by the Fund.	Ian Howe/ Colin Pratt	Ensuring, as far as possible, that the financial position of Community Admission Bodies is understood. On-going dialogue with them to ensure that the correct balance between risks and fair treatment continues.	**5**	**2**	**10**	**Treat**	Dialogue with the employers, particularly in the lead up to the setting of new employer contribution rates.	**3**	**2**	**6**	Ian Howe/ Colin Pratt	Managed at Service level
8	**Invs**	**If market investment returns are consistently poor and this causes significant upward pressure onto employer contribution rates**	Poor market returns, most probably caused by poor economic conditions	Significant financial impact on employing bodies due to the need for large increases in employer contribution rates	Chris Tambini/ Colin Pratt	Ensuring that strategic asset allocation is considered at least annually, and that the medium-term outlook for different asset classes is included as part of the consideration	**5**	**2**	**10**	**Treat**	Making sure that the investment strategy is sufficiently flexible to take account of opportunities and risks that arise, but is still based on a reasonable medium-term assessment of future returns	**4**	**2**	**8**	Chris Tambini/ Colin Pratt	Managed at service level
9	**Invs**	**If market returns are acceptable but the performance achieved by the Fund is below reasonable**	Poor performance of individual managers, or poor asset allocation policy	Opportunity cost in terms of lost investment returns, which is possible even if	Chris Tambini/ Colin Pratt	Ensuring that the causes of underperformance are understood and acted	**3**	**3**	**9**	**Treat**	After careful consideration, take decisive action where this is deemed appropriate. It should be	**2**	**2**	**4**	Chris Tambini/ Colin Pratt	Managed at service level

		expectations		actual returns are higher than those allowed for within the actuarial valuation		on where appropriate					recognised that some managers have a style-bias and that poor performance will happen on occasions.					
10	**Invs**	**Failure to take account of ALL risks to future investment returns within the setting of asset allocation policy and/or the appointment of investment managers**	Some assets classes or individual investments perform poorly as a result of incorrect assessment of all risks inherent within the investment.	Opportunity cost within investment returns, and potential for actual returns to be low. This will lead to higher employer contribution rates than would otherwise have been necessary.	Chris Tambini/ Colin Pratt	Ensuring that all factors that may impact onto investment returns are taken into account when setting asset allocation policy. Only appointing investment managers that integrate responsible investment into their processes, and ensuring that managers take a holistic view on the risks associated with the investments they make on behalf of the Fund.	**3**	**3**	**9**	**Treat**	Responsible investment aims to incorporate environmental, social and governance (ESG) factors into investment decisions, to better manage risk and generate sustainable, long-term returns	**2**	**2**	**4**	Chris Tambini/ Colin Pratt	Managed at service level
11	**Invs**	**Investment pooling within the LGPS fails to deliver a higher long term net investment return**	LGPS Central fails deliver better net investment returns than the Fund would have expected to achieve it investment pooling did not occur	Lower returns will ultimately lead to higher employer contribution rates than would otherwise have been the case	Chris Tambini/ Colin Pratt	Shareholders' Forum, Joint Committee and Practitioners' Advisory Forum will give significant influence in the event of issues arising.	**3**	**3**	**9**	**Treat**	Set-up of LGPS Central likely to most difficult phase, and Fund will continue to monitor closely how the company evolves	**2**	**2**	**4**	Chris Tambini/ Colin Pratt	Managed at service level
12	**Invs**	**Investment decisions are made without having sufficient expertise to properly assess the risks and potential returns**	The combination of knowledge at Committee, Officer and Consultant level is not sufficiently high	Poor decisions likely to lead to low returns and higher employer contribution rates	Chris Tambini/ Colin Pratt	Continuing focus on ensuring that there is sufficient expertise to be able to make thoughtfully considered investment decisions	**3**	**3**	**9**	**Treat**	On-going process of updating and improving the knowledge of everybody involved in the decision-making process	**2**	**2**	**4**	Chris Tambini/ Colin Pratt	Managed at service level

Key to risk scores:

Impact (I)

1: Negligible

2: Minor

3: Moderate

4: Major

5: Very high/critical

Likelihood (L)

1: Very rare/unlikely

2: Unlikely

3: Possible

4: Probable/likely

5: Almost certain

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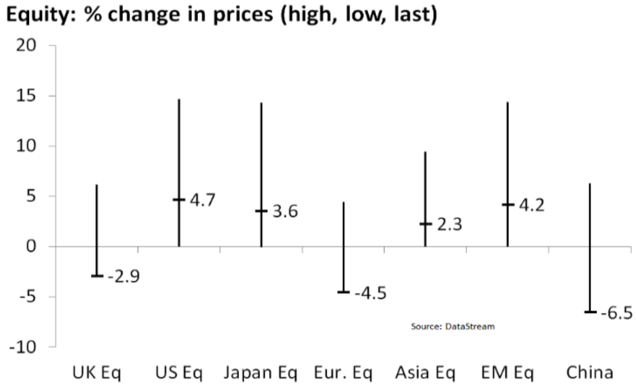
Market Backdrop

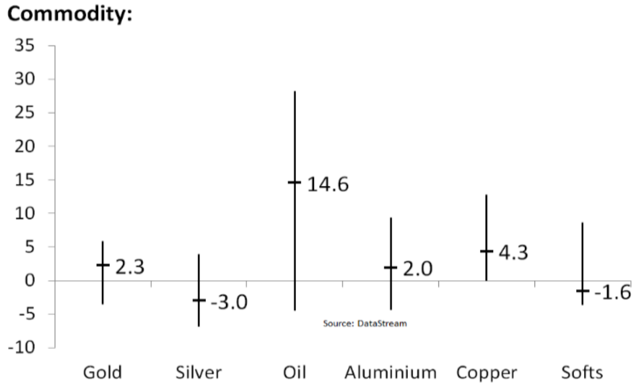
This note is intended to support discussion at the next meeting of the Local Pension Committee of the Leicestershire County Council Pension Fund.

At the time of writing, markets are particularly volatile. If there are meaningful changes between the date of production and the meeting then an update will be provided.

Market Movements

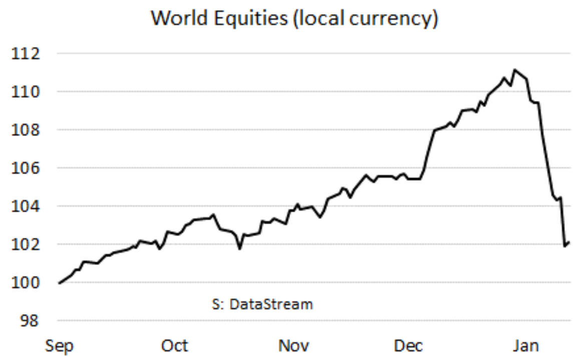
The figures below describe the % performance of various markets from the end of Q3, 2017 to the close on 10th February 2018; the charts also show the range of performance over that period.





Relative to the level at the end of the third quarter, equity markets have delivered a mixed performance with UK, Europe and China sitting on the lows while other markets have delivered modest returns. All markets attained higher levels during the period.

The real story of the past five months is perhaps better illustrated in evolution of global equities shown in the chart opposite. Equity prices had appreciated significantly through Q4, almost without interruption, well into January before falling precipitously. The market ascent in January was the strongest start to a year in many years; the subsequent reversal is proving just as noteworthy.

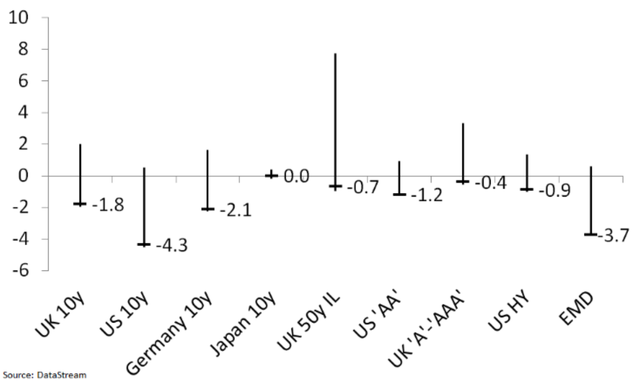


Catalysing the correction was the move higher in US bond yields as they respond to continuing strong economic data across the globe, the growing belief that several major central banks will join the US and UK in moving away from the extra-ordinary monetary policy setting and, recently, the apparent emergence of upward wage pressure in the US (albeit subject to minimum wage distortions). Bond investors tried to force yields higher a year ago but were thwarted by an unexpectedly weak start to the year in the US economy; no such headwind is apparent today. As will be shown later, US bond yields have risen to begin to offer a viable alternative to owning equities. Another section of this note will highlight some of the technical forces that are compounding the adjustments currently underway.

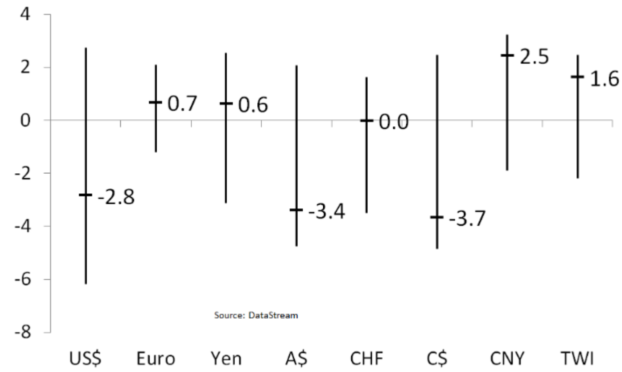
Commodity markets have demonstrated similar performance profiles and, as for equities, are currently below their best levels. The moves in the oil price have been significant as Brent Crude touched $70pb. Sustaining the higher prices has been ongoing production cuts in OPEC (and its satellites) and a steady decline in (previously elevated) inventory levels; this despite a rise in the US rig count and shale related production. Higher energy costs are being seen by those worried about inflation as ensuring that we don't get a repeat of the slow growth of consumer prices seen last year. Despite rising inflation expectations and, as we will see, a weaker US$, Gold has failed to sustain its rally (which saw the price hit $1360 per ounce).

