

# Avon Pension Fund

## Panel Investment Report Quarter to 31 March 2021

May 2021

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# Executive summary



# Executive summary

## Market background

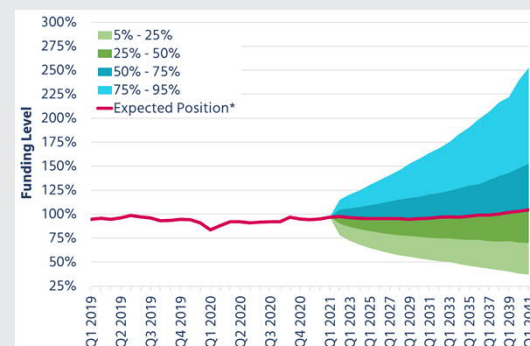
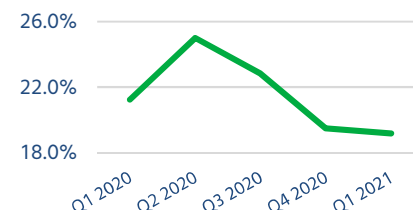
- Concerns around rising inflation has been the key macro theme to impact financial markets this quarter.
- Economic data continued to point towards a global recovery but with wide regional dispersions. Markets looked beyond the temporary setbacks created by Covid-19 restrictions. This led to another quarter of positive returns for risk assets and weaker performance for defensive assets, in particular government bonds.

## Mercer market views

- Our medium term views on the global economy (as at April 2021) are favourable, as we expect it to strengthen sharply as economies re-open more fully. Governments and central banks are likely to continue to support economic activity.

## Funding level and risk

- The funding level is estimated to have improved from 95% to 97% over Q1 as asset growth outweighed the rise in the value of the liabilities.
- It is estimated to have increased of by 13% over the year to 31 March 2021 (as illustrated to the right).
- The Value-at-Risk fell over the quarter to £1,049m, or 19.2% of liabilities.
- Risk as a proportion of liabilities has reduced over the year, largely due to the decision to move towards a dynamic equity option strategy.
- Whilst this will be implemented in Q2 2021, its impact has been illustrated from Q4 2020.
- The projected deficit at 2022 has fallen from £245m to £132m since the valuation



# Executive summary

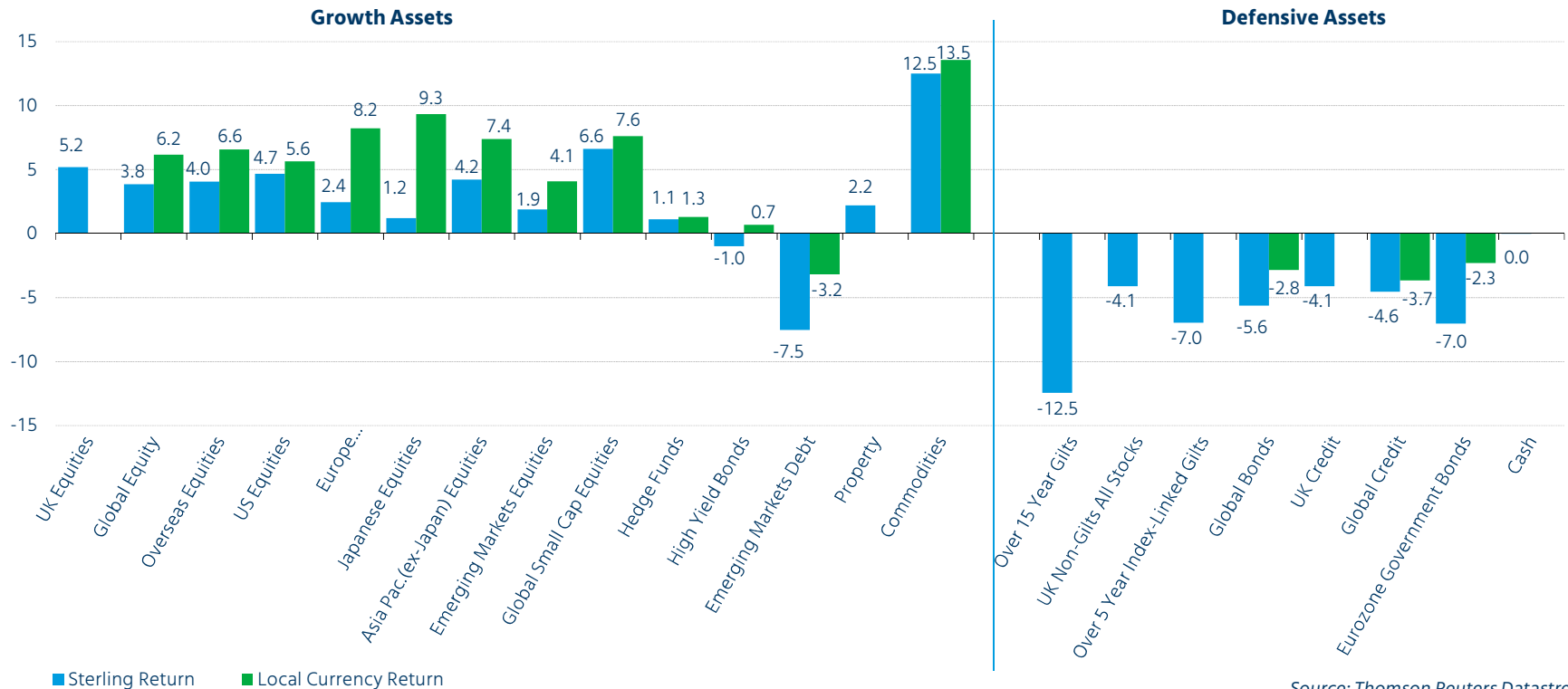
Performance	<ul style="list-style-type: none"><li>Fund returns over the quarter were driven mainly by the LDI portfolio as it protected against inflation increases.</li><li>The equity portfolio continued to deliver positive returns.</li></ul>				
	<ul style="list-style-type: none"><li>Underperformance relative to the strategic benchmark over the one year period to 31 March 2021 is mainly due to the impact of the equity protection strategy, but this has behaved in line with expectations given the increase in the underlying equity markets.</li></ul>		3 Months (%)	1 Year (%)	3 Years (% p.a.)
	<ul style="list-style-type: none"><li>Relative performance was otherwise strong at the mandate level, with the High Alpha Equity, Hedge Fund and MAC mandates standing out.</li></ul>	Total Fund <b>(1)</b>	2.7	17.3	4.9
	<ul style="list-style-type: none"><li>Relative performance over three years has been more mixed, though the Overseas Property mandate was the only notable detractor over this period.</li></ul>	Strategic Benchmark <b>(2)</b> (ex currency hedge)	4.1	20.5	6.8
	<ul style="list-style-type: none"><li>Absolute returns for most growth mandates are above the strategic returns modelled at the last investment strategy review in March 2019.</li></ul>	Relative <b>(1 - 2)</b>	-1.4	-3.2	-1.9
Asset allocation and strategy	<ul style="list-style-type: none"><li>In January, the Fund increased its inflation hedge ratio to c.45% of assets, the maximum level currently permitted.</li><li>In the same month, the Fund made its first investment into the UK Property mandate with Brunel.</li><li>At quarter end, all asset classes were within their ranges, except for the Renewable Infrastructure and Private Debt mandates which are still in the process of being drawn down.</li></ul>				

**Market background**



# Market background

## Return Over 3 Months to 31 March 2021 (%)



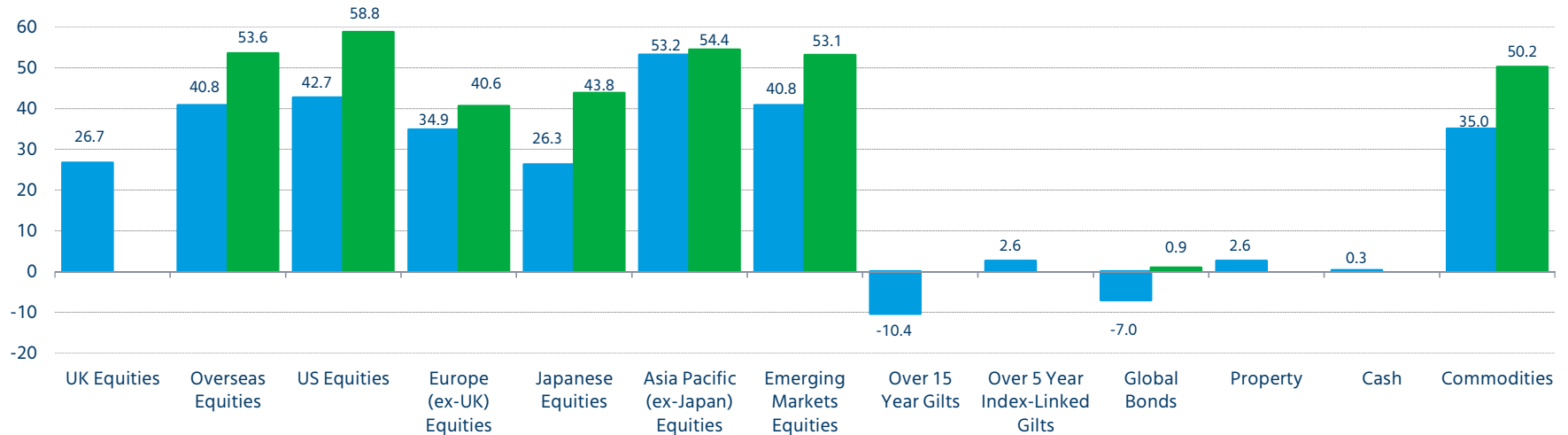
Source: Thomson Reuters Datastream.

The first quarter of 2021 began with lockdowns in numerous countries as much of the world faced another wave of Covid-19. Nevertheless, gradual vaccine rollout in developed countries drove economic recovery optimism. Political risk declined as Joe Biden was sworn in as US President, despite the incident on Capitol Hill on 6 January, and the UK completed its transition out of the EU without major incidents.

