Mercer

Avon Pension Fund

Committee Investment Report
Quarter to 30 September 2021

November 2021

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Mercer

Executive summary

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Executive summary

Market background

- The third quarter of 2021 started with optimism over reopenings but ended with global slowdown fears, amid concerns over the Delta variant and supply chain pressures.
- Developed equity markets remained in positive territory overall despite the sell-off in September though emerging markets contracted, driven by the regulatory crackdown in China and the restructuring of the large property developer Evergrande.
- Inflation expectations increased significantly, and gilt yields rose in response to hawkish signals from central banks.

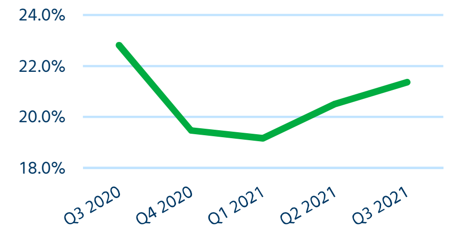
Mercer market views

- Our medium term views on the global economy continues to be that growth will remain strong, albeit with some potential short-term challenges.
- Corporate profit growth is expected to remain strong, though the heightened prospect of central bank tightening could undermine equities.
- 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 slightly over Q3 to just over 101%, as asset growth outweighed the rise in the value of the liabilities.
- It is estimated to have increased by 8% over the year to 30 September 2021 (as illustrated to the right).

- The Value-at-Risk rose over the quarter to £1,206m, or 21.4% of liabilities, mainly due to the increase in the absolute value of the assets.
- 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

- Most assets delivered positive returns over the quarter, particularly the LDI portfolio given the rise in inflation expectations.
- Equity assets were up overall, and private market assets in UK Property, Secured Income and Infrastructure did well.
- 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 and the currency hedge in place.
- Relative performance was mixed at the mandate level, though the Hedge Fund and Core Infrastructure mandates have continued to stand out in outperforming their benchmarks. The Diversified Returns mandate has also done well over the year.

	3 Months (%)	1 Year (%)	3 Years (% p.a.)
Total Fund **(1)**	2.9	13.8	6.0
Strategic Benchmark **(2)** (ex currency hedge)	3.3	16.2	7.8
Relative **(1 - 2)**	**-0.4**	**-2.4**	**-1.8**

- Absolute returns for all growth mandates, except for the two older Property funds and the Secured Income mandate (which is still being drawn down), 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.
- Within the alternative asset classes, Core Infrastructure has outperformed expectations, and the new UK Property mandate has done well since inception at the start of 2021. 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 September, the Fund received its first capital call from the Private Debt commitment 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.
- Post quarter-end, the Committee agreed to terminate the Fund's holdings in Emerging Markets Equity. Holdings will be distributed between the High Alpha and Sustainable Equity mandates (which still contain emerging markets exposure).
- From a strategic perspective, the allocation to Diversified Returns will also be reduced, and the global equity mandates correspondingly increased in order to maintain the overall expected return of the portfolio in light of the reduction in emerging markets equities. However, no rebalancing will take place at this stage due to prevailing relative positioning.

Liability hedging mandate

- BlackRock were in compliance with their 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. Changes to the inflation hedge ratio target will be considered in more detail by the FRMG in due course.

Equity option mandate

- Market value of options at end of the quarter was negative (£5m) as equity markets have risen since inception of the dynamic strategy in May.
- They rose in value over Q3 however as the strategy protected during a volatile quarter, particularly within emerging markets.

Collateral position

- Collateral within agreed constraints.
- The BlackRock QIF could sustain a 2.9% p.a. rise in interest rates, an 11% fall in the value of the options, or a 0.4% fall in inflation before the early warning trigger is breached.

Market background

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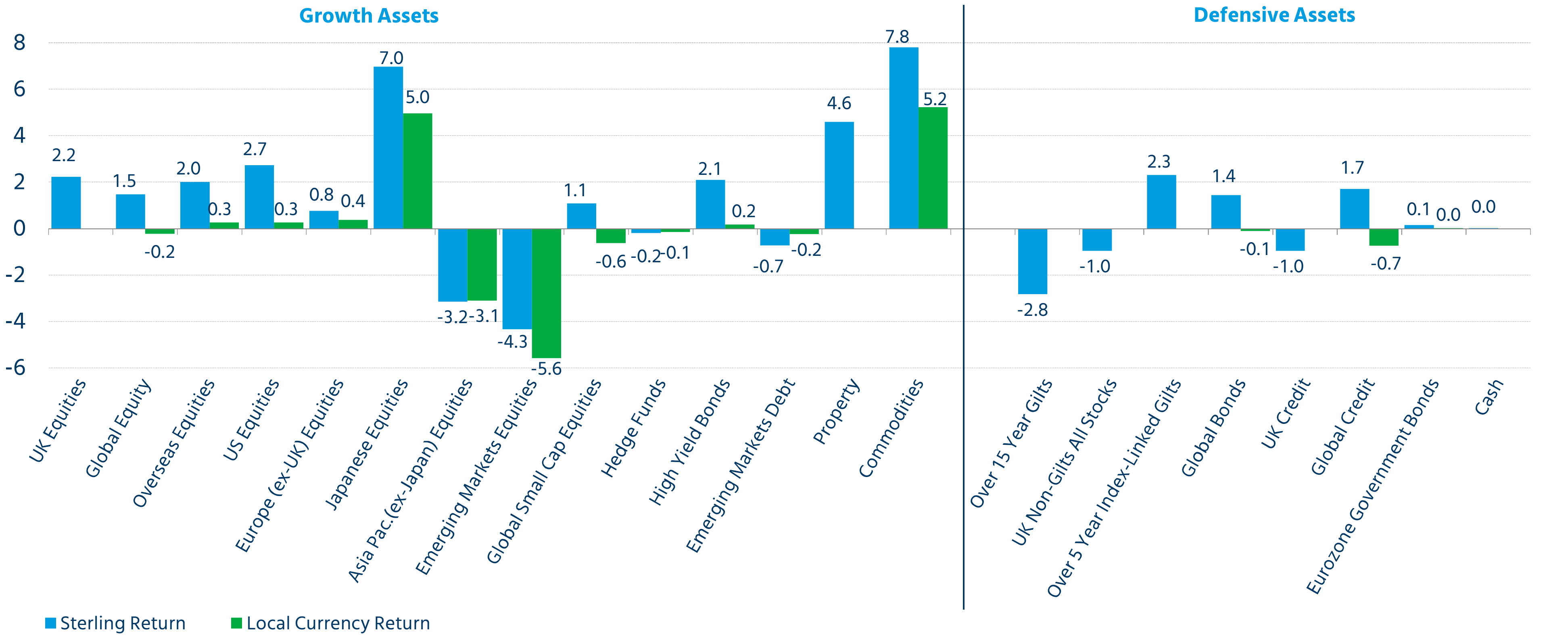
Market background

