LONDON BOROUGH OF SOUTHWARK - Quarterly Report December 2022

Market Background

Markets ended a very challenging calendar year on a slightly more positive note, despite persistently high inflation, tight monetary policy and lingering pessimism over the outlook for global GDP growth. Both equity and credit markets posted gains.

In terms of equities, European markets performed well with concerns over energy shortages easing and the UK recovering from the damage caused by the 'mini budget' whilst in Asia, the surprise relaxation of China's zero Covid policy provided support. In the round, global stock markets returned close to 8%, but appreciation in Sterling (or more accurately weakness in the Dollar) reduced gains to the unhedged UK investor of around 2%. Energy and related sectors (industrials and materials) outperformed whilst technology and consumer discretionary stocks performed poorly.

Bond market performance was mixed over the period; positive for conventional sterling issues and global credit, negative for inflation linked and non-UK sovereign debt.

The poorest performing asset class over the quarter was real estate, with some estimates showing capital declines of between 12% and 15%. Weak investor sentiment, and a high interest rate/low growth environment have slowed deal flows and led to sharp falls in capital values.

LGPS Funds

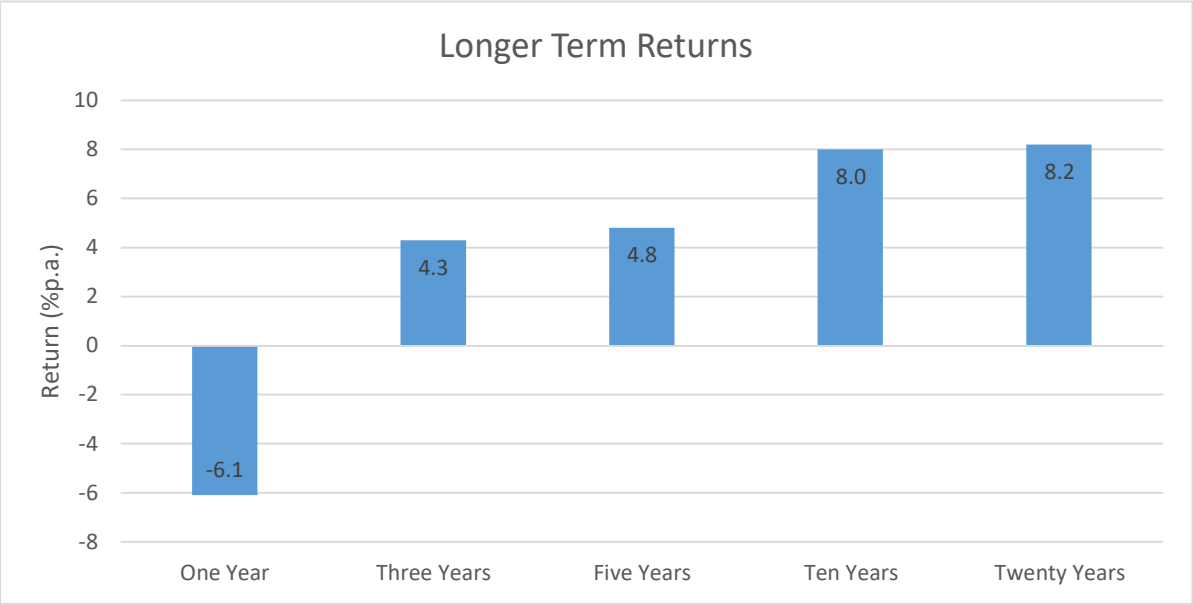
The average LGPS funds is expected to have returned +1%, arresting a series of quarterly losses.

Longer-Term

The one-year number has remained firmly in negative territory and the three- and five-year returns range between 4-5%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 was performing positively in October and November but gave up all, and more, of the gains in December to record a return of -1.1% for the quarter. This was behind the benchmark return of 1.3%.

