LONDON BOROUGH OF SOUTHWARK - Quarterly Report March 2023

Executive Summary

- This was the final quarter of a very challenging fiscal year for the sector and Southwark. Equities, bonds and property all delivered sub-zero returns
- The Fund underperformed by a small margin in the March quarter returning 2.8% compared to a benchmark of 3.1%
- The Fund struggled over the fiscal year as a whole due primarily to the performance of our real estate holdings. Whilst the asset performance was disappointing (around -9%) the comparative benchmark was very challenging
- The performance of the diversified growth and absolute return bond portfolios also impaired the Fund’s annual return. Both are in the process of being unwound due primarily to their lack of alignment with the Fund’s overarching strategy
- The medium and long-term returns for the Fund are strong, ahead of both heightened inflation and actuarial assumption, but behind benchmark
- 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

Market Background

Markets closed off the fiscal year on a positive note with both equities and bonds gaining over the quarter. Global growth was better than many expected, with energy prices falling, labour markets showing some resilience and business confidence improving. Recession appears to have been averted in the UK and prospects have picked up in most developed economies. Importantly, whilst central banks continued to raise rates, inflation fell in anticipation of an easing of the pace of recent tightening.

The quarter was a volatile one for equities with the collapse of Silicon Valley Bank and Signature Bank weighing on the banking sector. Growth stocks were buoyed by the potential for lower rates and falling bond yields, outperforming value stocks by a significant margin reversing the recent trend.

All regions recorded positive returns, but Europe posted the strongest gains with falling energy prices bolstering confidence. Further appreciation in Sterling reduced gains to the unhedged UK investor.

In sector terms, energy and financials underperformed. These are areas typically underrepresented in our active portfolio and that of many public sector funds, and so a measure of outperformance may be expected.

Bond market performance was volatile over the quarter but generally positive. In terms of GBP bonds, conventional (gilts and corporate) and index-linked bonds returned between 2% and 4%.

The poorest performing of the major asset classes over the quarter was real estate. Return estimates vary but a near zero outcome may be reasonable with income offsetting continued falls in capital values. The pace of decline in capital values appears to have slowed however which will be welcome news for investors who have built up relatively large stakes in the asset in recent years.

LGPS Funds

The average LGPS fund returned c3%, delivering some respite from the negative returns posted in each of the 2022 calendar quarters.

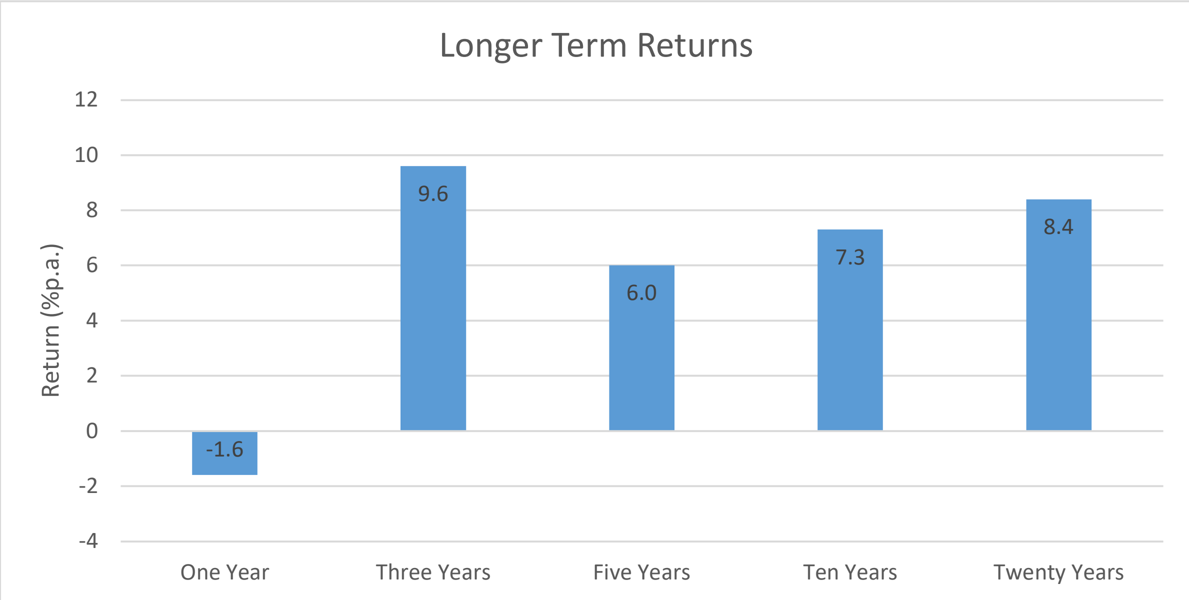
Longer-Term

Unsurprisingly, the one-year number remained in negative territory with a return in of -1.6%.