Return over 3 months to 30 September 2021 (%)

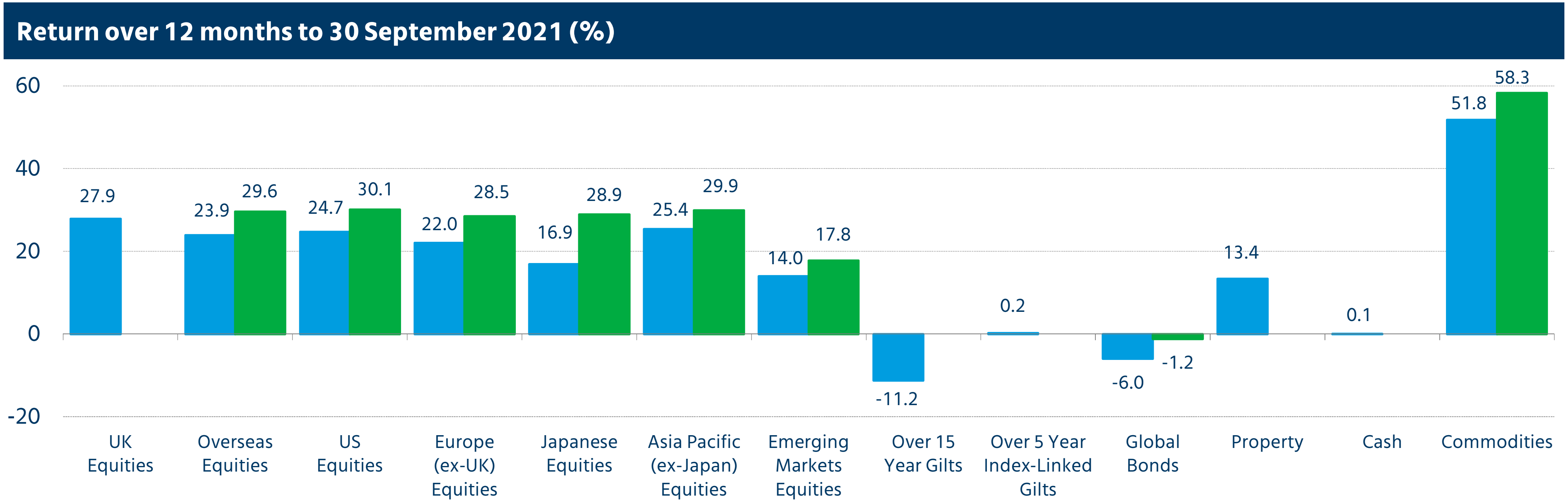


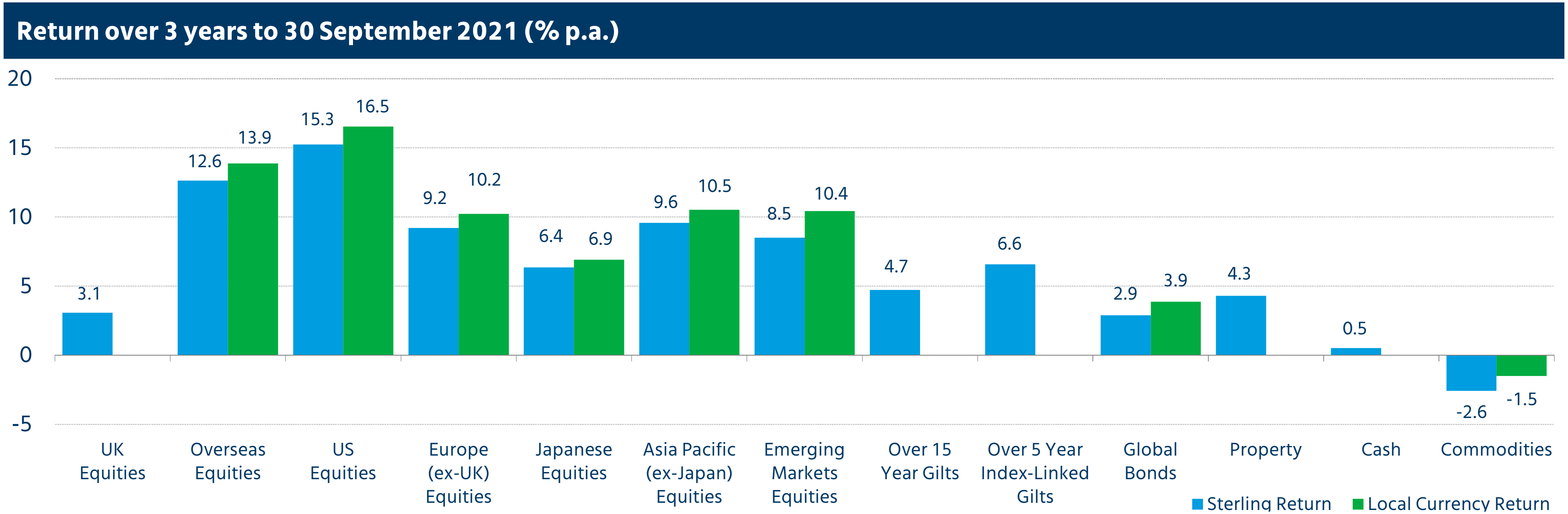
The third quarter of 2021 started with optimism over reopenings but ended with global slowdown fears. Over the first half of the quarter, the US, UK and much of Europe went ahead with fully reopening their economies which drove risk on sentiment. However, concerns over the Delta variant prompted some economies with 'zero Covid' policies, mostly around Asia Pacific to re-impose restrictions. This added to already existing supply chain pressures.