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	415,384	-1.2	0.7	-1.9	-0.2	0.1	-0.4
LGIM *	Equity/ILG	375,668	0.3	0.1	0.2	0.1	-	-
BLK	Diversified Growth	174,911	2.4	0.9	1.5	0.2	0.1	0.1
BLK	Absolute Return Bond	130,755	3.2	0.9	2.3	0.2	0.1	0.1
Newton	Global Equity	245,690	1.4	2.8	-1.3	0.2	0.3	-0.2
Comgest	EM Equity	89,442	1.7	1.8	-0.1	0.1	0.1	-
Brockton	Property	7,191	-0.2	3.6	-3.6	-	-	-
Nuveen	Property (Core)	240,785	-12.7	1.7	-14.2	-1.5	0.2	-1.7
Invesco	Property	33,241	4.8	1.9	2.8	0.1	-	-
M&G	Property	44,265	-1.6	1.9	-3.5	-	-	-0.1
Frogmore	Property	7,990	0.2	3.9	-3.5	-	-	-
Glenmont	Infrastructure	20,566	13.8	2.4	11.1	0.1	-	0.1
Temporis	Infrastructure	44,965	0.8	2.4	-1.6	-	0.1	-
Temporis (New)	Infrastructure	0	0.0	0.0	0.0	-	-	-
Temporis Impact	Infrastructure	12,561	0.7	2.4	-1.7	-	-	-
BLK	Infrastructure	9,451	-6.7	2.4	-9.0	-	-	-
Blackstone	Diversified Alternatives	50,044	-7.8	2.9	-10.4	-0.2	0.1	-0.3
BTG	Diversified Alternatives	36,522	-3.4	1.5	-4.8	-0.1	-	-0.1
Darwin	Diversified Alternatives	21,082	1.6	1.5	0.1	-	-	-
BLK/LBS	Cash	33,767	0.7	0.7	0.0	-	-	-
Total		**1,994,280**	**-1.1**	**1.3**	**-2.4**	**-1.1**	**1.3**	**-2.4**

**** 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.***

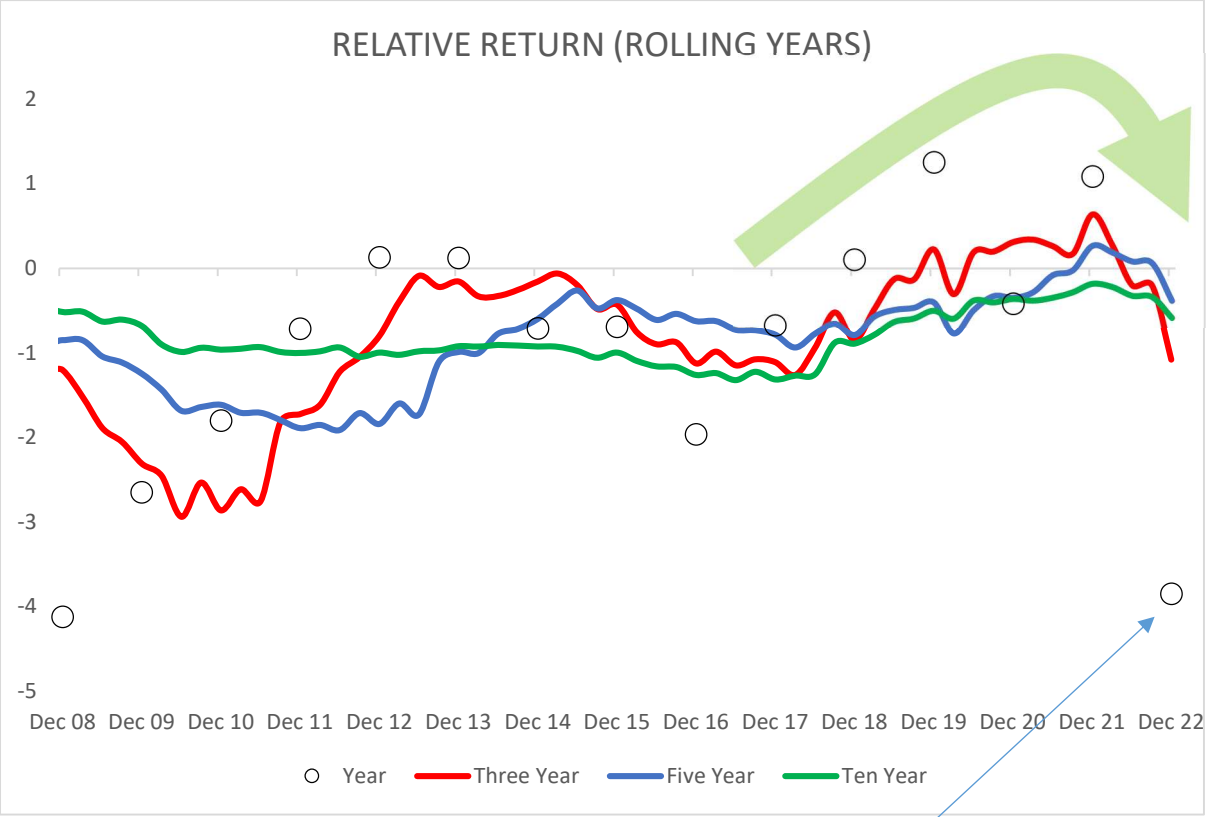
The third column from the right shows how much the managers have contributed to the overall return of -1.1%. The column on the extreme right-hand side shows how much the managers have contributed to the excess return of -2.4%. On both the absolute and relative measures, Nuveen had the most significant negative impact for a second successive quarter.

