FOR PUBLICATION

DERBYSHIRE COUNTY COUNCIL

PENSIONS AND INVESTMENTS COMMITTEE

WEDNESDAY, 7 DECEMBER 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 October 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 £285m. Whilst the timing of drawdowns will be lumpy and difficult to predict, the In-house Investment Management Team (IIMT) believes that the majority of 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 (3)	Benchmark Sterling Return	Benchmark Sterling Return
	Intermediate (1)	Final (1)	31/7/22 (2)	31/10/22	Final (1)	AF 7/12/22	DPF 7/12/22	AF 7/12/22	DPF 7/12/22	DPF 7/12/22	3 Months to 30/9/22	3 Months to 31/10/22
Growth Assets	**56.0%**	**55.0%**	**55.6%**	**54.9%**	**+/- 8%**	**(1.0%)**	**(0.7%)**	**54.0%**	**54.3%**	**55.1%**	**n/a**	**n/a**
UK Equities	14.0%	12.0%	13.3%	13.2%	+/- 4%	+1.0%	+1.0%	13.0%	13.0%	13.0%	(3.4%)	(4.6%)
Global Equities:	38.0%	39.0%	37.5%	36.7%	+/- 8%	(2.0%)	(2.7%)	37.0%	36.3%	36.3%	n/a	n/a
North America	6.0%	-	1.6%	1.1%	-	-	-	-	-	-	3.4%	(0.5%)
Europe	4.0%	-	0.5%	-	-	-	-	-	-	-	(2.0%)	(2.9%)
Japan	5.0%	5.0%	5.2%	5.2%	+/- 2%	-	-	5.0%	5.0%	5.0%	0.9%	(4.7%)
Pacific ex-Japan	2.0%	-	-	-	-	-	-	-	-	-	(4.5%)	(10.9%)
Emerging Markets	5.0%	5.0%	5.4%	5.1%	+/- 2%	-	-	5.0%	5.0%	5.0%	(2.3%)	(8.2%)
Global Sustainable	16.0%	29.0%	24.8%	25.3%	+/- 8%	(2.0%)	(2.7%)	27.0%	26.3%	26.3%	1.6%	(2.3%)
Private Equity	4.0%	4.0%	4.8%	5.0%	+/- 2%	-	+1.0%	4.0%	5.0%	5.8%	1.8%	(2.1%)
Income Assets	**24.0%**	**25.0%**	**25.2%**	**26.2%**	**+/- 6%**	**+2.0%**	**+1.2%**	**27.0%**	**26.2%**	**30.4%**	**n/a**	**n/a**
Multi-Asset Credit	6.0%	6.0%	6.6%	6.8%	+/- 2%	+2.0%	+0.8%	8.0%	6.8%	8.7%	1.6%	(0.7%)
Infrastructure	9.0%	10.0%	9.7%	10.6%	+/- 3%	-	+0.6%	10.0%	10.6%	12.9%	0.9%	0.9%
Direct Property (5)	5.0%	6.0%	5.9%	6.0%	+/- 2%	-	-	6.0%	6.0%	6.0%	(4.2%)	(4.2%) (4)
Indirect Property (5)	4.0%	3.0%	3.0%	2.8%	+/- 2%	-	(0.2%)	3.0%	2.8%	2.8%	(4.0%)	(4.0%) (4)
Protection Assets	**18.0%**	**18.0%**	**16.0%**	**15.3%**	**+/- 5%**	**(1.0%)**	**(1.5%)**	**17.0%**	**16.5%**	**16.5%**	**n/a**	**n/a**
Conventional Bonds	6.0%	6.0%	4.6%	4.6%	+/- 2%	(1.0%)	(1.0%)	5.0%	5.0%	5.0%	(12.8%)	(12.4%)
Index-Linked Bonds	6.0%	6.0%	5.5%	5.1%	+/- 2%	-	(0.5%)	6.0%	5.5%	5.5%	(9.3%)	(17.7%)
Corporate Bonds	6.0%	6.0%	5.9%	5.6%	+/- 2%	-	-	6.0%	6.0%	6.0%	(8.7%)	(9.7%)
Cash	**2.0%**	**2.0%**	**3.2%**	**3.6%**	**0 – 8%**	**-**	**+1.0%**	**2.0%**	**3.0%**	**(2.0%)**	**0.4%**	**0.4%**

Investment Assets totaled £5,748m at 31 Oct-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 trades placed at 31 Jul-22 but yet to trade by 31 Jul-22; MAC -0.4%; and Cash +0.4%.
(3) Adjusted for investment commitments at 31 Oct-22. Presumes all commitments funded from Cash.
(4) Benchmark Return for the three months to 30 Sept-22.
(5) The maximum permitted range in respect of Property is +/- 3%.

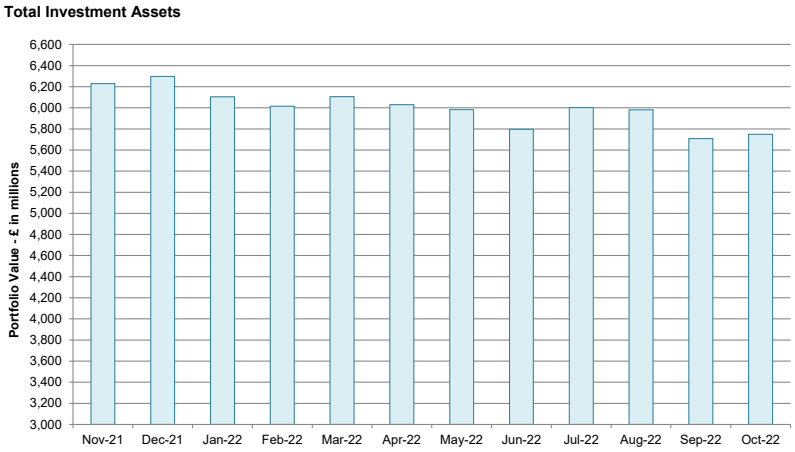
The table above shows the intermediate benchmark, together with the new final benchmark approved by Committee in November 2020. The final benchmark came into effect on 1 January 2022. The table above reflects the following three categorisations:

- **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 October 2022, was overweight Income Assets (1.2%) and Cash (1.6%) and underweight in Growth Assets (-0.1%) and Protection Assets (-2.7%). 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 -2.0%. 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.

