LONDON BOROUGH OF SOUTHWARK - Quarterly Report June 2022

Market Background

Where do we start describing market conditions as we head into a new fiscal year?

Only a few short months ago, markets were buoyant emerging from the pandemic but nonetheless cautious. Inflation was rising, governments were looking increasingly hawkish and Russia's intentions towards Ukraine were a concern. The latter crystalised during the fourth quarter as Russia invaded. Whilst barely registering in terms of global GDP, Russia and Ukraine produce a sizeable proportion of key commodities such as oil, gas and wheat.

A sharp spike in inflation to levels last seen in the 1980's, central governments' response by way of increased interest rates and a severely disrupted supply chain have meant the word "recession" is now on everyone's lips.

In normal circumstances a risk-off environment sees investors shun equities in favour of bonds but in this current climate both equities and bonds have declined. With these accounting for more than 70% of funds' assets, this is a near perfect storm. Diversification in these conditions is very difficult to achieve.

In terms of global equity markets, the World Index gave up 8.3% over the quarter, cushioned to some extent by a weaker Pound. All regions lost ground to greater or lesser extents. The US was the worst performer due to its large exposure to tech' stocks (hit particularly hard by rising interest rates) whereas the 'best' performers were the UK due to an overweighting to energy and mining and emerging markets supported by China's easing of lockdown restrictions.

The differential sectoral returns are of some significance to the LGPS which has tended to focus on active growth strategies favouring tech' in favour of energy and materials, sectors increasingly eschewed by environmentally cognisant investors.

Nominal sovereign and corporate bonds suffered high single figure losses whilst linkers retreated by nearly 18% (FTSE all maturities).

Property returns were solid with estimates suggesting returns in the region of 4% for the quarter.

LGPS Funds

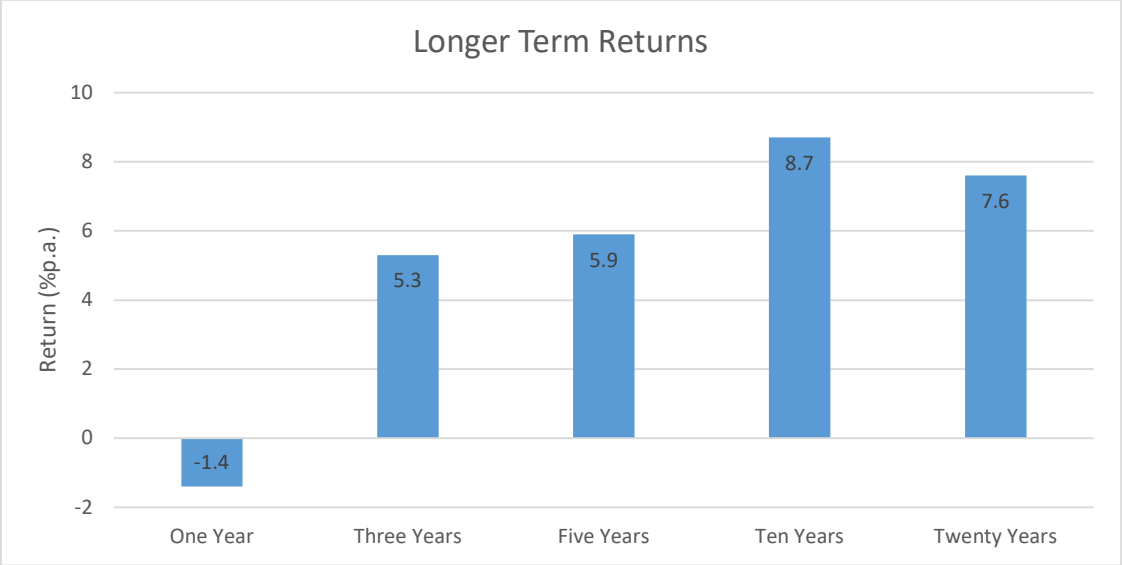
The average LGPS funds is expected to have returned -5%, a second successive negative showing.

Longer-Term

The one-year number has now slipped into negative territory and the three and five year returns rang between 5-6%p.a.

