FOR PUBLICATION

DERBYSHIRE COUNTY COUNCIL

PENSIONS AND INVESTMENTS COMMITTEE

WEDNESDAY, 6 SEPTEMBER 2023

Report of the Director - 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 on 31 July 2023 and the recommendations of the Director of Finance & ICT and Mr Fletcher, in relation to the Fund's strategic asset allocation benchmark (SAAB), 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, Infrastructure, Multi-Asset Credit and currently total around £203m. 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		Adjusted for Commitments (1)	Benchmark Sterling Return	Benchmark Sterling Return
		30/4/23	31/7/23		AF 6/9/23	DPF 6/9/23	AF 6/9/23	DPF 6/9/23	DPF 6/9/23	3 Months to 30/6/23	3 Months to 31/7/23
Growth Assets	**55.0%**	**55.5%**	**56.4%**	**+/- 8%**	**(1.0%)**	**-**	**54.0%**	**55.0%**	**55.6%**	**n/a**	**n/a**
UK Equities	12.0%	12.9%	12.5%	+/- 4%	+1.0%	+0.1%	13.0%	12.1%	12.1%	(0.5%)	(1.2%)
Global Equities:	39.0%	37.7%	38.9%	+/- 8%	(2.0%)	(1.0%)	37.0%	38.0%	38.0%	n/a	n/a
Japan	5.0%	5.4%	5.5%	+/- 2%	-	-	5.0%	5.0%	5.0%	3.0%	6.3%
Emerging Markets	5.0%	5.3%	5.5%	+/- 2%	-	-	5.0%	5.0%	5.0%	(2.0%)	5.7%
Global Sustainable	29.0%	27.0%	27.9%	+/- 8%	(2.0%)	(1.1%)	27.0%	27.9%	27.9%	3.3%	5.3%
Private Equity	4.0%	4.9%	5.0%	+/- 2%	-	+1.0%	4.0%	5.0%	5.6%	3.4%	5.5%
Income Assets	**25.0%**	**25.8%**	**25.8%**	**+/- 6%**	**+2.0%**	**+0.8%**	**27.0%**	**25.8%**	**28.7%**	**n/a**	**n/a**
Multi-Asset Credit	6.0%	7.1%	7.4%	+/- 2%	+2.0%	+1.5%	8.0%	7.5%	8.7%	2.4%	2.5%
Infrastructure	10.0%	10.9%	10.7%	+/- 3%	-	+0.9%	10.0%	10.9%	12.6%	1.6%	1.6%
Direct Property (3)	6.0%	5.6%	5.5%	+/- 2%	-	(0.5%)	6.0%	5.5%	5.5%	0.2%	0.2% (2)
Indirect Property (3)	3.0%	2.2%	2.2%	+/- 2%	-	(1.1%)	3.0%	1.9%	1.9%	0.9%	0.9% (2)
Protection Assets	**18.0%**	**15.1%**	**14.6%**	**+/- 5%**	**(1.0%)**	**(2.0%)**	**17.0%**	**16.4%**	**16.4%**	**n/a**	**n/a**
Conventional Bonds	6.0%	4.7%	4.5%	+/- 2%	(1.0%)	(0.8%)	5.0%	5.2%	5.2%	(5.4%)	(3.1%)
Index-Linked Bonds	6.0%	4.7%	4.5%	+/- 2%	-	(0.8%)	6.0%	5.2%	5.2%	(6.6%)	(3.3%)
Corporate Bonds	6.0%	5.7%	5.6%	+/- 2%	-	-	6.0%	6.0%	6.0%	(1.7%)	(0.8%)
Cash	**2.0%**	**3.6%**	**3.2%**	**0 – 8%**	**-**	**+0.8%**	**2.0%**	**2.8%**	**(0.7%)**	**1.1%**	**1.2%**

Investment Assets totaled £6,004m at 31 Jul-23

(1) Adjusted for investment commitments at 31 Jul-23. Presumes all commitments funded from Cash.
(2) Benchmark Return for the three months to 30 Jun-23.
(3) The maximum permitted range in respect of Property is +/- 3%.

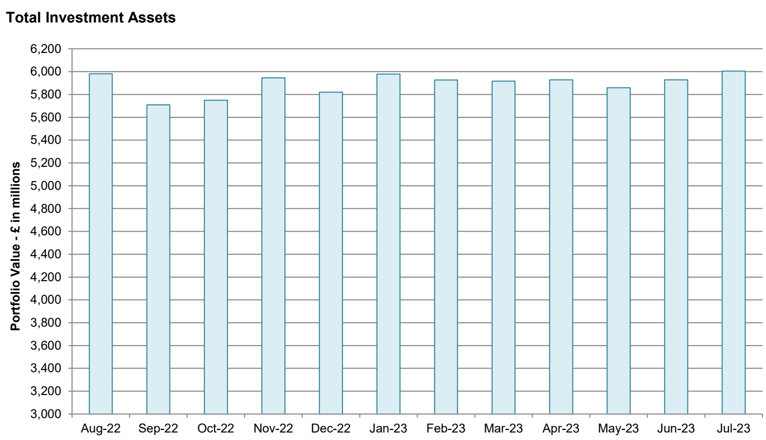
The table above reflects the following three categorisations:

- **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 on 31 July 2023, was overweight Growth Assets (1.4%), Income Assets (0.8%) and Cash (1.2%) and underweight Protection Assets (-3.4%). 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 -0.7%. 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.