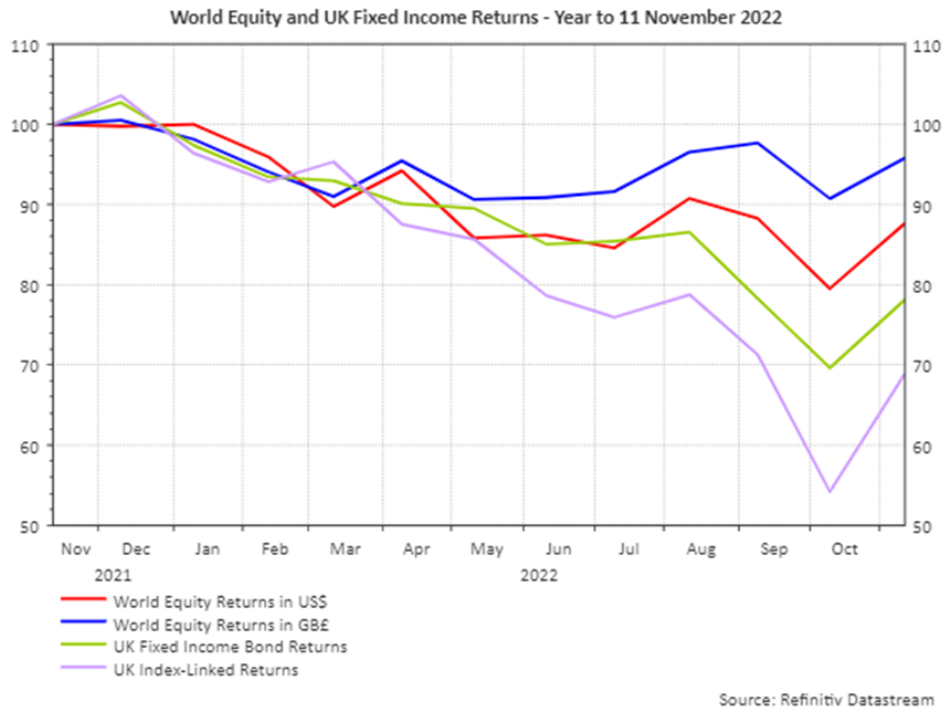
2.3 Total Investment Assets

The value of the Fund's investment assets reduced by £254m (-4.2%) between 31 July 2022 and 31 October 2022 to £5.748bn, comprising a non-cash market loss of around £270m, partly offset by cash inflows from dealing with members and investment income of around £15m. Over the twelve months to 31 October 2022, the value of the Fund's investment assets has fallen £287m (-4.8%), comprising a non-cash market loss of around £350m, 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 October 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 Gilts and UK Index Linked bonds for the twelve months to 11 November 2022.

Global Equities have lost around 20% of their value in US dollar terms over the 12-month period, although in Sterling terms Global Equities have only fallen by around 4%. Returns for Sterling investors have been sheltered by a stronger US$ relative to the GB Pound.

The returns from bond markets have also been negative. UK Gilts have lost around 21% of their value over the 12-month period, whereas UK Inflation-Linked Bonds have fallen almost 30%. Bond yields have risen in 2022 as markets have reacted to higher inflation by pricing higher interest rates rises to reduce inflationary pressures. A bond's price moves inversely to its yield, so this has resulted in lower capital values.

There has been considerable volatility in bond markets. The UK Government's 'mini-budget' in September 2022 was poorly received by bond

market investors, resulting in sharply higher Gilt yields as the risk of lending to the UK Government was repriced higher. The rise in yields was also exacerbated by leverage in the Liability Driven Investment market, which forced the Bank of England (BoE) to intervene to prevent market instability.

Since the last Committee meeting, equity market returns have continued to be heavily influenced by the inflation outlook and by expectations for Central Bank policy. Headline inflation in the UK rose by 2% month on month in October with the CPI rising 11.1% on an annual basis, up from 10.1% in September and exceeding economists' expectations of a rise of 10.7%. It was the highest annual CPI rate since the series began in January 1997, with modelling suggesting that the CPI rate would have last been higher in October 1981. The rise was driven by energy and food price inflation, despite the introduction of the Government's energy guarantee scheme. Food price inflation increased sharply to 16.5% year on year (yoy), the highest level for 45 years, due to rising input, energy and labour costs. Core inflation (excluding food and energy) held steady at 6.5% (yoy), although economists had expected core inflation to decline slightly to 6.4%.

Inflation also reached fresh highs in Europe in October, rising above 10.0% for the first time in the Eurozone's history. The inflation reading was pushed higher by German (+10.4%) and Italian (+11.9%) CPI. In the US, there are some tentative signs that inflation may have peaked, although the outlook remains uncertain. Headline inflation in October declined for the fourth consecutive month, and it is now more than one percentage point below its July peak. Core inflation also fell in October after two consecutive months of increases. However, it is too early to know for certain whether US inflation is 'cooling off'. Many of the underlying CPI components are still running 'hot' and significantly above the US Federal Reserve's (US Fed) 2% target. A more persistent and broad-based price decline, which is evidenced over several months, is required before the "cooling" narrative can be confirmed.

As a result of the inflationary environment, Central Bank policy has been hawkish (implementing and signalling a tighter monetary stance). The BoE raised rates by 50 basis points and 75 basis points at its September and November meetings, respectively, the 7th and 8th interest rate increase of this cycle, taking rates to 3.0%. The US Fed implemented its 4th consecutive 75 basis points increase in November and the 6th rise in total in this cycle, taking the upper range for rates to 4.0%. The European Central Bank (ECB) also implemented a 75 basis points increase in November, following previous

increases of 50 basis points and 75 basis points, taking the deposit rate from -50 basis points in July 2022 to 150 basis points (1.5%) in November 2022.

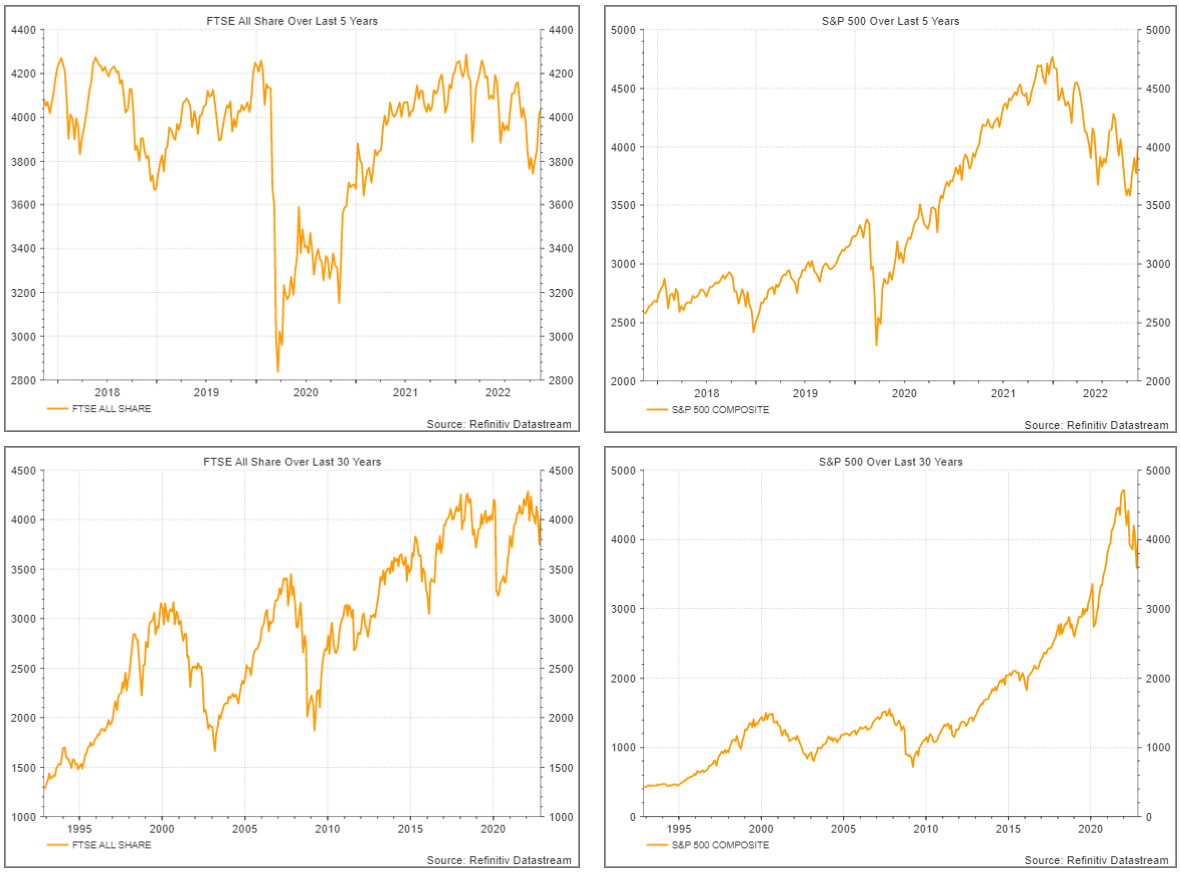
Notwithstanding the sizeable rate increases, the BoE, US Fed and ECB each highlighted the growing risk of recession from higher interest rates. The BoE is now forecasting that the UK fell into recession in Q3-22, which seems to have been confirmed by the initial Office for National Statistics estimate of a quarterly decline in GPD of 0.2%. The BoE is forecasting that the downturn will extend through 2023 and into the first half of 2024. The President of the ECB highlighted the need to weigh the 'pros and cons' of further interest rate rises against the increased risk of recession, and the US Fed acknowledged that a 'soft landing' (i.e. avoiding a recession) is still possible but the path to achieving it is narrowing.

