

## LONDON BOROUGH OF SOUTHWARK - Quarterly Report June 2024

### Executive Summary

- The economic outlook improved further this quarter. Equities responded positively whilst bond markets weakened as widely anticipated interest rate cuts remained elusive
- The Fund returned 1% over the period, but lagged the benchmark
- The Fund returned a very healthy 9.7% 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 largely unchanged - optimism around the direction of interest rates and inflation is being tempered by political tensions. 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

In many respects, the themes I highlighted last quarter that had generated positive sentiment were very similar to those providing momentum in the latest quarter. Global equity markets delivered positive returns over the quarter driven very much by resilient growth, and companies exposed to AI. Unsurprisingly in such an environment, classic 'value' sectors such as basic materials, consumer basics and industrials underperformed. Regionally, the US performed well but the best performances were seen in emerging and the smaller Asia Pacific markets, helped in part by the Chinese authorities support for the troubled real estate sector. Europe and Japan lagged over the period. Political uncertainty weighed heavily on the former whilst currency concerns impacted the latter. UK equities performed reasonably well on the back of an improving domestic economic environment.

With inflation proving somewhat 'sticky', expectations continued to suggest that interest rate cuts might be slower than previously anticipated and sovereign bond yields rose over the period. Corporate bonds outperformed as credit spreads widened.

We may finally be seeing some signs of a nascent recovery in the real estate sector with headline indices recording capital growth in all sectors with the exception of offices. A number of commentators see 2024 as a turning point, as lower inflation and falling interest should raise confidence and increase activity.

### LGPS Funds

The average LGPS fund is expected to have returned around about 2% over the quarter.

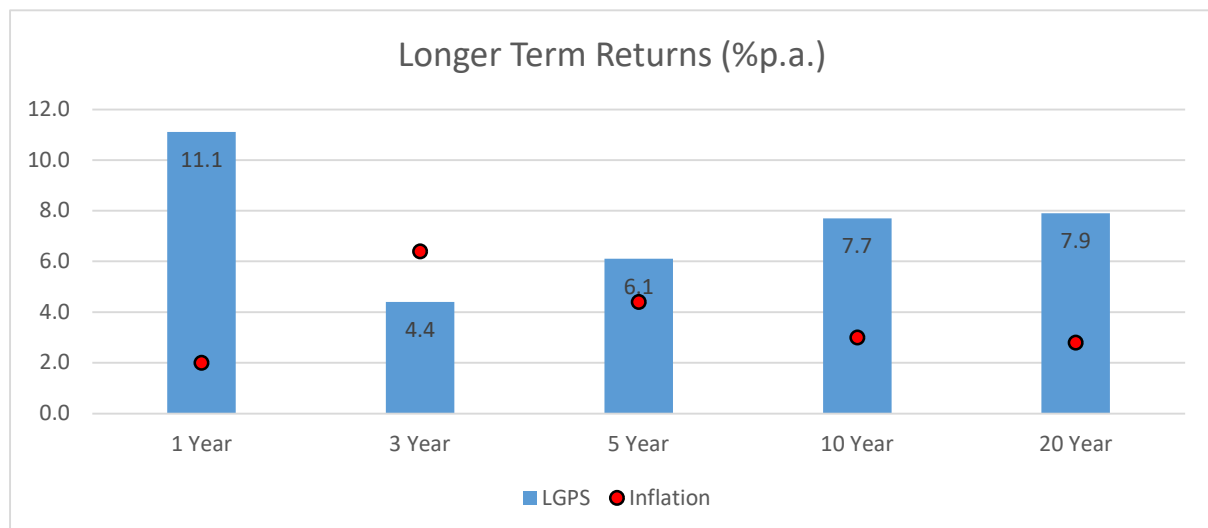
### Longer-Term

The full-year outcome is predicted to be in the region of 11%, around double that of the same period a year ago.

The three-year return, an important measurement point for the LGPS, is likely to have eased marginally to 4%p.a. still lagging stubbornly high inflation of more than 6%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 1.1% over the quarter. Compared to a benchmark return of 1.9%, this represents a relative underperformance of 0.8%.

