SOUTH YORKSHIRE PENSIONS AUTHORITY

QUARTERLY REPORT TO 31 MARCH 2019

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Market background

From the lows seen in the preceding period, the markets were able to bounce back up to levels previously seen last summer. A key driver of this move has been the shift in monetary policy led by the Federal Reserve which signalled an end to interest rate hikes. This boosted investor confidence and also led to a rally in sovereign bond markets with yields falling as investors priced in a looser monetary policy. The fall in yields combined with the increase in risk appetite supported a strong rally in credit markets and underpinned the recovery in equity markets. Another positive for the markets were the talks between the US and China in respect of the on-going trade war between the two. Although nothing was agreed, pro-active discussions between the parties led the market to believe that a compromise is in the offering.

Going into this quarter, US consumption was still strong especially in the service sector as real wage growth rose above inflation and the job market remained defiant.

In the UK, the economy continued to slow showing full year growth of 1.4% which is the lowest rate for several years. Prolonged Brexit uncertainty and lower than expected global growth has negatively impacted the UK economy. Business investment has fallen over the last four consecutive quarters and consumer spending has softened as consumer confidence measures have hit a six year low. The deadline for Brexit of 29 March came and went with no agreement on how or when we will leave the EU but the only positive being that a no-deal Brexit was ruled out. The deadline has now been extended to October of this year. One of the benefits of the uncertainty around Brexit has been an increase in production to build up inventories in order to manage risk which was evidenced in the March Manufacturing PMI survey. However, the Services PMI dropped below 50 which signals a contraction. Despite this slowdown the labour market remains strong with unemployment at a low and wage growth picking up. Given this backdrop and the fact that it cut its forecast for GDP growth in 2019 to 1.2% it was not unexpected that the Bank of England put the decision on raising interest rates on hold.

The indecision around this area had left markets in limbo with the GBP/EUR rate as at end of March at 1.1620, the strongest it has been since May 2017 indicating that a more favourable deal with EU, which would appease the ‘remainers’, was on the cards. However, the volatile nature of the situation especially with a number of stakeholders involved, suggest this is not a certainty.

Market background continued

Like the broad market indices, the bond markets also rallied, which invariably means that yields have fallen. In an environment such as this, where interest rates are declining and inflation is creeping up, longer dated index linked bonds gained the most, up 8.2%, followed by emerging market debt, high yield bonds, with investment grade bonds and conventional gilts holding up the rear.

With growth being forecast to be weak and inflation falling, the US Fed have indicated that interest rates will not rise in 2019. With this back drop, the 3 month Treasury bill rose more than the fall in the US 10-year Treasury note, which made that part of the yield curve invert suggesting caution amongst investors around economic growth. This inversion was also seen in the European bond markets too, where economic data weakened further through the quarter particularly for the manufacturing sector.

The commodity index rose around 39% on an annual basis, with crude oil, which makes up most of the index, attributing around 9% of the uplift. This has somewhat been substantiated by a tightening of supply by OPEC.

The main indicators surrounding the UK real estate market are subdued with the flow of funds and Brexit dominating the risks around this sector. The performance gap between the retail and industrial sector has continued to get wider with retail parks and shopping centres taking a great hit. Conversely, industrial property and warehouses, especially in London and south east UK, generating returns in excess of 11%.

Fund Valuation

as at 31 March 2019

	Dec-18		Quarterly Net	Mar 19		Benchmark	Range
	£m	%	Investment	£m	%	%	%
FIXED INTEREST							
Royal London	386.3	4.8	3.3	401.7	4.8	5	
UK ILGs	1000.9	12.4	2.1	1084.5	12.9	12	
High Yield Bonds	213.8	2.6	(4.1)	216.5	2.6	3	
EM Bonds	216.1	2.7	(0.9)	224.0	2.7	3	
TOTAL	**1817.1**	**22.5**	**0.4**	**1926.7**	**23.0**	**23**	**18-28**
UK EQUITIES	**1119.1**	**13.8**	**0.0**	**1231.5**	**14.6**	**15**	**10-20**
INTERNATIONAL EQUITIES							
Developed Market - BCPP	2058.7	25.4	0.0	2251.6	26.8	27.125	
Developed Market - SYPA	135.6	1.7	(8.0)	139.2	1.7		
Emerging Markets -BCPP	619.1	7.7	0.0	670.2	8.0	7.875	
Emerging Markets -SYPA	93.7	1.1	(56.2)	36.8	0.4		
TOTAL	**2907.1**	**35.9**	**(64.2)**	**3097.8**	**36.9**	**35**	**30-40**
PRIVATE EQUITY	**476.4**	**5.9**	**30.4**	**505.3**	**6.0**	**7**	**2-12**
PRIVATE DEBT FUNDS	**324.0**	**4.0**	**11.4**	**323.8**	**3.8**	**3.5**	**0-8.5**
REAL ASSETS	**253.4**	**3.1**	**29.5**	**292.1**	**3.5**	**5**	**0-10**
PROPERTY	**794.1**	**9.8**	**(23.6)**	**760.9**	**9.0**	**10**	**7-13**
CASH	**282.1**	**3.5**		**281.8**	**3.3**	**1.5**	**0-10**
EQUITY PROTECTION (EPO)	116.5	1.4		(5.5)	(0.1)		
TOTAL FUND	**8089.8**	**100.0**		**8414.4**	**100.0**	**100**	
COMMITTED FUNDS TO ALTERNATIVE INVESTMENTS	933.3			1009.0			