As a result of the weakening economic outlook, markets appear to be placing greater emphasis on company earnings. Underwhelming Q3-22 earnings have seen analysts cut their expectations for Q4-22. Although the energy sector saw strong earnings growth in Q3-22 of 137%, the rest of the index saw earnings fall by more than 5%, with 7 out of 11 sectors reporting negative growth. Expectations for Q4-22 earnings have now turned negative (-2.1%), having started at +5.1% for the quarter at the beginning of the quarter. The earnings outlook for 2023 is also starting to come under pressure. Two influential global banks have issued revised earnings forecasts indicating that negative earnings growth is now being considered as a possible base case for 2023.

Equity markets are extremely volatile at present and the global economic outlook, the inflationary outlook and the path for Central Bank policy remains uncertain. Recent rallies in equities from perceptions that US inflation may be 'cooling', particularly following the release of lower-than-expected US inflation numbers for October 2022, or that Central Banks may pivot away from further interest rate increases, may indicate that markets are keen to build a positive narrative to support price rallies. Whilst the IIMT believes that a cautious approach remains appropriate, flexibility will be required in response to changing economic, inflationary and monetary conditions.

Asset class weightings and recommendations are based on values at the end of October 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 -

0.9% YTD[1]. In contrast, the US market has been one of the worst performing regions in 2022 in local currency terms, declining by 15.8% YTD.



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 September 2022.

Per annum	DPF	Benchmark Index
1 year	(6.6%)	(5.9%)
3 years	2.8%	2.2%
5 years	4.1%	3.8%
10 years	7.5%	7.0%

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.

[1] 1 January 2022 to 11 November 2022

2.6 Category Recommendations

	Intermediate Benchmark	Final Benchmark	Fund Allocation	Permitted Range	Recommendation (1)		Benchmark Relative Recommendation (1)	
			31 Oct-22		AF	DPF	AF	DPF
Growth Assets	56.0%	55.0%	54.9%	± 8%	54.0%	54.3%	(1.0%)	(0.7%)
Income Assets	24.0%	25.0%	26.2%	± 6%	27.0%	26.2%	+2.0%	+1.2%
Protection Assets	18.0%	18.0%	15.3%	± 5%	17.0%	16.5%	(1.0%)	(1.5%)
Cash	2.0%	2.0%	3.6%	0 – 8%	2.0%	3.0%	-	+1.0%

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

At an overall level, the Fund was overweight Income Assets and Cash at 31 October 2022, marginally underweight Growth Assets and underweight Protection Assets. As highlighted on page 2, commitments at 31 October 2022 totalled £285m, potentially increasing Growth Assets by 0.8% and Income Assets by 4.2%. 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 54.3% (0.7% underweight) (UK Equities -0.2%; North American Equities -1.1%; Japanese Equities –0.2%; Emerging Market Equities –0.1%; and Global Sustainable Equities +1.0%), maintain Income Assets at 26.2%; increase Protection Assets by 1.2% (Conventional Bonds +0.4%; Index-Linked Bonds +0.4%; and Corporate Bonds +0.4%), and reduce Cash by 0.6%.

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

2.7 Growth Assets

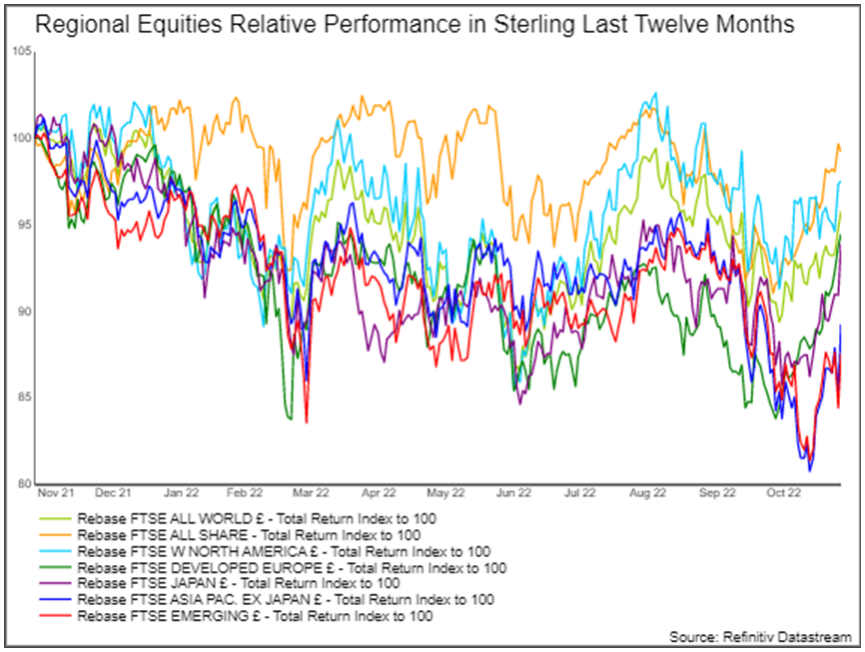
At 31 October 2022, the overall Growth Asset weighting was 54.9%, down from 55.6% at 31 July 2022, principally reflecting net divestment of £64m.

The IIMT recommendations in this report reduce the weighting to 54.3%, 0.7% underweight, reflecting the growth and valuation concerns, albeit flexibility will be required in response to changing economic and market conditions.

Equities have rallied in Q4-22 to date from YTD lows, particularly interest rate sensitive growth stocks, as investors started to price in the possibility of Central Banks adopting less restrictive monetary policy earlier than previously expected, a narrative that has recently been boosted by lower-than-expected US inflation data in October 2022.