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 graphically in relative terms:

	Manager	Returns		
		Fund	Benchmark	Relative
Global Equity	BLK	3.0	2.8	
	LGIM	3.0	2.9	
	Newton	3.9	3.5	
	Comgest	2.1	4.9	
MAC	Robeco	-0.0	0.0	
	LCIV	2.4	2.4	
Property	Nuveen	-0.6	1.7	
	Invesco	0.7	1.9	
	M&G	0.6	1.9	
	Darwin Leisure	-0.4	1.5	
	Frogmore	-5.4	3.9	
	Brockton	-4.9	3.6	
ESG Priority	Glenmont	-4.8	2.3	
	Temporis	-14.2	2.4	
	Temporis (New)	-17.9	1.7	
	Temporis (Impact)	-7.6	2.4	
	BLK	1.7	2.4	
	Darwin Bereavement	0.4	1.5	
	Blackstone	17.1	2.9	
	BTG	1.6	1.5	
Index-Linked	BLK	-2.9	-2.9	
	LGIM	-2.9	-2.9	
ARB	BLK			
Cash	LGIM/BLK/NT/Mgr Frictional	1.8	1.3	0.5
<b>Total Fund</b>		<b>1.1</b>	<b>1.9</b>	<b>-0.8</b>

During the quarter, performance from the illiquid portfolios, property and ESG priority, was generally disappointing.

This first table doesn't account for the size of any position and the resulting influence on the bottom line.

The table below groups the portfolios into our preferred asset classifications and this time, the size of the positions is accounted for:

	Fund Weight	BM Weight	Fund Return	BM Return	Relative Return	Asset Allocation Policy	Investment Selection
Global Equity	54.7	50.0	3.2	3.2	-0.0	0.1	
MAC	9.2	10.0	1.1	1.2	-0.1		
Property	15.8	20.0	-0.4	2.0	-2.4		-0.4
ESG Priority	12.8	10.0	-2.8	2.2	-4.9		-0.6
Index-Linked	6.8	10.0	-2.9	-2.9	-0.0	0.1	
Cash	0.7	0.0	4.7				
	<b>100.0</b>	<b>100.0</b>	<b>1.1</b>	<b>1.9</b>	<b>-0.8</b>	<b>0.2</b>	<b>-1.0</b>

Over the quarter, the Fund underperformed by 0.8%.

The aggregate over/underweights with respect to the target benchmark (“asset allocation policy” in the table) added 0.2%, but this was more than offset by the performance of our managers (“selection” in the table) which cost 1%. The most significant drag came from our illiquid property and ‘ESG Priority’ assets.

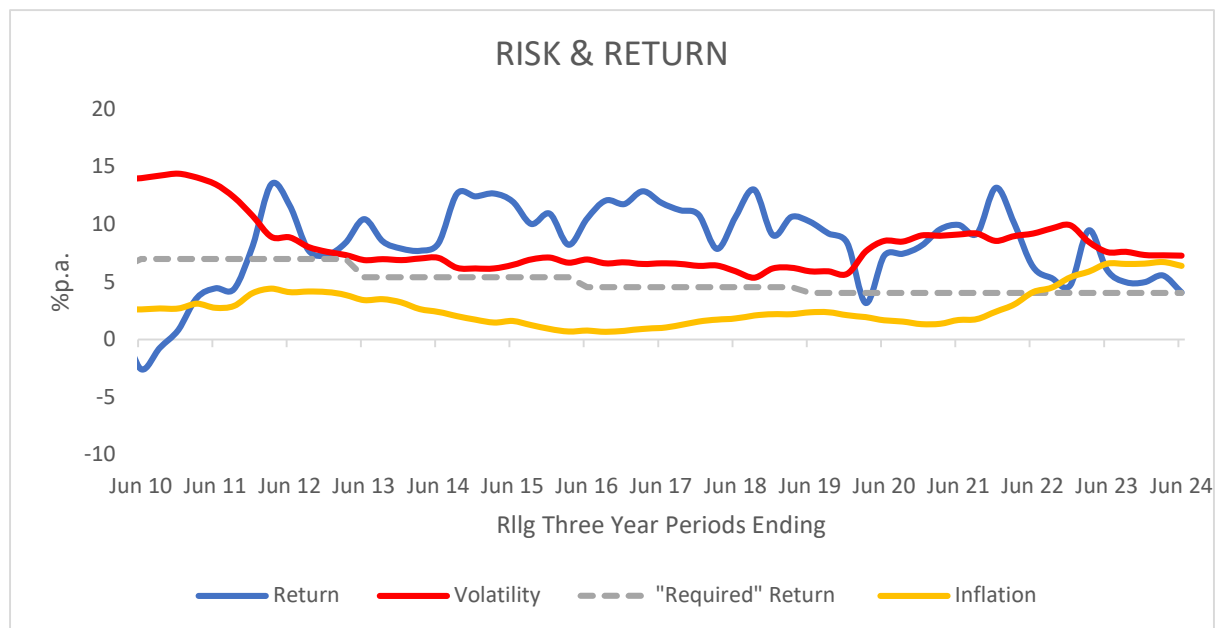
For illustrative purposes, overweights are shaded blue as are manager outperformances.

