Mercer

Avon Pension Fund

Committee Investment Report
Quarter to 31 March 2021

June 2021

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Executive summary

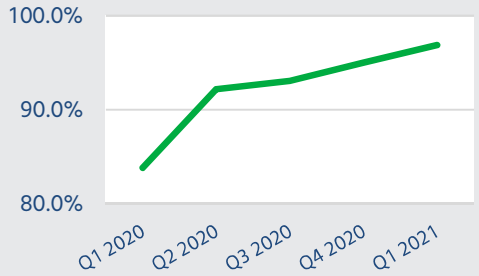
1

Executive summary

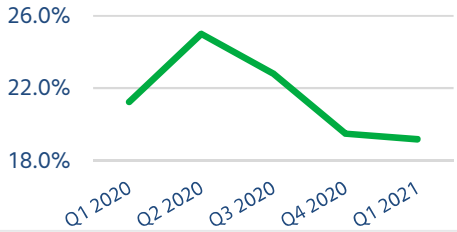
Market background	• Concerns around rising inflation has been the key macro theme to impact financial markets this quarter. • Economic data continued to point towards a global recovery but with wide regional dispersions. Markets looked beyond the temporary setbacks created by Covid-19 restrictions. This 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. • Our outlook for returns over a 1-3 year time horizon for the major asset classes are summarised below.

Funding level and risk

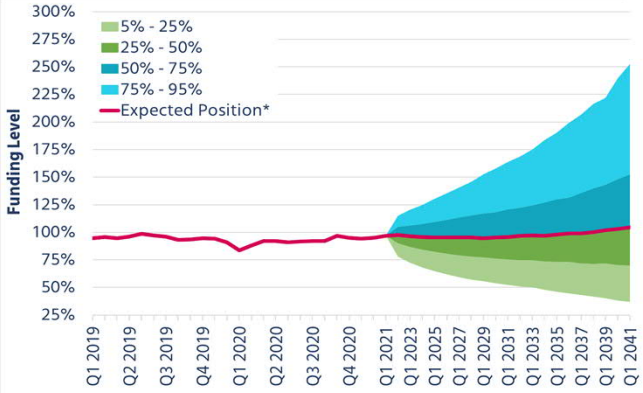
- The funding level is estimated to have improved from 95% to 97% over Q1 as asset growth outweighed the rise in the value of the liabilities.
- It is estimated to have increased by 13% over the year to 31 March 2021 (as illustrated to the right).
- In absolute terms the funding position is ahead of the target as set out by the recovery plan. However there is continuing uncertainty in the outlook for future returns which could impact on future funding requirements.



- The Value-at-Risk (VaR) 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. This more than doubled the VaR offsetting amount from the equity options.
- 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
- 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.



Executive summary

Performance

- Fund returns over the quarter were driven mainly by the LDI portfolio as it protected against inflation increases.
- The equity portfolio continued to deliver positive returns.

- 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.
- Relative performance was otherwise strong at the mandate level, with the High Alpha Equity, Hedge Fund and MAC mandates standing out.
- Relative performance over three years has been more mixed, though the Overseas Property mandate was the only notable detractor over this period.

	3 Months (%)	1 Year (%)	3 Years (% p.a.)
Total Fund **(1)**	2.7	17.3	4.9
Strategic Benchmark **(2)** (ex currency hedge)	4.1	20.5	6.8
Relative **(1 - 2)**	**-1.4**	**-3.2**	**-1.9**

- Absolute returns for most growth mandates are above the strategic returns modelled at the last investment strategy review in March 2019.
- This was the case for all equity mandates given the strength of equity markets since 2019.
- Within the alternative asset classes, MAC and Core Infrastructure have outperformed expectations, although the property mandates have underperformed due to the impact of Covid on the market as a whole.
- It is too early to assess performance of the other private market mandates, given that they are still in the drawdown phase.

Asset allocation and strategy

- In January, the Fund made its first investment into the UK Property mandate with Brunel.
- 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.

Liability hedging mandate

- BlackRock were in compliance with investment guidelines over the quarter.
- No triggers were breached over the quarter.
- Inflation hedge ratio increased to c. 45% of assets (outside the trigger framework) in January.

Equity option mandate

- Market value of options at the end of the quarter was negative (£186m) as equity markets have risen since inception.
- The implementation of the dynamic equity protection strategy will be completed post-quarter end.

Collateral and counterparty position

- Collateral within agreed constraints.
- The BlackRock QIF could sustain a 3.4% p.a. rise in interest rates, a 12% increase in equity markets or a 0.5% fall in inflation before the early warning trigger is breached.

