LONDON BOROUGH OF SOUTHWARK - Quarterly Report September 2022

Market Background

Further losses were incurred in the September quarter with investors facing now familiar headwinds. The most dominant of these over the quarter was continued heightened inflation and central banks' actions to mitigate the effects.

As in the previous quarter, both equity and bond markets fell as rising interest rates (central banks' blunt instrument response to rising inflation) reduced bond valuations and the net present value of future earnings for shares.

Global equities retreated by around 5% over the period although most UK investors will have 'enjoyed' marginally positive returns due to the weakness in sterling.

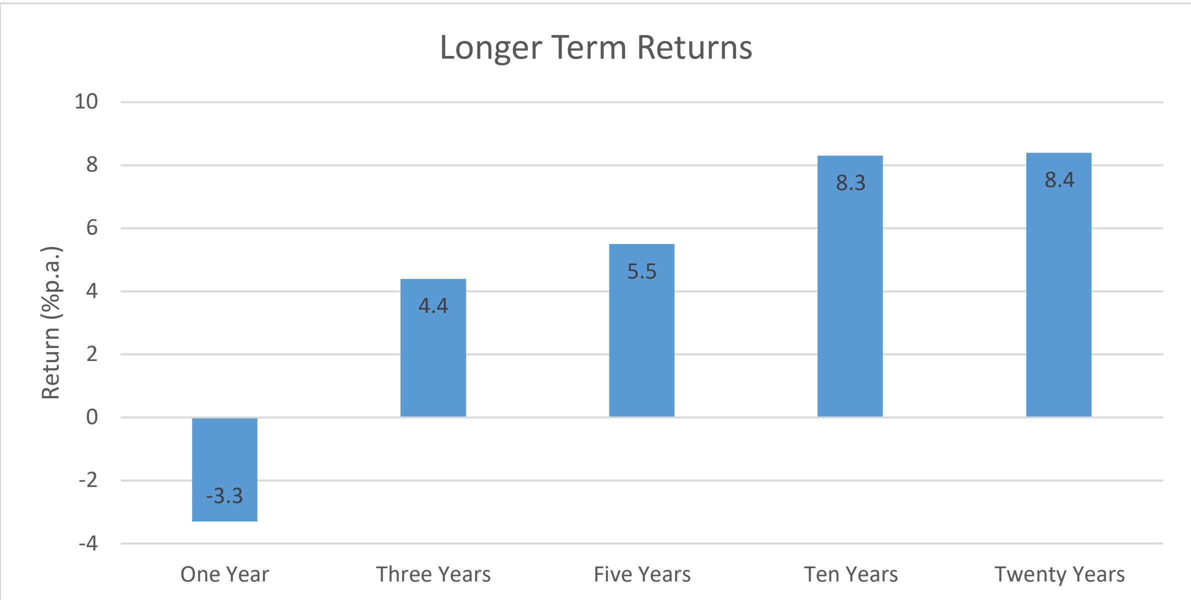
Regionally, the UK and Japan were better performers due in part to their weaker currencies but the former also benefitted from a higher exposure to energy stocks.

Conventional and inflation linked bonds fell sharply, with UK debt losses sharpened by Kwasi Kwarteng's controversial mini budget proposing supply side economic reforms and unfunded tax cuts.

Property markets were not immune from the global influences of higher for longer inflation and low growth. Return expectations have been pegged back with CBRE forecasting returns in the region of 5%p.a. in the near-term.

LGPS Funds
The average LGPS funds is expected to have returned -0.3%, a third successive negative showing.

Longer-Term
The one-year number has remained in negative territory and the three- and five-year returns range between 4-6%p.a.
Over the last ten years the average fund has delivered a return of 8% 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 started off the quarter brightly, returning 4% in July before falling back in September to close flat over the quarter. Over the period, the Fund underperformed the benchmark modestly (0.2% behind).

Performance from the Fund's managers was mixed as might be expected.

The analysis below shows the make-up of the returns, both absolute and relative.

