LGPS CENTRAL LIMITED TACTICAL ASSET ALLOCATION

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ISSUE 7 • September 2019

LGPS Central Limited

FOR PROFESSIONAL CLIENTS ONLY

LGPS CENTRAL LIMITED TACTICAL ASSET ALLOCATION: ISSUE 7

CIO SUMMARY

Introduction

Welcome to the 7th Edition of our LGPS Central Limited ("LGPSC") Tactical Asset Allocation Report.

We see this being used for short to medium term overlays over your strategic asset allocation to take advantage of current market conditions by refining your asset weights within your long-term allocation bands.

The last 3 months has seen LGPSC transitioning the GEMs Fund (completed with 3 investors and ~£600m), and the Climate Change Factor Based Fund (2 investors with ~£2,100m of investments) and the Corporate Bonds Fund (now looking to transition in the next 6 months). The Product Development Protocol ("PDP")-the detailed process and time-line for developing funds is shared with Partner funds at Monthly Investment Working Group ("IWG") meetings) now shows a further 8 funds being prepared across all asset classes. We attended the IWG Strategic Asset Allocation meeting with Partner Funds in September where the priorities for the new year were set. The following IWG meeting focussed on Infrastructure, UK equities, Property and Target Return sub-funds.

All of these are pooled vehicles and will be made available to all Partner Funds.

LGPSC is managing 12 mandates/portfolios for individual Partner Funds across all asset classes. Work continues with individual Partner Funds on various segregated mandates and portfolios including sustainable equities, G10 bonds and other advisory services.

The review of the legal agreements with these discretionary, advisory and advisory mandates is close to completion. This work is being carried out by our legal counsel Andrea Abbott working with Partner Funds external counsel. We will be asking that Partner Funds consider signing these agreements to ensure that LGPSC can share its advice with all Partner Funds if it is required.

Working with WMPF we will be holding a summit on Infrastructure investing on Tuesday 26 November and will also be focussing on developing a pooled Infrastructure Fund for Partner Funds. We are looking to offer a Climate Risk Monitoring Service utilising MSCI, Hermes and Mercers climate change products to Partner Funds in Q4 2019.

In the past three months we have shared monthly fact sheets on all the ACS funds and monthly reports from the Active Equities team, the TAA quarterly report No. 6 and the Fund Closure policy. All of these reports can be found on Cilla available on the LGPSC website. (https://www.lgpscentral.co.uk/client-login/)

In this edition of the report we have added a report from Tanya Nolan on "Affordable Housing".

The investment team now includes 30 people with the addition of the investment professional graduate trainee scheme. These new trainees will be working across all departments as part of their development. We have appointed a portfolio manager to work on the Manager of Managers team to assist in the launch of our new funds. We are currently advertising on four Investment positions which are all on our website and advertised on efinancial and Exec Appointments.

LGPSC is also looking to add to the Risk & Compliance, Legal, Operations, Programme Management and Finance teams who have been critical to the delivery of these Funds and services for you and the investment team.

Summary of Strategy thoughts

The last 12 months has seen good returns from all asset classes except for global equities which saw a disappointing 1.9% return in local terms however this was boosted to an 8.2% return in sterling terms. Gilts and UK Index linked saw the best returns over that period of 14.6% and 19% returns respectively.

LGPSC continue to prefer Growth and Income assets over Stabilising assets. Within Equities Emerging Markets and Asia Pacific have been upgraded but remain underweight, but UK equities have been moved to an overweight after the underperformance over the last 9 months. Gilts and Index linked remain underweight and US bonds moved to an overweight from neutral. Within factors the only change was that the Quality/ESG factor has moved from underweight to neutral. Infrastructure and Emerging Market debt remain our favoured investments in Income Assets.

Our views on currency remain the same favouring Sterling against Euros and the US dollar. Hedging foreign currency assets back to Sterling is something LGPSC continues to support in the current market environment.

Please read on for a more detailed analysis of our views.

Jason Fletcher, Chief Investment Officer

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LGPS CENTRAL LIMITED'S VIEW ON WEIGHTINGS

The following table gives a summary of our view on the 6-18 months tactical positioning horizon.

Table1: Weightings ▲ Upgraded, ▼ Downgraded compared to previous quarter

	Significant Underweight	Underweight	Neutral	Overweight	Significant Overweight
Estimated Probability	**80-70%**	**70-65%**	**55-45%**	**70-65%**	**70-80%**
BROAD ASSET CLASS		**Stabilising**		**Income, Growth**	
GROWTH ASSET CLASS	**US Equities, Private Equity** ▼	**GEM Equities** ▲		**UK Equities,** ▲ **EU Equities** ▼ **Commodities, Asia Pac Equities** ▲	**Japan Equities**
INCOME ASSETS		**Credit, Property** ▼		**Infrastructure, EM Debt**	
STABILISING ASSETS	**JP Bonds**	**UK Bonds, Index-Linked, EU Bonds** ▲	**IG Bonds**	**US Bonds** ▲	**Gold** ▲
INVESTMENT STYLES	**Size**		**Growth, Quality/ESG** ▲	**Momentum, Value, Low Volatility** ▼	
CURRENCIES		**US Dollar**	**Euro, Yen**	**GBP**	

LGPSC's view on "Weightings":

- LGPS Central Limited ("LGPSC") remains "Underweight" in Stabilising Assets and "Overweight" in Income Assets and Growth Assets.
- Some parts of the world already in a recession, positive sentiment and attractive valuations support LGPSC's Overweight position in Growth Assets.
- Stabilising assets have done well. LGPSC's outlook remains cautious on those but notes that they can provide downside protection in times of recession.
- LGPSC prefers exposure to Income Assets as an alternative where yields and expected returns will combine with a low correlation to those riskier Growth Assets

