LONDON BOROUGH OF SOUTHWARK - Quarterly Report June 2023

Executive Summary

- Equity markets were generally positive over the quarter whilst bond markets declined in response to rising interest rates
- The Fund outperformed the benchmark by 0.5% over the quarter
- The Fund fared less well relative to benchmark over the full year due primarily to the performance of our real estate holdings. Whilst the asset performance was disappointing (around -11%) the comparative benchmark was very challenging
- 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.
- The current asset allocation strategy continues to evolve and serve the Fund well. The performance from some of the newer investments remains quite encouraging

Market Background

There were mixed economic signals around the globe during the quarter. Inflation remained very close to the top of agendas in most developed economies during the quarter whilst in contrast, consensus forecasts for global growth improved albeit modestly.

Interest rates were hiked in Western markets in response to stubbornly high inflation and bond markets recorded losses accordingly.

Global equities gained ground however, but the gains were narrowly focused on the tech sector, buoyed by enthusiasm over “AI”. The US was the best performer in local currency terms due to its sizeable technology exposure but in Sterling terms, Japan was the standout performer due largely to the weakness of its currency. The UK was the worst performing developed market weighed down by weakness in the basic materials and energy sectors coupled with a strong Pound which impacted the overseas earnings of many UK companies. Weak economic Chinese data led to underperformance in emerging markets.

Real estate capital values are expected to have fallen over the period echoing the negative sentiment in the wider economy. The near-term outlook for the sector is one of subdued growth.

LGPS Funds

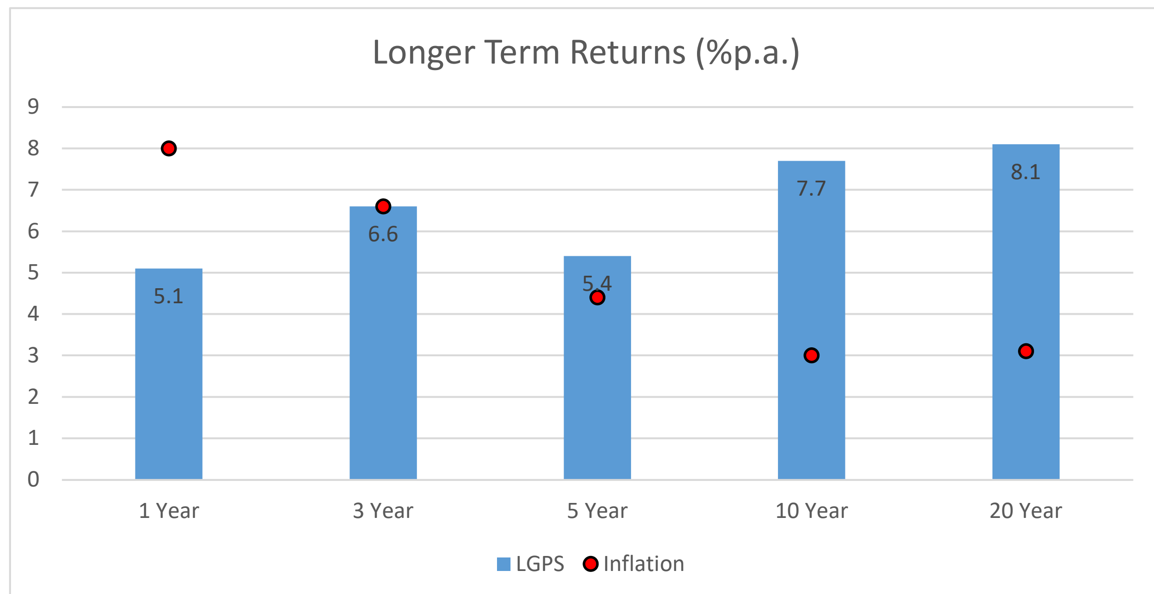
The average LGPS funds is expected to have returned +2%, starting the new year on a positive note.

Longer-Term

The one year at around 5% is positive thanks to the first calendar six months of the year.

The three-year return, always an important measurement point for the LGPS is running just shy of 7% and exactly in line with the rise in inflation. Over the last ten and 20 years the average fund has delivered a return in the region 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 2.3% over the quarter, compared to a benchmark return of 1.8%. This represents an outperformance of 0.5%.

