Border to Coast Pensions Partnership Joint Committee

Date of Meeting: 9 March 2021

Report Title: Border to Coast Market Review (for information and read only)

Report Sponsor: Border to Coast CIO – Daniel Booth

1 Executive Summary

1.1 This report provides an overview of market and fund performance as well as the broader macroeconomic environment. Charts are courtesy of Goldman Sachs unless stated.

2 Market Performance

2.1 2020 witnessed sharp declines in risk assets during 1Q 2020 followed by sustained rally 2Q-4Q 2020. Strong positive global equity returns (+17.5%) were driven by performance of growth stocks, especially in the US and China, with the UK market (-10%) underperforming. Nominal Bonds saw positive returns during early crisis period with Inflation Linked bonds benefiting from liquidity normalization. The excess return of credit spreads was broadly flat as were Commodities, although latter saw gains in precious and industrial metals offset by energy weakness. Table below is courtesy of Bridgewater:

2020 Passive Total Returns

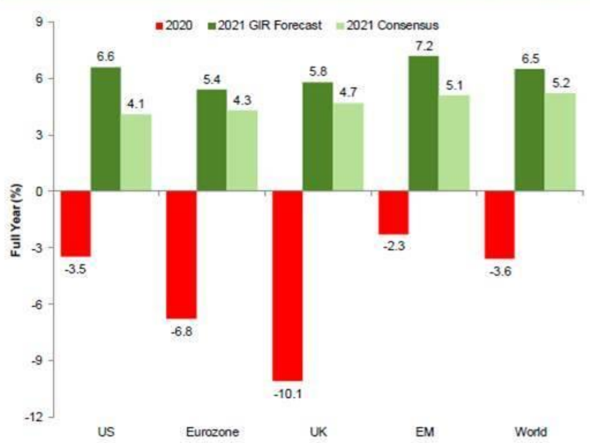
	Q1	Q2-Q4	2020
Equities			
Global (Unhedged)	-21.3%	49.2%	17.5%
US	-19.6%	47.3%	18.4%
Germany	-24.3%	38.7%	5.0%
France	-25.3%	31.1%	-2.1%
Italy	-26.8%	31.3%	-3.9%
Spain	-27.8%	23.5%	-10.8%
Japan	-16.2%	31.3%	10.1%
UK	-24.5%	18.9%	-10.2%
China	-10.3%	41.1%	26.5%
Canada	-19.5%	36.0%	9.5%
Australia	-23.8%	34.4%	2.4%
Emerging Markets ex-China (Unhedged)	-23.6%	55.3%	18.7%
Global Equity Slices			
Value	-27.6%	33.6%	-3.3%
Growth	-16.0%	56.2%	31.3%
Small Cap	-30.5%	63.7%	13.8%
Large Cap	-20.7%	43.4%	13.7%
Cyclical	-23.2%	43.1%	9.9%
Non-Cyclical	-12.6%	23.5%	8.0%
Digital Economy	-10.7%	54.7%	38.1%
Physical Economy	-22.2%	34.9%	4.9%
Strong Balance Sheet	-14.0%	59.3%	36.9%
Weak Balance Sheet	-31.0%	53.8%	6.2%
Global Equity Sectors (Best- and Worst-Performing)			
Internet Services	-2%	72%	71%
IT Manufacturers	-16%	80%	64%
Airlines	-47%	20%	-27%
Resources	-44%	20%	-24%
Commodities			
S&P GSCI Commodity Index	-1.1%	3.5%	2.3%
Bloomberg Commodity Index	-12.4%	12.0%	-1.9%
Crude Oil	-65.0%	76.4%	-38.3%
Gold	5.2%	16.9%	23.0%
Industrial Metals	-6.9%	11.9%	4.3%

	Q1	Q2-Q4	2020
Government Bonds			
US	10.4%	0.3%	10.7%
Germany	2.8%	1.4%	4.2%
Japan	0.6%	-0.3%	0.3%
UK	4.1%	1.6%	5.8%
Canada	8.4%	1.1%	9.6%
Australia	5.4%	-0.9%	4.5%
China	4.1%	-2.9%	1.1%
Inflation-Linked Bonds			
US	1.9%	10.2%	10.2%
Europe	-5.5%	11.4%	5.2%
Japan	-2.2%	0.1%	-2.1%
UK	1.6%	7.1%	8.8%
Canada	0.3%	11.1%	7.7%
Australia	-2.1%	10.0%	7.7%
Bond Aggregates (Bloomberg)			
US	3.1%	4.2%	7.5%
Global	1.4%	4.1%	5.6%
Spreads			
Corporate: US Investment-Grade	-2.0%	2.7%	0.6%
Corporate: Europe Investment-Grade	-1.6%	2.9%	1.3%
Corporate: US High-Yield	-13.8%	13.5%	-2.2%
Corporate: Europe High-Yield	-11.7%	17.0%	3.3%
Sovereign: Europe	-1.1%	3.5%	2.3%
Sovereign: Emerging Markets	-12.4%	12.0%	-1.9%
Other			
Hedge Funds (HFRX Global Index, Net)	-6.9%	11.9%	4.3%
US Real Estate (REITs)	-25.4%	26.2%	-5.9%
Currencies			
EUR vs USD	-2.3%	10.1%	7.6%
JPY vs USD	0.5%	3.8%	4.3%
CNY vs USD	-1.6%	9.3%	7.5%
EMFX ex-Asia vs USD	-15.8%	8.9%	-8.5%
US Cash	0.0%	0.0%	0.0%

