FOR PUBLICATION

DERBYSHIRE COUNTY COUNCIL

PENSIONS AND INVESTMENTS COMMITTEE

WEDNESDAY, 7 SEPTEMBER 2022

Report of the Director of Finance and ICT

INVESTMENT REPORT

1. Purpose

1.1 To review the Fund's asset allocation, investment activity since the last meeting, long term performance analysis and to seek approval for the investment strategy in the light of recommendations from the Director of Finance & ICT and the Fund's independent external adviser.

2. Information and Analysis

2.1 Report of the External Adviser

A copy of Mr Fletcher's report, incorporating his view on the global economic position, factual information for global market returns, the performance of the Fund and his recommendations on investment strategy and asset allocation, is attached as Appendix 2.

2.2 Asset Allocation and Recommendations Table

The Fund's latest asset allocation as at 31 July 2022 and the recommendations of the Director of Finance & ICT and Mr Fletcher, in relation to the Fund's final strategic asset allocation benchmark (SAAB), which came into effect on 1 January 2022, are set out on page 3.

The table also shows the recommendations of the Director of Finance & ICT, adjusted to reflect the impact of future investment commitments. These commitments relate to Private Equity, Multi-Asset Credit, Property and Infrastructure and currently total around £280m. Whilst the timing of drawdowns will be lumpy and difficult to predict, the In-house Investment Management Team (IIMT) believes that these are likely to occur over the next 18 to 36 months.

	Benchmark		Fund Allocation	Fund Allocation	Permitted Range	Benchmark Relative Recommendation		Recommendation (1)		Adjusted for Commitments (4)	Benchmark Sterling Return	Benchmark Sterling Return
	Intermediate (1)	Final (1)	30/4/22 (2)	31/7/22 (3)	Final (1)	AF 7/9/22	DPF 7/9/22	AF 7/9/22	DPF 7/9/22	DPF 7/9/22	3 Months to 30/6/22	3 Months to 31/7/22
Growth Assets	**56.0%**	**55.0%**	**55.3%**	**55.6%**	**+/- 8%**	**-**	**-**	**55.0%**	**55.0%**	**55.8%**	**n/a**	**n/a**
UK Equities	14.0%	12.0%	13.5%	13.3%	+/- 4%	-	+1.3%	12.0%	13.3%	13.3%	(5.0%)	(1.2%)
Global Equities:	38.0%	39.0%	37.0%	37.5%	+/- 8%	-	(2.1%)	39.0%	36.9%	36.9%	n/a	n/a
North America	6.0%	-	1.6%	1.6%	-	-	-	-	-	-	(9.5%)	3.1%
Europe	4.0%	-	0.5%	0.5%	-	-	-	-	-	-	(8.8%)	(2.2%)
Japan	5.0%	5.0%	5.1%	5.2%	+/- 2%	-	+0.2%	5.0%	5.2%	5.2%	(6.8%)	2.4%
Pacific ex-Japan	2.0%	-	0.9%	-	-	-	-	-	-	-	(3.2%)	(2.6%)
Emerging Markets	5.0%	5.0%	4.7%	5.4%	+/- 2%	-	+0.4%	5.0%	5.4%	5.4%	(2.7%)	(2.9%)
Global Sustainable	16.0%	29.0%	24.2%	24.8%	+/- 8%	-	(2.7%)	29.0%	26.3%	26.3%	(8.2%)	(1.3%)
Private Equity	4.0%	4.0%	4.8%	4.8%	+/- 2%	-	+0.8%	4.0%	4.8%	5.6%	(8.0%)	(1.1%)
Income Assets	**24.0%**	**25.0%**	**24.2%**	**25.2%**	**+/- 6%**	**+2.0%**	**+0.3%**	**27.0%**	**25.3%**	**28.9%**	**n/a**	**n/a**
Multi-Asset Credit	6.0%	6.0%	6.9%	6.6%	+/- 2%	+2.0%	+0.6%	8.0%	6.6%	7.8%	(3.4%)	(1.4%)
Infrastructure	9.0%	10.0%	9.3%	9.7%	+/- 3%	-	-	10.0%	10.0%	12.4%	0.7%	0.7%
Direct Property (6)	5.0%	6.0%	5.1%	5.9%	+/- 2%	-	(0.1%)	6.0%	5.9%	5.9%	3.3%	3.3% (5)
Indirect Property (6)	4.0%	3.0%	2.9%	3.0%	+/- 2%	-	(0.2%)	3.0%	2.8%	2.8%	3.7%	3.7% (5)
Protection Assets	**18.0%**	**18.0%**	**16.0%**	**16.0%**	**+/- 5%**	**(2.0%)**	**(1.6%)**	**16.0%**	**16.4%**	**16.4%**	**n/a**	**n/a**
Conventional Bonds	6.0%	6.0%	4.5%	4.6%	+/- 2%	(1.0%)	(1.0%)	5.0%	5.0%	5.0%	(7.4%)	(2.2%)
Index-Linked Bonds	6.0%	6.0%	5.5%	5.5%	+/- 2%	-	(0.5%)	6.0%	5.5%	5.5%	(17.5%)	(7.3%)
Corporate Bonds	6.0%	6.0%	6.0%	5.9%	+/- 2%	(1.0%)	(0.1%)	5.0%	5.9%	5.9%	(7.5%)	(0.5%)
Cash	**2.0%**	**2.0%**	**4.5%**	**3.2%**	**0 – 8%**	**-**	**+1.3%**	**2.0%**	**3.3%**	**(1.1%)**	**0.2%**	**0.2%**

Investment Assets totaled £6,002m at 31 Jul-22.

(1) Intermediate benchmark effective from 1 January 2021 to 31 December 2021. Final benchmark effective from 1 January 2022. Recommendations are relative to the Final benchmark
(2) Adjusted for completed trades in early Feb-22 – North American Equities -1.0%; European Equities -0.7%; Global Sustainable Equities +1.1%; and Cash +0.5%.
(3) Adjusted for trades placed at 31 Jul-22 but yet to trade by 31 Jul-22; MAC -0.4%; and Cash +0.4%
(4) Adjusted for investment commitments at 31 Jul-22. Presumes all commitments funded from Cash.
(5) Benchmark Return for the three months to 30 Jun-22.
(6) The maximum permitted range in respect of Property is +/- 3%.

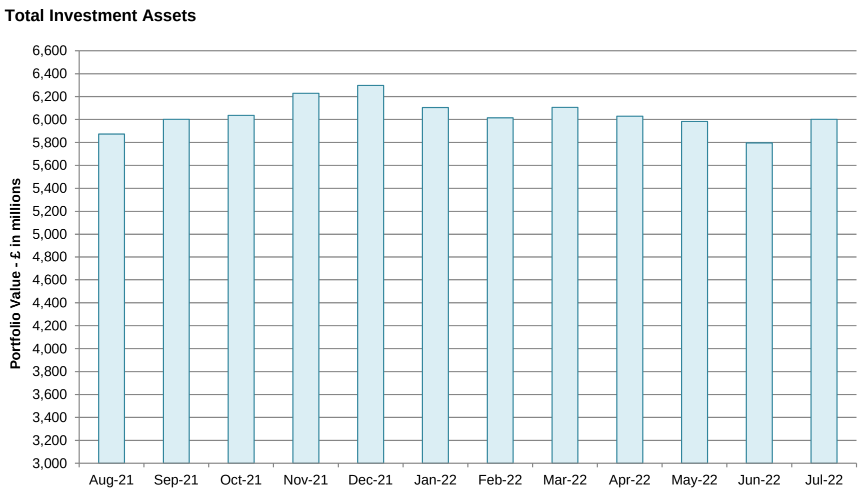
The table above shows the intermediate benchmark, together with the new final benchmark approved by Committee in November 2020. The final benchmark came into effect on 1 January 2022. The table above reflects the following three categorisations:

- **Growth Assets**: largely equities plus other volatile higher return assets such as private equity;
- **Income Assets**: assets which are designed to deliver an excess return, but with more stable return patterns than Growth Assets because income represents a large proportion of the total return of these assets; and
- **Protection Assets**: lower risk government or investment grade bonds.

Relative to the final benchmark, the Fund as at 31 July 2022, was overweight Growth Assets (+0.6%), Income Assets (0.2%) and Cash (1.2%) and underweight in Protection Assets (-2.0%). However, should all the IIMT recommendations set out in this report be implemented, together with the expected level of commitment draw-downs, the cash balance would reduce to -1.1%. In practice as these commitments are drawn-down, they will be partly offset by new net cash inflows from investment income, distributions from existing investments and changes in the wider asset allocation.