The one-year return for the Fund was disappointing both in absolute terms (-8.6%) and in relative terms (3.8% behind benchmark). Over the full year, the two biggest contributors to the sizeable shortfall were Nuveen and the DDG portfolio managed by BlackRock.

Medium-term, the Fund has returned between 4.7%p.a. and 5.8%p.a. over the three and five-year periods. Both periods' returns have been behind benchmark, the latter by a smaller margin.

Over the last ten-years, the Fund has delivered a very valuable 8.9%p.a. return but 0.6%p.a. off the target.

Over the course of the last couple of years, I have been reporting a general improvement in the Fund's relative performance; medium term returns above benchmark and longer-term returns behind but by ever decreasing margins. Performance throughout calendar year 2022 and in particular the last six months however, has reversed this trend quite markedly as is illustrated in my updated chart.



In summarising the chart,

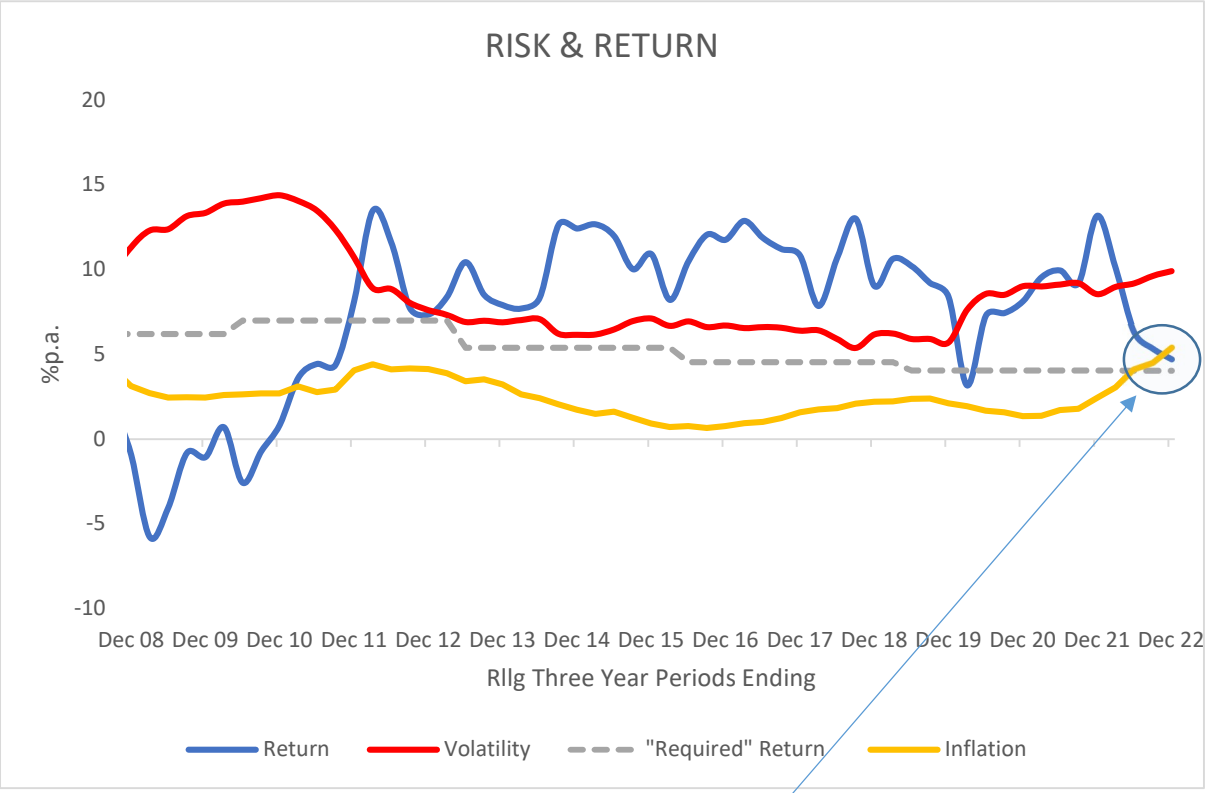
- The upward sloping trails toward the right of the chart (Dec 2017 – Dec 2021) highlight the pattern of improving returns
- The margin of underperformance in the latest year has had a pronounced bearing on the latest rolling results