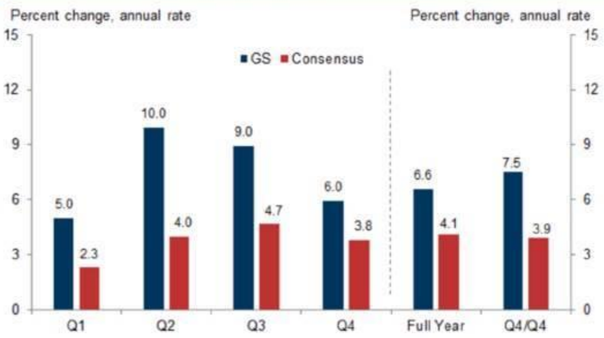
3 Macroeconomic Environment

3.1 *Growth:* following significant 2020 GDP drawdowns, strong consensus growth is expected in 2021 with Goldman expecting above consensus growth across all regions apart from China where in-line with consensus (as already recovered above pre-COVID levels). Improving medical situation (with roll out of the vaccination program) and additional US fiscal stimulus (with US households receiving $600 federal cheques) will support global growth rebound.

1. Global GDP Growth Estimates: 2020, 2021 GIR + Consensus Forecasts



2. GIR: 2021 US GDP Growth Forecasts



3.2 Consensus is for the EU recovery by mid-22 and UK recovery by mid-23. The UK is likely to perform better than expected due to:

a) UK reach herd immunity faster (vaccination program) and re-open faster than the EU

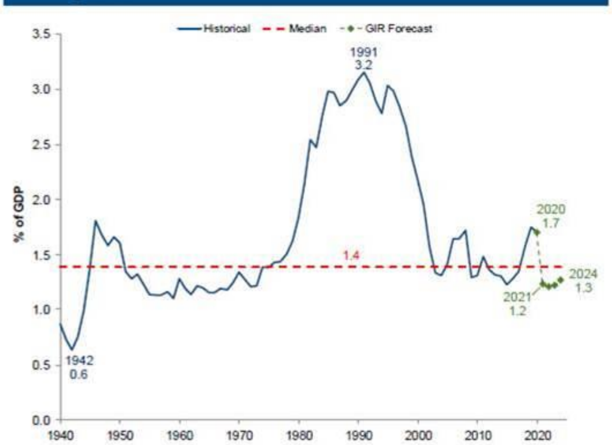
b) BREXIT has happened so reduced uncertainty despite increased trade frictions

c) Differences how UK and EU economies (Ger, Sp, Ita) calculate government activity led to a larger relative UK drawdown and will likely result in a sharper rebound. EU calculates educational and healthcare activity based upon **paid salaries** (unchanged) whereas UK calculates based upon **output** (lower as closed schools / cancellation of elective surgeries).

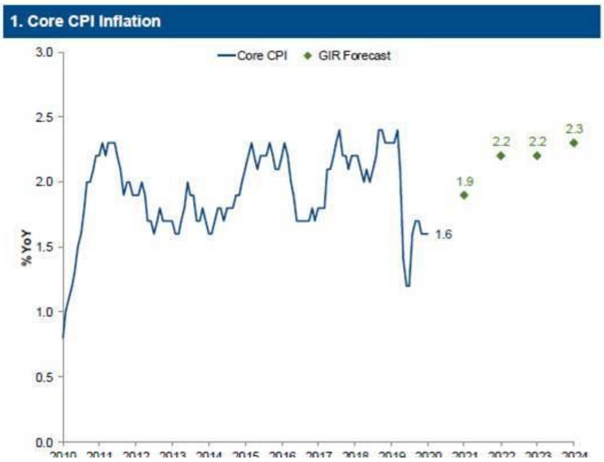
3.3 *Debt:* US debt levels projected to exceed prior WWII peak, but this is not considered an immediate issue as the cost of debt service is relatively low due to decline in interest rates.

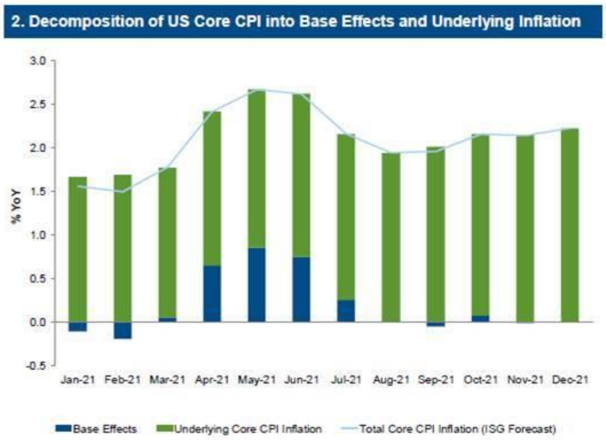
1. US Debt as Percent of GDP: Realized + GIR Forecasts Through 2024

2. US Interest Expense as Percent of GDP: Realized + GIR Forecasts Through 2024



3.4 *Inflation:* uptick 2021 inflation due to low base effects of prior year (2Q 2020) combined with potentially some localized supply constraints. US Core CPI is expected to reach 2.5% (2Q 21) before declining towards target later in the year.



