AGENDA ITEM 11

Border to Coast Pensions Partnership

Joint Committee

Date of Meeting: **28 November 2023**

Report Title: **Summary of Investment Performance and Market Review**

Report Sponsor: **Joe McDonnell (CIO)**

1 Executive Summary

1.1 This report provides an overview of the macroeconomic and market environment, the performance of Border to Coast funds and the medium-term investment outlook.

2 Recommendations

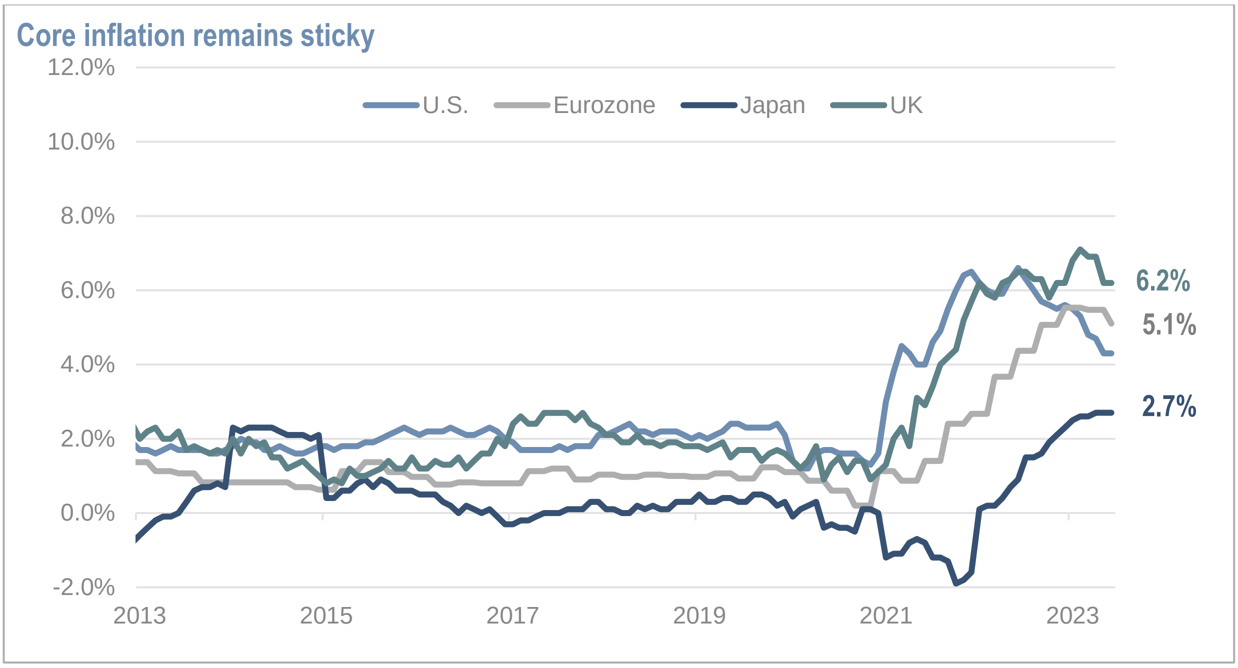
2.1 That the report is noted.