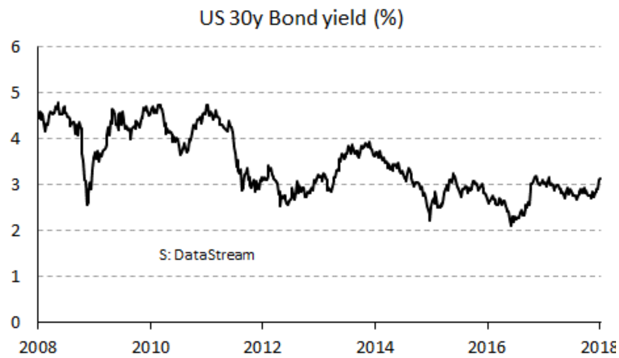
Bond markets have moved lower over the period with most markets currently seeing prices on lows for the period. That said, price movements remain orderly and subdued (relative to their history and to the current turbulence in equity markets). The sharpest adjustment has come in US bonds where yields have surged in recent weeks (the 30-year yield is 40bps higher than at the start of the year). That said, the absolute yield level remains well below that of the past ten years (see chart opposite). UK gilt 30-year yields have, by comparison, risen just 20bps (to 1.97%) highlighting the contrasting outlook for the UK economy.

Bonds:



FX (vs £):





The Pound trade weighted index (TWI) ended the period 1.6% better mostly reflecting the weakness in the US$ (which is now 10% lower, on a TWI basis, than its level at the end of 2016). £'s lift was also driven by the hike in UK base rates to 0.5% with the possibility of additional rate increases to come; UK policy rates are reflecting the higher level of UK inflation.

Consensus expectations – economic growth and inflation

Consensus economic forecasts for 2017 ended the year at the highs helped by relatively vibrant data prints across the globe for most of the second half of the year. The outlook for 2018 is, mostly, for a repeat of 2017 with moderation expected in 2019. The UK is expected to underperform both the EZ and US.

Table 1: Consensus forecasts – Real GDP growth (%)

	2017	2018	2019
US	2.3	2.7	2.3
Eurozone	2.4	2.2	1.9
UK	1.7	1.4	1.5
Japan	1.7	1.3	1.0
China	6.9	6.5	6.3

The Eurozone economy was notably firm in the middle of the year on the pent-up demand ‘released’ by the favourable French election result and as the ECB’s QE and negative interest rate policies started to work. So much so that, and despite the more moderate full year expectations for 2018, real time estimate of EZ growth in this quarter are running above 4%; heady days for Europe.

The US economy ended the year, firmly boosted by expectations around the tax reform that was to be announced around Christmas and by the lower US$. Tax reform will lift corporate profits (the initial indications are for a 4% increase in earnings per share in 2018) and many US companies have announced $1,000 handouts for staff. UBS has estimated that the giveaway is worth around 2 weeks of US retail spending; a boost but not a bonanza. The shale industry was instrumental in supporting a strong improvement in capital investment last year; 2018 is expected to see capital expenditure acquire a much broader base. As seen in the EZ, the Atlanta Federal Reserve estimates that the US economy is currently growing at a 4% pace (annualised rate). While the UK economy has also improved, from a much lower base, the forecasts are still discounting a negative *Brexit* impact; this is unlikely to change until clarity emerges over the eventual deal.

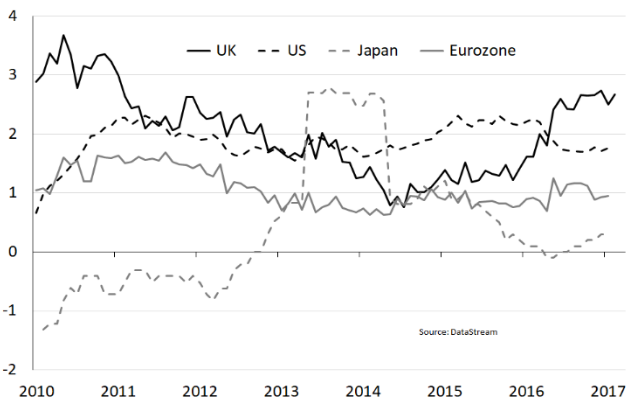
The outlook for inflation in 2017 and 2018 has generally lifted over the winter (Table 2 below). The main take-away remains however that inflation rates, this year and next, will remain contained. Nonetheless, monetary policymakers remain keen to exploit the better economic backdrop (moderate, synchronised and with low volatility) to move away from near zero (or negative) interest rates. This is about using the markets’ willingness to allow higher interest rates (in the US) to create some ‘altitude’ from which rates could later be reduced if necessary. US policymakers may also be keen to soften the impact of Trump’s fiscal expansion.

Table 2: Consensus forecasts – Inflation (CPI, %)

	2017	2018	2019
US	1.5	1.8	2.0
Eurozone	1.1	1.5	1.6
UK	1.6	2.5	2.1
Japan	0.0	0.9	1.0
China	2.1	2.3	2.3

Currently, core inflation rates in the major economies have been broadly stable (Chart 1). The exception is the Japan where prices, and wages, have been creeping higher. Japan’s inflation problem has been the lack of it and few will mourn the death of deflation. Just to be sure, the Bank of Japan has been clear that they are in no hurry to tighten monetary policy; they have had false dawns before and don’t want to risk another. QE and explicit yield suppression in Japan will continue.

Chart 1: Core CPI Rates (%, yoy)



In the UK, the latest data maintained higher levels of headline retail and consumer price inflation (Chart 2). This enabled the Bank of England to lift base rates in December, removing the ‘emergency’ post-*Brexit* policy easing. Although all sectors of the UK price data continue to see prices rising, Chart 2 and 3 offer a hint that the lift in prices might be starting to roll-over; time will tell (and will depend, as much as anything, on what happens to £).

Chart 2: UK inflation rates (%, yoy)

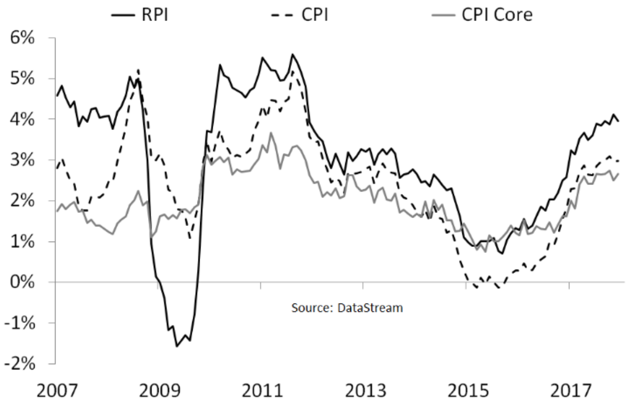
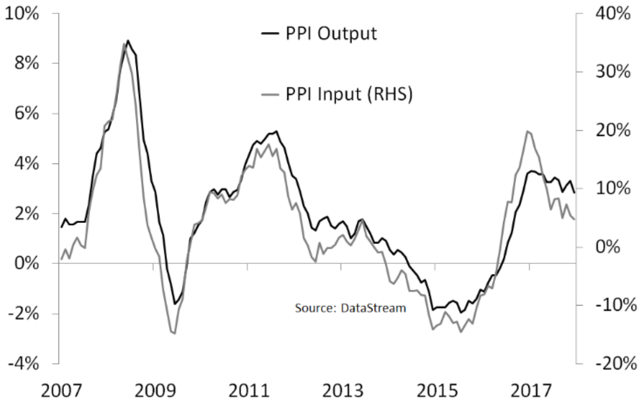


Chart 3: UK producer price growth (yoy)



Beyond the UK and US, diminished ‘macro’ risk is making it hard for policymakers to sustain the ‘emergency’ economic policy-setting of the post-GFC period and some look keen to try to introduce a level of normalisation. Risk markets, supported by a reasonable improvement in corporate earnings and, until very recently, have allowed this phase to develop. Should financial markets continued to gyrate wildly and economic volatility return, for whatever reason, this process could quickly stop.

Short and long-term interest rates

The current consensus forecast for the main policy settings are shown in Table R1; away from Japan, rates are perceived to be on the rise albeit at varying speeds.

Table R1: Consensus forecasts – main policy setting at year end (%)

	Latest	2018	2019
US Fed	1.38	2.30	2.85
ECB	-0.40	0.00	0.40
BoE	0.50	0.70	1.05
BoJ	-0.10	0.00	0.00

The US Fed validated market pricing by hiking rates again last December (to 1.5%). The market expects US policy rates to increase at least three times (to 2.25%) this year; some commentators think a fourth move is possible. In the context of the past forty years, US interest rates are still low and, in real terms, accommodative. FOMC members recently confirmed that they judge the neutral policy rate to be 2.8%; monetary policy might normalise but this will be to a ‘new’ normal. Longer term, in the US rates are expected to hit their terminal rate in 2019. This introduces the concept of a protracted pause at some stage.

The neutral projection suggests that the equilibrium longer term US real interest rate is 0.8% and implies that US 30-year inflation protected bonds are, at a real yield of 1%, looking cheap.

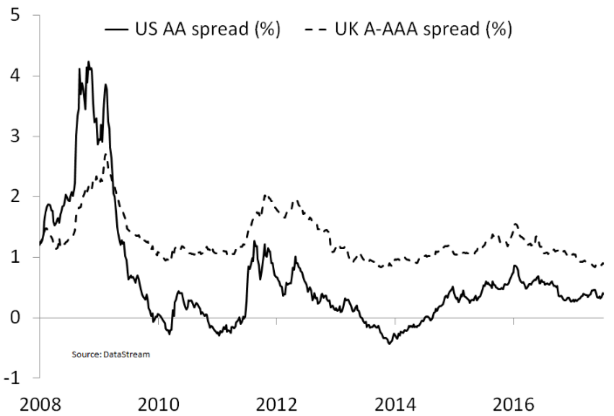
The outlook for longer dated nominal bond yields is shown in Table R2. US yields are expected to rise steadily into 2019 in response to the policy rate, on sustained economic growth and a recovery in inflation; higher US yields will drag other markets with them. Nonetheless, nowhere will yields get 'high'.