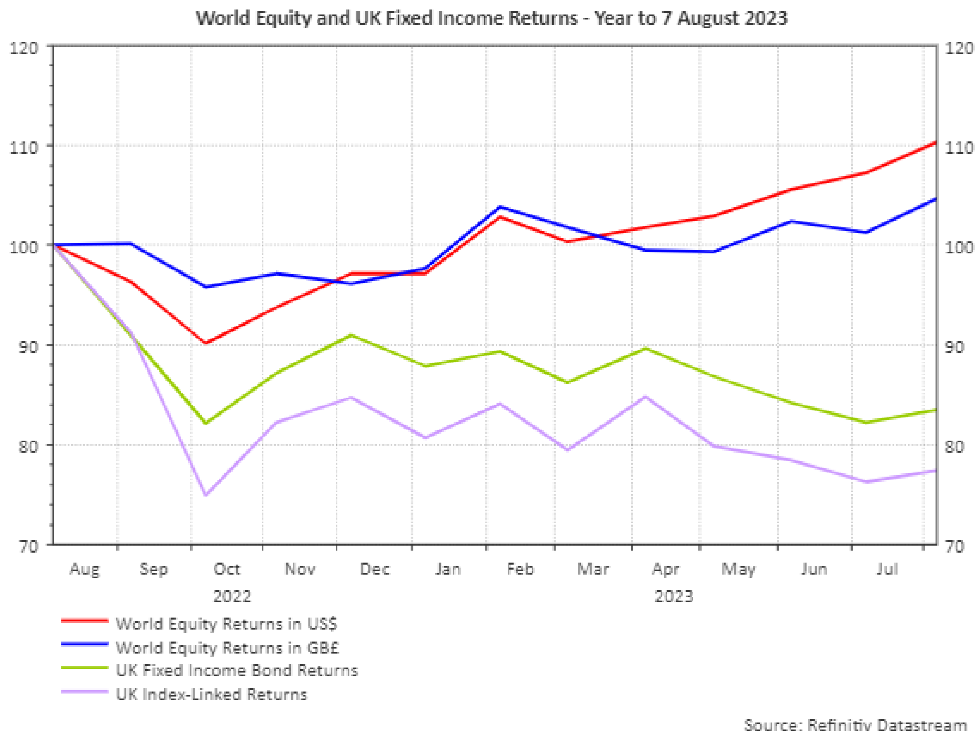
2.3 Total Investment Assets

The value of the Fund's investment assets increased by £76m (+1.3%) between 30 April 2023 and 31 July 2023 to £6.004bn, comprising a non-cash market gain of around £61m and cash inflows from dealing with members and investment income of around £15m. Over the twelve months to 30 April 2023, the value of the Fund's investment assets increased by £2m (+0.1%), comprising cash inflows from dealing with members & investment income of around £60m, largely offset by a non-cash market loss of around £58m.



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 on 31 July 2023 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 7 August 2023.

Global Equities (as measured by the FTSE All World) delivered a positive return of 4.7% in sterling terms over the 12-month period ending 7 August 2023 (10.8% in US dollar terms). However, bond returns have been negative over the comparable period. UK Conventional Gilts experienced a decline in value of 16.5%, while UK Index-Linked Bonds fell by 22.6%. The decline in bond values reflects higher market interest rates, as bond prices move inversely to yields. Central Banks have increased interest rates in response to higher inflation, with tighter financial conditions expected to reduce inflationary pressures.

Year-to-date (YTD)[1], equity markets have continued to deliver positive returns. At a headline level, Global Equities are up 9.1% in sterling terms, with almost half of the return delivered across June and July alone. Investor sentiment has started to improve recently as inflation has started to trend downwards, and contagion risks from US and European banking failures appear to have been effectively contained. Whilst headline figures appear very positive, the returns have primarily been driven by the ‘Magnificent

[1] Year to Date 1 Jan-23 to 7 Aug-23

Seven'[2], a small group of US technology / high growth companies which have achieved exceptional YTD returns. The group has an average YTD sterling return of 85%. These seven names now account for around 16% of the global listed equity market, significantly increasing market concentration risk, and are equivalent to the combined market-cap weights of the UK, Japanese, French and Chinese listed equity markets. Excluding these names, YTD equity returns have been much more muted. The narrow focus of YTD equity gains may suggest that investors are still cautious over the prospects for the global economy and corporate earnings.

Bond markets have continued to post negative returns, albeit the losses in 2023 have moderated in contrast to the significant declines experienced in 2022. Conventional Gilts have lost -4.0% of their value YTD, whereas Index-Linked Gilts had declined by -4.7%.

In the US, the rate of inflation has consistently fallen over the last twelve months to stand at 3.0% on 7 Aug-23, only marginally above the US Federal's Reserves (US Fed) 2% target. This is a significant decline from the peak in US inflation of 9.1% in June 2022 and from the rate of 6.5% inflation at the end of 2022. In the UK, inflation has proven to be much stickier, having peaked higher, at 11.1% in October 2022, and subsequently declining at a slower pace. The UK inflation rate currently stands at 7.9%, almost 6% higher than the Bank of England's (BoE) 2% target.

Central Banks have consistently raised interest rates over the last 12 months to push financial conditions into 'restrictive territory'. The aim of restrictive monetary policy is to reduce demand and slow economic activity, reducing price rises. In July 2023, the US Fed raised rates by an additional 0.25%, following a temporary pause in June 2023 to evaluate the impact of previous rate rises and regional US bank failures. This brought rates to a target range of 5.25% to 5.50%, the highest level since August 2007. During the press conference that followed the meeting, US Fed Chair Jerome Powell emphasised the committee's continued attentiveness to inflation risks and that further potential rate increases would be entirely data dependent. While there is a growing consensus that the US Fed has likely completed its tightening cycle, there remains a reasonable possibility of a further 0.25% increase to ensure inflation is fully controlled and returned to the 2% target.

In August 2023, the UK's Monetary Policy Committee (MPC) made its fifth rate increase of 2023, raising rates by 0.25% to 5.25%. This marks the

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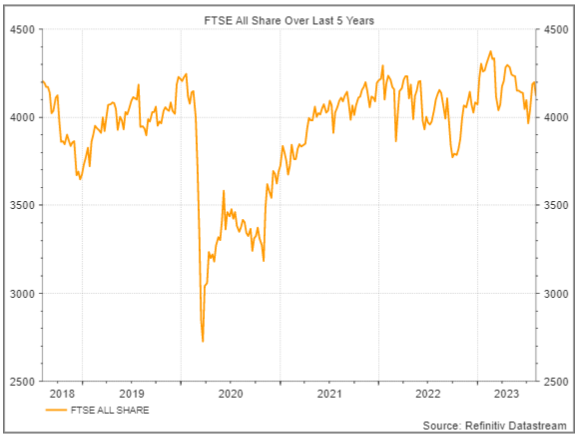
[2] Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia and Tesla

highest level since September 2008 and the 14th increase in the current cycle. Andrew Bailey, the BoE Governor, emphasised that rates in the UK will potentially need to move higher and remain in restrictive territory for a longer period 'in order to get inflation back to target'. The MPC does not expect inflation to reach the 2% target until midway through 2025. As such, market pricing currently suggest that UK interest rates could peak at slightly above 6.0% in Q1-24 and that it will take up until Q4-25 for rates to fall back below 5.0%.