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	425,294	2.9	2.8	0.1	0.6	0.6	-
LGIM *	Equity/ILG	384,853	2.4	1.3	1.1	0.5	0.2	0.2
BLK	Diversified Growth	141,523	0.2	1.1	-1.0	-	0.1	-0.1
BLK	Absolute Return Bond	133,397	-3.4	1.1	-4.5	-0.2	0.1	-0.3
Newton	Global Equity	268,133	2.0	4.0	-1.9	0.3	0.5	-0.2
Comgest	EM Equity	93,431	-3.9	-1.9	-2.0	-0.2	-0.1	-0.1
Brockton	Property	6,839	0.0	3.6	-3.5	-	-	-
Nuveen	Property (Core)	201,762	0.6	1.7	-1.1	0.1	0.2	-0.1
Invesco	Property	33,068	0.4	1.9	-1.6	-	-	-
M&G	Property	43,231	1.3	1.9	-0.6	-	-	-
Frogmore	Property	6,799	-3.3	3.9	-6.9	-	-	-
Glenmont	Infrastructure	26,437	-4.1	2.4	-6.3	-0.1	-	-0.1
Temporis	Infrastructure	43,392	49.2	2.4	45.7	1.1	0.1	1.0
Temporis (New)	Infrastructure	30,590	-1.0	1.7	-2.7	-	-	-
Temporis Impact	Infrastructure	12,646	32.1	2.4	29.0	0.2	-	0.2
BLK	Infrastructure	15,921	0.7	2.4	-1.7	-	-	-
Blackstone	Diversified Alternatives	48,179	10.4	2.9	7.3	0.2	0.1	0.2
BTG	Diversified Alternatives	35,743	-3.0	1.5	-4.4	-0.1	-	-0.1
Darwin	Diversified Alternatives	21,620	0.7	1.5	-0.8	-	-	-
BLK/LBS	Cash	31,404	0.7	0.7	0.0	-	-	-
Total		**2,004,262**	**2.3**	**1.8**	**0.5**	**2.3**	**1.8**	**0.5**

** The benchmarks calculated by JPM for these portfolios are under review and are subject to change.*

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;

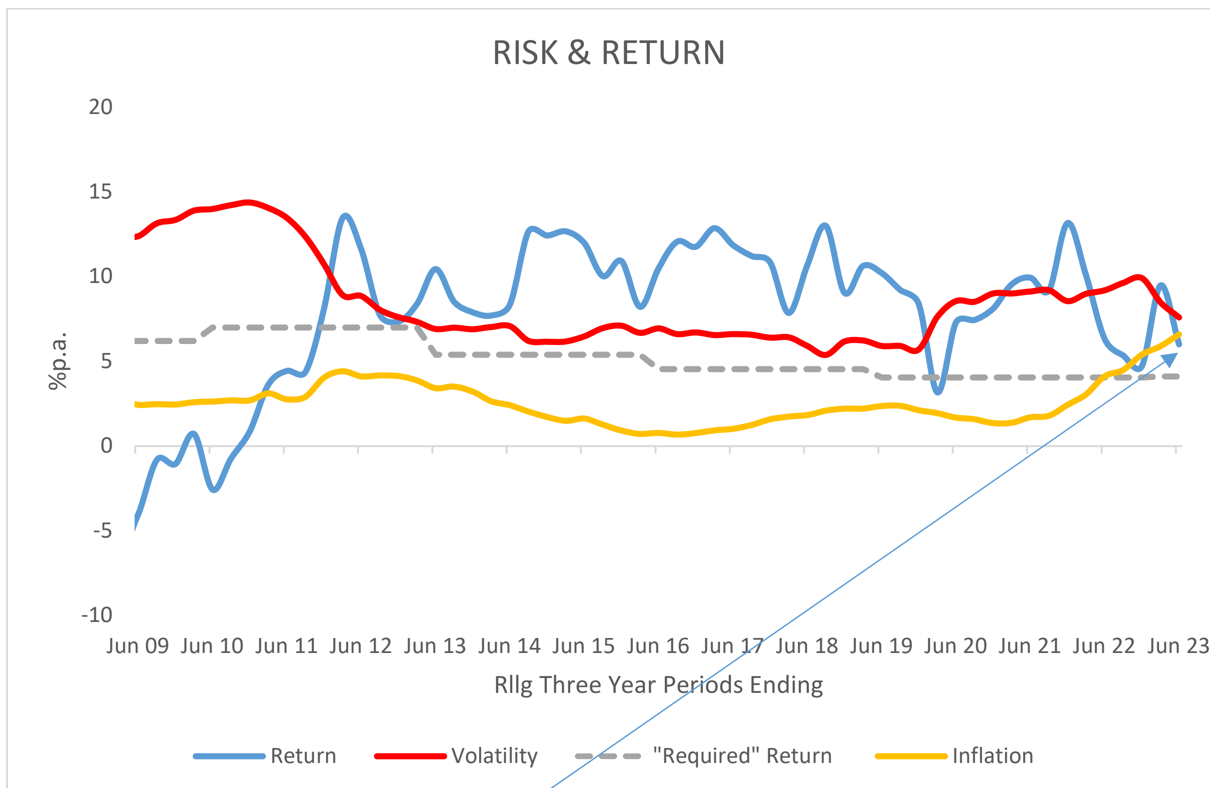
- In terms of the overall outcome of 2.3% (column D), the key positive contributors were the two 'aggregate' tracker portfolios (LGIM and BlackRock) and the Temporis Operational Renewable Energy fund.
- There were some very large deviations from benchmark (column C). The largest deviations, both positive and negative, came mostly from the smaller specialist or niche portfolios e.g., Temporis. 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 2% (column F), the Temporis Operational Renewable Energy fund was the key positive despite its relatively small size