However, despite the recent recovery in equities, there are remain some headwinds. In the short term, interest rates are likely to continue to rise, which will place further pressure on consumers who are already facing a cost-of-living crisis. Consumer confidence is already low and a further retrenchment by consumers may impact further on company earnings and economic activity.

The UK economy is already expected to fall into a recession, and revised GDP forecasts for the EU and US indicate that growth is set to stagnate in 2023; the risk of a recession for these economies cannot be ruled out. As a result, the IIMT recommends a cautious stance towards Growth Assets in the short-term.

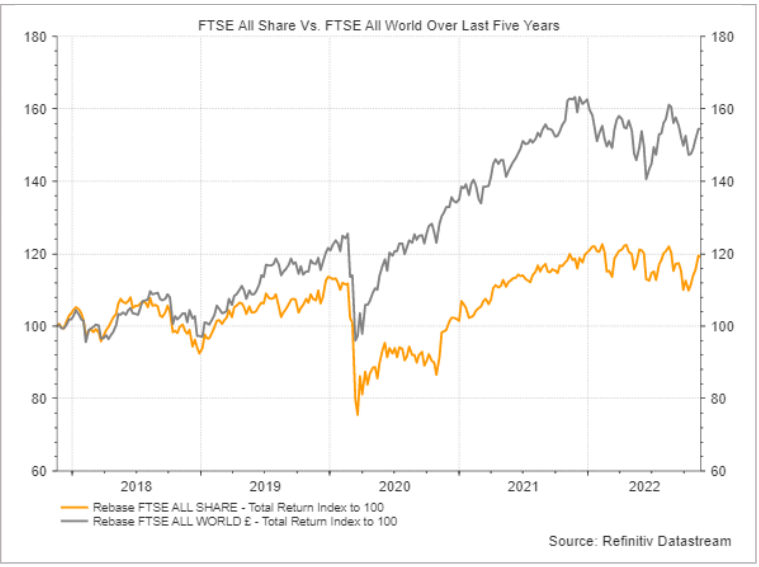


Benchmark Return	Currency	Q4-22 (*)	Q2-22	CYTD (*)	1 Year (**)	3 Year (**)	5 Year (**)	Since Last Committee (*)	L3M 31-Oct-22
Sterling Returns									
FTSE All World	GB£	6.1%	1.4%	(3.7%)	(3.6%)	7.7%	8.8%	(0.5%)	(2.3%)
FTSE UK	GB£	7.5%	(3.4%)	(0.9%)	(4.0%)	0.8%	2.2%	1.9%	(4.6%)
FTSE North America	GB£	5.7%	3.4%	(3.1%)	0.4%	11.5%	13.0%	(1.9%)	(0.5%)
FTSE Europe	GB£	13.1%	(2.0%)	(8.5%)	(9.5%)	5.1%	4.3%	7.7%	(2.9%)
FTSE Japan	GB£	6.5%	0.9%	(3.3%)	(13.6%)	1.2%	3.4%	5.4%	(4.7%)
FTSE Asia Pacific Ex-Japan	GB£	2.1%	(4.5%)	(7.6%)	(10.2%)	3.5%	4.0%	(4.2%)	(10.9%)
FTSE Emerging Markets	GB£	(0.8%)	(2.3%)	(7.9%)	(8.7%)	2.8%	3.5%	(6.0%)	(8.2%)
Local Currency Returns									
FTSE All World	US$	12.0%	(6.8%)	(16.3%)	(20.2%)	4.2%	4.9%	2.2%	(7.6%)
FTSE UK	GB£	7.5%	(3.5%)	(0.9%)	(4.0%)	0.8%	2.2%	1.9%	(2.3%)
FTSE North America	US$	11.5%	(4.9%)	(15.8%)	(16.9%)	7.9%	8.9%	0.7%	(5.9%)
FTSE Europe	€	13.2%	(4.1%)	(12.4%)	(17.1%)	1.5%	2.7%	6.6%	(5.3%)
FTSE Japan	¥	8.0%	(1.2%)	1.6%	(7.2%)	7.9%	4.8%	4.2%	0.2%
FTSE Asia Pacific Ex-Japan	US$	7.7%	(12.2%)	(19.7%)	(25.7%)	0.2%	0.2%	(1.6%)	(15.7%)
FTSE Emerging Markets	US$	4.7%	(10.1%)	(19.9%)	(24.2%)	(0.4%)	(0.2%)	(3.5%)	(13.1%)

Source: Performance Evaluation Limited & DPF analysis
(*) To 11 Nov-22
(**) To 30 Sept-22
CYTD = Calendar Year to 11 Nov-22

2.8 United Kingdom Equities

DPF Weightings	
Intermediate Neutral	14.0%
Final Neutral	12.0%
Actual 31.10.22	13.2%
AF Recommendation	13.0%
IIMT Recommendation	13.0%
Benchmark Returns (GB£)	
Q3 22/23 to 11 Nov-22	7.5%
Q2 22/23	(3.4%)
1 Year to Sept-22	(4.0%)
3 Years to Sept-22 (pa)	0.8%
5 Years to Sept-22 (pa)	2.2%



The Fund's UK Equity allocation fell from 13.3% at 31 July 2022 to 13.2% at 31 October 2022 (1.2% overweight), reflecting relative market weakness.

Mr Fletcher has increased his UK Equities recommended weight by 1.0% from 12.0% (neutral) to 13.0% (1.0% overweight), reflecting Mr Fletchers assessment of the relative value of UK Equities and Global Sustainable Equities.

The IIMT continues to favour UK Equities at the present time because of their defensive qualities. Lower valuations have offered a degree of protection against price-multiple compression, which has been experienced in the more expensive Growth focussed areas of the market. The UK index has also benefited from its structural exposure to Value stocks, in particular its overweight allocation to the energy sector, which has benefitted from higher global energy prices.

These characteristics have supported the defensive performance of the FTSE All Share in 2022 against a backdrop of sharply declining equity values globally. UK Equities have only declined by around 0.9% YTD, which compares favourably to the FTSE All World, which has lost over 16% of its value (in US dollar terms).

The IIMT believes that UK Equities still have the potential to outperform in the current environment given the backdrop of increased uncertainty around the inflationary outlook, the path for monetary policy and the increased risk of a global recession.

The IIMT recommends that the current overweight allocation of 1.2% is trimmed by 0.2% to 1.0% to 'lock-in' some of the relative YTD performance.