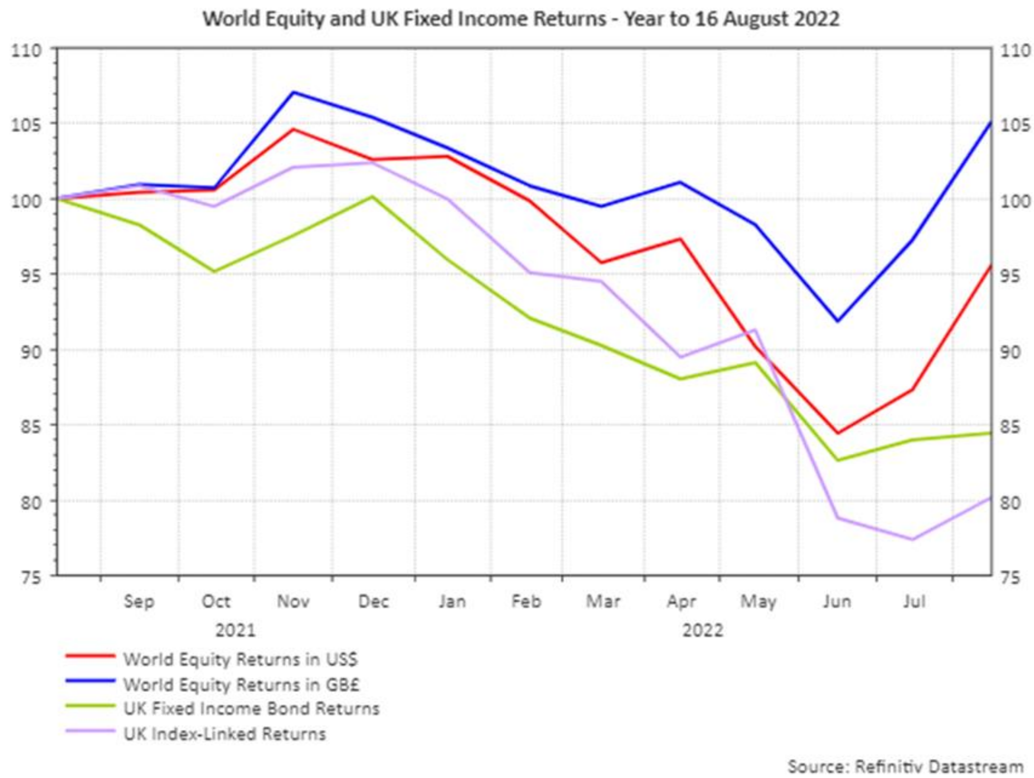
2.3 Total Investment Assets

The value of the Fund's investment assets reduced by £27m (-0.5%) between 30 April 2022 and 31 July 2022 to £6.002bn, comprising a non-cash market loss of around £42m, partly offset by cash inflows from dealing with members and investment income of around £15m. Over the twelve months to 31 July 2022, the value of the Fund's investment assets has increased by £118m (+2.0%), comprising a non-cash market gain of around £58m, and cash inflows from dealing with members & investment income of around £60m.



The Fund's valuation can fluctuate significantly in the short term, reflecting market conditions, and supports the Fund's strategy of focusing on the long term. A copy of the Fund's valuation as at 31 July 2022 is attached at Appendix 3.

2.4 Market returns over the last 12 months



The chart above shows market returns for Global Equities in Sterling and the US dollar, UK Fixed Income and UK Index Linked bonds for the twelve months to 16 August 2022. Whilst global equity returns were positive over the 12-month period in Sterling terms, they lost around 5% of their value in US dollar terms, as the GB£/US$ exchange rate fell from 1.37 to 1.21.

During 2021, investor sentiment was broadly positive. Covid-19 vaccination programmes were successful and despite the emergence of new variants, restrictions on social distancing and economic activity were gradually lifted. The resultant unwinding of pent-up demand stimulated a sharp recovery in economic growth. Corporate earnings reached record highs, pushing-up equity valuations, and bond yields remained tethered at historic lows. However, markets pivoted at the turn of the year as sentiment waned and investors' appetite for risk diminished. After reaching an all-time high in the final week of 2021, the S&P 500 suffered a peak to trough decline of more than 9% over the first four weeks of 2022.

Primarily, markets fell because the major central banks were increasingly viewed as having lost control of the narrative on inflation. Covid-19 pandemic related supply shocks, coupled with the release of pent-up demand, were proving to be a dangerous combination for rising prices. Although equity markets posted moderately positive returns in Q4-21, bond markets had already begun to signal a shift in sentiment, with short-term government bond yields rising significantly (bond yields rise when prices fall). Two-year yields in the US increased from 0.20% to 0.73%, whereas in the UK they rose from 0.12% to 0.69%. The market no longer believed that the increase in inflation was transitory and concluded that central banks would need to act more aggressively and tighten monetary conditions to tackle rising prices.

The Bank of England (BoE) and the US Federal Reserve (US Fed) went on to make hawkish policy pivots (signalling tighter monetary policy) in December 2021, acknowledging that they were behind the curve in controlling rising prices and abandoning the ‘transitory’ inflation narrative. Tighter financial conditions should reduce demand and dampen economic activity, therefore reducing the upward pressure on prices.

However, despite this policy shift, both central banks have consistently underestimated the strength and persistence of the current inflation cycle. In part, this is likely to be because inflation is currently being driven by both demand-pull and cost-push factors (i.e. from pent-up demand and disrupted supply chains). Central bank policy is considered to be most effective at influencing levels of demand; it can do little to offset or alleviate shocks to supply chains.

The Covid-19 pandemic had already caused significant disruption to global supply chains, albeit those disruptions had begun to ease as restrictions were lifted. However, Russia’s unexpected invasion of Ukraine in February 2022 caused another global supply shock, particularly in energy and commodity markets. Russia is the world’s second largest natural gas producer and the third largest producer of oil. Together, Russia and Ukraine also supply more than 25% of the world’s wheat and are key producers of other agricultural and industrial commodities. Consequently, the BoE has been repeatedly forced to revise upwards, and extend outwards, its projections for peak inflation, from a forecast spring peak of 7% in February, to a forecast autumn peak of 10% in May and to the current forecast winter peak of 13% (from the most recent August 2022 BOE meeting).

The revisions are largely the result of higher energy prices triggered by the war in Ukraine. Wholesale natural gas prices trebled between May 2022 and August 2022, as supplies of Russian gas to Europe were curtailed. There are growing concerns that further disruptions may occur in the autumn and winter when demand for gas peaks. The BoE now expects energy prices to contribute 50% of the forecast rise in year-on-year inflation of 13.1% in October and November 2022, having previously projected a maximum contribution of 30% in May 2022.

As the inflationary outlook has deteriorated, the BoE has been forced into increasingly aggressive rate increases. The BoE has already increased rates five times in 2022, from 0.25% to 1.75%. Further increases are expected at the BoE's September, November and December meetings, and markets are currently pricing rates to reach 3.3% by year end. A similar chain of events has occurred in the US. The US Fed has already increased rates four times YTD[1] with more increases expected, having previously advised that only three increases would be necessary in 2022.

The evolving inflationary outlook, and the concern that central banks are playing catch up with monetary policy, have led to risk aversion in financial markets. Growth stocks, which have valuations that are sensitive to rising interest rates, fell sharply over the first six months of 2022. The Nasdaq Composite Index, a US technology index that contains many of the world's largest Growth stocks, reported a peak to trough decline of 32% between January and June 2022 (in local currency terms). In contrast, US Value stocks, which trade at lower prices relative to company fundamentals, fell by only 16%. UK Equities returned -5% over the comparable period, reflecting a structural bias towards Value stocks, including energy and commodity focussed companies.