Market background

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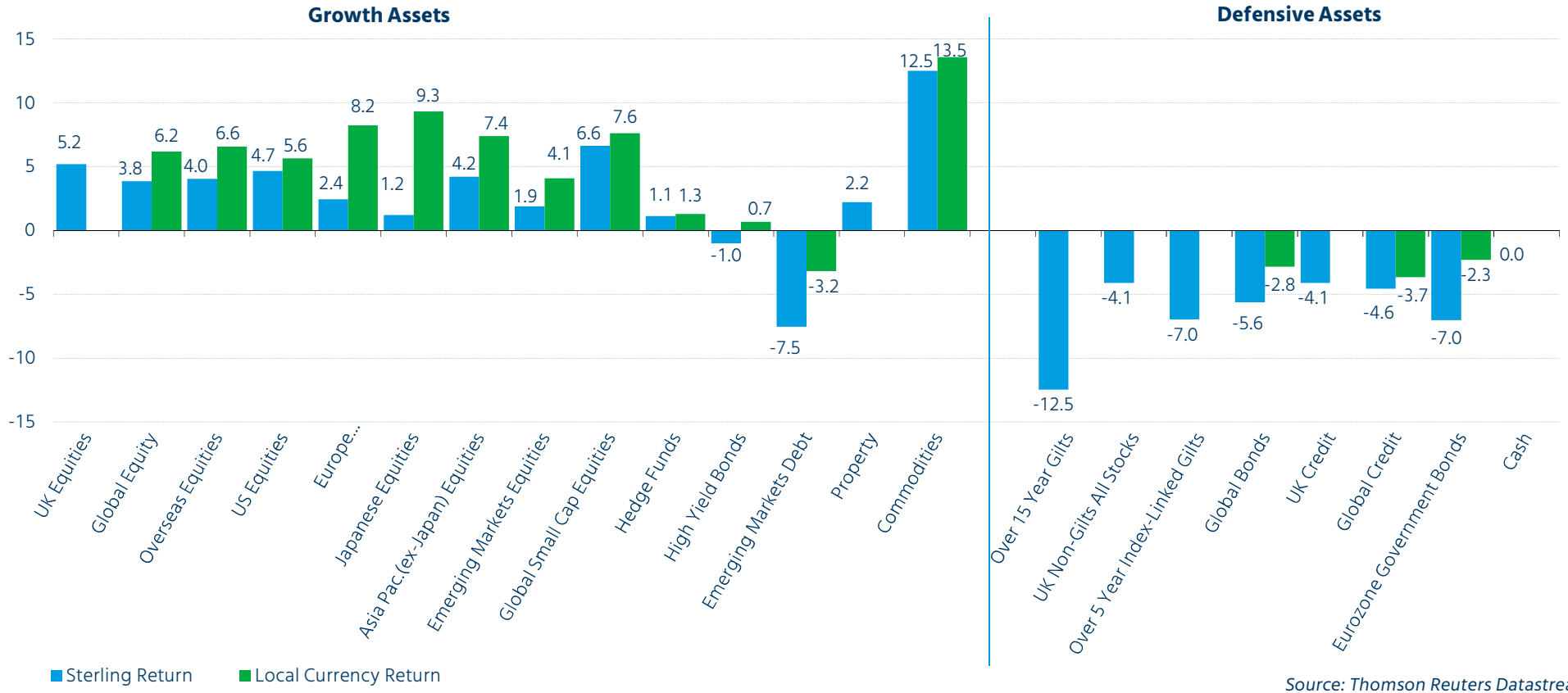
Market background

Return Over 3 Months to 31 March 2021 (%)



Source: Thomson Reuters Datastream.

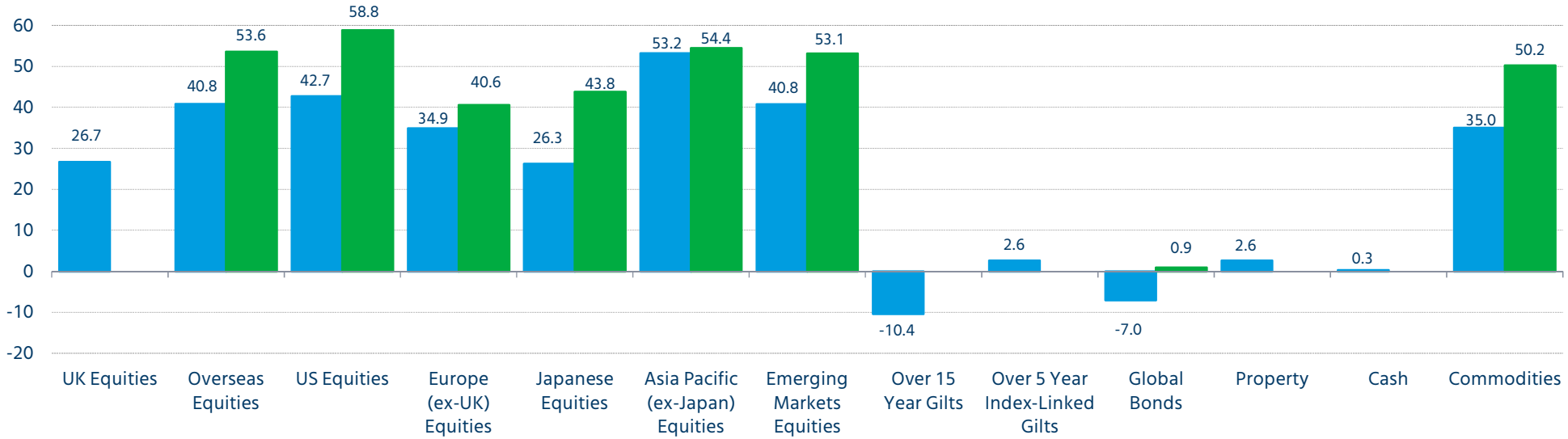
The first quarter of 2021 began with lockdowns in numerous countries as much of the world faced another wave of Covid-19. Nevertheless, gradual vaccine rollout in developed countries drove economic recovery optimism. Political risk declined as Joe Biden was sworn in as US President, despite the incident 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.