Table R2: Consensus forecasts – ten-year bond yields at year end (%)

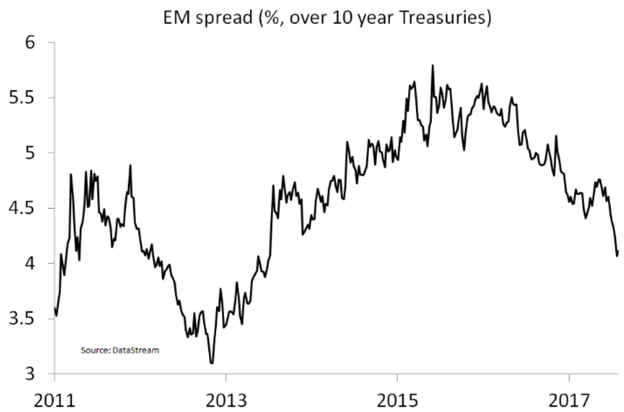
	Latest	2017	2018
US	2.4	2.9	3.4
Germany	0.8	0.9	1.3
UK	1.6	1.7	2.1
Japan	0.1	0.1	0.2

Non-Government Bonds

Investment grade (IG) bond spreads remain tight; spreads need to rise substantially to make them a compelling investment. That said, retail demand for IG bond funds has been very strong helped by improving credit quality consistent with better levels of economic growth and ongoing asset purchases by the European Central bank (as it implements QE). Until recently the same was true of high yield bonds where the spread was around multi-year lows; recent equity turbulence has led to HY profit-taking in this most economically sensitive fixed income market.



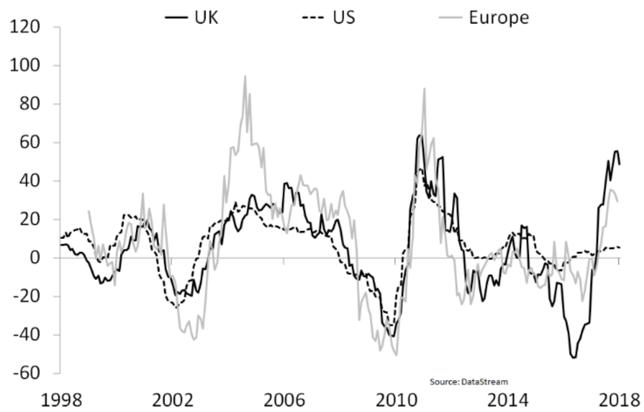
Regardless of which emerging market debt index is followed, all performed well through 2017. In a world of still wafer thin developed bond yields, investors continue to find EMD attractive – and more secure. Emerging markets have outperformed in the recent sell-off; for the moment, this has been a developed markets phenomenon.

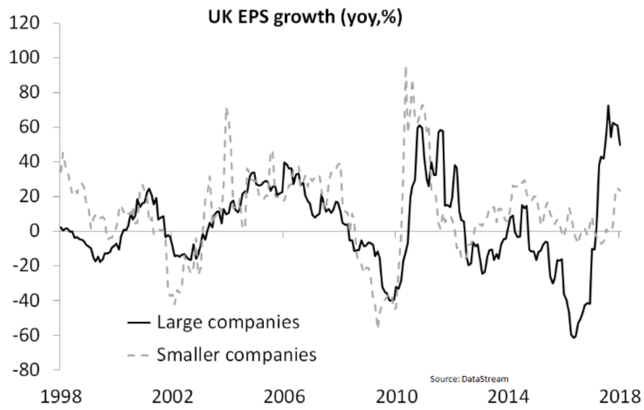


Equities

The chart (E1) below details how forecast earnings per share (EPS) for the UK, US, European and Japan equity markets have evolved over the past twenty years; they chime with the economic cycle. The fading, but significant, impact of £ weakness in 2016 on the earnings of the larger UK companies, made more dramatic by being off a low base, is clear to see. Note that U.S. corporate earnings will be boosted by tax reform (not yet appearing in the data).

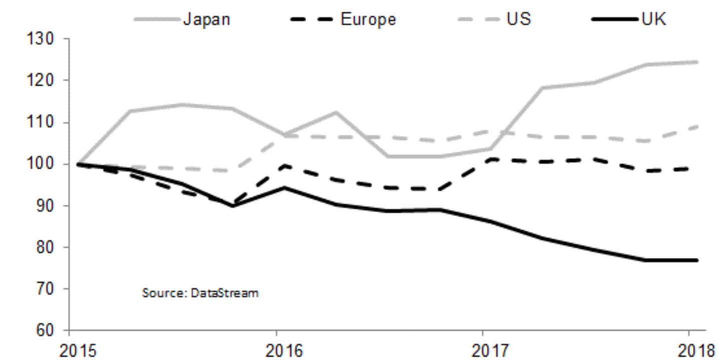
Charts E1: Experienced earnings per share growth





EPS forecasts for the next financial year point to an improvement in Japan (where the recent earnings season has been very strong) and the US (tax boosted). Analysts appear reluctant to discount a strong follow through in Europe where the strength of the € is a concern. The UK outlook remains poor.

Chart E2: Forecast earnings per share (next financial year, rebased to 100 in 2014)



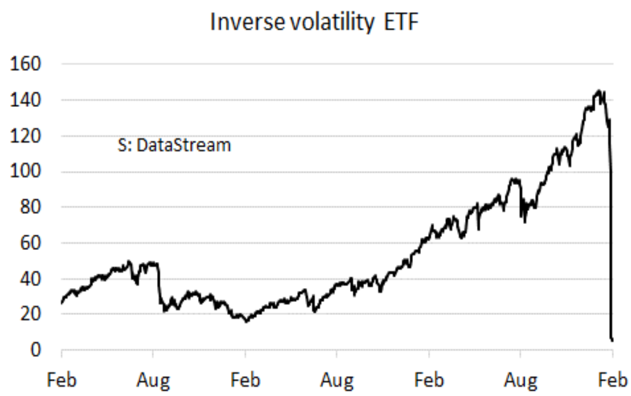
Looking beyond the next financial year, equity analysts are generally remain optimistic despite a modest markdown (Table 5); it should be remembered that analysts are rarely pessimistic.

Table 5: Consensus EPS growth forecasts – second and third financial years with change from previous report (source: DataStream)

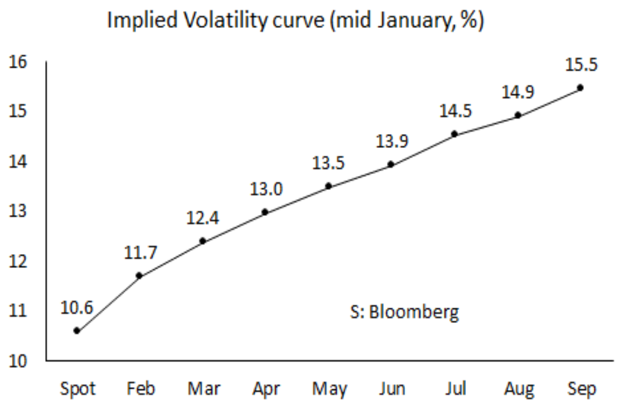
	UK	US	Japan	Europe
FY2	7% (u/c)	10% (-1%)	8% (+2%)	8% (u/c)
FY3	8% (u/c)	11% (+1%)	9% (+1%)	8% (-1%)

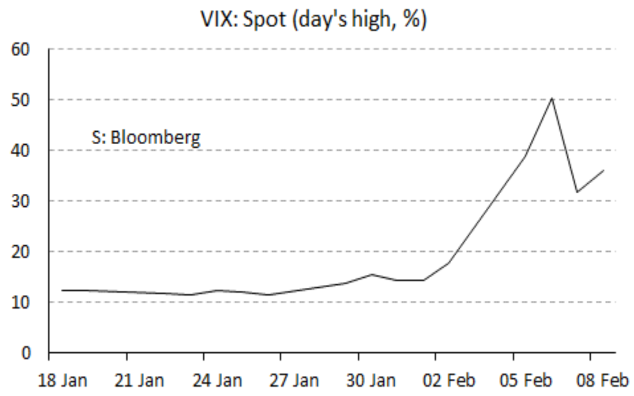
Feature: **'short vol' products**

One of the features of financial markets in recent years and until now was the very low level of market volatility e.g. the sharpest sell off in US equities in 2017 was, peak to trough, just 3%. Calm markets spawned a range of investment products which generate profits for investors if market volatility remained low. As invariably happens, demand emerges for leveraged versions of these constructs. The chart opposite is of an inverse volatility ETF. Prior to its near vertical collapse this ETF was worth \$2bn almost all of which was owned by retail investors. It is now worth nothing. This section provides detail on how these products work.



The expected level of stock volatility is a key component in the pricing of equity options: the higher the level of volatility expected, the greater, all else equal, will be the option price. Investors can not only trade in options but they can also speculate on the level of volatility itself (captured in the VIX index of US equity volatility). Typically, the implied level of volatility increases with time so that while, in mid-January, spot volatility was 10.6%, this was expected to rise steadily each month to 15.5% in September. If nothing changes then a trader could have, in mid-January, sold the September level of VIX index and, effectively, buy that contract back at 10.6% in September; in this the trader is benefitting from roll-down (so called). It is from harvesting roll-down that inverse volatility structures make their money. In the case of the ETF pictured above the average maturity of contracts sold was one month and, as at mid-January, at an average level of 11.7%.





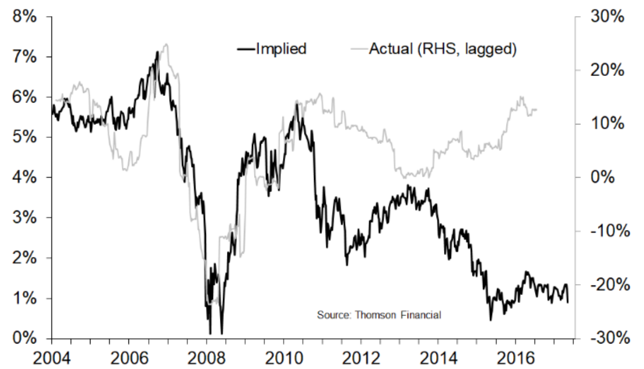
Unfortunately, things do change. In the example above, the ETF having sold February VIX at 11.7% found, in early February, that the level at which that contract had to be bought back had soared to 50% (more than four times the levels sold) representing a huge loss on the position. Over and above the need to lodge capital as surety against the position, investors in the ETF were redeeming in droves and so the short positions had to be bought back.

