Mercer

Avon Pension Fund

Committee Investment Report
Quarter to 30 June 2021

September 2021

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Executive summary

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Executive summary

Market background

- The gradual emergence of many developed countries from restrictions as vaccine rollouts continued drove investor optimism, helping to bring about another strong quarter for risk assets.
- Markets largely saw through continued elevated inflation expectations, but it remains a key question as well as the potential impact of the delta variant on the economic recovery. Government bond yields fell thanks to central bank signals that have been less dovish than expected.

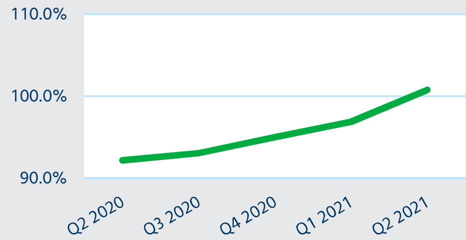
Mercer market views

- Our medium term views on the global economy 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.

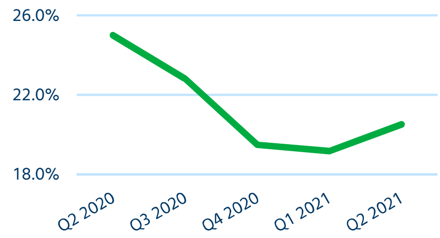
LISTED EQUITIES | GROWTH FIXED INCOME | DEFENSIVE FIXED INCOME | CASH

Funding level and risk

- The funding level is estimated to have improved from 97% to 101% over Q2 as asset growth outweighed the rise in the value of the liabilities.
- It is estimated to have increased of by 9% over the year to 30 June 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 rose over the quarter to £1,134m, or 20.5% 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 was implemented in Q2 2021, its impact has been illustrated from Q4 2020.



Executive summary

Performance

- Fund returns over the quarter were driven by the continued strength in growth assets.
- Most underlying mandates delivered positive relative returns, particularly those monitored against cash plus benchmarks.

- Underperformance relative to the strategic benchmark over the one and three year period to 30 June 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 has been mixed at the mandate level, though the High Alpha Equity, Hedge Fund and Core Infrastructure mandates have continued to stand out in outperforming their benchmarks.

	3 Months (%)	1 Year (%)	3 Years (% p.a.)
Total Fund **(1)**	4.3	12.6	5.6
Strategic Benchmark **(2)** (ex currency hedge)	3.9	14.7	7.6
Relative **(1 - 2)**	**+0.4**	**-2.1**	**-2.0**

- Absolute returns for all growth mandates, except for the two older property fund holdings, have been 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. The Diversified Returns mandate has done well since its inception less than a year ago.
- Within the alternative asset classes the Core Infrastructure has outperformed expectations. It is too early to assess performance of the other private market mandates as they are still in the drawdown phase.

Asset allocation and strategy

- In May, the Fund implemented the new dynamic structure for the equity option strategy.
- In June, the Fund terminated its Multi-Asset Credit holdings with Loomis Sayles, transferring these to a new MAC fund 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.
- The inflation hedge ratio was below its target of c. 45% of assets, as the refreshed LBP showed increased inflation sensitivity within the Fund's liabilities.

Equity option mandate

- Market value of options at the end of the quarter was negative (£10m) as equity markets have risen since inception of the dynamic strategy in May (at which point the holdings in the previous static protection strategy were crystallised and the market value of the options was reset to zero).

Collateral and counterparty position

- Collateral within agreed constraints.
- The BlackRock QIF could sustain a 3.1% p.a. rise in interest rates, a 7% increase in equity markets or a 0.4% fall in inflation before the early warning trigger is breached.

Market background

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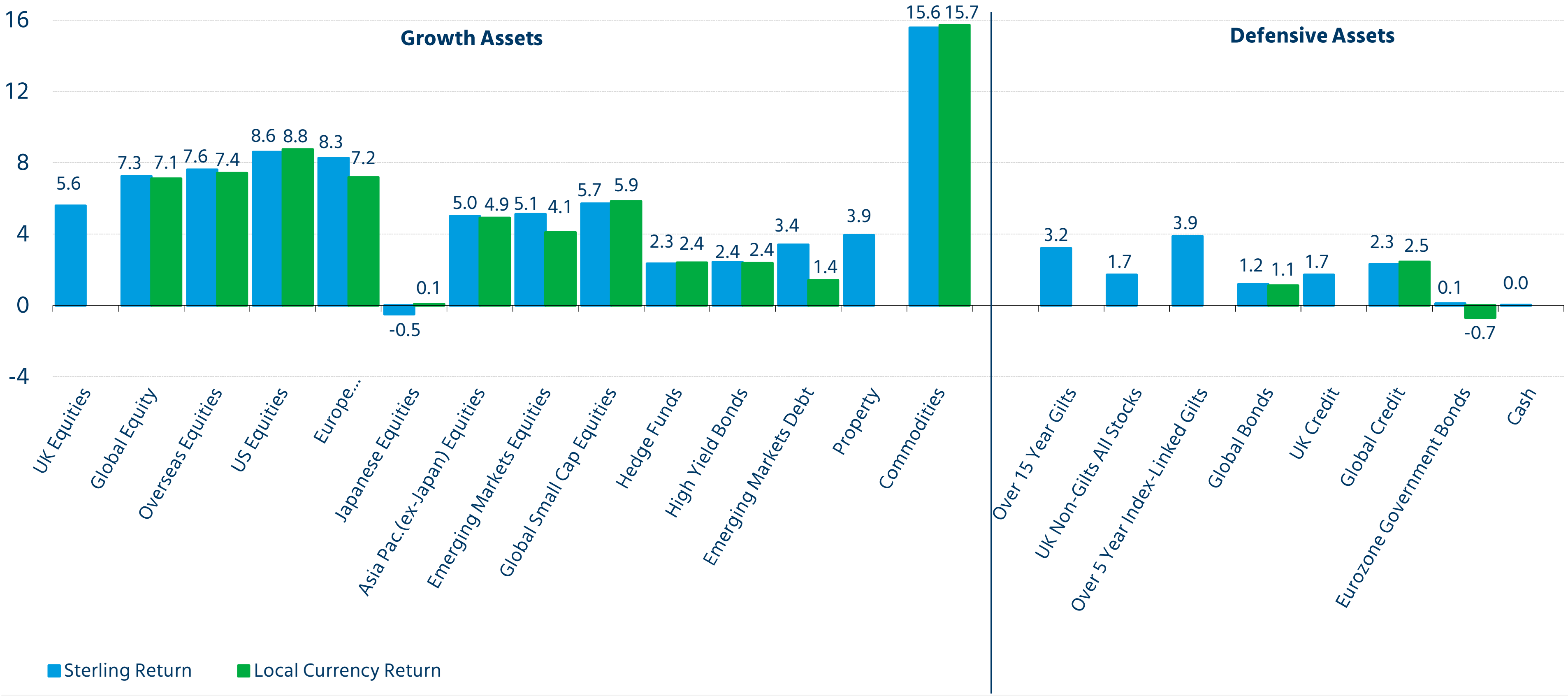
Market background

