Avon Pension Fund

Committee Investment Report
Quarter to 31 December 2021

March 2022

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Executive summary

1

Executive summary

Market background

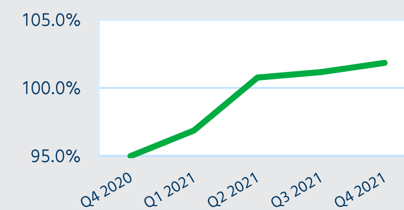
- The fourth quarter of 2021 came with a number of challenges. Global supply chains remained stretched and the new Covid-19 variant was discovered mid-quarter. Soaring inflation also forced some major central banks to accelerate their exit strategies from ultra-loose monetary policies.
- In spite of these headwinds, risk assets fared reasonably well with a few exceptions. The variant scare eased after it proved to be less vaccine resistant and severe than initially feared.
- Inflation expectations increased, and gilt yields generally declined slightly over the quarter.

Mercer market views

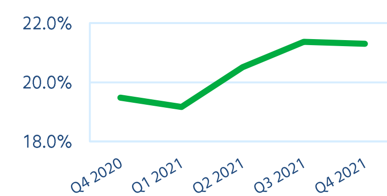
- Our medium term macroeconomic outlook for 2022 remains solid despite some turbulence in January.
- Low unemployment should bolster an consumption driven recovery, and inflation is likely to peak in the coming months and fall back towards central bank targets.
- Our outlook for returns over a 1-3 year time horizon for the major asset classes are summarised below:

Funding level and risk

- The funding level is estimated to have improved over Q4 to c.102%, as asset growth outweighed the rise in the value of the liabilities.
- It is estimated to have increased by 7% over the year to 31 December 2021 (as illustrated to the right).



- The Value-at-Risk rose over the quarter to £1,233m, mainly due to the increased allocation to equities under the new strategic asset allocation.
- It was however broadly unchanged as a percentage of liabilities at 21.3%.
- Risk as a proportion of liabilities is lower compared to last year thanks to the decision to move to the dynamic equity option strategy.



Executive summary

Performance

- Most assets delivered positive returns over the quarter, particularly the global equity portfolios.
- Property and Infrastructure also generally fared well.

- Underperformance relative to the strategic benchmark over the one and three year period to 31 December 2021 is mainly due to the impact of the equity protection strategy.
- 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 Secured Income mandate has also done well over the year.

	3 Months (%)	1 Year (%)	3 Years (% p.a.)
Total Fund **(1)**	3.6	14.2	8.2
Strategic Benchmark **(2)** (ex currency hedge)	3.8	16.0	10.3
Relative **(1 - 2)**	**-0.2**	**-1.8**	**-2.1**

- Absolute returns for all global equity mandates have been comfortably above the strategic returns modelled at the last investment strategy review in March 2019, given the strength of equity markets. Emerging market equities fell below strategic expectations prior to termination in Q4, due to contractions in 2021.
- Infrastructure returns have been above expectations, and the Brunel UK Property mandate has had a good first year. Returns from the Partners Overseas Property mandate are below strategic expectations since 2019, though it has fared better over longer time horizons.

Asset allocation and strategy

- During the quarter, the Fund transferred most holdings in the Low Carbon Equity fund to the Brunel passive Paris-Aligned Equity fund.
- It also terminated its holdings in Emerging Markets Equity, for which the strategic allocation was distributed between the High Alpha and Sustainable Equity mandates (which still contain emerging markets exposure).
- In practice the High Alpha holdings were topped up during the period, with the Sustainable Equity top-up to take place in 2022 using the remaining Low Carbon equity holdings.
- From a strategic perspective, the allocation to Diversified Returns was also 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.
- 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 their investment guidelines over the quarter.
- No triggers were breached over the quarter.
- The recent recalibration of the Fund’s Liability Benchmark Portfolio showed that the interest rate and inflation hedge ratios were broadly in line with the respective 10% and 40% targets.

Equity option mandate

- Market value of options at end of the quarter was negative (£25m) as equity markets have risen since inception of the dynamic strategy in May, and overall markets rose further over Q4, despite the mandate protecting against falls in emerging markets.