The supply impact was increasingly felt later in the quarter, in combination with concerns over pent-up demand peaking and Covid fears leading to a deterioration in sentiment. The struggles of China's largest property developer, Evergrande as well as the Chinese government intensifying its regulatory crackdown, against sectors such as technology and private education, added to concerns.

Source: Thomson Reuters Datastream.

Market background – longer term





Source: Thomson Reuters Datastream.

Funding level and risk

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Change in deficit

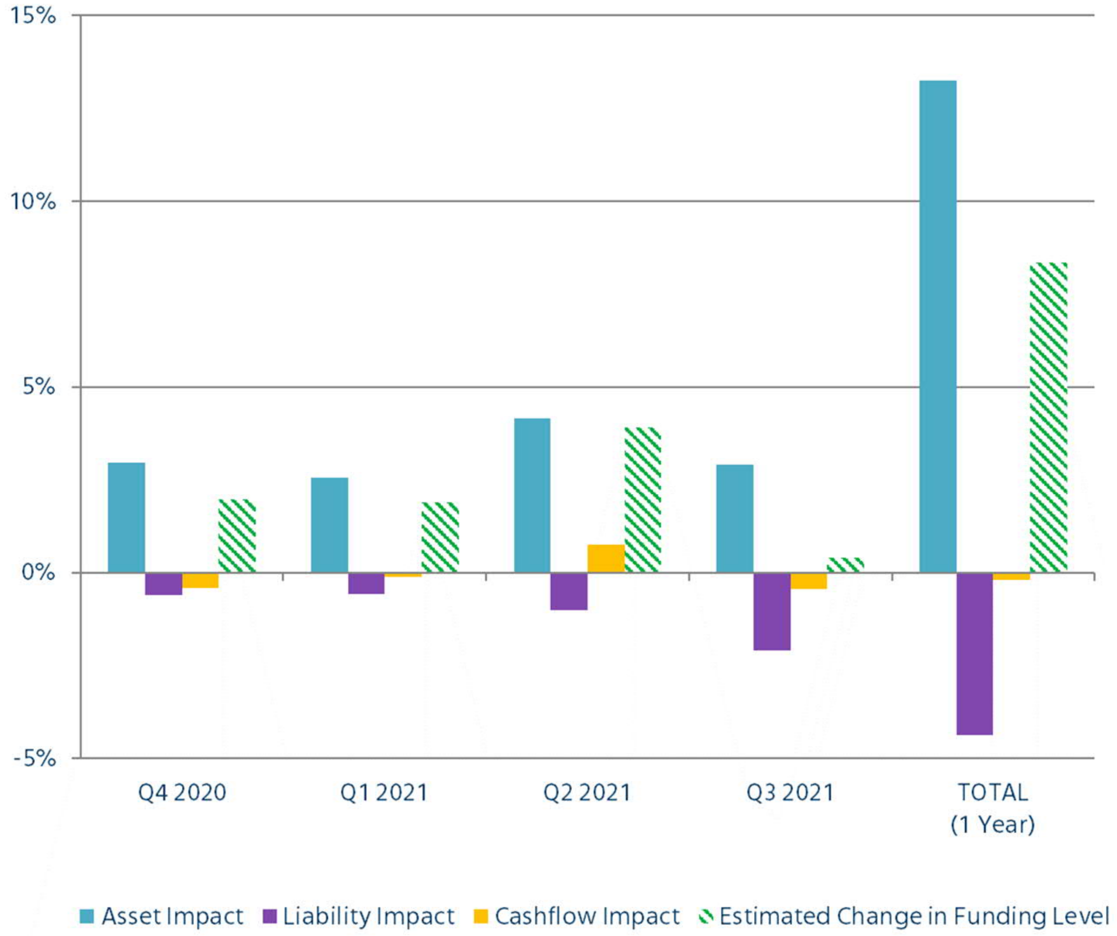
Based on financial markets, investment returns and net cashflows into the Fund, the surplus was estimated to have increased slightly over Q3 to £66m.

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.

Liability values are estimated by Mercer.

Funding level attribution



The Fund's assets returned 2.9% over the quarter, whilst the liabilities are expected to have increased by c. 2.1% due to the rise in inflation.

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

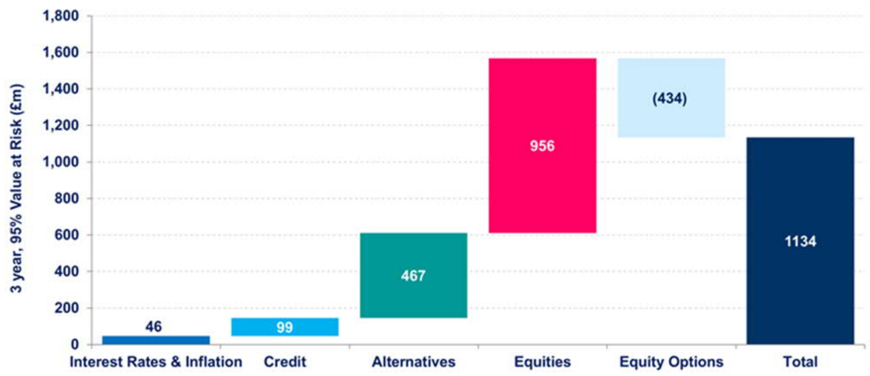
The funding level is estimated to have increased by c. 8% over the year to 30 September 2021.

Impact figures are estimated by Mercer.

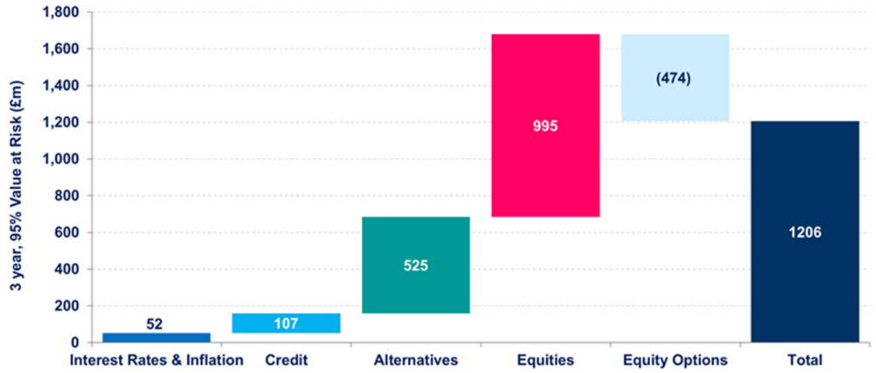
Risk decomposition – 3 year Value at Risk

- The two charts below 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 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 final columns show 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.