Return Over 3 Months to 30 June 2021 (%)



The second quarter of 2021 began with many developed countries gradually emerging from restrictions as vaccine rollouts started to have a notable positive impact on healthcare systems, in spite the emergence of a "variant of concern" first identified in India. However, countries with lower vaccination rates across Asia Pacific increased restrictions again towards quarter end. Global growth momentum remained robust as the service sector started to recover lost ground whilst goods demand remained solid. Supply chain stress and base effects drove a strong rebound in inflation that still exceeded already elevated expectations, at least for the US.

However, markets largely saw through this in what was another strong quarter for risk assets.

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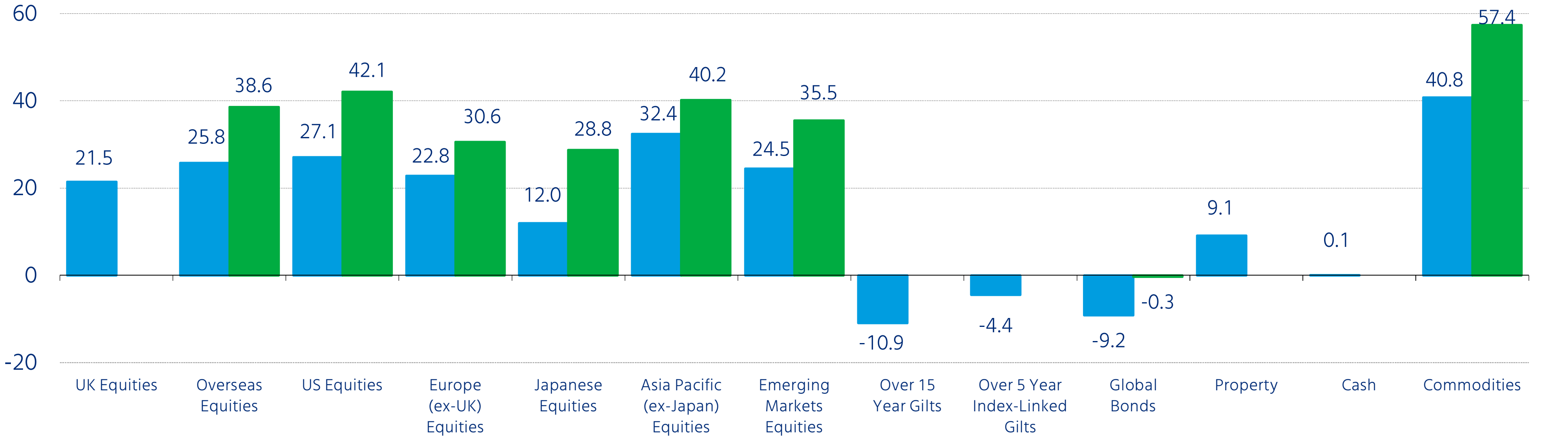
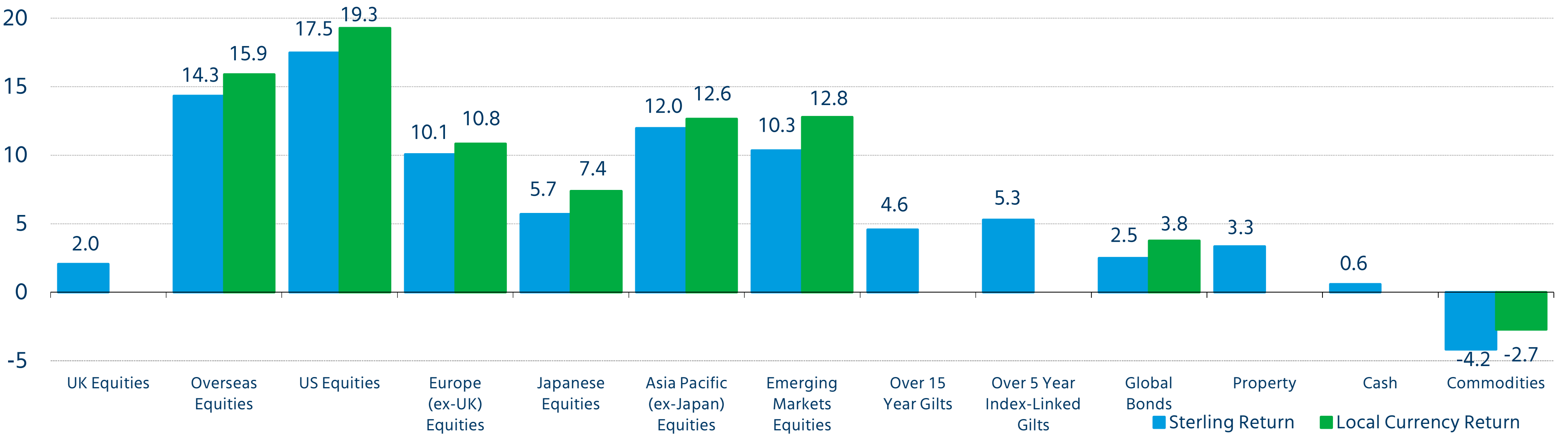
Source: Thomson Reuters Datastream.

Market background – longer term

Return Over 12 Months to 30 June 2021 (%)



Return Over 3 Years to 30 June 2021 (% p.a.)



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Source: Thomson Reuters Datastream.