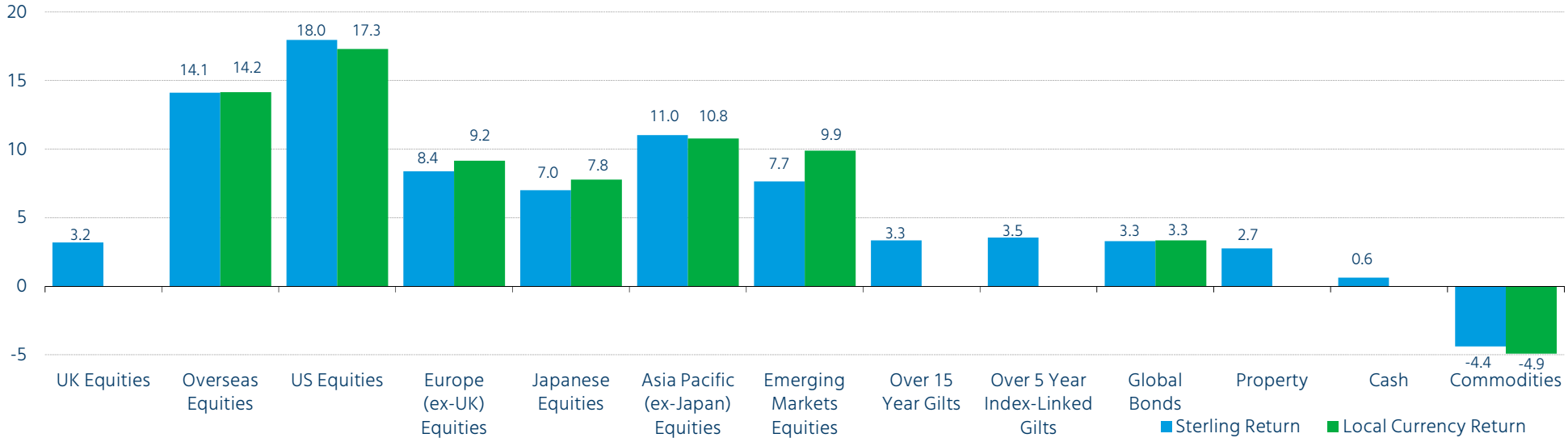
Source: Thomson Reuters Datastream.

Market background – longer term

Return Over 12 Months to 31 March 2021 (%)



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



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Source: Thomson Reuters Datastream.

Funding level and risk

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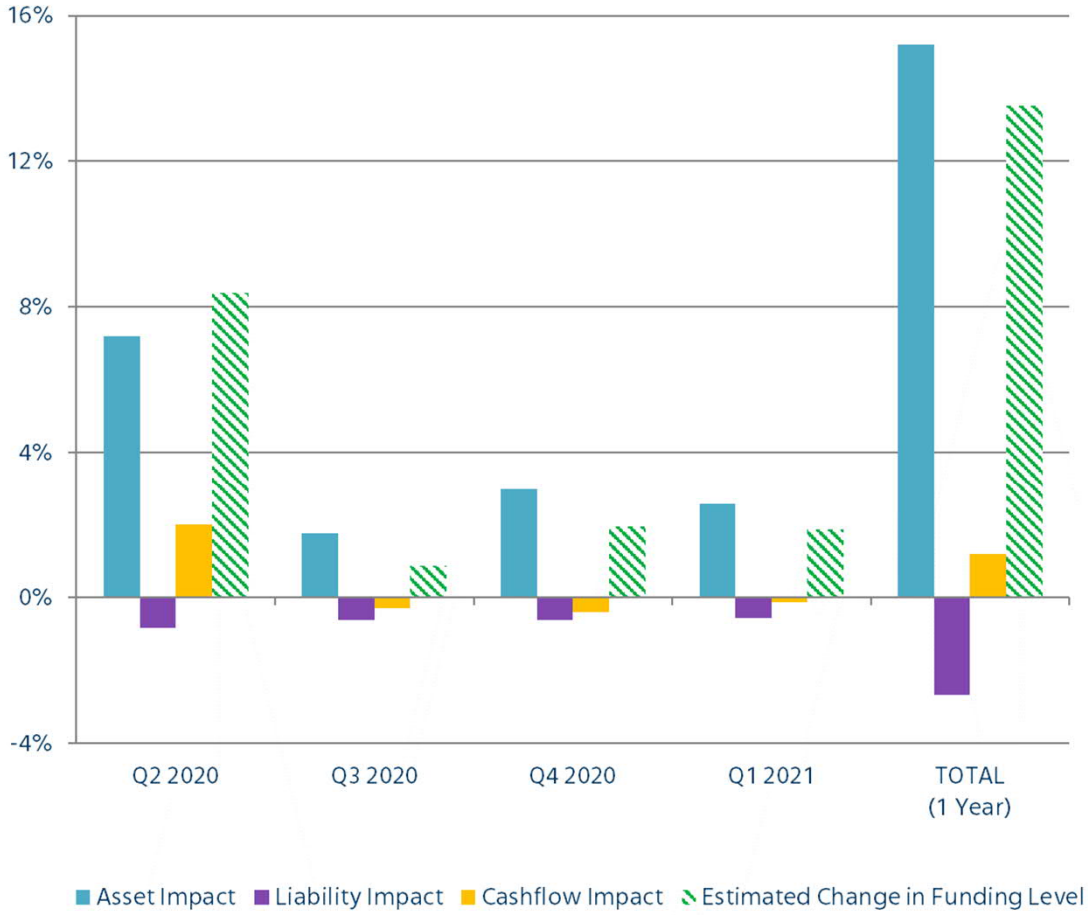
Change in deficit