Collateral position

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

Market background

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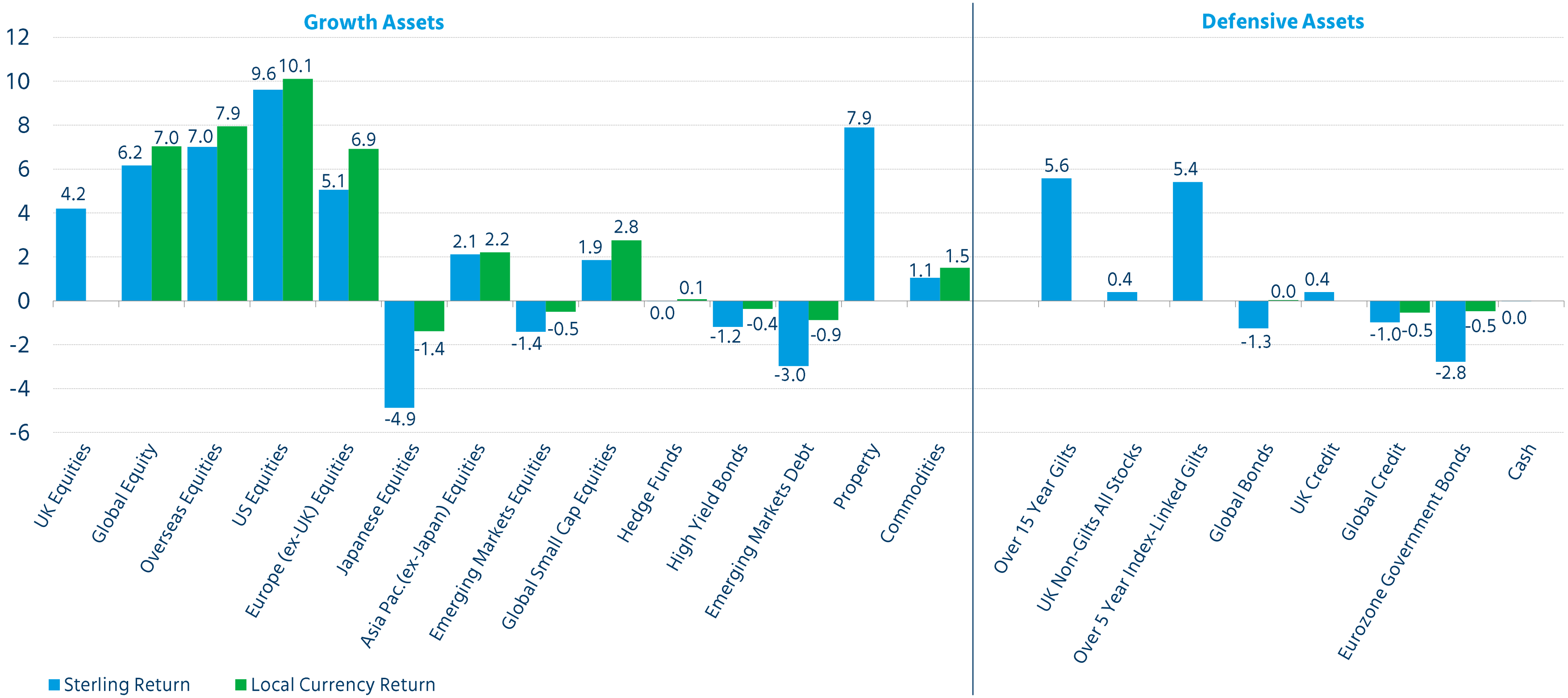
Market background

Return over 3 months to 31 December 2021 (%)



The fourth quarter of 2021 came with a number of challenges. Global supply chains remained stretched and some countries in continental Europe re-introduced Covid-19 related restrictions. This intensified with the discovery of a new variant, Omicron, mid-quarter. To make it worse, soaring inflation forced some major central banks in developed and emerging economies to accelerate their exit strategies from ultra-loose monetary policies. In spite of these headwinds, risk assets fared reasonably well with a few exceptions.

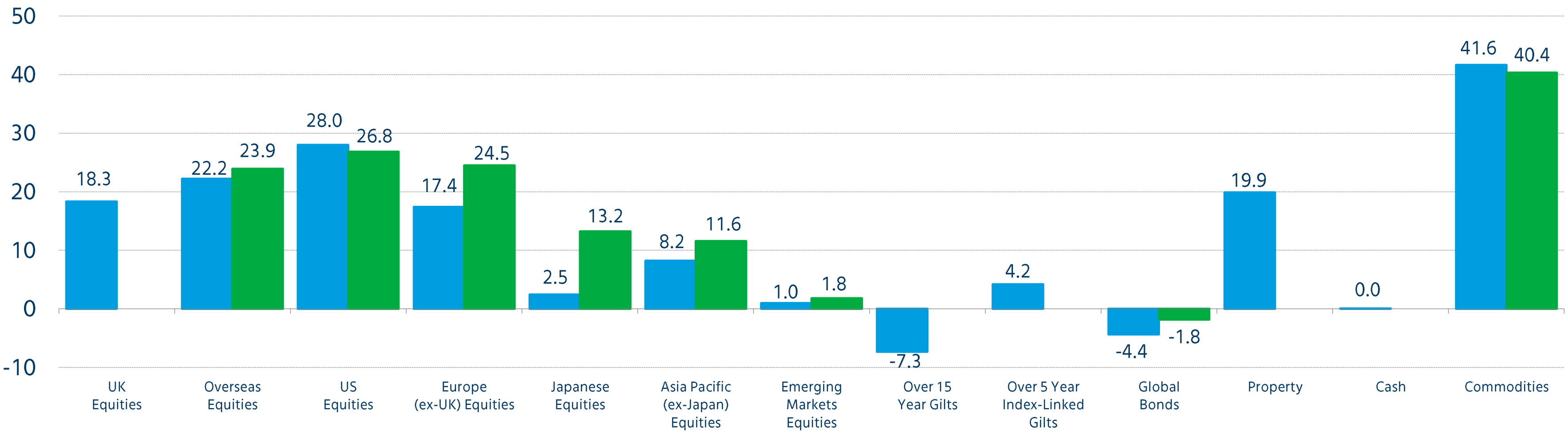
The variant scare eased after it proved to be less vaccine resistant and severe than initially feared. Whilst less accommodative monetary conditions would normally be bad news, markets had been pricing in tighter monetary policy for a while.