Over the last ten years the average fund has delivered a return of 9% p.a.

Over all longer-term periods, funds which have had a relatively high equity commitment are likely to have outperformed their peers despite facing sharper volatility.



Total Fund

The Fund returned -5.9% over the quarter underperforming the benchmark by 0.9%.

Performance from the Fund's managers was mixed as might be expected but the negatives were more pronounced. 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	470,831	-12.7	-9.7	-3.3	-2.8	-2.2	-0.7
LGIM *	Equity/ILG	427,283	-11.7	-10.8	-1.0	-2.4	-2.2	-0.2
BLK	Diversified Growth	191,389	-7.9	0.3	-8.1	-0.7	-	-0.7
BLK	Absolute Return Bond	132,310	-0.2	0.3	-0.5	-	-	-
Newton	Global Equity	266,290	-9.1	-7.8	-1.5	-1.1	-1.0	-0.2
Comgest	EM Equity	97,913	-8.6	-4.0	-4.8	-0.4	-0.2	-0.2
Brockton	Property	6,810	0.8	3.6	-2.7	-	-	-
Nuveen	Property (Core)	239,790	3.0	1.7	1.2	0.3	0.2	0.1
Invesco	Property	31,432	3.8	1.9	1.8	0.1	-	-
M&G	Property	42,927	1.4	1.9	-0.6	-	-	-
Frogmore	Property	8,011	-1.5	3.9	-5.2	-	-	-
Glenmont	Infrastructure	19,930	3.1	2.4	0.7	-	-	-
Temporis	Infrastructure	37,682	18.5	2.4	15.7	0.3	-	0.3
Temporis Impact	Infrastructure	12,372	-0.2	2.4	-2.5	-	-	-
BLK	Infrastructure	5,991	9.3	2.4	6.8	-	-	-
Blackstone	Diversified Alternatives	28,123	43.2	2.9	39.2	0.6	-	0.5
BTG	Diversified Alternatives	30,380	10.0	1.5	8.4	0.1	-	0.1
Darwin	Diversified Alternatives	20,428	1.6	1.5	0.1	-	-	-
BLK/LBS	Cash	43,027	0.2	0.2	-0.0	-	-	-
Total		**2,112,920**	**-5.9**	**-5.0**	**-1.0**	**-5.9**	**-5.0**	**-1.0**

**** The benchmarks calculated by JPM for these portfolios are under review and are subject to change. As a result, the relative returns and hence contributions to relative performance are probably closer to zero.***

The third column from the right shows how much the managers have contributed to the overall return of -5.9%. Both passive balanced portfolios and the Newton equity property portfolio detracted most.