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



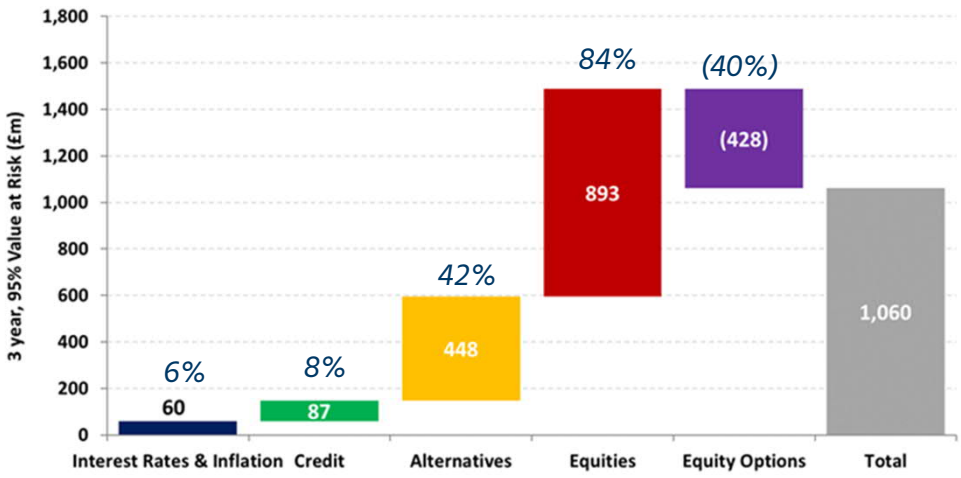
The Fund's assets returned 2.7% over the quarter, whilst the liabilities are expected to have increased by c. 0.6% due to the rise in inflation.

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

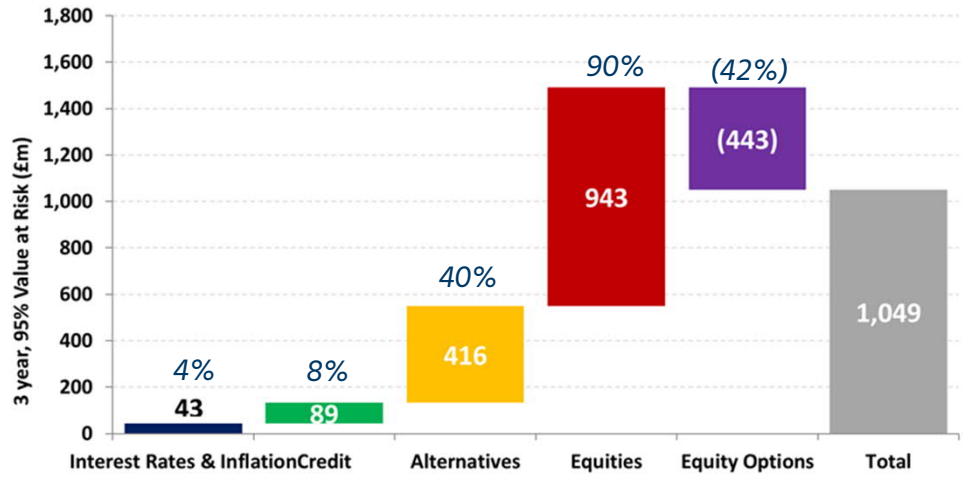
The funding level is estimated to have increased by c.13% over the year to 31 March 2021.

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 95th 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, which more than doubled.

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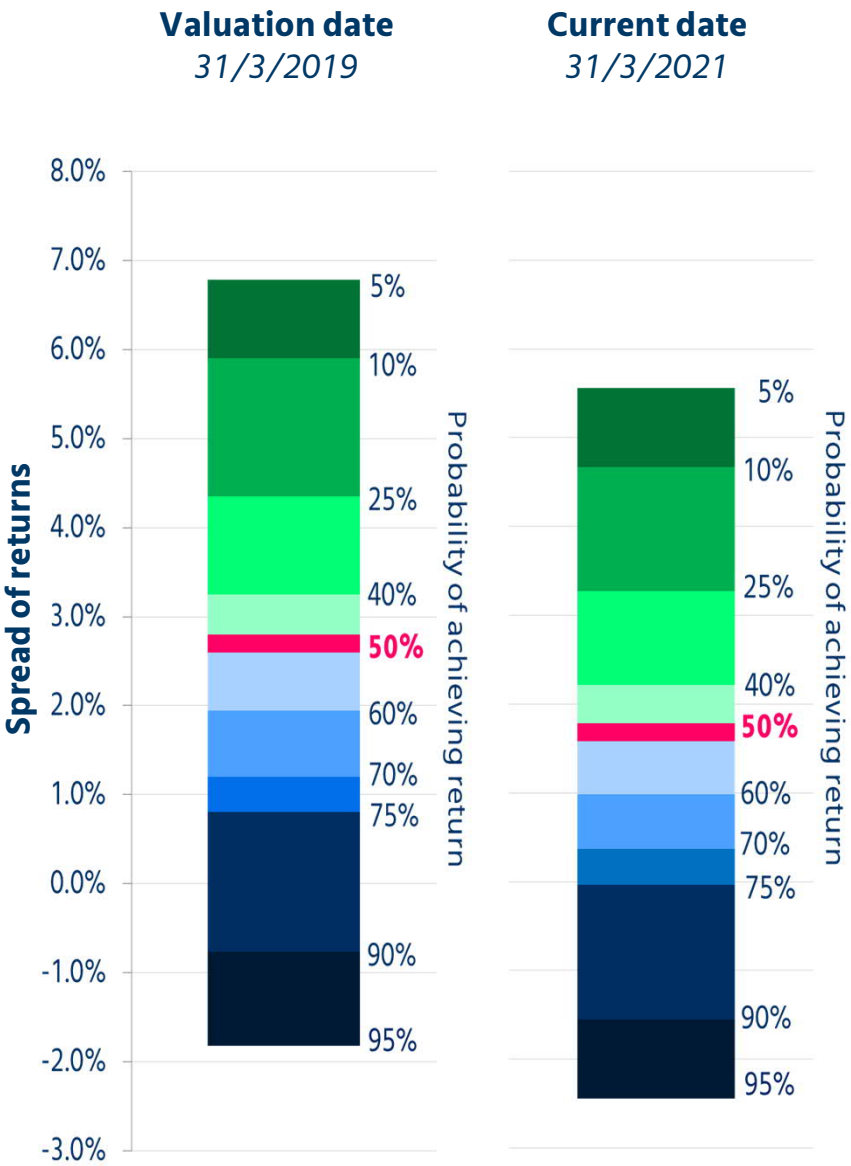
The VaR figures shown are based on approximate liability data rather than actual Fund cashflows, and are based on the strategic asset allocation at the time. They are therefore illustrative only and should not be used as a basis for taking any strategic decisions.