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BROAD ASSET CLASSES

Table 2: Growth/Income/Stabilising Assets

	Model Score[1]	View	Investment Notes
GROWTH	2	Overweight	Not much changed compared to previous quarter, supported by positive sentiment
INCOME	2	Overweight	Safe Income in economic downturn, valuation looking a bit more attractive and positive sentiment
STABILISING	-1	Underweight	Low/Negative expected return, remain expensive, but can provide protection in a recession

Table 3: Historical Annualised Returns (* except for the 3 months, where total return is used)

	3 months*	One year	Three years	Five years	Ten years	Twenty years	Bloomberg Ticker
GLOBAL EQUITIES	0.2%	1.9%	10.3%	7.5%	9.3%	4.9%	FTAW01 Index
PRIVATE EQUITY	7.8%	15.8%	15.9%	16.3%	14.0%	na	IPRV LN Index
PROPERTY	7.7%	20.8%	9.0%	11.1%	14.1%	11.6%	REIT INDEX
INFRASTRUCTURE	0.6%	14.6%	8.0%	5.8%	8.2%	na	SPGTIND Index
HIGH YIELD	1.9%	6.2%	5.8%	6.5%	11.1%	10.1%	HL00 Index
UK GILTS	6.6%	14.2%	3.4%	6.3%	5.8%	5.9%	G0L0 Index
UK INDEX-LINKED	8.1%	19.0%	5.1%	9.7%	8.9%	7.3%	G0LI Index
GOLD	0.2%	31.4%	5.6%	9.8%	6.7%	9.9%	XAUGBP Curncy

Source: Bloomberg (NB: assumes dividends were reinvested), Note: listed proxies have been used for Infrastructure, Property and Private Equity.

Table 4: Correlation Matrix (5 year historical correlation)

	FTSE All World AW TR GBP	iShares Listed Private	DJ REIT	S&P Global Infra	Sterling High-Yield	UK Gilt	UK Inf-Link Gilt	XAUGBP Index
GLOBAL EQUITIES	1	0.651	0.535	0.770	0.512	-0.245	-0.163	-0.274
PRIVATE EQUITY		1	0.367	0.482	0.423	-0.169	-0.112	0.014
PROPERTY			1	0.662	0.223	0.255	0.195	0.058
INFRASTRUCTURE				1	0.425	0.0441	0.056	-0.019
HIGH YIELD					1	-0.049	-0.043	-0.195
UK GILTS						1	0.818	0.452
UK INDEX-LINKED							1	0.387
GOLD								1

Source: Bloomberg Note: listed proxies have been used for Infrastructure, Property and Private Equity

LGPSC's view on "Broad Asset Classes":

- LGPSC favours Growth Assets due to significant positive sentiment, reduced economic growth expectations, and some leading indicators are suggesting some parts of the world are already in recession.
- Equity markets have rallied strongly. Most asset classes have seen good returns above inflation over the last three, five, ten and twenty years.
- Commodities and Gold provide good diversification against equity markets and could be added as a diversifier to the portfolio.
- Fixed Income can be allocated to the portfolio for the same reason, but we remain underweight, given its poor valuation and low expected returns and LGPSC favours Income Assets.

[1] Refers to LGPSC model as described on page 7

GROWTH ASSET VIEW

Table 5: Growth Assets

	Model Score[1]	View	Investment Notes
UK Equities	2 ▲	Overweight	Positive sentiment and neutral valuation, market risk has improved
NORTH AMERICA Equities	-3 ▼	Underweight	Expensive valuations are back, and economic risk is higher compared to other geographies. Sentiment slightly improved
EUROPE Equities	2 ▲	Overweight	Good dividend yields, neutral valuations, and positive sentiment, but economic outlook remains unstable
JAPAN Equities	5 ▲	Overweight	Very attractive valuation and economics have turned positive, but trade war consequences remain, sentiment positive
ASIA PAC Equities	2 ▲	Overweight	Economic growth potential, sentiment has improved but fears of trade war may overshadow the potential performance
GEMs Equities	-1 ▲	Underweight	Mixed picture, new positive sentiment, but economic growth concerns, relatively expensive valuation
PRIVATE EQUITY	-3	Underweight	High investment cost, sentiment negative, long-term economic outlook uncertain, we recommend selective positioning in quality and stable companies
COMMODITIES	1	Overweight	Neutral sentiment and exposure to weakening dollar but provides no yield

LGPSC's view on "Growth Assets":

- The main change across Growth Assets is improved sentiment which has increased the model weight for most Growth Assets.
- Only North America as worsened mainly due to expensive valuations.
- Japan receives the highest model score, due to attractive valuations, positive sentiment and supported by economic stability beginning this year but remains vulnerable to external factors such as the trade war.

INCOME ASSET VIEW

Table 6: Income Assets

	Model Score[1]	View	Investment Notes
CREDIT	-1	Underweight	Economic play, valuations have improved to neutral and sentiment remains negative
EMERGING MARKET DEBT	2 ▲	Overweight	Economic play remains strong, and valuation remains good, sentiment is improved to neutral
PROPERTY	-1 ▼	Underweight	Relative value, inflation protection, sentiment remains negative and high investment costs
INFRASTRUCTURE	2	Overweight	Relative value, inflation protection, neutral sentiment but high investment costs, renewables & sustainable exposure

LGPSC's view on "Income Assets":

- LGPSC retains its favourable view on Income Assets. Emerging market debt "Overweight" view remains mainly based on economic outlook and improved sentiment to neutral.
- Property is downgraded by a further notch to "Underweight" due to worsened sentiment, and Infrastructure remains "Overweight".
- We have removed Insurance-linked assets from the LGPSC view.