Funding level and risk

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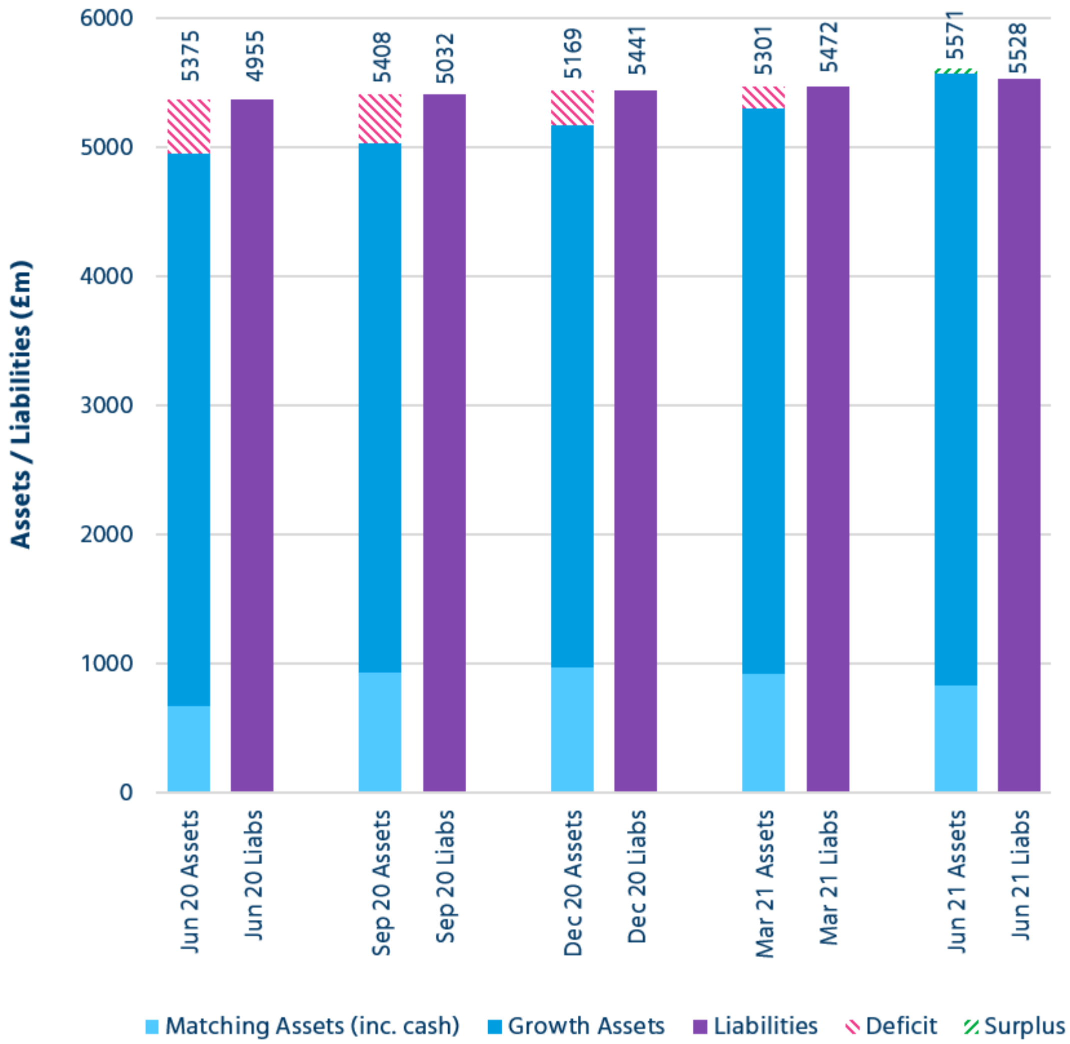
Change in deficit

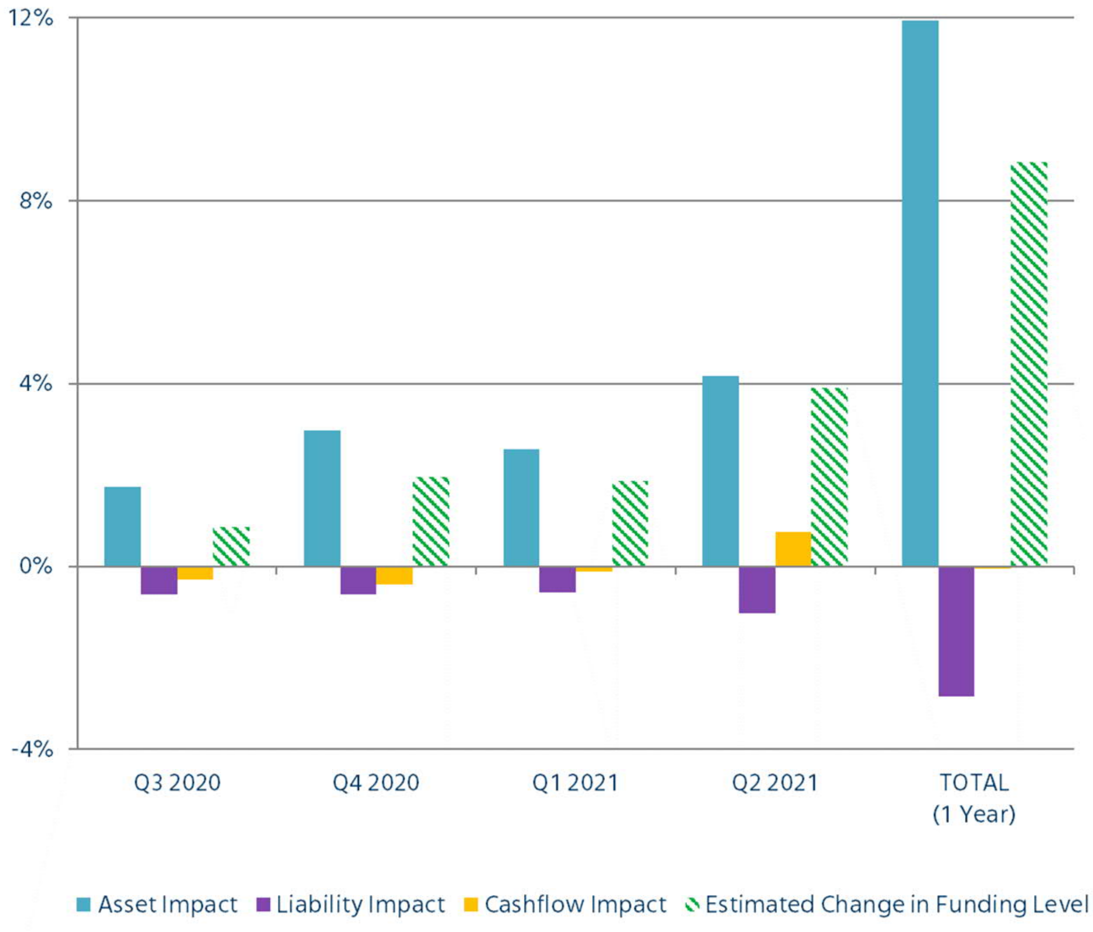


Based on financial markets, investment returns and net cashflows into the Fund, the deficit was estimated to have been eliminated over Q2 for the to Fund to finish the quarter with a surplus of £43m.