Mercer

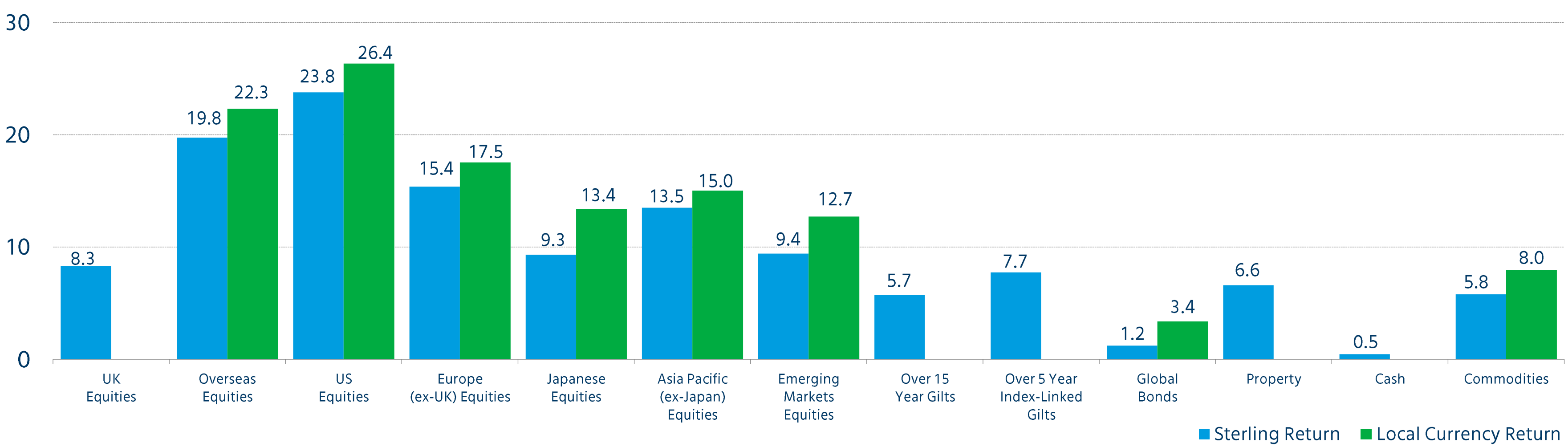
Source: Refinitiv

Market background – longer term

Return over 12 months to 31 December 2021 (%)



Return over 3 years to 31 December 2021 (% p.a.)



Mercer

Source: Refinitiv

Funding level and risk

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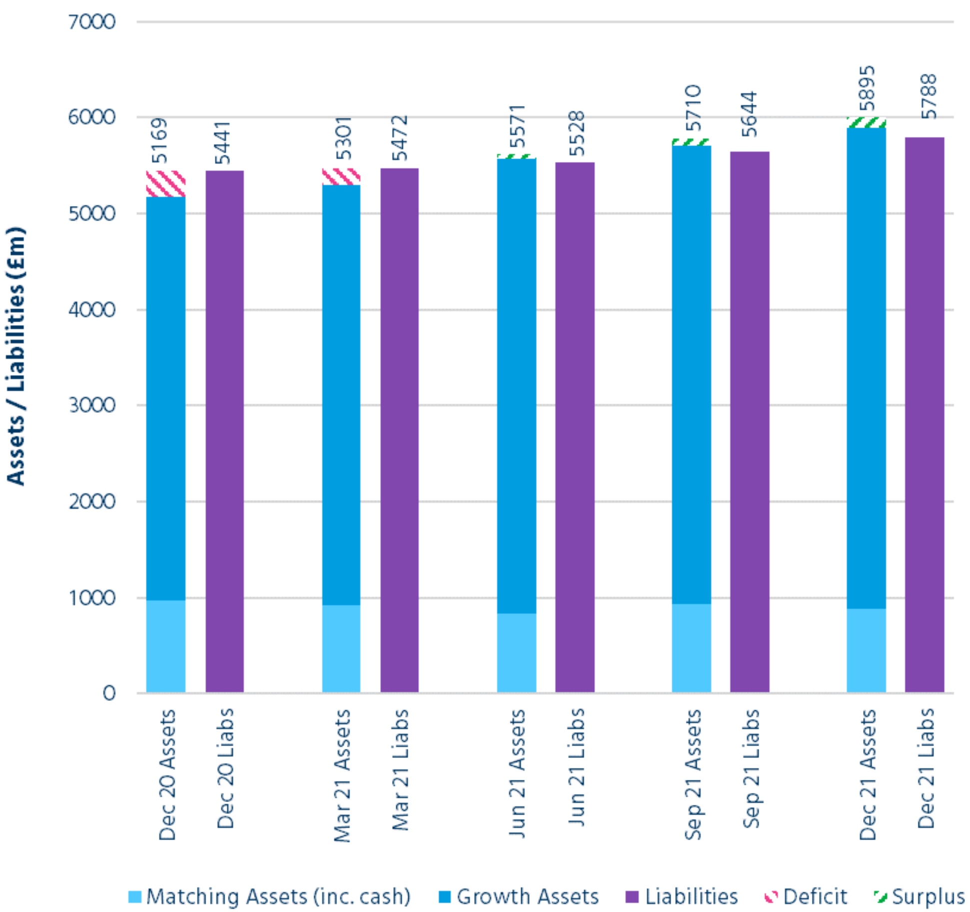
Change in deficit



Based on financial markets, investment returns and net cashflows into the Fund, the surplus was estimated to have increased further over Q4 to £107m.