Whilst there have been improvements in inflation data, economic data releases have become increasingly negative, highlighting the detrimental impact of higher interest rates on economic activity. A key focus for investors now is whether inflation can be brought under control without tipping economies into recession, which is known as a 'soft landing'. In the US and Eurozone, weak manufacturing output is weighing on economic growth, particularly in Europe where manufacturing surveys declined for a fourth consecutive month to a hit a 10-month low. The UK economy also appears to be experiencing a notable slowdown, as manufacturing and services purchasing managers' indices both fell to a year-to-date low in July 2023. Although the BoE is no longer forecasting that the UK economy will fall into a recession, the outlook for growth is subdued, with the Monetary Policy Committee expecting the UK economy to grow at approximately 0.5% per annum over its 3-year projection period, considerably below the pre-Covid trend.

The IIMT is maintaining a relatively cautious stance as it continues to believe that headwinds remain. Although, there is evidence of a downward inflation in inflation, there is still a long way to go in the UK and there are emerging signs that higher interest rates are starting to negatively impact economic activity. It is also unclear how the on-going cost of living crisis, together with ongoing inflation pressures, higher interest rates and tighter financial credit conditions will impact economic activity and corporate earnings over the next twelve months.

Asset class weightings and recommendations are based on values at the end of July 2023. As shown in the charts below, both the UK FTSE All Share and US S&P 500 are now trading towards the top end of their 30-year trading range.



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 2023.

Per annum	DPF	Benchmark Index
1 year	3.1%	2.8%
3 years	4.8%	4.4%
5 years	4.0%	3.7%
10 years	6.8%	6.4%

The Fund outperformed the benchmark over all time periods.

2.6 Category Recommendations

	Benchmark	Fund Allocation	Permitted Range	Recommendation		Benchmark Relative Recommendation	
		31 Jul-23		AF	DPF	AF	DPF
Growth Assets	55.0%	56.4%	± 8%	54.0%	55.0%	(1.0%)	-
Income Assets	25.0%	25.8%	± 6%	27.0%	25.8%	+2.0%	+0.8%
Protection Assets	18.0%	14.6%	± 5%	17.0%	16.4%	(1.0%)	(1.6%)
Cash	2.0%	3.2%	0 – 8%	2.0%	2.8%	-	+0.8%

At an overall level, the Fund was overweight Growth Assets, Income Assets and Cash on 31 July 2023, and underweight Protection Assets. As highlighted on page 2, commitments on 31 July 2023 totalled around £203m, potentially increasing Growth Assets by 0.6% and Income Assets by 2.9. The table on page 3 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 1.4% to 55.0% (neutral) (UK Equities -0.4%; Japanese Equities –0.5%; and Emerging Market Equities -0.5%), maintain Income Assets at 25.8% (MAC +0.1%; Infrastructure +0.2%: and Indirect Property -0.3%); increase Protection Assets by 1.8% (Conventional Bonds +0.7%; Index-Linked Bonds +0.7% and Corporate Bonds +0.4%), and reduce Cash by 0.4%.

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 recent levels of cash, reflecting both the general market uncertainty and cash held to fund existing commitment drawdowns.

2.7 Growth Assets

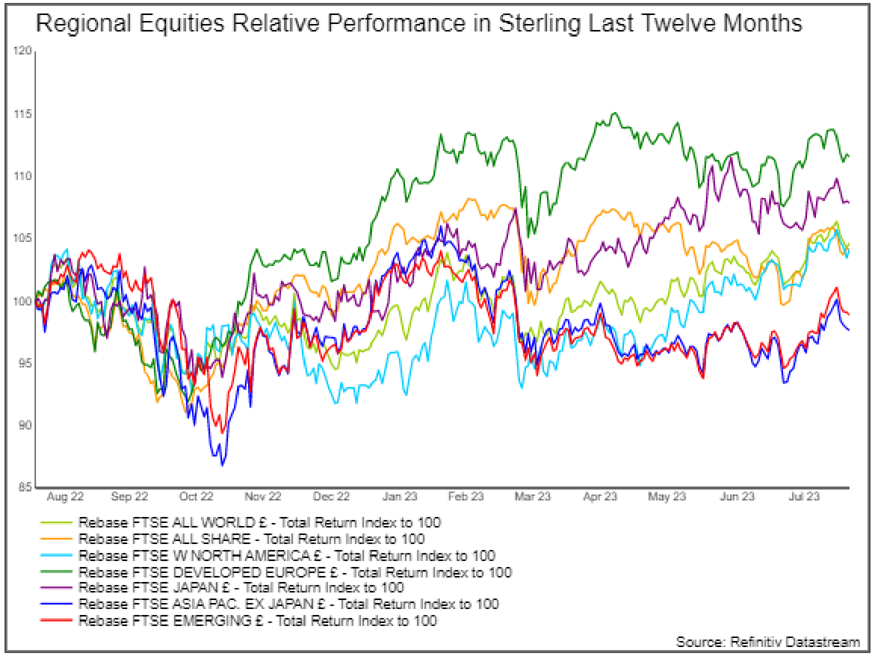
On 31 July 2023, the overall Growth Asset weighting was 56.4%, up from 55.5% on 30 April 2023, reflecting relative market strength.

The IIMT recommendations in this report reduce the weighting to 55.0%, neutral, albeit flexibility will be required in response to changing economic and market conditions. Excluding highly illiquid Private Equity (5.0% on 31 July 2023), the recommended listed equity weight is 50.0%, 1.0% underweight.

Mr Fletcher recommends an unchanged overall 1.0% underweight allocation of 54.0% to Growth Assets. Mr Fletcher notes that he remains cautious on equity markets, especially US Technology stocks which have reported significant YTD price earnings multiple expansion.

The IIMT notes that whilst global equities have returned +9.1% YTD, a significant portion of this return has been driven by the 'Magnificent Seven'. The very narrow focus of this year's rally has increased concentration risk and leaves equities vulnerable to sudden changes in sentiment.