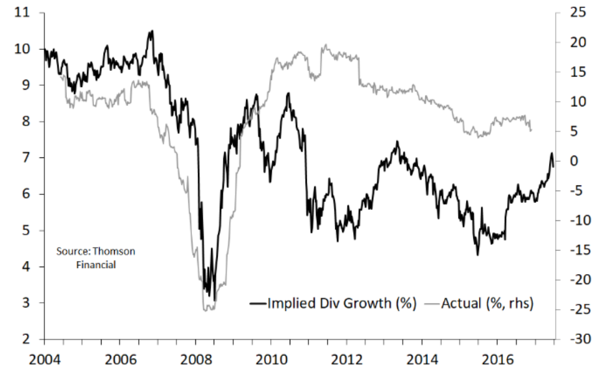
This is just one example of myriad ways in which investors had geared into the low volatility conditions of recent years. The eventual, and inevitable, end of these conditions and the problems that would result, was frequently highlighted by Ruffer as a cause for great concern. The scale of the 'low vol' trade was such that its unwinding could catalyse broader market selling; this is what has been seen in February.

Equity Valuation

A preferred means of assessing the relative valuation of equities draws upon the level of dividend growth required to generate the same returns relative to the alternative of investing in bonds. In the UK market (Chart E3), the implied breakeven level of long-term dividend growth looks to be modest in absolute terms and against what has been delivered; low bond yields help improve the comparison. If allowance is made for a risk premium – important given the uncertainties surrounding *Brexit,* then UK dividends may never grow but equities would still broadly offer better value than fixed income. This position could persist for some time. In the US on the other hand, equities have seen the breakeven dividend growth lift in recent months (Chart E4) to levels that are starting to look less like as a foregone conclusion; US bonds have become much more competitive especially with cash rates continuing to head higher.

Charts E3 and E4: UK (FT All Share, left chart) and US (S&P Composite, right chart) implied dividend growth





The implied outlook for the more domestically focused FTSE 250 is determined in the same manner as the broader market. Here and until recently, the path of actual dividend growth has been more consistent with the evolution of the breakeven rate (Chart E5). The chart also suggests that there may be some poor news on actual dividends to absorb in the near term.

Chart E5: UK (FTSE 250 Index), imp. div. growth

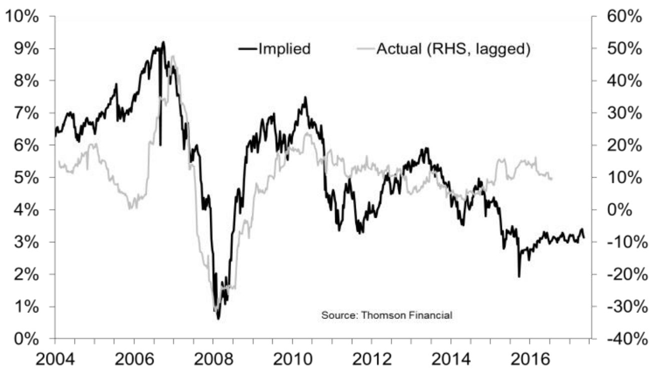
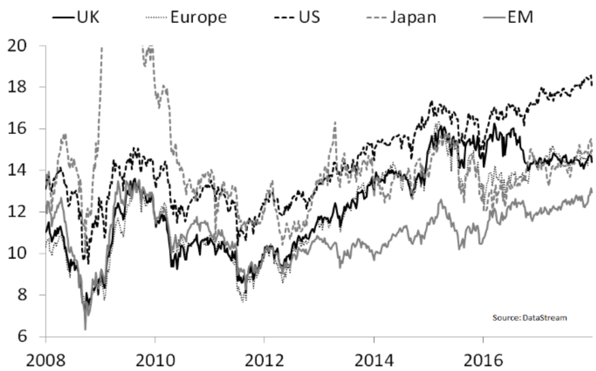


Chart E6: Regional PE ratios



Looking at PE ratios (Chart E6), valuations have been rising in the US and, at a lower level, across emerging markets; ratios in other three regions appear to have stabilised. In all cases the level of valuation is within historic ranges – albeit towards the upper end; the same cannot be said for (non-US) government or corporate bonds.

Regardless of how it is delivered, if the recent economic performance is sustained then equity markets should rebound from the recent weakness to enjoy strong returns unless wage growth starts to eat into profit margins. Investor confidence has however taken a strong knock and will take time to recover.

Equity style update

Appetite to find clever ways of beating the equity market remains undiminished and so the pursuit of lower cost *smart betas* is still strong (and the cost of playing these themes via ETFs continues to fall). These are style filters no smarter than was the designation, thirty years ago, of *value* and *growth*. Chart S1 updates on the relative performance of four common global *smart betas*: quality, high dividend yield, momentum and minimum volatility[1] (risk). Yield and volatility have languished in recent months as investors favoured a growth perspective. Momentum has been a positive theme until the recent blood-letting.

Chart S2 captures the performance of small cap, growth and value themes. Gyrations in small cap (largely driven by weightings in the US), have reflected the markets' assessment of whether Trump will be able to deliver on his election promises; optimism on this front has improved in recent weeks. Consolidation in oil prices and sustained appetite for growth stocks has been reflected in the relative performance of value stocks.

Chart S1: Performance of equity styles (vs MSCI)

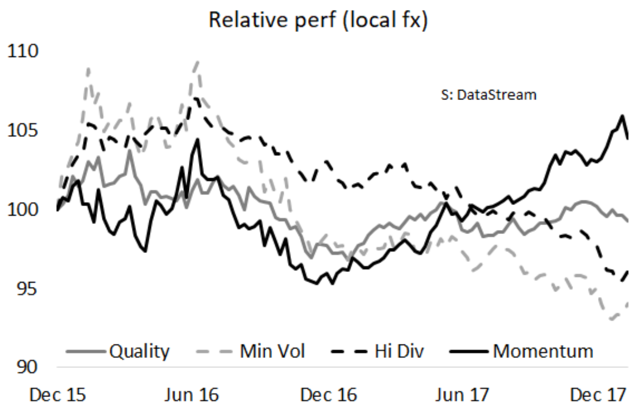
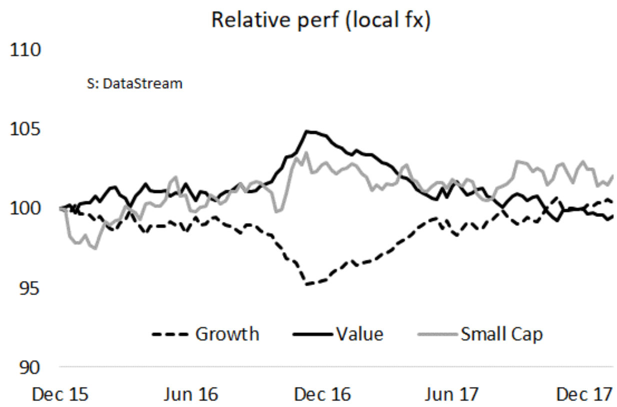
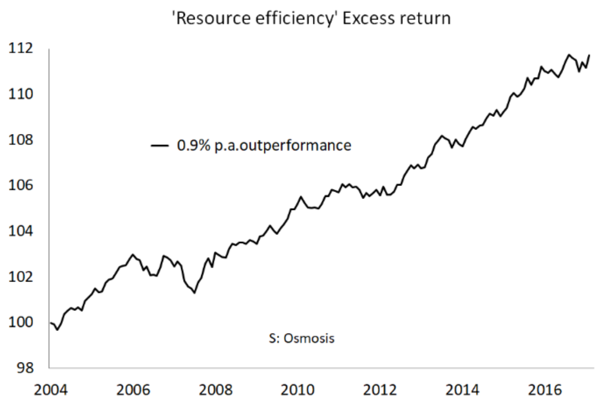


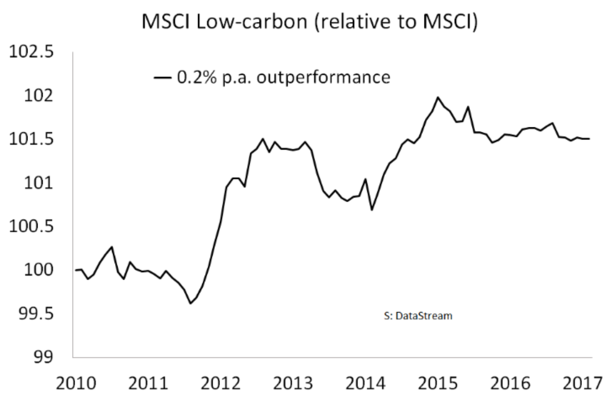
Chart S2: MSCI Growth vs Value relative



The strength of demand for growth and momentum plays together with rising bond yields has seen investors mark-down income as an investment theme in both the US and Europe. Nonetheless the Fund is recommended to sustain a strong weighting to equities characterised by robust dividend yields and solid dividend growth. As we are seeing, market conditions don't always stay supportive of 'risk'.

There are numerous ways of playing the sustainability theme; an example is one that favours those companies that are demonstrably better[2] at managing their water and energy inputs and waste outputs. The next chart plots the relative performance of this portfolio (relative to the MSCI). Shown alongside is the





[1] In practice, this 'style' captures those stocks which tend to have high levels of free cashflow yields.
[2] As disclosed formally in their regular company reports.

excess return from the MSCI ‘low carbon’ index. Thus far, the more complete approach (water, waste and energy) has delivered superior and more stable excess returns[3].

