Mercer

Avon Pension Fund

Panel Investment Report
Quarter to 31 March 2022

May 2022

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Contents

Executive summary

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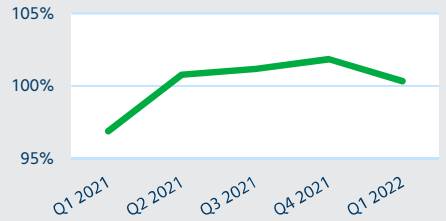
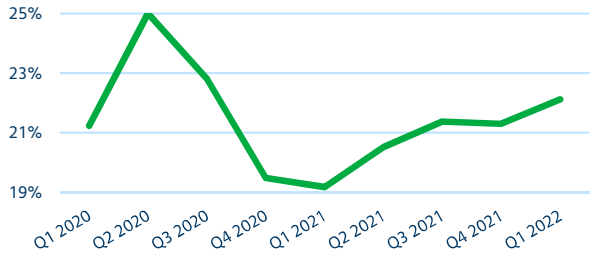
Executive summary

Market background	• The first quarter of 2022 was dominated by Russia's invasion of Ukraine and changes in central bank policies. These led to large movements in asset prices and elevated levels of volatility, with both equities and bonds delivering negative returns. • Inflation expectations increased over the quarter, and gilt yields rose significantly.
Mercer market views	• Our medium term outlook is mixed after the turbulent start to 2022, given the crosscurrents at play. • The rise in inflation and increasing bond yields are negatives for equities and growth fixed income, while geopolitical risks around the globe remain elevated. On the other hand, corporate profit growth should remain resilient in 2022 and interest rates should remain low for several quarters as they take time to "normalise".
Funding level and risk	• The funding level is estimated to have decreased marginally over Q1 to c.100%, as the assets fell in value whilst the liabilities rose slightly. • It is estimated to have increased by 3% over the year to 31 March 2022 (as illustrated to the right).
	• The Value-at-Risk rose over the quarter to £1,284m, due to increased volatility in equity, interest rates and inflation markets. • It also increased as a percentage of liabilities to 22.1%. • Risk as a proportion of liabilities has increased over the year, although remains below the levels of 2020. From Q4 2020, the VaR figures reflect the move from a static to a dynamic equity option strategy.





Executive summary

Performance

- The Fund assets fell in value primarily due to negative returns from the equity portfolio. The multi asset portfolios also delivered negative returns.
- The alternatives in real assets and the LDI portfolio offset some of the impact from equities, as they delivered positive returns.
- Underperformance relative to the strategic benchmark over the one and three year period to 31 March 2022 is mainly due to the impact of the equity protection strategy, although significant underperformance from the High Alpha and Sustainable Equity portfolios over Q1 2022 has also contributed over the year. This pattern of relative performance is not unexpected given that growth stocks have been re-rated due to rises in interest rates. Carbon heavy stocks performed relatively well over the quarter.

	3 Months (%)	1 Year (%)	3 Years (% p.a.)
Total Fund **(1)**	-1.1	10.0	6.5
Strategic Benchmark **(2)** (ex currency hedge)	1.6	13.3	9.1
Relative **(1 - 2)**	**-2.7**	**-3.3**	**-2.6**

- Conversely the real assets have done well over the one and three years against their benchmark, so relative performance at the mandate level has been mixed overall.
- The Currency Hedge overlay detracted from returns over the quarter and one year period due to a weakening of sterling, though it has added to returns over the three year period.
- Absolute returns for all global equity mandates, except for the recently-incepted Paris Aligned mandate, have been above the strategic returns modelled at the last investment strategy review in March 2019, given the strength of markets over this period.
- UK Property, Secured Income and Core Infrastructure have also done well relative to strategic expected returns.

Asset allocation and strategy

- During the quarter, the Fund completed the equity portfolio transitions with the top-up of the Sustainable Equity mandate and termination of the Low Carbon mandate.
- 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.
- c£22m was drawn down to Brunel private market portfolios during the period.

Market background

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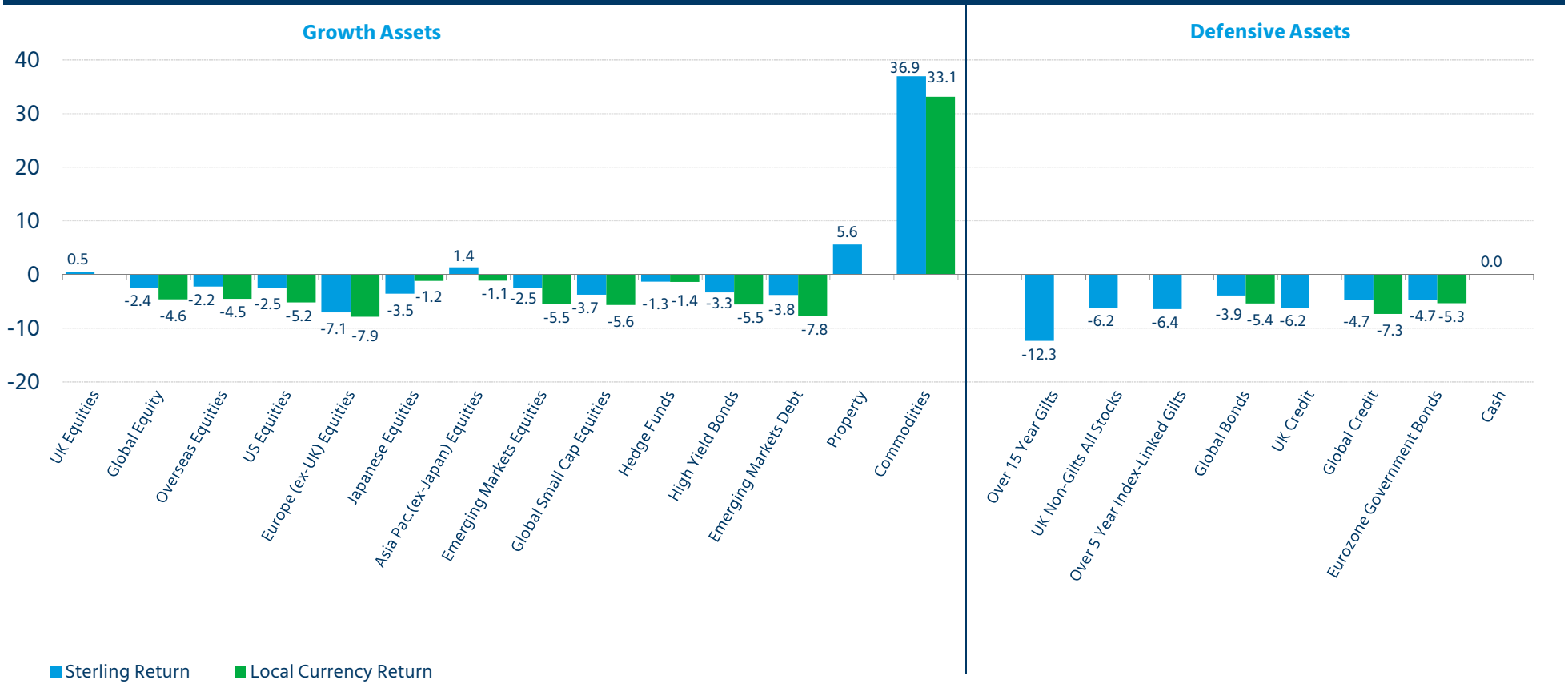
Market background

Return over 3 months to 31 March 2022 (%)