Whilst the IIMT remains optimistic about the long-term potential for Growth Assets, the IIMT recommends a relatively cautious stance at present given the recent deterioration in global economic data as the IIMT assesses the potential short to medium term impact on corporate earnings, which the IIMT believes is one of the most important drivers of long-term equity returns.

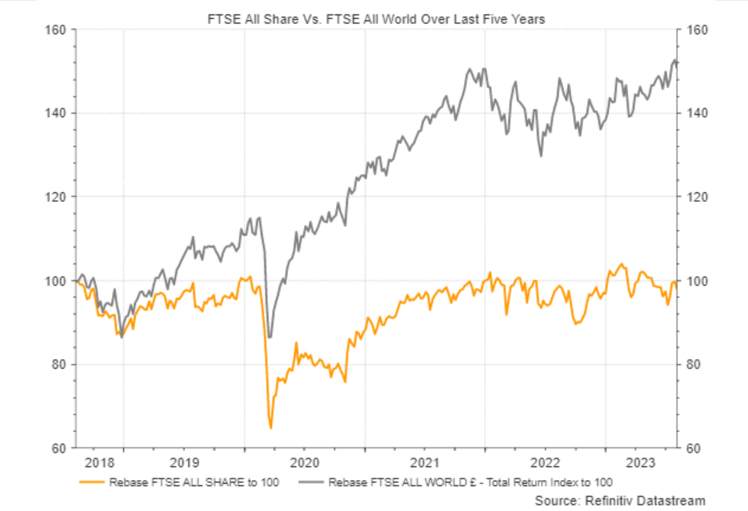


Benchmark Return	Currency	Q3-23 (*)	Q2-23	1 Year (**)	3 Year (**)	5 Year (**)	Since Last Committee (*)	L3M 31-Jul-23	YTD 07-Aug-23	L12M 07-Aug-23
Sterling Returns										
FTSE All World	GB£	1.2%	3.4%	11.7%	10.4%	9.4%	2.2%	6.0%	9.1%	4.7%
FTSE UK	GB£	0.9%	(0.5%)	7.9%	10.0%	3.1%	(0.6%)	(1.2%)	3.5%	4.1%
FTSE Japan	GB£	0.8%	3.0%	12.6%	4.9%	4.0%	(0.8%)	6.3%	7.2%	7.9%
FTSE Emerging Markets	GB£	3.1%	(2.0%)	(3.4%)	2.4%	3.0%	1.5%	5.7%	1.4%	(1.1%)
Local Currency Returns										
FTSE All World	US$	1.6%	6.3%	16.9%	11.5%	8.6%	4.8%	8.5%	15.8%	10.8%
FTSE UK	GB£	0.9%	(0.5%)	7.9%	10.0%	3.1%	(0.6%)	(1.2%)	3.5%	4.1%
FTSE Japan	¥	(0.3%)	15.0%	25.4%	16.7%	8.9%	3.6%	13.5%	22.8%	20.2%
FTSE Emerging Markets	US$	3.6%	0.9%	1.3%	3.6%	2.3%	4.0%	8.2%	7.6%	4.8%

Source: Performance Evaluation Limited & DPF analysis
(*) To 7 Aug-23
(**) To 30 Jun-23

2.8 United Kingdom Equities

DPF Weightings	
Neutral	12.0%
Actual 31.7.23	12.5%
AF Recommendation	13.0%
IIMT Recommendation	12.1%
Benchmark Returns (GB£)	
Q2 23/24 to 7 Aug-23	0.9%
Q1 23/24	(0.5%)
1 Year to Jun-23	7.9%
3 Years to Jun-23 (pa)	10.0%
5 Years to Jun-23 (pa)	3.1%



The Fund's UK Equity allocation fell from 12.9% on 30 April 2023 to 12.5% on 31 July 2023 (0.5% overweight), reflecting relative market weakness.

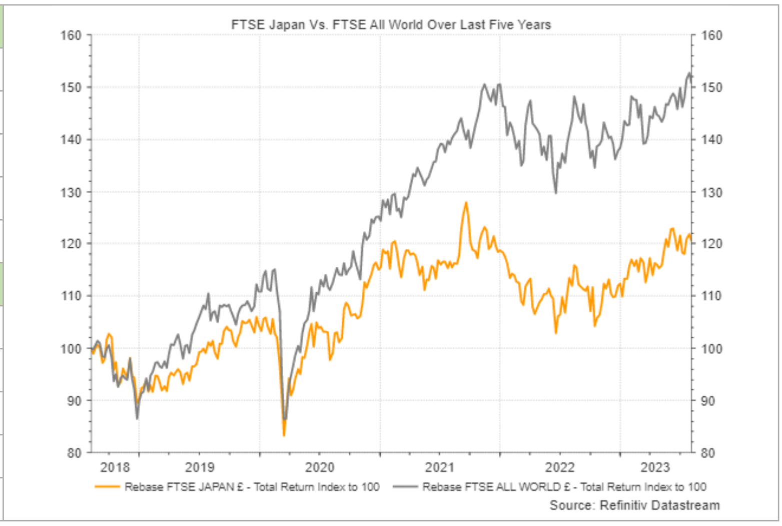
Mr Fletcher has maintained his UK Equities recommended weight of 13.0%, 1.0% overweight, reflecting Mr Fletcher's assessment of the relative value of UK Equities and Global Sustainable Equities.

The IIMT notes that UK Equities have offered strong relative performance against North American Equities during the interest rate tightening cycle due to their structural bias towards Value/Cyclical stocks. In particular, the UK has benefited from the trend of higher energy prices due to a significant overweight in Energy stocks. However, equity markets have recently pivoted away from Value/Cyclical stocks and back into interest rate sensitive Growth stocks, as the equity rally year-to-date has been broadly Technology driven. The lack of a significant UK Technology sector has left the UK index unable to meaningfully participate in this year's rally, and as such the FTSE All Share has only returned 3.5% YTD in sterling terms, less than half of the 9.1% return from the global index.

The IIMT believes that UK Equities are vulnerable to a continued Growth rally on a relative basis. As a result, the IIMT recommends that the Fund's current 12.5% overweight allocation to UK Equities is reduced by 0.4% to 12.1% (0.1% overweight) to 'lock-in' some of the strong relative performance from UK Equities over the last twelve months.