Asset Allocation Summary

The most significant transactions this quarter were the £64m raised from the residual overseas portfolios to fund the £48m net investment across the alternative portfolios.

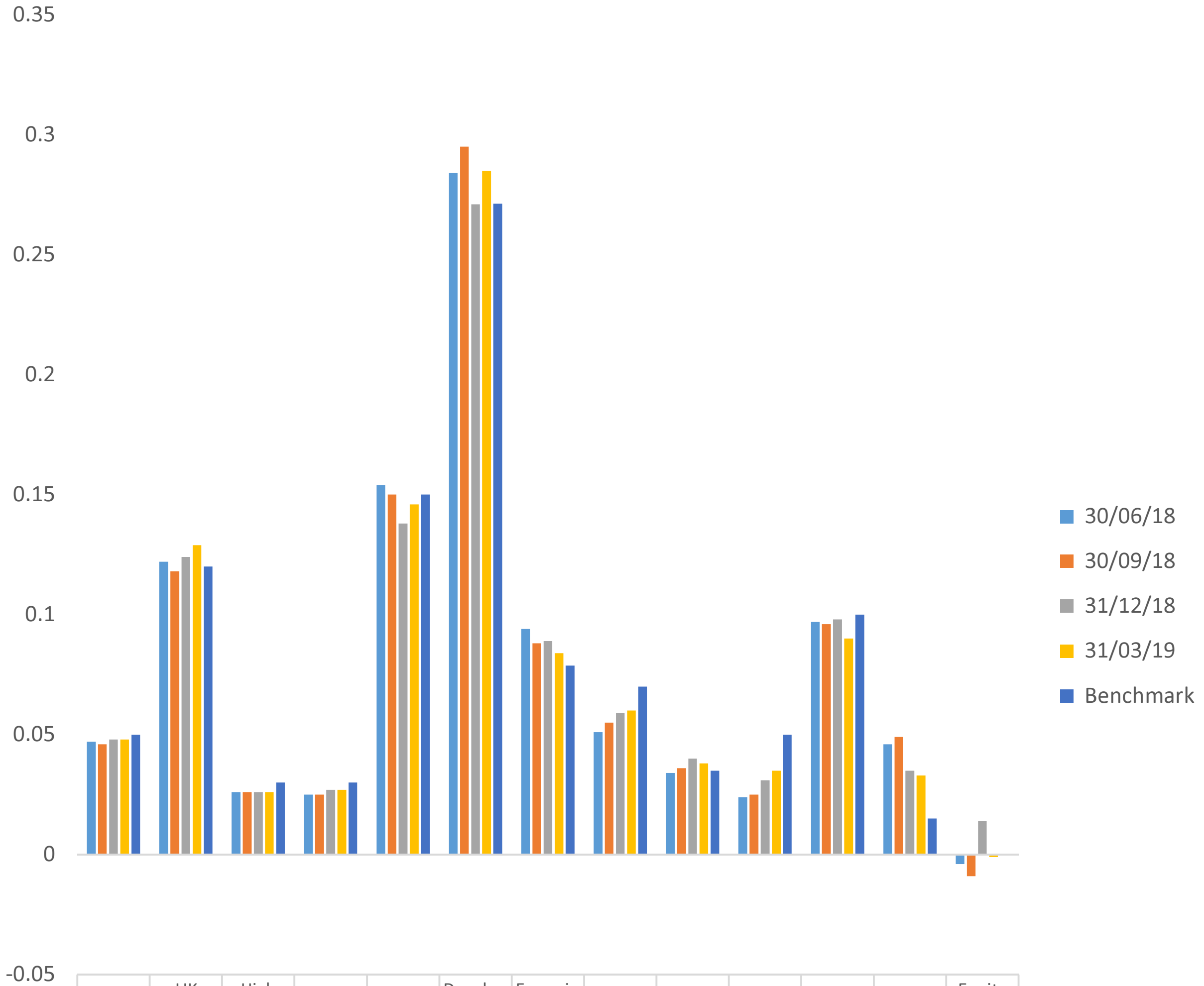
The other notable transaction was the sale of Midas House, Woking. This was sold to Woking Borough Council at a value 8.5% above the prevailing valuation.