It's probably worth putting some context around the sizeable underperformance in 2022. There were two primary detractors:

Nuveen – responsible for around 1.7% of the shortfall, it could be argued that the underperformance came not from lack of asset manager skill rather than the performance of the asset class itself. We have an aspiration of 7%p.a. for the asset but over a market cycle rather than year on year. A number of public sector funds have even more challenging aspirations e.g. inflation plus a percent or two and will have suffered even more!

BlackRock Diversified Growth – responsible for around 1.2% of the shortfall. We have appointed BLK to select from a broad universe of assets to deliver capital growth. Sold on the pretext of asymmetric and uncorrelated return, we appreciate there will of course be periods when the strategy will not deliver a positive return, but the magnitude of the underperformance is a concern and one which we are addressing. In contrast to Nuveen, the underperformance can be put down to manager skill (or lack thereof).

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



Again, as a reminder of what this is telling us,

- 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
- The return impact on the rolling return of the pandemic was relatively short-lived although volatility (the red trail) has remained heightened
- The blue line shows that 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). The performance in the latest year has reduced this margin however
- The extreme right hand side of the chart shows that inflation has now overtaken the 'base' return set by the actuary. With CPI likely to remain well ahead of the Government's target in the immediate short-term, this is a concern

Newton – Active Global Equity

Newton underperformed the World index by around 0.7% over the quarter. Stock selection and sector allocation weighed on returns. Disappointing performance in the health care and industrials sectors, underweighting energy and overweighting consumer discretionary and technology were key.

Relative to the stretched (index plus target aspiration) benchmark, the portfolio lagged by 1.3%.

The portfolio's annual return was sharply negative (5.8% short of the stretched benchmark) with each of the four quarters behind.

By way of some background, active managers in the round are unlikely to have performed well for their LGPS clients in recent quarters with many favouring 'growth' companies over 'value' companies. Over the calendar year, the value portion of the world index has gained around 4% whilst the growth index has lost around 19%.

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

I continue to track Newton's performance in both up and down markets. There remains 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, performed a touch behind benchmark over the quarter (portfolio 1.7%, index 1.8%).

Over the full year, the portfolio returned -9.7%, but outperformed the index by 0.4%.

BlackRock - Active

Both active positions delivered positive returns and outperformed the cash benchmark over the quarter.