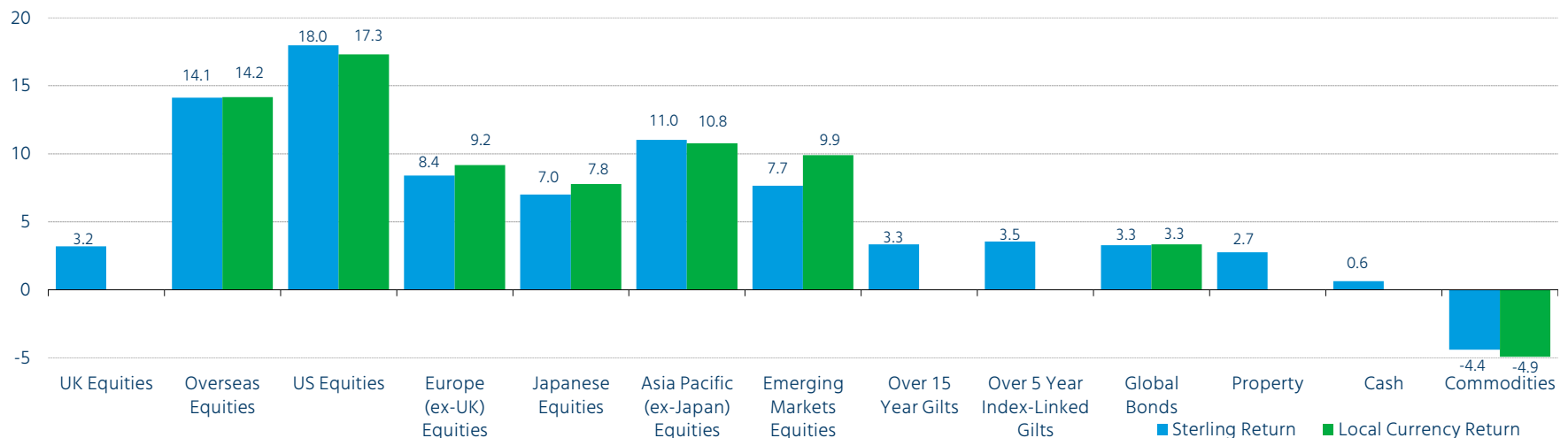
Economic data continued to point towards a global recovery but with wide regional dispersions. Markets looked beyond the temporary setbacks created by Covid-19 restrictions. This led to another quarter of positive returns for risk assets and weaker performance for defensive assets, in particular government bonds.

# Market background – longer term

## Return Over 12 Months to 31 March 2021 (%)



## Return Over 3 Years to 31 March 2021 (% p.a.)





# **Mercer market views**

**(as at April 2021)**



# Market Outlook

● Overweight ● Neutral weight ● Underweight

Global equities continued to rally aggressively, spurred on by hopes that the vaccine rollout would lead to an end to lockdown restrictions, unleashing a lot of pent up demand and causing a global economic boom. This boom would be led by consumers in those countries where mobility has been most restricted, such as those in the US and Europe and where consumers have been saving more and spending less than normal over the last 12 months.

COVID varied enormously by region and country and led to very different economic outturns in 2021Q1. In Europe, economic growth was negative as sharply rising cases in most countries led to renewed lockdowns. In the US, while rising COVID cases slowed growth somewhat, the stimulus bill passed at the end of 2020 helped keep overall economic growth strong. Elsewhere, activity was mixed and dependent on whether a country had COVID under control or not. Globally, manufacturing remained strong, with services more mixed.

We expect the global economy to strengthen sharply over the next quarters as economies re-open more fully, unleashing consumers, who are set to spend heavily, especially on those things that have been restricted over the last year. It is difficult to know how much of the excess savings that have been built up will be spent. While some will be saved permanently or used to pay down debt, it is inevitable that some will be spent over the next few quarters. Capex (business investment) has held up more strongly than expected and there is less pent-up demand than in the household sector. Nonetheless, the pick-up in overall economic activity and the low level of inventories should support stronger capex.

Governments and central banks are likely to continue to support economic activity. In the US, the new Biden administration has just passed a new large COVID support package and is planning to pass an infrastructure bill later in the year that will only partly be funded through higher taxes. In the EU, money from the Recovery Fund will start to become available soon. Central banks are likely to keep monetary policy exceptionally loose and will look through (central bank speak for ignore) any rise in inflation caused by re-opening over the next few months. Nonetheless, attention is likely to focus on reducing (or tapering) the amount of new quantitative easing being provided. While actual interest rate hikes remain some way off in developed countries, Russia, Turkey and Brazil all nudged their base rate higher for the first time in a while.

In terms of financial markets we think the outlook for risk assets such as equities and growth fixed income remains positive, although our concern about valuations have increased. Strong economic growth is likely to lead to strong corporate profit growth and this alongside still very supportive monetary policy provides a strong tailwind to equities and growth fixed income. However, with both equities and high yield bonds performing well at the start of 2021, valuations have become less attractive. High yield bond spreads are below normal levels and even though we expect defaults to remain low, these tight spreads provide little protection if our expectation of strong growth turns out to be too optimistic. We have thus pared back our categorization of growth fixed income from overweight to the overweight side of neutral. We also considered lowering our equity rating on valuation grounds as well. However, we decided against this, noting the strong tailwind from the macro environment and the fact that equities are not expensive relative to bonds. We have increased our cash position to offset the downgrade of growth fixed income.

Within equities we made no major changes, continuing to prefer emerging market equities and to a lesser extent small cap equities. Within growth fixed income, we revised the outlook for loans marginally higher at the expense of high yield following the recent high yield outperformance. Within defensive fixed income, we continue to like securitised bonds on a relative basis and remain on the underweight side of neutral in UK sovereign bonds and index-linked bonds. We think that government bonds yields will move higher on the back of strong economic growth and a pick-up in inflation. We expect inflation to rise sharply over the next few months as economies reopen, but we expect this will largely be temporary.

Mercer's current position/view

Position/view last time (if changed)



LISTED EQUITIES



GROWTH FIXED INCOME



DEFENSIVE FIXED INCOME



CASH\*

*\*In lieu of cash, investors might consider liquid alpha-oriented strategies with low sensitivity to equity, credit and duration.*

The views on these slides are as at April 2021, and the charts summarise Mercer's views on the medium term (1-3 years) outlook for returns.

These views are relevant for reflecting medium term market views in determining appropriate asset allocation. We do not expect the Fund to make frequent tactical changes to their asset allocation based upon these views.

# Listed equities

Overweight Neutral weight Underweight

Mercer's current position/view

Position/view last time (if changed)

## ASSET CLASS

## COMMENTARY



GLOBAL SUSTAINABLE EQUITY

The MSCI World Index returned around 4% in GBP terms over 2021 Q1 and 39% over a one-year period, one of the strongest year-on-year performances ever following the Covid-19 driven market sell off in 2020Q1<sup>1</sup>. We have maintained our broad market equity sector position at the underweight side of neutral within the global equities portfolio. At this time our concerns about valuations and frothy sentiment in equity markets are offset by the strong foundation for the economic recovery laid by successful vaccine roll-outs in the US and UK with Europe gradually catching up and robust fiscal and monetary policy support on a global level. While the current macro environment favours broad market equities in absolute terms, other sectors stand to benefit more strongly from expected positive developments for the rest of the year.



GLOBAL SMALL CAP EQUITY

Global small caps have once again seen the strongest rally of all equity subsectors, with the MSCI Small Cap index returning almost 9% in GBP terms over 2021 Q1 and 64% on a year-on-year basis<sup>1</sup>. We have maintained our small cap allocation at the overweight side of neutral. The macro environment remains favorable for small caps, which are expected to benefit significantly from a vaccine enabled full domestic reopening, especially over the remainder of 2021. Small caps greater exposure to value sectors relative to broad market equities also makes them a good proxy to express our preference of value over growth in an environment which should benefit out of favour sectors and provide additional upside from valuation expansion. Strength from small caps over the last few quarters has prevented us from further upgrading our view.



EMERGING MARKET EQUITY

The MSCI Emerging Markets index returned around 1% in GBP terms over 2021 Q1 and 43% on a year-on-year basis<sup>1</sup>. Despite the weakness out of China, which was the primary reason emerging market equities lagged during the quarter, we retain our overweight position within the global equities portfolio. Valuations are still more inviting than for other equity sectors. The emerging Asia region continues to benefit from foreign goods demand, which is expected to continue, even if on a smaller scale than last year. 2021 is likely to be a bit less spectacular for emerging markets equities than the previous year, as China curbing credit growth might be a headwind this year. That said, we expect China's government to continue to prioritize growth and our conviction in the asset class over a three-year time horizon remains strong.

# Growth fixed income

Overweight Neutral weight Underweight

Mercer's current position/view

Position/view last time (if changed)

## ASSET CLASS

## COMMENTARY



EM DEBT  
(LOCAL CURRENCY)

**EMD local currency markets struggled through Q1 2021, posting a negative GBP return of 7.5%<sup>1</sup>. We have maintained our position to a higher conviction neutral within the growth fixed income portfolio.** The recent rally in EMD local currency markets paused although EM FX continues to screen inexpensive relative to the USD with EM FX valuations remaining below their three-year average on a REER basis. Overall, the economic backdrop for emerging markets has improved with measures of global trade and manufacturing continuing to recover on both demand and supply factors along with strengthening in commodity prices. With the recent US elections out of the way, the arrival of COVID-19 vaccines and improving global growth should be particularly supportive of EM markets. We maintain a preference for local relative to hard currency given the rising US twin deficits, accommodative Fed policy, and improving growth, which should all help to ease the pressure of further US dollar strength.



EM DEBT  
(HARD CURRENCY)

**EMD hard currency markets declined through Q1 2021, as at March 31 2021, the index was down 5.4% in GBP terms<sup>1</sup>. We have maintained our overall neutral allocation within the growth fixed income portfolio.** The recent sell-off has led to a continuation in spread dislocation between investment and non-investment grade with high yield spreads widening further. Higher quality spreads, however, have broadly returned to pre-COVID tightness. Overall, the economic backdrop for emerging markets has improved with measures of global trade and manufacturing continuing to recover on both demand and supply factors along with further stability in commodity prices. With the recent US elections out of the way, the arrival of COVID-19 vaccines and improving global growth should be particularly supportive of EM markets.