Investment returns – updated outlook



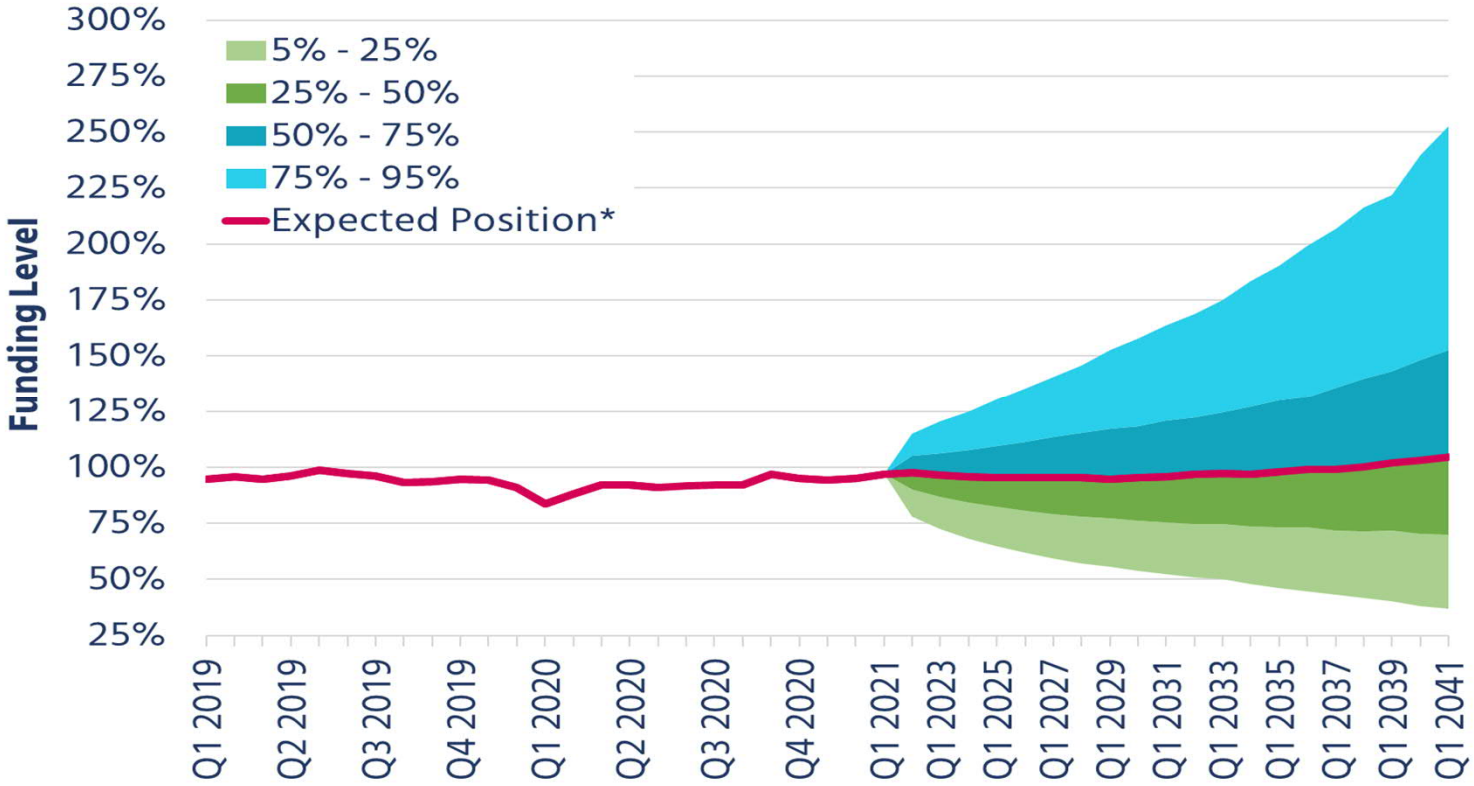
Return metrics (20 year)	31/3/19	31/3/21
Expected absolute return	5.0% p.a.	4.5% p.a.
Expected return over CPI	2.6% p.a.	1.6% p.a.
Probability of achieving past service discount rate of CPI + 1.75% p.a.	63%	47%
Probability of achieving future service discount rate of CPI + 2.25% p.a.	55%	39%