Over the **full year**, the Fund returned a very strong 9.7% but lagged the benchmark by more than 3%. The main contributors to the underperformance were active equity and the illiquid property and ESG priority portfolios.

**Medium-term**, the Fund has returned roughly 4%p.a. over the three-years and 7%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 0.9%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. This is expected to trend back towards some semblance of normality but in the immediate short-term, this continues to cause concern

### **Newton – Active Global Equity**

Newton recorded a return of 3.8% in the quarter, 0.9% ahead of the global equity index the manager aims to beat. This was the third consecutive quarter of outperformance, something we haven’t seen in a considerable time. This outperformance was driven by positive stock selection in the healthcare and consumer discretionary sectors. Not holding Nvidia for much of the quarter provided a partial offset.

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. Over the quarter, the adjusted benchmark was quite a bit ahead of the headline index and so the overall impact on the bottom line was supportive for Newton.

The portfolio’s annual return was a very substantial 18.6% but behind the benchmark due largely to the sharp underperformance in the September quarter.

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

Newton comment on the potential short-term disruption a US election may have on the generally benign climate, but in their words “seek out those businesses with credible net zero commitments, durable returns and enduring financial resilience”. This sounds an appropriate strategy.

### **Comgest – Active Emerging Market Equity**

Comgest returned 2.1% during the quarter, lagging the index benchmark by a sizeable 2.7%. In contrast to Newton, this was a fifth consecutive quarter of underperformance.

Unfortunately, it is difficult from Comgest’s reports to accurately isolate the attributes making up the relative performance. From a geographical viewpoint, country selection subtracted value overall due to underweighting China which performed well and overweighting Mexico and Brazil which performed poorly. From an industry perspective, positioning in industrials and consumer staples were detrimental.

Over the full year, the portfolio returned 5.2%, trailing the index by a very uncomfortable 7% margin.

Since inception returns have been disappointing in both absolute and relative terms (portfolio - 4.8%p.a., index -1%p.a.).

### **Nuveen Real Estate – Core Property**

The portfolio return was 0.9% over the quarter (Nuveen’s number). Income of 1.1% more than offset a modest capital reduction of 0.2%.

Valuations were pretty static over the period with a modest drag after transaction costs. The office assets held fell in value by a further 2+%, but increases elsewhere, notably in industrials made up any shortfall.

There was some activity during the quarter, the portfolio picking up the freehold of an industrial asset near to Silverstone, boasting excellent ESG credentials and a secure tenant.

The full year return reported by Nuveen was 0.2%, a small positive but significant improvement on recent quarters.

The current seven-year number of c2.5p.a. is the same as last quarter and remains some way behind the 7%p.a. target set by the Panel.

The portfolio’s one indirect holding performed quite well over the quarter but had a very poor 12 months.

There is some optimism in Nuveen’s latest report, and they remain confident that the current strategy and assets will exceed the performance objective over the longer-term.