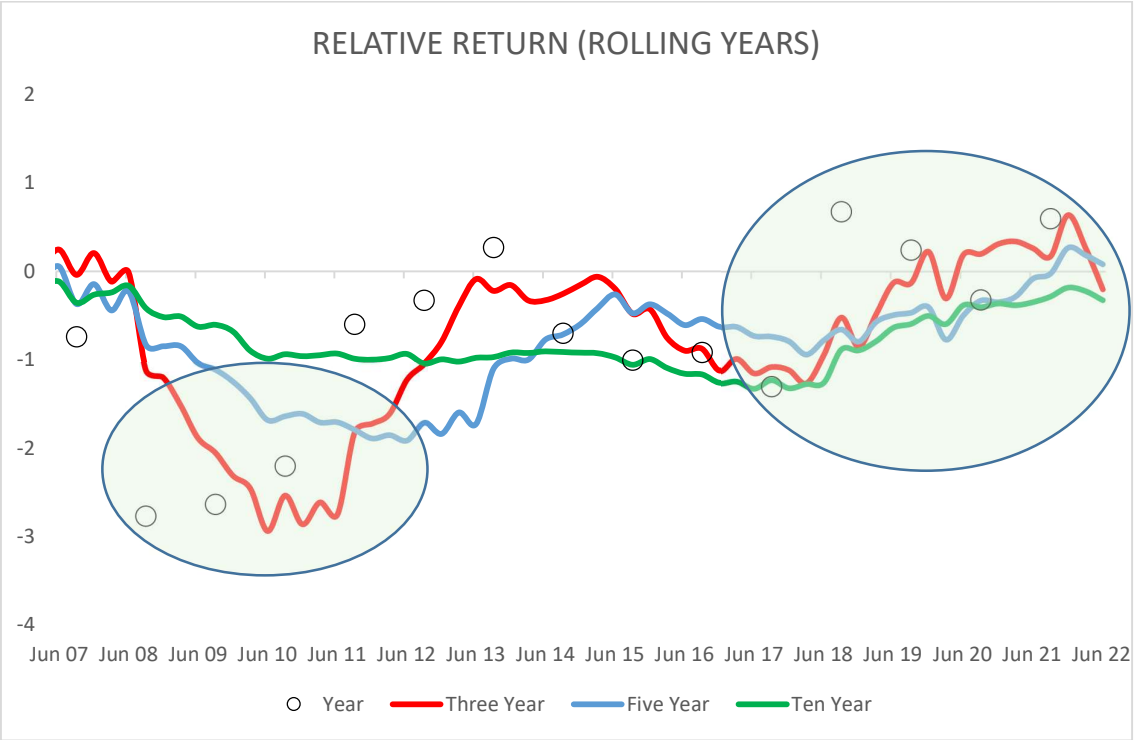
The column on the right-hand side shows how much the managers have contributed to the excess return of -1%.

The one-year return for the Fund was a disappointing -1.5% almost 0.6% behind benchmark.

Medium-term, the Fund has returned between 6.3%p.a. and 7.2%p.a. over the three and five-year periods. The shorter period return was behind benchmark, the longer period almost exactly in line.

Over the last ten-years, the Fund has delivered a very valuable 9.6%p.a. return but still 0.3%p.a. off the target.

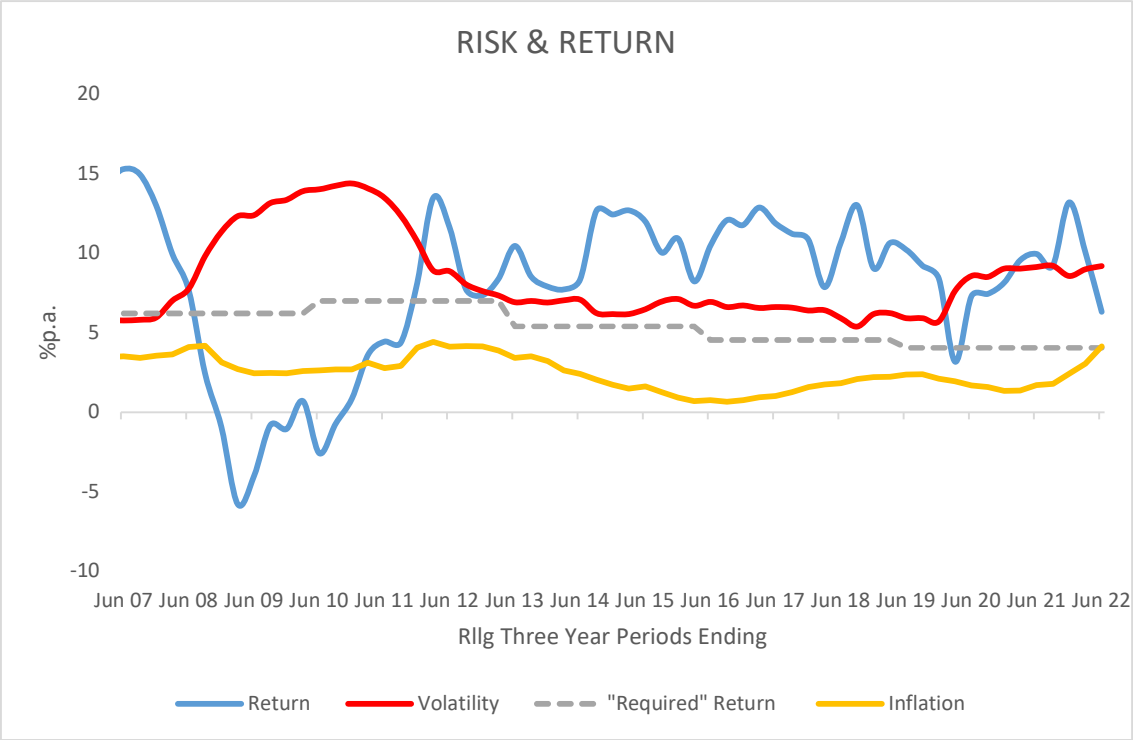
Returns have been improving of late (despite the latest quarter shortfall) and while long-term returns are still sub-benchmark, the margin is reducing. The legacy of poor active equity performance which had the Fund trailing by 2% to 3% p.a. a few years ago is diminishing. I enclose again a chart plotting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