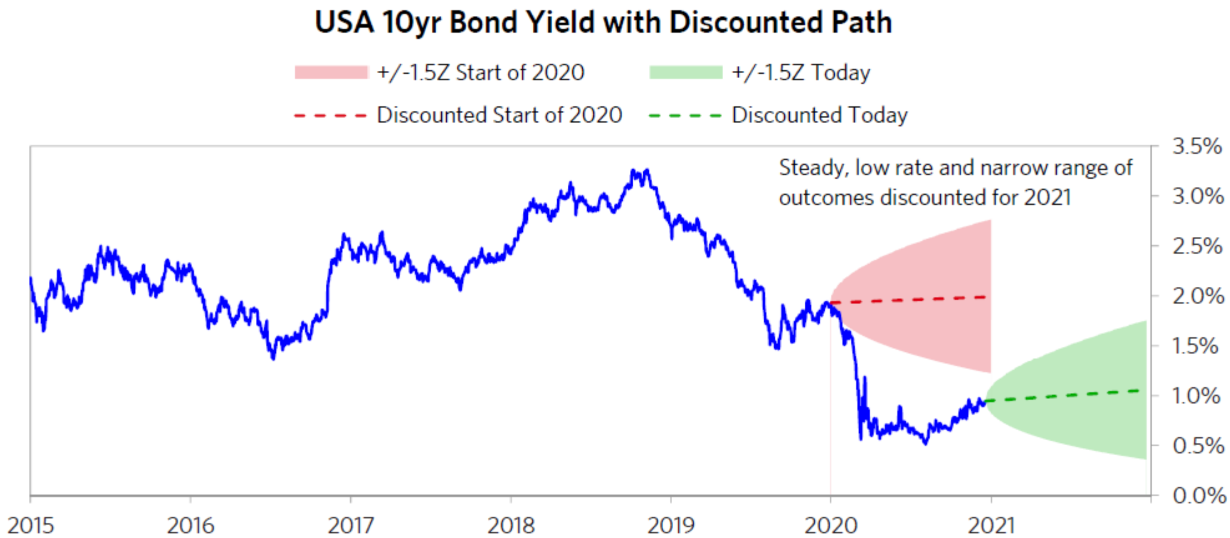


Key for investors will be understanding the difference between transitory and structural increases in inflation. Investors should monitor underlying trends in Service versus Goods inflation as well as measurements of labour market slack (wages, participation rates, unemployment).

Over the last 10 years **US** inflation (1.65%) has been close to but below 2% target and with current monetary and fiscal stimulation there is a reasonable chance that the Federal Reserve will meet / exceed target. The **EU** has been further below target and with ageing demographics and inflation anchoring make it more difficult to achieve their target with a higher risk of a Japanese style deflation. The **UK** is a small and open economy and over last 10 years has actually met 2% inflation target, albeit with higher inflation variability with the Bank of England writing letters to the Treasury when inflation is under 1% or over 3%.

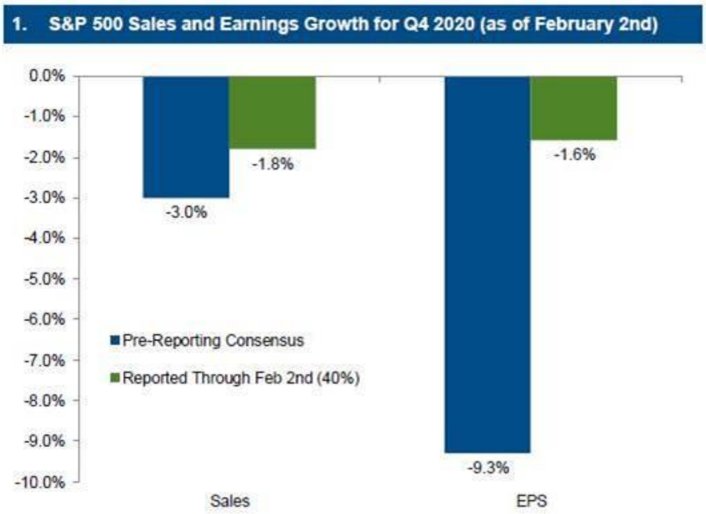
4 Bond Markets

4.1 Bridgewater chart of US bond yields - shows that at the start of 2021 yields are at a lower level than 2020, and with central banks forecasted to remain on hold for a prolonged period, are not priced to recover to pre-pandemic levels. Note the recent rise in yields reflects the market's recognition of stronger growth and near-term inflation expectations.