2.9 Japanese Equities

DPF Weightings	
Neutral	5.0%
Actual 31.7.23	5.5%
AF Recommendation	5.0%
IIMT Recommendation	5.0%
Benchmark Returns (GB£)	
Q2 23/24 to 7 Aug-23	0.8%
Q1 23/24	3.0%
1 Year to Jun-23	12.6%
3 Years to Jun-23 (pa)	4.9%
5 Years to Jun-23 (pa)	4.0%



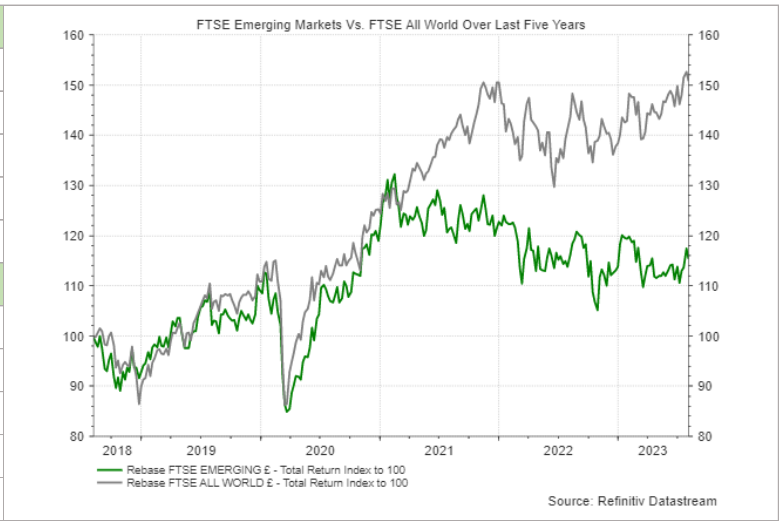
The Fund's allocation to Japanese Equities increased from 5.4% on 30 April 2023 to 5.5% on 31 July 2023, reflecting relative market strength.

Mr Fletcher recommends a neutral weighting relative to the benchmark.

The IIMT recommends that the Fund's Japanese Equity allocation is reduced by 0.5% to 5.0% neutral to 'lock-in' some recent relative outperformance. The IIMT notes that it is currently reviewing the requirement for a standalone Japanese Equity allocation as part of the H2-23 Investment Strategy Statement review.

2.10 Emerging Market Equities

DPF Weightings	
Neutral	5.0%
Actual 31.7.23	5.5%
AF Recommendation	5.0%
IIMT Recommendation	5.0%
Benchmark Returns (GB£)	
Q2 23/24 to 7 Aug-23	3.6%
Q1 23/24	(2.0%)
1 Year to Jun-23	(3.4%)
3 Years to Jun-23 (pa)	2.4%
5 Years to Jun-23 (pa)	3.0%



Relative market strength increased the Fund's allocation to Emerging Market Equities from 5.3% on 30 April 2023 to 5.5% on 31 July 2023 (0.5% overweight).

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

The IIMT recommends that the Fund's allocation to Emerging Market Equities is reduced by 0.5% to 5.0% neutral while the IIMT reviews the requirement for a standalone Emerging Market Equity allocation as part of the H2-23 Investment Strategy Statement review.

2.11 Global Sustainable Equities

DPF Weightings	
Neutral	29.0%
Actual 31.7.23	27.9%
AF Recommendation	27.0%
IIMT Recommendation	27.9%
Benchmark Returns (GB£)	
Q2 23/24 to 7 Aug-23	0.8%
Q1 23/24	3.3%
1 Year to Jun-23	12.0%
3 Years to Jun-23 (pa)	10.8%
5 Years to Jun-23 (pa)	9.8%

The Fund's allocation to Global Sustainable Equities increased from 27.0% on 30 April 2023 to 27.9% on 31 July 2023 (1.1% underweight) reflecting relative market strength.

The IIMT notes that the Fund's legacy investment in the Baillie Gifford Positive Change Fund of around £110m was transferred in-specie into the LGPS Central Limited Global Sustainable Equity Broad Strategy (managed by Baillie Gifford) in June 2023.

Mr Fletcher continues to recommend a 2.0% underweight allocation of 27.0% to Global Sustainable Equities because of the relatively higher interest rate sensitivity of the asset class.

The IIMT notes that the outlook for Global Sustainable Equities is closely linked to the outlook for inflation and interest rates. Global Sustainable

Equities typically favour interest rate sensitive growth stocks and tend to outperform when interest rates are falling and underperform when interest rates are rising. Whilst global interest rates appear to have peaked (noting that this differs by country), it may take some time before they start to consistently fall on a global basis. Furthermore, the IIMT is also concerned about increasingly expensive valuations in some areas of the Global Sustainable Equity market. For example, on 31 July 2023, the US Technology sector was trading on a forward-looking price earnings multiple of 31 times earnings, significantly higher than the 20-year average of 20 times earnings. The IIMT believes that valuations may mean revert over the long term and there is a risk that significant deviations from long-term averages tend to only be sustainable in the short term. This potentially leaves US Technology stocks (which accounts for around 25% of the global index) vulnerable to valuation downgrades (i.e. lower capital values).

The IIMT recommends that the Fund maintains its current 27.9% (1.1% underweight) allocation to Global Sustainable Equities.

2.12 Private Equity

DPF Weighting				
Netural	Actual 31.07.23	Committed 31.07.23	AF Recommendation	IIMT Recommendation
4.0%	5.0%	5.6%	4.0%	5.0%
Benchmark Returns (GB£)				
Q2 23/24 to 7 Aug-23	Q1 23/24	1 Year to Jun-23	3 Years to Jun-23 (pa)	5 Years to Jun-23 (pa)
1.0%	3.4%	13.0%	9.9%	3.5%

The Fund’s Private Equity weighting increased from 4.9% on 30 April 2023 to 5.0% on 31 July 2023, reflecting relative market strength (1.0% overweight).

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

The IIMT recommends maintaining the Fund’s Private Equity allocation at 5.0% (1.0% overweight), given the committed weight of 5.6% (1.6%).