The three-year return, always an important measurement point for the LGPS is running at a healthy 9.6%p.a. or 3%p.a. ahead of inflation.

Over the last ten years the average fund has delivered a return of c7% p.a. and over 20 years, c8%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 2.8% over the quarter, marginally underperforming the benchmark which came in at 3.1%.

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.

Column			A	B	C	D	E	F
				Returns			Contributions	
Manager	Brief	Start Value (£m)	Fund	Benchmark	Relative Return	Fund	Benchmark	Relative
BLK *	Equity/ILG	410,447	3.6	4.1	-0.5	0.8	0.9	-0.1
LGIM *	Equity/ILG	376,800	5.1	4.4	0.7	1.0	0.8	0.1
BLK	Diversified Growth	126,115	3.1	1.0	2.1	0.2	0.1	0.1
BLK	Absolute Return Bond	134,917	-1.2	1.0	-2.2	-0.1	0.1	-0.2
Newton	Global Equity	249,499	7.4	5.0	2.3	0.9	0.6	0.3
Comgest	EM Equity	91,122	2.4	1.1	1.2	0.1	0.1	0.1
Brockton	Property	7,179	-4.7	3.6	-8.0	-	-	-
Nuveen	Property (Core)	210,418	0.6	1.7	-1.1	0.1	0.2	-0.1
Invesco	Property	34,830	-5.0	1.9	-6.8	-0.1	-	-0.1
M&G	Property	43,562	-0.8	1.9	-2.6	-	-	-0.1
Frogmore	Property	8,195	-17.6	3.9	-20.7	-0.1	-	-0.1
Glenmont	Infrastructure	23,059	14.7	2.4	12.0	0.2	-	0.1
Temporis	Infrastructure	43,392	0.0	2.4	-2.3	-	0.1	-0.1
Temporis (New)	Infrastructure	30,590	0.0	1.7	-1.7	-	-	-
Temporis Impact	Infrastructure	12,646	0.0	2.4	-2.4	-	-	-
BLK	Infrastructure	12,691	7.2	2.4	4.7	-	-	-
Blackstone	Diversified Alternatives	46,373	-10.4	2.9	-12.9	-0.2	0.1	-0.3
BTG	Diversified Alternatives	34,943	2.3	1.5	0.8	-	-	-
Darwin	Diversified Alternatives	21,416	1.0	1.5	-0.5	-	-	-
BLK/LBS	Cash	45,039	0.9	0.9	-0.0	-	-	-
Total		**1,963,231**	**2.8**	**3.1**	**-0.3**	**2.8**	**3.1**	**-0.3**

** 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.*

There are a lot of numbers in the table but by way of explanation;

- Column A shows the returns generated by each of our managers and the aggregate outcome
- Column B shows the returns targeted by the managers and the aggregate
- Column C shows how each of the managers has fared relative to their own benchmark i.e. value add
- Column D is simply the weighted contribution to the total from each of the managers e.g. a portfolio returning 10% representing 5% of the Fund's assets would contribute 0.5%
- Columns E is the same but for the benchmark returns
- Column F is the same but for the relative returns

The takeaways for the latest quarter are;

- In terms of the overall outcome of 2.8% (column D), the key positive contributors were the two 'balanced' tracker portfolios (LGIM and BlackRock) and Newton. Unsurprisingly, these are our largest portfolios.
- There were some very large deviations from benchmark (column C). The largest deviations, both positive and negative, came mostly from the smaller specialist or niche portfolios e.g. Darwin Bereavement Services. These deviations are not untypical as the investments are long-term in nature and cashflows (payments to and from the Fund) are unpredictable and irregular. In a number of cases, the success (or otherwise) of such investments will only be determined after a number of years.