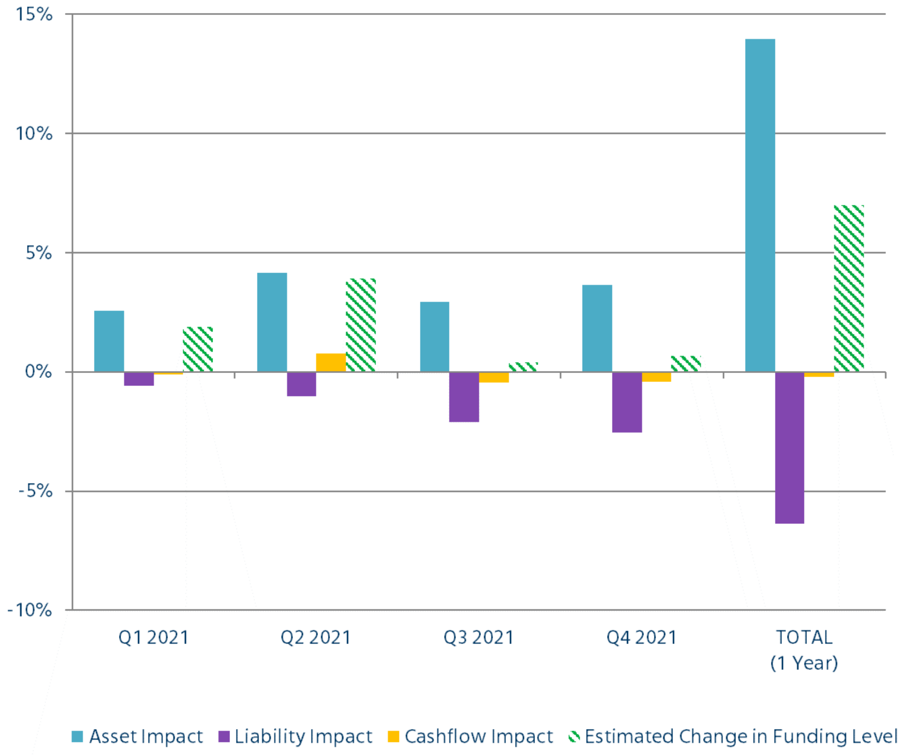
This occurred as the value of the assets rose by more than the present value of the liabilities over the period.

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.

Mercer

Funding level attribution



The Fund's assets returned 3.6% over the quarter, whilst the liabilities are expected to have increased by c. 2.6% 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 102%.

The funding level is estimated to have increased by c. 7% over the year to 31 December 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.

- As at 31 December 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 increased allocation to equities under the new strategic asset allocation, as well as the rise in the absolute value of the assets.

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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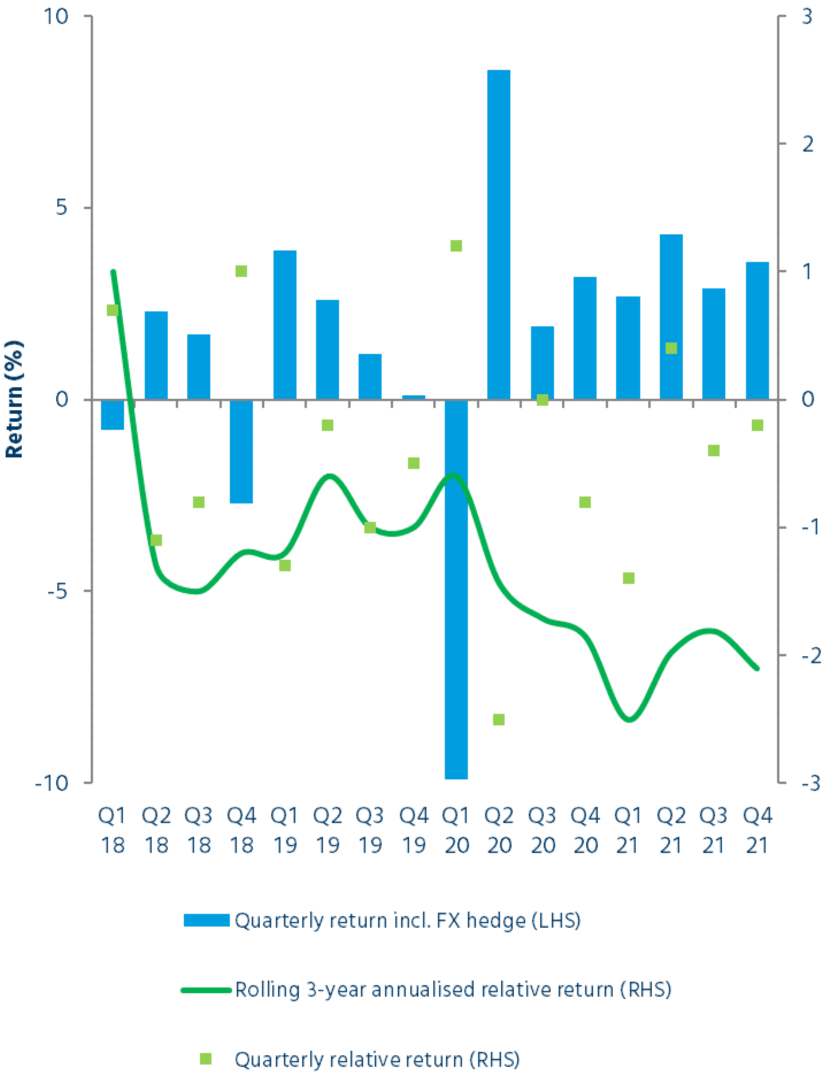
Total Fund performance



