LONDON BOROUGH OF SOUTHWARK - Quarterly Report December 2023

Executive Summary

- The economic outlook improved again this quarter and both real and monetary assets advanced
- The Fund returned almost 6% over the period, performing just ahead of the benchmark
- The Fund returned a very healthy 10.5% over the full year but remained some way behind the benchmark
- The medium and long-term returns for the Fund remain solid, ahead of both heightened inflation and actuarial assumption, but behind benchmark
- The near-term outlook for markets remains quite uncertain. Optimism around the direction of interest rates and inflation is being tempered by political tensions both at home and overseas. It is likely to remain a challenging environment for both our own investment strategy and the managers we employ to manage the assets

Market Background

The economic background improved in the final calendar quarter with inflation easing and investors becoming more optimistic about the prospect of rate cuts earlier in 2024 than previously expected. Headline equity and bond markets rose whilst credit spreads narrowed.

Despite a strong Pound paring back returns, global equities returned more than 6% over the quarter resulting in the best annual performance since 2019. Developed markets outperformed emerging markets which were impacted by on-going concerns over China's real estate sector. Regionally, the US performed best due largely to its high technology exposure. The UK and Japan underperformed, both impacted by currency strength and in the former, a high weighting to energy stocks which performed poorly.

Bonds had a very strong quarter with both nominal and inflation linked securities returning upwards of 8%. Corporate bond returns were of a similar magnitude.

Despite the modest improvement in the economic outlook, uncertainty and the persistence of high interest rates meant that property transaction activity has remained very subdued and capital values declined again over the quarter, most notably in the office sector. Property will always lag other asset classes in responding to macroeconomic sentiment, however.

LGPS Funds

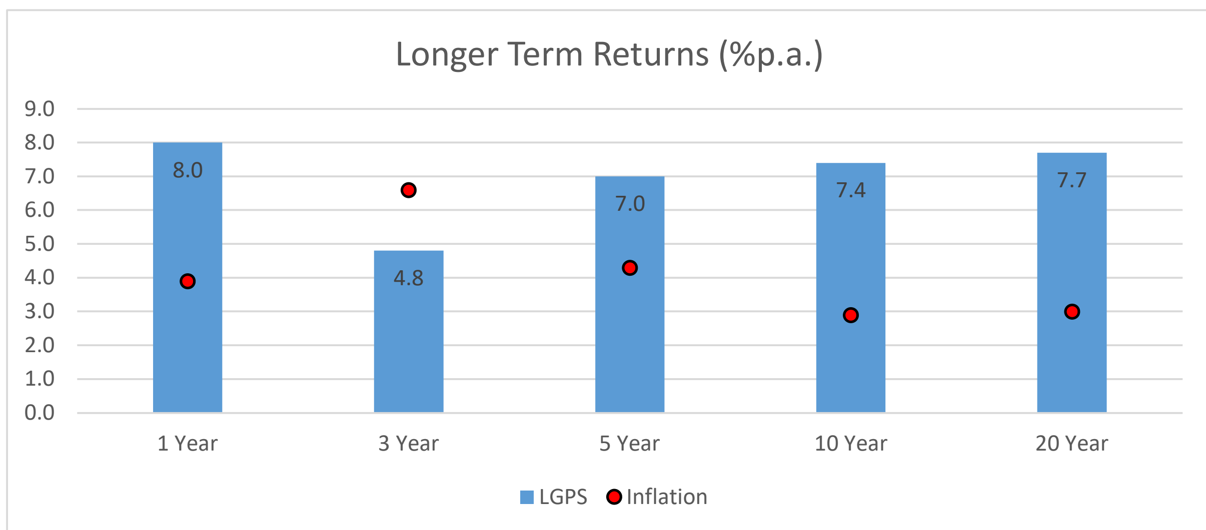
The average LGPS fund is expected to have returned around 5%.

Longer-Term

The one year at around 8% is positive and the three-year return, an important measurement point for the LGPS, is running just under 5%p.a.

Over the last ten and 20 years the average fund has delivered a return in the region of 7-8% p.a. Despite the recent spike in inflation, the longer-term returns represent a near 5%p.a. buffer.

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. Compared to a benchmark return of 5.8%, this represents an outperformance of 0.1%.

Performance from the Fund's managers was mixed, as is normally the case, and the analysis below shows the make-up of the returns, both absolute and relative.