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



Impact figures are estimated by Mercer.

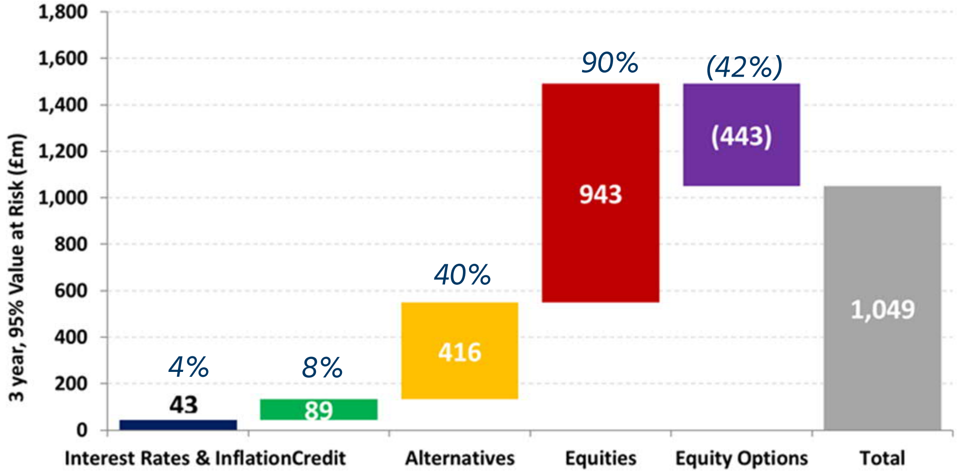
The Fund's assets returned 4.3% over the quarter, whilst the liabilities are expected to have increased by c. 1% due to the rise in inflation.

The combined effect of this, also allowing for expected cashflow over the period, saw the funding level improve from 97% to 101%.

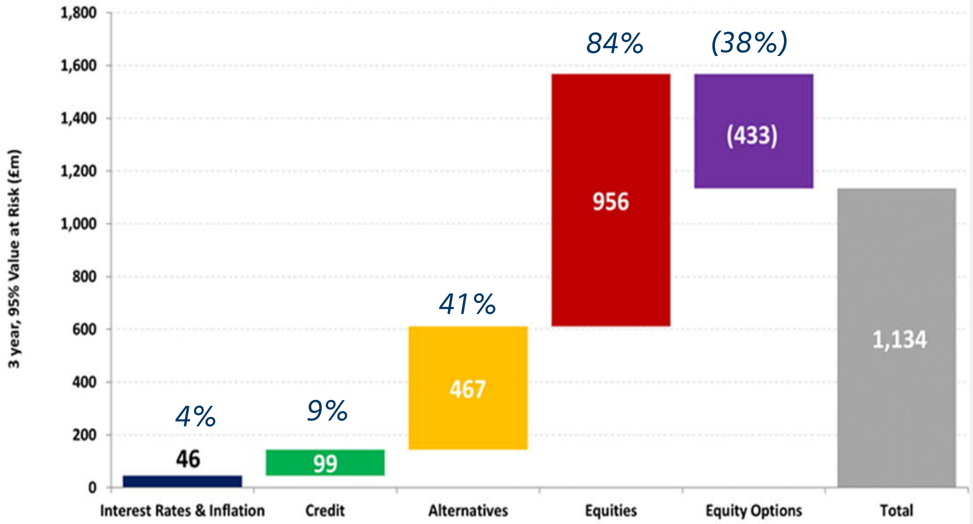
The funding level is estimated to have increased by c. 9% over the year to 30 June 2021.

Risk decomposition – 3 year Value at Risk

31 March 2021



30 June 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 30 June 2021, it shows that if a 1-in-20 'downside event' occurred over the next three years, the funding position could deteriorate by at least an additional **£1.1bn**.
- 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 rose over the quarter**, which was largely due to the increase in the absolute value of all asset classes over the period.
- Both decompositions illustrate the use of a dynamic equity option strategy, which the Fund implemented during the quarter. This has significantly reduced the VaR via an increased offsetting amount from the equity options.

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.

Performance summary

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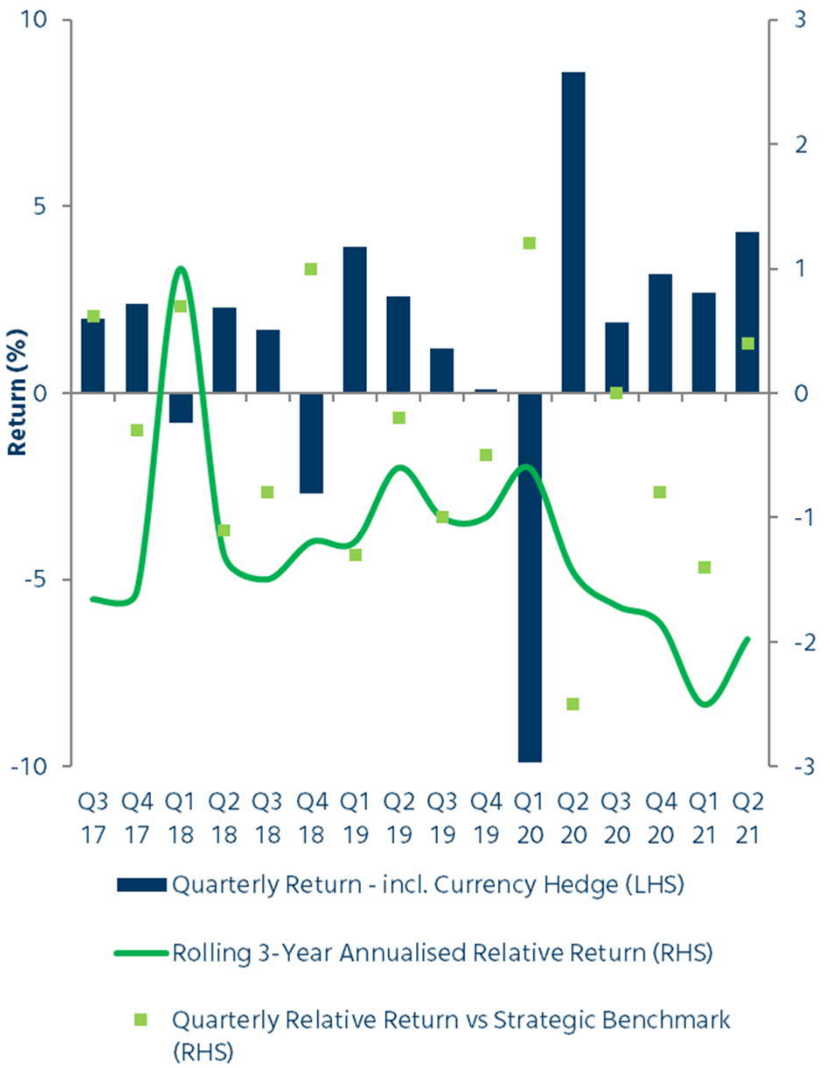
Total Fund performance