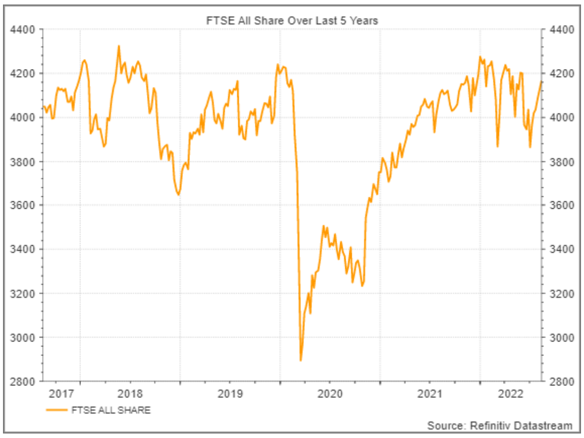
Government bond prices have also fallen in 2022. Bond yields were reduced to historic lows during the Covid-19 pandemic as interest rates remained at historic lows to stimulate economic activity. As a bond's yield moves inversely to its price, this acted as a strong tailwind for fixed income returns. The unwinding of loose monetary policy and the move towards the normalisation of interest rates, together with the inflationary outlook, has created a significant a headwind for fixed income markets (as higher bond yields mean lower prices). UK Gilt (conventional bonds) yields have risen at the fastest rate since 1994, resulting in YTD return of -13.4%; UK Index-Linked Bonds have returned -20.0%.

[1] 1 January 2022 to 16 August 2022

Notwithstanding the above, market sentiment had, more recently, started to pivot again. Concerns have been growing that high inflation and increasingly tight monetary policy will push many economies into recession later this year. For example, the BoE is now expecting the UK economy to contract for five consecutive quarters from Q4-22 onwards. As a result, markets started to price in central banks adopting less aggressive monetary policy for the remainder of 2022 and lower interest rates in 2023. As such, interest rate sensitive Growth stocks started to rally in Q3-22, and bond yields started to fall from their June 2022 peaks. However, a renewed focus on inflation in recent weeks has stalled this rotation.

The IIMT continues to believe that the global economic outlook remains uncertain and has some concerns about the sustainability of the current rally in equity returns. Global markets are extremely volatile at present, and whilst investor confidence has improved in Q3-22, several significant headwinds remain which could see this reverse, including a slowdown in global activity, increasing inflationary pressures, rising interest rates, energy security concerns, tight global supply chains, the conflict between Russia and Ukraine, the outcome of the upcoming US mid-term election and China's zero Covid-19 policy.

Asset class weightings and recommendations are based on values at the end of July 2022. As shown in the charts below, the UK equity market had largely recovered most of the March 2020 Covid-19 pandemic sell off prior to Russia's invasion of Ukraine. Equity markets have been volatile in 2022, but UK Equities have performed strongly relative to other markets, returning +1.5% YTD. In contrast, the US market has been one of the worst performing regions in 2022 in local currency terms, declining by 9.5%, reflecting its relatively heavy weighting in technology and other growth-related stocks. US Equities have rallied in Q3-22 (up 14.0% in local currency terms to 16 August 2022), as markets have increasingly priced in interest rate cuts by the US Federal Reserve in 2023 over the last few months against a weaker growth outlook. This assumed policy pivot has supported interest rate sensitive growth stocks over the period.



2.5 Longer Term Performance

Figures provided by Portfolio Evaluation Limited show the Fund's performance over 1, 3, 5 and 10 years to 30 June 2022.

Per annum	DPF	Benchmark Index
1 year	(3.2%)	(2.8%)
3 years	4.1%	3.8%
5 years	4.8%	4.5%
10 years	8.0%	7.5%

The Fund outperformed the benchmark over all time periods other than on a one-year basis. The Fund's equity allocations, in particular, the Fund's Global Sustainable Equity allocation, are tilted towards Growth stocks. Growth stocks have under-performed over the last twelve months, as Value stocks have rallied with investors favouring tangible (or 'real') assets over intangible growth assets. There has also been a shift in investor focus from green energy (i.e. renewables) to brown energy (i.e. fossil fuels).

2.6 Category Recommendations

	Intermediate Benchmark	Final Benchmark	Fund Allocation	Permitted Range	Recommendation (1)		Benchmark Relative Recommendation (1)	
			31 Jul-22		AF	DPF	AF	DPF
Growth Assets	56.0%	55.0%	55.6%	± 8%	55.0%	55.0%	-	-
Income Assets	24.0%	25.0%	25.2%	± 6%	27.0%	25.3%	+2.0%	+0.3%
Protection Assets	18.0%	18.0%	16.0%	± 5%	16.0%	16.4%	(2.0%)	(1.6%)
Cash	2.0%	2.0%	3.2%	0 – 8%	2.0%	3.3%	-	+1.3%

(1) Recommendation relative to the Final benchmark effective 1 January 2022

At an overall level, the Fund was overweight Growth Assets, Income Assets and Cash at 31 July 2022, and underweight Protection Assets. As highlighted on page 4, commitments at 31 July 2022 totalled £282m, potentially increasing Growth Assets by 0.8% and Income Assets by 3.9%. The table on page 4 assumes that these commitments will be funded out of the current cash weighting; in practice as these commitments are drawn-down they are likely to be funded partially out of cash and partially by distributions (income and capital) from existing investments and sales of public market assets.

The IIMT recommendations reflected in this report: reduce Growth Assets by 0.6% to 55.0% (neutral) (North American Equities -1.6%; European Equities -0.5%; Global Sustainable Equities +1.5%), increase Income Assets by 0.1% (Infrastructure +0.3%; and Indirect Property -0.2%); increase Protection Assets by 0.4% (Conventional Bonds +0.4%), and increase Cash by 0.1%.

The IIMT notes that the recommendations are subject to market conditions, liquidity, and product availability. The IIMT continues to recommend a defensive cash allocation, reflecting both the general market uncertainty and cash held to fund existing commitment drawdowns.

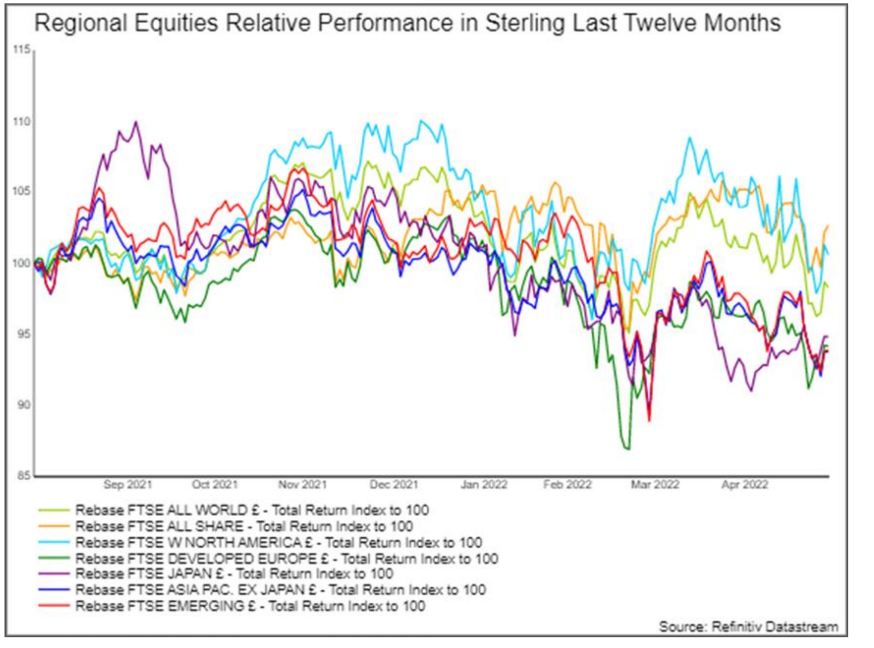
2.7 Growth Assets

At 31 July 2022, the overall Growth Asset weighting was 55.6%, up from 55.3% at 30 April 2022, principally reflecting relative market strength.

The IIMT recommendations in this report reduce the weighting to a neutral weighting of 55.0%, reflecting the growth concerns about a global recession.

Consumers are facing a cost-of-living crisis on a global basis as inflation reaches multi-decade highs, financial conditions are being tightened at an aggressive pace and several of the world's largest economies are on the brink of a recession. Against this backdrop, global PMIs are falling and moving below a reading of 50; a reading of below 50 is generally seen as an indicator that economic activity is contracting.

Having fallen sharply in H1-22, equity markets have rallied in Q3-22, as investors have started to price in central banks adopting less restrictive monetary policy to reduce recessionary pressures. Notwithstanding the Q3-22 equity rally, the IIMT continues to believe that the global economic outlook remains uncertain and the IIMT have some concerns about whether the current rally is sustainable in the short-term. Global markets are extremely volatile at present, and whilst investor confidence has improved in Q3-22, several significant headwinds remain which could see this reverse.