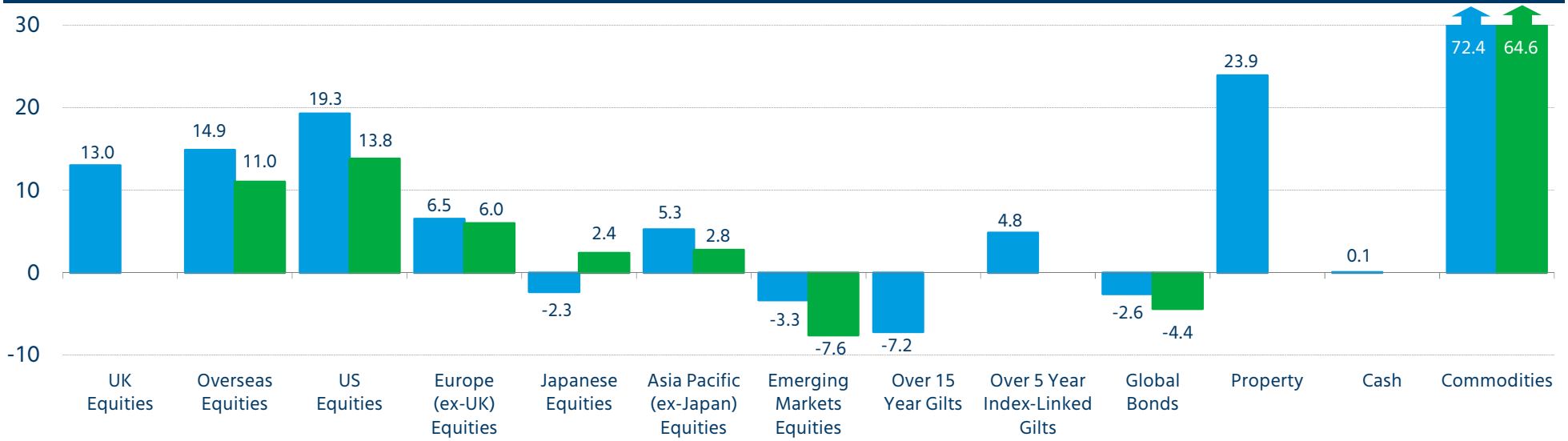
The first quarter of 2022 was dominated by Russia's invasion of Ukraine and central bank policy. This led to large movements in asset prices and elevated levels of volatility.

2022 started on a positive note. Most developed countries elected not to re-introduce far reaching pandemic-related restrictions, which supported demand. Although inflation came in at elevated levels, a combination of improving supply chains and moderate monetary tightening was expected to bring it under control. The invasion of Ukraine and subsequent spike in commodity markets completely changed this narrative, however. Central banks were forced to accelerate this pace of tightening even as growth expectations were dialed down. Commodity markets were the only asset class to produce positive absolute returns over the quarter as equity and bond markets struggled to navigate the ongoing uncertainty.

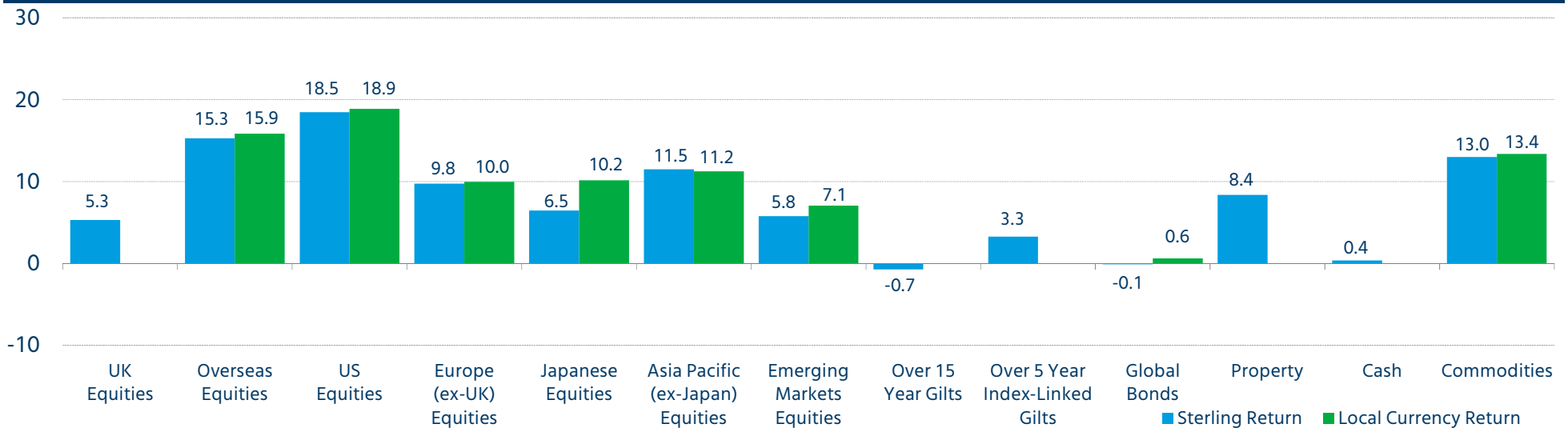
Source: Refinitiv

Market background – 1 & 3 years

Return over 12 months to 31 March 2022 (%)



Return over 3 years to 31 March 2022 (% p.a.)



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Source: Refinitiv

Mercer market views

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Market Outlook (April 2022)

Overweight Neutral weight Underweight

Mercer's current position/view

Position/view last time (if changed)

Global equities weakened in what was a volatile quarter in response to the Ukraine crisis, much higher inflation and the associated hawkish turn by many of the world's central banks. After seven consecutive quarterly gains since the COVID low in March/April 2020, the US S&P500 lost c.2% (GBP return), although losses had been double that in the weeks immediately after the Russian incursion into Ukraine. There were large dispersions within and across markets, with commodity exporters/producers generally doing a lot better than importers/buyers. Global bond yields rose sharply to their highest level in several years as inflation rose to levels not seen since the 1980's in the US and also reached multi-decade highs in other developed economies. Commodity prices surged, especially those produced in large quantities in Russia and Ukraine, such as oil, natural gas and wheat. Oil prices fell back a little into quarter end, allowing global equities to recover some of their losses towards quarter end, however, government bonds continued to weaken.

Global economic growth was strong at the end of 2021, but there were signs of slower growth at the start of 2022 as higher inflation started to eat into household incomes. This was especially the case in Europe, which relies much more on energy imports than the US, in particular large imports of Russian natural gas, whose price has skyrocketed. Despite this, the global economy has remained resilient in part because Europe and some other regions are benefiting from a gradual recovery in tourism and other sectors affected by the COVID pandemic, and labour markets are exceptionally strong. China remained a key outlier globally with its economy remaining under pressure from COVID-related lockdowns.

We expect the global economy to remain resilient, despite the surge in commodity prices and higher bond yields. These are likely to turn what would have been a great year in terms of global GDP growth into merely a decent year. However, the crisis in Ukraine is not over and with the timing and scope of an eventual end to the conflict unclear, there remain significant risks to global GDP. As we peer into 2023 and 2024, the risks of a hard landing or recession in the US have grown with the Federal Reserve set to raise interest sharply this year and into next.

Inflation has risen sharply in recent quarters and is at very elevated levels almost everywhere with the notable exceptions of Japan and China. Much of the inflation increase, such as the jump in used car prices and some energy prices, is likely transitory and will unwind, although the timing of that unwind is unclear. However, higher labour costs on the back of very low unemployment and strong labour demand are likely to persist and these should continue to put upward pressure on inflation for some time. The US stands out as having the tightest labour market and thus the highest inflation risk.

We expect monetary policy to be tightened almost everywhere with the key exceptions of China and Japan. The Fed has said it wants to get its policy rate to neutral, which it estimates at 2.4%[1]. To tame inflation the Fed might have to increase interest rates higher than the neutral rate and the higher it goes, the greater the risk of a subsequent US recession. Other central banks are not perceived to be as far behind the curve as the US and can proceed more cautiously. We expect the Bank of England to continue to hike interest rates, but stop sooner than the Fed and be more responsive to any signs of material economic weakness caused by higher inflation and tighter fiscal policy. The ECB is set to embark on an interest rate hiking cycle before year-end, although is likely to move cautiously. Central banks are also set to tighten monetary policy by reducing the size of balance sheets: so-called quantitative tightening.

There are a number of powerful crosscurrents to consider when assessing the outlook for key asset classes and weighing the significance of them is particularly challenging at the moment. The sharp rise in inflation, increasing bond yields and central bank policy is a key negative for equities and growth fixed income, while geopolitical risks from Ukraine and elsewhere around the globe remain elevated. On the other hand, corporate profit growth should remain resilient in 2022 and interest rates should remain low for several quarters as they take time to "normalize". Bond yields have already risen sharply with 2022Q1 being one of the worst quarters for developed market government bonds ever. While the chance of a near term pause has gone up, we still think bond yields will move higher on a 1-3 year view.

We have positioned our portfolio more cautiously as the current uncertainty makes it hard to have strong conviction anywhere and valuations have not come in enough to justify buying into the dip just yet. On the main asset classes, we have moved equities and growth fixed income back to neutral and increased our cash position to seize future opportunities if markets sell off more. Within equities, we have removed our preference to small caps and emerging markets. We have become slightly less negative on duration to reflect how bond markets have already priced in some of the tighter monetary outlook. We have left the growth and defensive fixed income sub asset class positions unchanged.

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

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The views on these slides are as at April 2022, and the charts summarise Mercer's views on the medium term (1-3 years) outlook for returns .