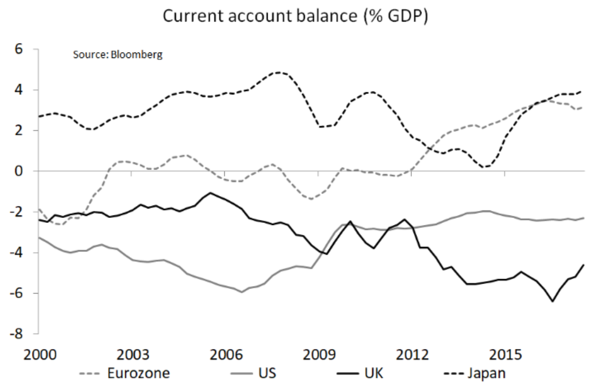
A resource efficient tilt to global equities is an attractive alternative to a holding in a global equity index implemented passively and superior to simply focusing on minimising a carbon footprint.

Currency markets

Recent currency swings have been driven less by overt policy manipulation and more by growth contrasts; the € has risen in line with unexpected levels of real economic growth while the US economy initially lagged forecasts. The associated rebalancing has benefitted the world economy however Trump’s anti-free trade stance is beginning to generate concern.

Consistent with the growth transfer is the operation of external deficits and lower surpluses; current account imbalances exert a strong influence on currency trends when other, more fleeting, drivers subside. Chart FX1 highlights the strong creditor nature of the Eurozone and Japanese economies as well as the UK’s need to attract international capital inflows to ‘balance the books’.

Chart FX1: Current account deficits (% of GDP)



It should be noted that the UK’s substantial current account deficit has improved recently but the deficit, as % of GDP, remains significant. The UK has been able to attract international capital despite the relatively low yields on offer. Higher yields in the US could emerge to ‘crowd’ out the UK; if so, £ would need to weaken.

£ is still low (Chart FX4) but may languish around current levels given the *Brexit* overhang, the absence of fresh economic stimulus from fiscal policy and the relatively weak economic outlook (Table 1). Political developments in the UK have the potential to change the landscape for £ considerably.

Chart FX2: £ Trade-weighted Index

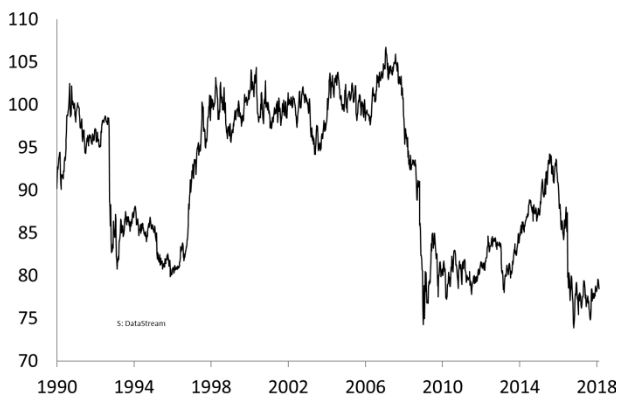
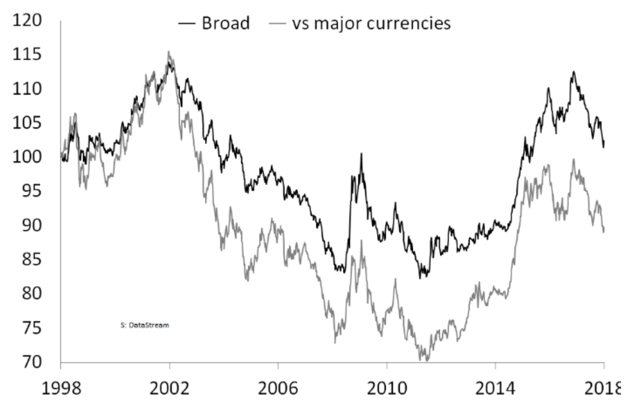


Chart FX3: US$ Trade-weighted Indices



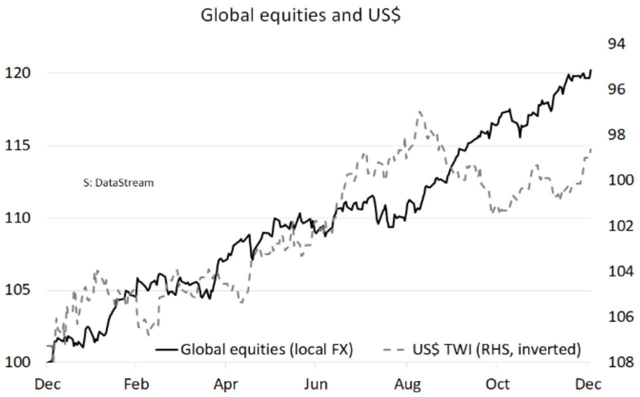
[3] Excess returns are perhaps to be expected; companies which minimise their input and output costs (associated with waste, water and energy) are probably better managed companies.

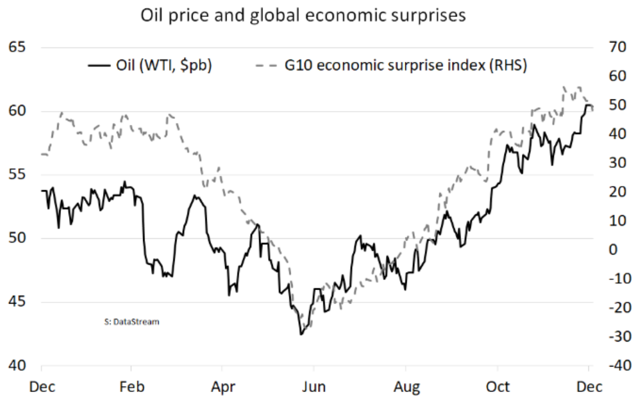
Commentary

Equity ('risk') markets performed very well in 2017 and much better than people expected when the year began. In many cases, indices attained all-time highs repeatedly throughout the year and the US equity market never fell in any calendar month in 2017; the local currency return of global equities was just over 20%.

The platform for these gains was formed, across the globe, by stronger and much more synchronised economic growth than expected, a related strong improvement in corporate earnings and a benign monetary policy response from Central Banks (shaped by still low inflation and evidenced by the slide in the US projected equilibrium policy rate to just 2.8%). A fourth, important factor was the failure of politics, in Europe most notably, to generate a sustained de-stabilisation. Despite unexpected developments in Spain, Austria and the UK, Macron's victory in France proved that stable politics at the core of Europe is all that matters. Investors were also reassured by Trump's repeated failure to turn bluster into policy, what he did manage was to deliver his promised, and welcomed, tax reform.

In what was to be repeated in 2018, the year began with equity investors hoping for positive economic data but braced for the higher bond yields that would come as a result. In the event, the emerging economic releases – led by the US, proved weaker than economists predicted and energy prices went lower. Bond yields fell as traders were caught 'short' helping valuations in equity markets to expand. By the time that Macron had won the French elections the economic tide was starting to turn beginning a sustained phase of positive economic surprises across the globe with the lead coming from Europe; Europe had once again become an investable area. Corporate earnings quickly followed suit allowing equity prices to move higher in tandem with the economic data. As the year ended, equity markets were given fresh impetus from Trump's US tax reform; investors entered 2018 in good spirits.





One feature of 2017 was the downshift in the US$. A weak $ is often associated with a brighter global economic outlook and this was the backdrop of 2017. Previous US$ strength had, in part, been driven by a paucity of attractive investment opportunities elsewhere. As a result, when the world outlook improved there were substantial cash balances 'parked' in the US$s available for investment elsewhere. These US$s flowed into Europe (as investors rebuilt positions), Japan and, perhaps most notably, emerging markets; EM equities returned 40% over 2017 to a $ based investor.

History suggests that the recovery from a financial shock typically takes around ten years. The 'Credit Crunch' arguably began early in 2007 when HSBC announced problems with its sub-prime mortgage lending subsidiary Household International. In 2017 the world economy looked to be finally pulling out of the deep malaise that followed. Wary of spoiling matters just as things were starting to improve, the world's major central banks exploited subdued inflation data to talk soft on policy rates; cash was not going to emerge as a viable competitive alternative to equities.

Taken together, the factors described combined to create a very benign platform for risk assets and equity indices went better as a result. Momentum strategies outperformed and defensives lagged – *who needs defensives when things are this easy?!* This virtuous circle ground to a halt in early February.

Looking ahead to 2018, investors began by expressing heady optimism about global economic growth (broadly based and above trend) and corporate earnings growth; the scope for 2018, however, to deliver upside surprises is much reduced from a year ago. Growth forecasts for the early part of the year for the Eurozone and US (at 4% and above) have invited speculation that the policy response will prove much less benign especially if wage growth and inflation continue to rise. US long-duration bond yields have already moved higher as a result; above 3%, bond yields are beginning to look attractive and now need US dividends to grow by more than 7% if equities are to be preferred. Boosted by tax reform this may well be delivered this year but this is a non-recurring boost to demand. A further factor likely to lead to higher equity market volatility is the rising price of oil.

In summary the world economy looks well placed to perform well in 2018 particularly if companies deliver a boost to capital investment (corporates had become serial under-investors since the GFC). A good part of this good news has however been priced by equity investors and the tussle between opportunities and risks has become much more two-way. Defensive growth strategies should recover ground in 2018 as a result.