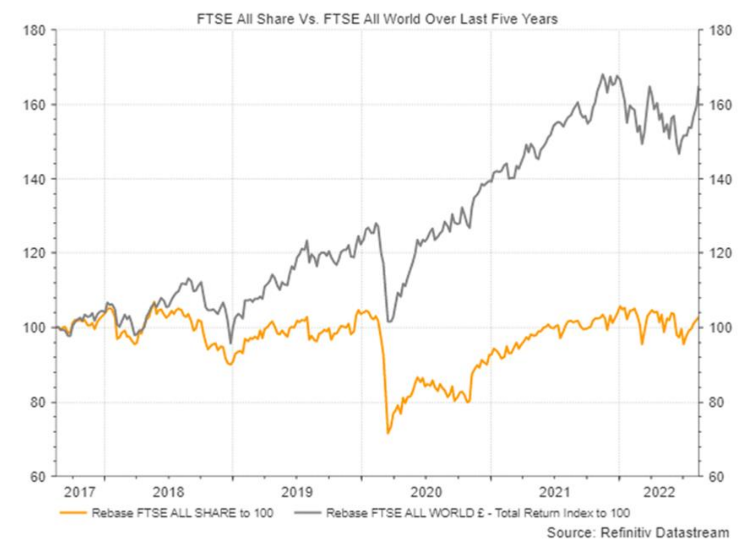


Benchmark Return	Currency	Q3-22 (*)	Q2-22	CYTD (*)	1 Year (**)	3 Year (**)	5 Year (**)	Since Last Committee (*)	L3M 31-Jul-22
Sterling Returns									
FTSE All World	GB£	11.1%	(8.3%)	(0.6%)	(3.6%)	8.4%	9.0%	5.5%	1.2%
FTSE UK	GB£	6.3%	(5.0%)	1.5%	1.6%	2.4%	3.3%	0.1%	(1.2%)
FTSE North America	GB£	14.5%	(9.5%)	1.4%	(0.4%)	12.0%	12.5%	8.6%	3.1%
FTSE Europe	GB£	6.9%	(8.8%)	(11.6%)	(10.4%)	3.4%	4.1%	(0.7%)	(2.2%)
FTSE Japan	GB£	7.7%	(6.8%)	(3.1%)	(8.5%)	3.0%	3.4%	4.1%	2.4%
FTSE Asia Pacific Ex-Japan	GB£	2.3%	(3.2%)	(3.2%)	(11.0%)	4.8%	5.3%	(0.7%)	(2.6%)
FTSE Emerging Markets	GB£	2.3%	(2.7%)	(2.8%)	(10.6%)	3.5%	4.9%	0.2%	(2.9%)
Local Currency Returns									
FTSE All World	US$	10.6%	(15.4%)	(11.2%)	(15.3%)	6.7%	7.5%	1.7%	(1.9%)
FTSE UK	GB£	6.3%	(5.0%)	1.5%	1.6%	2.4%	3.3%	0.1%	(1.2%)
FTSE North America	US$	14.0%	(16.6%)	(9.5%)	(12.4%)	10.3%	11.0%	4.7%	(0.1%)
FTSE Europe	€	9.3%	(10.3%)	(11.8%)	(12.7%)	3.9%	4.3%	0.8%	(1.9%)
FTSE Japan	¥	6.1%	(3.7%)	1.0%	(1.5%)	9.6%	6.0%	0.7%	2.4%
FTSE Asia Pacific Ex-Japan	US$	1.9%	(10.7%)	(13.5%)	(21.8%)	3.2%	3.9%	(4.3%)	(5.6%)
FTSE Emerging Markets	US$	1.9%	(10.2%)	(13.2%)	(21.3%)	2.0%	3.6%	(3.4%)	(5.9%)

Source: Performance Evaluation Limited & DPF analysis
(*) To 16 Aug-22
(**) To 30 Jun-22
CYTD = Calendar Year to 16 Aug-22

2.8 United Kingdom Equities

DPF Weightings	
Intermediate Neutral	14.0%
Final Neutral	12.0%
Actual 31.7.22	13.3%
AF Recommendation	12.0%
IIMT Recommendation	13.3%
Benchmark Returns (GB£)	
Q2 22/23 to 16 Aug-22	6.3%
Q1 22/23	(5.0%)
1 Year to Jun-22	1.6%
3 Years to Jun-22 (pa)	2.4%
5 Years to Jun-22 (pa)	3.3%



The Fund's UK Equity allocation reduced from 13.5% at 30 April 2022 to 13.3% at 31 July 2022 (1.3% overweight), reflecting relative market weakness.

Mr Fletcher has recommended a neutral weighting of 12.0% to UK Equities.

The IIMT continues to believe that an overweight allocation to UK Equities is justified due to their attractive valuations and sector diversification. Despite the significant fall in Global Equities, the FTSE All Share has achieved a positive YTD return of +1.5%. This compares to a local currency return of -11.2% and a sterling currency return of -0.6% for the FTSE All World (due to the strengthening of the US dollar against the pound).

The relative outperformance of UK Equities is primarily due to its sector diversification. The UK market is overweight the Energy sector and underweight the Technology sector, relative to the FTSE All World, which have been the best and worst performing sectors in 2022. The UK FTSE All Share has therefore benefitted from the style rotation from Growth stocks to Value stocks.

Lower valuations have also offered a degree of protection in falling markets as UK Equities have been less susceptible to the compression of earnings multiples that has occurred across the more expensive areas of the market, particularly in US Growth stocks.

As there is still uncertainty around the inflationary outlook, the number and scale of future interest rate increases and a deteriorating outlook for global growth, the IIMT continues to believe that UK Equities have the potential to outperform, supported by attractive valuations and diversified sector exposure. The IIMT recommends that the current 1.3% overweight allocation of 13.3% relative to the final benchmark is maintained, with a modest tilt towards small and mid-cap stocks.

2.9 North American Equities

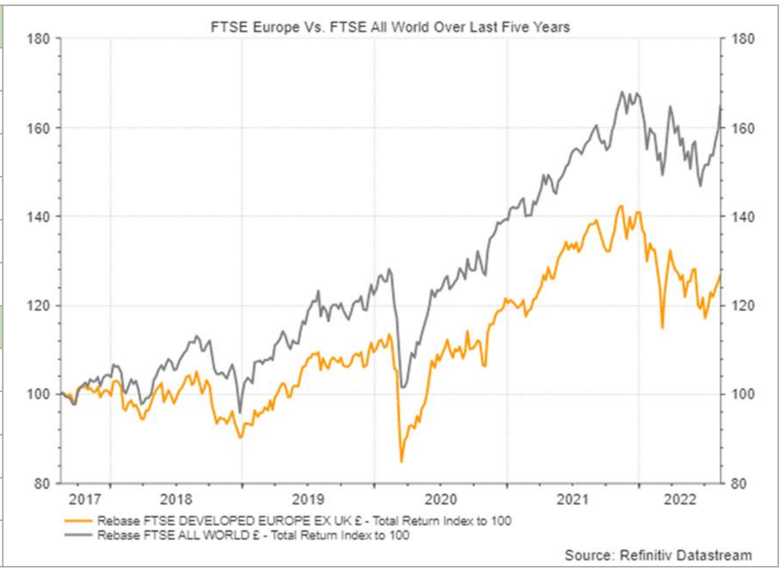
DPF Weightings	
Intermediate Neutral	6.0%
Final Neutral	-
Actual 31.7.22	1.6%
AF Recommendation	-
IIMT Recommendation	-
Benchmark Returns (GB£)	
Q2 22/23 to 16 Aug-22	14.5%
Q1 22/23	(9.5%)
1 Year to Jun-22	(0.4%)
3 Years to Jun-22 (pa)	12.0%
5 Years to Jun-22 (pa)	12.5%

The Fund’s North American Equity allocation remained flat between 30 April 2022 and 31 July 2022 at 1.6% (1.6% overweight).

Both Mr Fletcher and the IIMT recommended a zero-weighting to North American Equites in line with the new final benchmark.