This leaves the Fund with an underweight position to bonds, alternative funds and property, and an overweight position to international equities and cash.

The change in weightings over the last few quarters can be seen in the next chart. The Fund has been very close to its benchmark weightings for most asset classes over this period although it can be seen that it has gradually been increasing its weighting to alternatives at the expense of quoted equities.

Asset Allocation Summary

Asset Allocation (%)



	Royal London	UK Index Linked	High Yield Bonds	EM Bonds	UK Equities	Developed Market	Emerging Market	Private Equity	Private Debt	Real Assets	Property	Cash	Equity Protection
30/06/18	0.047	0.122	0.026	0.025	0.154	0.284	0.094	0.051	0.034	0.024	0.097	0.046	-0.004
30/09/18	0.046	0.118	0.026	0.025	0.15	0.295	0.088	0.055	0.036	0.025	0.096	0.049	-0.009
31/12/18	0.048	0.124	0.026	0.027	0.138	0.271	0.089	0.059	0.04	0.031	0.098	0.035	0.014
31/03/19	0.048	0.129	0.026	0.027	0.146	0.285	0.084	0.06	0.038	0.035	0.09	0.033	-0.001
Benchmark	0.05	0.12	0.03	0.03	0.15	0.27125	0.07875	0.07	0.035	0.05	0.1	0.015	0

Performance Summary

For the quarter to the end of March, the Fund returned 4.4% against the expected benchmark return of 6.0%. Looking at the Fund ex equity protection we showed an outperformance of the benchmark giving a return of 6.1%. The outperformance was due to stock selection as asset allocation was neutral over the period.

The breakdown of the stock selection is as follows:-

UK Equities	+0.1%
Developed Overseas Equities	+ 0.1%
Index-Linked Gilts	+0.1%
Alternative Assets	-0.1%
Property	-0.1%

Now looking at the equity protection strategy, the nominal value of the portfolio which was protected rose in value over the quarter by 4.4% and the value of the options detracted by £122m from the value of the Fund. This effectively reduced the return to the fund by 1.5%.

The indicative funding level as at 30 December 2018 was 98.7% and by 30 March 2019 was 101.6%. This is based on the formal 2016 valuation results, updated for market conditions at 31 March 2019 and actual fund returns to that date.

For the financial year the Fund returned 5.9% against the expected benchmark return of 6.2%. Ex the equity protection the Fund achieved a return of 6.5% which was an outperformance of 0.3%. The nominal value of the portfolio that was protected rose in value over the year by 9.9% and the value of the options detracted by £40m from the value of the Fund. The equity protection effectively reduced the return to the fund by 0.6%.

The breakdown of stock selection is as follows:-

UK Equities	+0.2%
Alternative Assets	+0.5%
Property	-0.2%

The performance of the Fund can be seen in detail in the following slides.

Performance

as at 31 March 2019

Return %	Quarter to 31/03/19		Financial Y.T.D.	
	SYPA	Benchmark	SYPA	Benchmark
Fixed Interest				
Royal London	4.0	4.1	4.1	3.7
UK ILG	8.2	7.8	6.1	5.7
High Yield Bonds	4.4	4.1	4.0	3.7
Emerging Market Bonds	5.3	6.0	2.3	1.5
Total	**6.5**	**6.0**	**5.0**	**4.8**
UK Equities	**10.0**	**9.4**	**7.5**	**6.4**
International Equities				
BCPP Overseas Developed Mkts	9.4	8.8		
SYPA Overseas Developed Mkts	8.8	8.8		
BCPP Emerging Markets	8.3	7.9		
SYPA Emerging Markets	0.3	7.9		
Total	**8.8**	**8.6**	**7.2**	**7.5**
Private Equity	**(0.3)**	**0.7**	**13.9**	**4.8**
Private Debt Funds	**(3.2)**	**0.7**	**4.8**	**4.8**
Infrastructure	**3.6**	**0.7**	**17.0**	**4.8**
Property	(0.4)	0.5	2.8	5.1
Cash	0.1	0.1	0.4	0.5
Total Fund ex Equity Protection	**6.1**	**6.0**	**6.4**	**6.2**
Equity Protection Options	(104.7)		(116.1)	
Total Fund	4.4	6.0	5.9	6.2