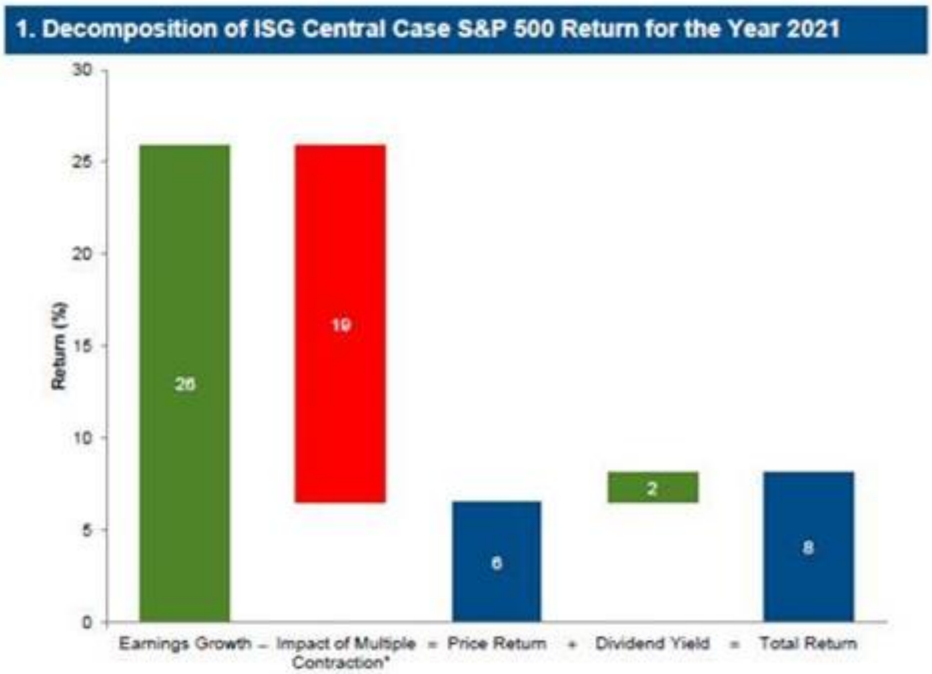


5 Equity Markets

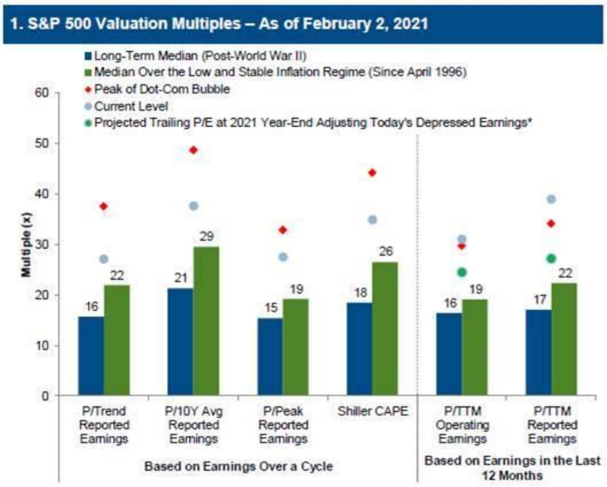
5.1 *Earnings:* 40% S&P reported 4Q earnings strong with 82% above expectation with 13.5% average beat (and market participants revising up earning estimates). Below shows sales and EPS numbers versus consensus up until 2nd February 2020:

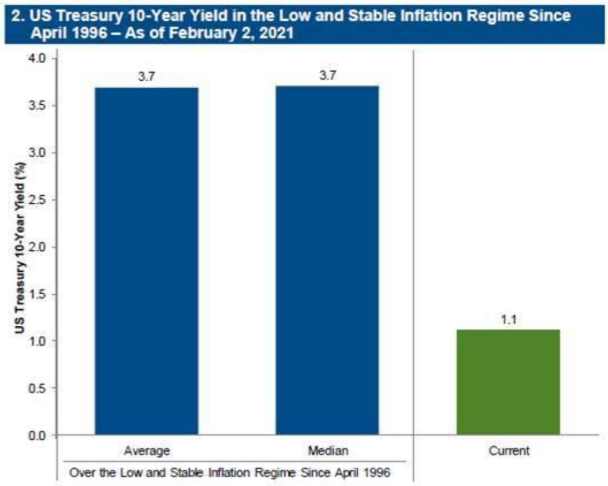


5.2 *Return Forecasts:* Goldman Sachs forecasts US Equities will deliver an 8% 2021 return with strong earnings growth (+26%) and dividend yield (2%) partly offset by declining multiple (-19%) partly due to rising rates. The catch-up earnings and multiple contraction is typical in this part of the market recovery.

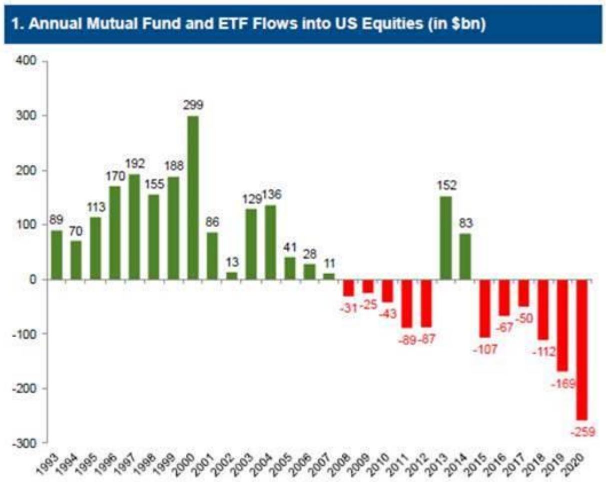


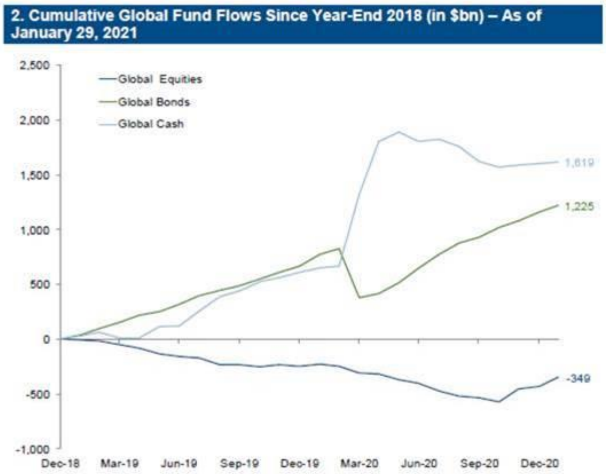
5.3 *Valuations:* US Equities are expensive relative to history (90th decile) but are below the dot.com bubble (red dot). Partly explain current equity valuations by low interest rate environment (1.1% vs 3.7% average) with low discount rates boosting Present Value of future cashflows and leading to higher multiples. 2021 year-end multiples adjusting for depressed earnings whilst still above median appear more reasonable.





5.4 Flows: Retail outflows from equities for 6yrs with $350bn equity outflow whilst $2,800bn inflow into bond and cash funds. Room for retail investors to reallocate into equity markets.