2.10 European Equities

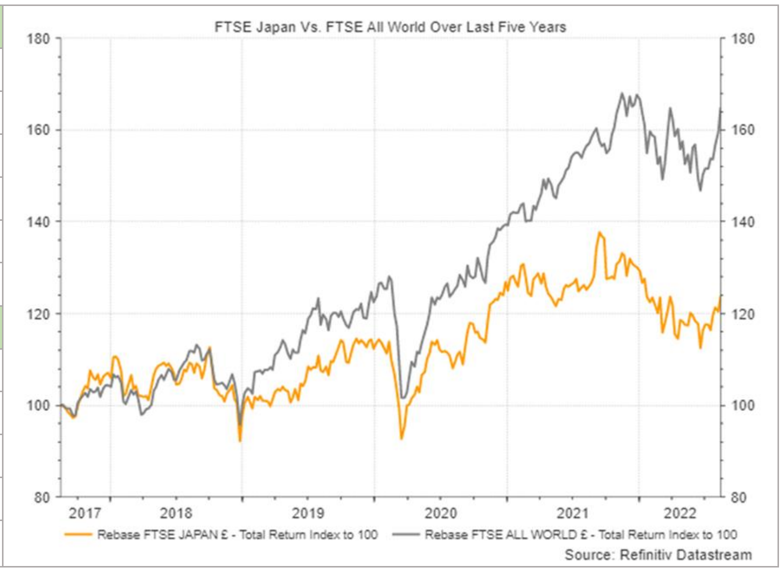
DPF Weightings	
Intermediate Neutral	4.0%
Final Neutral	-
Actual 31.7.22	0.5%
AF Recommendation	-
IIMT Recommendation	-
Benchmark Returns (GB£)	
Q2 22/23 to 16 Aug-22	6.9%
Q1 22/23	(8.8%)
1 Year to Jun-22	(10.4%)
3 Years to Jun-22 (pa)	3.4%
5 Years to Jun-22 (pa)	4.1%



The Fund's European Equity allocation remained flat between 30 April 2022 and 31 July 2022 at 0.5% (0.5% overweight). Subsequent to the period-end, the Fund has fully divested from its European Equity allocation in line with the new final benchmark.

2.11 Japanese Equities

DPF Weightings	
Intermediate Neutral	5.0%
Final Neutral	5.0%
Actual 31.7.22	5.2%
AF Recommendation	5.0%
IIMT Recommendation	5.2%
Benchmark Returns (GB£)	
Q2 22/23 to 16 Aug-22	7.7%
Q1 22/23	(6.8%)
1 Year to Jun-22	(8.5%)
3 Years to Jun-22 (pa)	3.0%
5 Years to Jun-22 (pa)	3.4%



Relative market strength increased the Fund's allocation to Japanese Equities from 5.1% at 30 April 2022 to 5.2% at 31 July 2022.

Mr Fletcher recommends a neutral weighting relative to the final benchmark.

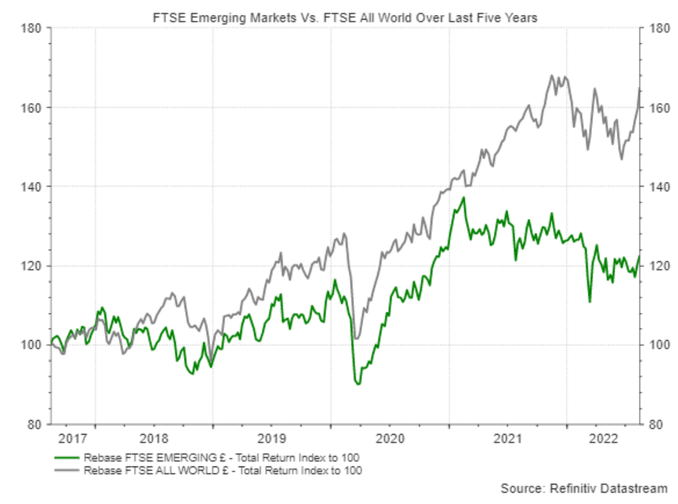
The IIMT favours Japanese Equities for their sector diversification, lower valuations and defensive performance during periods of increased uncertainty. In local currency terms, Japanese Equities have retained their value in difficult market conditions, returning +1.0% YTD in local currency, against a backdrop of a significant correction in Global Equities.

The Japanese Yen is traditionally viewed as a safe haven asset which rises in value during periods of market uncertainty, increasing returns for sterling investors. However, due to the growing divergence between US and Japanese bond yields since the turn of the year, the Yen has depreciated, which has lowered returns for sterling investors. In sterling terms, Japanese Equities have returned -3.1% YTD.

The IIMT believes that Japanese Equities remain attractively valued relative to their global peers and recommends that the Fund's overweight allocation is maintained at 0.2% relative to a neutral weight of 5.0%.

2.12 Asia Pacific Ex-Japan and Emerging Market Equities

DPF Weightings	Asia-Pac	EM
Intermediate Neutral	2.0%	5.0%
Final Neutral	-	5.0%
Actual 31.7.22	-	5.4%
AF Recommendation	-	5.0%
IIMT Recommendation	-	5.4%
Benchmark Returns (GB£)	**Asia-Pac**	**EM**
Q2 22/23 to 16 Aug-22	2.3%	2.3%
Q1 22/23	(3.2%)	(2.7%)
1 Year to Jun-22	(11.0%)	(10.6%)
3 Years to Jun-22 (pa)	4.8%	3.5%
5 Years to Jun-22 (pa)	5.3%	4.9%



The Fund fully divested from Asia Pacific Ex-Japan Equity allocation in the period in line with the final strategic asset allocation benchmark, with the Fund's final Asia Pacific Ex-Japan Equity holding (£54m) being transferred into the Fund's Emerging Market Equity allocation. The Fund's allocation to Emerging Market Equities increased from 4.7% at 30 April 2022 to 5.4% at 31 July 2022 (0.3% underweight), reflecting the transfer noted above, partly offset by market weakness.

Mr Fletcher recommends a neutral allocation of 5.0% to Emerging Market Equities.

In local currency terms, Emerging Market Equities have been the worst performing region so far in 2022, falling by over 13.2% YTD. However, due to the relative strength of the US dollar against the pound, the index has lost only 2.8% when translated into Sterling.

There has been significant dispersion in returns between the Emerging Markets regions. Latin American Equities have been the best performing region, returning +25% year to date (in sterling terms). The region is a net exporter of commodities and has been a major beneficiary of the sharp rise in commodity prices. In contrast, Chinese Equities have lost 11% during the same period. Low vaccination rates and less effective vaccines have contributed to a new wave of Covid-19 cases in China. As a result, Chinese authorities have reintroduced lockdowns in several major cities, including Shanghai, China's most populous city.

Russia was removed from the Emerging Markets index shortly after its invasion of Ukraine, with the country being viewed as uninvestable. Russian equities made up approximately 4% of the Emerging Markets index at the start of the year, and over 70% of the Emerging Europe index. There has been a contagion effect from the conflict, with eastern European countries most heavily affected due to their close proximity and trading ties to Russia and Ukraine. The Emerging Europe index has lost over 70% of its value YTD.

The IIMT continues to believe in the long-term growth potential of Emerging Markets, noting that these markets have accounted for well over half of global growth over the last ten years. The IIMT believes that Emerging Market Equities offer value relative to their global peers, a position that has been enhanced during the current market sell-off. The IIMT therefore recommends an overweight allocation of 5.4% (0.4% overweight).

2.13 Global Sustainable Equities

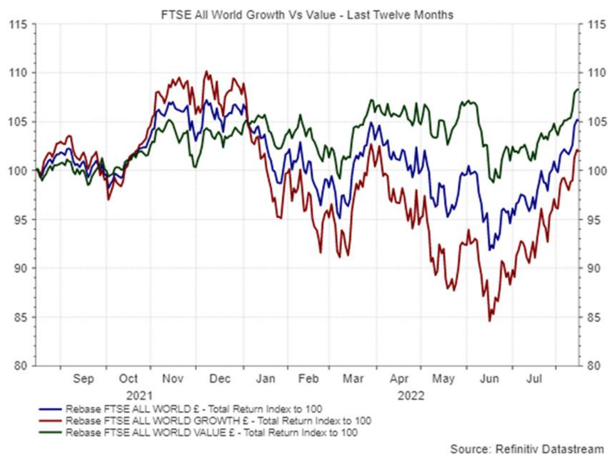
DPF Weightings	
Intermediate Neutral	16.0%
Final Neutral	29.0%
Actual 31.7.22	24.8%
AF Recommendation	29.0%
IIMT Recommendation	26.3%
Benchmark Returns (GB£)	
Q2 22/23 to 16 Aug-22	11.3%
Q1 22/23	(8.2%)
1 Year to Jun-22	(3.1%)
3 Years to Jun-22 (pa)	8.7%
5 Years to Jun-22 (pa)	9.2%

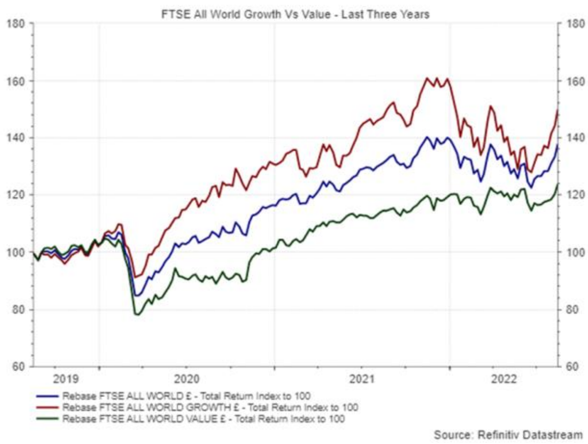
The Fund’s allocation to Global Sustainable Equities increased from 24.2% at 30 April 2022 to 24.8% at 31 July 2022 reflecting relative market strength.