Performance attribution

For the quarter, the Fund returned 4.4% against the expected return of 6.0%, with the Fund valuation rising from £8089.8m to £8414.4m.

Bonds
Stock selection was mixed across the portfolios but overall gave a positive relative performance.

UK Equities
Stock selection was positive over the quarter but being underweight the asset class was negative.

Overseas Equities
Stock selection across the portfolios was positive and being overweight the asset class also added value.

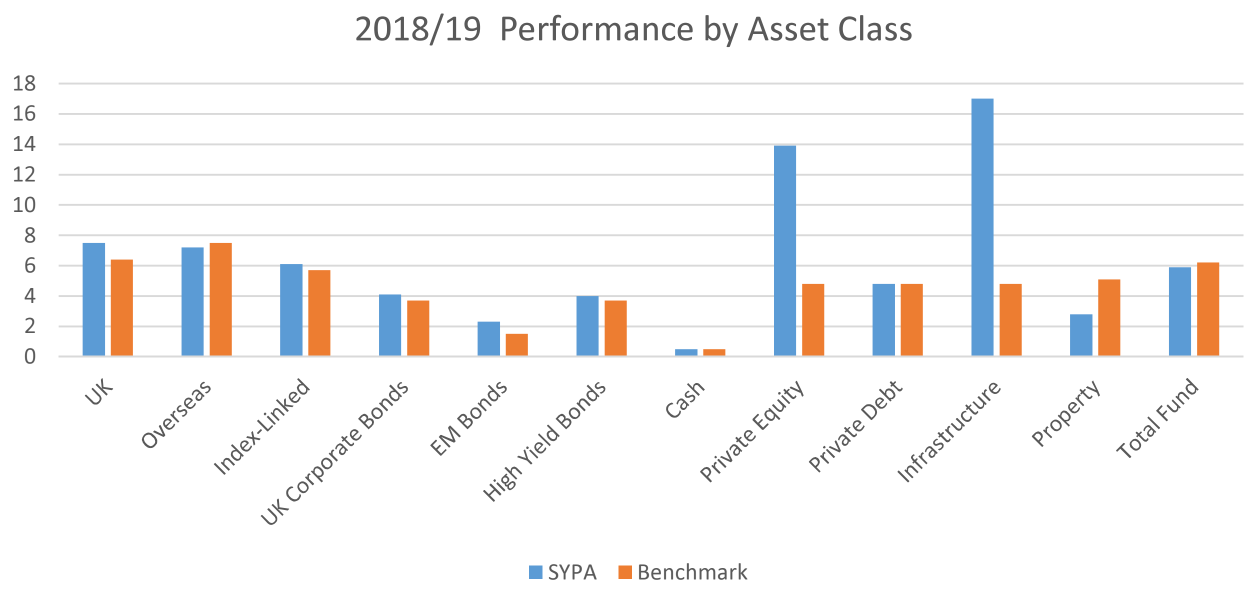
Alternatives
The performance across all the portfolios was mixed and in a period where equity markets were strong being underweight the asset class added to overall performance.