30 June 2021



30 September 2021



- As at 30 September 2021, if a 1-in-20 'downside event' occurred over the next three years, the funding position could deteriorate by at least an additional **£1.2bn**.
- Each bar to the left of the total 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 assets over the period.

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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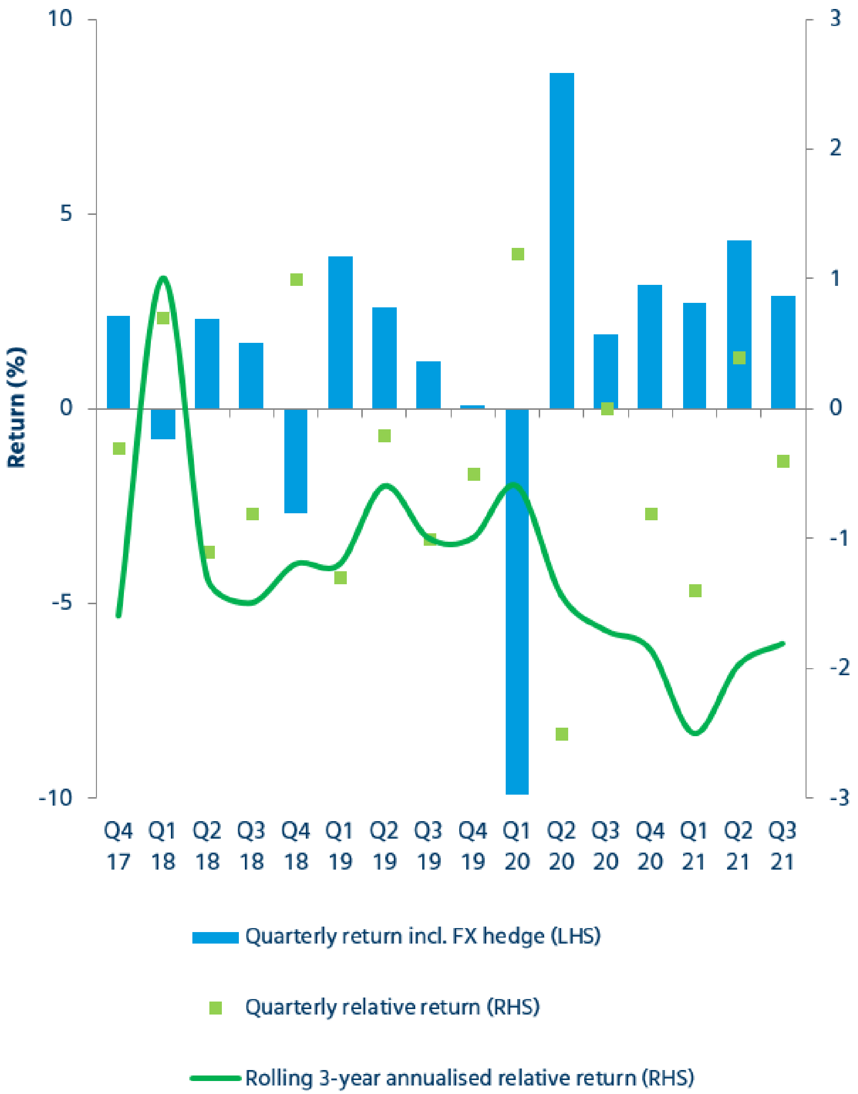
Total Fund performance



	3 Months (%)	1 Year (%)	3 Years (% p.a.)
Total Fund **(1)**	2.9	13.8	6.0
Total Fund (ex currency hedge)	3.4	12.8	5.9
Strategic Benchmark **(2)** (ex currency hedge)	3.3	16.2	7.8
Relative (1 - 2)	**-0.4**	**-2.4**	**-1.8**

Commentary

- Most assets delivered positive returns over the quarter, and the largest contribution came from the LDI portfolio given the rise in inflation expectations. The Fund outperformed its benchmark before factoring in the currency hedge, which detracted due to a weakening of Sterling.
- Equity assets were up overall due to the rise in developed markets. The Sustainable mandate did particularly well as a result of stock selection at the manager level, though the Emerging Markets mandate detracted. This was mitigated by the Equity Protection strategy, which as a whole slightly added value over the quarter. The UK Property mandate with Brunel was another notable performer, and other private market assets within Secured Income and Infrastructure also had a modest contribution to outperformance.
- Over the one year and three year periods, the outperformers continue to be the Hedge Fund and Core Infrastructure mandates compared to their cash plus benchmarks, whilst the Property portfolios have underperformed. The Diversified Returns mandate has also done well over the year. Renewable Infrastructure remains in negative territory over the year due to it being in the draw down phase, but is ahead of target since inception.
- The Equity Protection strategy is the main reason for underperformance relative to the strategic benchmark over the one and three year periods, though this is in line with expectations given the increase in the underlying equity markets. The Currency Hedge made a positive contribution over both periods as sterling strengthened.