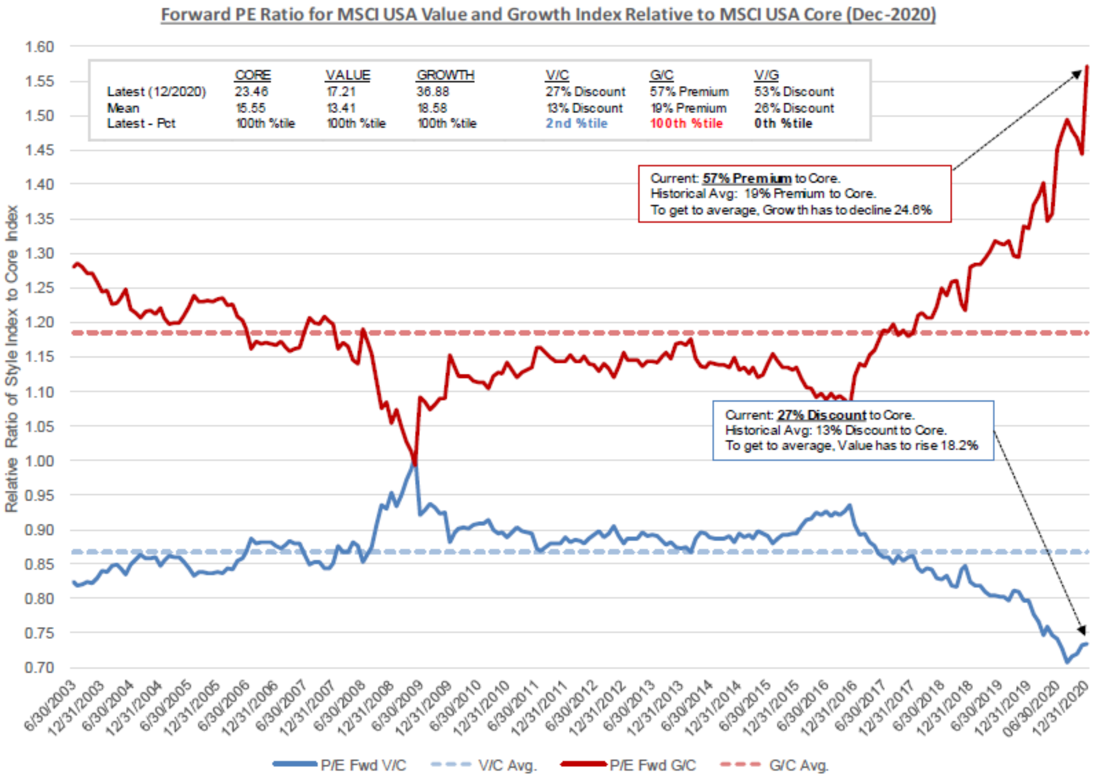


5.5 UK Equity market underperformed in 2020 partly as had only 1% technology sector allocation (18% world). In 2021 technology stocks appear fully priced and the UK market will likely benefit from overweights to cyclical sectors such as Financials (benefit steepening yield curve) and Energy (higher price ranges). Combine positive UK growth outlook, cheaper starting valuations and more favourable sector exposure then a higher probability of outperformance. Main risk for UK is a premature fiscal consolidation.

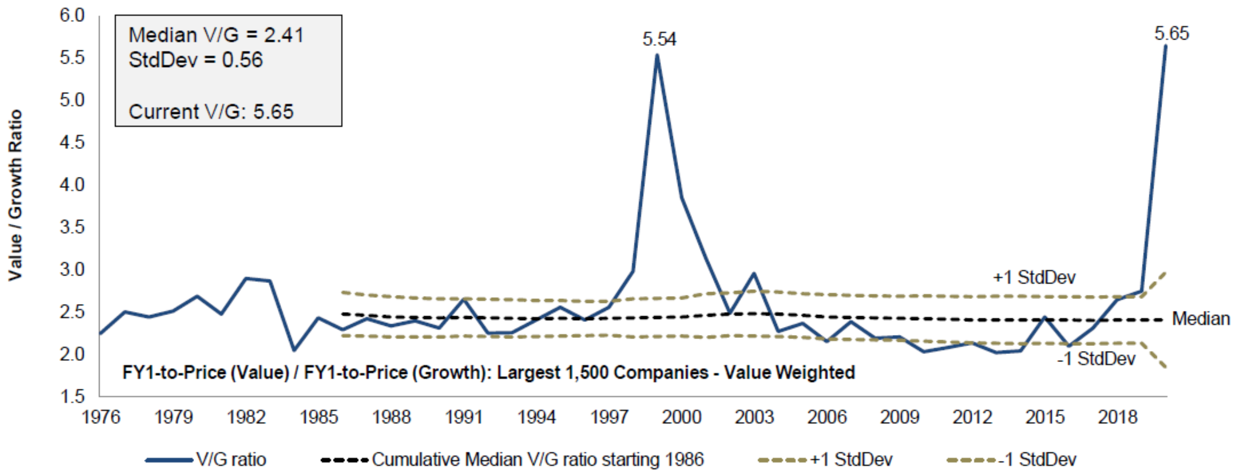
6 Equity Market Style Rotation

6.1 As the end of December 2020 (*data and graphs courtesy of LSV*):

- Growth stocks (high valuations) are currently trading at a 57% premium to the core market versus an average historical premium of 19% putting them in the 100th percentile range (expensive).
- Value stocks (low valuations) are currently trading at a 27% discount to the core market versus an average historical discount of 13% putting them in the 2nd percentile range (cheapest segments).