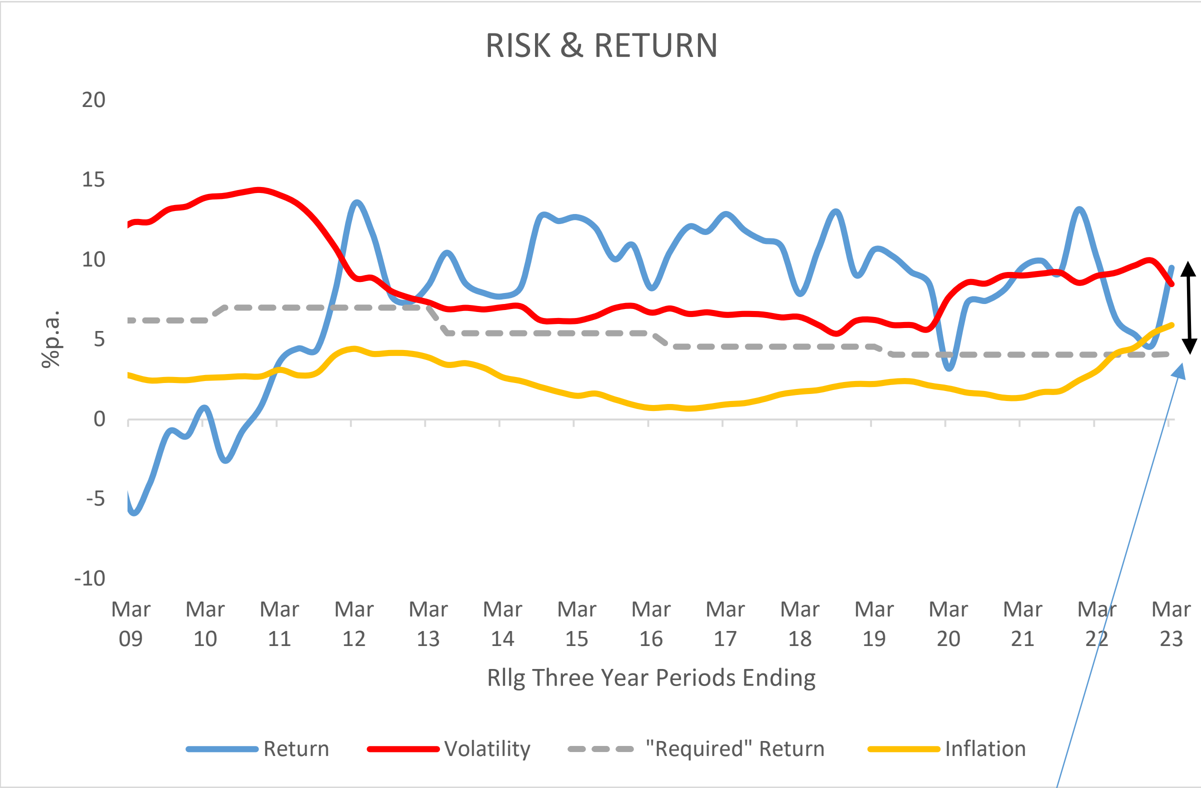
- In terms of contributions to the overall excess return of-0.3% (column F), the absolute return bond portfolio managed by BlackRock and the private equity portfolio managed by Blackstone were the key detractors. Our active equity portfolio (Newton) recouped 0.3%.

Over the **full fiscal year**, the Fund returned a disappointing -4.3%, some way behind the benchmark of -0.6%. The bulk of the underperformance came from our property holdings which alone detracted 2.7%. Also detracting value were the absolute return bond and diversified growth portfolios managed by BlackRock.

Medium-term, the Fund has returned between 9.5%p.a. and 6.8%p.a. over the three and five-year periods. Both periods' returns have been behind benchmark, the latter by a smaller margin.

Longer-term, over the last ten-years, the Fund has delivered a very valuable 8.2%p.a. return but 0.7%p.a. off the target.

Repeating the analysis I've been showing for the last few quarters charting the progress of the Fund's return in the context of inflation and the return assumed by the actuary;



In summary,

- 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 latest quarter has widened the margin quite considerably
- The red line shows the volatility of the returns being delivered (sometimes, and arguably unhelpfully, termed "risk"). This has remained heightened post pandemic due to global factors
- The extreme right hand side of the chart shows that inflation (the yellow line) 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

