LONDON BOROUGH OF SOUTHWARK - Quarterly Report September 2021

Market Background

A modest positive outcome for funds masked a quarter full of ups and downs. July opened on a down note with a new COVID variant and negative events in China undermining the outlook for global growth. A positive earnings season in developed regions coupled with lower infection/higher vaccination rates generally helped equities rise in August. Rising bond yields, the spectre of stagflation (high inflation/low growth) and continued worries over China weighed on sentiment and the result was a September sell-off.

Equity markets posted a small positive for UK investors, propped up by a weak pound. Regional performance was mixed. Japan was the standout performer with markets buoyed by a reopening of the economy and prospect of further monetary stimulus. Lesser Asian and emerging markets performed poorly weighed down by weak Chinese performance. At a sector level, energy stocks fared best on the back of rising prices and financials benefitted due to the prospect of higher interest rates.

Nominal bond markets posted negative returns as yields rose and linkers correspondingly returned positively as real yields fell.

Property returns are expected to be positive as capital values continue to rise in sectors such as industrials and stabilise in office and retail.

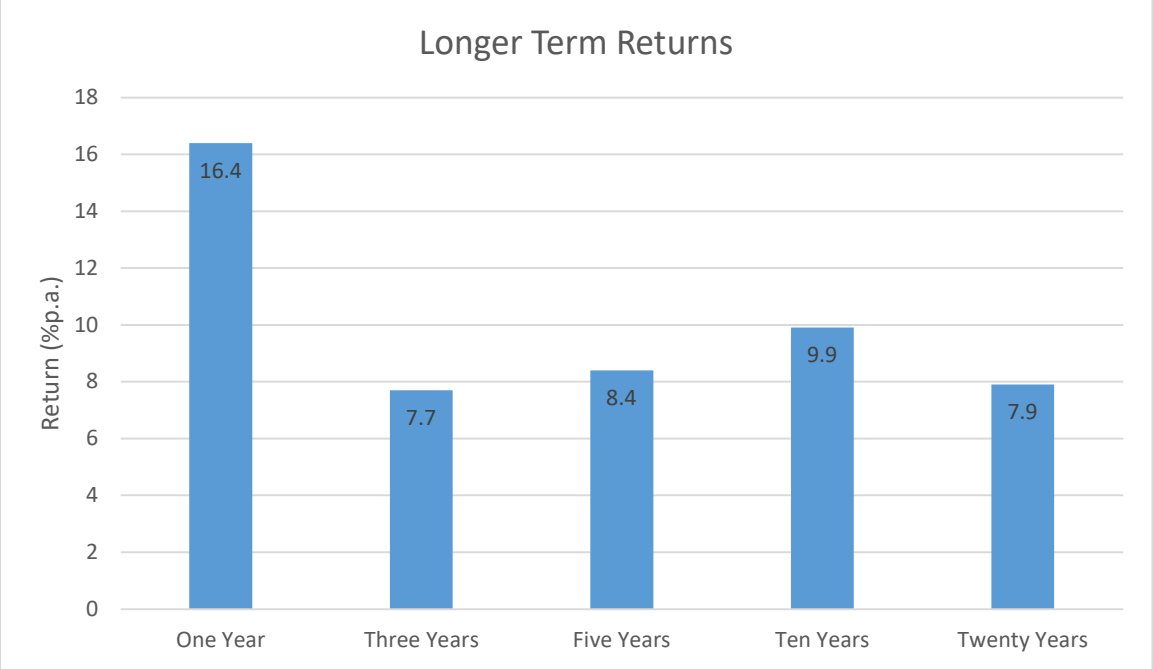
LGPS Funds

The average LGPS funds is expected to have returned a modest 1.4% over the quarter.

Longer-Term

The one-year number remains strongly positive at 16%, driven by buoyant equity returns.

The three-year number remains around 8% p.a., well ahead of most funds' expectations. Over the medium term, the returns remain strong with the ten-year result now nudging 10% p.a. and the twenty-year return +8% p.a.



Total Fund

The Fund returned 1.7% over the quarter outperforming the benchmark by a small margin.

Performance from the Fund's managers was mixed as might be expected but more negatives were posted than positives. The analysis below shows the make-up of the returns, absolute and relative.