	3 Months (%)	1 Year (%)	3 Years (% p.a.)
Total Fund **(1)**	3.6	14.2	8.2
Total Fund (ex currency hedge)	3.3	14.0	7.8
Strategic Benchmark **(2)** (ex currency hedge)	3.8	16.0	10.3
Relative (1 - 2)	**-0.2**	**-1.8**	**-2.1**

Commentary

- Most assets delivered positive returns over the quarter, with Global Equities doing particularly well. Property and Infrastructure also had a strong period amid a benign valuation environment for the underlying assets.
- The Fund underperformed its benchmark mainly due to the detraction from the equity protection as developed equities were strong, and underperformance of the High Alpha mandate and multi-asset mandates against their benchmarks. The Currency Hedge overlay added to overall returns due to a strengthening of sterling.
- High Alpha underperformed due to stock selection and an overweight to China, though elsewhere within the equity portfolio, the Sustainable Equity mandate outperformed thanks to sector allocation, particularly in IT. These mandates make up over a quarter of the Fund's strategic allocation.
- 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. Secured Income has also done well over the year.
- 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.

Mercer

Mandate performance to 31 December 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	7.9	7.3	+0.6	23.4	22.9	+0.4	19.6	19.2	+0.3	-	N/A
Brunel Global High Alpha Equity	6.3	7.4	-1.0	21.9	23.5	-1.3	N/A	N/A	N/A	+2-3	N/A
Brunel Global Sustainable Equity	6.8	6.3	+0.5	20.5	20.1	+0.3	N/A	N/A	N/A	+2	N/A
Brunel Passive Global Low Carbon Equity	7.4	7.4	0.0	23.1	23.2	-0.1	20.1	20.2	-0.1	-	N/A
Brunel Emerging Market Equity	-1.8	-1.7	-0.1	-1.9	-1.3	-0.6	N/A	N/A	N/A	+2-3	N/A
Brunel Diversified Returns Fund	0.5	0.8	-0.3	5.5	3.1	+2.3	N/A	N/A	N/A	+4-5	N/A
Brunel Private Debt	-0.9	1.0	-1.9	N/A	N/A	N/A	N/A	N/A	N/A	-	N/A
JP Morgan FoHF	0.2	0.8	-0.6	4.9	3.2	+1.7	10.0	4.3	+5.5	-	Target met
Brunel Multi-Asset Credit	0.4	1.0	-0.6	N/A	N/A	N/A	N/A	N/A	N/A	-	N/A
Brunel UK Property	7.9	7.5	+0.4	N/A	N/A	N/A	N/A	N/A	N/A	-	N/A
Partners Overseas Property*	4.4	2.5	+1.8	5.7	10.0	-3.9	2.1	10.0	-7.2	-	Target not met
Brunel Secured Income	2.1	2.4	-0.3	10.7	5.4	+5.0	N/A	N/A	N/A	+2	N/A
IFM Core Infrastructure	3.3	1.3	+2.0	15.6	5.2	+9.9	8.9	5.6	+3.1	-	Target met
Brunel Renewable Infrastructure	4.6	2.4	+2.1	3.4	5.4	-1.9	N/A	N/A	N/A	+4	N/A
Brunel Private Debt	-0.9	1.0	-1.9	N/A	N/A	N/A	N/A	N/A	N/A	-	N/A
BlackRock Corporate Bonds	1.1	1.1	0.0	-4.9	-4.9	0.0	7.3	7.4	0.0	-	N/A
BlackRock LDI	1.0	1.0	0.0	48.0	48.0	0.0	8.1	8.1	0.0	-	N/A
Equity Protection Strategy	-0.9			-5.7			-5.0			-	N/A

Since inception performance for Partners, which was the largest underperformer over the three year period, has been more favourable at 5.7% p.a. *

Source: Investment Managers, Custodian, Mercer estimates. Returns are net of fees.
Returns are in GBP terms, except for JP Morgan 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 September 2021 as this is the latest date that this is available. The mandate's inception was in 2009.

Mercer

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 (%)
Global Equity	760,524	1,086,633	13.3	18.4	17.0	12	-	22	+1.4
Global Sustainable Equity	607,893	649,094	10.6	11.0	14.5	9.5	-	19.5	-3.5
P. Low Carb/ Paris-Aligned Equity	763,187	822,170	13.4	13.9	10.0	5	-	15	+3.9
Emerging Market Equity	280,490	-	4.9	-	-	-	-	-	-
Diversified Returns Fund	533,213	535,962	9.3	9.1	6.0	4	-	10	+3.1
Fund of Hedge Funds*	288,796	228,309	5.1	3.9	-	No set range			-
Multi-Asset Credit	322,864	324,157	5.7	5.5	6.0	3	-	9	-0.5
Property	346,729	383,740	6.1	6.5	7.5	5	-	10	-1.0
Secured Income**	385,384	438,515	6.7	7.4	10.0	5	-	15	-2.6
Core Infrastructure	403,824	416,777	7.1	7.1	5.0	2.5	-	7.5	+2.1
Renewable Infrastructure**	70,741	80,341	1.2	1.4	5.0	2.5	-	7.5	-3.6
Private Debt	19,530	42,418	0.3	0.7	5.0	0	-	7.5	-4.3
Corporate Bonds	132,115	133,538	2.3	2.3	2.0	No set range			+0.3
LDI & Equity Protection	630,516	615,390	11.0	10.4	12.0	No set range			-1.6
Cash***	164,295	137,325	2.9	2.3	-	0	-	5	+2.3
Total	**5,710,314**	**5,894,582**	**100.0**	**100.0**	**100.0**				

Source: Custodian, Investment Managers, Mercer. 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.