6.2 Historically Value has traded at a multiple of 2.4 to every Growth stock (circa 40%) but at 2020 year-end they traded at a multiple of 5.65 (circa 18%) which was higher than the peak of the Dot.com bubble.



6.3 Reversal trend of growth outperformance during 4Q 2020 with US large cap value outperforming US large cap growth by circa 5% due to strong returns for value stocks. The spread still appears extreme by historical standards.

6.4 Passive Equities: the above has important implications for Passive equities which are currently concentrated in the mega-cap growth stocks that are trading at a high premium to the broader market whilst historically traded at same valuation and have underperformed. This is covered in more detail in appendix 1.

7 Fund Performance

7.1 The table below shows the performance of our Internal and External Equity composites, since inception (up until end Dec 20), as well as our 5 underlying funds that have track records of at least 12 months (source Northern Trust):

Fund Name	ITD (% p.a.)		
	Fund	Benchmark	Relative
Internal Equity Composite	3.85	2.90	**0.95**
UK Listed Equity Fund	-0.46	-1.88	1.42
Overseas Developed Equity Fund	9.78	8.68	1.11
Emerging Market Equity Fund	9.45	12.75	-3.30
External Equity Composite	12.02	11.78	**0.23**
UK Listed Equity Alpha Fund	6.74	2.83	3.91
Global Listed Equity Alpha Fund	12.44	14.51	-2.07

7.2 Internal Equity composite (asset-weighted) has delivered 0.95% outperformance over benchmark (0.05% underperformance versus target), with 5 of 6 internal PMs outperforming benchmark with the majority of excess returns driven by stock selection (high quality return) and achieved at the lower end of targeted tracking error range to deliver a high risk-adjusted return. Our internal Emerging Market fund is undergoing a long-planned product design change to a Hybrid internal / external structure which will help make the internal universe more manageable. The addition of local external managers for the Chinese market will better enable our investors to access smaller high growth companies which are emanating from the hub of Chinese innovation.

7.3 External Equity composite (asset-weighted) has delivered 0.23% outperformance over b benchmark with 1 of 2 funds outperforming (1.77% underperformance versus target). The UK Listed Equity Alpha fund has outperformed with strong recoveries from UK Consumer Service sector and Small Cap stocks 2-3Q and then Value stocks during 4Q. The Global Equity Alpha Fund was launched in November 2019 and suffered a 1Q 2020 drawdown due to underperformance from our value managers with a partial recovery during 4Q 2020. This fund is positioned to fully recover the underperformance versus benchmark in 2021.

7.4 Our external UK Investment Grade Credit fund was launched in March-20 and has delivered strong absolute and relative returns (above target). Our internal Sterling Inflation Linked Bond fund was launched in October-20 and over the short period has delivered in excess of its return target.

8 Conclusion

8.1 The combination of continuing fiscal (expect $1.5-1.9bn US Biden fiscal stimulus) and monetary (QE multiples above Global Financial Crisis levels), combined with high cash levels on household (enforced saving) and corporate (record borrowing) balanced sheets, creates a powerful liquidity dynamic as we re-open the economies, and is likely to support risk assets. Authorities will remain cautious and behind the curve, allowing inflation to increase and run above target for a period prior to any tightening. The near-term increase in inflation (due to low base effects) is expected and the key for investors will be ability to look through transition data to understand broader longer-term trends. The LGPS with long-dated inflation linked liabilities should be mindful of the increased longer term inflation risk and potential impact on both their assets and liabilities.

9 Report Author:

Daniel Booth, CIO daniel.booth@bordertocoast.org.uk
24th February 2020

10 Supplementary Papers:

Appendix 1: Is Now a Good Time to be invested in Passive Equities?

Appendix 2: Investing in the current pandemic, will the rise in corporate debt cause a drag on performance?

Important Information

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Appendix 1: Is Now a Good Time to be invested in Passive Equities?

Daniel Booth is Chief Investment Officer at Border to Coast.
The views expressed are the authors' own and do not constitute investment advice.
Graphs from LSV.

The combination of highly concentrated public equity markets, with high relative valuations in top stocks following a period of outperformance and high valuation dispersion across the broader markets, increases the probability that active management will add value over pure passive investing. The below charts from LSV (an academic quantitative value manager) provide some historical context.

1) *Stock Concentration:* the top 10 stocks change over time and when the index becomes over-concentrated then active managers tend to outperform passive indices.

The Top 10 S&P 500 Stocks Over Time

	December 1980	December 1990	December 2000	December 2010	December 2020
1	IBM	IBM	General Electric	Exxon Mobil	Apple
2	AT&T	Exxon	Exxon Mobil	Apple	Microsoft
3	Exxon	General Electric	Pfizer	Microsoft	Amazon
4	Standard Oil of Indiana	Phillip Morris	Citigroup	Berkshire Hathaway	Alphabet
5	Schlumberger	Royal Dutch Shell	Cisco Systems	General Electric	Facebook
6	Shell Oil	Bristol-Myers Squibb	Wal-Mart Stores	Wal-Mart	Berkshire Hathaway
7	Mobil	Merck	Microsoft	Google	Johnson & Johnson
8	Standard Oil of California	Wal-Mart Stores	AIG	Chevron	JP Morgan Chase & Co
9	Atlantic Richfield	AT&T	Merck	IBM	Visa
10	General Electric	Coca-Cola	Intel	Procter & Gamble	Procter & Gamble