Over the **full year**, the Fund returned a modest 4% but lagged the benchmark by more than 2%. All of this underperformance can be attributed to our property holdings which alone detracted 2.5%. Also detracting value were the absolute return bond portfolio managed by BlackRock, and the Blackstone portfolio.

Medium-term, the Fund has returned roughly 6%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 8.5%p.a. return but 0.6%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 red line shows the volatility of the returns being delivered (sometimes, and arguably unhelpfully, termed "risk"). This has remained heightened post pandemic but has begun to reduce
- The extreme right-hand side of the chart shows that inflation (the yellow line) has now overtaken both the Fund return and 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 failed to sustain the excellent performance of last quarter underperforming the index by nearly 2%. In a difficult quarter for active stock pickers, selection in technology, financials and consumer discretionary weighed on returns. An interesting observation from the manager was the cost to the portfolio of not holding Nvidia (around 0.5%), which it sold as part of the portfolio net-zero transition. In their report they now show a comparison of the portfolio relative to a notional benchmark adjusted for the adjusted 'opportunity set' arising from the transition. This is a helpful metric.

The portfolio's annual return was very strong indeed at 12.5%. This was ahead of the World index but behind the 3% outperformance target (which has subsequently been removed).

Longer-term numbers have been disappointing in benchmark relative terms, but the delivered returns have been extremely positive.

Newton are rightly cautious over the near-term outlook for stock markets given the pain of high interest rates has yet to feed into the real economy. A focus on companies with resilient long-term prospective earnings and credible net zero commitments sounds prudent.

Comgest – Active Emerging Market Equity

As with Newton, Comgest failed to build on the March quarter momentum and delivered a negative absolute and relative return over the quarter – portfolio -3.9%, index -1.9%.

Over the full year, the portfolio returned -0.3%, but this was much better than the corresponding -2.8% for the index.

BlackRock - Active

The active positions performed quite differently over the quarter. Both underperformed the cash benchmark, however.

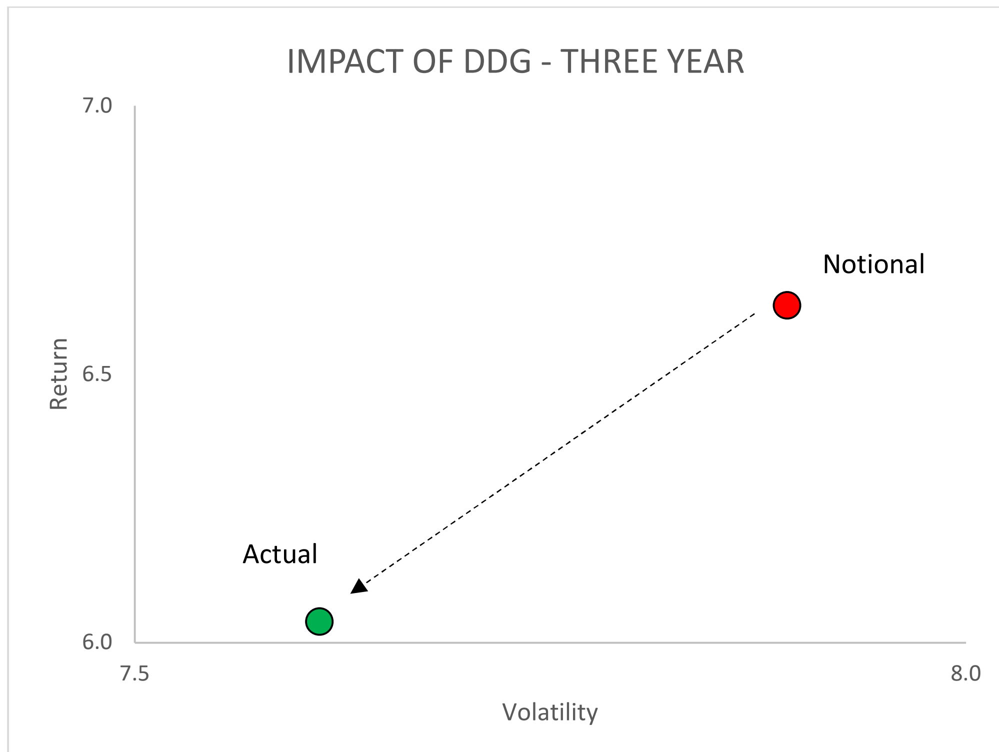
The DDG portfolio returned 0.2%, representing a shortfall of almost 1%. Positive equity returns were offset by poor returns from credit and some of their alternative strategies.