2.9 North American Equities

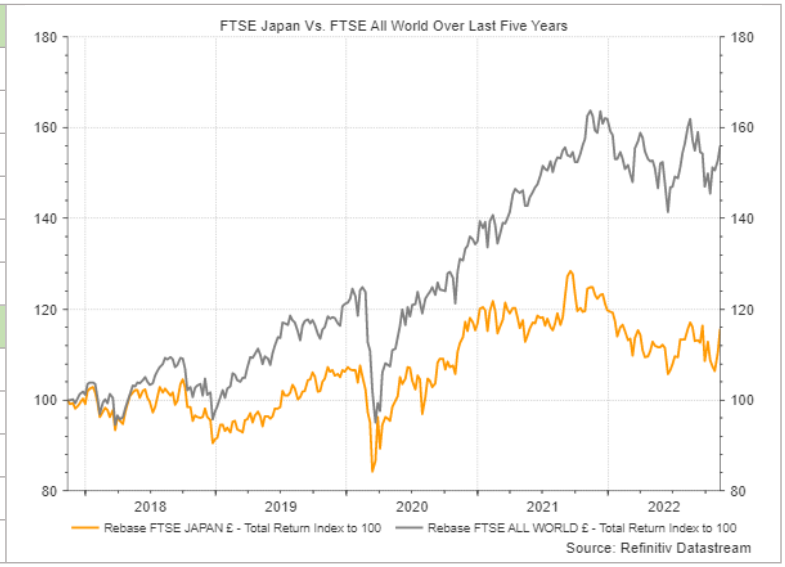
DPF Weightings	
Intermediate Neutral	6.0%
Final Neutral	-
Actual 31.10.22	1.1%
AF Recommendation	-
IIMT Recommendation	-
Benchmark Returns (GB£)	
Q3 22/23 to 11 Nov-22	5.7%
Q2 22/23	3.4%
1 Year to Sept-22	0.4%
3 Years to Sept-22 (pa)	11.5%
5 Years to Sept-22 (pa)	13.0%

The Fund's North American Equity allocation fell from 1.6% at 31 July 2022 to 1.1% at 31 October 2022 (1.1% overweight), principally reflecting net divestment of £34m.

Both Mr Fletcher and the IIMT recommended a zero-weighting to North American Equites in line with benchmark, with the divestment proceeds of around £60m being switched into Global Sustainable Equities. It should be noted that North American Equities account for around 60% of the typical Global Sustainable Equities portfolio.

2.10 Japanese Equities

DPF Weightings	
Intermediate Neutral	5.0%
Final Neutral	5.0%
Actual 31.10.22	5.2%
AF Recommendation	5.0%
IIMT Recommendation	5.0%
Benchmark Returns (GB£)	
Q3 22/23 to 11 Nov-22	6.5%
Q2 22/23	0.9%
1 Year to Sept-22	(13.6%)
3 Years to Sept-22 (pa)	1.2%
5 Years to Sept-22 (pa)	3.4%



The Fund's allocation to Japanese Equities remained flat between 31 July 2022 and 31 October 2022 at 5.2%; 0.2% overweight.

Mr Fletcher recommends a neutral weighting relative to the benchmark.

The IIMT continues to favour Japanese Equities for their sector diversification, lower valuations and defensive performance during periods of increased uncertainty. Japanese Equities have performed well in 2022 YTD against a challenging global backdrop of sharply lower prices. In local currency terms, Japanese Equities have returned +1.6%.

Traditionally, the Japanese Yen has been viewed as a safe-haven asset which rises during periods of uncertainty, which increases the returns for sterling investors in Japanese assets. However, the Bank of Japan has maintained its accommodative monetary policy and yield curve control at a time when US bond yields have risen sharply. The divergence in yields has led to the depreciation of the Yen, as investors have favoured dollar-denominated assets. In sterling terms, Japanese Equities have therefore lost 3.3% YTD.

The IIMT believes that Japanese Equities remain reasonable value. The IIMT recommends that the Fund's 0.2% overweight allocation is reduced to a neutral weight of 5.0%.

2.11 Emerging Market Equities

DPF Weightings	
Intermediate Neutral	5.0%
Final Neutral	5.0%
Actual 31.10.22	5.1%
AF Recommendation	5.0%
IIMT Recommendation	5.0%
Benchmark Returns (GB£)	
Q3 22/23 to 11 Nov-22	(0.8%)
Q2 22/23	(2.3%)
1 Year to Sept-22	(8.7%)
3 Years to Sept-22 (pa)	2.8%
5 Years to Sept-22 (pa)	3.5%

Relative market weakness reduced the Fund's allocation to Emerging Market Equities from 5.4% at 31 July 2022 to 5.1% at 31 October 2022; 0.1% overweight.

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 close to 20% YTD. However, due to the relative strength of the US dollar relative to the pound, the index has lost around 8% when translated into Sterling.

China, which makes up around a third of the index, has fallen more than 21% YTD in Sterling. 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. Latin American equities have been the best performing region, returning 30% YTD in Sterling. The region is a net exporter of commodities and has been a major beneficiary of the sharp rise in commodity prices.

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 therefore recommends a neutral allocation of 5%, 0.1% lower than that reported at 31 October 2022.

2.12 Global Sustainable Equities

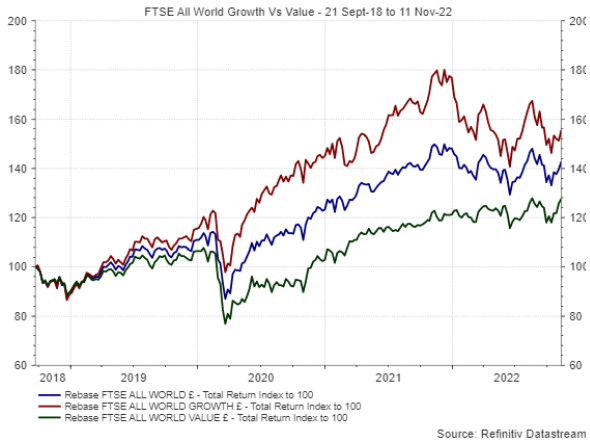
DPF Weightings	
Intermediate Neutral	16.0%
Final Neutral	29.0%
Actual 31.10.22	25.3%
AF Recommendation	27.0%
IIMT Recommendation	26.3%
Benchmark Returns (GB£)	
Q3 22/23 to 11 Nov-22	6.1%
Q2 22/23	1.6%
1 Year to Sept-22	(3.3%)
3 Years to Sept-22 (pa)	8.0%
5 Years to Sept-22 (pa)	8.8%

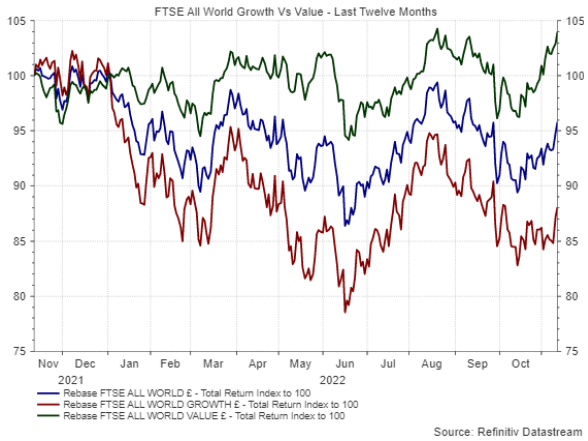
The Fund's allocation to Global Sustainable Equities increased from 24.8% at 31 July 2022 to 25.3% at 31 October 2022 (3.7% underweight) reflecting relative market strength.

Mr Fletcher recommends a 2.0% underweight allocation of 27.0% to Global Sustainable Equities, down from a neutral weighting recommendation of 29.0% at 31 July 2022. Mr Fletcher believes that while the medium-term outlook for equities has improved following the recent market sell-off, inflation has not yet peaked, interest rates have further to rise and there is growing economic uncertainty. As a result, Mr Fletcher is cautious about equity markets in the short-term, particularly in the more interest rate sensitive growth sectors. As noted earlier, Global Sustainable Equity portfolios are typically tilted towards growth stocks.