The IIMT notes that it is reviewing the Fund’s strategic allocation to Private Equity as part of the H2-23 Investment Statement Strategy review (potentially leading to a higher asset class allocation) and the IIMT is currently assessing several private equity opportunities which may lead to future commitments.

2.13 Income Assets

On 31 July 2023, the overall weighting in Income Assets was 25.8% (0.8% overweight), in line with that reported on 30 April 2023. Net investment of around £28m was offset by relative market weakness. The IIMT recommendations below maintain the weighting at 25.8%; 28.7% on a committed basis.

2.14 Multi Asset Credit

DPF Weighting				
Netural	Actual 31.07.23	Committed 31.07.23	AF Recommendation	IIMT Recommendation
6.0%	7.4%	8.7%	8.0%	7.5%
Benchmark Returns (GB£)				
Q2 23/24 to 7 Aug-23	Q1 23/24	1 Year to Jun-23	3 Years to Jun-23 (pa)	5 Years to Jun-23 (pa)
1.3%	2.4%	8.9%	5.0%	3.7%

The Fund's allocation to Multi-Asset Credit increased from 7.1% on 30 April 2023 to 7.4% on 31 July 2023 (1.4% overweight), principally reflecting net investment of around £28m, partly offset by relative market weakness.

Mr Fletcher has maintained his 2.0% overweight allocation of 8.0% to Multi-Asset Credit. Mr Fletcher notes that global credit spreads have moved sideways over the last quarter, but the overall yield has increased, when combined with the low duration and floating rate nature of many of the asset classes it suggests to Mr Fletcher that Multi-Asset Credit remains attractive, relative to longer duration, more interest rate sensitive assets.

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 7.4% is increased by 0.1% to 7.5% (1.5% overweight) to reflect scheduled private debt draw-down commitments; 8.7% on a committed basis.

2.15 Property

DPF Weighting				
Netural	Actual 31.07.23	Committed 31.07.23	AF Recommendation	IIMT Recommendation
9.0%	7.7%	7.7%	9.0%	7.4%
Benchmark Returns (GB£)				
Q2 23/24 to 7 Aug-23	Q1 23/24	1 Year to Jun-23	3 Years to Jun-23 (pa)	5 Years to Jun-23 (pa)
Not available	0.2%	(15.0%)	2.5%	1.6%

The Fund's allocation to Property fell by 0.1% to 7.7% on 31 July 2023, reflecting relative market weakness. Direct Property accounted for 5.5% (0.5% underweight) and Indirect Property accounted for 2.2% (0.8% 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 an opportunity for the Fund to take advantage of distressed selling by other investors to increase its exposure to in-direct property funds at a discount to NAV and thereby increase the overall property exposure to neutral.

The Fund's Direct Property manager notes that the UK economy remains weak (GDP growth Q1-23: +0.1%) and a technical recession is still possible whilst interest rates and inflation remain high. The manager notes that the latest increase in the base rate on 3 Aug-23 raised the rate from 5.0% to 5.25%. On a more positive note, although further increases cannot be ruled out it appears that with inflation now on a firm downward trajectory interest rates are at or are near their peak. The current economic difficulties have kept the UK commercial property market subdued. Although the significant erosion in value experienced in H2-22 appears to be over, capital values are currently flat rather than rebounding. At present, investor sentiment is weak and transaction volumes have consequently fallen sharply over the last year. Occupationally, rental value growth remains at healthy levels overall (+3.5% per annum, June 2023), but mainly because of continued strong industrial sector rental value growth.

The total return for all UK commercial property for Q2-23, as measured by the MSCI Quarterly Index, was +0.2%, comprising an income return of +1.1% and a capital value fall of -1.0%. For the 12-month period to 30 Jun-23, the sharp capital value falls in the second half of 2022 continues to have an impact. The total return for this period was -15.0%, comprising an income return of +4.3% and a capital value fall of -18.5%. In comparison, the total return for the Fund's property portfolio was +0.7% for the quarter and -11.7% for the 12 months to 30 June 2023. The current void rate within the portfolio is 4.3% (last quarter: 4.4%). This compares to the MSCI benchmark void rate of 8.2%.

As, and when, further Fund liquidity becomes available, the discretionary manager's purchasing strategy will be to invest in sectors and individual properties which offer the best opportunities for rental growth and total returns in the medium term. The manager will continue to focus on assets that provide strong core fundamentals in terms of location, quality of tenant and lease length. At present, the sectors that look most attractive in relative terms are the retail warehousing and industrial sectors where occupational vacancy rates remain low and consequently future rental value growth is most likely. The discretionary manager expects property yields and property total returns to remain impacted by elevated interest rates, bond yields and swap rates during the remainder of 2023, but with an improvement coming through in 2024 as investor confidence and buying activity increases.

The IIMT recommends that the Fund's allocation to Direct Property is maintained at 5.5%, albeit 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. The IIMT recommends reducing the Indirect Property weighting by 0.3% to 1.9% (1.1% underweight) to reflect scheduled redemptions, albeit redemption timing is uncertain.

2.16 Infrastructure

DPF Weighting				
Netural	Actual 31.07.23	Committed 31.07.23	AF Recommendation	IIMT Recommendation
10.0%	10.7%	12.6%	10.0%	10.9%
Benchmark Returns (GB£)				
Q2 23/24 to 7 Aug-23	Q1 23/24	1 Year to Jun-23	3 Years to Jun-23 (pa)	5 Years to Jun-23 (pa)
0.7%	1.6%	5.2%	3.2%	3.0%

The Fund’s allocation to Infrastructure fell from 10.9% on 30 April 2023 to 10.7% on 31 July 2023 (0.7% overweight), reflecting relative market weakness partly offset by net investment of £8m, of which £3m related to renewable energy assets.