[1]Source: Bloomberg

Listed equities

ASSET CLASS	JANUARY 2022	APRIL 2022	COMMENTARY
Global Equity	Neutral	Neutral	**The MSCI World Index returned -2.3% in GBP terms over 2022Q1 but still had positive returns of 15.9% on a one-year basis.[1] We have maintained our broad market equity sector position at neutral within the global equities portfolio.** Valuations have improved over the quarter but remain at similar levels as one year ago when we did not deem global equities to be outright attractive either. Importantly, the macroeconomic and earnings outlook was much better then as markets were positioning for a reopening boom and inflation was deemed to be transitory. Now, earnings momentum is fading[2], central banks have initiated an aggressive hiking cycle as inflation has proven to be persistent and the conflict in Ukraine and its impact on commodity prices has added uncertainty to already moderating growth and increasing inflation expectations. Investor sentiment as measured by the Bank of America fund manager March 2022 survey has been deteriorating with a large number of investors seeing late cycle dynamics, and fearful of a bear market ahead. Profit expectations as measured by the Citigroup Global Earnings Revisions index turned negative in March 2022 for the first time since mid-2020. We therefore do not believe that current valuations, even if they have improved over the quarter, compensate for these elevated risks just yet. However, we maintain our neutral position as we believe that large companies with pricing power will not necessarily be worse off than more cyclical small caps if a recession materializes, while EM comes with additional idiosyncratic risk.
Global Small Cap Equity	Neutral	Neutral	**The MSCI Small Cap index returned -3.7% in GBP terms over 2022Q1 and 4% on a one-year basis[1]. We have downgraded our small cap allocation from the overweight side of neutral to neutral.** Valuations have improved over the quarter and are also more attractive than a year ago. They are now below their historical average on some metrics and are still more attractive than their large cap counterparts. Nevertheless, we have decided to remove our preference for small caps over large caps this quarter. The macro economic environment has become more challenging and risks are to the upside which affects small caps to the same, if not larger degree than large caps given their more cyclical nature. Their regional focus and lower duration profile may help in a tightening monetary environment marred by geopolitical uncertainty but we do not have sufficient conviction at the moment to maintain our small cap tilt.
Emerging Markets	Neutral	Neutral	**The MSCI Emerging Markets index returned -4.3% in GBP terms over 2022Q1 and -6.8% on a one-year basis[1]. We have downgraded our position at the overweight side of neutral to neutral.** Valuations have improved a lot over the quarter and emerging markets remain the most attractively valued equity sub-sector. Although the increasing uncertainty of the macro and geopolitical environment equally impacts emerging markets, tailwinds exist in the form of commodity exposure from Latin America, and Chinese policy easing rather than tightening. However, the index's heavy Asia and especially China exposure also comes with additional idiosyncratic risks. China's hardline approach to Covid-19 has led to severe restrictions and lockdowns again, covering now the majority of China's largest cities. Rising input prices and slowing global demand could have a negative impact on exporters from China, Korea and Taiwan. Western countries have moved beyond Covid controls which is shifting demand from goods to services. Our conviction level is therefore not strong enough any more to maintain our current preference for emerging over developed market equities.

[1]Source: Bloomberg, DataStream as of end of 1Q2022
[2]Source: Factset

Growth fixed income

ASSET CLASS	JANUARY 2022	APRIL 2022	COMMENTARY
Global Loans	Neutral	Neutral	**Over 2022Q1, global loans returned 2.8% in GBP hedged terms[1]. We have maintained our bank loans position at neutral within the growth fixed income portfolio.** Despite the lower credit quality of the loan index, valuations appear relatively attractive given an average price below par and a yield of 6%. Further, their floating rate nature and senior secured position makes them quite appealing in an environment of more hawkish central banks. Forward looking default rate expectations remain low, and we believe investors are seeing sufficient reward for the level of risk at these levels. Our outlook for elevated interest rate volatility has us favoring the floating-rate nature of the loan asset class versus high yield.
High Yield	Neutral	Neutral	**Over 2022Q1, global high yield returned -2.8% on a GBP hedged basis[1]. We have maintained our global high yield position at the negative side of neutral within the growth fixed income portfolio.** Despite the drawdown, high yield valuations appear slightly rich with spreads still well inside their longer term averages. While strong fundamentals support low default activity going forward, it is worth pointing out that spreads may be vulnerable to an environment with less abundant liquidity and potentially slower economic growth. We hold a slight preference for global loans over high yield given the floating rate nature and senior secured status of the loan asset class.
EM Debt (Local Currency)	Neutral	Neutral	**EMD local currency market returns fell through Q1 2022, posting a return of -3.8% in GBP hedged terms[1]. We have maintained our position at a higher conviction neutral within the growth fixed income portfolio.** We maintain a slight preference relative to Hard Currency due to more attractive spread valuations, historically cheap EM currencies, and generally lower duration profile. Despite the inherent volatility of the sector, LC rates and FX have held up quite well in the face of Russia's invasion of Ukraine. However, the post-pandemic global growth story appears vulnerable in the near term to an escalation in tensions. The sharp rise in commodity prices will drive a number of idiosyncratic stories and will support both headwinds and tailwinds for a number of regions. Further supply disruptions are likely to support an already elevated inflation level further raising the potential for swifter tightening monetary policy globally. Overall, flows have been heavily disrupted by the Russian invasion which could give potential investors pause for thought for some time.
EM Debt (Hard Currency)	Neutral	Neutral	**EMD hard currency markets underperformed through Q1 2022, posting a return of -7.4% in GBP hedged terms[1]. We have maintained our overall neutral allocation within the growth fixed income portfolio.** Spreads continued to widen and remain elevated versus pre-pandemic levels with EM HY spreads being the widest they have been outside of a recession. The recent strength of the US dollar could impact the ability of some EM countries to repay, rising rates and continuing geo-political risks are headwinds, as is the large duration component of the asset class. Whilst Russia's invasion of Ukraine was the largest driver of performance over the quarter, pre-invasion the market was already down c.2.75% with inflationary pressure and rate rises weighing on the duration heavy HC market. Whilst the market saw spreads widen broadly towards the end of February, the largest portions of the initial drawdown appear to be somewhat contained to Russia, Belarus, Ukraine and some neighbouring countries. Recent signals from the Fed point towards a more aggressive hiking path to help tame inflation, with an increasingly hawkish Fed showing no signs that the Russian invasion will impede tightening. This has added fuel to the recent dollar rally which, in tandem with rising US rates, will increase interest payments on HC debt. Sentiment remains vulnerable to the evolution of the Covid pandemic, inflation, US rate hikes and the ongoing situation in Ukraine.