Mr Fletcher recommends a neutral weighting of 29.0% relative to the final benchmark.

The IIMT remains confident about the long-term investment case for the Fund’s allocation to Global Sustainable Equities, which typically favour growth stocks relative to value stocks.

The charts below shows that growth stocks have out-performed value stocks over the last three years, particularly since the start of the Covid-19 pandemic, as investors favoured quality growth stocks over pro-cyclical stocks, in part supported by low forward interest rate expectations.





However, value stocks have rallied over the last twelve months as both economic activity, and in particular, forward interest rate expectations have increased, albeit growth stocks started to rally in Q3-22 as markets began to price in interest rate cuts by the US Federal Reserve in 2023 against a weaker growth outlook.

The IIMT recommends that Fund's allocation to Global Sustainable Equities is increased to 26.3%; 2.7% underweight. As noted earlier, the IIMT recommends an overall neutral weight to Growth Assets, with the underweight in respect of Global Sustainable Equities being used to fund overweight allocations in respect of UK Equities, Japanese Equities, Emerging Market Equities and Private Equity. The IIMT believes that these allocations offer greater relative value in the short-term.

2.14 Private Equity

DPF Weighting					
Intermediate Netural	Final Neutral	Actual 31.7.22	Committed 31.7.22	AF Recommendation	IIMT Recommendation
4.0%	4.0%	4.8%	5.6%	4.0%	4.8%
Benchmark Returns (GB£)					
Q2 22/23 to 16 Aug-22	Q1 22/23	1 Year to Jun-22	3 Years to Jun-22 (pa)	5 Years to Jun-22 (pa)	
11.3%	(8.0%)	(4.0%)	1.1%	2.9%	

The Private Equity weighting remained flat at 4.8% between 30 April 2022 and 31 July 2022 (0.8% overweight relative to the final benchmark).

Mr Fletcher recommends a neutral weighting of 4.0% in Private Equity.

The IIMT notes that whilst the Fund is overweight to Private Equity on a committed basis, due diligence is currently being carried out on a potential £30m commitment to a Private Equity fund-of-fund managed by LGPS Central Limited.

The IIMT recommends maintaining the current Private Equity allocation of 4.8% (0.8% overweight) (5.6% on a committed basis) but with the flexibility to make a £30m commitment to the LGPS Central Limited Private Equity fund-of-fund subject to the completion of satisfactory due diligence.

2.15 Income Assets

At 31 July 2022, the overall weighting in Income Assets was 25.2%, 1.0% higher than that reported at 30 April 2022, reflecting net investment of £42m, together with relative market strength. The IIMT recommendations below slightly increase the overall Income Asset weighting by 0.1% to 25.3%; 28.9% on a committed basis.

2.16 Multi Asset Credit

DPF Weighting				
Intermediate Neutral	Final Neutral	Actual 31.7.22	AF Recommendation	IIMT Recommendation
6.0%	6.0%	6.6%	8.0%	6.6%
Benchmark Returns (GB£)				
Q1 22/23 to 16 Aug-22	Q1 22/23	1 Year to Jun-22	3 Years to Jun-22 (pa)	5 Years to Jun-22 (pa)
1.9%	(3.4%)	(2.5%)	1.9%	2.6%

The Fund's allocation to Multi-Asset Credit reduced from 6.9% at 30 April 2022 to 6.6% at 31 July 2022, principally reflecting net distributions of £25m; 0.6% overweight relative to the final benchmark.

Mr Fletcher recommends a 2.0% overweight allocation of 8.0% to Multi-Asset Credit, funded from a 1.0% underweight allocation to both conventional UK gilts and investment grade bonds (see Protection Assets). Mr Fletcher notes that the widening of spreads for sub-investment grade bonds in Q2-22, together with the floating rate nature of loans and asset backed securities have increased the attractiveness of the asset class. Mr Fletcher also notes that Multi-Asset Credit benefits from a lower interest rate sensitivity, so provided defaults do not increase significantly, the asset class should deliver better returns in a rising inflation and interest rate environment relative to investment grade bonds and sovereign bonds.

The IIMT continues to be positive about the long-term attractions of the asset class and favours a strong bias towards defensive forms of credit (e.g., senior secured debt and asset backed securities). Q2-22 was a difficult quarter for credit markets, with spreads widening, and on a GBP hedged basis, both the European High Yield Index and US High-Yield Index fell by 10.4%. Credit markets have partly rallied in Q3-22 to date, as recessionary fears started to outweigh inflation concerns – leading investors to consider that the ongoing aggressive monetary tightening may come to an end sooner than expected.

The IIMT believes that the current running yield available from the Multi-Asset Class asset class is attractive, and offers value over the longer term, albeit there could be volatility in the short-term. As a result, the IIMT recommends that the current allocation of 6.6% is maintained (0.6% overweight); 7.8% on a committed basis.

2.17 Property

DPF Weighting				
Intermediate Neutral	Final Neutral	Actual 31.7.22	AF Recommendation	IIMT Recommendation
9.0%	9.0%	8.9%	9.0%	8.8%
Benchmark Returns (GB£)				
Q2 22/23 to 16 Aug-22	Q1 22/23	1 Year to Jun-22	3 Years to Jun-22 (pa)	5 Years to Jun-22 (pa)
Not Available	3.4%	19.9%	7.8%	7.1%

The Fund's allocation to Property increased by 0.9% to 8.9% at 31 July 2022, reflecting net investment of £39m and relative market strength. Direct Property accounted for 5.9% (up 0.8%, 0.1% underweight relative to the final benchmark) and Indirect Property accounted for 3.0% (up 0.1%, neutral to the final benchmark).

The Fund purchased two direct properties in the period at a net cost of £39m; a freehold single-let industrial asset in Eastleigh for £19m and a retail warehouse park and hotel in Saffron Walden for £20m.

Mr Fletcher recommends a neutral overall allocation of 9.0% to property but notes that he would like to see the Direct Property allocation increased, funded from realisations out of the Indirect Property allocation. However, Mr Fletcher acknowledges that this should be done with caution as it is a very long-term investment decision, and property transactions tend to be quite expensive.

The Fund's Direct Property manager notes that the increasingly poor economic news in respect of the UK economy is starting to have a negative impact on the UK commercial property market in terms of sentiment and investor confidence. Although this has not yet fed through to recent valuations and performance returns, which remain at healthy levels, lower valuations are expected in the second half of 2022. The total return of the Fund's property portfolio for the year to 30 June 2022 was 17.6%. The portfolio void rate was 6.9% at 30 June 2022, down from 8.1% at 31 March 2022, and 0.9% better than the benchmark.

The manager notes that the strategy is to maintain the current sector exposures within the portfolio (with one exception noted below) by remaining overweight in the industrial, retail warehousing and supermarket sectors and remaining underweight high street retail, shopping centres and office space.

The manager is seeking to increase the Fund's weighting in 'alternatives', where the manager sees value based upon current yield levels. However, the manager notes that care is needed with stock selection because the sector (which includes hotels, cinemas, restaurants and bars) will not be completely immune to an economic downturn.

The IIMT recommends that the Fund's allocation to Direct Property is maintained at 5.9% (0.1% underweight), whereas the allocation to Indirect Property is reduced by 0.2% to 2.8% (0.2% underweight). The IIMT recommend that further liquidity of up to £60m (1.0%) is made available to the Direct Property manager to make incremental investments at the right time should suitable investment opportunities be identified, funded from matching Indirect Property redemptions.

Notwithstanding the above comments in respect of increasing the Fund's Direct Property allocation from a lower Indirect Property allocation, the IIMT continues to believe that Indirect Property has a role in the Fund's overall portfolio and increases the options available to the Fund to deploy capital into a relatively illiquid asset class and increases portfolio diversification, including exposure to overseas assets, private rented accommodation, student accommodation, development capital and medical centres.