			Returns			Contributions		
Manager	Brief	Start Value (£m)	Fund	Benchmark	Relative Return	Fund	Benchmark	Relative
BLK *	Equity/ILG	411,212	1.0	-1.3	2.3	0.2	-0.3	0.5
LGIM *	Equity/ILG	377,352	-0.4	-1.1	0.7	-0.1	-0.2	0.1
BLK	Diversified Growth	176,458	-0.9	0.6	-1.5	-0.1	-	-0.1
BLK	Absolute Return Bond	132,064	-1.0	0.6	-1.5	-0.1	-	-0.1
Newton	Global Equity	242,349	1.3	2.1	-0.8	0.2	0.3	-0.1
Comgest	EM Equity	89,652	-0.4	-3.8	3.5	-	-0.2	0.2
Brockton	Property	6,862	1.4	3.6	-2.1	-	-	-
Nuveen	Property (Core)	247,044	-3.4	1.7	-5.0	-0.4	0.2	-0.6
Invesco	Property	32,626	1.9	1.9	-0.1	-	-	-
M&G	Property	43,515	1.7	1.9	-0.2	-	-	-
Frogmore	Property	8,045	-2.1	3.9	-5.8	-	-	-
Glenmont	Infrastructure	20,361	2.3	2.4	-0.2	-	-	-
Temporis	Infrastructure	44,634	0.7	2.4	-1.6	-	0.1	-
Temporis Impact	Infrastructure	12,347	1.7	2.4	-0.7	-	-	-
BLK	Infrastructure	7,785	9.2	2.4	6.6	-	-	-
Blackstone	Diversified Alternatives	41,614	-0.5	2.9	-3.3	-	0.1	-0.1
BTG	Diversified Alternatives	33,080	10.4	1.5	8.8	0.2	-	0.1
Darwin	Diversified Alternatives	20,758	1.6	1.5	0.1	-	-	-
BLK/LBS	Cash	43,116	0.4	0.4	0.0	-	-	-
Total		**1,990,875**	**0.0**	**0.2**	**-0.2**	**0.0**	**0.2**	**-0.2**

** 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 0%. The column on the extreme right-hand side shows how much the managers have contributed to the excess return of -0.2%. On both the absolute and relative measures, Nuveen had the most significant negative impact.

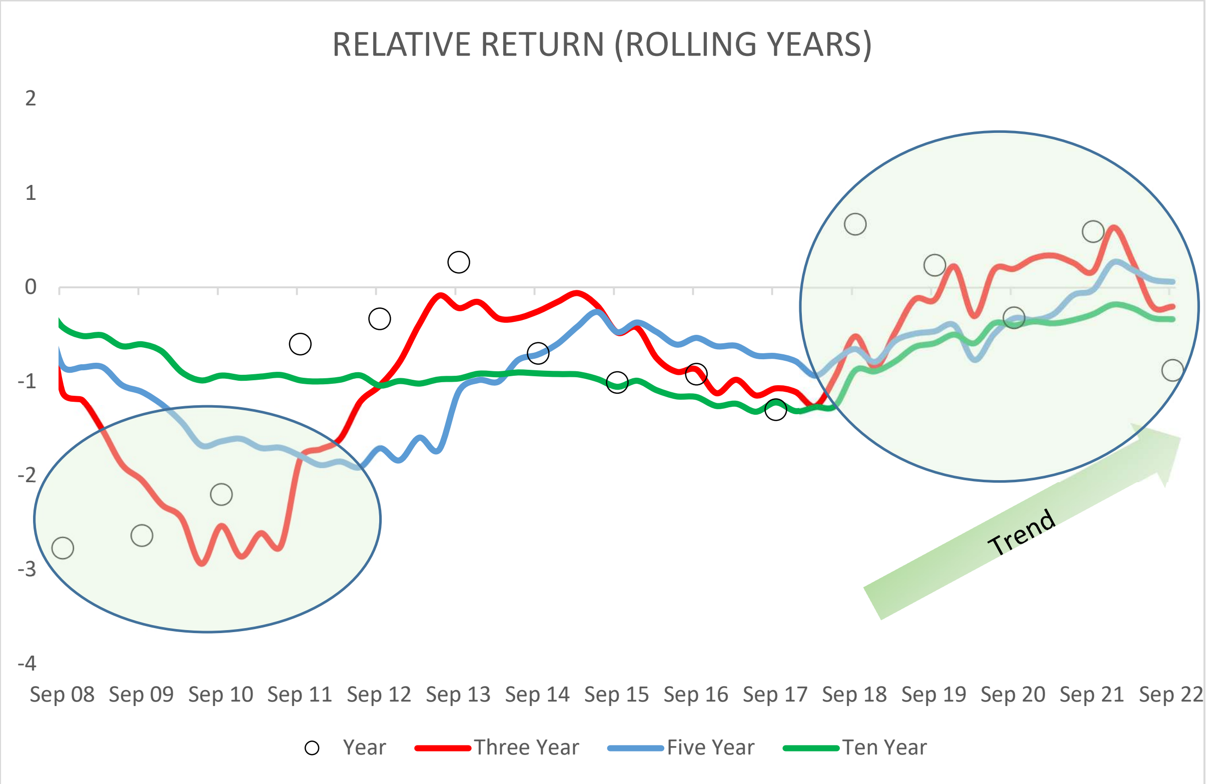
The one-year return for the Fund was disappointing both in absolute terms (-3.1%) and in relative terms (0.9% behind benchmark).