[1]Source: Bloomberg, DataStream as of end of 1Q2022

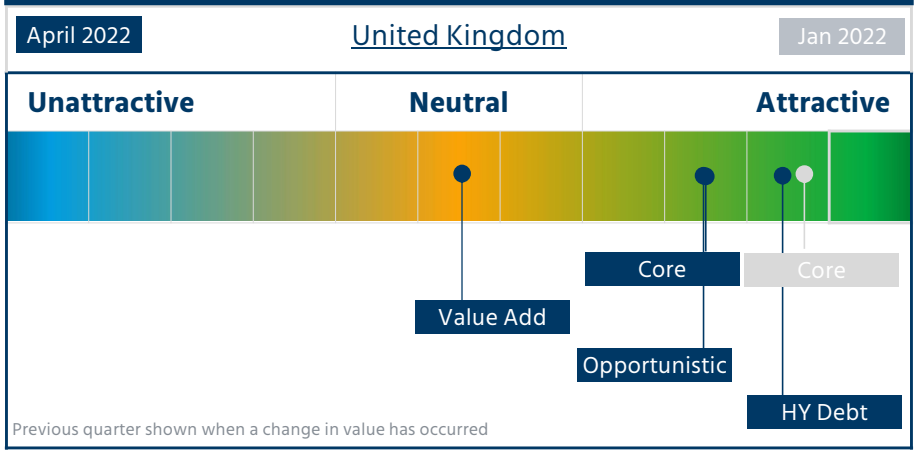
Defensive fixed income

ASSET CLASS	JANUARY 2022	APRIL 2022	COMMENTARY
UK Sovereign Fixed Income	Neutral	Neutral	**Over 2022Q1, UK sovereign bonds returned -3.1% in GBP terms. We have maintained our neutral position in UK sovereign fixed income within the defensive fixed income portfolio.** 10yr gilt yields rose significantly over the quarter, from 0.97% to 1.60%, following two Bank of England (BoE) rate rises in response to elevated levels of inflation. The BoE now expects inflation to run as high as 8% over the coming months, well ahead of its 2% target. The rise in yields has improved our outlook from a valuation perspective, but we acknowledge the potential for further downside given the inflation outlook. The BoE's third hike in a row was no surprise but its more dovish tone contrasted with the Fed, with the BoE acknowledging that households will likely come under significant pressure in the coming months due to surging energy prices. The market is currently pricing in 4 to 5 further rate hikes over 2022, which would take the base rate close to 2%.
UK Inflation-Linked Bonds	Underweight	Underweight	**Over 2022Q1, UK inflation linked bonds returned -5.4% in GBP terms. We maintain our underweight position in the defensive fixed income portfolio.** Despite upside inflation risks, structurally rich valuations and sensitivity to changes in real rates with a more hawkish BoE, supports our underweight position. Although surging nominal yields drove negative quarter-to-date returns as the conflict escalated, inflation-linked bonds gained ground towards quarter end. Real yields fell over March as breakevens widened, supporting the asset class from both a duration and inflation risk perspective. Pre-invasion, there were already concerns over high energy prices, high goods inflation, bottlenecks across supply chains and fears of a deteriorating growth outlook. Supply chains are likely to become even more fractured amidst sanctions on Russian entities and the growth outlook has worsened too. However, we still expect global inflationary pressures to ease as supply chains normalize, seeing current inflation prints falling but remaining above central bank targets for the foreseeable future. From a technical perspective, with stagflation risks rising, demand for inflation protection should remain elevated. UK linkers in particular continue to be supported by a captive local market seeking to hedge inflation risks in long-dated pension liabilities, supported by lack of issuance.
UK Investment Grade Credit	Neutral	Neutral	**Over 2022Q1, UK investment grade credit returned -6.2% in GBP terms. We have maintained UK investment grade credit within the defensive fixed income portfolio at neutral.** Risk-off sentiment dominated and spreads widened over the quarter in all sectors in response to elevated geo-political risk and concerns regarding inflation, economic growth and the rate environment but spreads are still close to their pre-pandemic lows. Despite the heighted risk environment, corporate fundamentals remain solid; balance sheets have largely improved and downgrade and default expectations remains muted. Persistent supply chain bottle necks (with continued Chinese lockdowns), coupled with rising input costs pose a threat to corporate earnings. Households will come under additional strain in the coming months. The market should continue to benefit from technical tailwinds in the form of continued demand for spread product, although the winding-down of asset purchase programs will remove some support. Outsized issuance in 2020 and 2021, coupled with a rising rate environment, should see less supply over 2022 which should be supportive from a technical standpoint.

[1]Source: Bloomberg, DataStream as of end of 4Q2021

Real Estate Outlook and Opportunities

Relative Attractiveness by Fund Style



- **Core:** The strong momentum of the post-pandemic recovery is likely to fade against a backdrop of weaker macroeconomic fundamentals. We have therefore slightly reduced our positive view on core investment strategies compared with last quarter. We expect the core UK institutional investor base to remain focused on income security and inflation protection, such as residential and long lease strategies.

- **Value Add**: Income risk strategies remain at neutral with no change on last quarter. The recovery of occupier markets has surprised on the upside but risks remain elevated for some sectors of occupier demand, for example offices and retail.

- **Opportunistic**: Opportunistic strategies remain attractive in our view. We think there is a good probability of achieving asset acquisitions at discounted pricing as market dislocations play out with 'special situations' most likely to emerge in the retail and leisure sectors. Faster obsolescence due to the growth of ESG requirements may also result in turnaround opportunities for Offices.

- **High Yield Debt**: Real estate debt funds continue to look attractive for income seeking investors as traditional bank lenders remain cautious. Together, these features mean higher margins can be achieved by non-bank lenders particularly outside of London and the most liquid sectors.

Market Outlook

- The combination of elevated inflation and tax increases dampened consumer sentiment in the first quarter, while the outlook for 2022 GDP growth fell by 60bps[1]. However, the expectation remains for decent economic growth at 4.1% for the year. Inflation is likely to rise further in the short term, but is likely to fall back towards the Bank of England's target in 2023. The market implied path for the BoE Bank Rate is for it to rise to around 2% by year-end.

- The outlook for UK real estate remains positive although we expect a moderation of returns following a remarkably strong post pandemic recovery. We think the relative pricing of the sector as a whole should remain fundamentally attractive, especially to income seeking investors, despite the prospect of higher interest rates in the near term. The industrial and residential sectors should continue to outperform offices and retail, although by a much smaller margin than over the past year.

- Our top three sector/geographic picks in terms of real estate fundamentals:

  1. **Mid-market Private Rented Residential:** We prefer strategies targeting higher yielding Private Rented Residential assets that are affordable to average households. The sector has robust supply and demand dynamics and should be attractive to cash flow focused investors in search of diversification and inflation protection. However, operational expertise is vital to minimizing cost inefficiencies.

  2. **Urban Logistics:** The fundamentals of supply and demand remain strong for logistics sites in and around major urban areas, as commerce continues to move towards a home delivery model while supply is generally constrained by competing land uses. Attractive pricing is difficult to achieve for standing assets, however, and so build-to-core strategies appear more attractive.

  3. **Non-fashion retail warehousing:** Following several years of declining values as a result of weakening occupier demand, we think there is now relative value in the sector although risks remain elevated. We think accessible retail parks with rebased rents, sustainable income profiles and low fashion exposure have attractive risk return dynamics at current pricing levels.

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[1]Source: average of forecasts by Goldman Sachs, JP Morgan, and Morgan Stanley

Funding level and risk

4

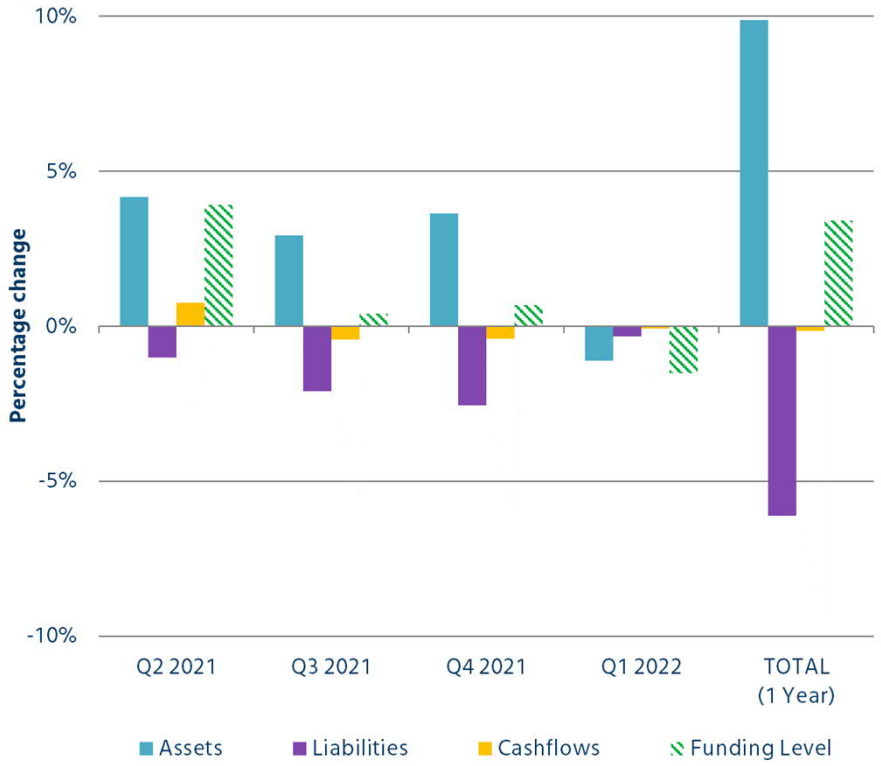
Change in deficit

Based on financial markets, investment returns and net cashflows into the Fund, the surplus was estimated to have decreased over Q1 from £107m to £19m.

This occurred as the value of the assets decreased, whilst the present value of the liabilities increased marginally.

Liability values are estimated by Mercer.
They are based on the actuarial valuation assumptions as at 31 March 2019 and the 'CPI plus' discount basis.

Funding level attribution



The Fund's assets contracted by 1.1% over the quarter, whilst the liabilities are expected to have increased by c. 0.3% due to the rise in inflation.

The combined effect of this, also allowing for expected cashflow over the period, saw the funding level decrease to c.100%.

The funding level is estimated to have increased by c. 3% over the year to 31 March 2022.