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	275,451		297,132	4.8	5.0
Brunel	Global High Alpha Equity	448,289	275,580	756,038	7.9	12.8
Brunel	Global Sustainable Equity	607,893		649,094	10.6	11.0
Brunel	Global Low Carbon Equity	763,187	-574,942	225,669	13.4	3.8
Brunel	Passive Dev Eq Paris Aligned	0	574,901	596,501	0.0	10.1
Brunel	Emerging Market Equity	280,490	-275,580	0	4.9	0.0
Brunel	Diversified Returns Fund	533,213		535,962	9.3	9.1
JP Morgan	Fund of Hedge Funds	288,796	-59,332	228,309	5.1	3.9
Brunel	Multi-Asset Credit	322,864		324,157	5.7	5.5
Brunel	UK Property	140,467	43,880	198,282	2.5	3.4
Schroder	UK Property	29,669	-17,980	11,909	0.5	0.2
Partners	Overseas Property	176,593	-8,030	173,549	3.1	2.9
Brunel	Secured Income*	385,384	44,062	438,515	6.7	7.4
IFM	Core Infrastructure	403,824		416,777	7.1	7.1
Brunel	Renewable Infrastructure*	70,741	6,130	80,341	1.2	1.4
Brunel	Private Debt	19,530	22,963	42,418	0.3	0.7
BlackRock	Corporate Bonds	132,115		133,538	2.3	2.3
BlackRock	LDI & Equity Protection	630,516		615,390	11.0	10.4
Record	Currency Hedging**	16,330	-12,000	22,354	0.3	0.4
BlackRock	ETF	102,066	-40,000	65,532	1.8	1.1
Internal Cash	Cash***	80,830		81,060	1.4	1.4
Total		5,710,314	-20,451	5,894,582	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.
*** Start of quarter valuation includes assets in transit.

Appendix

Q4 2021 equity market review

Equity markets performance was strong over the fourth quarter.

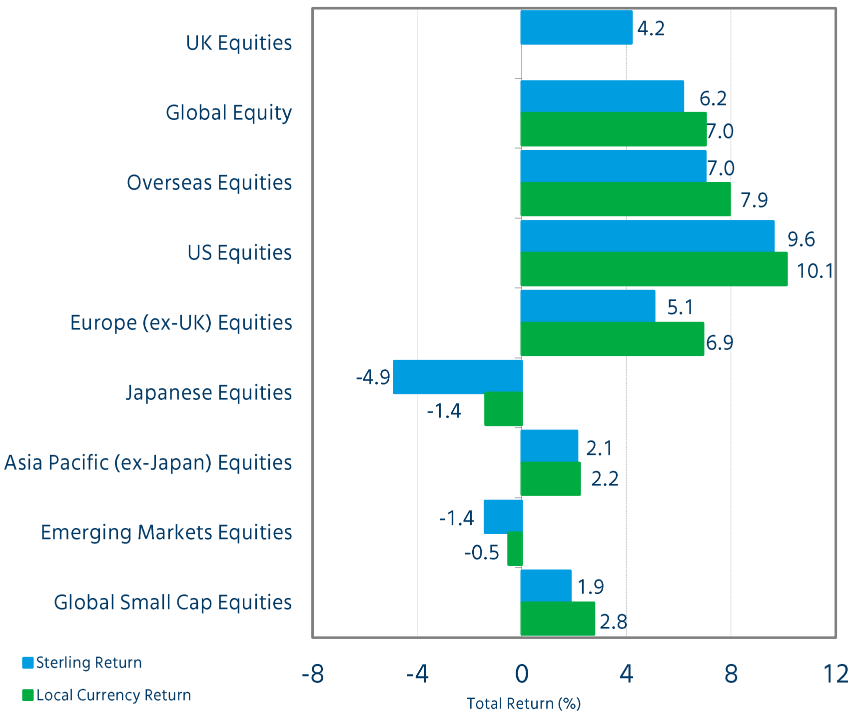
Global Equities returned 7.0% in local currency terms. Markets sold off mid-quarter as the risk of meaningful Covid-19 restrictions returning following the discovery of the latest variant were priced in; but rallied towards year end when this did not materialise.

US equities returned 10.1% in local terms, supported by the favourable earnings outlook, whilst **European (ex-UK) equities** returned 6.9%. **Japanese equities** stood out as the only large developed market with negative returns of -1.4%. For both Europe and Japan, the aforementioned supply chain stresses and high energy prices were headwinds.

Emerging markets equities returned -0.5% in local terms. Russian and Brazilian equity markets performed poorly over the quarter as the commodity price rally stalled somewhat, China continued to grapple with the impact of the property market slowdown on the wider economy whilst supply chain stresses were also a headwind for South Korea.