Medium-term, the Fund has returned between 5.3%p.a. and 6.8%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 9.3%p.a. return but still 0.3%p.a. off the target.

Returns have generally been improving of late (despite the last few quarters) 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.

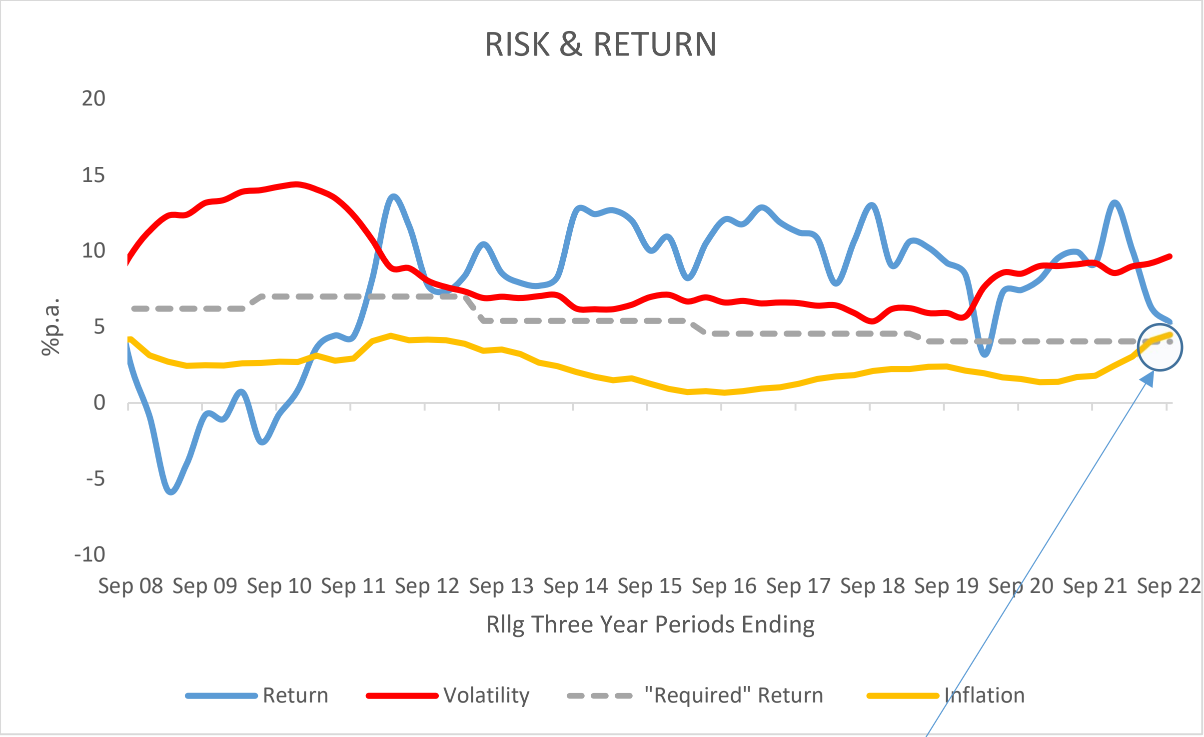
I enclose again a chart plotting the Fund's returns over a number of rolling periods relative to the benchmark. I have selected a 15-year period to review.



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 (highlighted) 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 on the rolling return 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
- It is worth remarking again that the 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 11% and is expected to remain at or above this rate in the immediate near-term.

Newton – Active Global Equity

Newton underperformed the World index by around 0.2% over the quarter. Stock selection was key to the underperformance over the period due to weakness in the financials, health care and consumer discretionary sectors. Asset allocation provided a partial offset, avoiding telecoms and real estate helped.

Relative to the stretched (index plus target aspiration) benchmark, the portfolio lagged by 0.8%.

The portfolio's annual return was sharply negative (4.7% short of the stretched benchmark) with three quarters behind. When they last presented to PAP, one analysis they tabled showed resilient performance in down markets. This has not been our experience over the year.

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

In terms of activity, despite quite significant underperformance, Newton have made few changes since (in their words) they are comfortable with the structure of the portfolio against a backdrop of more volatile market conditions.

When they last presented to PAP, one analysis they tabled showed resilient performance in down markets. This has not been our experience, and over the last five years, there has been no discernible correlation between their relative performance and the direction of markets.