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

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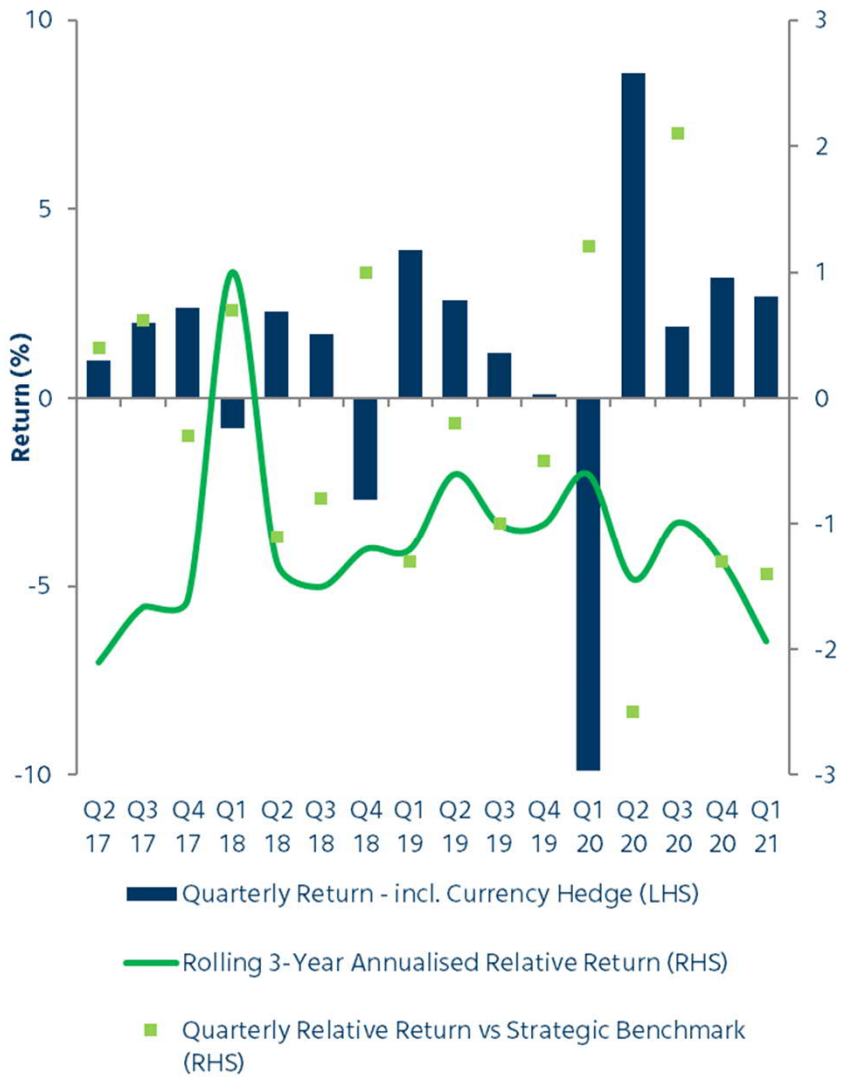
Total Fund performance



	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
Relative (1 - 2)	**-1.4**	**-3.2**	**-1.9**

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.

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

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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
Total	5,169,488	5,301,031	100.0	100.0	100.0		

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
Total		5,169,488	-7,196	5,301,031	100.0	100.0

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.

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Appendix

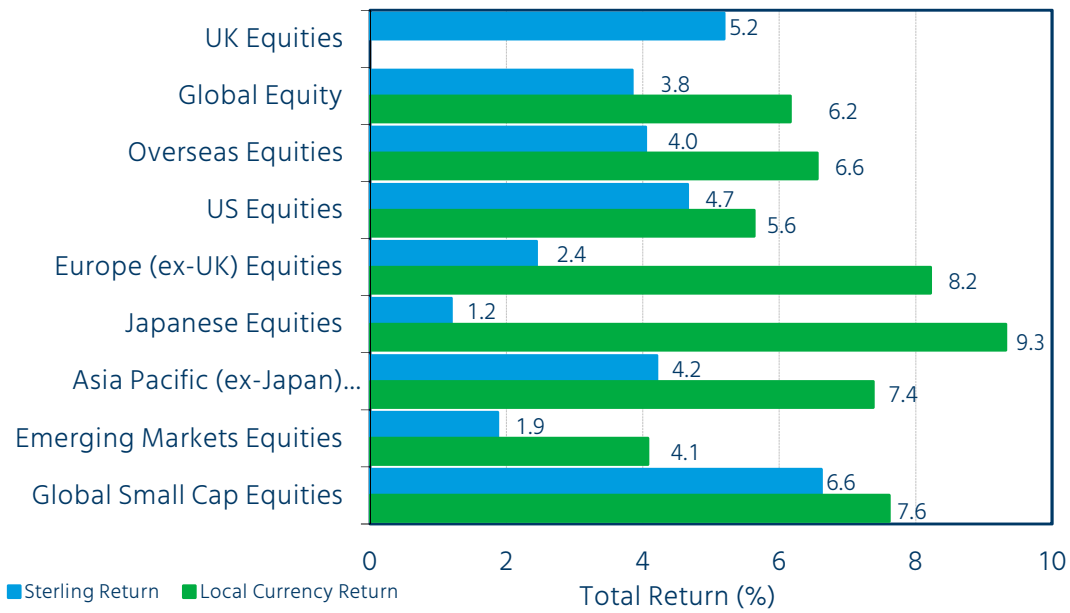
Q1 2021 equity market review

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.