STABILISING ASSET VIEW

Table 7: Stabilising Assets

	Model Score[1]	View	Investment Notes
UK BONDS	-2 ▼	Underweight	UK bonds more underweight due to worsened sentiment and unattractive valuation
INDEX-LINKED	-2	Underweight	Unchanged, due to negative expected return and concern about long duration/interest rates
US BONDS	1 ▲	Overweight	Fair value but increasing deficit and monetary easing, inflation risk and economic growth slowing
JP BONDS	-5	Underweight	Unchanged, poor valuation and Central Bank policy supportive market, in addition to currency risk
EU BONDS	-2 ▲	Underweight	Slight improvement but remains underweight due to unattractive valuation, economic outlook and sentiment
IG CORPORATE BONDS	0	Neutral	Corp spreads neutral and anchored to government bond yields, but general good credit outlook
GOLD	3 ▲	Overweight	Favoured Stabilising Asset, when we do not like other Stabilising Assets

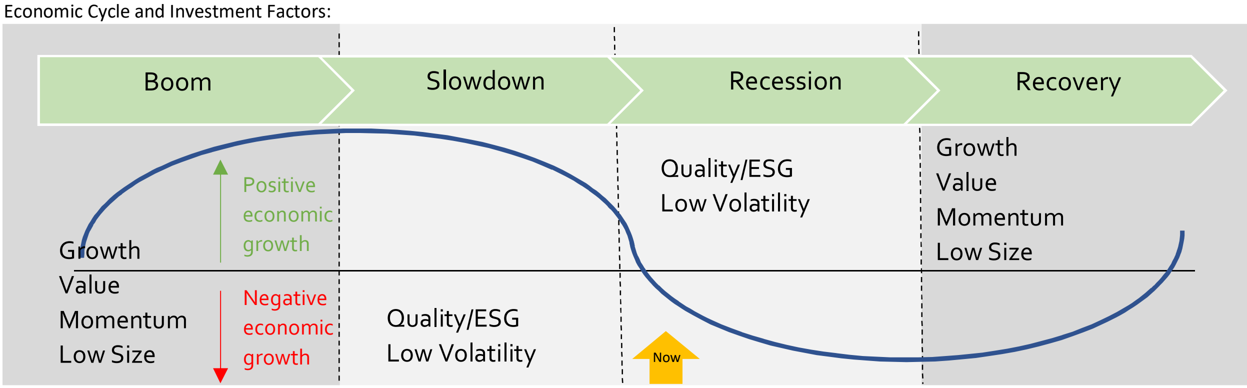
LGPSC's view on "Stabilising Assets":

- LGPSC remains "Underweight" for most Stabilising Assets mainly based on the low/negative yields but recognises that they should represent a proportion of the portfolio given the downside protection they can offer.
- "Underweight" view remains for most geographies, in particular for Japan. Only US bonds are "Overweight" due to neutral valuations and the US economic outlook.
- Gold offers good diversification and a safe haven in turbulent markets and protects against political and economic risks.

INVESTMENT FACTORS (EQUITIES)

Factor based investing provides a way of potentially adding outperformance relative to a market-cap-based approach at a much lower cost than active investing. It recognises that the market-cap-based index does not provide the best risk-adjusted return for a portfolio given its natural overweight to momentum, large cap and expensive stocks. In the following factor model, we have taken the seven factors of value, growth, income growth, size (small cap), ESG, low volatility and momentum and then applied the same criteria we use to consider other asset classes in our model assessing each factor for valuation, sentiment, economic suitability, risk suitability, investment cost and currency. Investment cost in factor-based investing is low relative to the other asset classes, though momentum factors (given their higher turnover) and ESG factors (given their higher index costs) are both scored neutral. Given all strategies are global, the currency scores are all neutral. Note that ESG and quality share similar characteristics. Climate change as a factor is little correlated to specific economic cycles given its long-term investment impact horizon of 10-20 years. The graph below summarises the preferred overweight factor(s) depending on the various stages of the economic cycle.

Economic Cycle and Investment Factors:



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FACTOR ASSET VIEW

Table 7: Investment Factors

	Model Score[1]	View	Investment Notes
Value	2 ▼	Overweight	Very attractive valuations, unloved and remains most favoured factor
Growth	0	Neutral	Poor sentiment and increased risks, score unchanged
Size	-4 ▼	Underweight	Concern with slowing economy, negative sentiment and market risk worsen score
Momentum	1 ▼	Overweight	Overweight based on current attractive valuation and sentiment
Low Volatility	1	Overweight	Poor long-term performance but remains attractive due to possible change in economic cycle
Quality/ESG	0 ▲	Neutral	Positioning in light of potential economic slowdown and protection against market declines, improved sentiment

LGPSC's view on "Investment Factors":

- LGPSC's view on Investment Factors remains broadly the same in light of increased recession concerns.
- Quality/ESG has improved form "Underweight" to "Neutral" due to a change in sentiment.
- In light of the current economic cycle, market risk and sentiment, the favoured factor remains "Value".

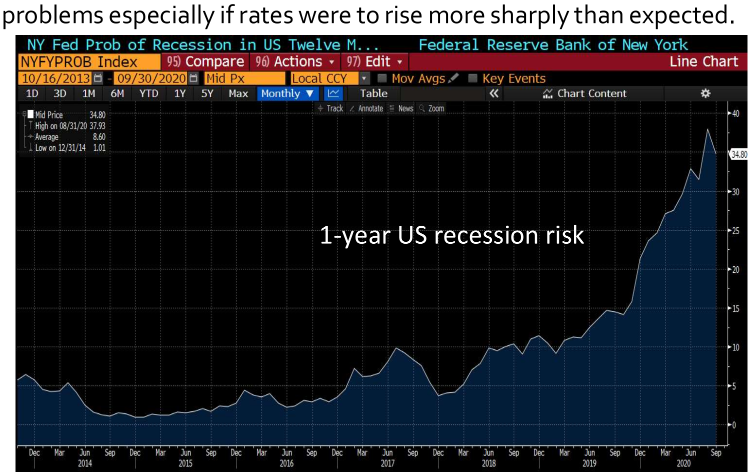
ABOUT LGPS CENTRAL LIMITED'S SCORING MODEL

LGPSC's model scores each asset class against its valuation, sentiment, economic outlook, market risk, currency and investment cost (scored between -2 and +2). Positive scores suggest (strong) overweight and negative scores, (strong) underweight positions. Where a zero is assigned, our view is neutral. The scores for the different assessment areas, e.g. valuation, sentiment etc. are then added to derive the final score for that asset class. We are constantly developing this scoring to include other variables such as ESG measures and technical factors.