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 since index inception in Sept-18, 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 rallied over the last twelve months as both economic activity, and in particular, forward interest rate expectations increased, albeit growth stocks started to rally in July and August 2022 as markets began to price in interest rate cuts by the US Fed in 2023 against a weaker growth outlook. The rally faded in September and October 2022 but returned in November 2022, when equity markets responded positively to lower-than-expected US inflation numbers for October 2022, which may suggest that US inflation has peaked. The US Federal Reserve remains relatively hawkish, albeit the US central bank has indicated that the rate of interest rate rises is likely to slow moving forward. The focus is likely to switch to the quantum of the ultimate target interest rate, and it is too early to call the peak in US inflation.

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 underweight allocation of 0.7% to Growth Assets, with the recommended 2.7% underweight in respect of Global Sustainable Equities being used to fund overweight allocations in respect of UK Equities (1.0%) and Private Equity (1.0%).

Any flexibility in the stance on Growth Assets in response to changing economic, inflationary and monetary conditions will likely be reflected in the Fund's weighting in Global Sustainable Equities.

2.13 Private Equity

DPF Weighting					
Intermediate Netural	Final Neutral	Actual 31.10.22	Committed 31.10.22	AF Recommendation	IIMT Recommendation
4.0%	4.0%	5.0%	5.8%	4.0%	5.0%
Benchmark Returns (GB£)					
Q3 22/23 to 11 Aug-22	Q2 22/23	1 Year to Sept-22	3 Years to Sept-22 (pa)	5 Years to Sept-22 (pa)	
6.4%	1.8%	(4.7%)	1.2%	2.8%	

The Fund's Private Equity weighting increased by 0.2% between 31 July 2022 and 31 October 2022 to 5.0% (1.0% overweight) reflecting relative market strength.

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

The IIMT notes that the Fund is 1.8% overweight to Private Equity on a committed basis at 31 October 2022. As a result, the Fund is not considering any further commitments to the asset class at present.

The IIMT recommends maintaining the current Private Equity allocation of 5.0% (1.0% overweight) (5.8% on a committed basis).

2.14 Income Assets

At 31 October 2022, the overall weighting in Income Assets was 26.2% (1.2% overweight), 1.0% higher than that reported at 31 July 2022, reflecting net investment of around £20m, together with relative market strength. The IIMT recommendations below maintain the weighting at 26.2%; 30.4% on a committed basis.

2.15 Multi Asset Credit

DPF Weighting				
Intermediate Neutral	Final Neutral	Actual 31.10.22	AF Recommendation	IIMT Recommendation
6.0%	6.0%	6.8%	8.0%	6.8%
Benchmark Returns (GB£)				
Q3 22/23 to 11 Nov-22	Q2 22/23	1 Year to Sept-22	3 Years to Sept-22 (pa)	5 Years to Sept-22 (pa)
1.5%	1.6%	(1.7%)	2.2%	2.8%

The Fund's allocation to Multi-Asset Credit increased from 6.6% at 31 July 2022 to 6.8% at 31 October 2022 (0.8% overweight), principally reflecting relative market strength.

Mr Fletcher recommends a 2.0% overweight allocation of 8.0% to Multi-Asset Credit, funded from a 1.0% underweight allocation to both Global Sustainable Equities and Conventional Bonds. Mr Fletcher notes that spreads have narrowed slightly since the end of Q3-22 but the overall yield available combined with the low duration and floating rate nature of many of the assets suggests to Mr Fletcher than Multi-Asset Credit remains attractive, relative to longer duration assets in a rising interest rate environment.

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). 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 6.8% is maintained (0.8% overweight); 8.7% on a committed basis.

2.16 Property

DPF Weighting				
Intermediate Neutral	Final Neutral	Actual 31.10.22	AF Recommendation	IIMT Recommendation
9.0%	9.0%	8.8%	9.0%	8.8%
Benchmark Returns (GB£)				
Q3 22/23 to 11 Nov-22	Q2 22/23	1 Year to Sept-22	3 Years to Sept-22 (pa)	5 Years to Sept-22 (pa)
Not Available	(4.1%)	12.2%	6.8%	6.1%

The Fund's allocation to Property fell by 0.1% to 8.8% at 31 October 2022, reflecting net divestment of around £6m, principally in respect of Indirect Property funds in unwind, and relative market weakness. Direct Property accounted for 6.0% (up 0.1%, neutral) and Indirect Property accounted for 2.8% (down 0.2%, 0.2% underweight).

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 in the medium term, funded from realisations out of the Indirect Property allocation. However, Mr Fletcher believes that there may be a short-term opportunity for the Fund to take advantage of distressed selling by other investors by increasing the Fund's exposure to Indirect Property Assets.

The Fund's Direct Property manager notes that Q3-22 was a politically turbulent one, which has not helped an already challenging economic landscape. The short-lived Liz Truss premiership and the September 2022 'mini-budget' adversely impacted financial markets' confidence in the UK's ability to deal with the economic challenges that have arisen. Whilst a new Prime Minister is now in place, inflation has continued its upward trajectory, and the BoE increased the bank rate by 0.75% to 3.0% on 3 November 2022.

The effect of this political and economic turbulence on the UK commercial property investment market has been a sharp reversal in sentiment compared to the first half of the year and capital values fell over the quarter to the end of September as a result. Capital value growth in Q3-22, as measured by the MSCI Quarterly Index, was -5.1%, with the total return, once income return had been accounted for, being -4.2%. The current void rate within the portfolio is 5.6% (Q2-22: 6.9%), 2.4% lower than the benchmark void rate of 8.0%. The manager believes that with a pricing correction underway, this may provide the Fund with opportunities to invest in good quality assets at pricing levels significantly lower than previously obtainable. Rather than a structural change in the attraction or otherwise of commercial property investment, the market is re-calibrating to changing financial conditions. Those sectors with good underlying occupier market fundamentals will be best placed when positive investor sentiment returns. The manager will continue to focus on those sectors that provide such fundamentals, and these include the industrial, food store and retail warehousing sectors and some alternative sub-sectors.

The IIMT recommends that the Fund's allocation to Direct Property is maintained at 6.0% (neutral), together with maintaining the Indirect Property weighting at 2.8% (0.2% underweight). The IIMT recommends 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.

2.17 Infrastructure

DPF Weighting					
Intermedidate Neutral	Final Neutral	Actual 31.10.22	Committed 31.10.22	AF Recommendation	IIMT Recommendation
9.0%	10.0%	10.6%	12.9%	10.0%	10.6%
Benchmark Returns (GB£)					
Q3 22/23 to 11 Nov-22	Q2 22/23	1 Year to Sept-22	3 Years to Sep-22 (pa)	5 Years to Sept-22 (pa)	
0.5%	0.9%	2.8%	2.4%	2.6%	

The Fund's allocation to Infrastructure increased from 9.7% at 31 July 2022 to 10.6% at 31 October 2022 (0.6% overweight), largely reflecting net investment of £26m, together with relative market strength.