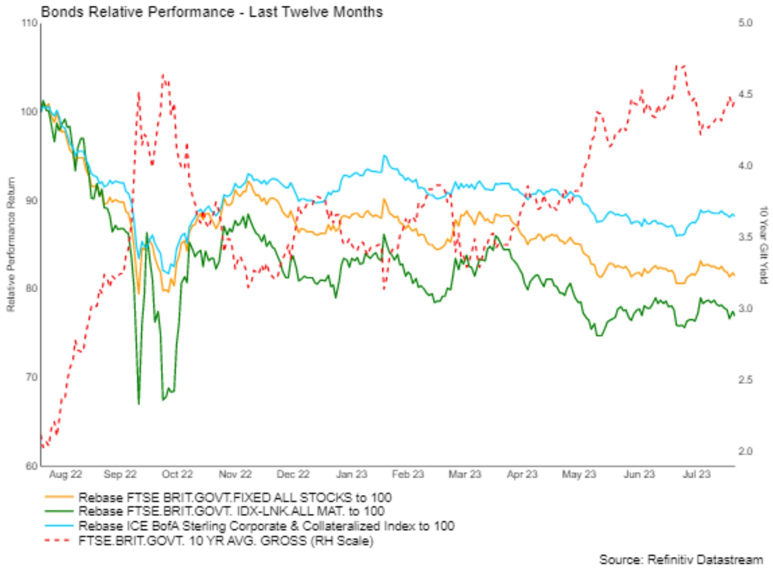
Mr Fletcher recommends a neutral weighting relative the final benchmark.

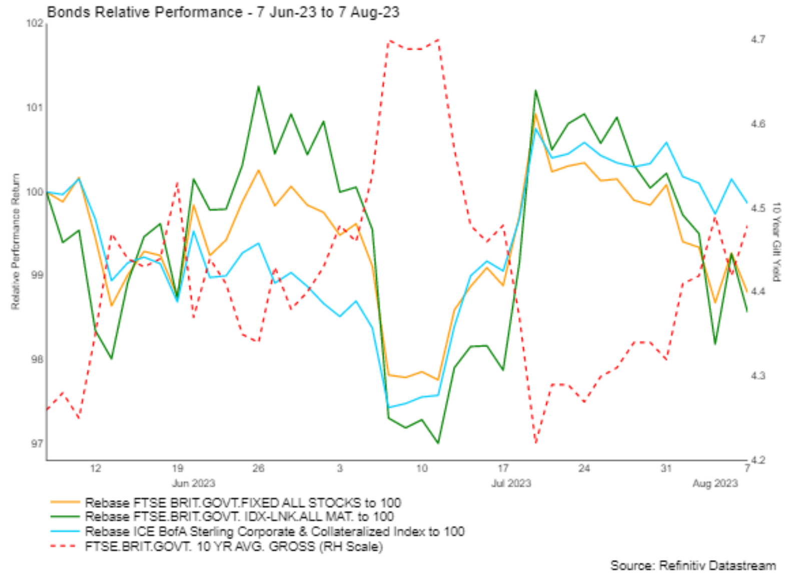
The IIMT continues to view Infrastructure as an attractive long-term asset class and favours a bias towards core infrastructure assets or renewable energy assets. These assets can offer low volatility; low correlation to equity and fixed income markets; and reliable long-term cash flows.

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. The current market valuation of some infrastructure assets is becoming increasingly stretched (driven by strong investor demand) and are vulnerable to the impact of elevated inflation.

The IIMT recommends that the invested weighting is increased by 0.2% to 10.9% (0.9% overweight) to reflect expected commitment drawdowns; 12.6% on a committed basis. Given the current committed weight of 12.6%, the IIMT is not reviewing new opportunities at the current time, albeit this is monitored by the IIMT on an on-going basis.

2.17 Protection Assets



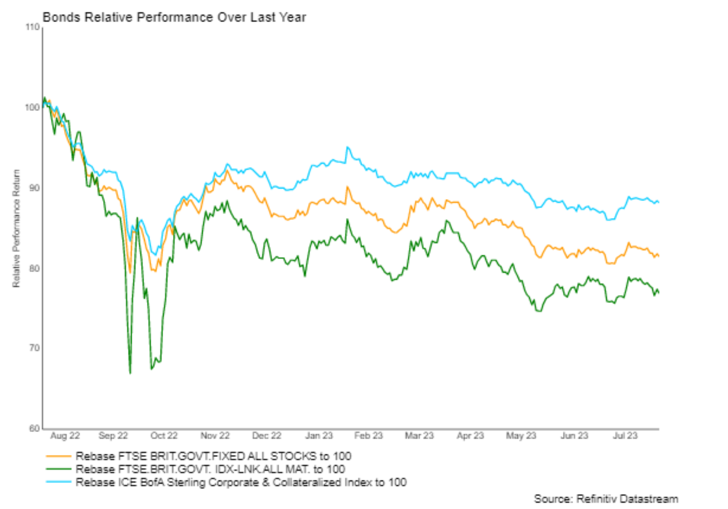


The weighting in Protection Assets on 31 July 2023 was 14.6%, down from 15.1% on 30 April 2023, reflecting relative market weakness. The IIMT recommendations below increase the weighting by 1.8% to 16.4%.

Although the 12 months' return from fixed income markets was sharply negative, the majority of the drawdown in bond markets occurred in 2022 as bond yields initially rose quite rapidly (lowering prices) to adjust for the higher inflation and interest rate environment. The sharp rise in UK bond yields was exacerbated by the UK Government's 'mini-budget' in September 2022, which resulted in a sharp sell-off in long-dated gilts (pushing yields even higher). Bond yields have been relatively volatile YTD as inflation has proven to be more persistent than anticipated (it is taking longer than expected for inflation to decline from its peak and return to trend). As a result, the market is pricing in rates peaking at much higher levels (slightly above 6.0%) and remaining in restrictive territory for a longer period (until at least late 2025), hence yields have risen quite sharply from earlier in the year when inflation was initially expected to decline at a faster rate. The yield on the 10-Year Gilt has increased approximately 80 basis points YTD to reach 4.46%, which is only marginally below where yields peaked following the 'mini-budget' in September 2022.