RECESSION WATCH

Key indicators for a recession have worsened over the last quarter with 1) an inverted yield curve, 2) stabilising employment and 3) the changing monetary environment in the US. The amount of corporate debt is a worry in certain markets alongside EU banks' non-performing loans. Chinese domestic corporate leverage is of concern and some areas of the high yield market could pose problems especially if rates were to rise more sharply than expected. Auto finance is also showing some signs of stress. The US growth cycle has been rather long and increased asset volatility may indicate the first signs of a recession in the medium term.

***LPGS Central Limited View** –We see the likelihood of a recession as medium over the next 12 months. 2020 could mark the start of the next recession.*



Source: Bloomberg

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Q3 LGPS CENTRAL LIMITED MARKET UPDATE[2]

Global equity markets experienced mixed performance over the quarter amid ongoing geopolitical tension. The Euro STOXX50 and Nikkei indices advanced by 2.76% and 2.26% respectively while the US market (as measured by the S&P 500) made more modest gains (+1.19%). Asia Pacific (ex Japan) was a notable laggard, returning -4.88% as the trade war between the US and China continued.

Volatility (as measured by the VIX index) spiked in August as the trade war intensified. The University of Michigan Consumer Sentiment Index weakened to a three-year low during August before rebounding slightly in September as consumer confidence recovered.

Against a backdrop of global growth concerns and muted inflation, the US Federal Reserve opted to cut rates twice during the quarter to a target range of 1.75% to 2.0%. The benchmark US 10-year Treasury yield fell by 34 bps as risk appetite waned, closing the quarter at 1.66%. Significantly, the Treasury yield curve inverted for the first time since 2006 during August as the 10-year yield briefly fell below the two-year yield, leading to speculation that a recession may be on the horizon.

In the UK, activity was dominated by continued uncertainty over the UK's withdrawal from the European Union and the appointment of Boris Johnson as Prime Minister. The Bank of England maintained the base rate at 0.75% and the 10-year UK gilt yield ended the quarter 34.5 bps lower (at 0.49%).

The European Central Bank announced that it would resume its quantitative easing programme in November and indicated further interest rate cuts could occur if inflation remains below the target level.

The oil price closed 8.7% down compared to the previous quarter-end as news emerged of a growing oil surplus while the price of gold rose by 4.5%. In the currency markets sterling weakened against the US dollar by 3.21% but strengthened against the euro.

LGPS CENTRAL LIMITED Q3 RESPONSIBLE INVESTMENT UPDATE

In a textbook case of the financial materiality of corporate governance, WeWork has pulled its IPO in the face of significant investor criticism. CEO Adam Neumann has resigned and conceded majority control of the organisation, and the company will postpone its entrance into the public markets. The shared workspace company's aggressive expansion into more than 500 offices in 111 cities has caused it to burn through capital, reporting a 2018 loss of $1.6bn on sales of $1.8bn. Public investors were spooked by the IPO prospectus which proposed that Mr Neumann would have 20 times the voting power of ordinary shareholders. Such preferential voting rights would have been twice as great as those at Facebook and Google; even Uber transformed to a one-share-one-vote model. Other concerns abound, including Mr Neuman engaging in self-dealing, and a name change (from WeWork to WeCompany) yielding a payment to Neumann of $5.9m for the trademark. We think that, in general, private ownership aligns well with investors that place a high value on good governance. If your exit strategy involves an IPO, public investors are making it clear that governance is a must, not an optional extra.

The collapse of Thomas Cook has intensified the already-existing debate in the UK over what should be expected from an audit. MPs announced a wide-scale inquiry into the collapse of the travel company, focusing on its accounting practices, executive pay and the role of its auditors. Both PwC and EY will come under scrutiny: PwC was auditor from 2008 until EY took over the role in 2017. In 2018 EY signed off on Thomas Cook's accounts as a going concern, revealing its judgement that the company could survive another 12 months. Pressure is mounting in favour of an expansion to the role of an auditor from a supplier who checks whether international standards have been correctly applied, to a genuinely objective verifier of information that is decision-useful for investors.

More than 400,000 German car owners have signed up to litigate Volkswagen, making "dieselgate" the largest legal claim of its kind in German history. The scandal has already cost the company over $30bn, whilst Daimler was recently fined €1bn by EU prosecutors for similar allegations. The auto industry is undergoing huge change as companies announce strategies to anticipate (or react to) government policies to phase out internal combustion engine technology. This is more than a fig leaf to win back consumer sentiment. Daimler and Ford are among several

[2] Performance for the quarter measured over period of 30/06/2019 to 30/09/2019

majors to announce development partnerships. VW is betting on electric, moving from 15m EV units produced per year to 22m by 2030. Over 70 new VW EV models will be launched in the next 10 years, taking EVs to 40% of VW's fleet. Auto supply chains face risks and opportunities, for example VW's EV strategy has led to battery supply deals with Samsung, LG Chem, SKI and CATL. Last year alone Volkswagen invested $25bn in battery supplies to bolster its EV strategy.