2.18 Infrastructure

DPF Weighting					
Intermedidate Neutral	Final Neutral	Actual 31.7.22	Committed 31.7.22	AF Recommendation	IIMT Recommendation
9.0%	10.0%	9.7%	12.4%	10.0%	10.0%
Benchmark Returns (GB£)					
Q2 22/23 to 16 Aug-22	Q1 22/23	1 Year to Jun-22	3 Years to Jun-22 (pa)	5 Years to Jun-22 (pa)	
0.5%	0.7%	2.4%	2.4%	2.5%	

The Fund's allocation to Infrastructure increased from 9.3% at 30 April 2022 to 9.7% at 31 July 2022 reflecting net investment of £13m, the majority of which related to renewable energy assets, together with relative market strength.

The committed infrastructure weight increased from 11.2% at 30 April 2022 to 12.4% at 31 July 2022, reflecting a €72.5m commitment to a European infrastructure fund approved by the Pensions and Investments Committee in June 2022. It should be noted that the commitment was increased by €5m relative to that approved by Committee to trigger a higher LGPS aggregated management fee reduction. The increase in the commitment was approved by the Chair of the Pensions and Investments Committee and the Director of Finance & ICT.

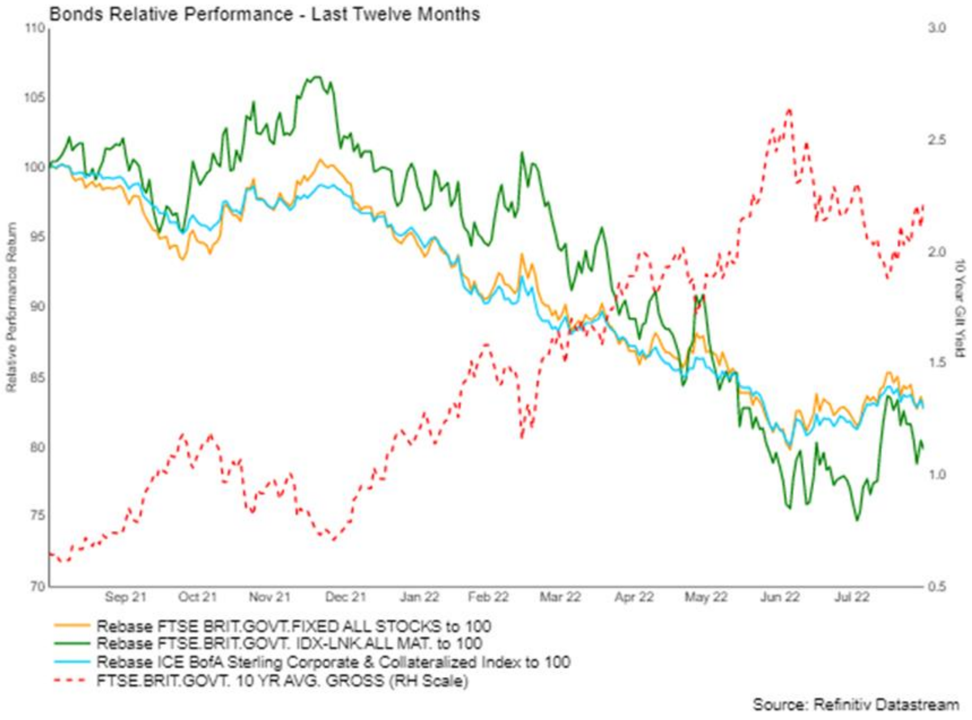
Mr Fletcher recommends a neutral weighting relative to the final benchmark of 10.0% allocation.

The IIMT continues to view Infrastructure as an attractive long-term asset class and favours a bias towards core infrastructure assets or renewable energy assets. These assets can offer low volatility; low correlation to equity and fixed income markets; and reliable long-term cash flows.

Notwithstanding the noted favourable long-term characteristics of the asset class, the IIMT continues to believe that infrastructure assets are exposed to increased political and regulatory risk, and this risk is best mitigated through asset type and geographical diversification. It should also be noted that the current market valuation of some infrastructure assets, particularly renewable infrastructure assets, are becoming increasingly stretched driven by strong investor demand.

The IIMT recommends that the invested weighting is increased by 0.3% to 10.0% neutral, reflecting anticipated closed-ended fund draw-downs; 12.4% on a committed basis. Given the current committed weight of 12.4%, the IIMT is not reviewing new opportunities at the current time.

2.19 Protection Assets

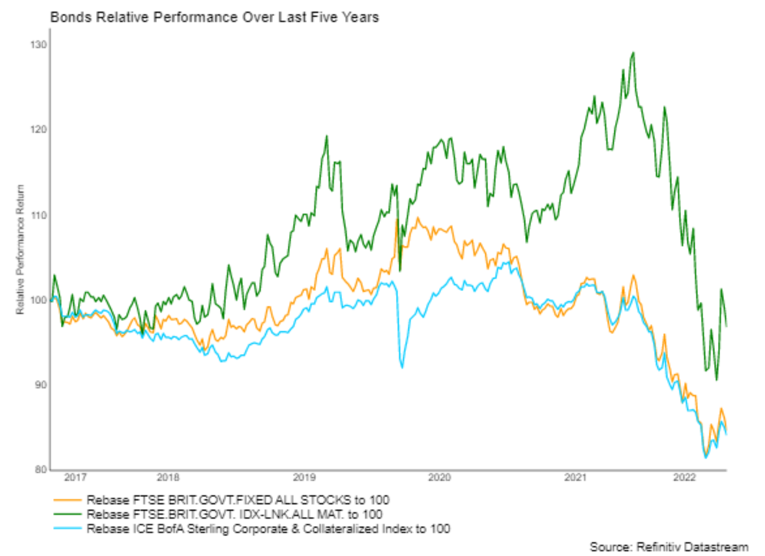


The weighting in Protection Assets at 31 July 2022 was 16.0%, flat with that reported at 30 April 2022. Net investment of £27m was offset by relative market weakness. The IIMT recommendations below increase the weighting by 0.4% to 16.4%.

Fixed income returns have come under increasing pressure in 2022 as bond yields have risen (lowering prices), as markets priced in interest rates of well over 2% in both the US and the UK to tackle rising inflation. Notwithstanding the general year-to-date increase in yields, yields fell in July 2022 as fears of an economic downturn encouraged investors back into the sovereign debt market but have recently resumed their rise.

2.20 Conventional Bonds

DPF Weightings	
Intermediate Neutral	6.0%
Final Neutral	6.0%
Actual 31.7.22	4.6%
AF Recommendation	5.0%
IIMT Recommendation	5.0%
Benchmark Returns (GB£)	
Q2 22/23 to 16 Aug-22	0.7%
Q1 22/23	(7.4%)
1 Year to Jun-22	(13.6%)
3 Years to Jun-22 (pa)	(3.4%)
5 Years to Jun-22 (pa)	(0.7%)



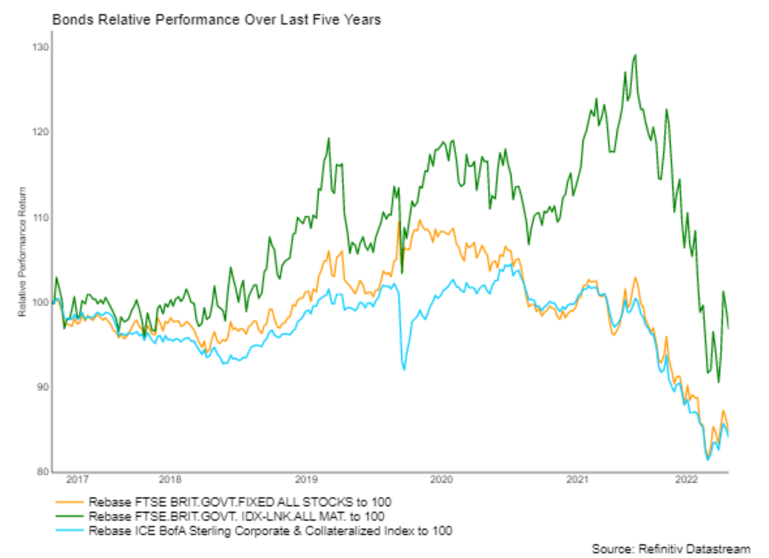
The Fund's allocation to Conventional Bonds increased by 0.1% to 4.6% between 30 April 2022 and 31 July 2022, reflecting net investment of £15m, largely offset by relative market weakness; 1.4% underweight relative to the final benchmark.