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.



Again, there's a lot of information in this chart but what this shows is,

- Once the impact of the global financial crisis dropped out of the observations (the left hand side of the chart), both return and volatility had 'mean reverted', tracking within a reasonably narrow range
- Somewhat surprisingly, the impact of the pandemic was relatively short-lived although volatility (the red trail) has remained heightened
- Over almost all post financial crisis periods, returns delivered have consistently outpaced the return assumption used in the Actuary's modelling (the dotted line on the chart) i.e. investment performance has done the heavy lifting
- Importantly however, the extreme right hand side of the chart shows the actuary's return assumption and observed inflation converging. This is a concern. At the time of writing, annual inflation (as measured by CPI) has nudged past 10% and is expected to remain above this rate in the immediate near-term.

Newton – Active Global Equity

Newton underperformed the World index by around 0.9% over the quarter. Asset allocation was the key to the underperformance. Voiding energy was the biggest single detractor but Newton found themselves on the wrong side of a number of sector calls e.g. overweighting tech' and consumer discretionary. Their cash holding offered a small buffer.

Relative to the stretched (index plus target aspiration) benchmark, the portfolio lagged by 1.4%.

The portfolio's annual return was sharply negative (4.3% short of the stretched benchmark) due largely to the last two quarters.

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, but both lagged the SONIA benchmark.

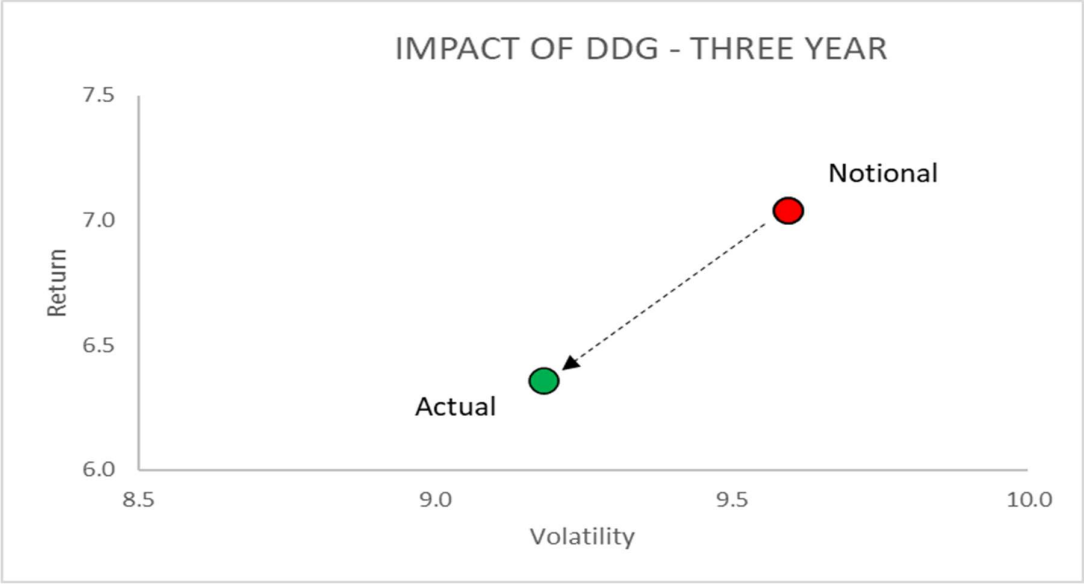
Performance in the ARBF portfolio was negative but less severely so than the main traditional bond indices.