In July 2019 the rate of Amazonian deforestation was the highest for two and a half years. Whilst Brazilian President Jair Bolsonaro's custody of the rainforest has been repeatedly questioned, his reaction has underwhelmed his political peers, notably President Macron of France. Since Mr Bolsonaro's term started (January 2019), an area bigger than the size of Luxembourg has been razed by loggers. In addition, cuts to Brazil's environmental agency budget and reduced pressure to enact strict conservation laws have allowed ranchers to log and burn more freely. The Amazon plays a vital role in absorbing carbon dioxide emissions and stabilising global temperatures. There have since been measures put in place by Bolsonaro to protect the forest, but many argue this has come too little too late. Exposure to Amazonian deforestation can appear in institutional portfolios through commodity producers and meat producers. Western businesses are reportedly threatening to boycott Brazilian produce in response, which could affect supply and price stability for some value chains. The Brazilian business community has called on the President to resolve the situation without further economic harm. We remain alert to the potential for populist policies to cause unintended economic consequences.

RISK ANALYSIS

Table 8: Risk in order of probability

RISK	LGPSCL Possibility	LGPSCL Impact	Change	Comment	LGPSC favoured assets to protect against the risk
EQUITY DOWNTURN	Medium	Moderate	→	Slightly increased possibility for this risk, but not enough to assign "high" possibility. Exaggerated growth expectations, profit taking in the equity market, increased recession risk and limited monetary policy stimulus available could see equity markets fall.	Safe haven assets such as government bonds and gold, increased demand for equity downside protection makes volatility rise, buy volatility early, as short-term measure protect through selling futures
NO DEAL BREXIT	Medium	High	↓	Scenario changed from general Brexit to No Deal Brexit. Hence, we assign possibility Medium now, as we believe there is a 50% chance for a No Deal Brexit but much of this appears to be already priced into the market. In the worst-case scenario, we believe this can impact UK assets by 10% down but would expect a sterling fall to lift the value of international assets by up to 10%.	A hard Brexit would have a negative impact, but there is also the possibility of no Brexit too which is why LGPSC has a balanced view on UK equities
GLOBAL RECESSION	Medium/ High	Moderate	↗	Recession watch factors are pointing towards a possible global recession in 2020 fuelled by US growth stagnating, Chinese debt leverage and elevated interest rates in the US. ASR survey reveals 50% chance of recession of which some is already priced into the bond/equity market. Equity could suffer by -20%. In a recession liquidity becomes an issue which could make matters worse.	Factors such as Quality/ESG and low volatility perform relatively well in a recession. Stabilising and income assets will outperform if economy enters recession
POLITICAL RISKS	Medium	Low	↓	There is a considerable amount of other political risks arounds the globe, such as the Syria/ Turkey situation and domestic US political risks. There is also an increased UK election risk. We are also considering in this scenario the risk of nationalisation of assets post a UK election, which would have a negative impact on UK equities and Infrastructure.	Overweight protective assets such as Gold, non-Euro assets, buy US Dollar
ISOLATION & PROTECTION/CHINA	High	High	→	General trade war concerns from 2018 carry on their trend in 2019 with increased negative sentiment and worries about the possible consequences. Exports are down everywhere. General overleveraged China concerns in combination with recent demonstration in Hong Kong which has had a significant negative impact in this market.	Slowdown of economic growth and de-stabilising effect, overweight Gold and insurance linked, overweight US equities, underweight GEMs

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RISK	LGPSCL Possibility	LGPSCL Impact	Change	Comment	LGPSC favoured assets to protect against the risk
CREDIT RISK/DEBT ISSUES	High	Moderate	⬆	In the event of a marked slowdown highly leveraged corporates might find it difficult to refinance cheaply, at a time that profitability is under pressure. Corporate bond spreads might also widen. UK political risks are increasing, EU banks have not taken enough non-performing loan action, China and Automotive debt are concerns at present.	Underweight EU and China, underweight selective credit, such as Automotive. Incorporating ESG reduces Credit Risk.
US$ WEAKNESS	Low	Moderate	➡	If significant GDP slow down occurs and US rates decrease by 200bps the US$ could fall around 10%.	Overweight US$ government bonds, hedge the US$, Overweight EM equities
CLIMATE-RELATED TRANSITION RISK	Medium	Moderate	➡	- EU carbon price over €20 per tonne since March - Sales of Tesla units nearing 100,000 per Q - Labelled green bond issuance USD117.8bn in H1 2019 (up 48% on H1 2018)	Underweight Energy & GEMs, overweight Renewables and sustainable investment themes such as Infrastructure
CLIMATE-RELATED PHYSICAL RISK	Medium	Moderate	➡	- US Billon Dollar Disaster (BDD) Event Frequency: 10 US BDDs as of October 2019; annual average is 12.6 - 77% year on year increase in Amazonian forest fires	Hold a well-diversified portfolio

LGPSC's view on "Scenario Risks":

- LGPSC's view is that with a well-diversified portfolio, the majority of key risks from these scenarios should balance out potential strong negative impacts. Alternatively, short term asset adjustments can be made to the portfolio to seek protection or a derivative overlay can hedge out undesired potential negative impacts and provide protection.
- The LGPSC Investment Team has undertaken the half yearly review of the emerging risks and updated the table accordingly.
- We have removed FAANG risk as we believe that FAANG's business models are becoming increasingly diversified and the risk is priced into the market.
- We also have removed monetary surprises as there no longer appears to be upside risk to major interest rates movements, and they are more likely more to fall from here. Any surprise is likely to be on the downside.
- We also have modified the Brexit risk to be more specific to a "No Deal" Brexit.
- We have added a new scenario of the US$ weakening, the implications could be to invest in US$ bonds and hedge the US$.
- It remains our view that the next 12 months should produce a positive return for Income Assets and will probably see low to negative returns for Stabilising Assets. Our opinion is that fixed income does not offer good risk adjusted returns relative to equities for pension fund money at this time and should remain underweight. Growth Assets have become more attractive due to a change in sentiment and the lack of other investments offering return alternatives. As a result, we have reduced the equity downturn risk although there remains a risk of a recession that is deeper than is currently priced into markets and this outcome would be very negative for equity valuations.