	3 Months (%)	1 Year (%)	3 Years (% p.a.)
Total Fund **(1)**	4.3	12.6	5.6
Total Fund (ex currency hedge)	4.4	10.3	5.4
Strategic Benchmark **(2)** (ex currency hedge)	3.9	14.7	7.6
Relative (1 - 2)	**+0.4**	**-2.1**	**-2.0**

Commentary

- Fund returns over the quarter were driven by the continued strength in growth assets.
- The continued rise in equity markets bolstered the physical equity holdings, and the two active global mandates topped this up with outperformance thanks to stock selection and sustainable-themed holdings doing well. Markets also helped the Diversified Returns mandate to become the largest outperformer in the portfolio, against its cash plus benchmark, though at the portfolio level returns were curtailed again by the equity protection in place. The Hedge Fund and Core Infrastructure mandates also did well against their cash plus benchmarks.
- Relative performance at the mandate level has been mixed over the one year period to 30 June 2021. The High Alpha Equity mandate remains strongly up, and Hedge Funds and Core Infrastructure have continued to do particularly well. The Renewable Infrastructure mandate is in negative territory, but this largely reflects that it is still in the drawdown phase, and it has nevertheless still outperformed its benchmark since inception after a strong start.
- Underperformance relative to the strategic benchmark over the one and three 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. The currency hedging policy made a positive contribution over both periods as sterling strengthened.

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Manager performance to 30 June 2021

Manager / Asset Class	3 Months Fund (%)	3 Months B'mark (%)	3 Months Relative (%)	1 Year Fund (%)	1 Year B'mark (%)	1 Year Relative (%)	3 Year Fund (% p.a.)	3 Year B'mark (% p.a.)	3 Year Relative (% p.a.)	3 Year Performance Target (% p.a.)	3 Year Performance vs Target
BlackRock Global Equity	7.6	7.6	0.0	24.4	24.4	0.0	13.7	13.3	+0.4	-	Target met
Brunel Global High Alpha Equity	9.3	7.8	+1.4	32.2	24.9	+5.8	N/A	N/A	N/A	+2-3	N/A
Brunel Global Sustainable Equities	8.4	7.4	+0.9	N/A	N/A	N/A	N/A	N/A	N/A	+2	N/A
Brunel Global Low Carbon Equity	7.7	7.8	-0.1	24.9	25.1	-0.2	N/A	N/A	N/A	-	N/A
Brunel Emerging Market Equity	4.6	5.0	-0.4	28.7	26.4	+1.8	N/A	N/A	N/A	+2-3	N/A
Brunel Diversified Returns Fund	5.8	0.0	+5.8	N/A	N/A	N/A	N/A	N/A	N/A	+4-5	N/A
JP Morgan FoHF	2.5	0.8	+1.7	17.6	3.3	+13.9	9.5	4.6	+4.6	-	Target met
Schroder UK Property	2.2	3.8	-1.5	5.6	8.5	-2.6	2.1	3.0	-0.9	+1	N/A
Brunel UK Property	5.6	3.8	+1.7	N/A	N/A	N/A	N/A	N/A	N/A	-	N/A
Partners Overseas Property*	0.9	2.5	-1.6	0.9	10.0	-8.3	1.0	10.0	-8.2	-	Target not met
Brunel Secured Income	2.7	1.7	+1.0	5.6	2.5	+3.0	N/A	N/A	N/A	+2	N/A
IFM Core Infrastructure**	6.1	1.2	+4.9	14.3	5.2	+8.7	10.4	5.7	+4.5	-	Target met
Brunel Renewable Infrastructure	-0.7	1.7	-2.4	-3.3	2.5	-5.7	N/A	N/A	N/A	+4	N/A
BlackRock Corporate Bonds	2.6	2.6	0.0	2.0	2.0	0.0	7.0	7.0	0.0	-	N/A
BlackRock LDI	2.5	2.5	0.0	27.3	27.3	0.0	3.7	3.7	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 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 (mainly reflecting passive mandates).
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.
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 the Appendix.
*Partners performance is to 31 March 2021 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	688,410	755,574	13.0	13.7	12.0	7 - 17	1.7
Global Sustainable Equity	541,101	586,798	10.2	10.7	10.0	5 - 15	0.7
Global Low Carbon Equity	691,544	745,054	13.0	13.6	10.0	5 - 15	3.6
Emerging Market Equity	286,760	299,916	5.4	5.5	5.5	3 - 9	0.0
Diversified Growth Funds	501,330	530,215	9.5	9.6	10.0	5 - 15	-0.4
Fund of Hedge Funds*	276,402	283,763	5.2	5.2	-	No set range	0.2
Multi-Asset Credit	317,539	317,354	6.0	5.8	6.0	3 - 9	-0.2
Property	377,969	353,307	7.1	6.4	7.5	5 - 10	-1.1
Secured Income**	280,324	350,558	5.3	6.4	10.0	5 - 15	-3.6
Core Infrastructure	365,544	389,545	6.9	7.1	5.0	2.5 - 7.5	2.1
Renewable Infrastructure**	50,205	55,286	0.9	1.0	5.0	2.5 - 7.5	-4.0
Private Debt	-	-	-	-	5.0	0 - 7.5	-
Corporate Bonds	130,825	134,187	2.5	2.4	2.0	No set range	0.4
LDI & Equity Protection	562,219	526,595	10.6	9.6	12.0	No set range	-2.4
Cash***	230,621	169,542	4.4	3.1	-	0 - 5	3.1
Total	5,301,031	5,570,651	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 and other residual holdings.
*Mandate due to be terminated.
Valuations include both funding cycle allocations.
***Valuation includes the ETF and currency instruments, as well as assets in transit towards the new Brunel MAC mandate.