GLOBAL LOANS

**Over 2021 Q1, global loans returned 0.8% in GBP terms<sup>1</sup>. We have modestly upgraded our bank loans position to neutral within the growth fixed income portfolio.** With an average price below par and a yield over 4.5%, global loan valuations look relatively attractive given the general context of low to negative yields globally. Further, their floating rate nature and senior secured position makes them quite appealing in the current environment. Forward looking default rate expectations continue to trend lower, and we believe investors are seeing sufficient reward for the level of risk. Our outlook for strong growth and elevated rate volatility has us favoring the floating-rate nature of the loan asset class versus high yield.



GLOBAL HIGH YIELD




**Over 2021 Q1, global high yield returned -1.9% on a GBP basis<sup>1</sup>. We have modestly downgraded our global high yield position to the negative side of neutral within the growth fixed income portfolio.** High yield valuations have become less attractive as spreads have continued to narrow and are now inside of where they entered 2020. As a result, further spread compression, particularly within the higher quality segment of the market, appears quite limited at this point. While the backdrop remains favorable for credit assets, we hold a slight preference for global loans over high yield given the floating rate nature and senior secured status of the loan asset class.

# Defensive fixed income

● Overweight ● Neutral weight ● Underweight

Mercer's current position/view

Position/view last time (if changed)

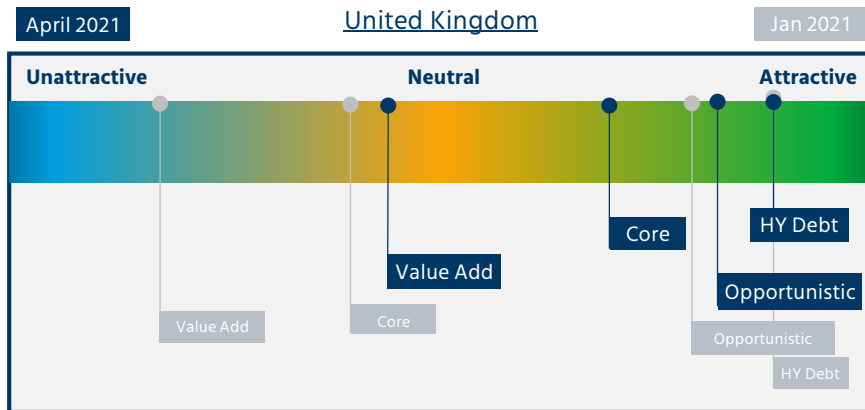
ASSET CLASS	COMMENTARY
 <p>UK SOVEREIGN FIXED INCOME</p>	<p><b>Over 2021Q1, UK sovereign fixed income returned -2.5% in GBP hedged terms<sup>1</sup>. We have maintained our negative side of neutral position in UK Sovereign Fixed Income within the defensive fixed income portfolio.</b> Following the sell-off in Q1, rates have become marginally more attractive on an absolute basis. However, we do not yet believe we are at the point where we would recommend a higher allocation to nominal bonds just yet, acknowledging the risk that yields may rise further off stronger growth prospects as the UK economy reopens.</p>
 <p>UK INFLATION-LINKED BONDS</p>	<p><b>Over 2021 Q1, UK inflation linked bonds returned -6.4% in GBP terms<sup>1</sup>. We have maintained our position at the negative side of neutral for UK inflation-linked government bonds within the defensive fixed income portfolio.</b> Break-evens remain expensive relative to the BoE's target of 2%, and breakevens across the maturity spectrum are currently being priced above the long-run averages. Although due to a number of primarily technically-driven factors, as well as uncertainties around post-Brexit inflation risks, it demonstrates that investors are paying substantially for inflation protection in the current market.</p>
 <p>UK BUY AND MAINTAIN CREDIT</p>	<p><b>Over 2021Q1, UK buy and maintain credit returned -4.0% in GBP hedged terms<sup>1</sup>. We have maintained UK Buy &amp; Maintain Credit within the defensive fixed income portfolio at neutral as we see risk better rewarded in securitised credit at the current time.</b> Spreads were mostly unchanged from Q1, and we expect them to consolidate at current levels, offering carry but limited capital gain with very few areas offering value. Over the short term, the corporate bond market should continue to benefit from a stronger economy and technical tailwinds in the form of demand for spread products, and expected weaker supply than in 2020. Over the medium term we are becoming more cautious, with a lot of good news already priced in but with very little reward for tail risks.</p>

<sup>1</sup>Source: Bloomberg, DataStream as of end of 1Q2021

<sup>2</sup>Commerical Mortgage-Backed Securities (CMBS: Bloomberg Barclays US CMBS 2.0 AAA Index), Asset Backed Securities (ABS: Bloomberg Barclays US ABS Index), Collateralized Loan Obligations (CLOS: JP Morgan CLOIE Investment-Grade Index) & Mortgage-Backed Securities (MBS: Markit iBoxx US Non-Agency RMBS Index). Source: Bloomberg, DataStream, JP Morgan as of end of 1Q2021

# Real estate outlook and opportunities

## Relative attractiveness by Fund Style



- **Core:** We have upgraded our view on core investment strategies as confidence grows in the economic recovery. We expect this positivity to arrest the decline in valuations and boost occupier demand, albeit from a low base. Investors will continue to focus on income security, such as that offered by long lease strategies, but pricing of mainstream core real estate has become increasingly attractive relative to other asset classes and we expect performance to recover to historic norms by year end.
- **Value Add:** Income risk strategies have become more attractive over the past quarter as the market has most likely moved through the depths of the economic downturn. As the vaccination programme gathers pace, optimism about the path to recovery is returning, but risks remain elevated for some sectors of real estate occupier demand.
- **Opportunistic:** Opportunistic strategies have become more attractive in our view as the probability of achieving asset acquisitions at discounted pricing increases the longer the pandemic continues. Special situations opportunities are most likely to emerge in the retail and leisure sectors. Increasing obsolescence due to the growth of ESG requirements may result in redevelopment opportunities.
- **High Yield Debt:** Real estate debt funds continue to look attractive for income seeking investors as traditional bank lenders reduce activity while underlying assets devalue. Together, these features mean higher margins can be achieved by non-bank lenders particularly outside of London and the most liquid sectors.

## Market Outlook

- The UK leads among large developed countries in terms of the vaccination roll-out, feeding the optimism felt in spring 2021. However, concerns over the relentless spread of the pandemic elsewhere in the world and fears of vaccine resistant variants remain. Optimism over the unfolding recovery is also tempered by the continued rise in longer dated bonds yields and associated fear of tightening in financial conditions.
- Rising UK gilt yields are not expected to impact on property yields given the generous spread that remains in place, especially as industrial, residential and office assets remain in strong demand. Covid restrictions remaining in place to some extent until June will likely mean capital values for some sectors, particularly retail and leisure, remain under pressure. Overall returns are expected to return to historic norms by year end 2021.
- Our top three sector/geographic picks in terms of real estate fundamentals:
  1. **Operational real estate:** Funds targeting assets where real estate performance is linked to an operating platform, including residential, self-storage, senior housing and leisure.
  2. **Logistics:** Fundamentals remain strong for logistics sites in and around major urban areas, although attractive pricing is difficult to achieve for standing assets.
  3. **Accessible non-fashion retail:** Retail Parks with rebased rents, sustainable income profiles and low fashion exposure have attractive risk return dynamics at current pricing levels.

# Funding level and risk





# Change in deficit



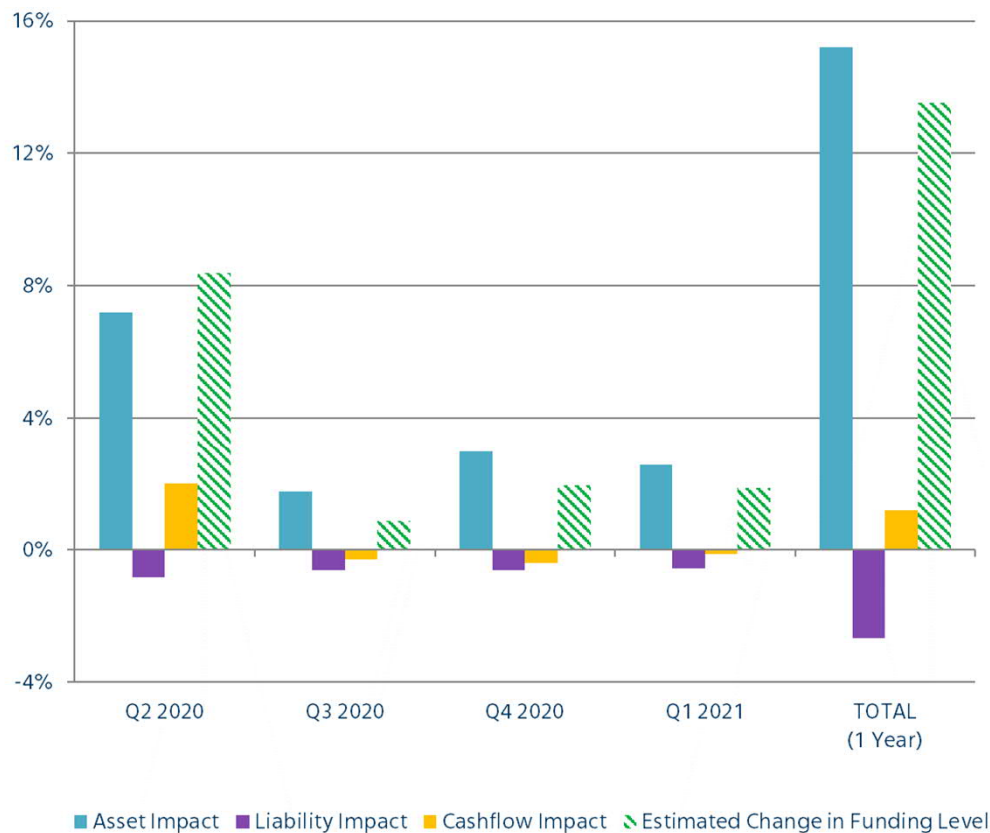
Based on financial markets, investment returns and net cashflows into the Fund, the deficit was estimated to have reduced further over the first quarter of 2021, from £272m to £171m.