2.18 Conventional Bonds

DPF Weightings	
Neutral	6.0%
Actual 31.7.23	4.5%
AF Recommendation	5.0%
IIMT Recommendation	5.2%
Benchmark Returns (GB£)	
Q2 23/24 to 7 Aug-23	(0.5%)
Q1 23/24	(5.4%)
1 Year to Jun-23	(14.5%)
3 Years to Jun-23 (pa)	(11.5%)
5 Years to Jun-23 (pa)	(4.2%)



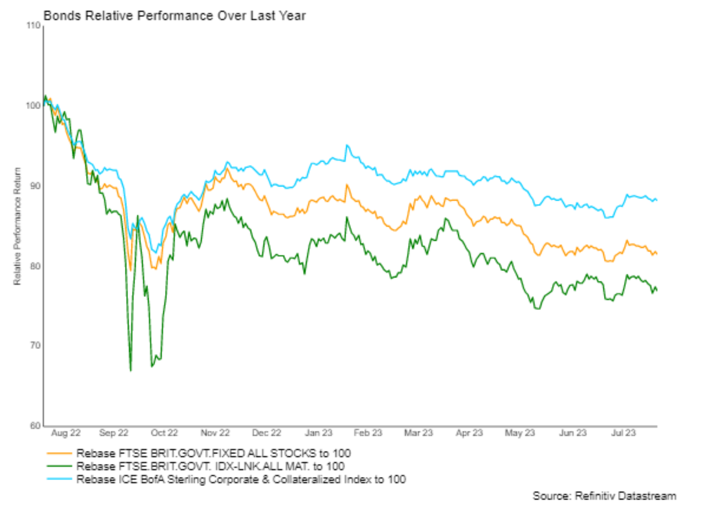
The Fund's allocation to Conventional Bonds reduced from 4.7% on 30 April 2023 to 4.5% on 31 July 2023 (1.5% underweight), reflecting relative market weakness. The Fund's allocation on 31 July 2023 comprised 85% UK Conventional Gilts and 15% US Treasuries.

Mr Fletcher has maintained his 1.0% underweight allocation to Conventional Bonds. Mr Fletcher notes that he is 'somewhat torn' between the allocation to Conventional Bonds and Index-Linked Bonds. Whilst Mr Fletcher has not changed his recommendation to be underweight Conventional Bonds and neutral Index-Linked Bonds, Mr Fletcher notes that he could just as easily be underweight Index-Linked Bonds and neutral Conventional Bonds.

The IIMT believes that conventional sovereign bonds offer better long term value now than they have for many years following the substantial rise in yields over the last twelve months. 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 2022 fall in bond yields as concerns about the global economy intensified. The IIMT recommends increasing the weighting by 0.7% to 5.2% (0.8% underweight) in line with Mr Fletcher's recommendation.

2.19 Index-Linked Bonds

DPF Weightings	
Neutral	6.0%
Actual 31.7.23	4.5%
AF Recommendation	6.0%
IIMT Recommendation	5.0%
Benchmark Returns (GB£)	
Q2 23/24 to 7 Aug-23	(2.1%)
Q1 23/24	(6.6%)
1 Year to Jun-23	(17.0%)
3 Years to Jun-23 (pa)	(12.6%)
5 Years to Jun-23 (pa)	(4.3%)



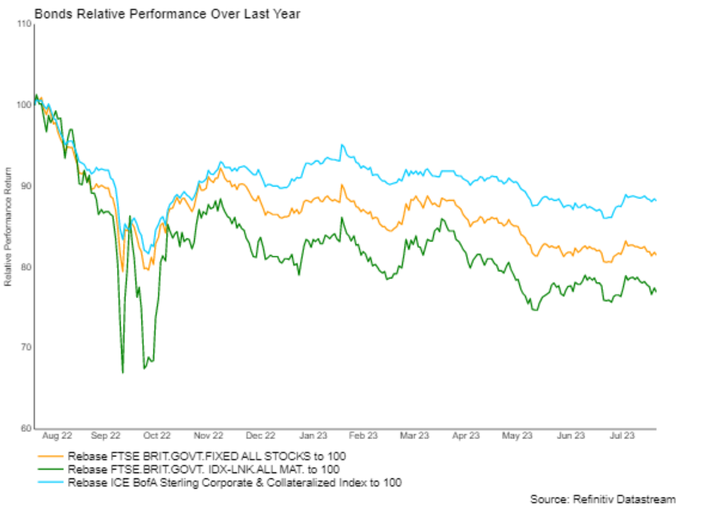
The Fund's allocation to Index-Linked Bonds fell from 4.7% on 30 April 2023 to 4.5% on 31 July 2023 (1.5% underweight), reflecting relative market weakness. The Fund's allocation on 31 July 2023 comprised 77% UK Index-Linked Bonds (UK Linkers) and 23% US Treasury Inflation Protected Bonds (US TIPS).

Mr Fletcher has maintained his 6.0% (neutral) allocation to Index-Linked Bonds. Mr Fletcher believes Index-Linked Bonds are expensive in the short term and is more pessimistic about the longer-term fall in demand and potential increased supply of Index-Linked Bonds, albeit Mr Fletcher notes that Index-Linked Bonds are much cheaper than they were at the beginning of last year, with the real yield increasing from around -2%, 18 months ago to +1.1% currently.

The IIMT believes that current yields, together with the potential for a longer-term period of elevated inflation, supports a small increase in the Fund's current allocation to Index-Linked Bonds. As a result, the IIMT recommends increasing the weighting to 5.2%; 0.8% underweight.

2.20 Corporate Bonds

DPF Weightings	
Neutral	6.0%
Actual 31.7.23	5.6%
AF Recommendation	6.0%
IIMT Recommendation	6.0%
Benchmark Returns (GB£)	
Q2 23/24 to 7 Aug-23	0.7%
Q1 23/24	(1.7%)
1 Year to Jun-23	(3.3%)
3 Years to Jun-23 (pa) (1)	(5.0%)
5 Years to Jun-23 (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 the Fund's weighting in Global Investment Grade Bonds fell from 5.7% on 30 April 2023 to 5.6% on 31 July 2023 (0.4% underweight), reflecting relative market weakness.

Mr Fletcher has maintained his neutral allocation to Corporate Bonds at 6.0%.

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. The IIMT recommends increasing the Corporate Bonds allocation by 0.4% to 6.0% (neutral).

2.21 Cash

The Cash weighting on 31 July 2023 was 3.2% (1.2% overweight), down from 3.6% on 30 April 2023, 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 remain 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, persistent high interest rates (relative to recent years), energy security concerns, tight global supply chains and the continuing conflict between Russia and Ukraine.

The IIMT recommends a relatively defensive cash allocation of 2.8% (0.8% overweight) due to the uncertain economic and political 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 on 31 July 2023.

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