### **Residential/Oppportunistic Real Estate**

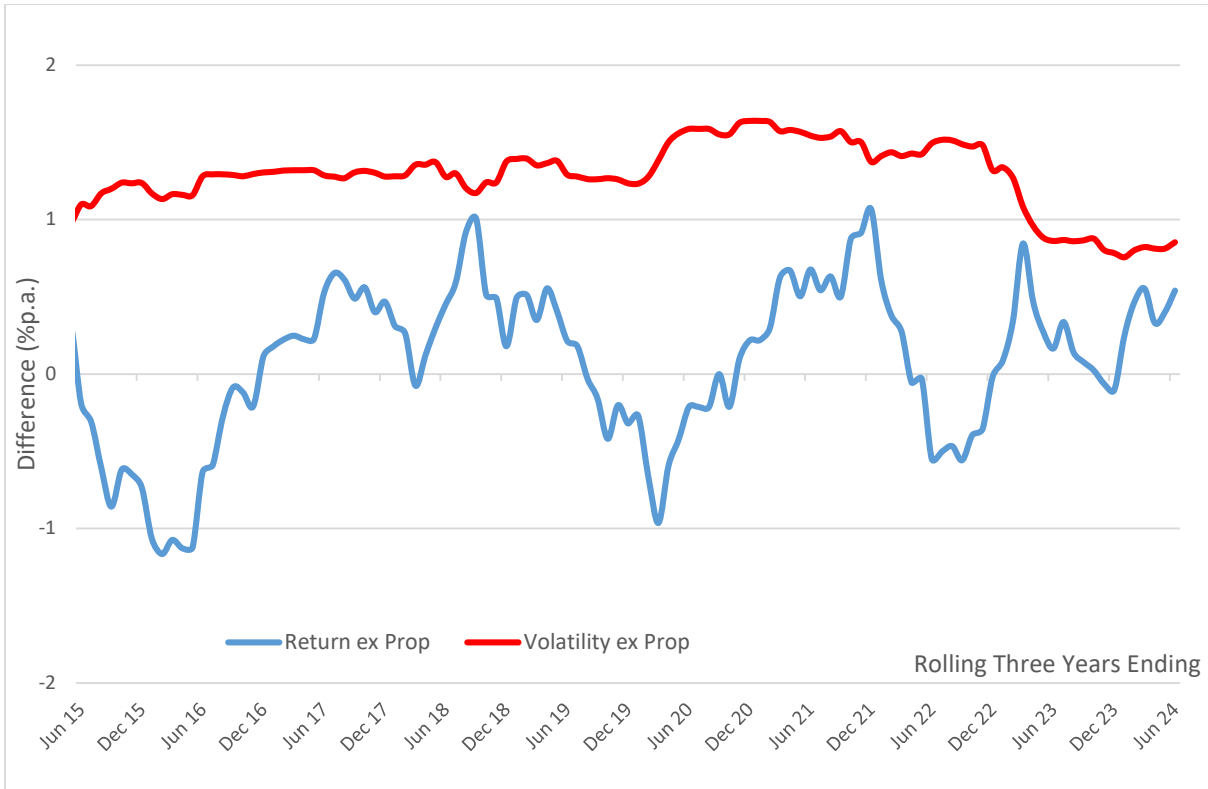
As can be seen from the graphic on page 3 above, the non-core portfolio struggled over the quarter, with all of the managers failing to hit benchmark. In the round, the aggregate returned around -0.2%.

### **Southwark’s Property Allocation**

Both the core and aggregate added value/opportunistic assets performed weakly over the quarter and lagged their respective benchmarks. Over the full year, the story was similar, with both core and non-core delivering single figure negative returns thereby falling somewhat short of benchmark. The following table gives a flavour of this.