This occurred as the value of the assets rose by more than the present value of the liabilities over the period.

This is calculated using the actuarial valuation assumptions as at 31 March 2019 and the 'CPI plus' discount basis.



# Funding level attribution



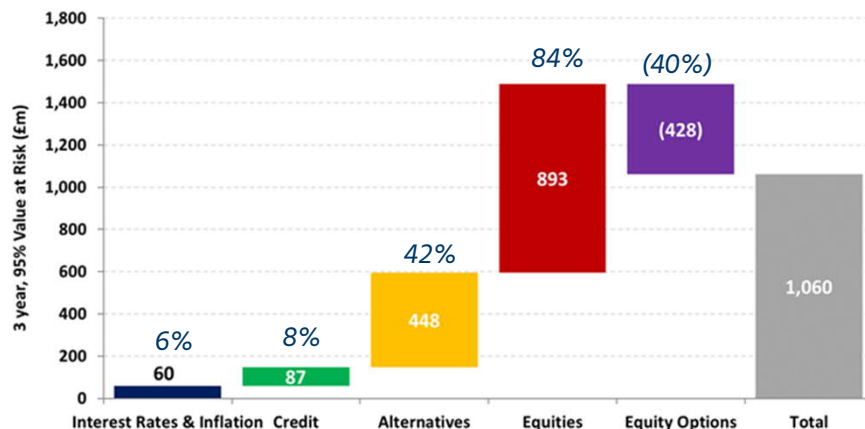
The Fund's assets returned 2.7% over the quarter, whilst the liabilities are expected to have increased by c. 0.6% due to the rise in inflation.

The combined effect of this, also allowing for cashflow over the period, saw the funding level improve from 95% to 97%.

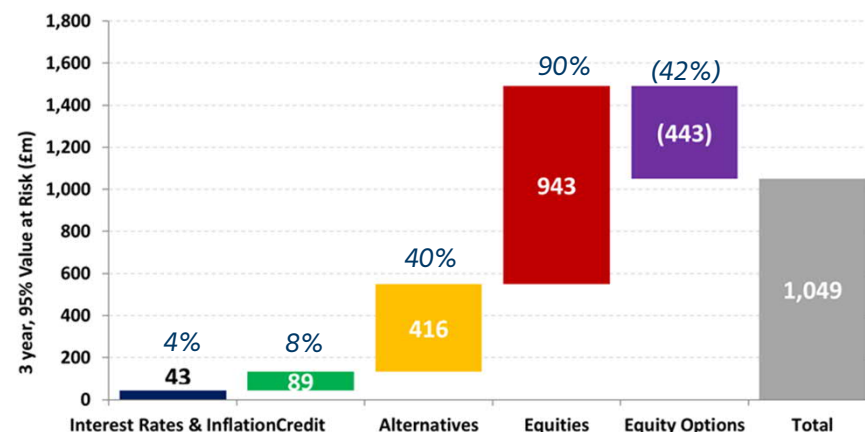
The funding level is estimated to have increased by c.13% over the year to 31 March 2021.

# Risk decomposition – 3 year Value at Risk

31 December 2020



31 March 2021

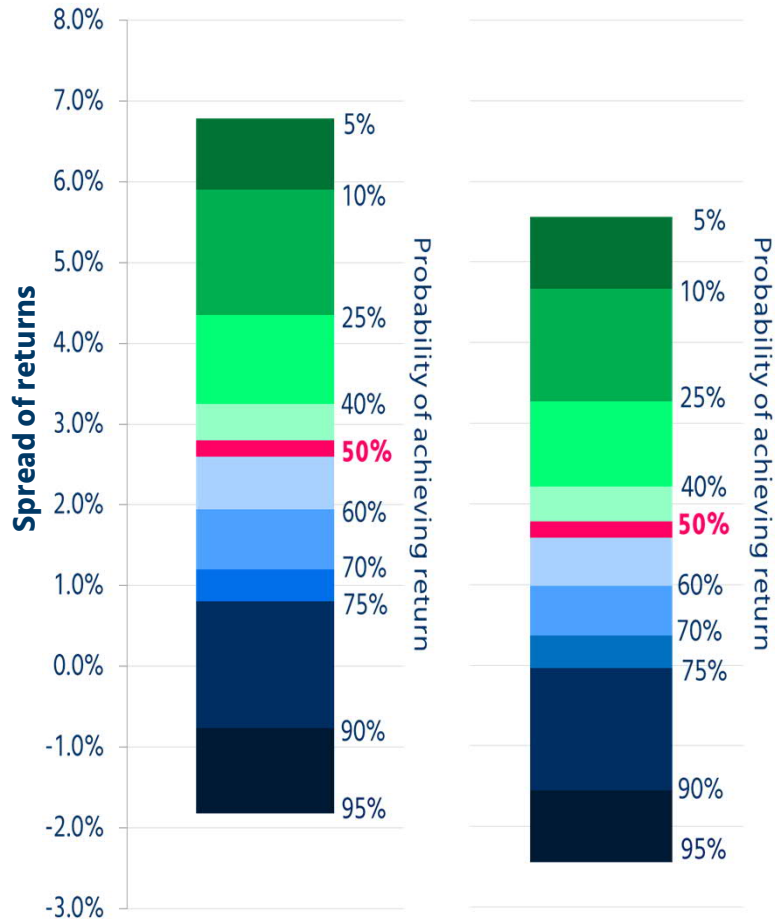


- The two charts to the left illustrate the main risks that the Fund is exposed to on the 2019 funding basis, and the size of these risks in the context of the change in the deficit position.
- The purpose of showing these charts is to ensure there is an awareness of the risks faced and how they change over time, and to initiate debate on an ongoing basis around how to best manage these risks, so as not to lose sight of the 'big picture'.
- The grey column on the right hand side of each chart shows the estimated 95<sup>th</sup> percentile Value-at-Risk (VaR) over a one-year period. In other words, if we consider a downside scenario which has a 1-in-20 chance of occurring, what would be the impact on the deficit relative to our 'best estimate' of what the deficit would be in three years' time.
- If we focus on the chart at 31 March 2021, it shows that if a 1-in-20 'downside event' occurred over the next three years, the deficit could increase by at least an additional **£1.0bn**.
- Each bar to the left of the grey bar represents the contribution to this total risk from the primary underlying risk exposures (interest rates and inflation, changes in credit spreads, volatility of alternative assets and equity markets, and the benefit from equity options).
- Overall, **the VaR has fallen over the quarter**, which is largely attributable to the rise in gilt yields and lower volatility for fixed interest gilts. Both decompositions illustrate the use of a dynamic equity option strategy, which the Fund will be implementing during Q2 (as opposed to the previous static strategy). This significantly reduced the VaR via an increased offsetting amount from the equity options.

# Investment returns – updated outlook

**Valuation date**  
31/3/2019

**Current date**  
31/3/2021



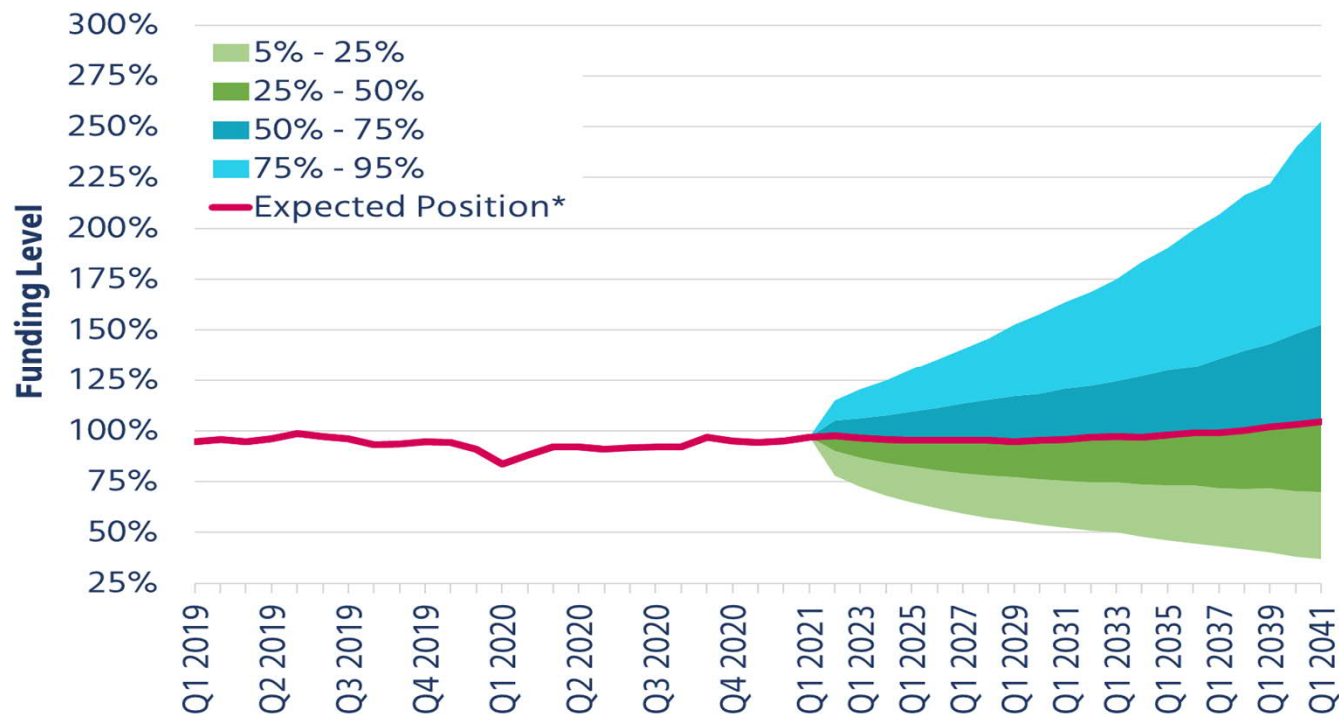
Return metrics (20 year)	31/3/19	31/3/21
Expected absolute return	5.0% p.a.	4.5% p.a.
Expected return over CPI	2.6% p.a.	1.6% p.a.
Probability of achieving past service discount rate of CPI + 1.75% p.a.	63%	47%
Probability of achieving future service discount rate of CPI + 2.25% p.a.	55%	39%

Key return percentiles	31/3/19	31/3/21
50% confidence	CPI + 2.6% p.a.	CPI + 1.6% p.a.
60% confidence	CPI + 1.9% p.a.	CPI + 1.0% p.a.
70% confidence	CPI + 1.2% p.a.	CPI + 0.4% p.a.