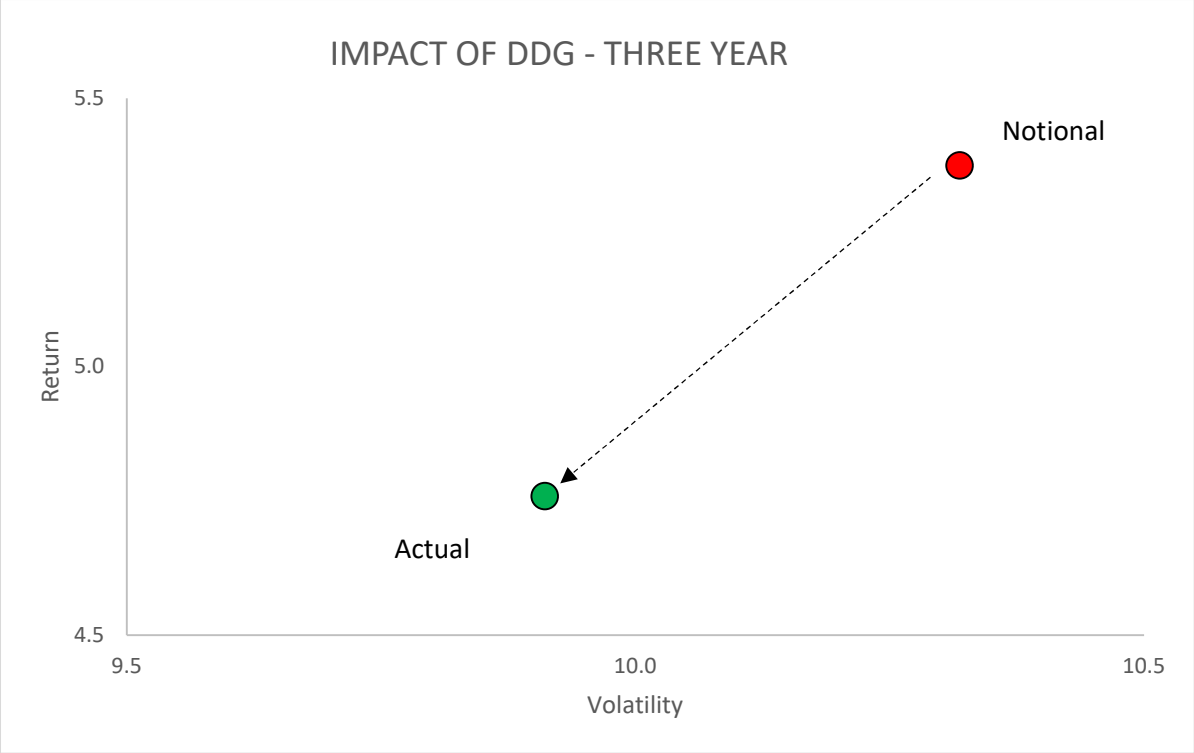
The ARB portfolio benefitted from a longer duration in government bonds as yields fell. The DG portfolio benefitted from the positive returns available from equities and credit.

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.

Focusing on 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 to equites, the Fund's primary growth driver.

Nuveen Real Estate – Core Property

The portfolio returned -12.4% over the quarter (Nuveen numbers). The overall return comprised an income return of 0.8% and capital reduction of -13.1%. The portfolio assets depreciated across the board with returns ranging from -10% from offices and 16% industrial holdings. The portfolios single indirect asset, the UK Retail Warehouse Fund decreased by almost 18%.

The full year return reported by Nuveen was -7.4%, a significant reversal of the near +14% reported last quarter. This has dented medium-term numbers (three and five year numbers are between 1.5%p.a. and 2.5%p.a.) and longer-term returns (the ten year return is around 6%p.a.).

The current seven-year number of c2.7p.a. has fallen back sharply and remains some way 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.

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.