Comgest – Active Emerging Market Equity

The portfolio, in place now for a year, outperformed the index benchmark by a sizeable margin, despite posting a negative return (portfolio -0.4%, index -3.8%). In terms of positives, country allocation was favourable particularly underweighting China and overweighting Brazil. The portfolio was holding just under 10% in cash which also added to the bottom line.

Over the full year, the portfolio returned -15.3%, in itself disappointing but worse when compared to the benchmark at -13.2%. It is far too early to draw any conclusions from this short-term performance.

BlackRock - Active

Unfortunately, both active positions delivered negative returns and performed poorly relative to the cash benchmark over the quarter.

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

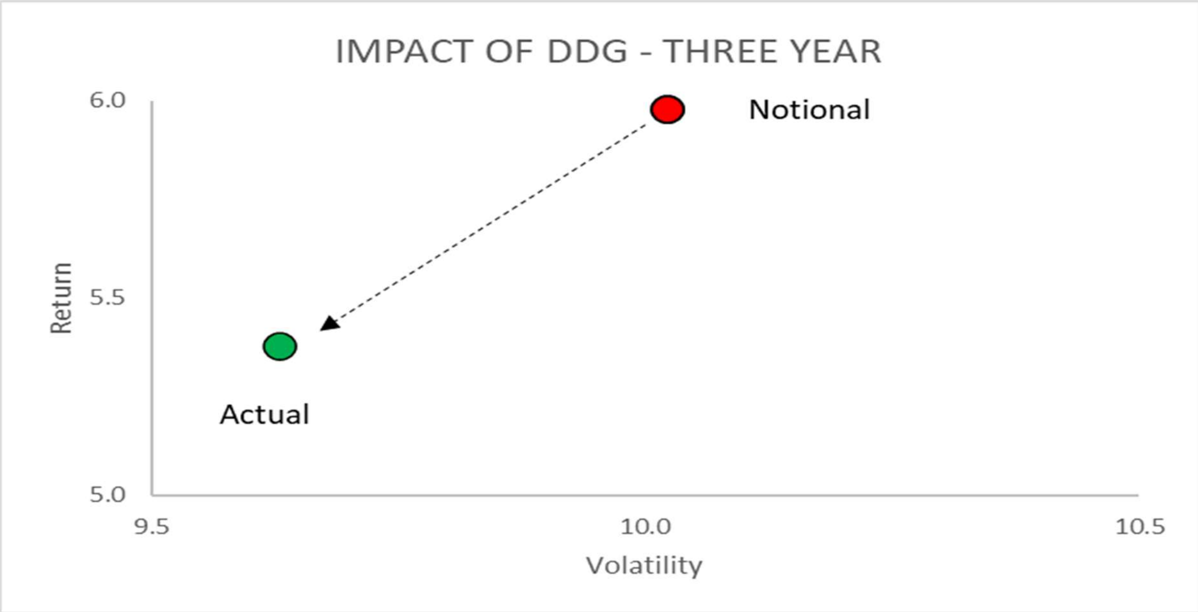
The negative return from the DG portfolio stemmed from the developed equity and credit positions.

Since their inception, returns from both strategies have been in modest low digit single figures and disappointingly behind our modest expectation (cash plus 3 or 4%).

These two portfolios hold traditional assets, but return profiles are designed to deliver results differently. Both aim simply to produce capital growth i.e. positive returns. It is anticipated that in strong growth environments, returns will appear pedestrian, but in down markets, returns should be less impacted and ideally positive.

Looking at the DDG portfolio, whilst seeking to offer downside protection, return generation is intended to be uncorrelated to that of any single asset class and as such, the overall Fund volatility should reduce in any prevailing market condition.

To see how this has worked in practice 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 (by 0.4%p.a.) but at the cost of some potential return (0.6%).

In terms of the balance between risk and return, the trade-off is arguably quite poor. One of the main reasons for this is that the returns being generated are quite highly correlated (on my crude calculations) to equites, the Fund's primary growth driver.

Nuveen Real Estate – Core Property

The portfolio returned -3.3% over the quarter (Nuveen numbers). The overall return comprised an income return of 1.0% and capital reduction of -4.2%. The capital depreciation was led very much by reduced activity brought about by market uncertainty and a resultant weakening in sentiment. Unsurprisingly, the return fell short of the benchmark (7%p.a.) but was marginally better than comparable real estate measures. The portfolio's industrial assets were the weakest over the period reversing some very positive performance in recent periods.

The full year return reported by Nuveen is a very healthy 13.8%. This has improved medium-term numbers (three and five year numbers are in the region of 6%p.a.).

The current seven-year number of 5%p.a. has fallen back and remains behind the 7%p.a. target set by the Panel.