3 Macroeconomic environment

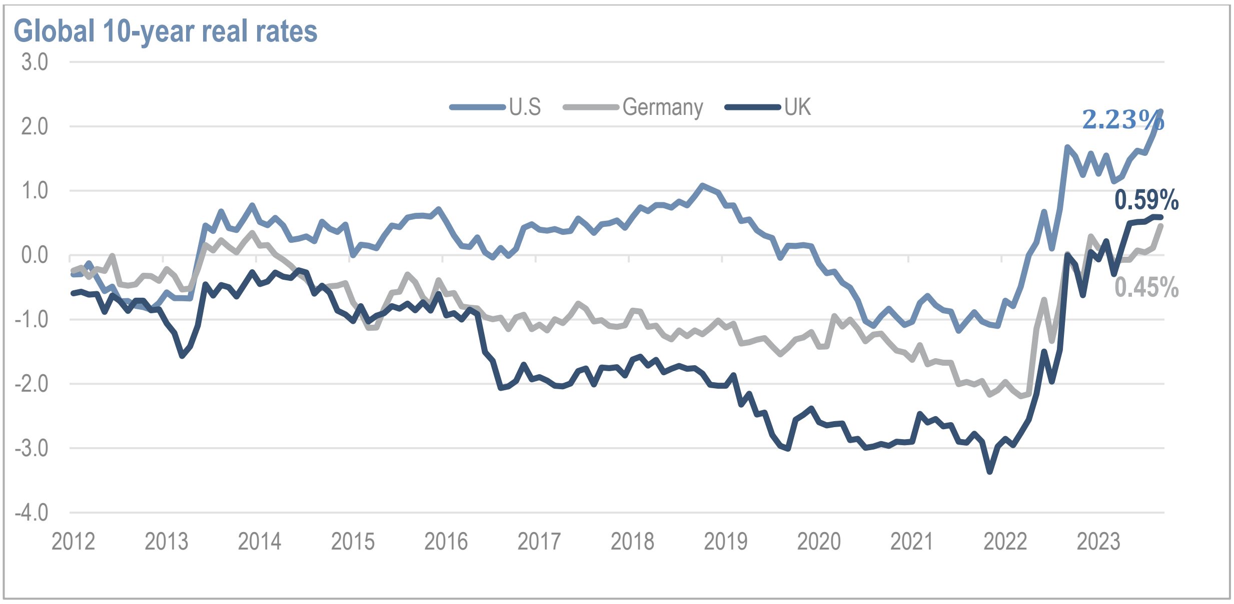
3.1 The story of the third quarter has been that good news for the economy has not been good news for financial assets. 10-year US Treasury yields surged nearly 75 basis points over the course of the quarter to their highest level since 2007. Robust domestic data and policy rate projections from the Federal Reserve are signalling the economy can handle high interest rates, so calls for an imminent recession continue to be premature.

3.2 Global growth is slowing, inflation is falling (but sticker than forecasts) and the central belief is that interest rates will be higher for longer. Corporate earnings are under pressure and are showing signs that higher rates, wage increases, and commodity price resurgence are hitting margins.

3.3 Inflation has now peaked but a return to central bank targets for core inflation may prove difficult. Headline inflation continues to ease but core inflation remains sticky. As at end of September, core Inflation in the US is 4.3% and 6.2% in the UK. The challenge that firms face in finding staff raises the likelihood they will hoard workers even if activity levels slow. The tightness in the labour market party explains why core inflation remains elevated across the US, eurozone and UK.



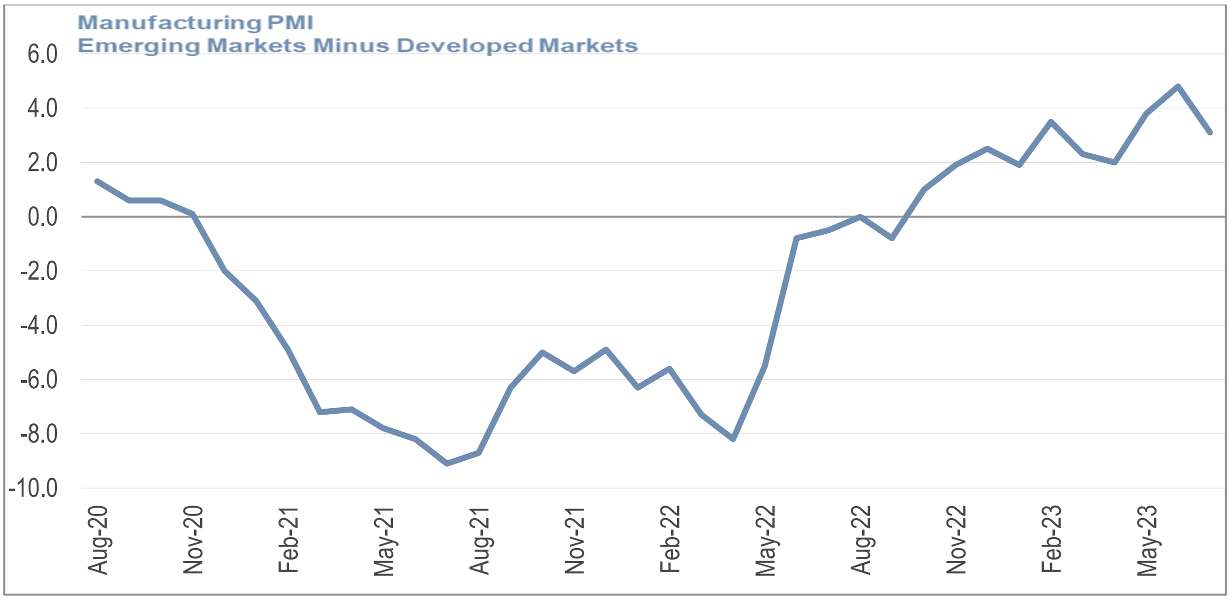
3.4 Real rates are moving back to previous highs. It is important for investors to consider this dynamic and how supportive this is of bonds (nominal and inflation linked exposures). The meaningful risk-free weight coupled with falling inflation could bolster investor appetite for bonds.