			Returns			Contributions		
Manager	Brief	Start Value (£m)	Fund	Benchmark	Relative Return	Fund	Benchmark	Relative
BLK	Equity/ILG	553,145	1.7	0.6	1.1	0.5	0.2	0.3
LGIM	Equity/ILG	485,245	2.4	1.6	0.8	0.6	0.4	0.2
BLK	Diversified Growth	197,122	0.5	0.8	-0.3	-	0.1	-
BLK	Absolute Return Bond	135,308	-0.2	1.0	-1.2	-	0.1	-0.1
Newton	Global Equity	255,209	1.8	2.1	-0.3	0.2	0.3	-
Comgest	EM Equity	0	-	-	-	-	-	-
Brockton	Property	5,591	0.0	3.6	-3.4	-	-	-
Nuveen	Property (Core)	202,136	4.1	4.9	-0.7	0.4	0.5	-0.1
Invesco	Property	30,289	0.5	1.9	-1.4	-	-	-
M&G	Property	22,511	1.0	1.9	-1.0	-	-	-
Frogmore	Property	7,352	-0.7	3.9	-4.4	-	-	-
Glenmont	Infrastructure	14,787	0.8	2.4	-1.6	-	-	-
Temporis	Infrastructure	23,979	1.8	2.4	-0.7	-	-	-
BLK	Infrastructure	3,004	3.1	2.4	0.6	-	-	-
BLK/LBS	Cash	90,000	0.0			-	-	-
Total		**2,025,677**	**1.7**	**1.6**	**0.1**	**1.7**	**1.6**	**0.1**

The third column from the right shows how much the managers have contributed to the overall return of 1.7%. Both passive balanced portfolios* and the core property portfolio contributed most whilst none of the managers registered a meaningful negative contribution. The column on the right-hand side shows how much the managers have contributed to the excess return of 0.1%.

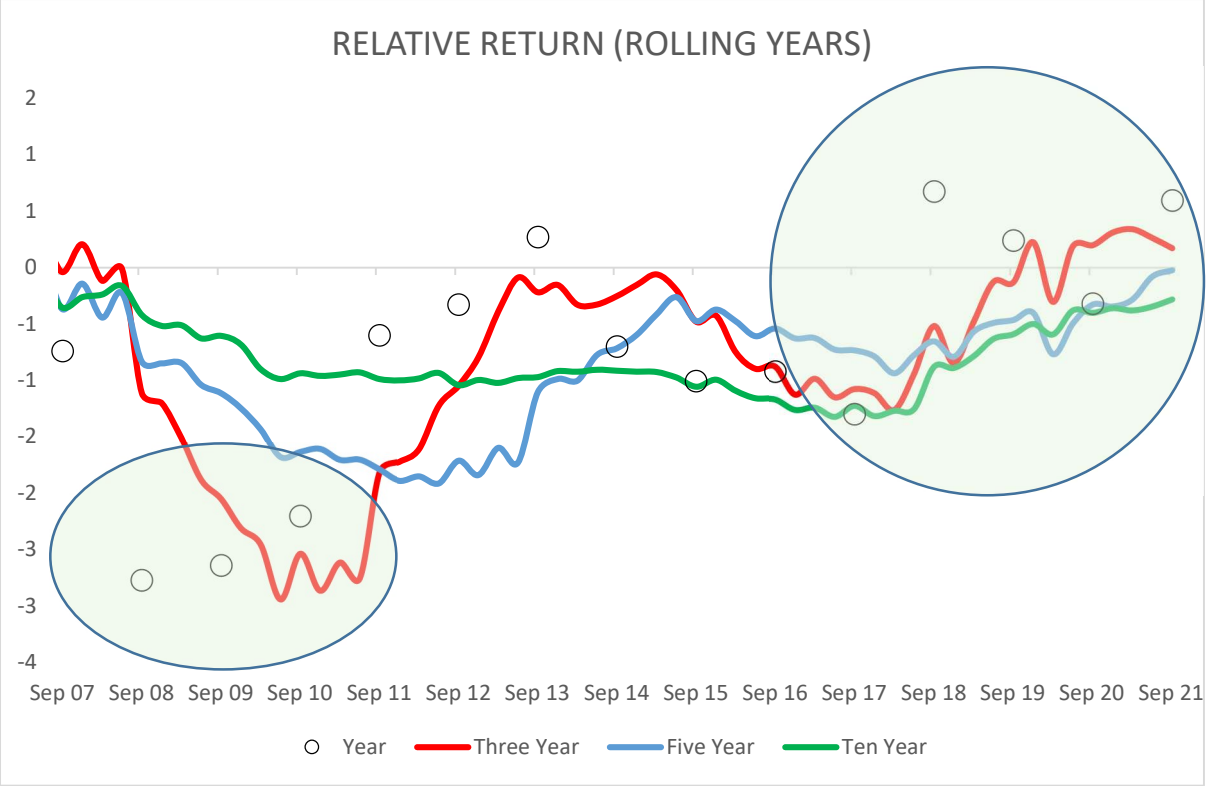
The one-year return for the Fund was an extremely healthy 15.8% almost 0.7% above benchmark.