The probability of returns outperforming the discount rate relative to CPI has fallen as real returns continue to be difficult to come by, particularly with long term implied inflation expectations rising but forward looking expected absolute returns falling versus the valuation date.

# Funding and contributions

## Projection of outcomes from 31 March 2021



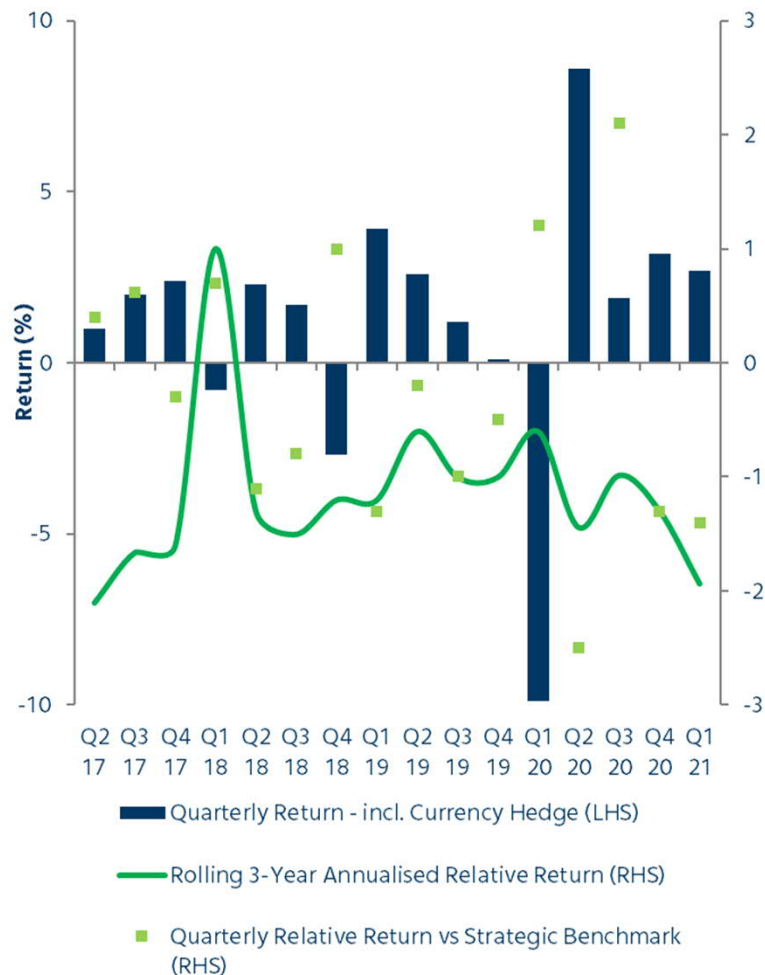
\* actual funding level progression (as calculated by PFaroe) shown from 31 March 2019 to 31 March 2021

- The chart above demonstrates the actual funding level progression to date, and the projection of outcomes over the next 20 years thereafter.
- The funnel of potential outcomes is very wide, representing the uncertainty in the future funding level. This is driven by the level of risk within the strategy.
- The Fund is a long term investor therefore the focus should be on the probability of being successful in the longer term.
- The funnel of potential outcomes is positively skewed with a greater potential for more positive outcomes versus negative outcomes. This is attributed to the strength of the downside protection strategies put in place to date.

# Performance summary

5

# Total Fund performance



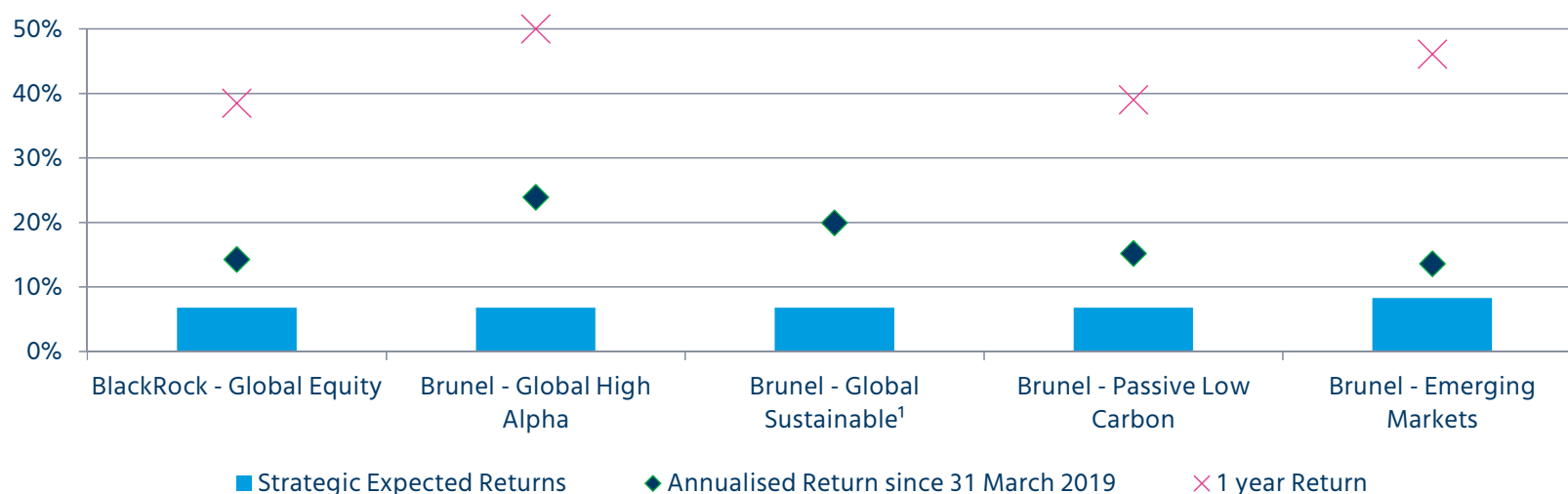
	3 Months (%)	1 Year (%)	3 Years (% p.a.)
Total Fund (1)	2.7	17.3	4.9
Total Fund (ex currency hedge)	2.2	14.9	5.0
Strategic Benchmark (2) (ex currency hedge)	4.1	20.5	6.8
<b>Relative (1 - 2)</b>	<b>-1.4</b>	<b>-3.2</b>	<b>-1.9</b>

## Commentary

- Fund returns over the quarter were driven by the rise in the value of the LDI portfolio as it protected against inflation increases. The equity portfolio also continued to deliver returns, and the currency hedging policy made a positive contribution as sterling strengthened.
- The equity portfolio underperformed relative to the benchmark, however. In particular the Sustainable Equities fund has struggled due to its strong bias away from "value" factors, which have done well over the last few months. The equity protection also detracted from relative performance at the total Fund level. Falls in the MAC and Renewable Infrastructure mandates meant they also underperformed their cash/inflation plus benchmarks.
- Relative performance at the mandate level has been stronger over the one year period to 31 March 2021, with the High Alpha Equity, Fund of Hedge Funds and MAC mandates standing out. Underperformance relative to the strategic benchmark over this period is mainly due to the impact of the equity protection strategy, but it is important to note that this has behaved in line with expectations given the increase in the underlying equity markets.
- Relative performance over three years was more mixed. The Overseas Property mandate detracted, and the impact of the equity protection will have had a negative impact. The underperformance from some of the terminated mandates are also reflected.

# Performance vs. expected strategic returns

	BlackRock Global Equity	Brunel Global High Alpha	Brunel Global Sustainable	Brunel Passive Low Carbon	Brunel Emerging Markets
<b>Benchmark allocation</b>	12.0%	10.0%	10.0%	10.0%	5.5%
<b>Commentary</b>	Returns have been above expectations for all equity mandates, given the strength of equity markets since 2019.				
	Returns are above strategic expectations as the fund has tracked the underlying market	Strong manager outperformance adding to returns	Strong returns from equity markets, although the fund has underperformed the benchmark to date	Returns are above strategic expectations as the fund has tracked the underlying market	Returns are above strategic expectations as the fund has performed broadly in line with the underlying market



## Notes:

We have illustrated the key mandates within the Fund's investment strategy.

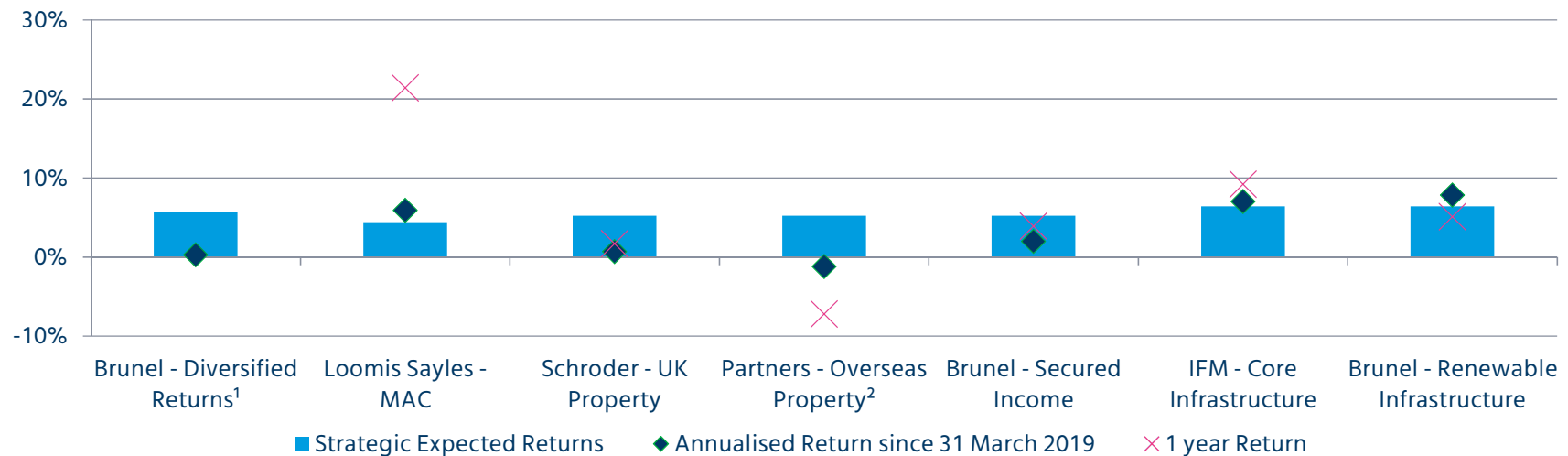
The strategic expected returns are from the 2019 strategy review, which reflect the 20 year mean Mercer Q1 2019 asset model assumptions.