Top 10 stock typically make up 20% of the index and when an index concentration occurs then the following 5 years tend to be years of strong performance for active managers. In the 1980s 7 of top 10 companies were oil stocks. Today the top 10 US stocks represent 28.6% index versus average 20.5%:

Weight of Top 10 Stocks in the U.S. Over Time

2) *Valuation:* top 10 stocks typically trade at the same price as market but today they are trading at a 41% premium (after peaking at a 57% premium in September 2000 which was 2nd highest relative valuation after December 1999 Dot.com bubble):

Relative Valuation of Top 10 Stocks vs. Bottom 490 in the U.S. Over Time

3) *Performance:* historically top 10 underperform the market **by 1.67%** (as suffer from both competition from below and regulation from above). However, over the last 3 years they have outperformed the market by circa **14% p.a.**

Performance of Top 10 Stocks in the U.S. Over Time

4) *Active Management:* favourable environment for Active Management to Outperform Passive Management. Rolling 5-year data shows following prior period of passive outperformance (late 1990s) was followed by 0 years of active outperformance:

Rank of S&P 500 in Active eVestment Large Cap Universe

Rolling 5-Year Returns: 1980 – 2020

Today we have a Highly Concentrated Index trading at an Expensive multiple following a period of significant Outperformance. It is extremely rare to find periods of such high relative valuation and concentration and history suggests now is a good time to be a contrarian investor.

Appendix 2: Investing in the current pandemic will the rise in corporate debt cause a drag on performance?

Daniel Booth is Chief Investment Officer at Border to Coast. Mark Lyon is Head of Internal Management.
The views expressed are the authors' own and do not constitute investment advice.

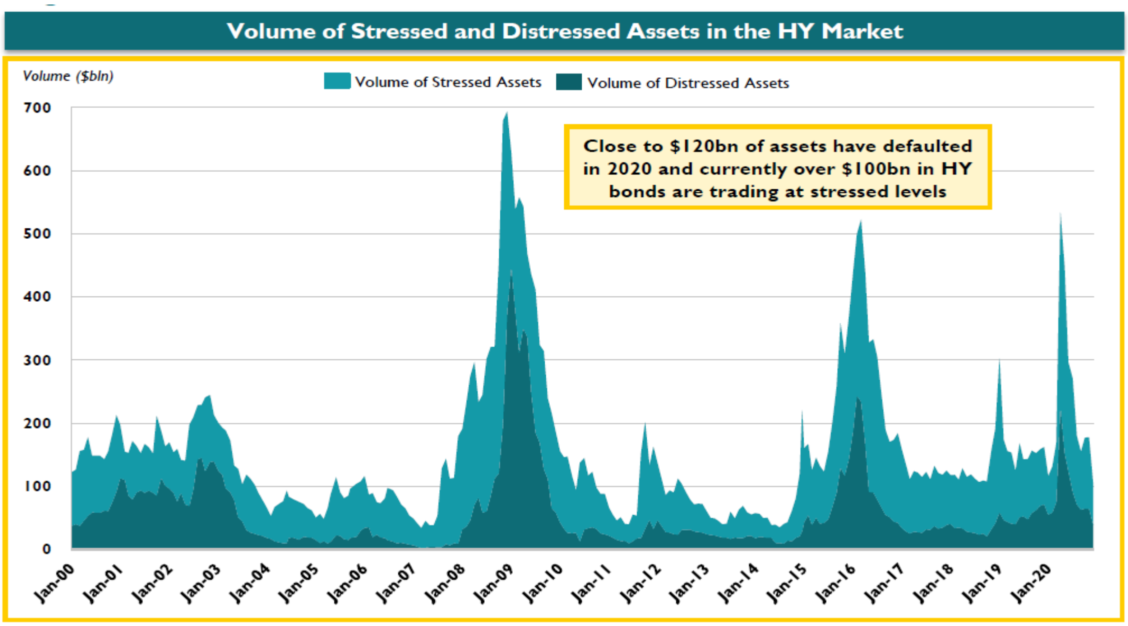
During COVID-19 companies have gone on a borrowing binge to ensure they can ride out the pandemic and may find themselves excessively indebted after the coronavirus pandemic, but it's not all doom and gloom. Daniel Booth and Mark Lyon consider the corporate credit environment for 2021.

Key Takeaways:

- Our expectation for Alternatives is that the current environment appears to be more attractive for specialty lending than for traditional distressed strategies.
- With lower-than-expected defaults our focus has been on investing in the right strategies with the right managers who have long experience, large teams and workout capability.

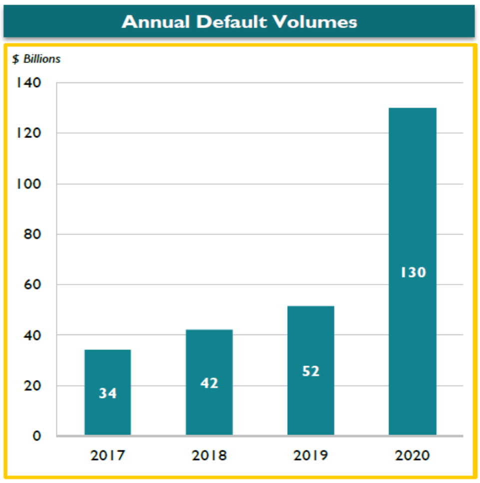
As the pandemic took hold across the globe companies borrowed to create a cash war chest to sustain them as turnover declined during the coronavirus crisis. According to data supplier Refinitiv, global corporate debt surged to $5.4tn, more than a fifth above last year raising alarm that while the debt will allow them to survive, they may be over leveraged and unable to service their debt in the future.