3.5 The evolution of government debt to GDP in the US, eurozone and UK is a concern. The UK for example has grown from 85% in 2020 to 105% today. Futher, government interest payments as a % of nominal GDP have risen form 1.6% to 3.8% over the same time frame. This speaks to the fiscal limitations of the coming years.

3.6 China underperformed in Q3 as indicators continued to point to a lacklustre economic recovery and as problems in the property sector resurfaced. Limited policy stimulus has been announced to address both issues, but macroeconomic data released towards the end of the quarter was more positive than anticipated.

3.7 However, more broadly after two years of weak growth versus Developed Markets Emerging markets growth forecasts are improving – as can be seen from the manufacturing PMI improvements in 2023.

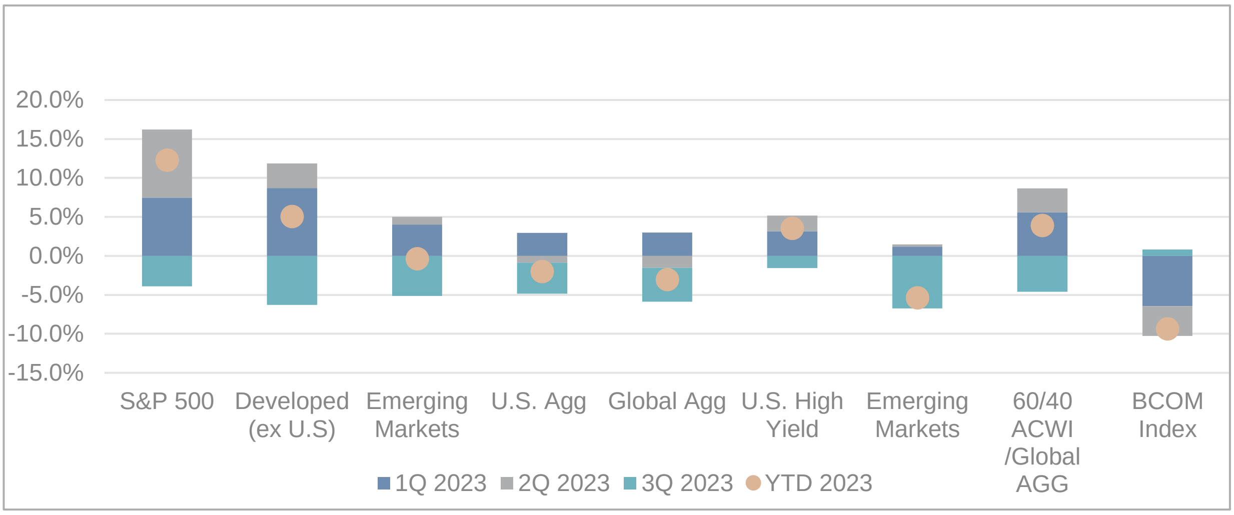


4 Markets

4.1 Following a robust rally for stocks in the first half of 2023 the third quarter offered something of a reality check. Developed market equities fell by -3.4% over the quarter, taking year to date returns down to a still strong +11.6%. Value stocks proved relatively resilient vs their more expensive growth counterparts, returning -1.7% over the quarter in comparison to -4.9% for growth stocks. The gap between the two styles remains high year to date, with growth stocks outperforming by more than 18% for in 2023. Any deterioration in the geopolitical environment would see this advantage narrow. A sell-off in global bond markets was partly to blame for the pressure on risk assets, with the