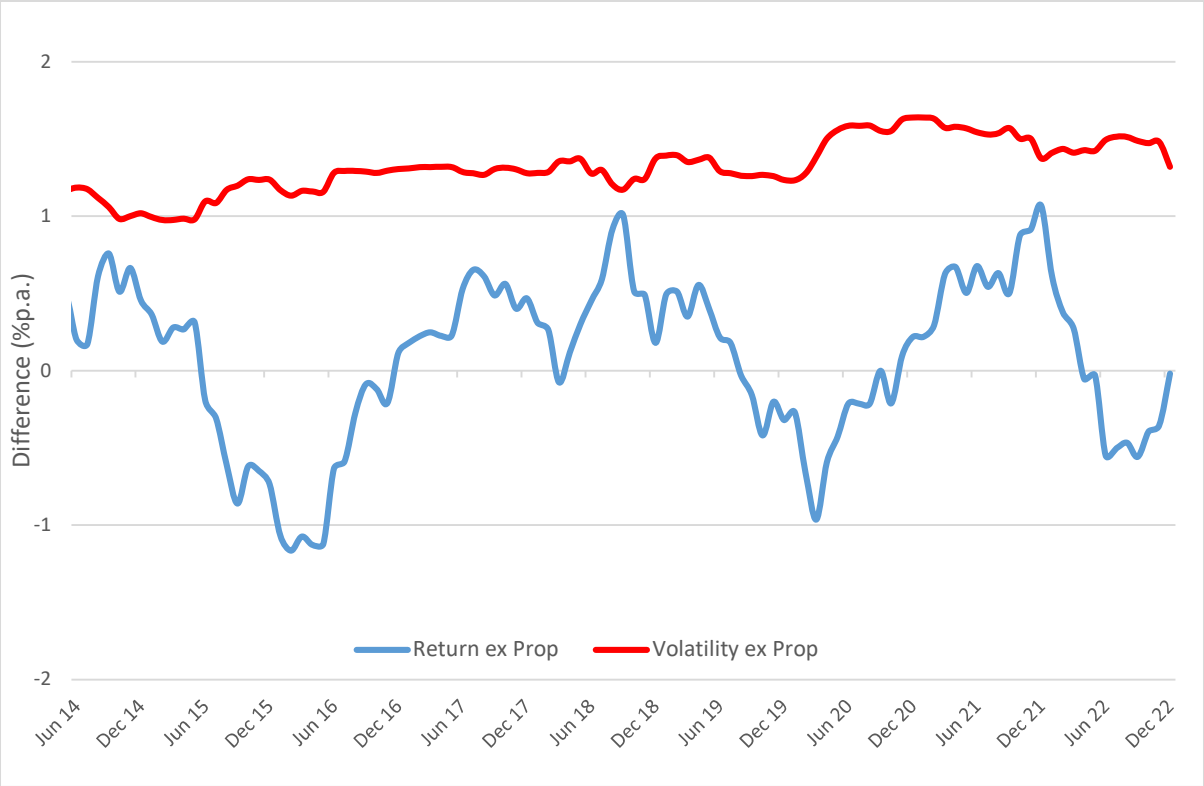
Southwark's Property Allocation

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	-8.5	1.9	-10.2	-3.3	7.6	-10.2
Core	-12.7	1.7	-14.2	-7.7	7.0	-13.7
Ex Core	1.0	2.2	-1.2	6.3	9.2	-2.7

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 outperforming and enhancing 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, holding property has not impacted the overall return but has significantly reduced the volatility significantly (by around 1.3%p.a.). This continues to be a very acceptable trade-off.

Infrastructure

The Fund's infrastructure investments are relatively new and comprise just over 6% of the overall asset value. They are very early stage but returns so far have been ahead of expectation, particularly from the earlier Temporis and Glenmont funds.

"ESG Priority Allocation"

These portfolios are also relatively new and comprise just about 5% of the Fund's assets. Returns so far are ahead of expectation.

Passive Portfolios

The portfolios tracked within tolerance over the quarter.

Summary

- This was the final quarter of a very challenging year for the sector and Southwark
- The Fund underperformed for a fourth successive quarter resulting in the poorest annual relative performance since 2008
- Property had a major impact on the outcome but as I explain above, due to the asset class as opposed to the asset manager
- Performance from the diversified growth portfolio was also a significant drag and has been a disappointing asset since inception. In light of this and other factors (notably the lack of climate awareness), the Panel believes DG no longer aligns appropriately with the overarching investment strategy and will be exited
- The short and medium-term outlook for markets remains very uncertain. Inflation remains abnormally high and interest rates continue to increase. It is hoped that the former has peaked and the need for higher rates will diminish, but until this happens both real and monetary assets will stay somewhat subdued
- The current asset allocation strategy continues to serve the Fund well and the performance from some of the newer investments has been quite encouraging