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	249,770		268,832	4.7	4.9
Schroder	Global Equities	1,515		1,524	0.0	0.0
Brunel	Global High Alpha Equity	403,274		440,841	7.6	8.0
Brunel	Global Sustainable Equity	541,101		586,798	10.2	10.7
Brunel	Global Low Carbon Equity	691,544		745,054	13.0	13.6
Brunel	Emerging Market Equity	286,760		299,916	5.4	5.5
Brunel	Diversified Returns Fund	501,330		530,215	9.5	9.6
Brunel	Multi-Asset Credit	-	317,354	317,354	0.0	5.8
JP Morgan	Fund of Hedge Funds	276,402		283,763	5.2	5.2
Loomis Sayles	Multi-Asset Credit	317,539	-320,925	-	6.0	0.0
Brunel	UK Property	106,841	2,469	115,388	2.0	2.1
Schroder	UK Property	92,565	-34,487	58,712	1.7	1.1
Partners	Overseas Property	178,563	-2,207	179,206	3.4	3.3
Brunel*	Secured Income	280,324	61,731	350,558	5.3	6.4
IFM	Core Infrastructure	365,544		389,545	6.9	7.1
Brunel*	Renewable Infrastructure	50,205	5,510	55,286	0.9	1.0
BlackRock	Corporate Bonds	130,825		134,187	2.5	2.4
BlackRock	LDI & Equity Protection	562,219		526,595	10.6	9.6
Record**	Currency Hedging	97,316	-25,000	72,250	1.8	1.3
BlackRock	ETF	108,631	25,000	67,385	2.0	1.2
Internal Cash***	Cash	58,223	12,695	73,977	1.1	1.3
Total		5,301,031	42,137	5,570,651	100.0	100.0

Source: Investment Managers, Mercer. Totals may not sum due to rounding and other residual holdings.
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. Q2 Cash valuation also includes the assets in transit towards the new Brunel MAC mandate.
* Valuations include both funding cycle allocations.
** Valuation includes the collateral holdings for the currency overlay.

Appendix

Q2 2021 equity market review

Global equity markets rallied over the quarter, returning 7.3% in sterling terms and 7.1% in local currency terms. Volatility in equity markets was lower compared to the first quarter of the year. However, fears of inflation and an acceleration in policy tightening did lead to a number of spikes in volatility. Reopenings across the western world and the ongoing strong recovery in corporate earnings supported equity momentum.

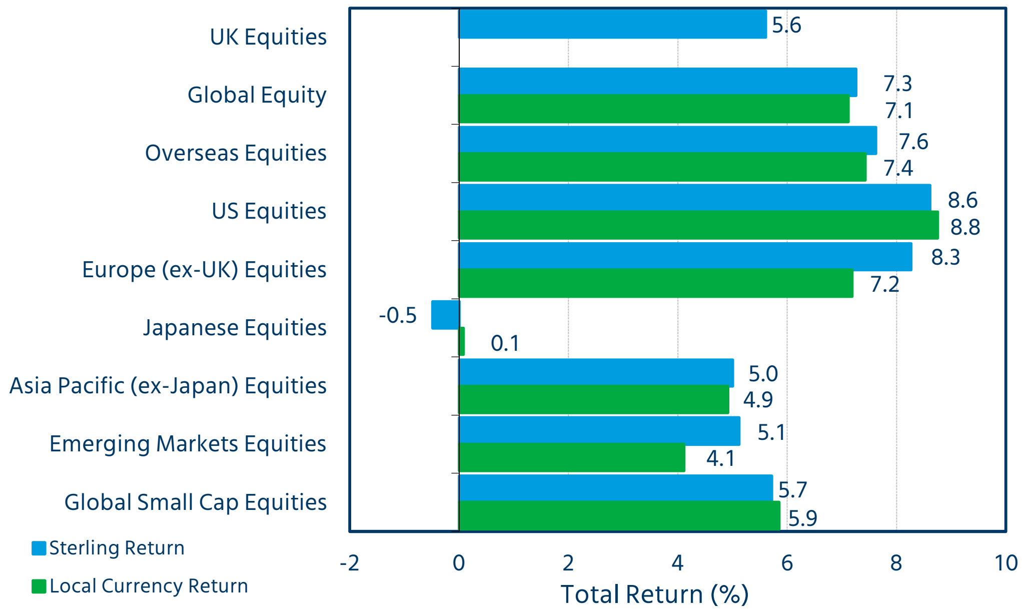
US equities returned 8.8% in local currency terms whilst European (ex UK) equities returned 7.2%. With a heavier weight in growth than in value and heavy exposure to tech stocks, the US benefited more from growth outperforming value over the quarter.

Emerging markets ('EM') equities returned 4.1% in local terms. Brazilian and Russian equities saw strong returns over the quarter, driven by rising commodity prices. Returns were positive for all other regions as well, including for India in spite of a pandemic-related slowdown. China was the weakest EM performer as a result of the ongoing regulatory crackdown on its tech sector and credit tightening.

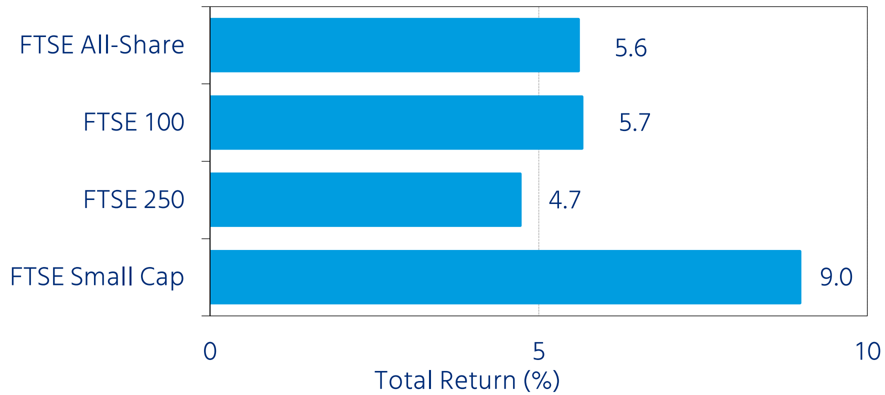
Global small cap stocks returned 5.9% in local terms. Small caps lagged global equities as momentum began to slow somewhat after a very strong first quarter.