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 March 2022, if a 1-in-20 'downside event' occurred over the next three years, the funding position could deteriorate by at least an additional **£1.3bn**.
- 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**, due to increased volatility in equity, interest rates and inflation.

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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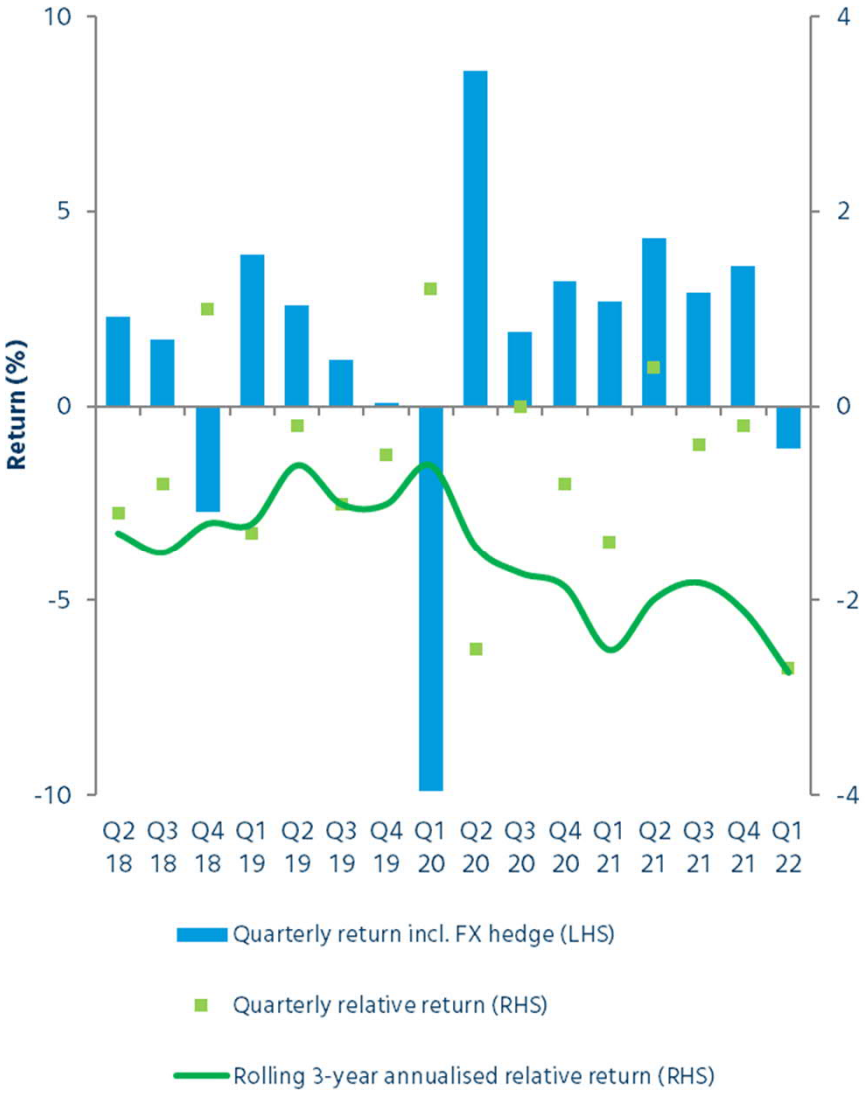
Total Fund performance

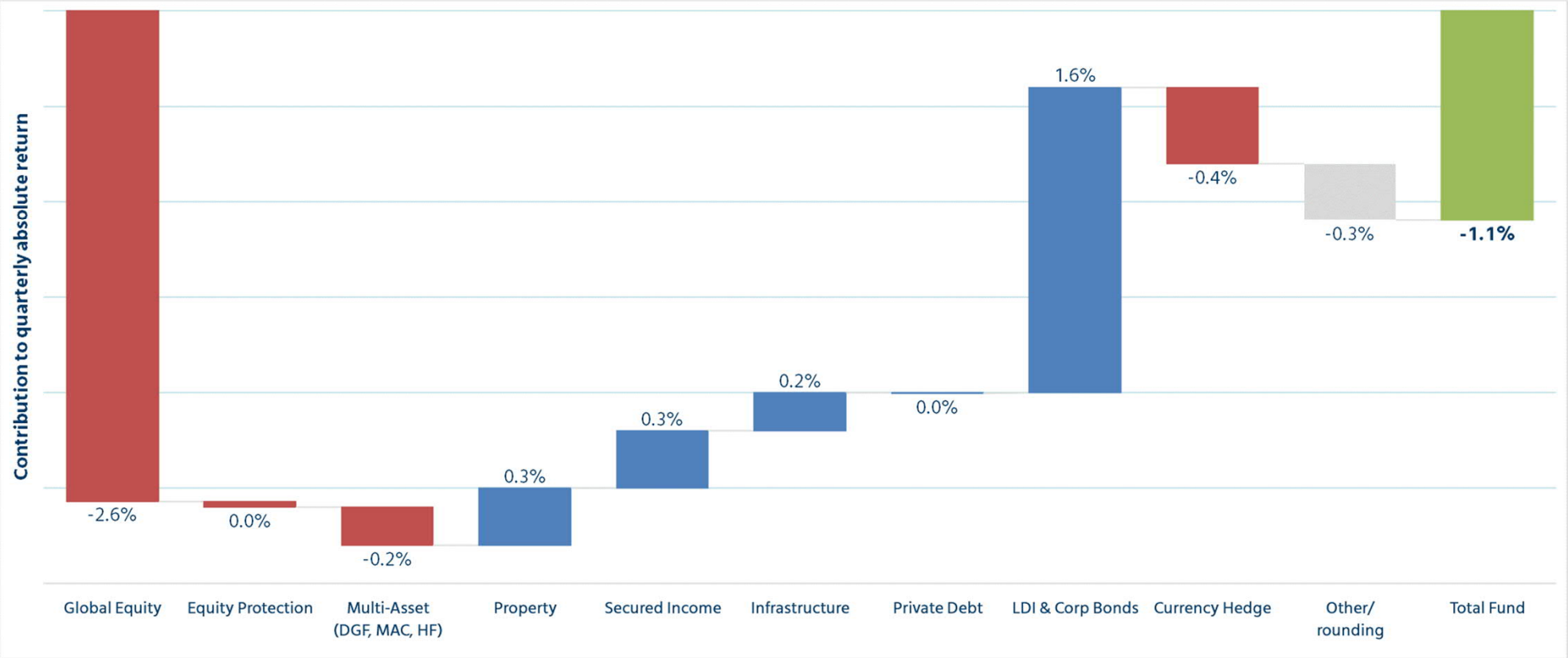


	3 Months (%)	1 Year (%)	3 Years (% p.a.)
Total Fund **(1)**	-1.1	10.0	6.5
Total Fund (ex currency hedge)	-0.7	10.8	6.4
Strategic Benchmark **(2)** (ex currency hedge)	1.6	13.3	9.1
Relative (1 - 2)	**-2.7**	**-3.3**	**-2.6**

Commentary

- As illustrated on the next slide, the Fund assets fell in value over the quarter largely due to negative returns from the equity portfolio. Alternative investments in real assets mitigated this to an extent by delivering positive returns, with the UK Property and Secured Income mandates standing out. The LDI portfolio added to returns due to the rise in inflation.
- Underperformance relative to the benchmark was driven by the High Alpha and Sustainable Equity mandates, and the Multi-Asset mandates underperformed against their 'cash plus' benchmarks. The Alternative investments mitigated this with their own outperformance.
- Over three years, relative performance of the Hedge Fund and Core Infrastructure mandates continues to be strong, and outperformance has also been seen from the Renewable Infrastructure and Secured Income mandates, whose cycle 1 investments have now been in place for this length of time.
- The Equity Protection strategy is the main reason for overall underperformance over the one and three year periods, whilst the Overseas Property portfolio, and more recently the active Equity portfolios, have also detracted.
- Equity market losses have accelerated in to Q2 at the time of writing. In this environment, the Equity Protection has worked as expected and helped protect the portfolio by c.1-2%.