Actual returns between 31 March 2019 to 31 March 2021, except if otherwise stated below.

<sup>1</sup> Returns are shown since the mandate's inception date and annualised.

# Performance vs. expected strategic returns

	Brunel Diversified Returns	Loomis Sayles MAC	Schroder UK Property	Partners Overseas Property	Brunel Secured Income	IFM Core Infra	Brunel Renewable Infra
<b>Benchmark allocation</b>	10.0%	6.0%	3.75%	3.75%	10.0%	5.0%	5.0%
<b>Commentary</b>	Mandate inception in July 2020; too early to draw conclusions	Returns above expectations due to narrowing of spreads on sub-investment grade debt since March 2021	Returns below expectations due to the impact of Covid on the property market	Returns below expectations due to the impact of Covid on the property market. Focus should be on long-term performance as the mandate is still in the drawdown phase	Returns below expectations but mandate is still in the drawdown phase	Returns above expectations as real assets have continued to deliver	Returns above expectations but mandate is still in the drawdown phase



## Notes:

We have illustrated the key mandates within the Fund's investment strategy.

The strategic expected returns are from the 2019 strategy review, which reflect the 20 year mean Mercer Q1 2019 asset model assumptions.

Actual returns between 31 March 2019 to 31 March 2021, except if otherwise stated below.

<sup>1</sup> Returns are shown since the mandate's inception date and annualised.

<sup>2</sup> Returns are shown up to 31 December 2020, as this is the latest data available.



# Manager performance to 31 March 2021

Manager / Asset Class	3 Months			1 Year			3 Year			3 Year Performance Target (% p.a.)	3 Year Performance vs Target
	Fund (%)	B'mark (%)	Relative (%)	Fund (%)	B'mark (%)	Relative (%)	Fund (% p.a.)	B'mark (% p.a.)	Relative (% p.a.)		
BlackRock Global Equity	3.7	4.0	-0.3	38.5	38.4	+0.1	13.9	13.4	+0.4	-	Target met
Brunel Global High Alpha Equity	3.2	4.1	-0.9	50.0	39.1	+7.8	N/A	N/A	N/A	+2-3	N/A
Brunel Global Sustainable Equities	0.4	3.7	-3.2	N/A	N/A	N/A	N/A	N/A	N/A	+2	N/A
Brunel Global Low Carbon Equity	3.8	3.9	-0.1	39.0	39.2	-0.1	N/A	N/A	N/A	-	N/A
Brunel Emerging Market Equity	2.1	1.4	+0.7	46.1	42.8	+2.3	N/A	N/A	N/A	+2-3	N/A
Brunel Diversified Returns Fund	-1.3	0.0	-1.3	N/A	N/A	N/A	N/A	N/A	N/A	+4-5	N/A
JP Morgan FoHF	2.8	0.8	+2.0	23.0	3.6	+18.6	9.0	4.8	+4.0	-	Target met
Loomis Sayles MAC	-1.3	1.0	-2.3	21.4	4.2	+16.5	4.2	4.6	-0.4	-	Target not met
Schroder UK Property	0.6	2.2	-1.6	1.7	2.5	-0.8	2.0	2.4	-0.4	+1	Target not met
Partners Overseas Property*	-0.6	2.5	-3.0	-7.2	10.0	-15.7	1.4	10.0	-7.8	-	Target not met
Brunel Secured Income	1.9	0.2	+1.7	3.9	0.7	+3.2	N/A	N/A	N/A	+2	N/A
IFM Core Infrastructure**	1.6	0.7	+0.9	9.2	3.4	+5.7	9.6	4.6	+4.8	-	Target met
Brunel Renewable Infrastructure	-3.0	0.2	-3.2	5.1	0.7	+4.4	N/A	N/A	N/A	+4	N/A
BlackRock Corporate Bonds	-6.8	-6.8	0.0	12.9	12.9	0.0	5.6	5.6	0.0	-	Target met
BlackRock LDI	21.0	21.0	0.0	30.5	30.5	0.0	3.4	3.4	0.0	-	Target met

Since inception performance for Partners, which was the largest underperformer over the three year period, has been more favourable at 5.4% p.a. \*

- Source: Investment Managers, Custodian, Mercer estimates.
- **Returns are in GBP terms**, consistent with overall fund return calculations before currency hedging is applied, **except for JP Morgan and Partners, whose performance is shown in local currency terms.**
- **Returns are net of fees.**
- In the relative performance columns, returns in blue text exceeded their respective benchmarks, those in red underperformed, and black text shows performance in line with benchmark.
- In the table above, and throughout this report, relative returns have been calculated geometrically (i.e. the portfolio return is divided by the benchmark return) rather than arithmetically (where the benchmark return is subtracted from the portfolio return).
- In the table above, Partners performance is measured against an IRR target of 10% p.a.
- A summary of the benchmarks for each of the mandates is given in Appendix 1.
- \*Partners performance is to 31 December 2020 as this is the latest date that this is available. The mandate's inception was in 2009.
- \*\*IFM returns are in GBP terms after the manager switched to GBP reporting in January 2020. Historical USD performance has been converted to GBP.

**Asset allocation**

6

# Valuations by asset class

Asset Class	Start of Quarter (£'000)	End of Quarter (£'000)	Start of Quarter (%)	End of Quarter (%)	Benchmark (%)	Ranges (%)			Difference (%)
Global Equity	657,218	688,410	12.7	13.0	12.0	7	-	17	1.0
Global Sustainable Equity	538,779	541,101	10.4	10.2	10.0	5	-	15	0.2
Global Low Carbon Equity	665,924	691,544	12.9	13.0	10.0	5	-	15	3.0
Emerging Market Equity	280,823	286,760	5.4	5.4	5.5	3	-	9	-0.1
Diversified Growth Funds	508,027	501,330	9.8	9.5	10.0	5	-	15	-0.5
Fund of Hedge Funds*	265,097	276,402	5.1	5.2	-	No set range			0.2
Multi-Asset Credit	321,648	317,539	6.2	6.0	6.0	3	-	9	0.0
Property	415,310	377,969	8.0	7.1	7.5	5	-	10	-0.4
Secured Income**	133,870	280,324	2.6	5.3	10.0	5	-	15	-4.7
Core Infrastructure	359,670	365,544	7.0	6.9	5.0	2.5	-	7.5	1.9
Renewable Infrastructure**	48,089	50,205	0.9	0.9	5.0	2.5	-	7.5	-4.1
Private Debt	-	-	-	-	5.0	0	-	7.5	-
Corporate Bonds	140,422	130,825	2.7	2.5	2.0	No set range			0.5
LDI & Equity Protection	496,882	562,219	9.6	10.6	12.0	No set range			-1.4
Cash***	337,490	220,797	6.5	4.4	-	0	-	5	4.4
<b>Total</b>	<b>5,169,488</b>	<b>5,301,031</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>				

Source: Custodian, Investment Managers, Mercer. Green numbers indicate the allocation is within tolerance ranges, whilst red numbers indicate the allocation is outside of tolerance ranges.

Totals may not sum due to rounding.

\*Mandate due to be terminated.

\*\*Valuations include both funding cycle allocations.

\*\*\*Valuation includes the ETF and currency instruments

Renewable Infrastructure and Private Debt mandates are still being drawn down so allocations are below target ranges.

# Valuations by manager

Manager	Asset Class	Start of Quarter (£'000)	Cashflows (£'000)	End of Quarter (£'000)	Start of Quarter (%)	End of Quarter (%)
BlackRock	Global Equity	240,876		249,770	4.7	4.7
Schroder	Global Equities	7,135	-5,548	1,515	0.1	0.0
Brunel	Global High Alpha Equity	390,871		403,274	7.6	7.6
Brunel	Global Sustainable Equity	538,779		541,101	10.4	10.2
Brunel	Global Low Carbon Equity	665,924		691,544	12.9	13.0
Brunel	Emerging Market Equity	280,823		286,760	5.4	5.4
Brunel	Diversified Returns Fund	508,027		501,330	9.8	9.5
JP Morgan	Fund of Hedge Funds	265,097		276,402	5.1	5.2
Loomis Sayles	Multi-Asset Credit	321,648		317,539	6.2	6.0
Brunel	UK Property	-	102,561	106,841	0.0	2.0
Schroder	UK Property	225,963	-135,027	92,565	4.4	1.7
Partners	Overseas Property	189,346	-779	178,563	3.7	3.4
Brunel**	Secured Income	133,870	143,400	280,324	2.6	5.3
IFM	Core Infrastructure	359,670		365,544	7.0	6.9
Brunel**	Renewable Infrastructure	48,089	3,366	50,205	0.9	0.9
BlackRock	Corporate Bonds	140,422		130,825	2.7	2.5
BlackRock	LDI & Equity Protection	496,882		562,219	9.6	10.6
Record	Currency Hedging	71,968		97,316	1.4	1.8
BlackRock	ETF	48,603	60,000	108,631	0.9	2.0
Internal Cash	Cash	234,945	-175,135	58,223	4.5	1.1
<b>Total</b>		<b>5,169,488</b>	<b>-7,196</b>	<b>5,301,031</b>	<b>100.0</b>	<b>100.0</b>

Source: Investment Managers, Mercer. Totals may not sum due to rounding.