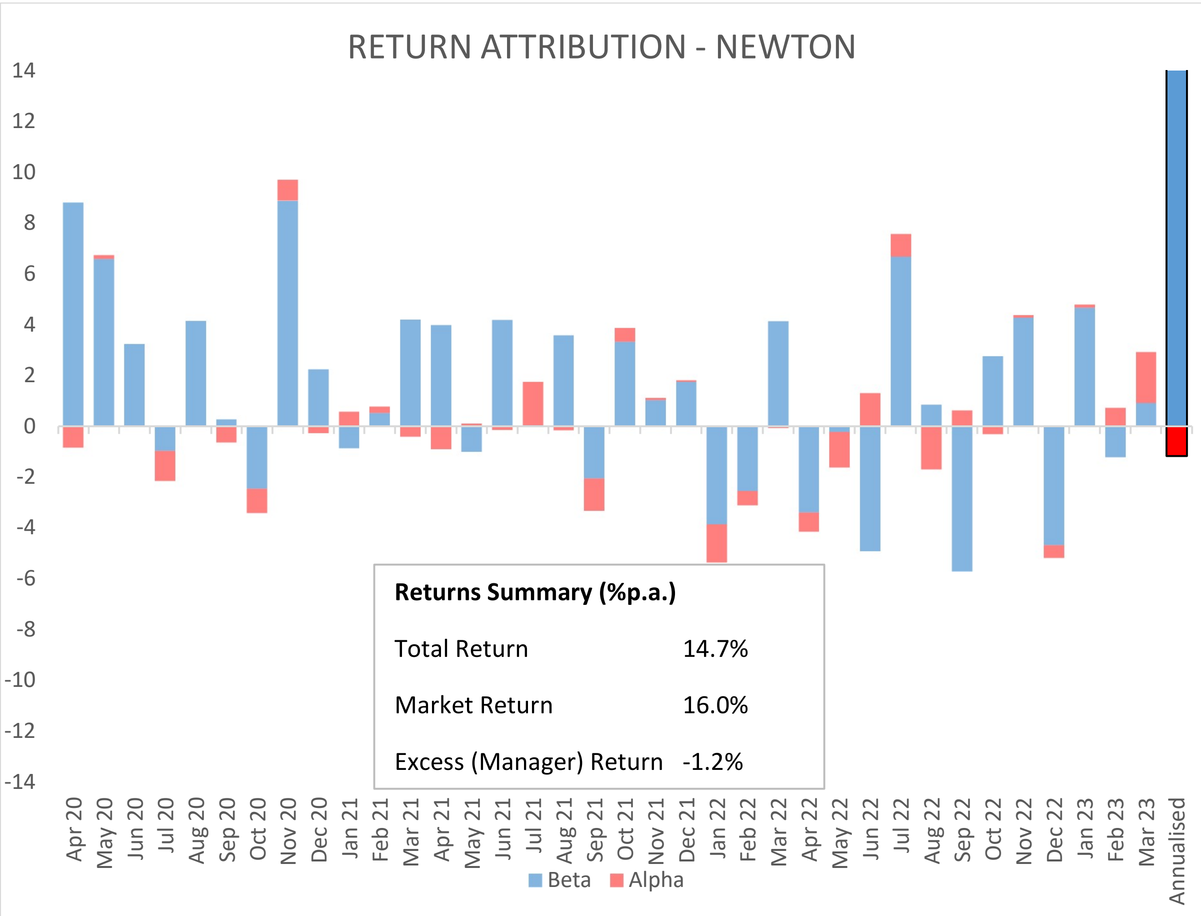
Newton – Active Global Equity

Newton enjoyed an excellent quarter, outperforming the World Index by around 3%. This is their best showing in more than a decade. Over the period, stock selection within healthcare, industrials and consumer discretionary were additive. A zero weighting in energy and overweights to the consumer discretionary and technology were also beneficial.

The portfolio's annual return was barely positive but ahead of the comparative index. The return fell short of the target (index +3%) however.

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

As a brief aside, a question was asked at the last PAP meeting regarding how much of the return came from the actions of a manager. Whilst not specifically asked in relation to Newton, I've used this portfolio as an example. In the chart below, I plot the returns generated each month over the last three years;



The simple takeaway from this chart is that by far the largest portion of the return delivered comes from the market (sometimes described as "beta" and shown in blue in the above plots) rather than the manager (sometimes known as "alpha" and shown in red in the plots). *This is not a Southwark nor Newton phenomenon; it is quite universal.*

For completeness, volatility (or risk) can be similarly attributed with the market itself dictating the outcome;

- Observed volatility 13.4%p.a.
- Market risk 12.7%p.a.
- Manager risk 3.0%p.a.