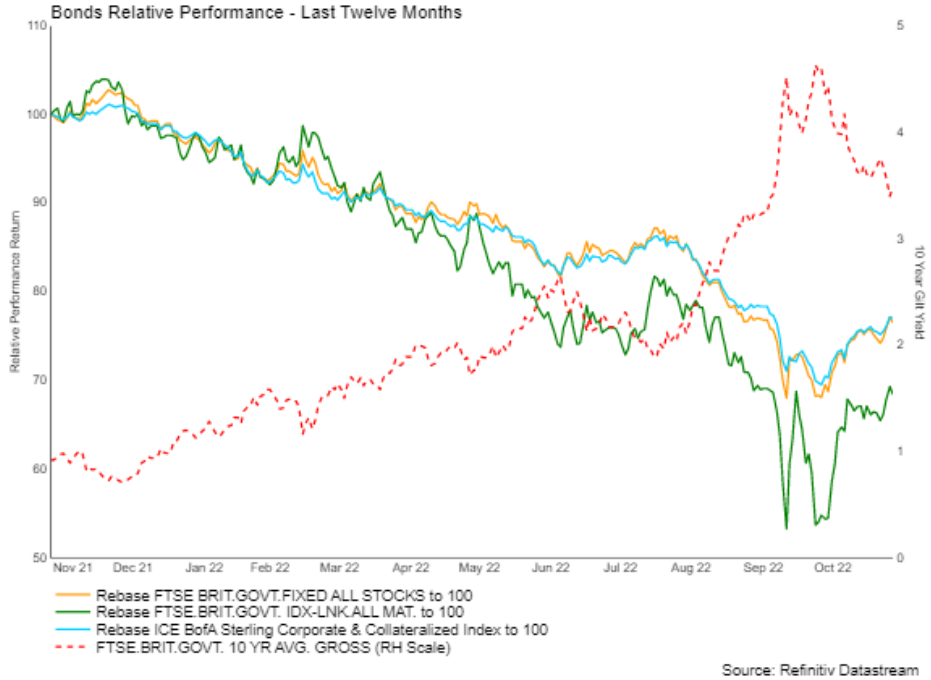
Mr Fletcher recommends a neutral weighting relative to the final benchmark of 10.0% allocation.

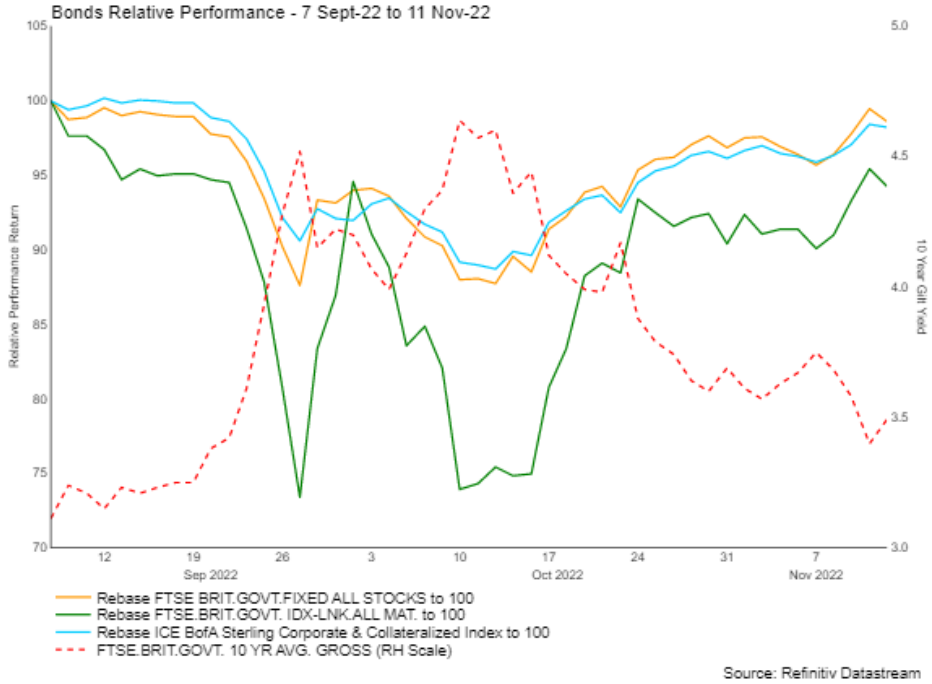
The IIMT continues to view Infrastructure as an attractive long-term asset class and favours a bias towards core infrastructure assets or renewable energy assets. These assets can offer low volatility; low correlation to equity and fixed income markets; and reliable long-term cash flows.

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 maintained at 10.6% (0.6% overweight); 12.9% on a committed basis. Given the current committed weight of 12.9%, the IIMT is not reviewing new opportunities at the current time.

2.18 Protection Assets



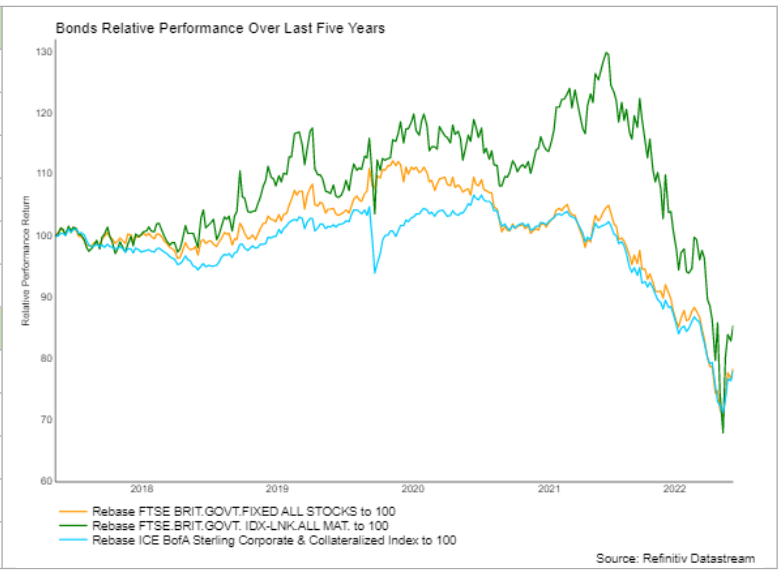


The weighting in Protection Assets at 31 October 2022 was 15.3%, 0.7% lower than that reported at 31 July 2022. Net investment of £20m was offset by relative market weakness. The IIMT recommendations below increase the weighting by 1.2% to 16.5%.

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. UK bond yields were extremely volatile in Q3-22, particularly in response to the UK Governments ‘mini-budget’ in September 2022. The ‘mini-budget’ was followed by a sharp sell-off in long-dated gilts (pushing up yields), and the BoE was forced into the temporary purchases of government bonds to ensure that the market continued to function properly. Whilst the UK bond markets have subsequently stabilised and prices have risen (pushing down yields), UK investor confidence appears low.