The cashflow column shows only the cash movements within the asset portfolio. It does not include non-investment cash movements such as employer contributions or pension payments made, however these amounts are included in the 'Internal Cash' start and end balance to reflect the asset value position of the total Fund.

\*Valuation includes the collateral holdings for the currency overlay.

\*\*Valuations include both funding cycle allocations.

Current topics



# Current topics

## Aiming for a net-zero target

**The draft UK Regulatory guidance on "Governance and Reporting of Climate Change Risk" impacts schemes >£5bn from October 2021, and schemes >£1bn from 2022.**

- The draft regulations required that trustees of schemes in scope must:
- Set **at least one absolute Greenhouse Gas emissions** based metric;
  - Set **at least one emissions intensity** based metric;
  - Set **at least one additional (non-emissions based)** metric (for example, green revenues, process based);
  - Set an **annual target** to manage climate related risks using one of the metrics;
  - **Report annually** on the value of the metric and progress against target.

*Understanding the carbon intensity and carbon footprint in your scheme's asset classes will help you understand **where your carbon exposures lie** and enable you to start the conversation on **how to transition the portfolio** and ultimately lead to the implementation of a decarbonisation path to net-zero with measurable targets and milestones.*

### Relevance to the Fund



The Fund has committed to net zero by 2050. Part two of the equity portfolio review will help develop a plan to implement and monitor this.

Merger's climate transition advice, supported by our **Analytics for Climate Transition (ACT)**, follows a **step-by-step approach** to align to a net zero outcome by 2050.



## Is credit really a free lunch?

- European and US investment grade and high yield credit spreads narrowed further in Q1 2021 back to historically low levels seen in early 2020 and 2017-2018
- Subject to the efficacy of the vaccines and their take-up rate, our base scenario is that the global economy will return to something close to normal by end 2021 with growth in Q3 extremely strong as pent-up spending power is released
- At face value, this is favourable environment for credit as an asset class. Central banks are also buying corporate bonds and supporting markets, most notably the ECB. **But is credit really a free lunch?**

### Should we worry about the Zombies?

Zombie firms are companies that cannot cover debt servicing costs from current profits and are dependent on creditors to survive. Downgrade of investment grade zombies' debt may pose significant risk. Default risk is higher than the favourable environment suggests.

### What should investors do?



#### Governance

- Review your allocation to credit
- Assess the downgrade and default risk of your credit portfolio



#### Risk Management

- Understand your managers exposure to Zombie companies, if any, and the risk to broad market indices



#### Strategy

- Is your credit allocation strategic or tactical?
- Is mark-to-market risk a concern given your triennial valuation cycle?
- Assess the mix of credit assets held, e.g. investment grade vs high-yield, listed vs private etc.
- Rebalancing activity may provide an opportunity to adjust asset allocations.

### Relevance to the Fund



It is worth asking Brunel and BlackRock to see if they have considered "zombie" company risks.

# Appendix

# Q1 2021 equity market review

**Global equity markets** rallied over the quarter, returning 6.2% in local currency terms. Returns in sterling terms were 3.8% as the sharp sterling appreciation detracting from returns for unhedged UK investors. Volatility in equity markets was high over the quarter; enthusiasm from retail investors triggered short squeezes in January, and then volatility increased again amid concerns over rising bond yields during February and March.

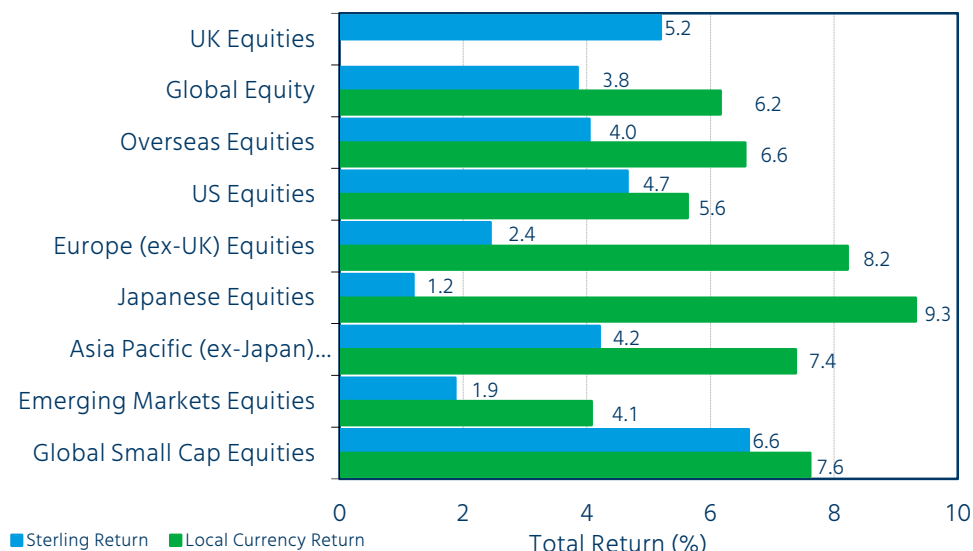
**US equities** returned 5.6% in local currency terms whilst European (ex UK) equities returned 8.2%. With a heavier weight in value than in growth and heavy export exposure, European stocks are expected to benefit more from the recovery even if Europe's economic fundamentals are weaker than for the US.

**Emerging markets equities** returned 4.1% in local terms. Returns were positive for India and Russia amid a highly expansionary budget for the former and commodity exposure for the latter.

**Global small cap stocks** returned 7.6% in local terms. Small caps continued to outperform global equities in local currency terms, as investors saw room for small caps to expand in a full reopening.

The **FTSE All Share index** returned 5.2% over the quarter. The large exposure to financials, oil & gas, and basic materials helped as these sectors benefitted from a strong cyclical value recovery over the quarter.

Equity Performance - Three Months to 31 March 2021

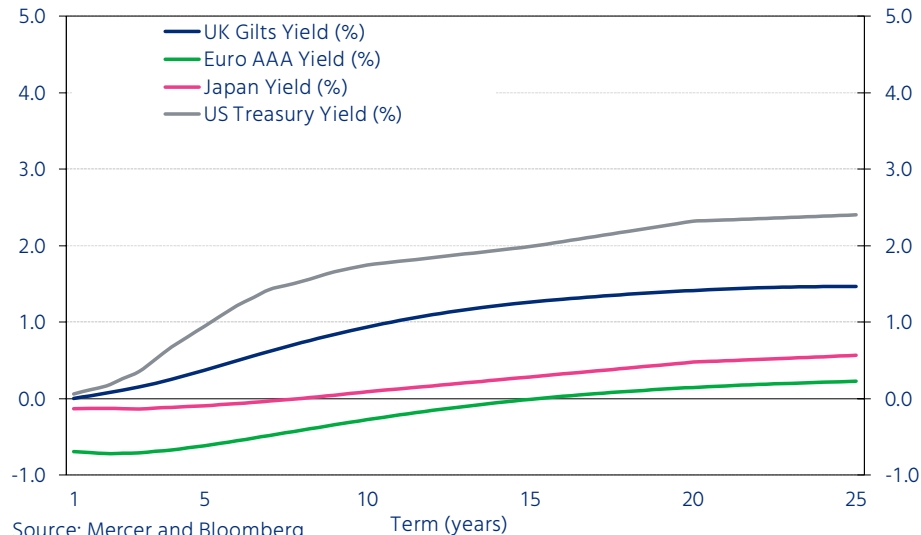


FTSE Performance by Market Cap (FTSE) - Three Months to 31 March 2021



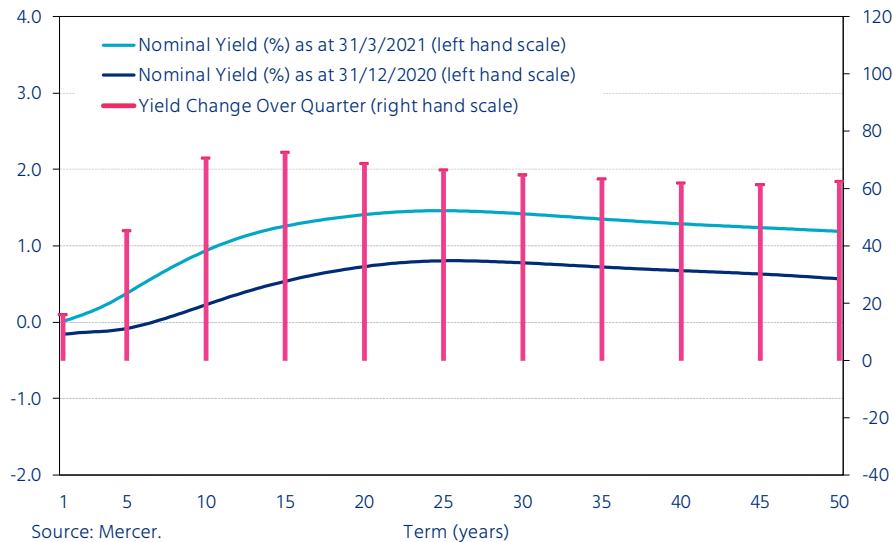


# Q1 2021 bond market review (1)



## Government Bond Yields

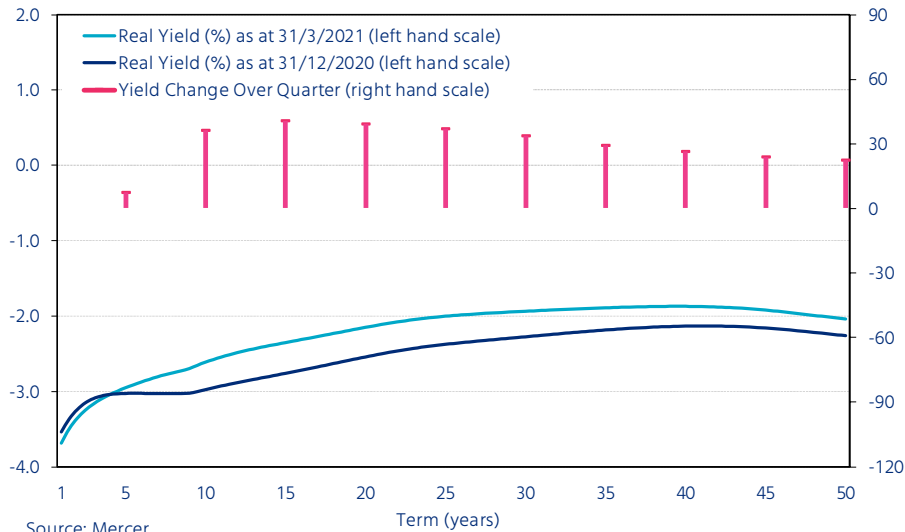
Government bond yields rose globally over the quarter. In the US, the 10-year government bond yield rose by almost 85 basis points due to increased confidence in an economic recovery, fueled by an additional \$1.9 trillion stimulus package leading to inflation concerns. There were similar moves in the UK and Germany with the 10-year benchmark bonds rising almost 65 and 25 basis points. The move in the Japanese yield curve was relatively muted.