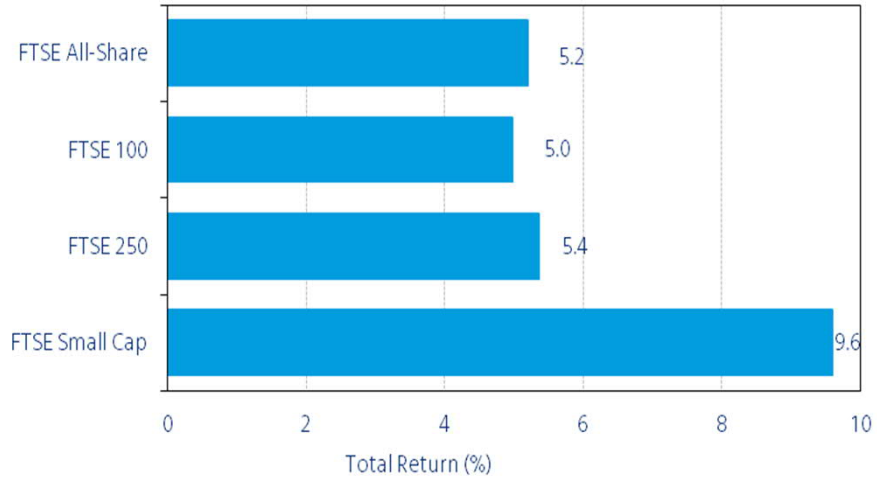
Equity Performance - Three Months to 31 March 2021



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.

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



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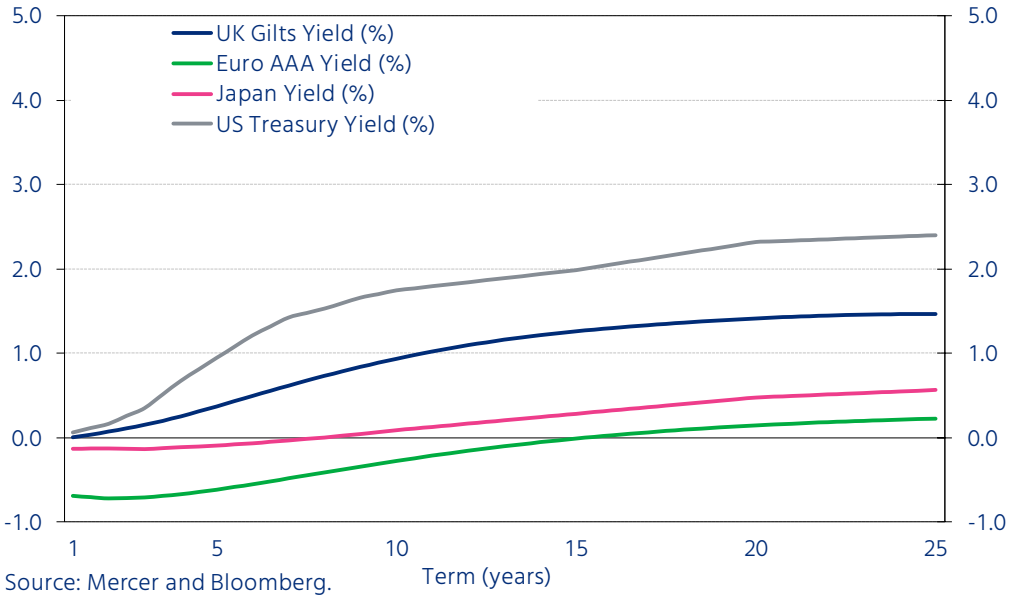
Source: Thomson Reuters Datastream.

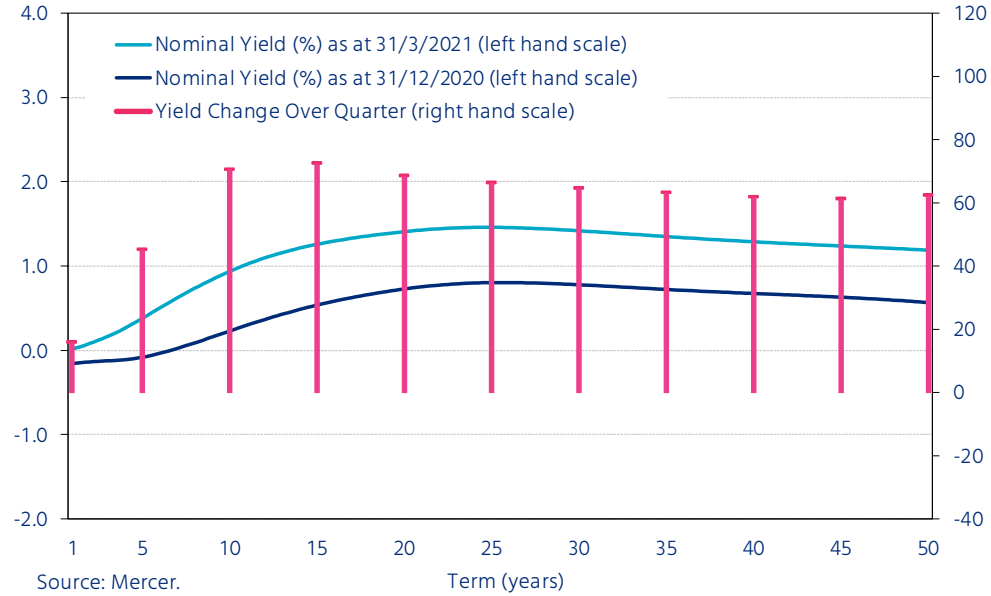
Q1 2021 bond market review (1)



Source: Mercer and Bloomberg.

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.