	Manager	Returns		
		Fund	Benchmark	Relative
Global Equity	BLK	7.7	6.7	
	LGIM	7.3	7.6	
	Newton	8.5	7.0	
	Comgest	3.0	3.3	
MAC	Robeco	7.3	7.3	
Property	Nuveen	5.6	1.7	
	Invesco	10.3	1.9	
	M&G	-2.5	1.9	
	Darwin Leisure	0.4	1.5	
	Frogmore	-2.9	3.9	
	Brockton	0.0	3.6	
ESG Priority	Glenmont	0.5	2.4	
	Temporis	5.7	2.4	
	Temporis (New)	4.1	1.7	
	Temporis (Impact)	0.4	2.4	
	BLK	-2.2	2.4	
	Darwin Bereavement	1.8	1.5	
	Blackstone	-2.7	2.9	
	BTG	-4.1	1.5	
Index-Linked	BLK	10.8	10.5	
	LGIM	10.5	10.5	
ARB	BLK	3.5		
Cash	LGIM/BLK/NT/Mgr Frictional	1.3	1.3	0.0
Total Fund		**5.9**	**5.8**	**0.1**

In a key change this quarter, we have changed the calculation basis of the benchmark.

Until now, the weights used to determine the aggregate benchmark return were the actual portfolio weights, but we will now be using the weights prescribed by the Fund's strategic asset allocation.

The implication of the previous methodology was that the only contribution to the overall relative return came from the actions of the managers. From this quarter, both the manager performances **and** any over or underweight relative to the overarching strategy will have a measurable impact on the bottom line.

The table below shows what this looks like for the December quarter:

	Fund Weight	BM Weight	Fund Return	BM Return	Asset Allocation Policy	Investment Selection
Global Equity	51.3	50.0	7.4	6.7		0.3
MAC	4.9	10.0	7.3	7.3	-0.1	
Property	16.0	20.5	4.4	2.0	0.2	0.4
ESG Priority	13.3	9.5	0.8	2.3	-0.1	-0.2
Index-Linked	6.4	10.0	10.7	10.5	-0.2	
ARB	5.8	0.0	3.5		-0.1	
Cash	2.3	0.0	1.3		-0.1	
	100.0	**100.0**	**5.9**	**5.8**	**-0.4**	**0.5**

Over the quarter, the Fund outperformed by 0.1%. During the quarter, over/underweights ("asset allocation policy" in the table) cost 0.4% but this was offset by good aggregate manager performance of 0.5% ("selection" in the table). In terms of policy, by way of an example, the best performing asset over the period was index-linked with a market return of 10.5%. We were below target weight hence the negative contribution.

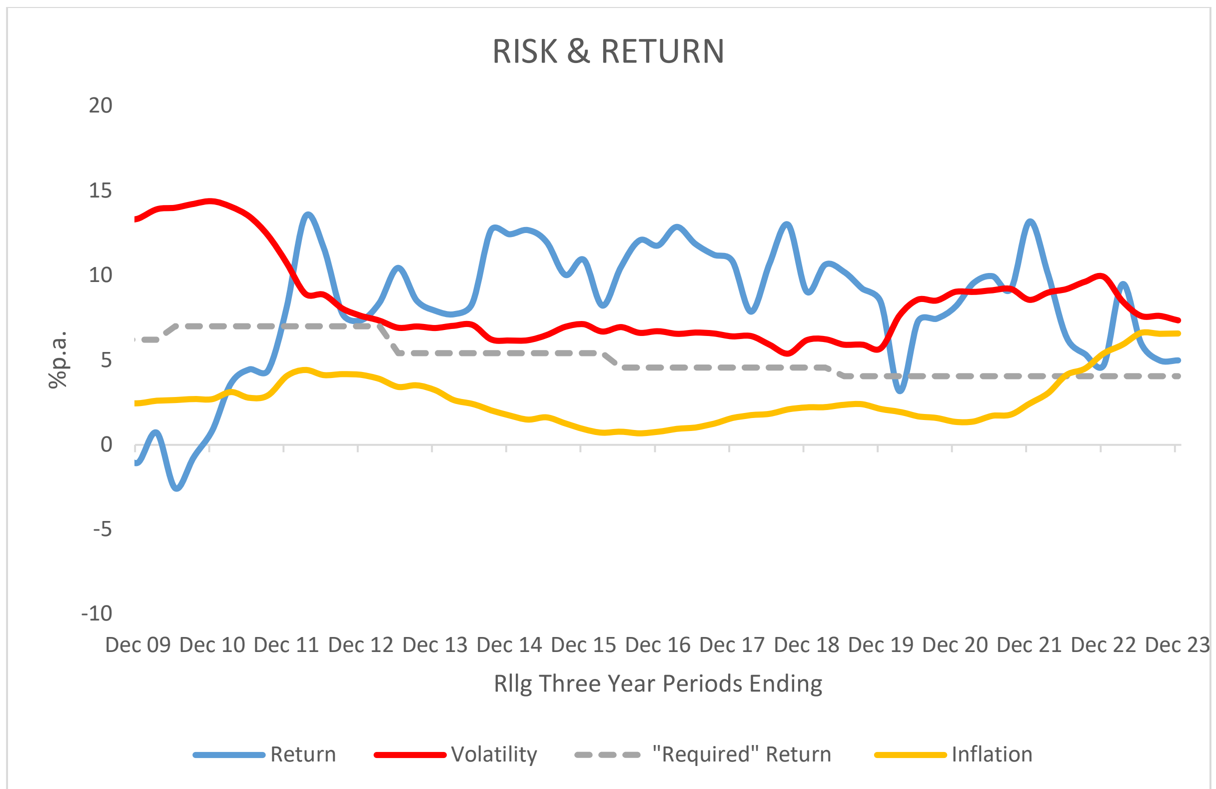
For illustrative purposes, overweights are shaded blue as are manager outperformances.