The return from the DG portfolio was a more pronounced negative driven by developed equity and corporate bond performance.

Since their inception, returns from both strategies have been modest low digit single figures.

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.

As an example, the chart below looks at the impact the diversified growth portfolio has on the whole Fund. The actual Fund outcome is the green plot, the notional outcome i.e. what would the Fund have looked like without the DDG investment the red plot.



What this clearly shows is that volatility has been reduced through the addition of the DDG investment but at the cost of some potential return.

How good a trade-off this is depends on one's viewpoint however.

Nuveen Real Estate – Core Property

The portfolio performance was positive over the quarter, returning 3.5% (Nuveen numbers). The overall return comprised an income return of 1.0% and capital growth of 2.5% led by strong performance from the industrial assets. Direct holdings, the bulk of the portfolio, returned 3.5% whilst the remaining indirect holding (Retail Warehouse Fund) delivered 5.3%.

The full year return reported by Nuveen is a very healthy 22.3%. This has improved medium-term numbers (three and five year numbers are 7-8%p.a.).

The current seven-year number of 6.1%p.a. continues to improve but remains behind the 7%p.a. target set by the Panel.

There are many headwinds facing the commercial real estate sector and many believe the recent strong gains to be pared back in the second half of the year.

Residential/Opportunistic Real Estate

Reported returns were typically behind benchmark over the quarter and the full year. Going on JP Morgan's returns, Invesco and Frogmore are stronger performers over the full year but since inception, all four non-core portfolios have lagged their respective (and challenging) benchmarks.

Southwark's Property Allocation

The core and added value/opportunistic assets continue to perform quite differently. The following table gives a flavour of this.

	Quarter			Year		
	Fund	Benchmark *	Relative	Fund	Benchmark *	Relative
All Property	2.7	1.9	0.8	18.6	7.6	10.2
Core	3.0	1.7	1.2	23.2	7.0	15.2
Ex Core	1.9	2.2	-0.3	5.5	9.4	-3.5

******The benchmark numbers shown are calculated from first principles and not those quoted by JP Morgan*

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 table shows the non-core assets impairing the overall return.

The Fund's large commitment to the asset class as a whole 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 lower (around 0.6%p.a.) but volatility significantly higher (by around 1.5%p.a.). This continues to be a very acceptable trade-off.

Infrastructure

The Fund's infrastructure investments are relatively new and comprise just over 4% of the overall asset value. They are very early stage but appear to be generative in terms of excess return.

"ESG Priority Allocation"

These portfolios (Darwin, Blackstone and BTG) are too new to warrant commentary. At quarter end, they comprised just under 5% of the Fund's assets.

Passive Portfolios

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

Summary

- A second very difficult quarter for the sector and Southwark with negative returns and heightened volatility in evidence
- The Fund has not kept pace with the benchmark although both are the subject of an on-going review with JP Morgan and may change (for better or worse)
- There is very little by way of good news on the horizon – inflation is back to levels last seen forty years ago, growth is forecast to be tepid at best and interest rates are at their highest since early 2009
- Our recent experience of strong asset growth outperforming growth in liabilities is being challenged
- Actuarial models are calibrated in such a way that ensures short-term spikes in inflation or other defining factors have a limited impact on valuation results. The 2022 valuation results due soon will however likely include a provision for higher costs
- The valuation results notwithstanding, pension uplifts are explicitly linked to September CPI so funds will be liable for a c10% increase in costs from April next year and a resulting demand for increased investment income
- Our one active equity portfolio, Newton, has struggled in recent months with sector allocation being a key factor. They have claimed previously to perform less badly (than punchy active growth managers) in falling markets, but this isn't playing out. I hate sounding like a broken record, but there is nothing but bland comment surrounding the outlook either for markets or their intentions
- The Fund's asset allocation strategy continues to develop with increased diversification and explicit investments in targeted ESG strategies