Total Fund performance attribution – quarter



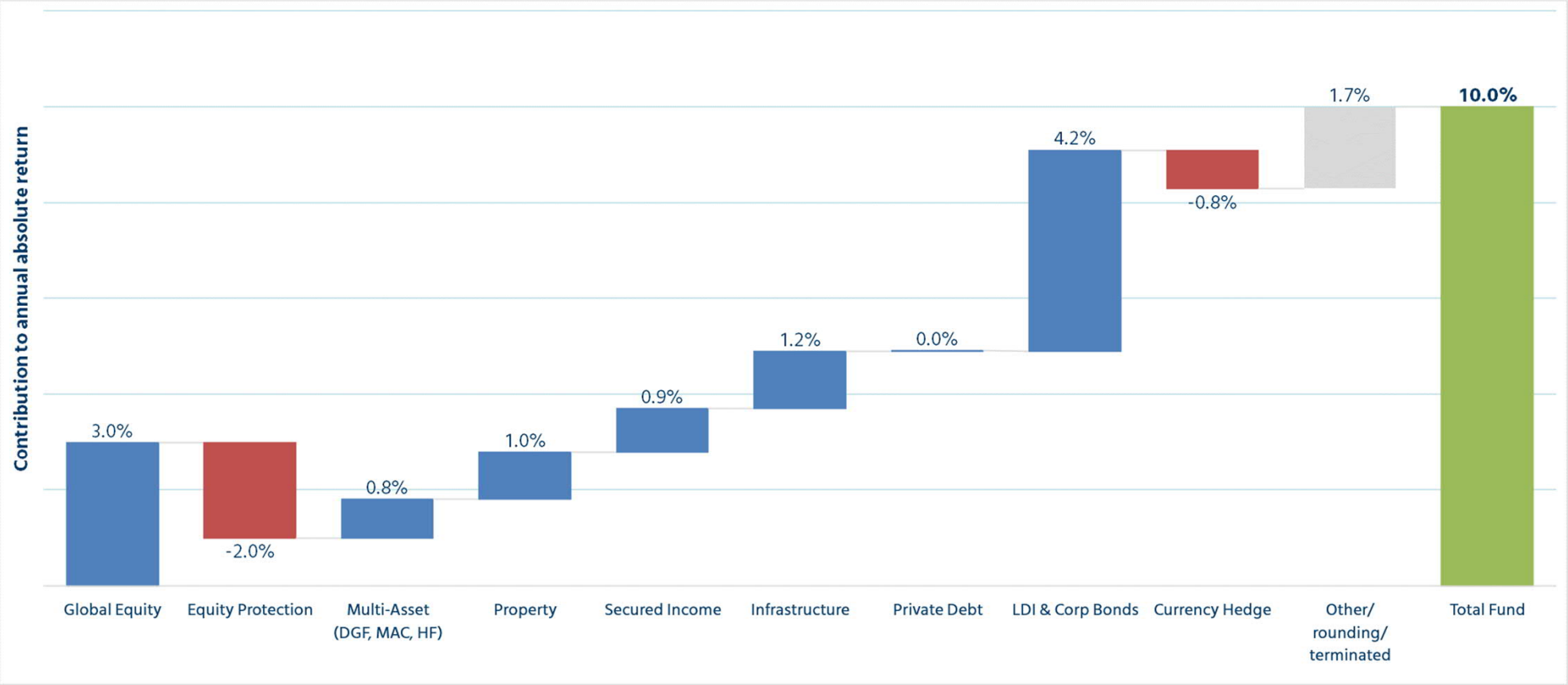
Source: Custodian and Mercer estimates
'Other' contributions to the total can include the relatively small holdings in the ETF, cash, the impact of cashflows and terminated mandates, as well as rounding error.

Equities continue to be the biggest driver of returns, and were the main reason for the negative returns in the first quarter. Performance was significantly below the index for the High Alpha and Sustainable Equity portfolios, so the equity protection did not particularly dampen these losses.

The Currency Hedge overlay detracted due to the weakening of sterling, and the Multi-Asset portfolios also detracted in aggregate, however the Alternative portfolios in real assets contributed value.

The LDI portfolio made a large positive contribution to returns due to the protection it provides against inflation.

Total Fund performance attribution –1 year



'Other' contributions to the total can include the relatively small holdings in the ETF, cash, the impact of cashflows and terminated mandates, as well as rounding error.

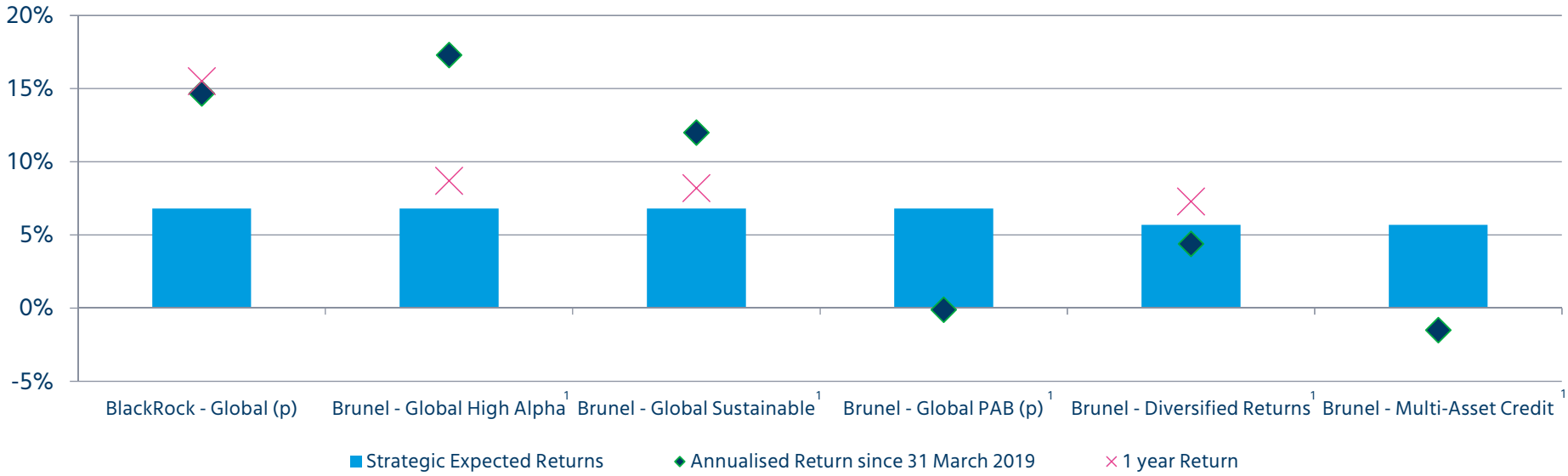
Equities made a positive contribution over the year (making up c30% of total returns), which was dampened by the equity protection in place in line with expectations.

The Alternative portfolios added value, and the LDI portfolio made the largest contribution overall (c.42% of total returns).

The Currency Hedge detracted due to sterling weakening.

Performance vs. expected strategic returns

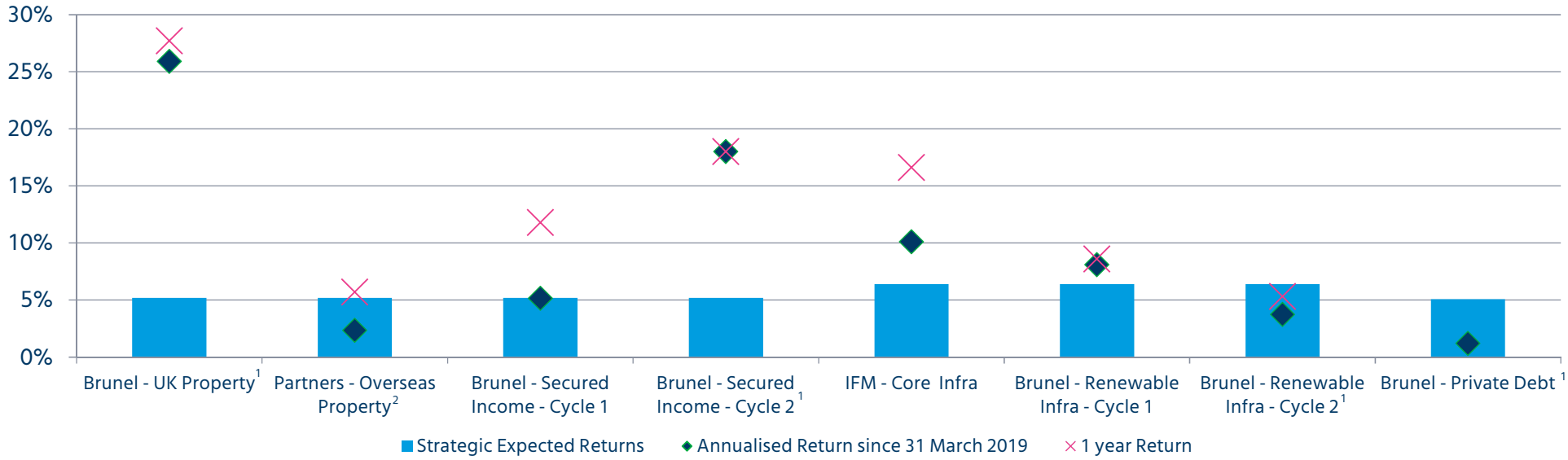
	BlackRock Passive Global Equity	Brunel Global High Alpha	Brunel Global Sustainable	Brunel Passive Global PAB	Brunel Diversified Returns	Brunel Multi-Asset Credit
Benchmark allocation	4.0%	12.5%	15.0%	10.0%	6.0%	6.0%
Commentary	Returns above strategic expectations due to strength of equity markets since 2019. Mandate has tracked the underlying market.	Returns above expectations given strength of markets since 2019. Strong initial manager outperformance added to returns, though recent performance has been weaker.	Returns above expectations given strength of markets since 2020, though has so far underperformed benchmark.	Flat returns so far given October 2021 inception date. Too early to draw conclusions.	Returns marginally below expectations due to a dampening of performance over the past nine months.	Returns below expectations due to sell-off in Q1 2022.