Medium-term, the Fund has returned between 9.2%p.a. and 9.5%p.a. over the three and five-year periods. The shorter period return was ahead of benchmark, the longer period almost exactly in line.

Over the last ten-years, the Fund has delivered a very valuable 11.0%p.a. return but still 0.2%p.a. off the target.

Returns have been improving of late and while long-term returns are still sub-benchmark, the margin is reducing. The legacy of poor active equity performance which had the Fund trailing by 2% to 3% p.a. a few years ago is diminishing. I enclose again a chart plotting the Fund's returns over a number of rolling periods relative to the benchmark. I have selected a 15-year period to review.

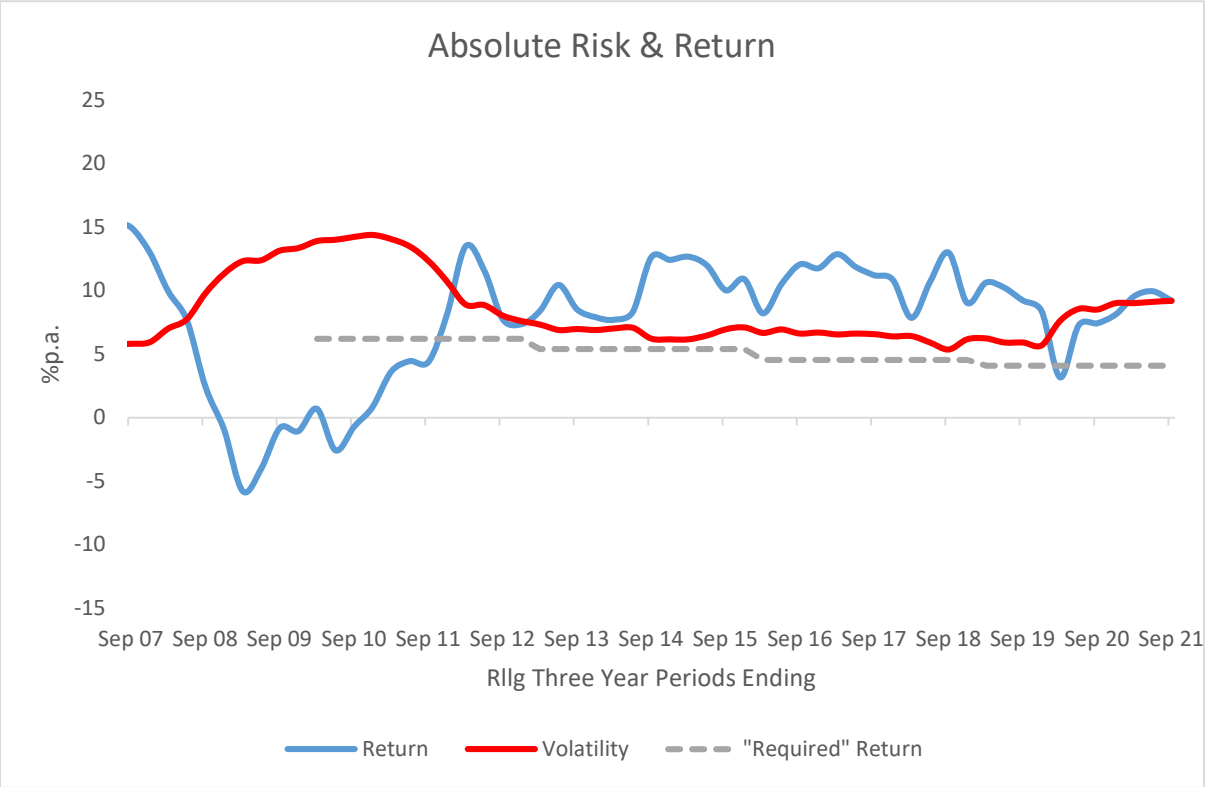
* The benchmarks calculated by JPM for these portfolios are under review