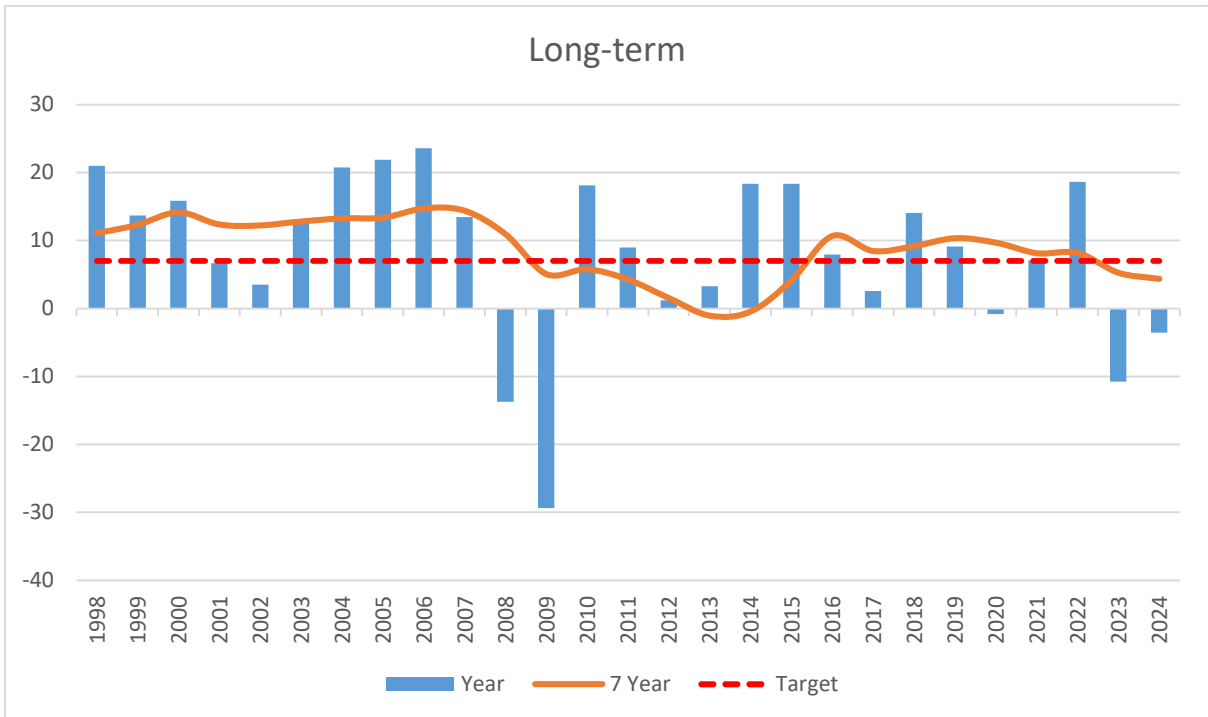
	Quarter			Year		
	Fund	Benchmark	Relative	Fund	Benchmark	Relative
All Property	-0.4	1.8	-2.2	-3.5	7.5	-10.3
Core	-0.6	1.7	-2.3	-4.8	7.0	-11.0
Ex Core	-0.2	2.0	-2.2	-2.7	8.4	-10.2

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 impacted negatively by our real estate holdings (by around 0.5%p.a.). Volatility overall has been reduced by a slightly higher margin (around 0.9%p.a.). There has therefore been a small benefit in terms of risk/return trade-off.

I've commented often about the long-term nature of the asset class and illustrate this in the chart below.



This shows that, notwithstanding the global financial crisis period, property had been a steady generator of positive and relatively stable returns over time. The last couple of years have been challenging for the asset class, however. Whilst high inflation and the cost of borrowing have depressed valuations and reduced activity, these influences may well prove relatively short-lived. What has and continues to challenge the traditional investment case is the post-pandemic shift to remote working and growth in e-commerce. These influences have significantly impacted the office and retail sectors meaning that managers have had to reappraise their asset selection. Nuveen address this in their quarterly reports and the Panel needs to be across this also.

### **Robeco – Global Credit**

The portfolio performed very much in line with the benchmark over the quarter, both recording returns of 0%. I reported last quarter that we are unlikely to see wide variances in relative performance as we move ahead, and this has been borne out. Since inception however, they have made a solid start.

### **CQS – Global Credit**

The Fund Invested £100mn in a new credit fund managed by CQS In March of this year. This portfolio is part of the LCIV pool's fund range. In its first full quarter, the portfolio returned 2.4%, exactly in line with the target benchmark (SONIA +4.5%p.a.).

### **“ESG Priority” Allocation**

The performance of the Fund's infrastructure and other diversified alternative investments was disappointing over the quarter, with the Temporis funds standing out. As I've mentioned in the past, these are long-term investments that need time to come to fruition, so comments on a quarterly basis whilst interesting, don't add a huge amount of useful information. A 'deep dive' as the funds begin to mature may be worthwhile next year.

### **Passive Portfolios**

The portfolios tracked within tolerance over the quarter.