global aggregate bond benchmarks falling by -3.6% in the third quarter. The US Treasury market was a notable laggard, while in credit, the lower interest rate sensitivity of high yield bond benchmarks helped both the US and European high yield markets eke out positive returns, return +0.5% and +1.5% respectively. As bonds and stocks fell simultaneously, commodities were the notable out performer, returning 4.7% over the quarter, echoing the market dynamics of 2022.

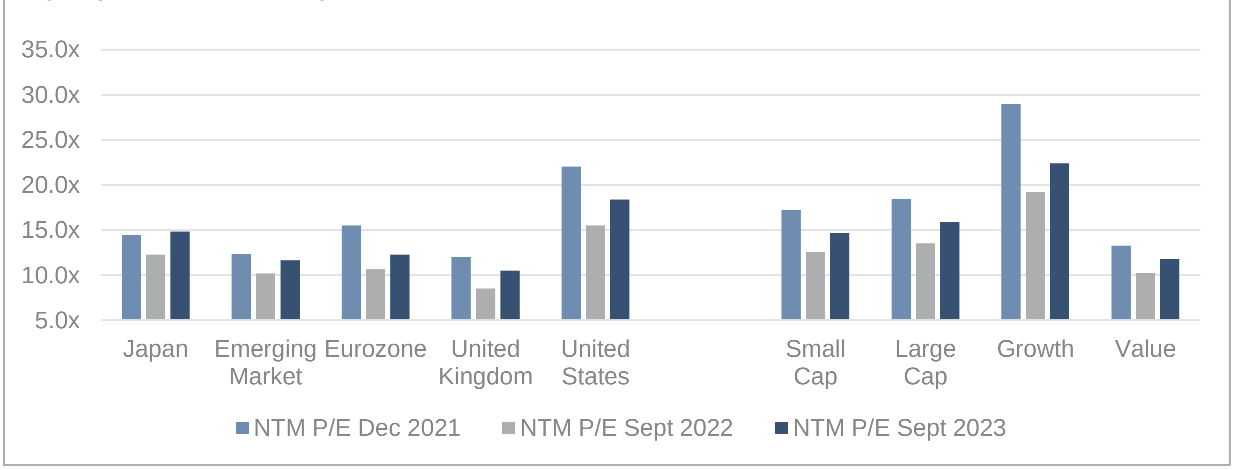
4.2 The best performing major equity market in local currency terms was Japan, returning +2.5% over the quarter to continue a strong run year to date. The UK market was the next strongest performer regionally, returning +1.9% in part that to its relatively large tilt towards the energy sector, which was supported by a sharp rise in oil prices. Returns were negative in all other regions, taking year-to-date returns in the US and Europe ex-UK to +13.1% and +10% respectively. In emerging markets, renewed concerns about the state of the property sectors in China weighed on sentiment, despite a number of new stimulus measures announced over the quarter that were aimed at stabilizing housing activity. In fixed income markets, government bond returns were negative across developed markets as yields rose over the quarter. UK Gilts remain the major laggard year to date, but did enjoy a relatively better few months, returning -0.7% over the quarter as weaker growth data forced investors to dial down their expectations for where interest rates will peak in this hiking cycle.