Comgest – Active Emerging Market Equity

The portfolio, in place now for over a year, performed strongly over the quarter outperforming the benchmark index by 1.2% (portfolio 2.4%, index 1.1%).

Over the full year, the portfolio returned -5.2%, underperforming the benchmark by 0.3%.

BlackRock - Active

The active positions performed quite differently over the quarter.

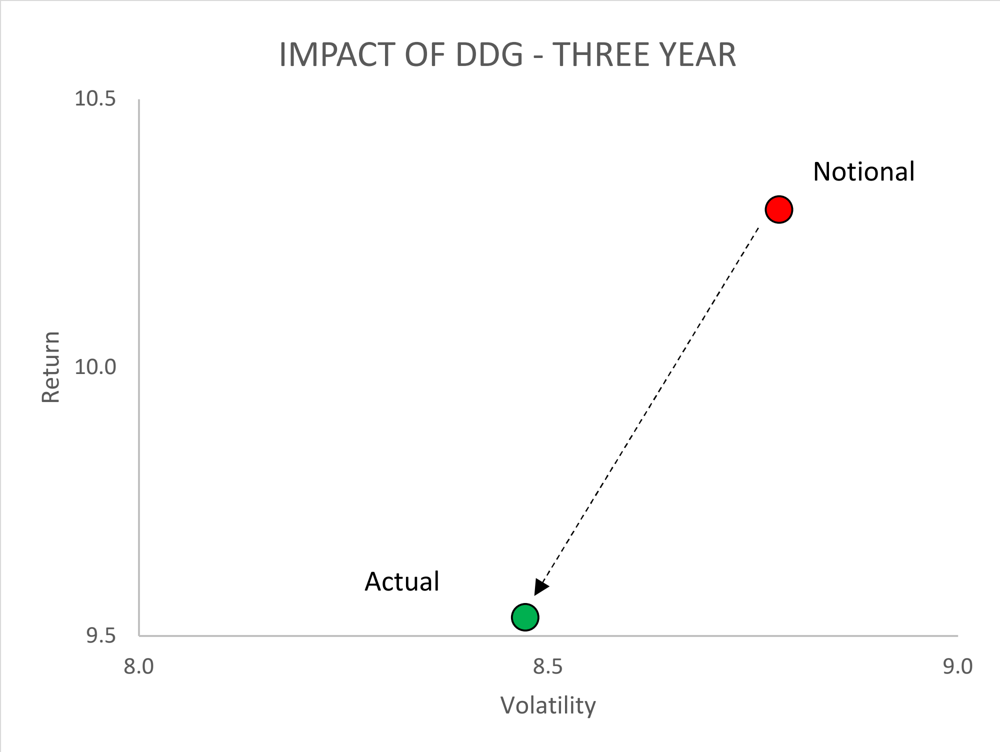
The DDG portfolio returned 3.1%, outperforming the cash benchmark. Equities, as usual, were the main positive but non-government bonds also added value.

In contrast, the ARB portfolio underperformed the cash benchmark by 2.2% over the quarter. Longer duration positions in developed market government debt weighed on returns as yields rose.

Since their inception, returns from both strategies have been disappointing, delivering less than 2%p.a. and some way behind our modest expectation (cash plus 3 or 4%).

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.

I show again a chart illustrating how this has worked in practice. As a reminder, 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 shows is that volatility has been reduced through the addition of the DDG investment but very marginally (by 0.3%p.a.) but at the cost of some potential return (0.8%).

In terms of the balance between risk and return, the trade-off is poor. One of the main reasons for this is that the returns being generated are highly correlated to equites, the Fund's primary growth driver. ***This is not an ideal fit for our baseline strategy and one of the key reasons the position is being wound down.***

Nuveen Real Estate – Core Property

The portfolio return was zero for the final fiscal quarter (manager figures). Income of around 1% was offset by capital depreciation of -1%.

Office valuations decreased most significantly by 2.9%, industrial valuations by 0.2% whilst retail increased by 0.1%. The portfolio's single indirect investment (UK Retail Warehouse Fund) performed reasonably well returning 4.7%.

The full year return reported by Nuveen was -12.4 %, a modest improvement on the calendar year. The medium-term numbers remain impaired (three and five year numbers are around 2.5%p.a.) and longer-term returns solid at 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 all behind benchmark over the quarter and for 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 time-specifically challenging) benchmarks.