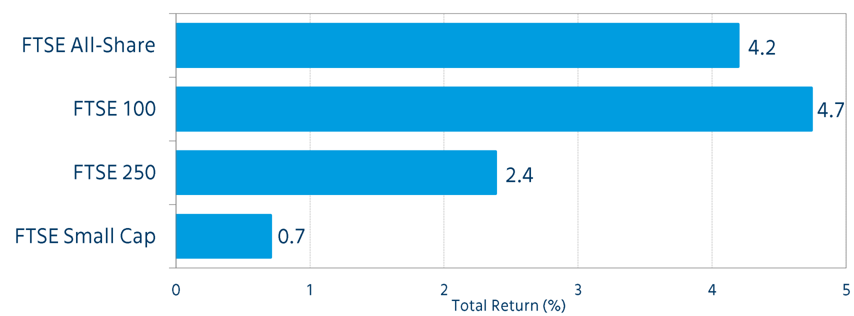
Global small cap stocks returned 2.8% in local terms. Small caps lagged global equities as investors opted for less cyclical stocks in a quarter that cast some doubt on the durability of the economic rebound, at least in the short term.

Equity Performance - Three Months to 31 December 2021



The FTSE All Share index returned 4.2% over the quarter with the large cap FTSE 100 index returning 4.7%. UK small cap and mid-cap stocks produced positive returns, after initial sell-offs amid the risk of the latest Covid-19 variant on consumption and business activity in the short term.

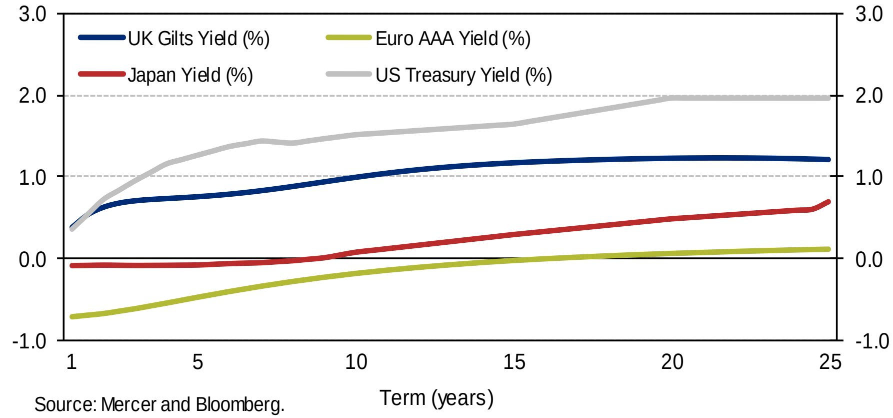
FTSE Performance by Market Cap - Three Months to 31 December 2021



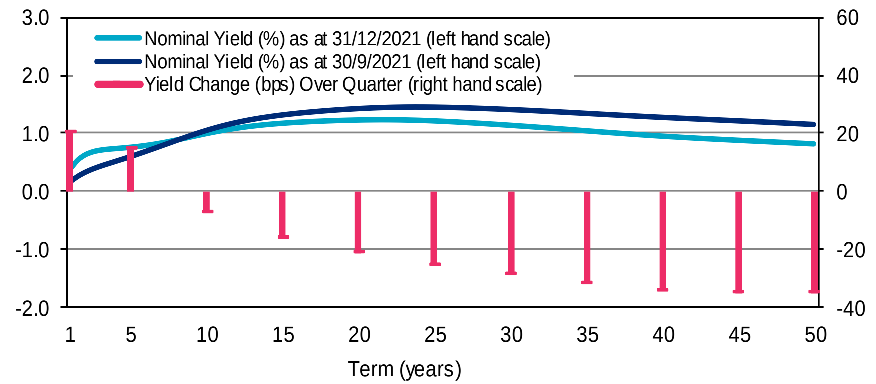
Mercer

Source: Refinitiv

Q4 2021 bond market review



Source: Mercer and Bloomberg.
End date taken as at 30 December 2021.



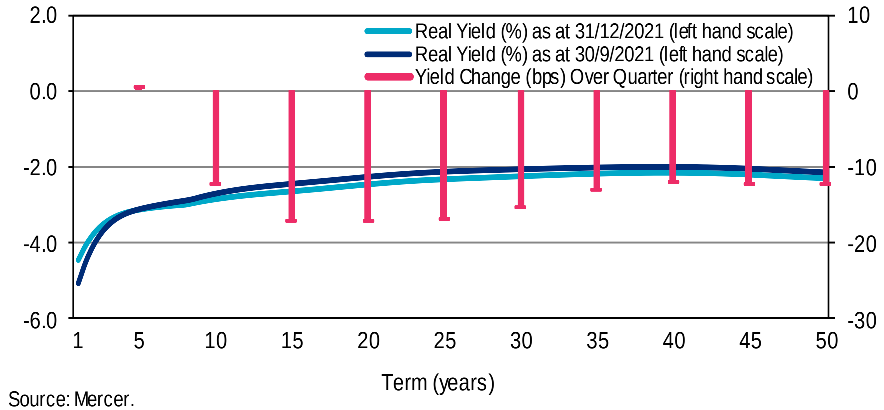
Source: Mercer.
End date taken as at 31 December 2021.