Mandate performance to 30 September 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 Passive Global Equity	2.5	2.4	+0.1	23.6	23.5	+0.1	12.0	11.9	+0.1	-	N/A
Brunel Global High Alpha Equity	1.7	2.6	-0.9	25.2	24.1	+0.9	N/A	N/A	N/A	+2-3	N/A
Brunel Global Sustainable Equity	3.6	1.5	+2.1	23.1	22.7	+0.3	N/A	N/A	N/A	+2	N/A
Brunel Passive Global Low Carbon Equity	2.4	2.5	-0.1	23.7	23.9	-0.2	12.7	12.8	-0.1	-	N/A
Brunel Emerging Market Equity	-6.5	-5.7	-0.8	13.7	13.7	0.0	N/A	N/A	N/A	+2-3	N/A
Brunel Diversified Returns Fund	0.6	0.0	+0.6	8.1	0.1	+8.0	N/A	N/A	N/A	+4-5	N/A
JP Morgan FoHF	-0.6	0.8	-1.4	11.8	3.2	+8.3	8.8	4.5	+4.2	-	Target met
Brunel Multi-Asset Credit	0.6	1.0	-0.4	N/A	N/A	N/A	N/A	N/A	N/A	-	N/A
Schroder UK Property	0.6	4.5	-3.8	5.8	13.1	-6.5	1.8	4.0	-2.1	+1	N/A
Brunel UK Property	5.4	4.5	+0.9	N/A	N/A	N/A	N/A	N/A	N/A	-	N/A
Partners Overseas Property*	1.3	2.5	-1.2	-1.4	10.0	-10.3	1.2	10.0	-8.0	-	Target not met
Brunel Secured Income	3.6	1.0	+2.6	10.5	3.0	+7.3	N/A	N/A	N/A	+2	N/A
IFM Core Infrastructure	3.8	1.3	+2.5	16.5	5.2	+10.7	8.9	5.6	+3.1	-	Target met
Brunel Renewable Infrastructure	2.7	1.0	+1.7	-0.9	3.0	-3.8	N/A	N/A	N/A	+4	N/A
BlackRock Corporate Bonds	-1.5	-1.5	0.0	-0.8	-0.8	0.0	6.8	6.8	0.0	-	N/A
BlackRock LDI	18.1	18.1	0.0	49.0	49.0	0.0	8.3	8.3	0.0	-	N/A
Equity Protection Strategy	0.2			-0.1			-1.3			-	N/A

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 net of fees.
Returns are in GBP terms, except for JP Morgan and Partners , whose performance is shown in local terms.
Relative returns have been calculated geometrically (i.e. the portfolio return is divided by the benchmark return) rather than arithmetically.
A summary of the benchmarks for each of the mandates is given in the Appendix.
Green = mandate exceeded benchmark. Red = mandate underperformed benchmark. Black = mandate performed in line with benchmark (mainly reflecting passive mandates).

Performance for JP Morgan and Partners in IRR terms. Performance for IFM is in TWR terms.
Performance of the Secured Income and Renewable Infrastructure mandates currently reflect those for the first commitment cycles only.
Performance of the Equity Protection Strategy is estimated by Mercer based on the change in market value of the options over time, accounting for realised profit/loss upon rolling of the strategy.
*Partners performance is to 30 June 2021 as this is the latest date that this is available. The mandate's inception was in 2009.

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 (%)			Relative (%)
Passive Global Equity	755,574	760,524	13.6	13.3	12.0	7	-	17	1.3
Global Sustainable Equity	586,798	607,893	10.5	10.6	10.0	5	-	15	0.6
Passive Global Low Carbon Equity	745,054	763,187	13.4	13.4	10.0	5	-	15	3.4
Emerging Market Equity	299,916	280,490	5.4	4.9	5.5	3	-	9	-0.6
Diversified Growth Funds	530,215	533,213	9.5	9.3	10.0	5	-	15	-0..7
Fund of Hedge Funds*	283,763	288,796	5.1	5.1	-	No set range			0.1
Multi-Asset Credit	317,989	322,864	5.7	5.7	6.0	3	-	9	-0.3
Property	353,307	346,729	6.3	6.1	7.5	5	-	10	-1.4
Secured Income**	350,558	385,384	6.3	6.7	10.0	5	-	15	-3.3
Core Infrastructure	389,545	403,824	7.0	7.1	5.0	2.5	-	7.5	2.1
Renewable Infrastructure**	55,286	70,741	1.0	1.2	5.0	2.5	-	7.5	-3.8
Private Debt	-	19,530	-	0.3	5.0	0	-	7.5	-4.7
Corporate Bonds	134,187	132,115	2.4	2.3	2.0	No set range			0.3
LDI & Equity Protection	526,595	630,516	9.5	11.0	12.0	No set range			-1.0
Cash***	241,631	164,295	4.3	2.9	-	0	-	5	2.9
Total	5,570,651	5,710,102	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.

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

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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	268,832		275,451	4.8	4.8
Schroder	Global Equity	1,524		1,545	0.0	0.0
Brunel	Global High Alpha Equity	440,841		448,289	7.9	7.9
Brunel	Global Sustainable Equity	586,798		607,893	10.5	10.6
Brunel	Global Low Carbon Equity	745,054		763,187	13.4	13.4
Brunel	Emerging Market Equity	299,916		280,490	5.4	4.9
Brunel	Diversified Returns Fund	530,215		533,213	9.5	9.3
JP Morgan	Fund of Hedge Funds	283,763		288,796	5.1	5.1
Brunel	Multi-Asset Credit	317,989	2,876	322,864	5.7	5.7
Brunel	UK Property	115,388	17,950	140,467	2.1	2.5
Schroder	UK Property	58,712	-29,918	29,669	1.1	0.5
Partners	Overseas Property	179,206	-5,816	176,593	3.2	3.1
Brunel	Secured Income*	350,558	22,487	385,384	6.3	6.7
IFM	Core Infrastructure	389,545		403,824	7.0	7.1
Brunel	Renewable Infrastructure*	55,286	13,318	70,741	1.0	1.2
Brunel	Private Debt	-	19,175	19,530	-	0.3
BlackRock	Corporate Bonds	134,187		132,115	2.4	2.3
BlackRock	LDI & Equity Protection	526,595		630,516	9.5	11.0
Record	Currency Hedging**	72,250	-30,000	16,330	1.3	0.3
BlackRock	ETF	139,475	-40,000	102,066	2.5	1.8
Internal Cash	Cash***	73,977	6,634	80,830	1.3	1.4
Total		5,570,651	-23,385	5,710,102	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.
* Valuations include both funding cycle allocations.
** Valuation includes the collateral holdings for the currency overlay.
*** Valuation includes assets in transit.

Appendix

Q3 2021 equity market review

Equity markets performance was mixed over the third quarter.

Global Equities returned -0.2% in local currency terms. Markets sold off during the second half of September amid fears of a global economic slowdown, driven by peaking demand and supply constraints, potential contagion from the restructuring of Evergrande and large central banks signalling that monetary policy might become less expansive.