2023 Global Asset Class Returns (end Q3 2023)

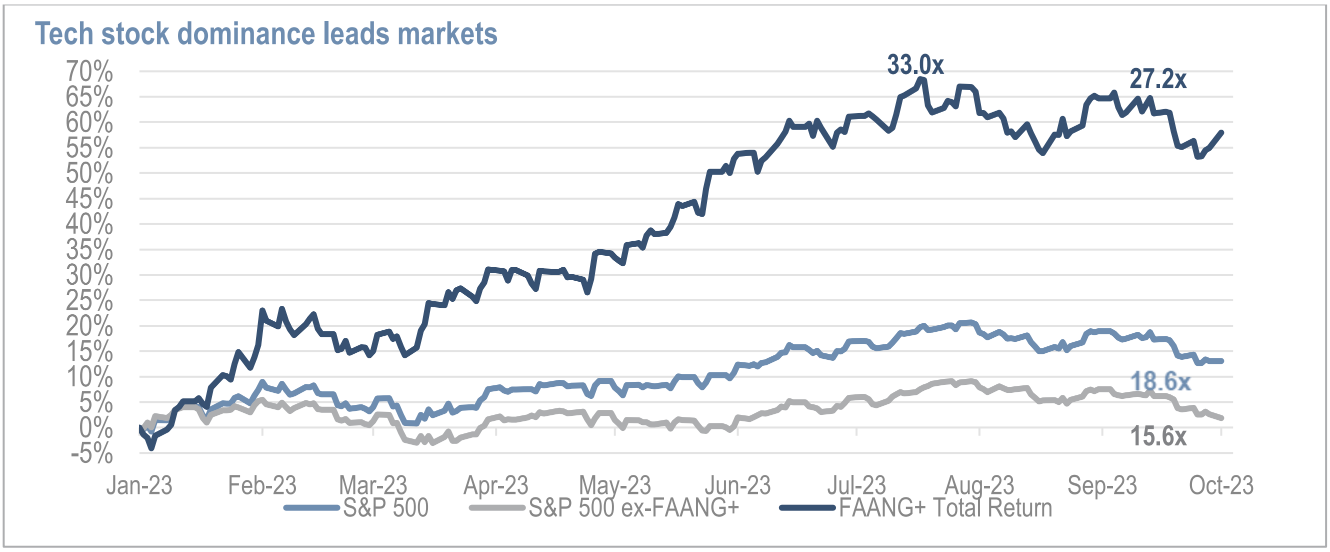


4.3 US equity valuations are at a premium to other regions and the valuation premium of growth to value remains very high.

Key regional, size and style valuations



4.4 While much of 2023 has been about US Tech dominance we are beginning to see this plateau. With valuation gaps very wide across regions, styles and capitalisation, we are likely to be entering a very good period for active investors with a medium-term view.



5 Fund Performance

5.1 The table below shows performance data for the ACS funds (listed assets) to 30 September 2023 for funds with more than 12 months since inception. Note these returns are annualised. Performance for the private markets assets are given in a later report.

% p.a. Since inception	Target vs. B'Mark	Type	Launch date	Return	B'Mark	Relative to B'Mark	Relative to Target
Equities							
UK Listed Equities	+1%	Internal	Jul-18	4.1%	3.3%	+0.8%	-0.2%
UK Equity Alpha	+2%	External	Dec-18	4.9%	5.9%	-1.0%	-3.0%
Overseas Developed	+1%	Internal	Jul-18	8.7%	7.2%	+1.5%	+0.5%
Global Equity Alpha	+2%	External	Oct-19	9.1%	8.9%	+0.2%	-1.8%
Emerging Market Equities	+1.5%	Hybrid	Oct-18	2.5%	4.2%	-1.7%	-3.0%
Alternatives							
Listed Alternatives	N/A	Internal	Feb-22	-3.4%	4.0%	-7.4%	N/A
Fixed Income							
Sterling Inv Grade Credit	+0.6%	External	Mar-20	-1.7%	-2.7%	+1.1%	+0.5%
Sterling Index Linked Bonds	+0.2%	Internal	Oct-20	-22.1%	-22.3%	+0.3%	+0.1%
Multi Asset Credit Fund	N/A	Hybrid	Nov-21	-3.7%	6.1%	-9.8%	N/A

5.2 **Benchmark Relative Returns:** As can be seen in the table above 5/9 ACS funds are ahead of benchmark since inception. Overseas Developed, Global Equity Alpha, UK Listed Equities, Sterling Investment Grade Credit and Sterling Index Linked Bonds are all ahead of benchmark since inception. UK Equity Alpha, Emerging Markets Equity, Listed Alternatives and Multi-Asset Credit Funds are below benchmark since inception.