Notes:
We have illustrated the performance of the key mandates within the Fund's investment strategy.
Actual returns are from 31 March 2019 to 31 March 2022, except if otherwise stated below. Returns for periods over a year have been annualised.
The strategic expected returns are from the 2019 strategy review, which reflect the 20 year mean Mercer Q1 2019 asset model assumptions.
[1] Mandate was incepted after 31 March 2019. A list of inception dates can be found in the Appendix.

Performance vs. expected strategic returns

	Brunel UK Property	Partners Overseas Property	Brunel Secured Income	IFM Core Infra	Brunel Renewable Infra	Brunel Private Debt
Benchmark allocation	3.75%	3.75%	10.0%	5.0%	5.0%	5.0%
Commentary	Returns above expectations; property has fared very well since inception in January 2021.	Returns below expectations. Improvements seen over past year, and generally the mandate's longer-term performance is stronger.	Returns in line with expectations for cycle 1 (first drawdown in 2019), but above expectations for cycle 2 (2021) thanks to strong property markets. Mandates are still in the drawdown phase.	Returns above expectations as real assets have delivered. Recent outperformance assisted by non-recurring gains on certain assets and valuation increases.	Returns above expectations for cycle 1 (2019), but below expectations for cycle 2 (2020). Mandates are still in the drawdown phase so longer-term performance will be more meaningful.	Mandate incepted in September 2021; too early to draw conclusions.



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[1] Mandate was incepted after 31 March 2019. A list of inception dates can be found in the Appendix.
[2] Returns are shown up to 31 December 2021, as this is the latest data available.

Mandate performance to 31 March 2022

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	-2.9	-2.4	-0.5	15.5	15.4	+0.1	14.7	14.6	+0.1	-	N/A (p)
Brunel Global High Alpha Equity	-8.0	-2.3	-5.8	8.7	15.9	-6.2	N/A	N/A	N/A	+2-3	N/A
Brunel Global Sustainable Equity	-9.8	-2.5	-7.5	8.2	12.9	-4.2	N/A	N/A	N/A	+2	N/A
Brunel Passive Global Equity Paris-Aligned	-3.7	-3.7	0.0	N/A	N/A	N/A	N/A	N/A	N/A	-	N/A
Brunel Diversified Returns Fund	0.4	0.8	-0.4	7.3	3.2	+4.0	N/A	N/A	N/A	+4-5	N/A
JP Morgan FoHF	-2.3	0.9	-3.2	-0.3	3.1	-3.3	7.9	3.2	+4.5	-	Target met
Brunel Multi-Asset Credit	-2.7	1.1	-3.8	N/A	N/A	N/A	N/A	N/A	N/A	-	N/A
Brunel UK Property	6.3	5.6	+0.7	27.7	23.1	+3.7	N/A	N/A	N/A	-	N/A
Partners Overseas Property*	2.1	2.5	-0.4	5.7	10.0	-3.9	2.5	10.0	-6.9	-	Target not met
Brunel Secured Income - Cycle 1	3.0	1.7	+1.3	11.8	7.0	+4.5	5.2	3.1	+2.0	+2	Target met
Brunel Secured Income - Cycle 2	6.3	1.7	+4.5	18.0	7.0	+10.3	N/A	N/A	N/A	+2	N/A
IFM Core Infrastructure	2.4	1.3	+1.1	16.6	5.2	+10.8	9.5	5.5	+3.8	-	Target met
Brunel Renewable Infrastructure - Cycle 1	1.9	1.7	+0.2	8.6	7.0	+1.5	7.8	3.1	+4.6	+4	Target met
Brunel Renewable Infrastructure - Cycle 2	1.0	1.7	-0.7	5.3	7.0	-1.6	N/A	N/A	N/A	+4	N/A
Brunel Private Debt	0.7	1.1	-0.4	N/A	N/A	N/A	N/A	N/A	N/A	-	N/A
BlackRock Corporate Bonds	-8.6	-8.6	0.0	-6.8	-6.8	0.0	1.9	1.9	0.0	-	N/A (p)
BlackRock LDI	16.2	16.2	0.0	42.0	42.0	0.0	12.7	12.7	0.0	-	N/A (p)
Equity Protection Strategy	-0.0			-2.5			-5.0			-	N/A

Since inception performance for Partners, which was the largest underperformer over the three year period, has been 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 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 31 December 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 (%)
Global Equity	1,086,633	1,007,071	18.4	17.3	16.5	11.5 - 21.5	+0.8
Global Sustainable Equity	649,094	802,687	11.0	13.8	15.0	10.0 - 20.0	-1.2
Paris-Aligned Equity	822,170	574,338	13.9	9.9	10.0	5 - 15	-0.1
Diversified Returns Fund	535,962	538,061	9.1	9.2	6.0	4 - 10	+3.2
Fund of Hedge Funds*	228,309	171,125	3.9	2.9	-	No set range	-
Multi-Asset Credit	324,157	315,433	5.5	5.4	6.0	3 - 9	-0.6
Property	383,740	391,001	6.5	6.7	7.5	5 - 10	-0.8
Secured Income	438,515	468,845	7.4	8.0	10.0	5 - 15	-2.0
Core Infrastructure	416,777	427,128	7.1	7.3	5.0	2.5 - 7.5	+2.3
Renewable Infrastructure	80,341	89,252	1.4	1.5	5.0	2.5 - 7.5	-3.5
Private Debt	42,418	42,713	0.7	0.7	5.0	0 - 7.5	-4.3
Corporate Bonds	133,538	121,987	2.3	2.1	2.0	No set range	+0.1
LDI & Equity Protection	615,390	708,640	10.4	12.2	12.0	No set range	+0.2
Cash**	137,325	167,500	2.3	2.9	-	0 - 5	+2.9
Total	5,894,582	5,825,780	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.
**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	297,132		288,513	5.0	5.0
Brunel	Global High Alpha Equity	756,038		695,906	12.8	11.9
Brunel	Global Sustainable Equity	649,094	211,266	802,687	11.0	13.8
Brunel	Global Low Carbon Equity	225,669	-215,531	-	3.8	0.0
Brunel	Passive Global Equity Paris Aligned	596,501		574,338	10.1	9.9
Brunel	Diversified Returns Fund	535,962		538,061	9.1	9.2
JP Morgan	Fund of Hedge Funds	228,309	-59,065	171,125	3.9	2.9
Brunel	Multi-Asset Credit	324,157		315,433	5.5	5.4
Brunel	UK Property	198,282		210,953	3.4	3.6
Partners	Overseas Property	173,549		168,035	2.9	2.9
Brunel	Secured Income – Cycle 1	370,147	14,593	381,102	6.3	6.5
Brunel	Secured Income – Cycle 2	68,368		87,742	1.2	1.5
IFM	Core Infrastructure	416,777		427,128	7.1	7.3
Brunel	Renewable Infrastructure – Cycle 1	62,526	6,587	70,620	1.1	1.2
Brunel	Renewable Infrastructure – Cycle 2	17,815	511	18,632	0.3	0.3
Brunel	Private Debt	42,418		42,713	0.7	0.7
BlackRock	Corporate Bonds	133,538		121,987	2.3	2.1
BlackRock	LDI & Equity Protection	615,390		708,640	10.4	12.2
Record	Currency Hedging*	22,354	-10,000	-10,360	0.4	-0.2
BlackRock	ETF	65,532	40,451	105,127	1.1	1.8
Internal Cash	Cash	81,060	9,859	93,576	1.4	1.6
Total		5,894,582	-9,927	5,825,924	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.
* Valuation includes the collateral holdings for the currency overlay.