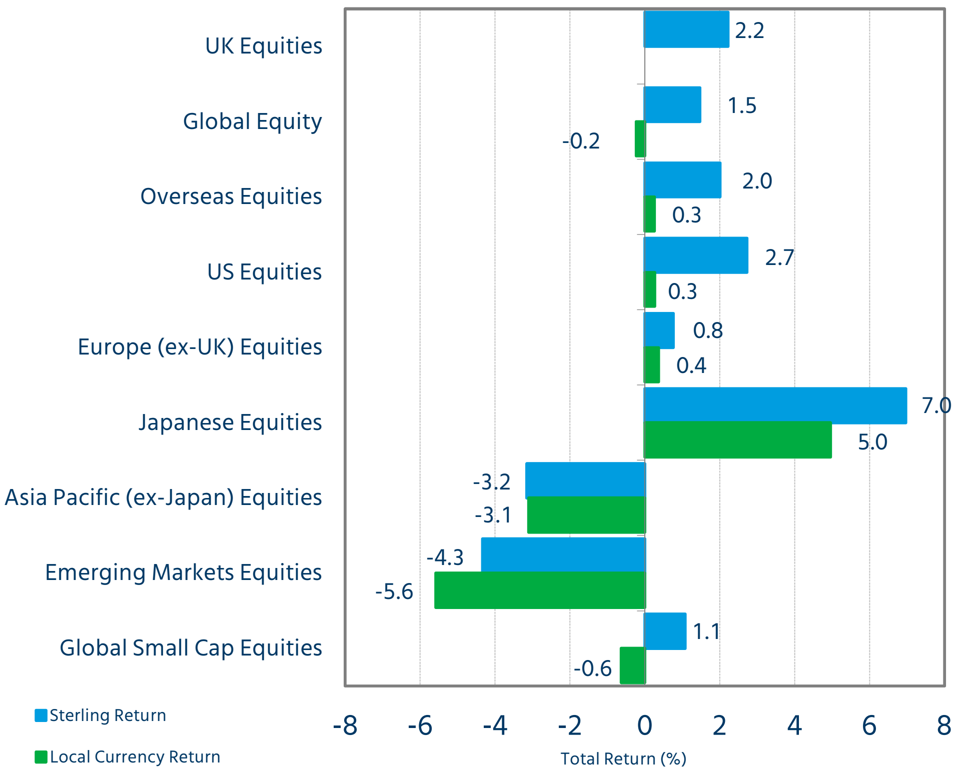
US equities returned 0.3% in local terms whilst **European (ex-UK) equities** returned 0.4%. Exposure to global trade and rising energy prices were headwinds for European equities. **Japanese equities** stood out as the best performer as political uncertainty reduced somewhat following the change in prime minister, returning 5.0%.

Emerging markets equities returned -5.6% in local terms, driven by the sell-off in China. Offshore Chinese stocks entered correction territory in light of the far-reaching regulatory crack down. Asia Pacific (ex-Japan) returned -3.1% as Covid restrictions held back growth in the region.

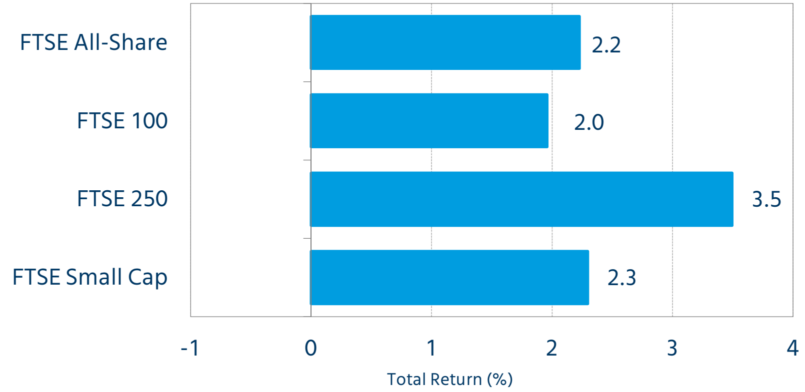
Global small cap stocks returned -0.6% in local terms. Small caps lagged global equities in local currency terms, as reopening momentum began to slow somewhat after a very strong first half of the year.

The FTSE All Share index returned 2.2%. The large exposure to financials, oil & gas, and basic materials supported UK large caps once again while small caps benefited from the economic rebound as the UK economy fully reopened earlier in the quarter. Momentum weakened later in the quarter due to soaring natural gas prices shocking the energy sector and lorry driver shortages exacerbating supply constraints, especially for crucial products such as petrol.

Equity Performance - Three Months to 30 September 2021



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



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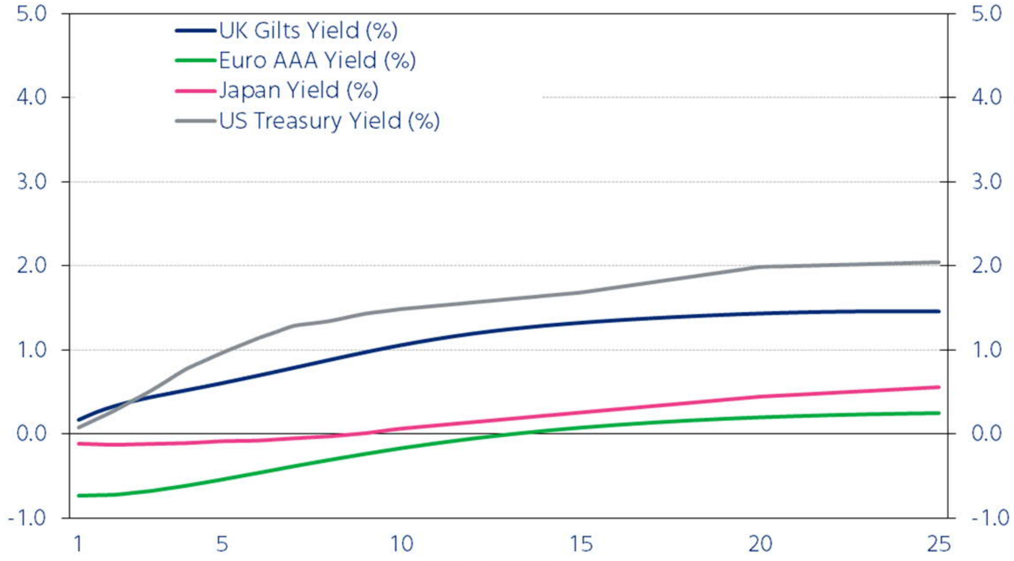
Source: Thomson Reuters Datastream.