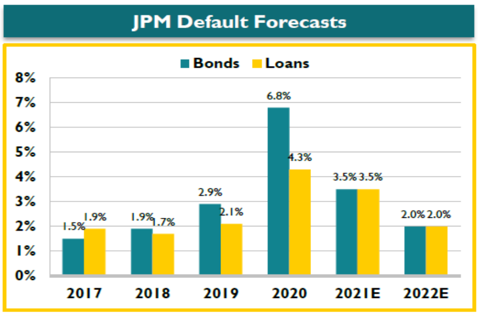
However, data from Goldentree Asset Management and JP Morgan show corporate defaults to have been much lower than expected given the size of the economic decline and defaults are surprisingly closer to the 2015 selloff when investors sold shares globally as a result of the decline in Chinese GDP, the fall in oil prices and the Greek debt default, than in the global financial crisis of 2008-09 (see graph below).



As of November 30, 2020. *Source: J.P. Morgan High-Yield and Leveraged Loan Morning Intelligence Report. Stressed assets represent bonds priced below $90 and distressed assets represent bonds priced below $70 in the JP Morgan HY Index.*

Last year we witnessed a significant rise in default activity with the current rolling last twelve-month (LTM) default rates above 6% set to remain elevated into 2021. (see graph below)





Most Impacted Industries

Industry	$Bn Affected	# of Actions
Cable & Satellite	14.4	1
Energy	49.1	35
Retail	15.3	12
Telecom	16.7	1

As of December 31, 2020. Source: JP Morgan Credit Strategy Weekly Update and Default Monitor.

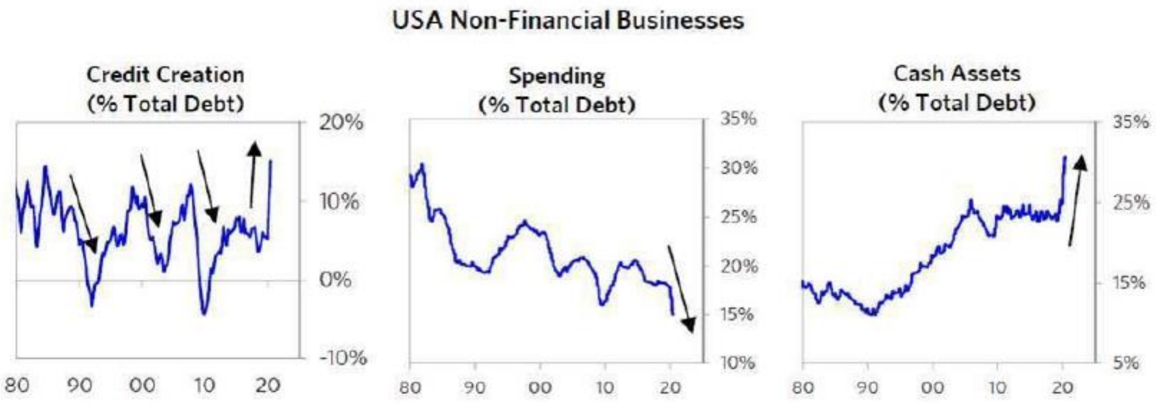
This is a much better outcome than many expected. That is partly due to the lack of debt covenants (the protection afforded creditors) offering deferred defaults and lower future payment recoveries. The other major factor is the current financing environment which has seen robust borrowing activity in the public credit market, generous government corporate lending programmes and a relaxation of monetary policy by the major central banks.

Smaller private companies have been more impacted with debt burdens, according to survey data from international law firm Proskauer. These companies are experiencing higher default rates, particularly those with earnings (EBITDA) of less than $25m who are facing default rates of 9.2% compared with larger borrowers, with earnings of more than $50m, enjoying default rates of 5.3%.

The increase in corporate debt demand was mainly because of companies ensuring they had sustainable corporate liquidity in the uncertain environment ushered in by COVID-19 and we would expect this to dissipate gradually as the economy returns to a "new normal".

Others turned to bridge financing, especially those in COVID-impacted industries like leisure and entertainment, to supplement lost cashflow and income, which would leave companies with higher debt multiples. However, whilst leverage multiples have increased, the cost of debt with lower rates and tightening spreads has not increased as much.

Global government programmes enabling access to easy credit have allowed companies to increase borrowing at the same time as they have been cutting spending, and the additional borrowing has created an increase in corporate cash balances. In effect we have seen an increase in corporate credit creation, a reduction in corporate spending and an increase in corporate cash holdings. (see graphs below)



Source: Bridgewater

As a result, debt levels are higher but so is cash on corporate balance sheets. Therefore, according to Bridgewater, the increased debt is offset by the rise in cash holdings and lower borrowing rates mean the cost of debt service is more affordable.

At Border to Coast our internally managed equity funds tend to focus on higher quality companies with stronger balance sheets and visible income streams, although, on the margins, we have been purchasing companies with a more cyclical quality. For our external funds where we have exposure to cyclical companies with clear value strategies, we have been working with our external partners to ensure a low risk of permanent capital impairment with associated bankruptcy risks and have benefited from the recent rotation into value stocks.

For our Alternatives programme – those assets which do not fall into one of the conventional investment categories like equities – our expectation is that the current environment appears to be more attractive for specialty lending strategies rather than for typical distressed strategies as in cycles witnessed in the recent past.

With lower-than-expected defaults and those defaults concentrated in sectors with limited hard asset coverage, such as retail, or structurally challenged industries like energy, our focus here has been on investing in the right strategies with the right managers who have long experience, large teams and workout capability if needed, as well as the ability to deploy capital in changing market conditions.