5.3 **Target Relative Returns**: Target returns in excess of benchmark are set for each ACS fund. These excess return targets reflect the return we feel is commensurate with the active risk we take. Since inception Overseas Developed Equity, Sterling Index Linked Bonds and Investment Grade Credit are above target. UK Listed Equities is close to its target excess return. UK Equity Alpha, Global Equity Alpha, Emerging Markets Equity and Listed Alternatives are below their target return.

5.4 Q3 was a difficult quarter for our funds and we have seen a pull-back in relative performance. Year to date 4 of the 9 funds are beating their benchmark (Sterling Inflation linked, Sterling Investment Grade, Overseas Developed and Global Equity Alpha).

5.5 A new ACS fund – Emerging Markets Equity Alpha (EMEA) was launched in August 2023 with four external managers: two China – Fountain Cap and UBS; and two Ex-China – Ballie Gifford and GSAM. Performance of this fund will be reported to the Joint Committee after its 1-year anniversary.

5.6 Credit spreads have been stable year-to-date. Sterling Investment Grade saw solid relative performance from our managers and the fund is above its performance target +1.0% year-to-date. Index linked bonds continue to have headwinds in 2023 but has seen modest relative year-to-date performance of +0.1%. The Multi-Asset Credit (MAC) fund has performed very well over a 12-month horizon, returning +9%, which is ahead of its cash plus benchmark (by 1.39%). YTD performance is less impressive, +4.2%, as returns have slowed over Q2 & Q3.

5.7 The rising/high interest rate environment has been challenging for the Listed Alternatives fund. Based on the output of the annual review we are proposing to shift the portfolio to capture a broader opportunity set including an allocation to liquid investment grade bonds of issuers withing the Listed Alternatives universes. We are also looking to improve overall risk balance of the portfolio. However, both the yield (+3% above equities) and high discounts to NAV are supportive of the strategy.

6 Looking forward

6.1 We are emerging from a uniquely challenging environment in financial markets: the MSCI World Index and Bloomberg US Treasury Total Return Index have delivered negative results in each of the past three months. This marks the longest time stocks and bonds have declined in concert on a monthly basis since at least 1972.

6.2 Twelve-month forward earnings per share estimates are still rising, though the pace of improvement will slow as economic activity moderates. The downshift in growth will help solidify the view that the Federal Reserve's tightening cycle is also likely over. Historically, stocks have tended to rally for a few months once the US central bank stops hiking rates, regardless of whether or not there is a soft or hard landing.

6.3 The main themes that have come out of the Border to Coast Asset Allocation Committee are – 1) equity headwinds are building – new orders, credit availability and money supply point of weakness in the coming quarters. 2) Emerging Marekt Opportunities are looking better with rate cuts (Brazil, China and Chile) and 3) the much anticipated slowdown in inflation is materialising

6.4 The key risks in the short term are now firmly geopolitical. Conflicts are now open on two fronts (Ukraine and Middle East). Escalation on either front will impact risk assets and indeed may have more significant sustainable impact on energy prices.

6.5 Even as inflation moderates it is not likely to return to explicit targets for some time. Governments will likely allow above trend inflation to persist. A higher average inflation environment (above 3%) and low/modest growth is an investment regime that is supportive of portfolios that combine public and private (real assets). With that in mind Investors will continue to look for diversified sources of investment return, particularly from assets offering explicit or implicit inflation protection. This may encompass a broad range of alternative assets and strategies, including real assets, such as infrastructure and property.

7. Author

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10 November 2023

Important Information