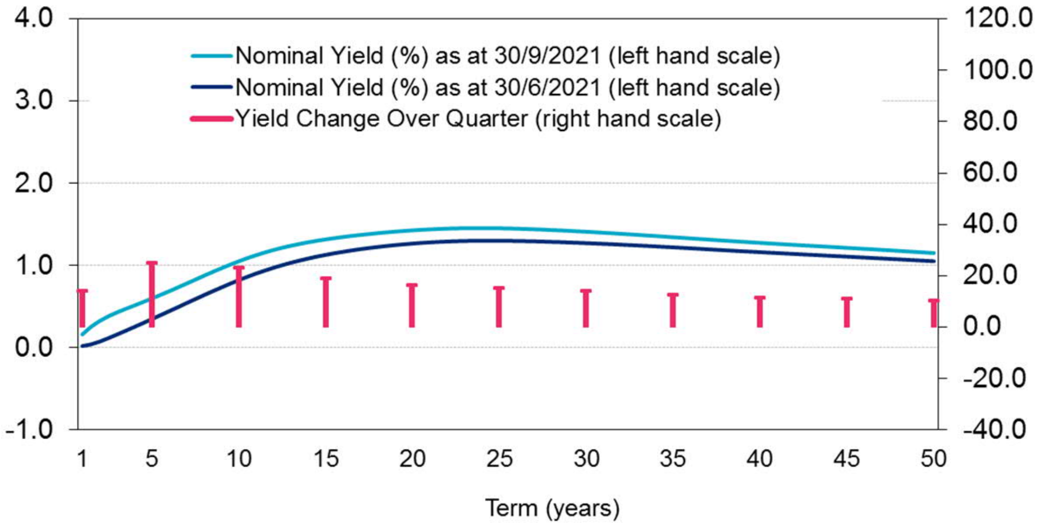
Q3 2021 bond market review



Source: Mercer and Bloomberg.

Government Bond Yields

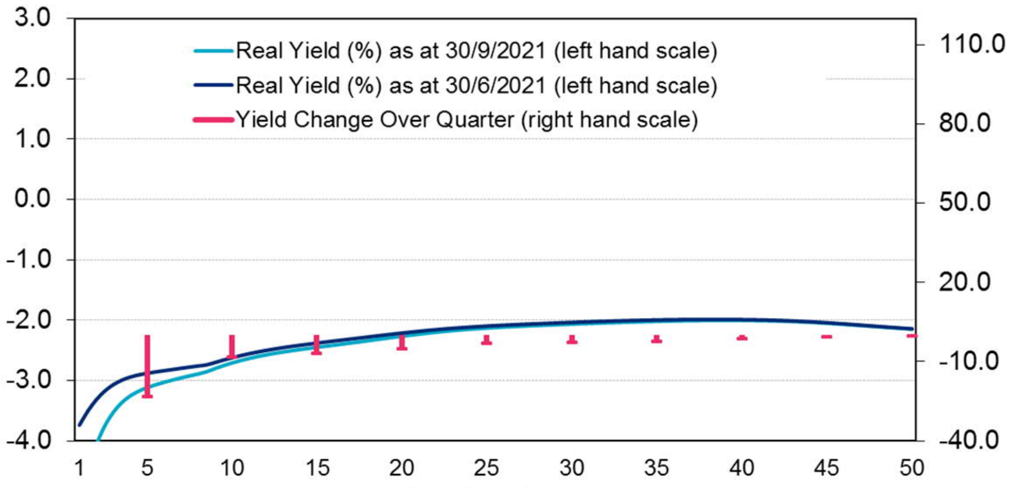
Global government bond yields generally rose over the quarter. Gilt yields rose sharply in September after falling earlier in the quarter. The UK 10-year benchmark yield rose by 27 basis points and the yield curve shifted upwards, with the 5 and 10-year yields rising the most. The US 10-year government bond yield rose by 8 basis amid expectations of tapering of asset purchases later in 2021.



UK Nominal Gilt Yields

The UK yield curve shifted upwards over the quarter. The Bank of England surprised markets by bringing forward expectations of the timing of rate increases, hinting at a move in 2022 with the first increase potentially coming as early as late 2021. During the quarter, the first green gilt was issued by the UK government and was met with strong demand from the market.

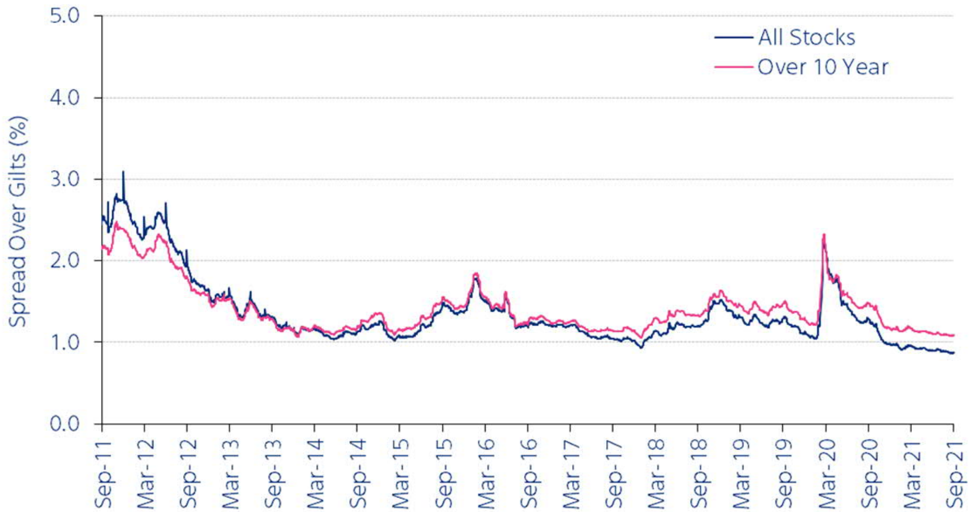
Q3 2021 bond market review



Source: Mercer.