Scott M Jamieson, February 2017

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Leicestershire County Council Pension Fund Q4 2017 – Market Report

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Contents

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Historic Returns for World Markets

	Q4 (%)	1 year (%)	3 years (%pa)
Citi WGBI Non-GBP TR	0.09	-2.04	6.83
FTSE 100 TR	5.02	11.95	9.56
FTSE 350 TR	4.99	12.91	9.92
FTSE Actuaries UK Idx-Lnk Gilts All Stocks TR GBP	3.52	2.34	8.01
FTSE Actuaries UK Conven Gilts All Stocks TR GBP	1.97	1.83	4.07
FTSE Actuaries UK Conven Gilts Over 15 Y TR GBP	3.65	3.32	7.00
FTSE All-Share TR	4.96	13.10	10.06
FTSE Japan TR	7.93	14.44	18.17
FTSE Small Cap TR	4.16	18.15	13.80
FTSE World Europe ex UK TR GBP	0.39	17.53	14.00
FTSE World ex UK TR GBP	4.97	13.45	15.72
LIBID GBP 7 Day	0.10	0.28	0.38
Markit iBoxx Sterling Non Gilts Overall TR	1.83	4.32	5.07
MSCI EM (Emerging Markets) TR GBP	6.62	25.83	14.80
MSCI Pacific ex Japan TR GBP	6.17	15.13	12.86
S&P 500 TR	5.77	11.29	16.80
Commodities	2.25	-1.03	-10.72
£ Trade Weighted Index	1.07	0.81	-3.94

	Q4 (%)	1 year (%)	3 years (%pa)
Euro	0.75	3.99	4.58
Japanese Yen	-0.90	-5.43	7.04
US Dollar	-0.82	-8.66	4.84

All returns are GBP currency, and returns over 1 year are annualised.

Source: Kames Capital as at 31 December 2017.

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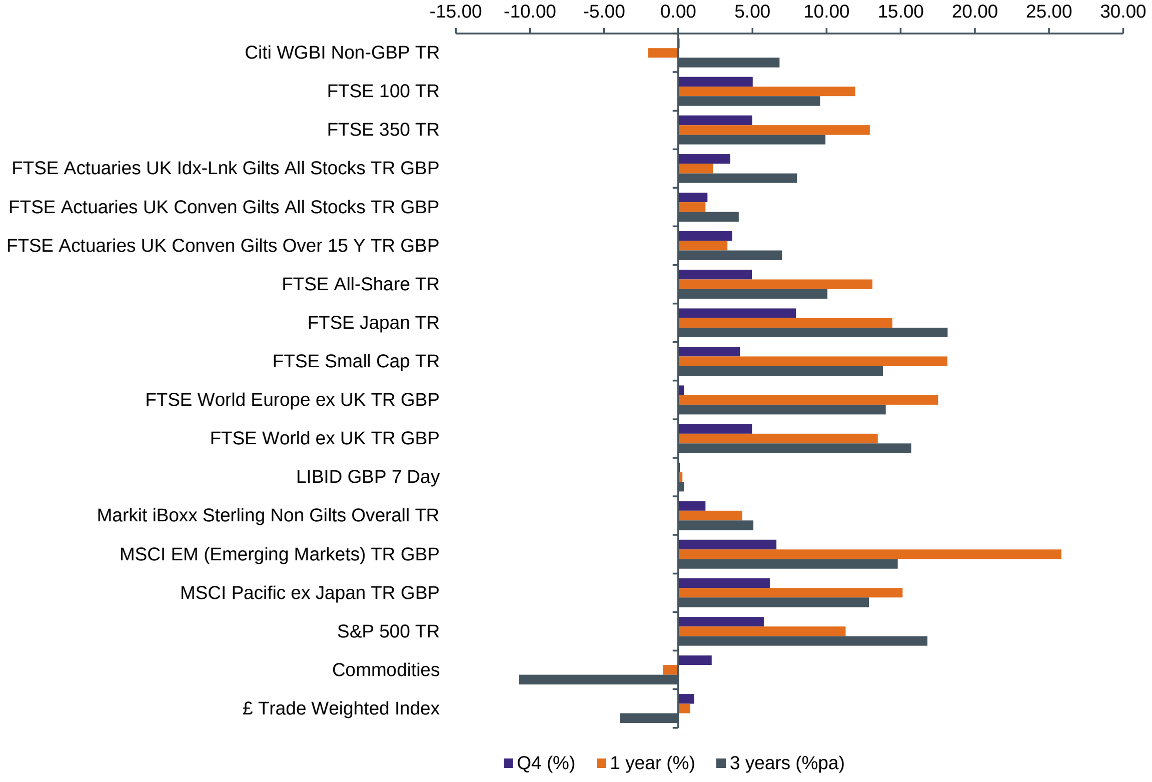
Historic Returns by Market Index



All returns are GBP currency, and returns over 1 year are annualised.

Source: Kames Capital as at 31 December 2017

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Market Review

UK equities

UK equities ended 2017 strongly with the FTSE All Share index up 4.96% for the fourth quarter and 13.10% for the year as a whole. Large-cap stocks produced the best returns over the fourth quarter, outperforming both their small and mid-cap counterparts. The picture for the year, however, was considerably different; mid-cap stocks were the clear winners with the FTSE 250 index up 17.78% compared to 15.61% for the FTSE Small-Cap index and 11.95% for the FTSE 100.

In sector terms, resource-related areas such as mining and oil & gas producers performed well over the quarter, as did food retailers, beverages, travel & leisure, software and mobile telecoms. These sectors, along with construction, financial services and non-life insurance also proved to be among the strongest areas over the year. The weakest sectors in the fourth quarter were defensive in nature (utilities, fixed telecoms and pharmaceuticals). General retailers and support services also struggled in relative terms. Those sectors of the market with exposure to the domestic UK economy tended to lag areas with exposure to international markets, specifically Asian and emerging markets.

The main economic news over the quarter was the Bank of England’s decision on 2 November to increase interest rates for the first time in 10 years – the 0.25% rise brought the rate up to 0.5%. The Bank justified its decision by pointing to stronger global economic growth, record-low unemployment and Brexit-induced inflation. With average wage increases falling behind inflation, the UK consumer continued to feel the squeeze and retail sales figures were therefore somewhat lacklustre. Momentum stocks were in favour with those names that benefited from upgrades early in the period generally performing well over the quarter as a whole. Resource-related areas benefited from the continued rise in the oil price.

US equities

US equities performed well in the fourth quarter, with the S&P 500 rising 5.77% in sterling terms (6.64% in US dollars). The strong returns for the quarter mirrored what was a very strong year for US equities; the index was up 11.29% in sterling terms for 2017 as a whole and an impressive 21.83% in dollar terms.

An increased appetite for risk, together with strong third quarter earnings helped maintain the rally in US stocks. In December the Federal Reserve raised interest rates by 0.25%. At the same time it raised its growth forecast for 2018 to 2.5%. The positive backdrop was highlighted in strong corporate earnings and generally buoyant economic data. The market was also boosted by signs of progress (after a significant amount of uncertainty) on the government’s much-discussed tax reforms.

Many of the best performing sectors were cyclical in nature, including financials and a particularly strong showing from technology stocks. Resource related areas also performed well given the rally seen in the oil price. In contrast, healthcare sectors came under pressure, including pharmaceuticals and biotechnology.

European equities

In the fourth quarter of 2017, the FTSE Europe ex-UK index increased by a modest 0.39% in sterling terms, which was significantly behind other major market returns. Over the year as a whole, however, the index was up 17.53% which was in line with the returns seen elsewhere within global equities.

At the beginning of the quarter, geopolitical crises hampered the markets’ performance. Spanish stocks for example struggled as political tensions between Madrid and the regional Catalan government escalated. These tensions detracted from the markets attempt to react positively to strong German data and ongoing Central Bank support. As the period progressed, however, it was the turn of German politics to hamper progress as Chancellor Merkel struggled to form a new coalition government. A strong euro also conspired to dampen the market’s progress, while the ECB reiterated its caution regarding the outlook for the economy.

In sector terms, the weaker sectors included pharmaceuticals, telecoms, general retailers and banks. On the positive side, oil & gas producers benefited from the rise in oil prices. Autos and technology (both hardware and software) also rallied.

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Japanese equities

Over the fourth quarter of 2017 the FTSE Japan index rose by a robust 7.93% in sterling terms (8.91% in yen terms). The returns for the year as a whole were equally impressive with the index up 14.44% in sterling terms and 21.00% in yen terms.

The depreciating yen, along with the re-election of Shinzo Abe's coalition government early in the quarter, supported equity markets. Economic data continued to be buoyant and the earnings picture also highlighted an economy that is slowly emerging from the deflationary environment that had gripped it for so long. Similar to other major markets, cyclical sectors led the way over the quarter while traditional defensive areas were weaker in comparison.

In sector terms, resource-related area rallied, driven by the increase in the oil price. Software, autos and banks also performed well, given the positive economic backdrop. Defensive areas of the market such as tobacco, utilities and telecoms were among weaker sectors.

Asia (ex-Japan) equities

The MSCI AC Asia Pacific ex-Japan index rose 7.09% in sterling terms over the fourth quarter. This brought to an end a year in which the region made solid progress; the index finished up 25.43% in sterling terms for 2017 as a whole. The region continued to benefit from the 'pro-risk' sentiment that has underpinned the global stock markets.

Despite some concerns over the strength of the Chinese economy, growth remained relatively stable over the quarter. An increase in government regulations caused some concern; at the Communist Party Congress the government looked to address structural risks in the economy but also promised to focus on growth.

In regional terms, most markets performed well over the period, with Thailand, Korea, Indonesia and Singapore the best performers. India also performed well after the government acted to acted to recapitalise state-controlled banks. In sector terms, both consumer staples and discretionary areas were strong, as were autos, banks and technology.

Property

The UK economy grew by 0.4% in Q3 2017 according to the ONS, confirming a trend of slower growth that has been driven by weaker consumer spending and a squeeze on real household incomes. Whilst growth figures for the final quarter are not yet available, the UK is set to record its weakest economic expansion in a calendar year since 2012 despite evidence of a strengthening global economy. Encouragingly however, Brexit negotiations progressed at the end of the year with talks advancing to discussions over the UK's future trading relationship with the EU, although the complex nature and political sensitivities of talks means that significant uncertainties remain.

According to the IPD Monthly Index, the UK commercial property market completed the year with another healthy quarterly total return of 3.4% in Q4. Despite a decelerating economic backdrop, this translated to an above-trend full year return of 11.2% in 2017 which defied earlier expectations of a market slowdown from some commentators. Strong investment demand, especially from overseas investors based in the Middle East and Far East, has led to yield compression and supported capital values which have returned to pre-referendum levels. In addition the resilience of the economy, bolstered by stronger global growth, has helped underpin the occupational market with rental growth in 2017 measured at a respectable 1.9%, although there are variations across different sectors and regions.