2.19 Conventional Bonds

DPF Weightings	
Intermediate Neutral	6.0%
Final Neutral	6.0%
Actual 31.10.22	4.6%
AF Recommendation	5.0%
IIMT Recommendation	5.0%
Benchmark Returns (GB£)	
Q3 22/23 to 11 Nov-22	5.0%
Q2 22/23	(12.8%)
1 Year to Sept-22	(23.3%)
3 Years to Sept-22 (pa)	(9.6%)
5 Years to Sept-22 (pa)	(3.4%)



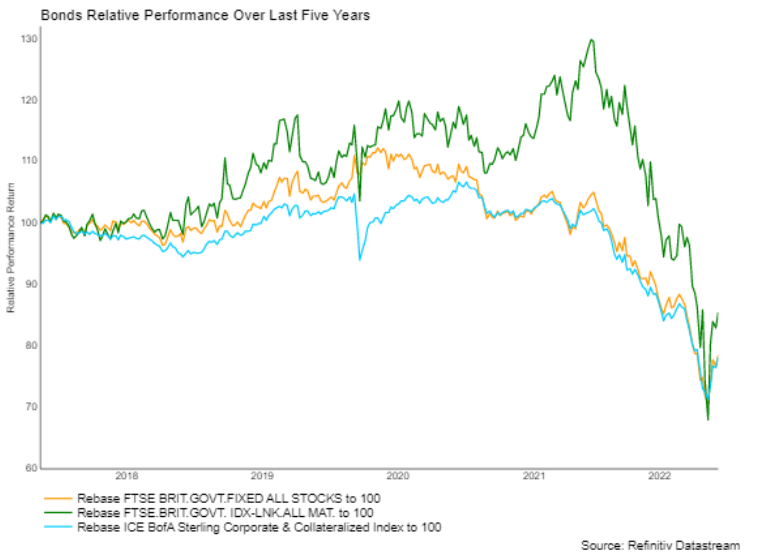
The Fund's allocation to Conventional Bonds remained flat at 4.6% (1.4% underweight) between 31 July 2022 and 31 October 2022, with net investment of £10m being offset by relative market weakness. The Fund's allocation at 31 October 2022 comprised 80% UK Gilts and 20% US Treasuries.

Mr Fletcher has maintained his recommended 1.0% underweight allocation to Conventional Bonds. Despite the increase in bond yields since Mr Fletcher's last report, Mr Fletcher still expects yields to rise as interest rates are increased, albeit noting that in 12 months' time slower growth and lower inflation could mean that bond yields start to fall even if there have been no cuts in interest rates As a result, Mr Fletcher has a negative outlook in respect of Conventional Bonds in the near term, instead favouring Index-Linked Bonds and Corporate 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% (1.0% underweight) which is in line with Mr Fletcher's recommendation.

2.20 Index-Linked Bonds

DPF Weightings	
Intermediate Neutral	6.0%
Final Neutral	6.0%
Actual 31.10.22	5.1%
AF Recommendation	6.0%
IIMT Recommendation	5.5%
Benchmark Returns (GB£)	
Q3 22/23 to 11 Nov-22	(0.2%)
Q2 22/23	(9.3%)
1 Year to Sept-22	(25.9%)
3 Years to Sept-22 (pa)	(9.2%)
5 Years to Sept-22 (pa)	(2.1%)



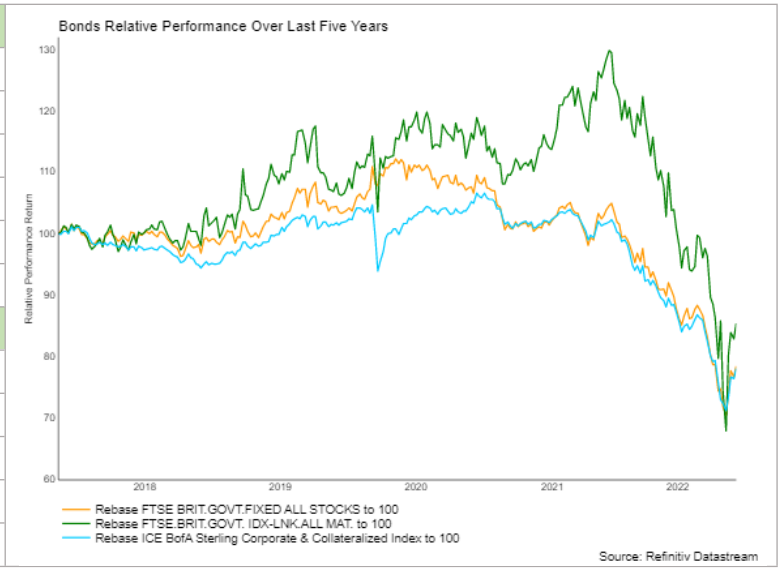
The Fund's allocation to Index-Linked Bonds fell from 5.5% at 31 July 2022 to 5.1% at 31 October 2022; 0.9% underweight. Net investment of £10m was offset by relative market weakness. The Fund's allocation at 31 October 2022 comprised 80% UK Index-Linked Bonds (UK Linkers) and 20% US Treasury Inflation Protected Bonds (US TIPS).

Mr Fletcher has maintained his 6.0% (neutral) allocation to Index-Linked Bonds. Whilst Mr Fletcher still expects yields to rise in the short term, as interest rates are increased, Mr Fletcher believes that Index-Linked Gilts and Corporate Bonds have become more attractive as a medium-term investment.

The IIMT believes that current yields, together with the potential for a longer-term period of elevated inflation, supports the Fund's allocation to Index-Linked Bonds. As a result, the IIMT recommends increasing the weighting to 5.5%; 0.5% underweight.

2.21 Corporate Bonds

DPF Weightings	
Intermediate Neutral	6.0%
Final Neutral	6.0%
Actual 31.10.22	5.6%
AF Recommendation	6.0%
IIMT Recommendation	5.5%
Benchmark Returns (GB£)	
Q3 22/23 to 11 Nov-22	4.3%
Q2 22/23	(8.7%)
1 Year to Sept-22	(21.0%)
3 Years to Sept-22 (pa) (1)	n/a
5 Years to Sept-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 5.9% at 31 July 2022 to 5.6% at 31 October 2022.

Mr Fletcher has increased his previous 1.0% underweight allocation to Corporate Bonds to 6.0% neutral. Whilst Mr Fletcher still expects yields to rise in the short term, as interest rates are increased, Mr Fletcher believes that Index-Linked Gilts and Corporate Bonds have become more attractive as a medium-term investment.

The IIMT believes that the spread on investment grade bonds is now relatively attractive and investment grade bonds are likely to be more defensively positioned relative to risk-on assets (e.g. equities), should markets experience further periods of weakness. However, the challenging economic backdrop increases the risk of a rise in corporate defaults. The IIMT recommends increasing the current allocation to Corporate Bonds of 5.6% (0.4% underweight) to 6.0% (neutral).

2.22 Cash

The Cash weighting at 31 October 2022 was 3.6% (1.6% overweight), up from 3.2% at 31 July 2022, principally reflecting net divestment across the total portfolio of around £30m 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 and whilst investor confidence has shown signs of improvement, several significant headwinds remain which could see this reverse, including a slowdown in global activity, continuing inflationary pressures, rising interest rates, energy security concerns, tight global supply chains, the conflict between Russia and Ukraine, China's zero Covid-19 policy and the outcome of the US mid-term elections, which could result in political gridlock, with the Democrats controlling the Senate and the Republicans controlling the House of Representatives.

The IIMT recommends a defensive cash allocation of 3.0% (1.0% overweight) 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 £100m over the course of the next twelve months).

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 October 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.

Report Author: **Neil Smith**

Contact details: **neil.smith2@derbyshire.gov.uk**

Appendix 1

Implications

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