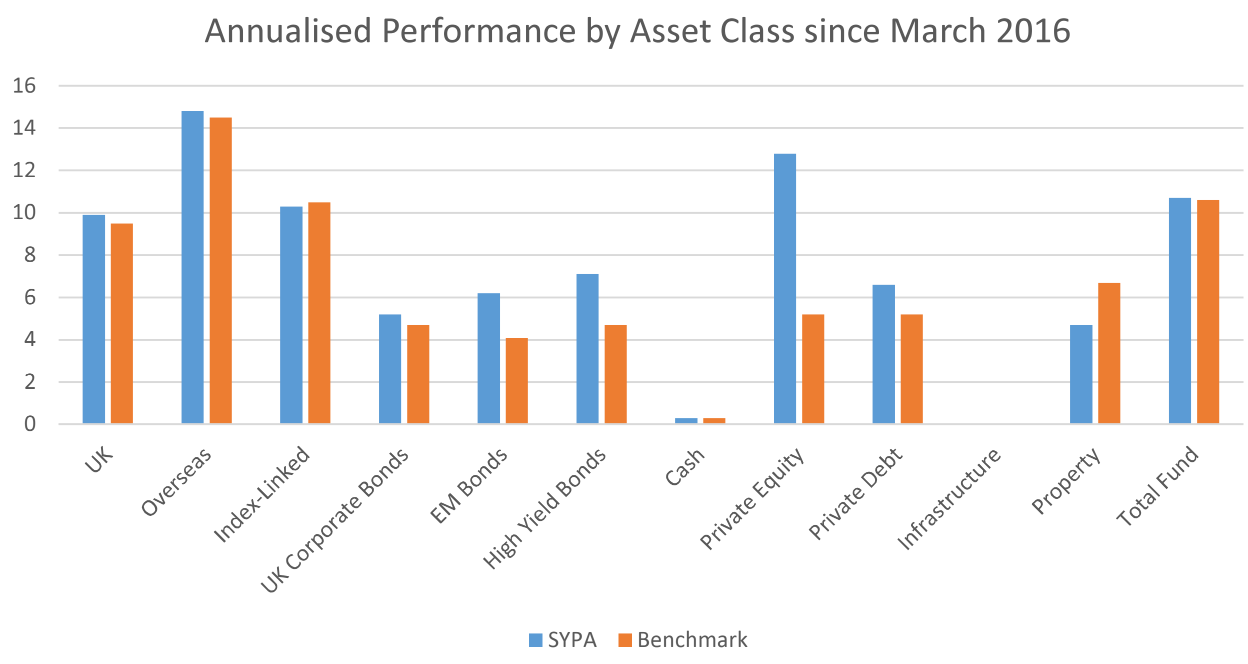
Property
Performance was behind the benchmark.

Equity Protection
With the sharp bounce back in equity markets the equity protection strategy detracted value from the Fund.

SOUTH YORKSHIRE PENSIONS AUTHORITY

Performance-Medium term





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Equity Protection

The equity protection strategy generated a negative return over the quarter given the sharp rise in the financial markets. The strategy impacted the Fund value by £122m, which detracted from overall performance by 1.5%.

Source: Schroders, Portfolio Solutions, Bloomberg. Since inception. Unitised. The data incorporate the prevailing foreign exchange rates, the accur
return calculations as well as the valuation of the options with expected maturity in 2020.

The gap in valuation between the equity protection strategy and the underlying equities has varied over the period. When markets fall there has been a positive impact but more recently as markets have risen strongly we can see that there is now a negative impact for the Fund. At the end of March this negative impact was £5.5m.