Government Bond Yields

Global government bond yields generally declined slightly over the quarter as concerns around the Omicron variant sparked risk-off sentiment. Gilt yields fell by most compared to other countries and the curve flattened, whereas US 10-year Treasuries remained largely unchanged over the quarter.

Both the Federal Reserve and the Bank of England signalled less accommodative stances, heralding an end to ultra-loose monetary policy. This triggered an increase in short term rates in both the US and UK. The effect was less pronounced in the Eurozone.

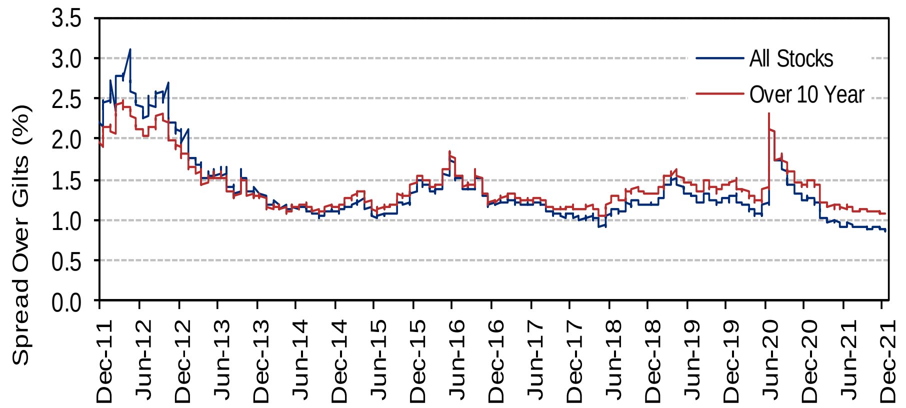
Q4 2021 bond market review



Source: Mercer.
End date taken as at 31 December 2021.

UK Index-Linked Gilt Yields

UK real yields fell across the curve, except for at the short end. Market based measures of inflation expectations, in the form of breakeven inflation, shifted upwards which added to the modest fall in nominal yields. The UK 10-year breakeven rate rose to 4.2% intra-quarter but fell back to 4.0% by quarter end – still the highest level since the 2008 Financial Crisis.



Source: Refinitiv.
End date taken as at 31 December 2021.

Corporate bonds

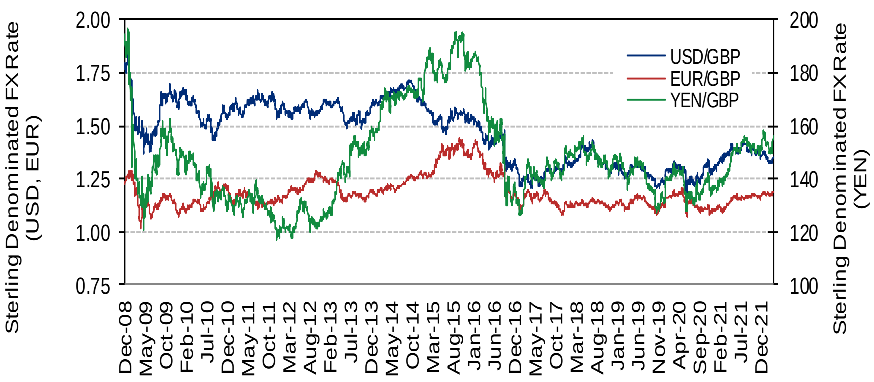
Spreads on UK investment grade credit generally rose which largely offset the decrease in gilt yields, leading to almost flat performance over the quarter.

Mercer

Q4 2021 currency market review

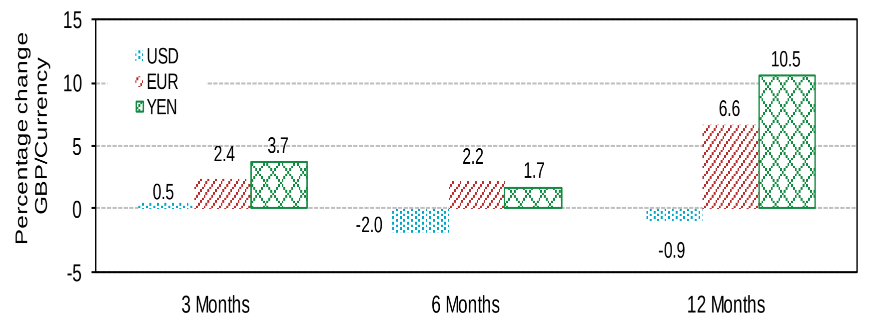
Sterling appreciated against the US dollar, euro and yen over the quarter, following the Bank of England's interest rate increase at year end. For the year as a whole, sterling has appreciated considerably vs yen and euro as stronger economic growth and the prospect of rising UK yields makes sterling more attractive relative to the former two, but has weakened marginally against US dollar as US monetary conditions are tightening as well.

Sterling Denominated FX Rate



Source: Refinitiv.

Change in sterling against foreign currencies



Source: Refinitiv.
Performance figures for 3 months, 6 months and 12 months are show n since 31 December 2021, 30 June 2021 and 31 Decemeber 2020 to 31 December 2021 respectively.

Q4 2021 property

UK property as measured by the MSCI Index increased by 7.9% over the quarter to 31 December 2021.

Mercer

Source: Refinitiv

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	Passive Paris Aligned Developed Equity	FTSE Developed World PAB Index	-	October 2021
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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