Mr Fletcher has maintained his recommended 1.0% underweight allocation to Conventional Bonds. Mr Fletcher notes that he has been surprised by the level of upward market repricing (i.e. lower yields) since the last Committee meeting. As a result, Mr Fletcher believes that bond yields are just as likely to rise from here as they are to fall but not by much in the short term. Mr Fletcher continues to believe that an overweight allocation to Multi-Asset Credit, funded from an underweight allocation to Conventional Bonds, is warranted because Multi-Asset Credit benefits from a lower interest rate sensitivity, so provided defaults do not increase significantly, Multi-Asset Credit should deliver better returns in a rising inflation and interest rate environment relative Conventional Bonds.

The IIMT believes that conventional sovereign bonds offer better value now than they have for some time following the substantial year-to-date rise in yields from historic lows. Sovereign bonds are also diversifying assets which should afford greater protection than other asset classes in periods of market uncertainty, as evidenced by the July fall in bond yields as concerns about the global economy intensified. The IIMT recommends increasing the weighting by 0.4% to 5.0% which is in line with Mr Fletcher's recommendation.

2.21 Index-Linked Bonds

DPF Weightings	
Intermediate Neutral	6.0%
Final Neutral	6.0%
Actual 31.7.22	5.5%
AF Recommendation	6.0%
IIMT Recommendation	5.5%
Benchmark Returns (GB£)	
Q2 22/23 to 16 Aug-22	2.7%
Q1 22/23	(17.5%)
1 Year to Jun-22	(16.3%)
3 Years to Jun-22 (pa)	(3.9%)
5 Years to Jun-22 (pa)	(0.3%)



The Fund's allocation to Index-Linked Bonds remained flat at 5.5% (0.5% underweight relative to the final benchmark) with net investment of £12m being offset by market weakness. The Fund's allocation at 31 July 2022 comprised 80% UK Index-Linked Bonds (UK Linkers) and 20% US Treasury Inflation Protected Bonds (US TIPS).

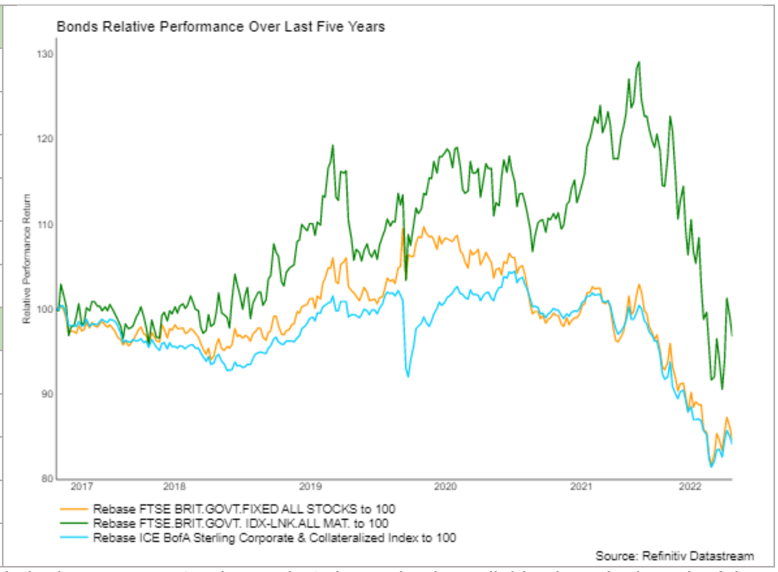
Mr Fletcher has maintained his 6.0% (neutral) allocation to Index-Linked Bonds. Mr Fletcher notes that despite the significant increase in Index-Linked Bond yields over the last year, they remain over-valued. Mr Fletcher notes that while he has consistently recommended an underweight allocation in the past, he recommends a neutral allocation at the current time.

The IIMT notes that markets and the major central banks have become increasingly concerned about higher inflation, which has been driven by the 'post Covid-19' economic recovery; supply constraints; high-savings rates (which could reverse and lead to a spending surge); previous central bank policy stimulus; higher energy costs; and the conflict between Russia and Ukraine. However, it is unclear whether this will be a relatively short-term issue or whether inflationary pressures will become more entrenched.

The IIMT believes that the potential for a longer-term period of elevated inflation supports the Fund's current Index-Linked bonds allocation, and therefore recommends that the weighting is maintained at 5.5%.

2.22 Corporate Bonds

DPF Weightings	
Intermediate Neutral	6.0%
Final Neutral	6.0%
Actual 31.7.22	5.9%
AF Recommendation	5.0%
IIMT Recommendation	5.9%
Benchmark Returns (GB£)	
Q2 22/23 to 16 Aug-22	2.6%
Q1 22/23	(7.5%)
1 Year to Jun-22	(13.9%)
3 Years to Jun-22 (pa) (1)	n/a
5 Years to Jun-22 (pa) (1)	n/a



(1) Benchmark returns for the LGPS Central Limited Investment Grade Bonds Sub-Fund only available since the launch of the product in February 2020

There were no transactions in the period and relative market weakness reduced the Fund's weighting in Global Investment Grade Bonds from 6.0% at 30 April 2022 to 5.9% at 31 July 2022.

Mr Fletcher has maintained his 1.0% underweight allocation of 5.0% to Global Investment Grade Bonds, reflecting the high interest rate sensitivity of these assets, and Mr Fletchers preference to maintain an overweight position in Multi-Asset Credit.

Investment grade bond spreads (yield spread over sovereign bond yields) have generally widened in 2022 but have tightened over the last few months as risk appetite as increased. Whilst the current spreads in respect of both UK[2] and US[3] investment grade bonds are higher than five-and ten-year averages, it remains unclear whether current spreads fully compensate for the increased level of credit risk against an uncertain economic outlook. However, the IIMT believes that investment grade bonds are likely to be more defensively positioned relative to risk-on assets (e.g. high yield bonds), should markets experience a prolonged period of weakness. As a result, the IIMT recommends maintaining the current allocation of 5.9% (0.1% underweight) to the asset class.

[2] UK Current (17 Aug-22) 152bps; YTD High 178bps; 5 Year Average 125bps; and 10 Year Average 129bps
[3] US Current (17 Aug-22) 159bps; YTD High 183bps; 5 Year Average 119bps; and 10 Year Average 123bps

2.23 Cash

The Cash weighting at 31 July 2022 was 3.2% (1.2% overweight relative to the final benchmark), down from 4.5% at 30 April 2022, reflecting net investment of £95m over the period.

Mr Fletcher has maintained his recommended weighting in Cash at 2.0% (neutral).

The IIMT notes that global markets are extremely volatile at the moment and whilst investor confidence has shown signs of improvement, several significant headwinds remain which could see this reverse, including a slowdown in global activity, increasing inflationary pressures, rising interest rates, energy security concerns, tight global supply chains, the conflict between Russia and Ukraine, the outcome of the upcoming US mid-term election and China’s zero Covid-19 policy.

The IIMT recommends a defensive cash allocation of 3.3% (1.3% overweight relative to the final benchmark) due to the uncertain economic outlook. This will also ensure that the Fund has sufficient operational headroom after adjusting for term-loan maturities (i.e., short-term loans provided by the Fund to other public sector bodies) to cover upcoming investment commitment drawdowns (expected to be in excess of £180m over the course of 2022-23).

3. Implications

3.1 Appendix 1 sets out the relevant implications considered in the preparation of the report.

4. Background Papers

4.1 Papers held in the Investment Section.

5. Appendices

5.1 Appendix 1 – Implications
5.2 Appendix 2 – Report of independent external adviser.
5.3 Appendix 3 – Portfolio Valuation Report at 31 July 2022.

6. Recommendation(s)

That Committee:

a) notes the report of the independent external advisor, Mr Fletcher.
b) notes the asset allocations, total assets and long-term performance analysis set out in the report.
c) approves the IIMT recommendations outlined in the report.

7. Reasons for Recommendation(s)

7.1 Both Mr Fletcher's report and the analysis set out in this report in respect of asset allocation, total assets and long-term performance provide an overview of the Fund's investment strategy and performance track-record on which to assess the asset allocation recommendations for the Fund for the upcoming quarter.

7.2 The rationale for each of the IIMT asset allocation recommendations included in this report is set out in Section 2.

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Appendix 1

<u>Implications</u>

Financial

1.1 None

Legal

2.1 None

Human Resources

3.1 None

Information Technology

4.1 None

Equalities Impact

5.1 None

Corporate objectives and priorities for change

6.1 None

Other (for example, Health and Safety, Environmental, Sustainability, Property and Asset Management, Risk Management and Safeguarding)

7.1 None