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LGPSC's Thoughts On Affordable Housing

There is no doubt that Affordable Housing is very much on the Government's agenda and this appears to be being picked up the asset managers with various investment options coming to the market.

So, what is affordable housing? The Government has specified that affordable housing includes intermediate housing, affordable rented and social rented. These are all provided to specified eligible households whose needs are not met by the market. It can be a new-build property or a private sector property that has been purchased for use as an affordable home.

The threshold for affordability set by the Government is defined as an individual household's monthly rent costing less than 35% of their monthly gross income. For the landlords, the Government have stated that affordable homes should cost no more than 80% of the average local market rent.

In more detail, the types of affordable housing that an investor may come across are:

Shared Ownership homes allow the purchaser to buy a share in the equity while paying rent on the non-purchased share. This scheme aims to allow people the chance to get onto the housing ladder who would not have been able to do so via a full equity purchase. The homebuyer will pay rent on the unsold share which is owned by the provider of the Help to Buy, who receives the rent.

Rent to Buy homes also sit under intermediate housing. These are let to working households at an intermediate rent (intermediate rent must be offered for a minimum of 5 years) to give the tenant the opportunity to save for a deposit to buy their first home.

Affordable Rent homes are for those who rent in the private rental sector and need support to be able to afford market rents. Affordable rents are usually let at higher rents than Social Rented Housing that are let out at rents 20% lower than those in the private rental market.

Social Housing is arranged by Local Authorities or Housing Associations on behalf of Local Authorities. Rents are regulated by Government using a formula based on property value, local and tenant income and property size. The Government also dictates by how much the rents can then be increased on an annual basis.

How does this work for investors?

Statistically it has been shown that there is a shortage of housing alongside a funding gap that needs to be filled via private investment. That said there is no guarantee of continued Government support so there will always be a political risk factor.

As with any property investment, the investor is looking for a steady income. Formerly, regulated rents rose by RPI plus 0.5% which provided predictability and allowed for business planning. However, in 2015 the Government imposed a 1% per annum reduction in social rents for four years, but they have stated that the original figure will be restored after 2020.

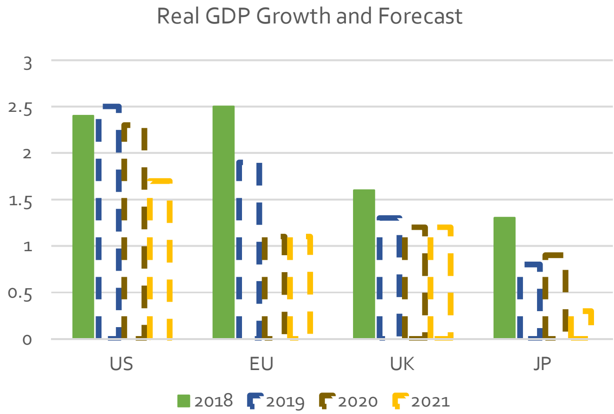
It should be noted that except for Social Housing, the fund manager will be able to set the rent levels to ensure the required income is generated.

Returns, although not high, should be reasonable when compared with the current low yields of inflation-linked gilts and could be useful for Pension Funds for managing cash flows. In real return figures, fund managers are offering yields of up to 3% p.a. It is possible that higher returns may be achieved through taking on some construction risk also.

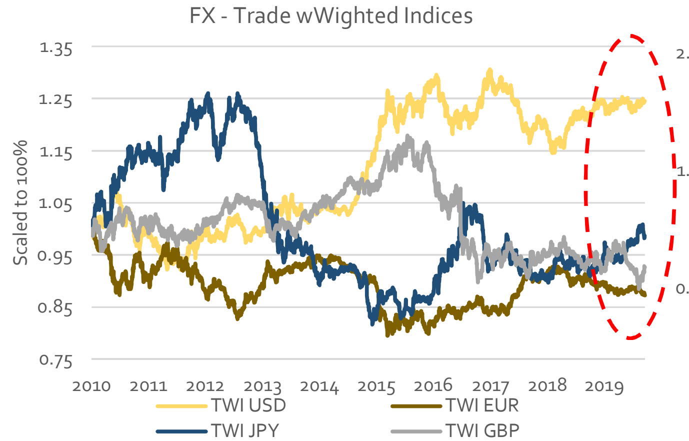
In conclusion, there are opportunities being offered out in the market, many with mixed strategies so that they are not solely focused Affordable Housing which can help with yield returns. There is an obvious positive political slant however, investors need to be confident that any fund manager is able to produce long term stable cash flows, diversification and inflation hedging characteristics expected from the asset class.

Another consideration for Partner Funds investing in housing is the potential for adverse reputation issues arising and whilst it may be impossible to remove this risk completely, this would be a key area of due diligence when evaluating these opportunities.

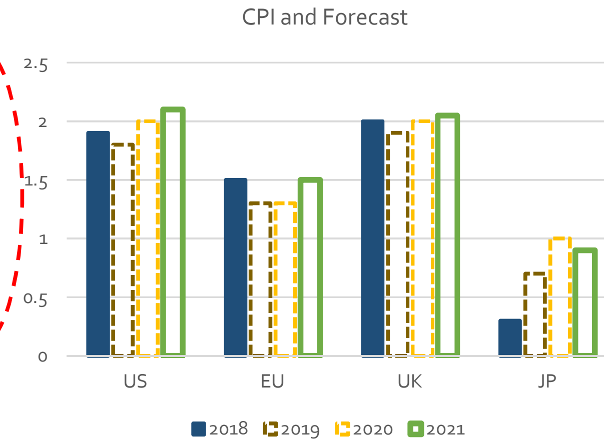
APPENDIX 1: ECONOMIC OUTLOOK



Since last quarter the World Economic forecasts have been revised downward globally.



The trade-weighted strength of the Dollar has remained unchanged from the previous quarter.



Inflation forecasts have not moved much since the last quarterly update and broadly remain the same across the globe.