There is quite a bit to take away from this busy chart but in summary,

- Individual annual returns (the black discs) have more often than not been below the horizon i.e., behind benchmark. Of the 15 years, 11 have been below but most significantly in 2008 to 2010 where the Fund suffered from poor asset manager performance.
- What is clear is that the returns are on an improving trend e.g., three of the last five years are above benchmark and the rolling 'trails' are trending in the right direction
- Importantly, annual return volatility has become more contained

One final chart shows the progression of risk and return over time.



What this shows is,

- Once the impact of the global financial crisis drops out of the observations (the left hand side of the chart), both return and volatility track within a reasonably narrow range
- Over this same period, returns have consistently outpaced the return assumption used in the Actuary's modelling (the dotted line on the chart)
- Risk and return moreso have largely 'mean reverted' following the short sharp dip at the outset of the pandemic (right hand side of the chart)

Newton – Active Global Equity

Newton outperformed the World index by around 0.3% over the quarter. In a difficult market dominated by macro shifts, sector allocation was neutral, and it was stock selection that added value.

Relative to the stretched (index plus target aspiration) benchmark, the portfolio lagged by .3%.

The portfolio's annual return was strongly positive but quite a bit behind the benchmark – fund 22%, benchmark (inc. stretch) 25.8%.

Longer-term numbers are very strong in absolute terms but remain some way short of target (particularly nearer-term).

BlackRock - Active

Once again, the two active positions performed quite differently over the quarter.

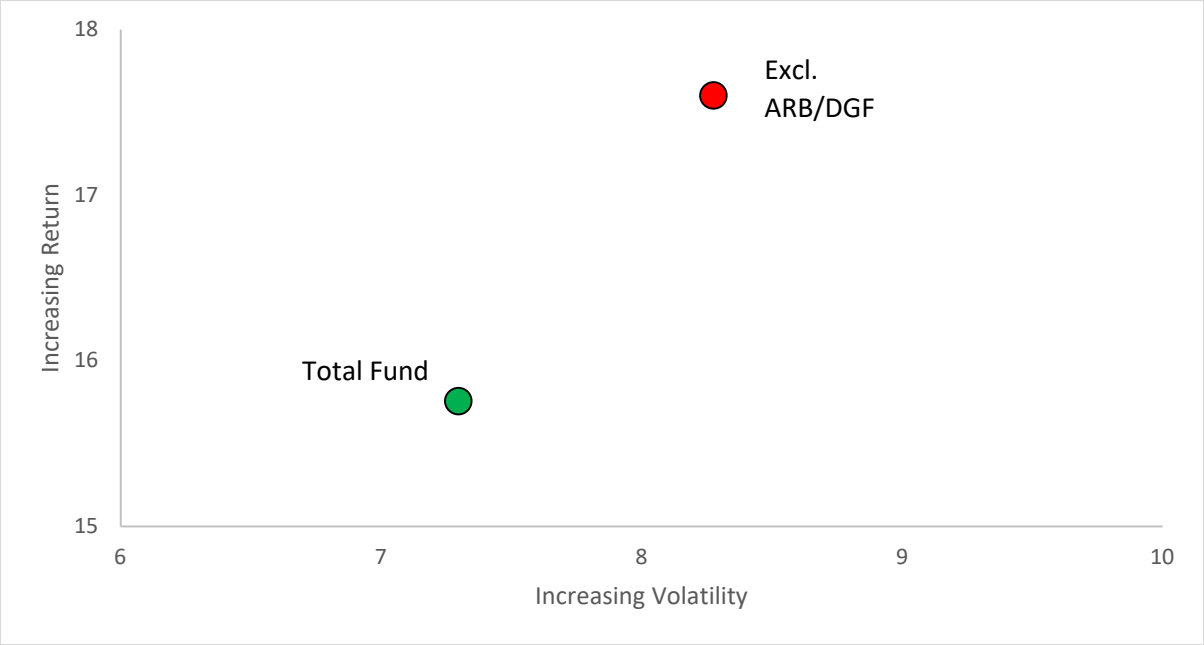
Performance in the ARBF portfolio was negative but less severely so than the main traditional bond indices. A shorter duration and exposure to Asian credit weighed on returns.