The ARB portfolio underperformed the cash benchmark by a sizeable 4.6% over the quarter. Longer duration positions were the main cause of the underperformance.

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 (0.6%).

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 0.6% for the quarter. This was all generated by income with capital growth of zero.

Office valuations decreased most significantly (by 3.0%) whilst all other main sectors returned positively, notably industrials.

The full year return reported by Nuveen was -14.8%, a further reduction from the -12.4 % reported at the fiscal year-end. The medium-term numbers remain impaired (three- and five-year numbers are between 2% and 4%p.a.) but longer-term returns remain 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

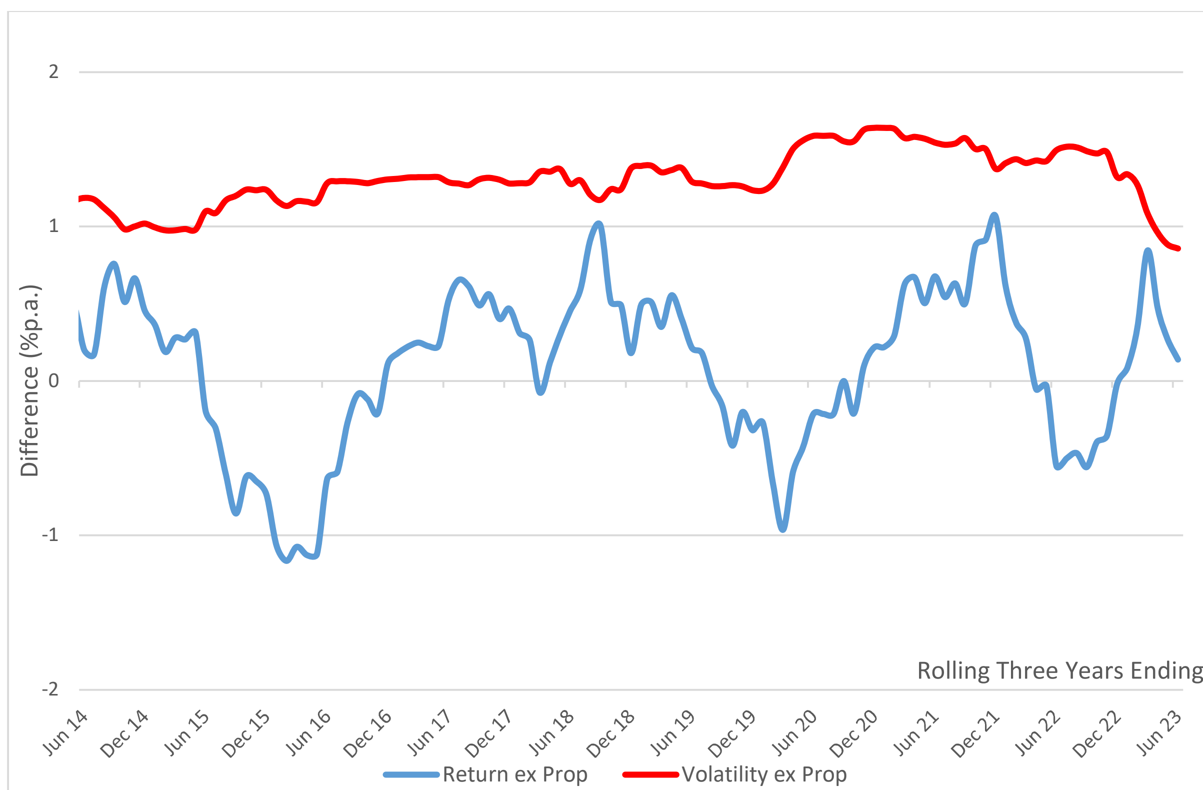
The core and added value/opportunistic assets performed very much in line over the quarter but over the full year, continue to perform quite differently. There may well be a lag effect in the valuations of the non-core holdings however and this differential may switch in the coming quarters. The following table gives a flavour of this.

	Quarter *			Year		
	Fund	Benchmark	Relative	Fund	Benchmark	Relative
All Property	0.5	1.9	-1.3	-10.6	7.6	-17.0
Core	0.6	1.7	-1.1	-14.7	7.0	-20.3
Ex Core	0.5	2.2	-1.7	-0.9	9.2	-9.3

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 full year, 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 very marginally negatively impacted by our real estate holdings (by approximately 0.1%p.a.). Volatility overall has been reduced but by a much bigger margin (just under 1%). There has therefore been a beneficial 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 full year, I estimate the assets to have added in the region of 1% 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.