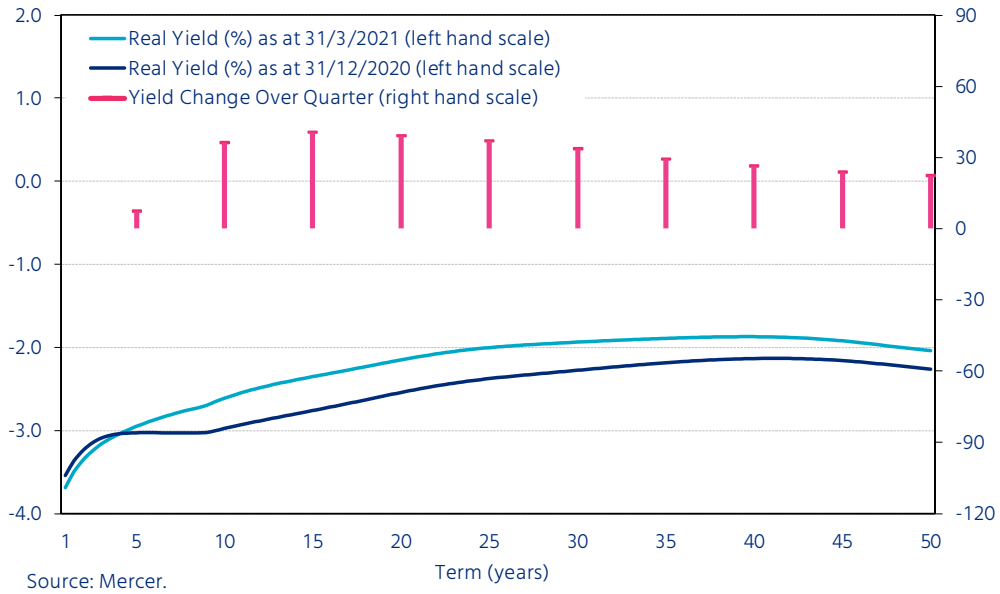


Source: Mercer.

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)



Source: Mercer.

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.

Source: Thomson Reuters Datastream.

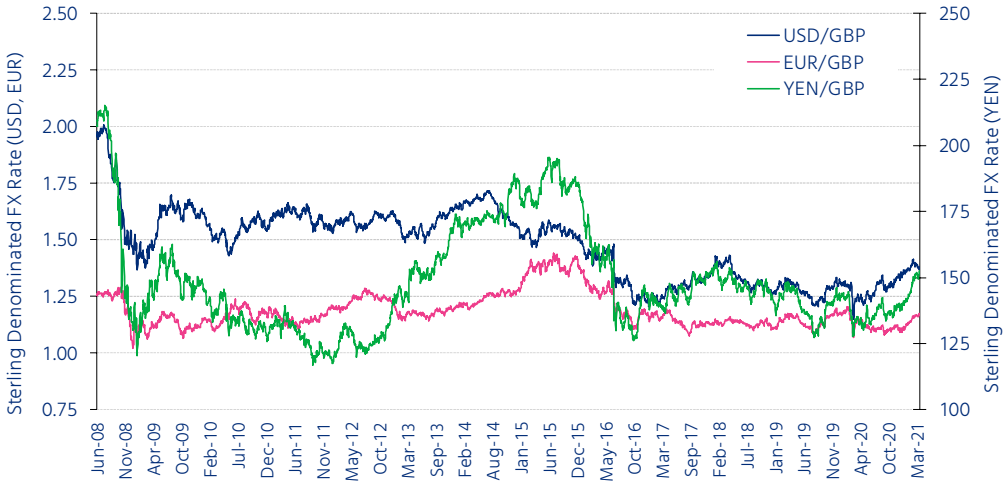
Corporate bonds

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

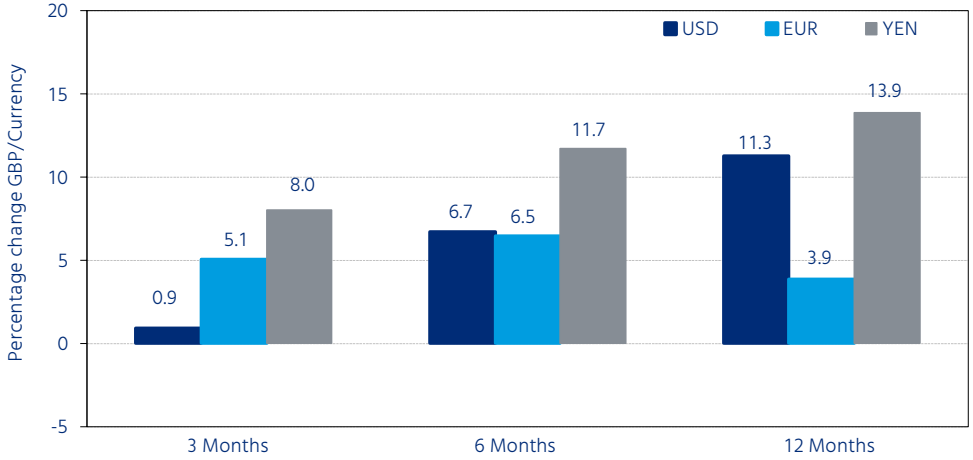
Sterling strengthened against all major developed currencies over the quarter. The currency enjoyed a post Brexit rally after the relatively seamless final transition out of the EU. There was also optimism over Britain's vaccination program that is among the most successful ones in the world. The US 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



Source: Thomson Reuters Datastream.

Change in sterling against foreign currencies



Source: Thomson Reuters Datastream.

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.

This report is correct as at May 2021. It will not be updated unless requested.