## UK Nominal Gilt Yields

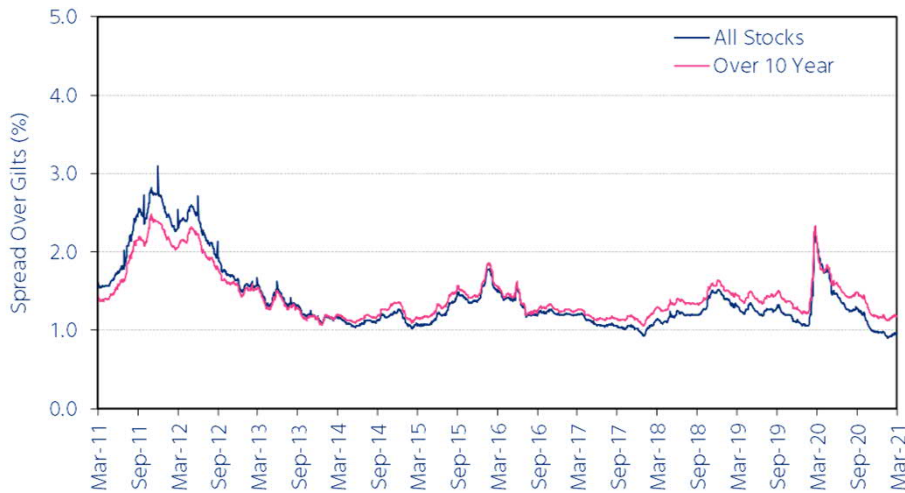
The UK yield curve shifted up considerably over the quarter as inflation expectations spiked in anticipation of a strong recovery later in the year whilst fiscal and monetary policy are set to remain loose.

# Q1 2021 bond market review (2)



## UK Index-Linked Gilt Yields

UK real yields rose over the quarter, in line with nominal yields. The rise in nominal yields offset the increase in inflation expectations with markets pricing in higher growth.



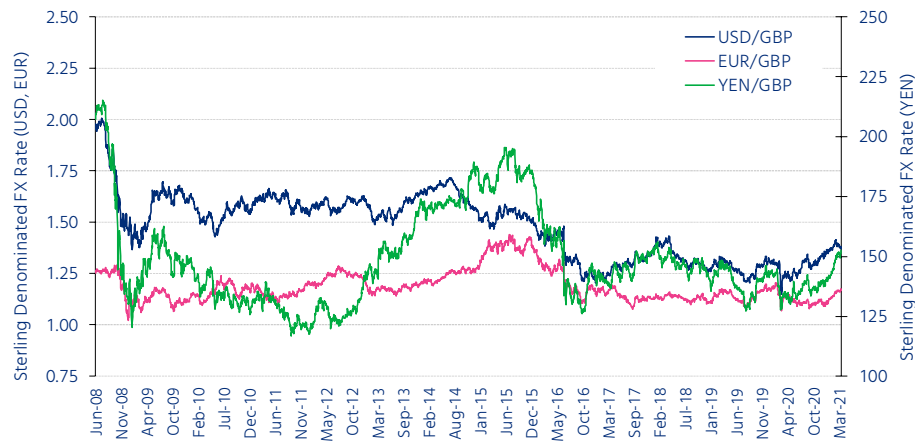
## Corporate bonds

UK investment grade credit spreads tightened over the quarter, as demand for spread assets remained strong. Investment grade spreads for the All Stocks Index have now retraced all of the spread widening experienced in 2020 and ended the quarter just below their late-2019 level.

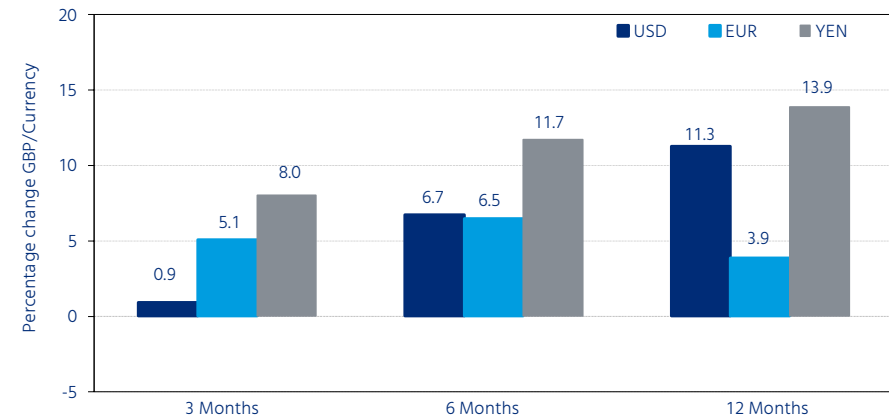
# Q1 2021 currency market review

Sterling strengthened against all major developed currencies over the quarter. The currency enjoyed a post Brexit rally after the relatively seamless final transition out of the EU. There was also optimism over Britain's vaccination program that is among the most successful ones in the world. The US dollar strengthened against other major developed market currencies over the quarter due to the better economic outlook for the US and the more pronounced rise in US bond yields.

**Sterling Denominated FX Rate**



**Change in sterling against foreign currencies**



## Q1 2021 property

UK property as measured by the MSCI Index increased by 2.2% over the quarter to 31 March 2021.

# Summary of mandates

Manager	Mandate	Benchmark/Target	Outperformance Target (p.a.)
BlackRock	Global Equity (passive)	MSCI World	-
Brunel	Global High Alpha Equity	MSCI World	+2 -3%
Brunel	Global Sustainable Equity	MSCI AC World	+2%
Brunel	Global Low Carbon Equity (passive)	MSCI World Low Carbon	-
Brunel	Emerging Market Equities	MSCI Emerging Markets	+2 -3%
Ruffer	Diversified Growth Fund	3 Month LIBOR +5% p.a.	-
Brunel	Diversified Returns Fund	SONIA	+4-5%
JP Morgan	Fund of Hedge Funds	3 Month LIBOR +3% p.a.	-
Loomis Sayles	Multi-Asset Credit	3 Month LIBOR +4% p.a.	-
Schroder	UK Property	IPD UK Pooled	+1%
Brunel	UK Property	MSCI/AREF UK Quarterly Property Fund Index	-
Partners	Overseas Property	Net IRR of 10% p.a. (local currency)	-
Brunel	Secured Income	CPI	+2%
IFM	Core Infrastructure	6 Month LIBOR +2.5% p.a.	-
Brunel	Renewable Infrastructure	CPI	+4%
Brunel	Private Debt	3 Month LIBOR + 4% p.a.	-
BlackRock	Buy-and-Maintain Corporate Bonds	Return on bonds held	-
BlackRock	Matching (Liability Driven Investing)	Return on liabilities being hedged	-
Record	Passive Currency Hedging	N/A	-
BlackRock	Exchange-Traded Fund (ETF)	Bespoke benchmark to reflect total Fund allocation	-
Cash	Internally Managed	7 Day LIBID	-

# Market statistics indices

Asset Class	Index
UK Equities	FTSE All-Share
Global Equity	FTSE All-World
Global Developed Equity	FTSE AW Developed
Overseas Equities	FTSE World ex UK
US Equities	FTSE USA
Europe (ex-UK) Equities	FTSE W Europe ex UK
Japanese Equities	FTSE Japan
Asia Pacific (ex-Japan) Equities	FTSE W Asia Pacific ex Japan
Emerging Markets Equities	FTSE AW Emerging
Global Small Cap Equities	FTSE World Small Cap
Hedge Funds	HFRX Global Hedge Fund
High Yield Bonds	BofA Merrill Lynch Global High Yield
Emerging Market Debt	JP Morgan GBI EM Diversified Composite
Property	IPD UK Monthly Total Return: All Property
Infrastructure	S&P Global Infrastructure
Commodities	S&P GSCI
Over 15 Year Gilts	FTA UK Gilts 15+ year
Sterling Non Gilts	BofA Merrill Lynch Sterling Non Gilts
Over 5 Year Index-Linked Gilts	FTA UK Index Linked Gilts 5+ year
Global Bonds	BofA Merrill Lynch Global Broad Market
Global Credit	Barclays Capital Global Credit
Eurozone Government Bonds	BofA Merrill Lynch EMU Direct Government
Cash	BofA Merrill Lynch United Kingdom Sterling LIBOR 3 month constant maturity

These are the indices used in this report for market commentary; individual strategy returns are shown against their specific benchmarks.

# Modelling assumptions as at 31 March 2021

## Absolute forward looking arithmetic mean returns over 10 years

Asset class	Return (p.a.)
Global equities	5.7%*
Emerging market equities	7.5%
DGF	4.8%
Hedge funds	3.5%
Infrastructure	5.3%
Property	4.3%
HLV Property	3.0%
MAC	4.6%
Corporate Bonds	1.6%

Best estimate 10 year CPI assumption of 2.8% assuming flat wedge of 0.6% p.a. as at 31 March 2021.

\* Equity return makes no allowance for the equity protection strategy and assumes currency hedging in place.

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Market conditions used to model asset projections are based as at 31 March 2021.

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