The **FTSE All Share index** returned 5.6% over the quarter. The large exposure to financials, oil & gas, and basic materials supported UK equities as markets priced in the cyclical recovery and rising commodity prices.

Equity Performance - Three Months to 30 June 2021



FTSE Performance by Market Cap (FTSE) - Three Months to 30 June 2021



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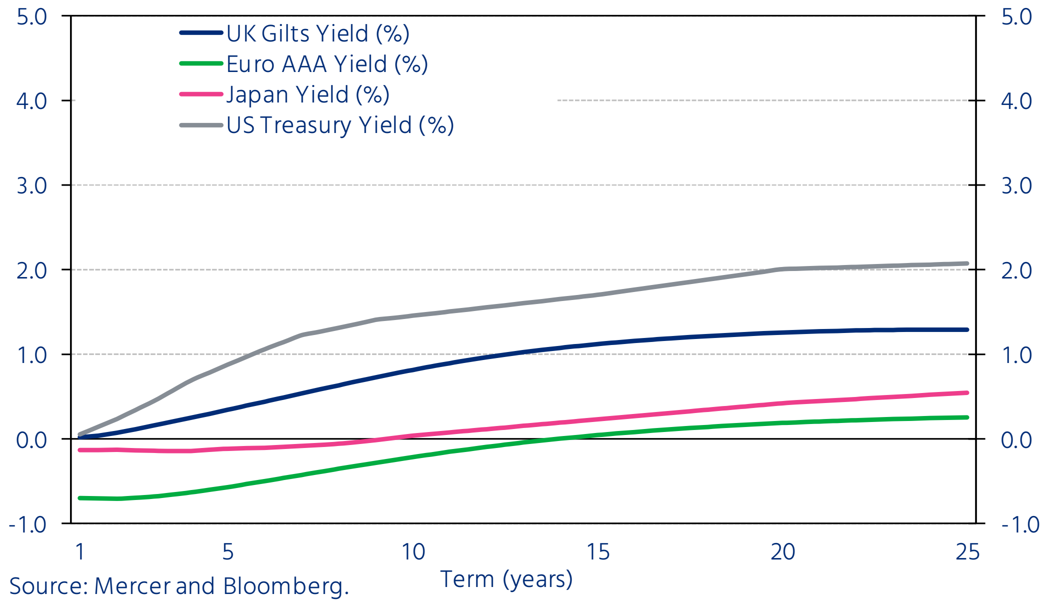
Source: Thomson Reuters Datastream.

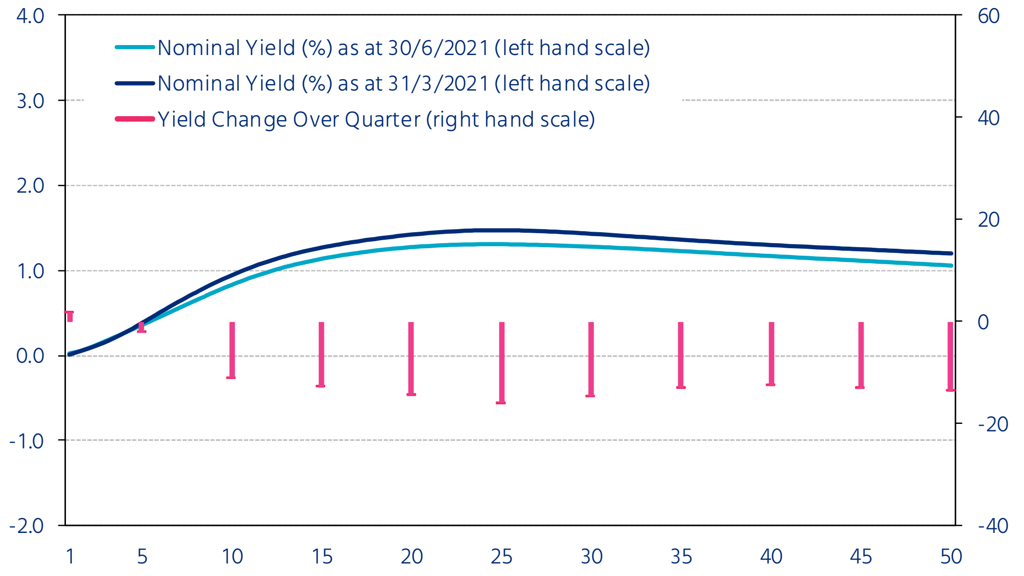
Q2 2021 bond market review (1)



Source: Mercer and Bloomberg.

Government Bond Yields

Government bond yields generally fell globally over the quarter after the rebound seen in Q1. The US 10-year government bond yield fell by 30 basis points as inflation worries eased somewhat towards quarter end and the Federal Reserve qualified its June statement that was initially perceived to be less dovish than expected. UK and Japanese 10-year benchmark yields fell by 13 and 4 basis points respectively. However, the German 10-year yield rose by 9 basis points.

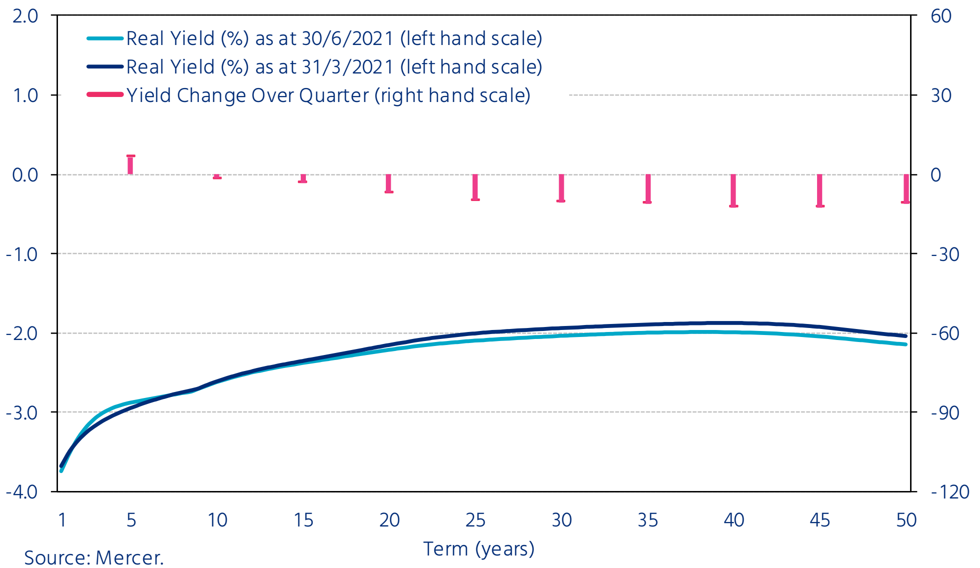


Source: Mercer.