There are many headwinds facing the commercial real estate sector and returns are likely to be behind expectation until such times as inflation and interest rates revert to some semblance of normality and activity picks up.

Please note that JPM and Nuveen returns are now being calculated on a consistent basis.

Residential/Opportunistic Real Estate

Reported returns were typically behind benchmark over the quarter and the full year. Going on JP Morgan's returns, Invesco has been the better performer 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.

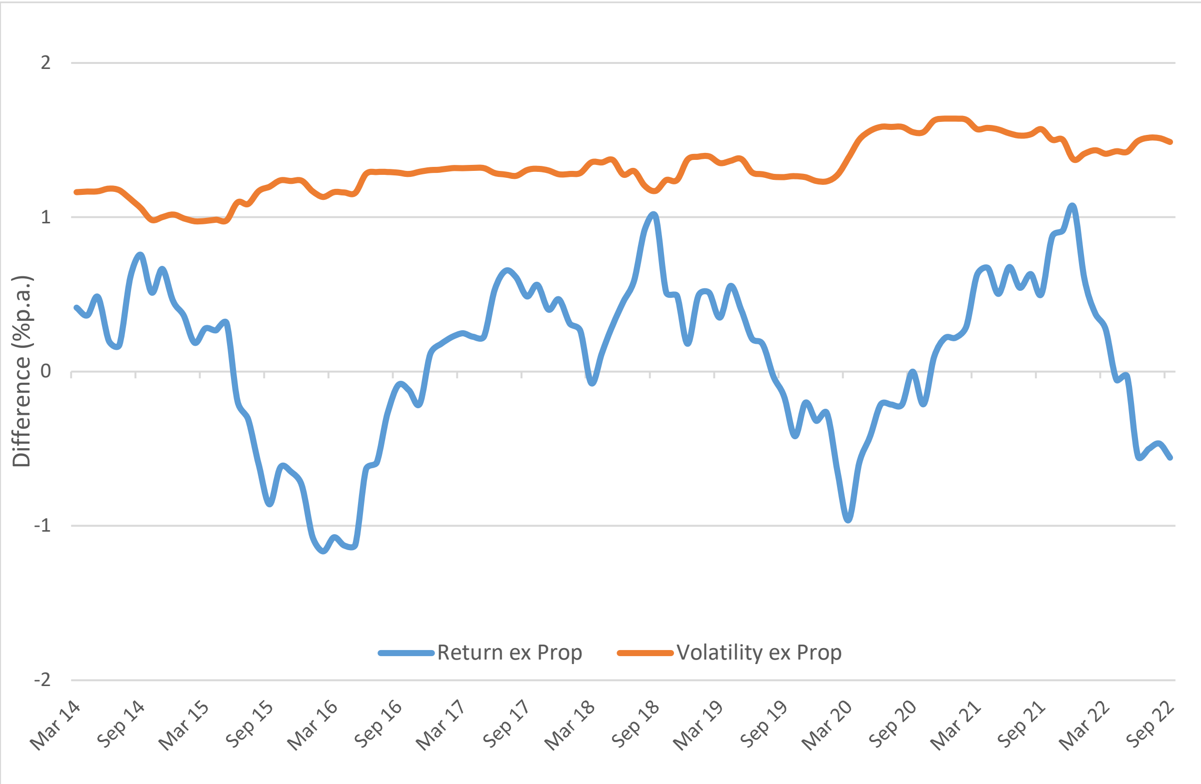
	Quarter *			Year		
	Fund	Benchmark	Relative	Fund	Benchmark	Relative
All Property	-2.0	1.8	-3.8	12.6	7.6	4.6
Core	-3.4	1.7	-5.0	14.4	7.0	6.9
Ex Core	1.4	2.2	-0.8	6.5	9.3	-2.5

**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, had the Fund not held property, the return would have been 0.6%p.a. worse off and the 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 returns so far have been encouraging.

"ESG Priority Allocation"

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

Passive Portfolios

The BLK equity mandate exhibited some abnormal tracking in the latest quarter, but this is likely to wash out over time. Elsewhere, the passive mandates have largely tracked the respective benchmarks.

Summary

- This was a third very difficult quarter for the sector and Southwark with flat to negative returns and heightened volatility in evidence
- The Fund had a lacklustre September quarter and has not kept pace with the benchmark
- There is very little by way of good news on the horizon – inflation is back to levels last seen forty years ago, recession in the UK and other developed economies is becoming a reality and interest rates are at their highest since early 2009
- 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
- The Fund's asset allocation strategy continues to develop with increased diversification and explicit investments in targeted ESG strategies. The increased diversification has proven timely!