Southwark's Property Allocation

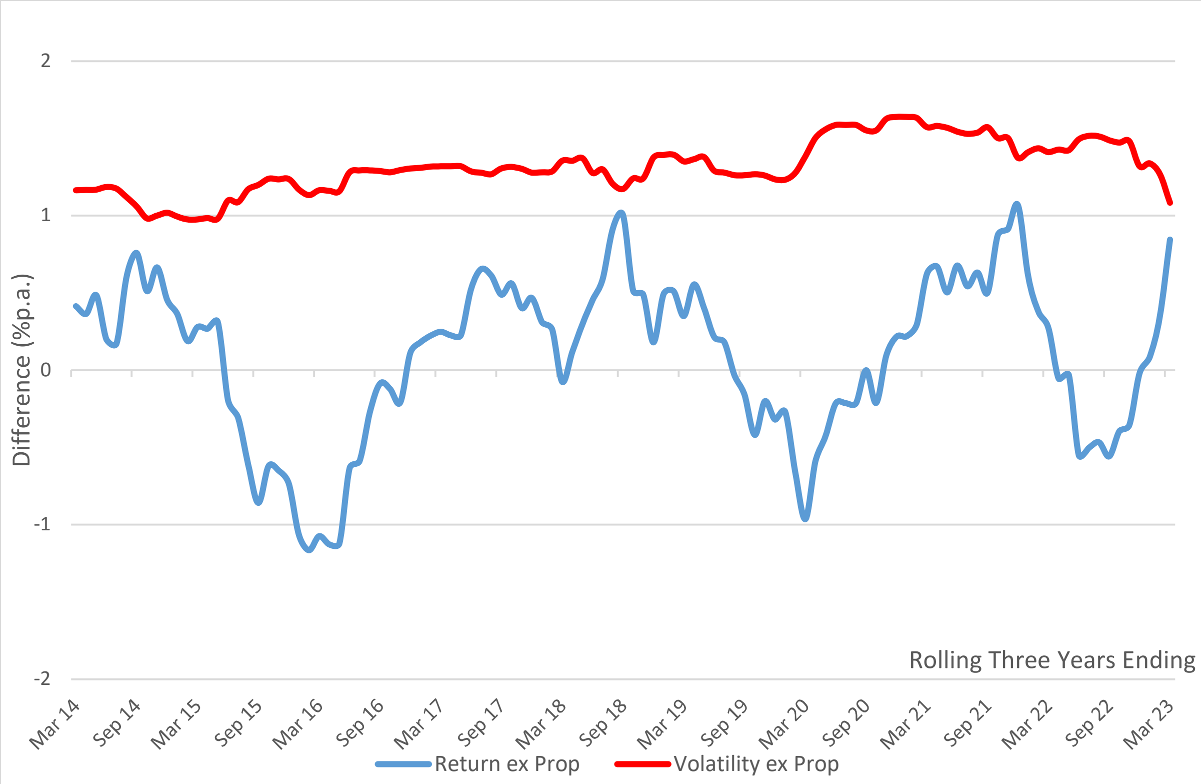
The core and added value/opportunistic assets continue to perform quite differently. The following table gives a flavour of this.

	Quarter			Year		
	Fund	Benchmark	Relative	Fund	Benchmark	Relative
All Property	**-0.8**	**1.8**	**-2.6**	**-8.7**	**7.6**	**-15.2**
Core	*0.6*	*1.7*	*-1.1*	*-12.6*	*7.0*	*-18.4*
Ex Core	*-3.8*	*2.2*	*-5.9*	*0.5*	*9.2*	*-8.0*

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

The table shows that over the quarter, the non-core assets underperformed and dampened the overall return. Over the full year, the opposite has been the case, where the non-core assets have enhanced the overall return.

The Fund has a sizeable allocation to real estate. This has, and will have, a significant bearing on the performance (and volatility) of the Fund and 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, the overall Fund return has been impacted negatively by our real estate holdings (by nearly 0.9%). Volatility overall has been reduced but by a similar margin. There has therefore been little benefit in terms of risk/return trade-off.

Infrastructure

The Fund's infrastructure investments are relatively new and comprise just over 6% of the overall asset value. It is too early to provide any meaningful commentary on performance, but early signs are quite encouraging. Over the fiscal year, I estimate the assets to have added in the region of 0.3% to the bottom line.

"ESG Priority Allocation"

It's a similar story for these portfolios i.e. it's very early to provide any meaningful commentary on performance but early signs are of returns ahead of expectation.

Passive Portfolios

The portfolios tracked within tolerance over the quarter.