UK Index-Linked Gilt Yields

UK real yields fell across the curve, more so at the short end. Market based measures of inflation expectations, in the form of breakeven inflation, shifted upwards. The UK 10-year breakeven rate rose 50bps to 3.8% - the highest level since the 2008 Financial Crisis.



Source: Thomson Reuters Datastream.

Corporate bonds

Yields on investment grade credit generally rose as the increase in government bonds was only partially offset by tighter credit spreads.

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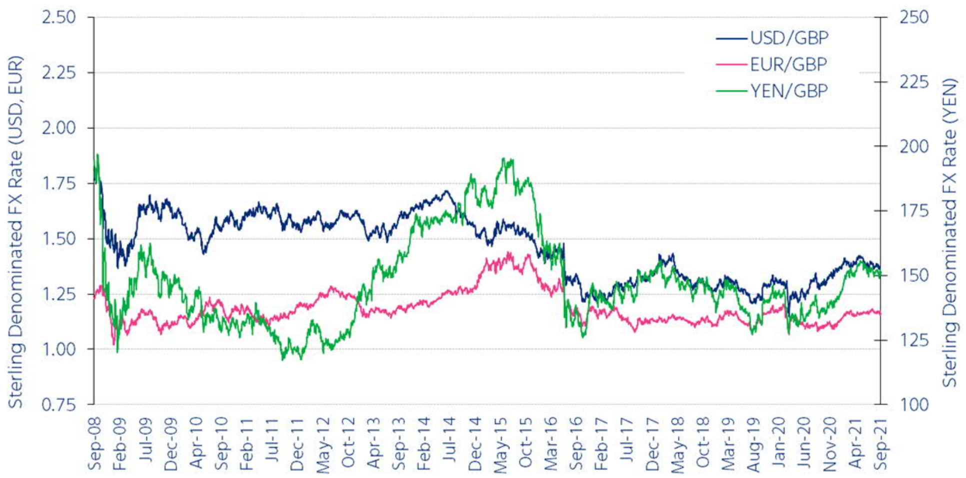
Q3 2021 currency market review

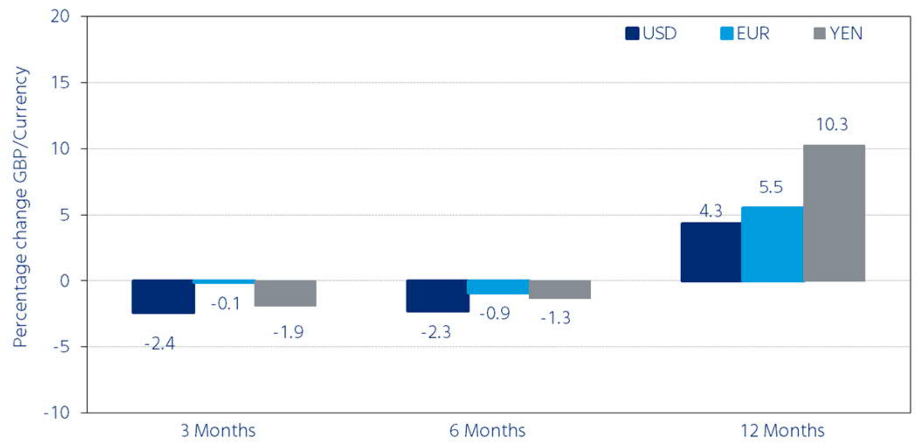
Sterling depreciated against all major developed currencies as the energy and supply shortages made investors re-consider their bullish positioning amid reopenings and a smooth Brexit. Nevertheless, on a one year basis, sterling appreciation against major currencies remains substantial. The US dollar strengthened against major developed market currencies over the quarter, due to monetary tightening in the US and safe haven demand towards the end of September.

Sterling Denominated FX Rate



Source: Thomson Reuters Datastream.

Change in sterling against foreign currencies



Source: Thomson Reuters Datastream.

Q3 2021 property

UK property as measured by the MSCI Index increased by 4.6% over the quarter to 30 September 2021.

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Source: Thomson Reuters Datastream.

Summary of mandates

Manager	Mandate	Benchmark/Target	Outperformance Target (p.a.)	Inception Date
BlackRock	Passive Global Equity	MSCI World	-	December 2017
Brunel	Global High Alpha Equity	MSCI World	+2-3%	November 2019
Brunel	Global Sustainable Equity	MSCI AC World	+2%	September 2020
Brunel	Passive Global Low Carbon Equity	MSCI World Low Carbon	-	July 2018
Brunel	Emerging Market Equity	MSCI Emerging Markets	+2 -3%	October 2019
Brunel	Diversified Returns Fund	SONIA	+4-5%	July 2020
JP Morgan	Fund of Hedge Funds	3 Month LIBOR +3% p.a.	-	July 2015
Brunel	Multi-Asset Credit	SONIA	+4-5%	June 2021
Schroder	UK Property	IPD UK Pooled	+1%	January 2009
Brunel	UK Property	MSCI/AREF UK Quarterly Property Fund Index	-	January 2021
Partners	Overseas Property	Net IRR of 10% p.a. (local currency)	-	September 2009
Brunel	Secured Income	CPI	+2%	January 2019
IFM	Core Infrastructure	3 Month LIBOR +5% p.a.	-	April 2016
Brunel	Renewable Infrastructure	CPI	+4%	December 2018
Brunel	Private Debt	3 Month LIBOR + 4% p.a.	-	September 2021
BlackRock	Buy-and-Maintain Corporate Bonds	Return on bonds held	-	February 2016
BlackRock	Matching (Liability Driven Investing)	Return on liabilities being hedged	-	February 2016
Record	Passive Currency Hedging	N/A	-	March 2016
BlackRock	Exchange-Traded Fund (ETF)	Bespoke benchmark to reflect total Fund allocation	-	March 2019
Cash	Internally Managed	7 Day LIBID	-	-

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Market background indices

Asset Class	Index
UK Equity	FTSE All-Share
Global Equity	FTSE All-World
Overseas Equity	FTSE World ex UK
US Equity	FTSE USA
Europe (ex-UK) Equity	FTSE World Europe ex UK
Japanese Equity	FTSE Japan
Asia Pacific (ex-Japan) Equity	FTSE World Asia Pacific ex Japan
Emerging Markets Equity	FTSE AW Emerging
Global Small Cap Equity	MSCI 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
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

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