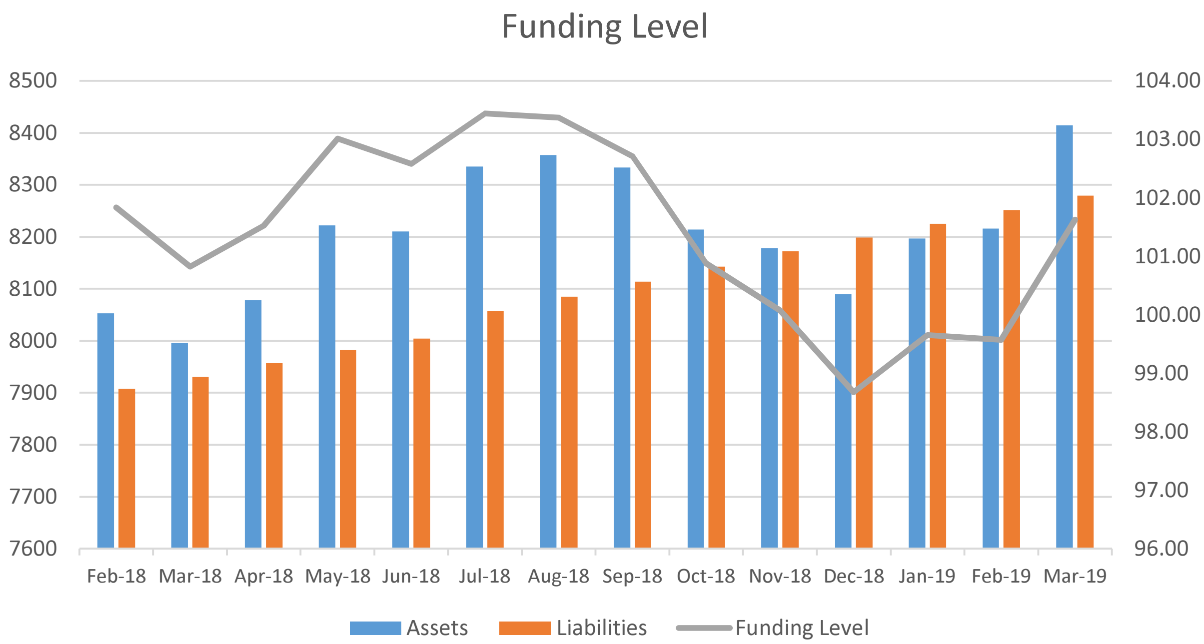
Funding Level

The funding level as at 31st March 2019 was around 101.6%, an increase from the previous quarter value of 98.7%.

The breakdown is as follows:

Fund's Assets:
As at 31 Mar 2019: £8,414.4m
As at 31 Dec 2018: £8,089.8m
An increase of £324.6m.
The value of Funds asset's at the last triennial valuation date in March 2016 was £6,270m.

Funds Liabilities:
As at 31 Mar 2019: £8,279m
As at 31 Dec 2018: £8,198m
An increase of £81m.
The value of Funds liabilities' at the last triennial valuation date in March 2016 was £7,293m.



Outlook

While there are undoubtedly short-term challenges facing markets we believe that equities should be favoured over fixed income.

UK Equities

Brexit continues to dominate the headlines and will do for some time until the latter part of this year and as such uncertainty will remain and all the risks associated with that. We would still, therefore, expect to remain neutral to underweight in this sector.

Overseas equities

Global inflation remains relatively benign, and despite relatively strong labour markets, wage growth appears contained. Concerns remain, however, regarding the lack of productivity growth. Although monetary conditions are tightening it is at a much slower pace than was expected and these are likely to remain relatively loose in developed market economies, particularly Europe and Japan. The key concern remains that there is insufficient room for central banks to use monetary policy to stimulate economies in the event of a recession, as interest rates are not high enough to enable cuts to have an impact and further quantitative easing risks merely boosting asset prices. Due to high rates of government debt it is unlikely that fiscal policy can be used to stimulate growth.

Market conditions are likely to remain volatile with the recent sharp recovery in equity markets looking overdone. Valuation measures are above their long term average at a time that earnings growth is moderating. We remain more weighted to overseas equities than to UK equities.

Emerging Markets – With both China and US imposing tariffs on each other's imports, the short term will see weakness in the markets which could dissipate should the parties come to a resolution at the G20 summit. However, some countries may benefit from the fall-out between the two global powers. Prior to the announcement by China to impose further tariffs on US imports, equity valuations in EM were attractive, although some economies will remain vulnerable due to the slowdown in global growth.

Outlook

Bonds

The recent bounce has removed much of the attraction in valuation levels in EM and high yield. High yield is not as dear as it was in mid-2018 but spreads are a long way south of the levels reached (briefly) in 2016 when yields blew out on worries about China growth. EM is decent value, but not compelling. We would look to re-invest some of the cash that has built up in these portfolios but not all.

As for index linked gilts, performance was strong enough in March to push real yields below the all-time lows seen in 2017. Real yields have bounced back a little from there but are still at extremely low, value destroying levels that cannot be justified on any rational investment basis.

Real Estate

Brexit related uncertainty remains and ASI expect capital declines over the next year, although income returns will mitigate this to a degree. The hierarchy of preferred sectors remains largely unchanged with industrials and income focussed real estate assets remaining the top picks and the retail sector and West End and City of London offices being the least favoured. They will look for acquisitions in the industrial sector or for a prime asset within the rest of the UK office sector or assets with long dated income in one of the alternative sectors (eg hotels, student accommodation).

Alternatives

The alternative investment market, includes investments within private equity, private debt and infrastructure, generally generates above market returns and with the pension fund currently slightly underweight in this sector, we are looking to add further investments into this asset class.

Going forward new potential investments in the alternative market space will be implemented by Border to Coast Pensions Partnership (BCPP). The existing legacy investments currently are held with the Authority, who will monitor and administer the funds accordingly.

Commitment was made to four new funds totalling £79m during the quarter.

Outlook

Cash

The deployment of cash to alternatives should see the reduction in cash balances.

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