The return from the DG portfolio was positive, driven primarily from developed and emerging equities.

Since their inception, returns from both strategies have been modest low digit single figures. In combination, the result has been generally ahead of the 3-4% absolute return sought.

These two portfolios hold traditional assets, but return profiles are designed to deliver results differently. In strong growth environments, returns will appear pedestrian, but in down markets, returns should be less impacted. Importantly, overall Fund volatility should reduce in any prevailing market condition – growth or cyclical.

The chart below illustrates the impact over the full year to September. The actual Fund outcome is the green plot, the notional outcome (excl. ARB/DG) is the red plot.



This picture has remained 'normal' in a return sense as growth assets have re-exerted dominance.

In essence, the strategy has worked in terms of risk reduction but arguably, the return sacrifice has been greater than we would have liked. This is a very short-term view however.

Nuveen Real Estate – Core Property

The portfolio performance was positive over the quarter, returning 3.9% (Nuveen numbers). Capital appreciation and income both added value. The return of positive valuation growth is very encouraging indeed. The Fund's industrial assets benefited from a further strong quarter, delivering total returns of 8.9%. In terms of valuations, over the quarter industrial valuations increased by 7.8%, retail increased by 0.5% and office valuations increased marginally by 0.2%.

The portfolio's remaining indirect holding performed extremely well returning almost 23% over the period. Valuations have rebounded substantially post the easing of lockdown.

The full year return reported by Nuveen is 11%. This has improved medium-term numbers, but these remain disappointing not just for Southwark but for the asset class generally.

The current seven-year number of 5.4%p.a. is behind the 7%p.a. target set by the Panel.

Other Real Estate

Reported returns were typically behind benchmark over the quarter and the full year. Quarterly reporting helps little in understanding investments in this sector.

Southwark's Property Allocation

The core and added value/opportunistic assets continue to perform quite differently.

As mentioned previously, the added value/opportunistic portfolios are still early stage so a measure of underperformance against their relatively challenging benchmarks and volatility thereof should not cause undue concern.

The core portfolio is around three-quarters of the overall allocation so this will realistically dictate how the Fund's real estate assets perform.

The Fund's large commitment to the asset class is an important differentiator in its overall strategy.

The chart below shows the impact on risk and return over consecutive rolling three-year periods.

In the latest three-year period, without property the overall return would have been higher (around 0.5%p.a.) but volatility significantly higher (by around 1.6%p.a.). This continues to be a very acceptable trade-off.

Infrastructure

The Fund's infrastructure investments are just over a year old and comprise around 2% of the overall asset value. They are very early stage and some way from being generative in terms of return.

Passive Portfolios

The passive mandates have largely tracked the respective benchmarks as we would expect.

Summary

- Another positive quarter for the Fund despite continued fluctuations in sentiment over the period
- Funds have performed extremely well in general and ours, illustrated in the charts above is no different
- Highlights have been excellent returns from our growth assets and an improvement in the property returns
- Despite recent market turbulence, assets have grown more than actuarial assumptions and barring any significant return shocks, will see a significant improvement in funding levels at the next valuation
- Newton continues to generate positive returns but lags the target aspiration. I'll do some more work on this for my next report
- Returns from the newer infrastructure and smaller property portfolios appear behind target but we should remind ourselves that these are longer-term investments. Short-term performance measures are often spurious