The industrial sector delivered a remarkable total return of 6.4% in the final quarter of 2017, continuing a trend of outstanding performance which led to a full year return of 21.1% and the sector easily being the stand-out performer of the UK commercial property market. The twin drivers of strong occupier market demand (driven by the growth of e-commerce and the need for retailers to re-organise their supply chains), and low levels of supply led to industrial rental growth of 4.9% last year - the highest annual rate of growth in over 16 years – whilst yields have compressed further to remain at record lows. The office sector delivered a more modest quarterly return of 2.5% in Q4, and completed 2017 with an annual return of 8.5%. Regional office markets outperformed the central London office market with leasing conditions generally remaining robust in major cities outside of the capital, partly due to low levels of development activity. In contrast, central London office rents have come under downward pressure due to a combination of Brexit-related uncertainty for financial service occupiers and an increase in availability. The retail sector returned 2.0% during the quarter and 7.7%

over the full year, continuing a long-term trend of consistent underperformance which has now stretched back nearly seven years. The continuing growth in market share of on-line retail means that the structural challenges facing physical retail stores are unlikely to change over the medium term, with secondary retail centres in weaker or smaller towns remaining vulnerable.

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Fixed Income

Bond markets performed well in the fourth quarter of 2017, bringing to an end another year in which the asset class generated positive returns for investors.

In the second half of 2017 the global economy experienced the most positive environment we have seen since the Great Financial Crisis. Growth was not only above potential, balanced and synchronised across developed and emerging markets, but also felt less dependent on ultra-stimulatory Central Bank policy.

Despite rising expectations, economic data consistently surprised to the upside. In particular, Europe and benefited from improving global dynamics, as reflected by the pick-up in trading activity. Brazil and Russia left behind their recessionary periods and are now well positioned to contribute to growth in the coming quarters.

Importantly for financial markets the strong growth was accompanied by a healthy but modest level of inflation; deflationary fears dissipated but inflationary concerns have not mounted.

Government bonds calm under pressure

Changes in government bond yields were surprisingly muted – over the year, 10-year US Treasuries and UK gilts traded in a relatively tight range with 10-year German bunds even tighter. It was in fact the narrowest trading range for government bonds in a number of years, reflecting the aforementioned opposing forces of robust growth but muted underlying inflation. The net result was a range-bound year for 'risk free' assets while their 'risky' cousins rallied throughout the year – an unusual dynamic.

Within this rather muted backdrop, there were periods of relative volatility. For much of the year government bond markets were mainly focused on the political stories of the moment. These included the French presidential election in Europe and Trump's ability to deliver the significant fiscal reforms he promised on his campaign trail. These issues, as well as others caused periods of short-term volatility in risk-free assets.

In the fourth quarter government bonds recovered from the more testing conditions they experienced in the previous quarter (which was due mainly to concerns over potential rate rises). Over the final three months of the year the iBoxx £ Gilts index increased 2.05%, bringing the return for the year to 0.30%. The UK index linked market also performed well over the quarter with the FTSE UK ILG index up 3.34%, but for the year as a whole inflation-linked assets came under pressure slightly with the index down by -0.04%.

Table 1: 10-year yield movements in core and European periphery benchmark bonds

	Core government bonds				Peripheral Europe				
Country	UK	US	Germany	Japan	Spain	Italy	Greece	Ireland	Portugal
Yield, end Sep 2017	1.37	2.33	0.46	0.07	1.60	2.11	5.60	0.74	2.36
Yield, end Dec 2017	1.19	2.41	0.43	0.05	1.56	2.01	4.07	0.67	1.91
Change in yield	-0.18	+0.08	-0.03	-0.02	-0.04	-0.10	-1.53	-0.07	-0.45

Source: Bloomberg, as at 31 December 2017

Corporate bonds still in demand

Corporate bond markets also enjoyed a positive final quarter and, indeed, posted solid returns for the year as a whole; the iBoxx £ Non-Gilt index rose by 1.85% for the fourth quarter and by 2.43% for 2017. The high yield bond market enjoyed a robust final three months of the year with the Barclays Global High Yield (USDH) index increasing 1.57%. The asset class was clearly the star of the show for the year as a whole with the index up 7.26%.

The final quarter of 2017 (and the year) saw credit spreads make further progress, bolstered by a combination of supportive global macroeconomic data and an ongoing belief that central banks would err on the side of caution in terms of their withdrawal of monetary stimulus. In sector terms financials outperformed non-financials, with subordinated bonds among the strongest performers. The good performance of credit arrived despite a healthy new issue pipeline which was generally well digested by the market.

In the UK, the first rate hike in 10 years was greeted with much fanfare, but the ongoing travails around Brexit and concerns over the enduring health of the domestic economy dampened expectations that the MPC would follow up with a series of further hikes. Of more significance to credit markets was the surprisingly dovish comments and action from Mario Draghi in October, when he confirmed the ECB's commitment to its QE programme until at least September 2018, albeit at a reduced rate. There had been some concerns in markets

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around the potential for a hard stop to the ECB’s QE programme, and the ECB announcement saw credit spreads rally aggressively in the immediate aftermath.

A growing belief that President Trump would manage to effect some change to corporate and personal tax rates in the US acted as a further stimulant to risk markets over the quarter, with US credit markets also speculating that the potential ability for large swathes of the TMT sector (most notably Apple) to bring onshore cash trapped overseas would reduce supply in this sector, acting as a further technical support.

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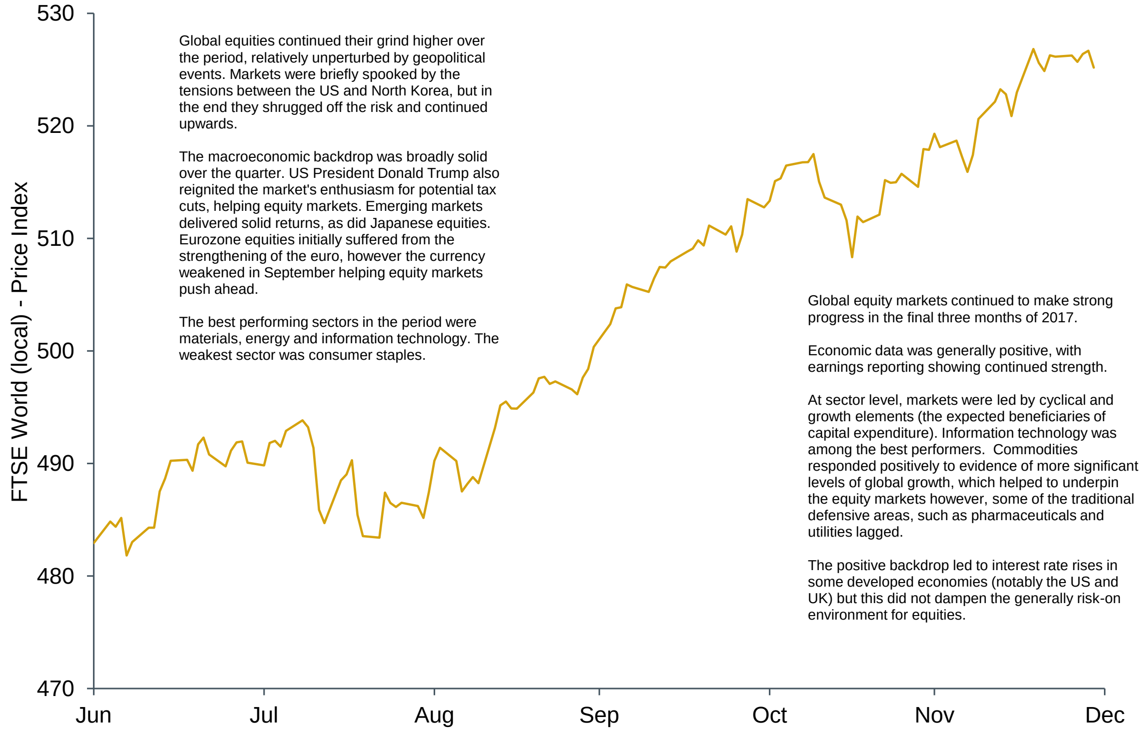
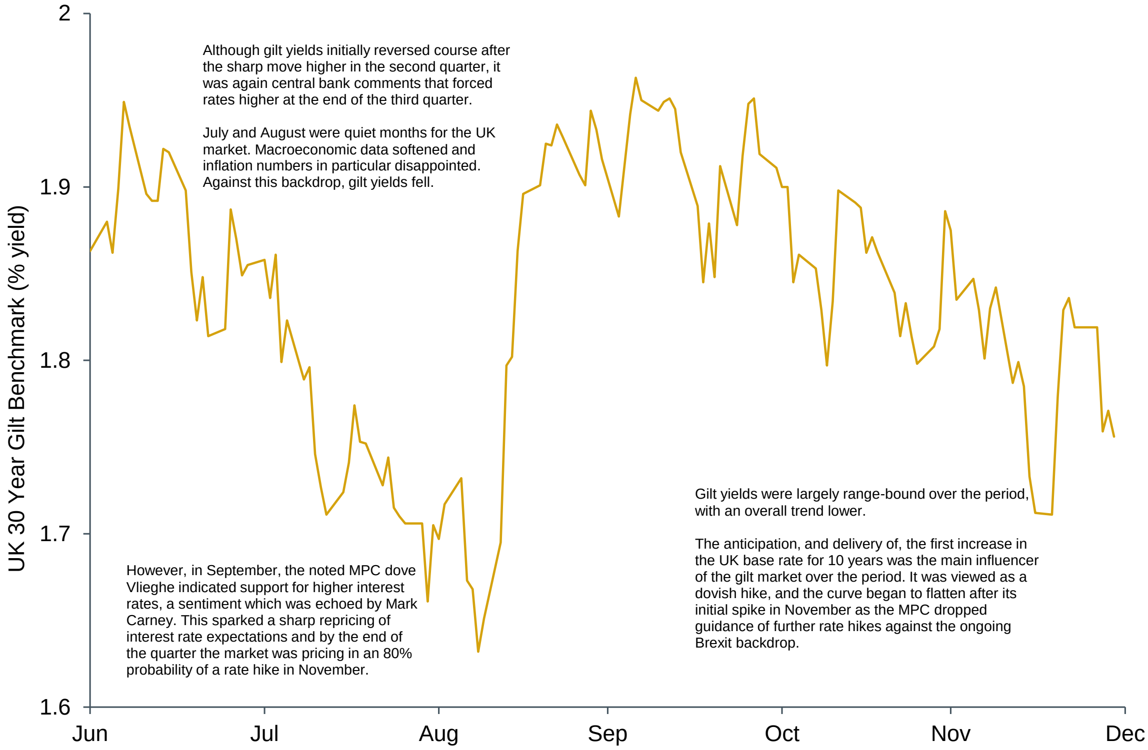
Key Market Movements

The following charts provide a pictorial summary of key market movements during the six month period to end of December 2017.