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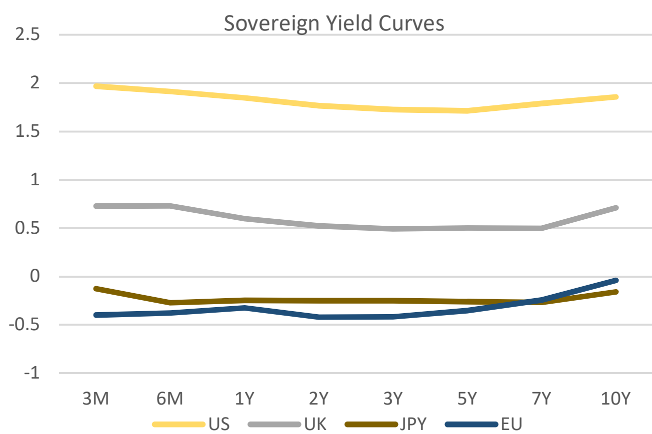
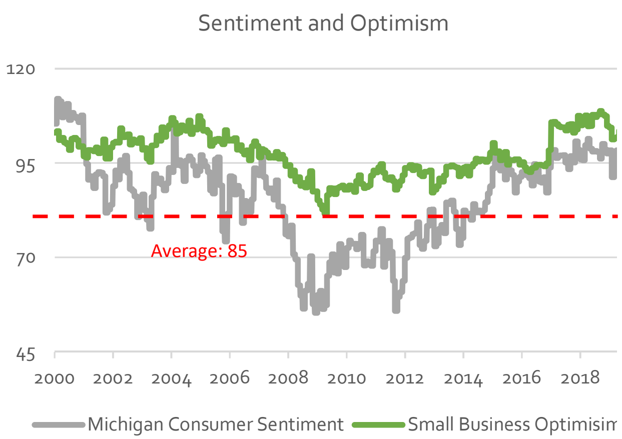
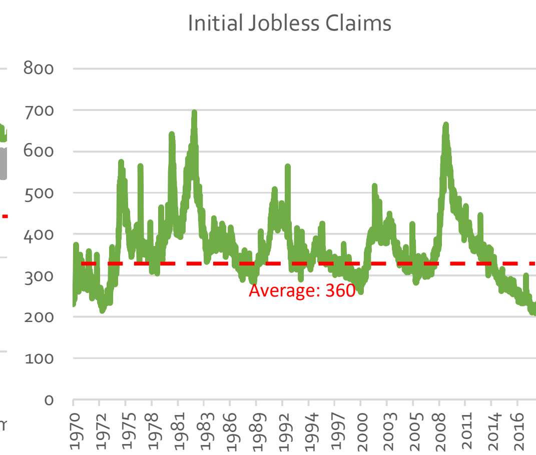


US Sovereign yield curve shows signs of inversion mainly due to US growth concerns and the US-China trade war provoking a more dovish policy stance. Recent EUR rate cut.



Consumer confidence remains well above the average of 85, indicating less concerns than other economic indicators.



..... with initial jobless claims providing a similar positive picture below long-term average and showing a falling trend.

Source: Bloomberg, OECD, data as of 16/09/2019

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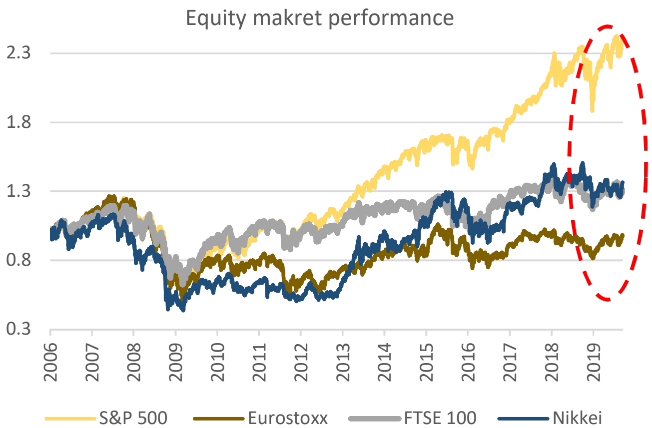
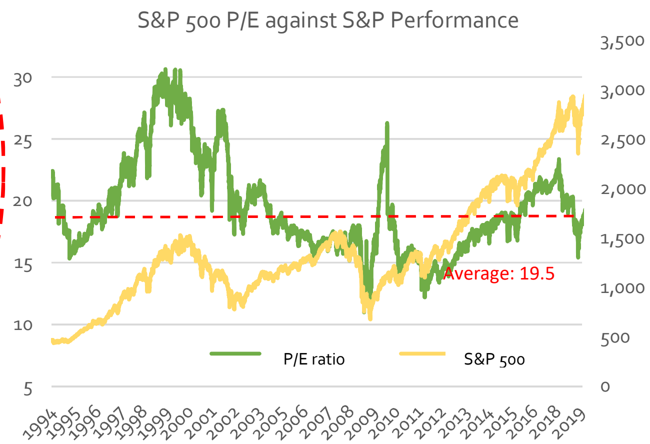
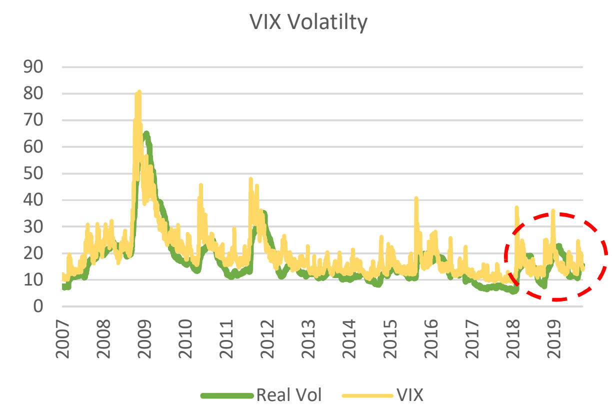
APPENDIX 2: MARKET OUTLOOK



The US has significantly outperformed the rest of the world since 2009, YTD markets have been relatively stable across the globe and have steadily climbed.