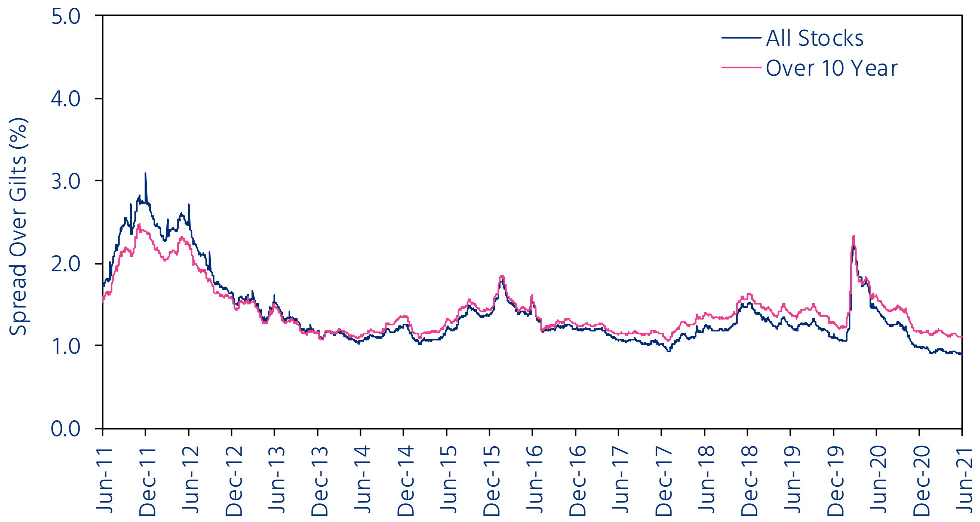
UK Nominal Gilt Yields

The UK yield curve shifted downwards over the quarter as inflation expectations eased despite fiscal and monetary policy continuing to remain loose.

Q2 2021 bond market review (2)



Source: Mercer.



Source: Thomson Reuters Datastream.

UK Index-Linked Gilt Yields

UK real yields fell across the curve, in line with nominal yields. The fall in nominal yields offset the decrease in inflation expectations.

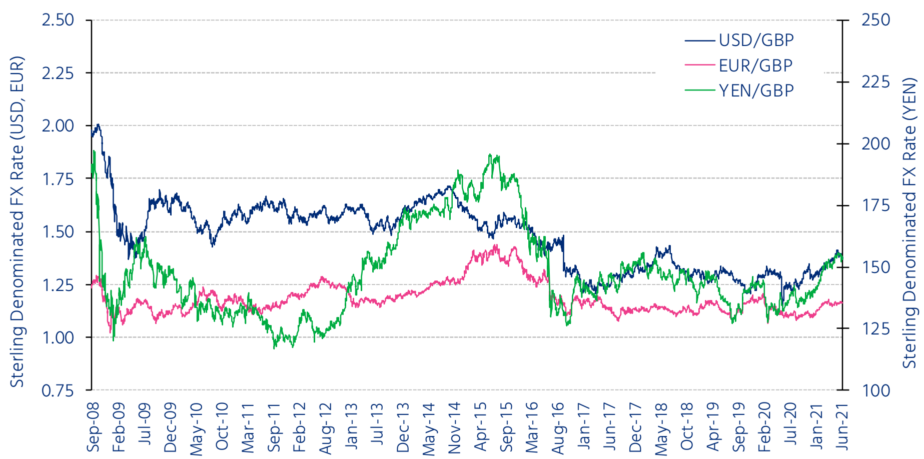
Corporate bonds

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

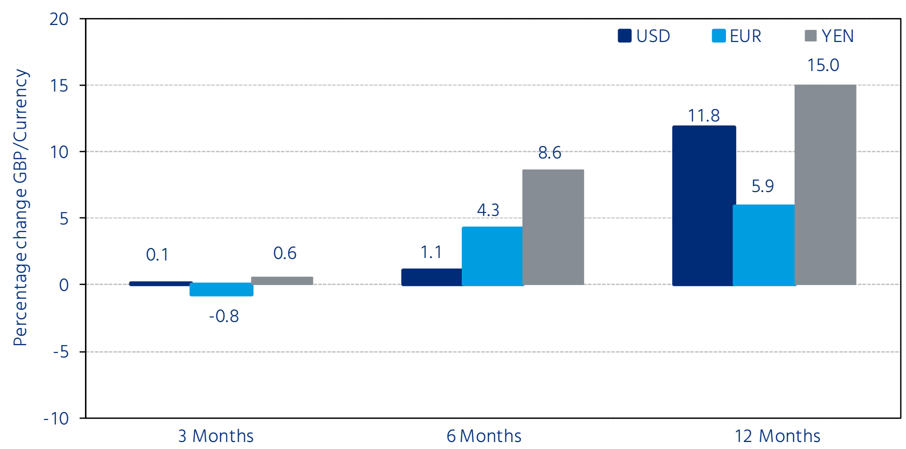
Q2 2021 currency market review

Sterling was relatively stable against all major developed currencies compared to previous quarters. On a one year basis, sterling has enjoyed a post Brexit rally after the final transition out of the EU. There was also optimism over Britain's gradual reopening thanks to its successful vaccination programme. The US dollar weakened against other major developed market currencies on a one year basis driven by the combination of rising inflation relative to other countries and concerns over excessively lose monetary and fiscal policy.

Sterling Denominated FX Rate



Change in sterling against foreign currencies



Q2 2021 property

UK property as measured by the MSCI Index increased by 3.9% over the quarter to 30 June 2021.

Source: Thomson Reuters Datastream.

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.	-
Brunel	Multi-Asset Credit	SONIA	+4-5%
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	3 Month LIBOR +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.

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