Global Equities (FTSE World Price Index)



Long Gilts (UK 30 year gilt)



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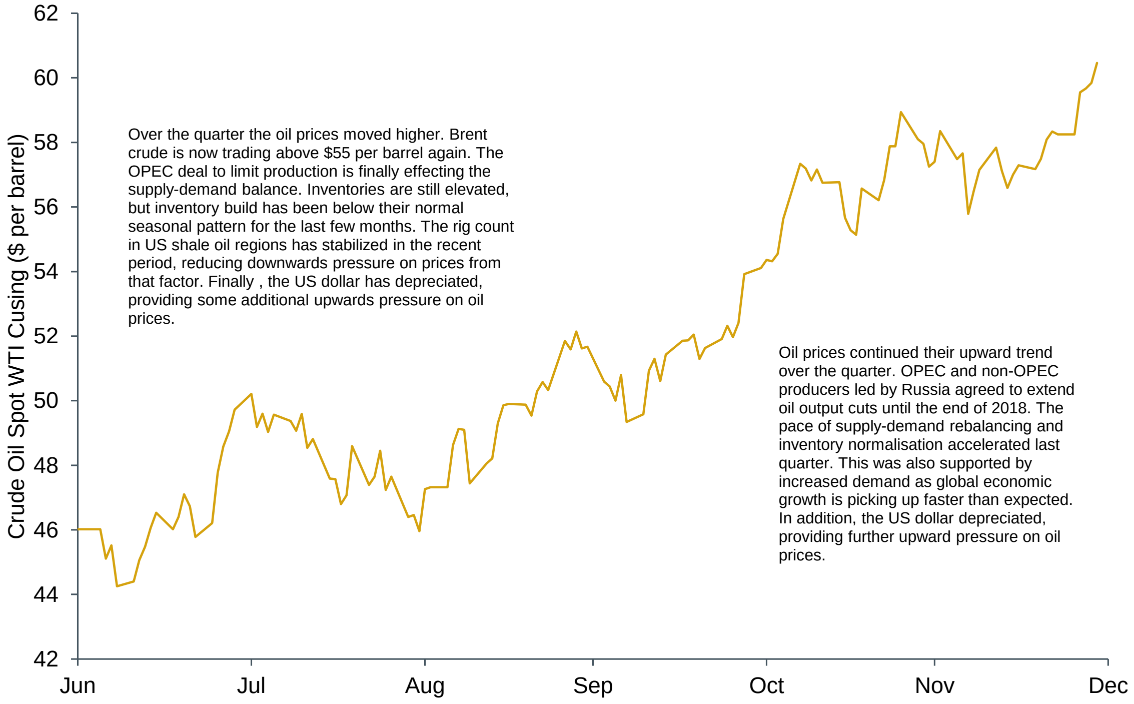
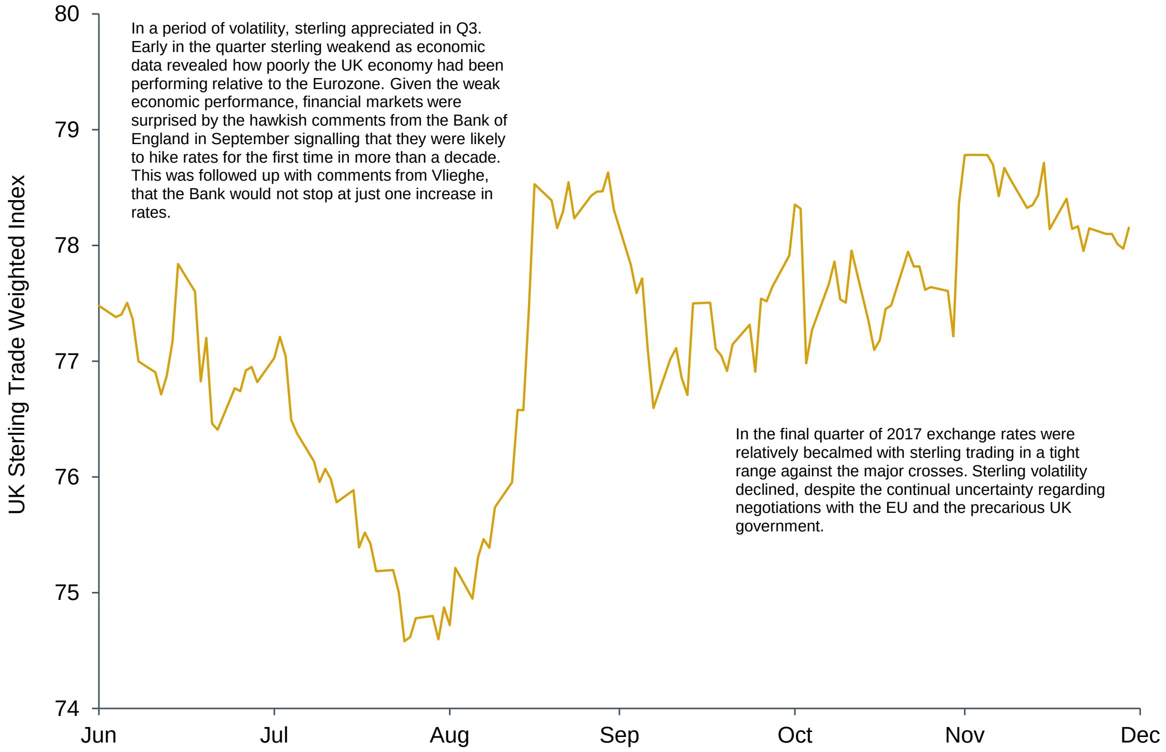
Oil Price (Crude Oil Spot WTI Cushing ($ per barrel))



UK Sterling (UK Sterling Trade Weighted Index)



Source: Datastream

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Quarterly Thought Piece

2017 was the first year since 2010 where global growth beat expectations

In 2017, economic activity has been broad-based and synchronised across both developed and emerging markets. Encouragingly, the composition of growth has been balanced. Domestic consumption was a key contributor with healthy employment and real disposable income along with lower savings. This was complemented by a boost in investment activity, something that has been lacking over the past few years (weak global productivity is a vivid reflection of this dynamic).

The positive momentum of global growth suggests a healthy 2018. However further positive surprises appear unlikely. Less activity in Asia, in particular China, is likely to exert downward pressure on growth. In Japan, GDP has been unsustainably high in recent quarters, at 1% above economic potential. We do expect growth in the eurozone will continue but the brisk pace of 2017 is unlikely to persist.

Overall, the macroeconomic environment remains positive, but the second half of 2017 might have been as good as it gets. Global growth is likely to be above 3% in 2018, but it has limited room to beat expectations.

Where will any surprises come from?

The upside surprise

A more forceful increase in investment is most likely. Since the global financial crisis, corporate capital expenditure has been subdued. A lack of confidence in the business sector along with plentiful ‘cheap’ labour has kept investments below pre-crisis levels. In light of increasing confidence, healthy profits and falling slack in employment, companies might finally gain the confidence to commit to investments. With readily available credit and elevated confidence, animal spirits might return to the corporate sector.

The downside surprise

The NAFTA negotiations are proving very challenging and could collapse. In 2016 there were US $2 trillion of trading flows between the US and Mexico-Canada, and China. A collapse of trading flows would be very negative for global growth, meaningfully increasing the risk of recession. This could also have an impact on the tax reforms in the US as legislators may not support the tax bill if negotiations breakdown.

The unknown

In recent years, monetary policy has been very predictable. The ‘central bank put’ has worked extraordinary well, providing support for risk markets and depressing volatility. As the economic cycle moves forward and financial stability considerations start playing a more meaningful role in central banks’ decision-making, their reactions will become less predictable. In particular, the direction of the US Federal Reserve is uncertain. Although Yellen’s replacement (Powell) represents ‘continuity’, with little slack in the employment market, likely higher inflation from the second quarter of 2018 and a better global environment, the removal of accommodation might take place at a faster pace than the market is expecting.

How would we position a typical global fixed income portfolio?

We prefer corporate over government bonds and therefore we have a bias towards credit.

Within corporates, given tight valuations, we are cautiously optimistic. In investment grade markets, we see most value in financials versus non-financials, especially in those banks and insurers with European exposure. In high yield we maintain a slightly below average allocation; we look for companies with very predictable cash flows, and we currently prefer BB and B-rated firms and have no exposure to CCCs. We remain very selective and as we move along the investment cycle and corporate fundamentals deteriorate, stock picking will become more prominent.

In government bonds we maintain a conservative approach. Our overall interest rate risk is towards the lower end of our historical range. We prefer the US versus Europe and the UK, and we see opportunities in inflation exposure (currently expressed in the US). Our yield curve position is neutral but in the medium term we maintain a flattening bias, especially in Europe.

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In emerging markets we have a light allocation as we do not think that, in broad terms, the asset class offers a compelling proposition. We are looking for idiosyncratic opportunities, with interest in alpha rather than beta propositions.

Juan Valenzuela
Investment Manager – Fixed Income

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Agenda Item 18

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