The current S&P P/E is 19.6, higher the previous quarter with 18.6 and now just above its long-term average.



Implied volatility remains low and close to historical volatility indicating a confident equity market.

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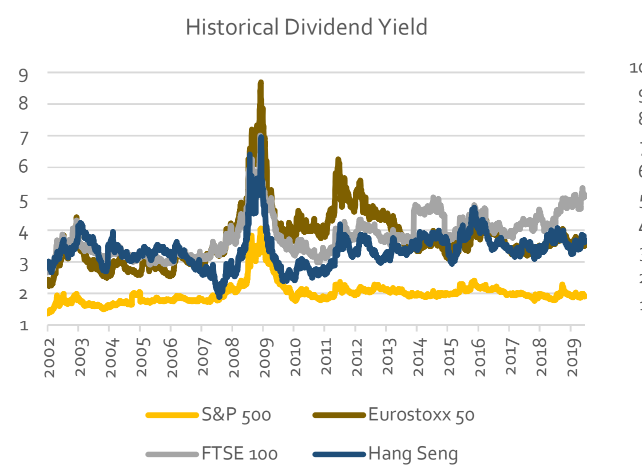
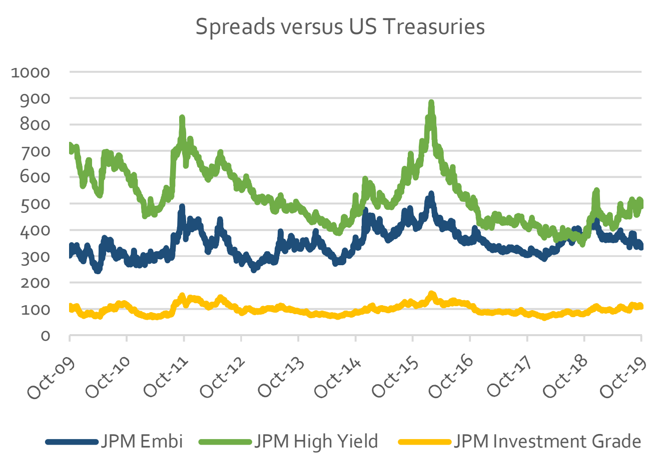
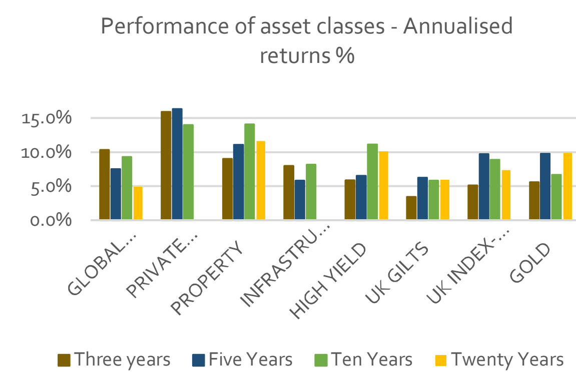


Dividend yields show a slight upwards trend, with the UK showing a strong dividend yield over the last couple of years.



Emerging Market Bond Index provides an attractive yield advantage.



Recent positive equity market performance has brought 1 year performance in positive territory, over the long-term good returns can be observed across asset classes.

Source: Bloomberg, OECD, data as of 18/09/2019

Please read important information at the end of the report

APPENDIX 3: INVESTMENT IDEAS – MEET THE TEAM

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Please contact Callum Campbell, Head of Client Services and Stakeholder Relations, if you would like to discuss the views outlined in this report with LGPS Central's Investment Directors

1 Selective Overweight Private Equity (J. Sidhu)

- Fund raising environment remains robust, with substantial "dry powder" for investments;
- Possibility of PE Managers overpaying for assets due to increased competition;
- Favour PE downside protection (e.g. private debt) and high quality/low risk
- Direct investment in defensive companies/sectors and/or upper quartile managers
- Sell unattractive and legacy assets

2 Underweight Fixed Income (G. Ross)

- 0.70% nominal yield on benchmark 10-year Gilt remains unattractive on a real return's basis.
- Following ECB rate move, some intermediate European Government Bonds look attractive hedged back to GBP.
- G10 monetary policy likely to remain accommodative until there are signs of above-target inflation.

3 Neutral property – Negative Outlook (M. Hardwick)

- Heightened sensitivity to Brexit deterring some investors and slowing investment activity
- Continued pressure on Retail valuations likely to accelerate as valuation departments assert their independence
- Retail will present value at some point, just not yet
- Occupational demand a mixed bag but slowing even in strongest sectors
- Yield still attractive versus other asset classes

4 Overweight infrastructure (M. Hardwick)

- Expensive historically but good value versus bonds
- Opportunities may arise from some global investors paring back interest in UK
- Maturing pension schemes and better funding levels should support demand
- Fears of nationalisation of infrastructure assets under a future Labour government could impact investment returns especially in light of political instability emanating from Brexit deal rejection

5 Overweight Equities (J. Fletcher)

- Sentiment for equities at extreme lows and positive sentiment to cash at extreme highs
- Economic growth expectations set a low level with increased recession expectations
- Valuations moderately expensive but attractive Dividend Yield of 2.9% in low interest rate environment

GLOSSARY:

GEMs	**Global Emerging Markets**
ESG	**Environmental, social and governance**
LTM	**Last twelve months**
IG	**Investment Grade**
VIX	**S&P Implied Volatility Index**
IPO	**Initial Public Offering**
OPEC	**Organisation of Petroleum Exporting Countries**
FAANG	**Facebook, Apple, Amazon, Netflix & Google**
UNPRI	**Principles for Responsible Investment**
YTD	**Year to date**
PE	**Private Equity**

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