Over the **full year**, the Fund returned a very strong 10.5%, but lagged the benchmark by around 0.9%. The two biggest contributors to the underperformance were Newton (active global equity) and Blackstone (private equity). It is worth pointing out however, that the valuation for the latter, as with any of our early-stage illiquid investments will fluctuate widely as monies are drawn-down ("called") or distributed, factors largely out with our control.

Medium-term, the Fund has returned roughly 5%p.a. over the three-years and nearer 8%p.a. over the five-year period. 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 0.7%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 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 continues to cause concern

Newton – Active Global Equity

Newton recorded a return of 8.5% in the quarter, 1.5% ahead of benchmark. This outperformance was driven by positive stock selection in the health care and consumer discretionary sectors. As oil prices slid over the period, the portfolio's zero exposure to energy was also beneficial.

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 net-zero transition. Unsurprisingly given the performance of energy stocks, the adjusted benchmark was higher than the headline by more than 1%, reversing the opposite effect last quarter. Newton outperformed the adjusted benchmark, however.

This is a very helpful metric that shows the Panel the impact of their decisions around the net-zero transition alongside Newton's contribution.

The portfolio's annual return was a very substantial 13.8% but considerably behind the benchmark due to last quarter's sharp underperformance.

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 remains a prudent strategy.

Comgest – Active Emerging Market Equity

Comgest returned 3% during the quarter, lagging the index benchmark by 0.3%.

Unfortunately, it is difficult from Comgest's reports to accurately isolate the attributes making up the relative performance, but geographical allocation had a more material impact than sector selection.

Over the full year, the portfolio returned 0.4% (JP Morgan quoted return), trailing the index by a sizeable 3.2%.

Since inception returns have been disappointing in both absolute and relative terms.

BlackRock - Active

The ARB portfolio performed well over the quarter, returning 3.5% and outperforming the cash benchmark by 2.2%. Longer duration positions were helpful as was stock selection in credit markets.

The full year outcome was a disappointing shortfall of 3.6% and returns since inception have been very poor in absolute and in relative terms.

Nuveen Real Estate – Core Property

The portfolio return was -0.8% for the quarter (manager number). Income of 1.2% was more than offset by capital falls of -2%.

Falls in valuations were evidenced in all sectors with the portfolios industrial and office holdings falling furthest.

The full year return reported by Nuveen was near zero which represents a significant improvement on the numbers reported earlier in the year.

The current seven-year number of c3p.a. has stayed broadly the same and remains some way behind the 7%p.a. target set by the Panel.

The portfolio's one indirect holding performed poorly over the quarter and since inception but is due to be redeemed early in 2024.

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

Of the non-core property portfolios, only Invesco reported a positive return. Going by JP Morgan's returns, all portfolios have lagged their respective (and time-specifically challenging) benchmarks.

Southwark's Property Allocation

Both the core and aggregate added value/opportunistic assets performed positively over the quarter and added value over and above benchmark. Over the full year, the core and non-core portfolios performed quite differently but fell someway short of benchmark. The following table gives a flavour of this.

	Quarter			Year		
	Fund	Benchmark	Relative	Fund	Benchmark	Relative
All Property	5.0	1.9	3.1	4.9	7.7	-2.6
Core	5.6	1.7	3.8	6.9	7.0	-0.1
Ex Core	3.4	2.2	1.2	0.1	9.1	-8.2

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 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 was improved marginally by our real estate holdings. Volatility overall has been reduced by a more significant margin – around 0.8%p.a. There has therefore been a beneficial risk/return trade-off.

Robeco

This is a new multi-asset credit portfolio valued at £105m by quarter end. It got off to a positive start posting a return of 7.3%, very much in line with the benchmark.

"ESG Priority" Allocation

The Fund's infrastructure and other diversified alternative investments are relatively new but comprise an increasingly significant c13% of the overall asset value. It is too early to provide any meaningful commentary on performance however, but early signs are reasonably encouraging. Over the full year, I estimate the assets to have added in the region of 0.5% to the bottom line.

Passive Portfolios

The portfolios tracked within tolerance over the quarter.