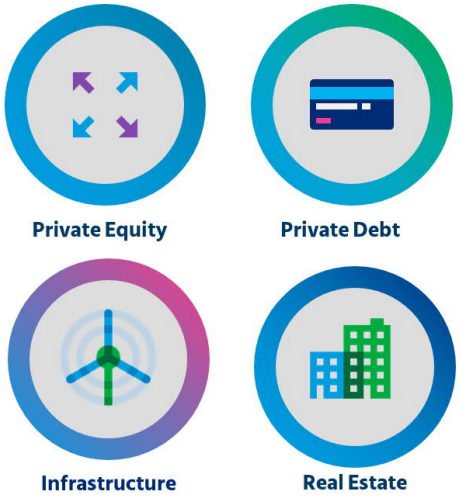
Current topics

7

Current topics

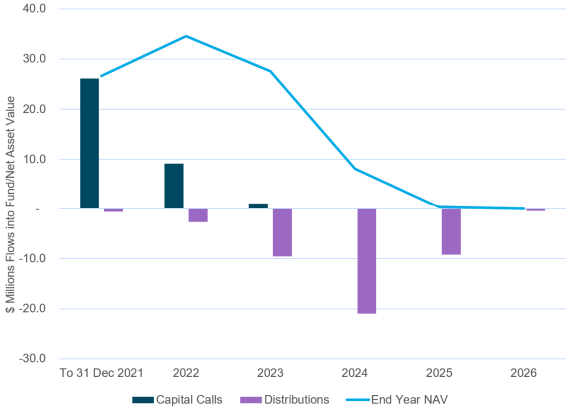
Private Markets – Cash Flow Planning

Different asset classes



Sustainable opportunities
Within multiple asset classes

Example cashflow profile



As private market funds mature, overall cashflow will become negative as distributions overtake capital calls.

To maintain private market exposure, investors need to plan reinvest with reference to the cashflow forecast.

Summary

Private market assets can offer investors a return premium over listed securities and help achieve medium and long-term objectives

Certain private assets such as private debt hold a yield component, and as a floating rate asset class, can also provide some inflation protection

Having a well thought out commitment plan targeting an allocation, cashflows and return, whilst ensuring illiquid assets are mostly run-off by the time the illiquidity assets can no longer be tolerated, should help investors achieve their objectives

Relevance to the Fund

The Fund accesses private markets through Private Debt, Infrastructure, Secured Income and Property. It recently made new commitments to the first three of these, taking into account the amounts required to achieve and maintain the target allocations in the near future.

Impact Investing – Is it on your agenda?

The biggest sustainability challenges

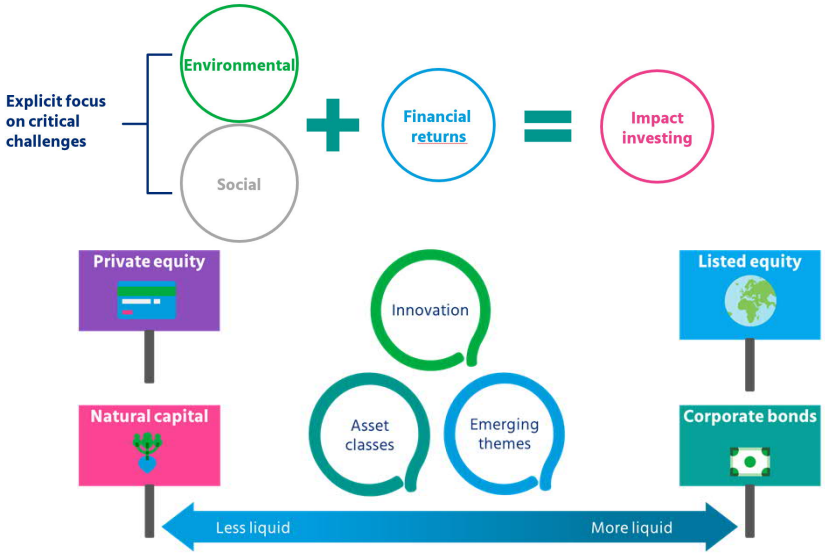
Environmental

- **Climate change** — **$2.4 trillion** investment in energy systems required to limit warming to 1.5°C[1]
- **Biodiversity** — **68% loss** in animal population since 1970[2]
- **Circular economy** — **$4.5 trillion** in economic benefits to 2030

Social

- **Financial inclusion** — **1.7bn people** unbanked[4]
- **Water** — **$6.7 trillion** required in water infrastructure investment by 2030[5]
- **Education** — **$800bn cost** of illiteracy to the global economy[6]

Sources:
1 Intergovernmental Panel on Climate Change, Summary for Policymakers, 2018
2 WWF 2020
3 World Economic Forum – Circular Economy and Material Value Chains
4 World Bank 2018
5 OECD 2018
6 UNESCO 2018



Relevance to the Fund

The Committee have discussed the extent of impact investing within the portfolio and the opportunity set for further integration.

Mercer

Current topics

UK Social and Affordable Housing

Social and Affordable Housing are terms that may be used to refer to housing provided with public subsidy, or in a general way to describe housing of any housing tenure that is affordable to a particular group.

We define Social and Affordable housing as **residential real estate that is leased to occupants whose housing costs relative to their incomes exceed norms and who may face problems with housing-related payments.**

Social and Affordable Housing

Supported Housing	Social and Affordable Rent	Affordable Home Ownership	Affordable Private Rent
• For residents requiring varying degrees of care provision. E.g. refuges, the homeless and those with physical or mental health disabilities.	• Accommodation made available at below the local market rent. Usually managed by Registered Providers or Local Authorities.	• Predominantly Shared Ownership. Occupants buy a share of a property and pay discounted rent on the remaining share. Option to increase ownership over time ("staircasing").	• Homes provided for rent on the open market with rental levels set at levels deemed to be affordable for the local community. Not a regulated form of housing.

Why now?

Housing affordability is poor
- High cost of accessing home ownership and private market rental accommodation for people on low and average incomes

Driven by economic & demographic trends
- Persistent low interest rates and weak earnings growth
- Population growth and shrinking household sizes (fewer people per household)
- 4.0m households social renting with 1.2 million on waiting lists
- 4.4m households in private rented sector*

Supply is constrained
- Chronic lack of Government funding for providers of Social and Affordable accommodation
- Transfer of existing social housing to private sector under 'right to buy'

Relevance to the Fund

✔ The Committee has discussed the potential benefits from making a strategic allocation to Affordable Housing.

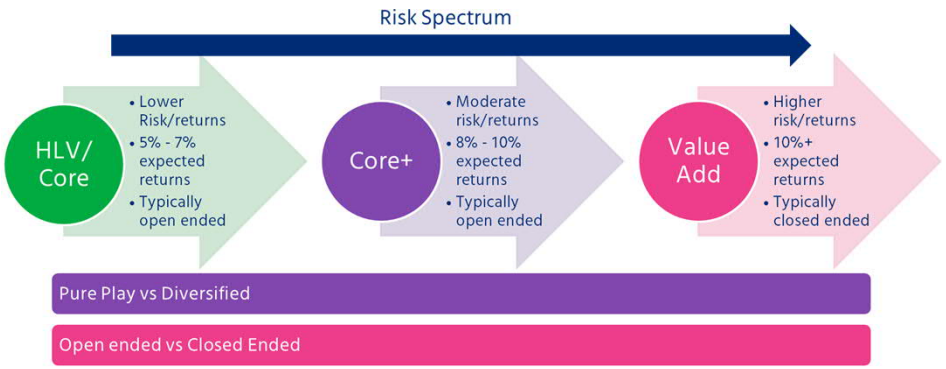
Attractions for investors

Diversifi-cation
- Diversification within a multi-asset portfolio vs commercial real estate sectors
- Within social and affordable funds, e.g. by geography and housing tenure
- Asset class is less sensitive to wider economic and financial market risk factors

Secure income
- Potential to achieve long lease terms with implicit Government backing
- Future rental levels more predictable due to regulated nature of some tenures
- High levels of occupation/low vacancy expected

Inflation linkage
- Lease contracts will typically feature index-linked rental uplifts
- Regulated formats of social and affordable housing are associated with inflation-linked benefit payments
- Open market rents tend to rise with household incomes

ESG
- Asset class has very strong "**S**ocial" impact credentials
- May accommodate vulnerable members of the community and those whose needs are not met by the market
- May help alleviate the wider housing shortage and lead to the creation of low carbon homes



Mercer

Appendix

Q1 2022 equity market review

Equity markets contracted over the first quarter.

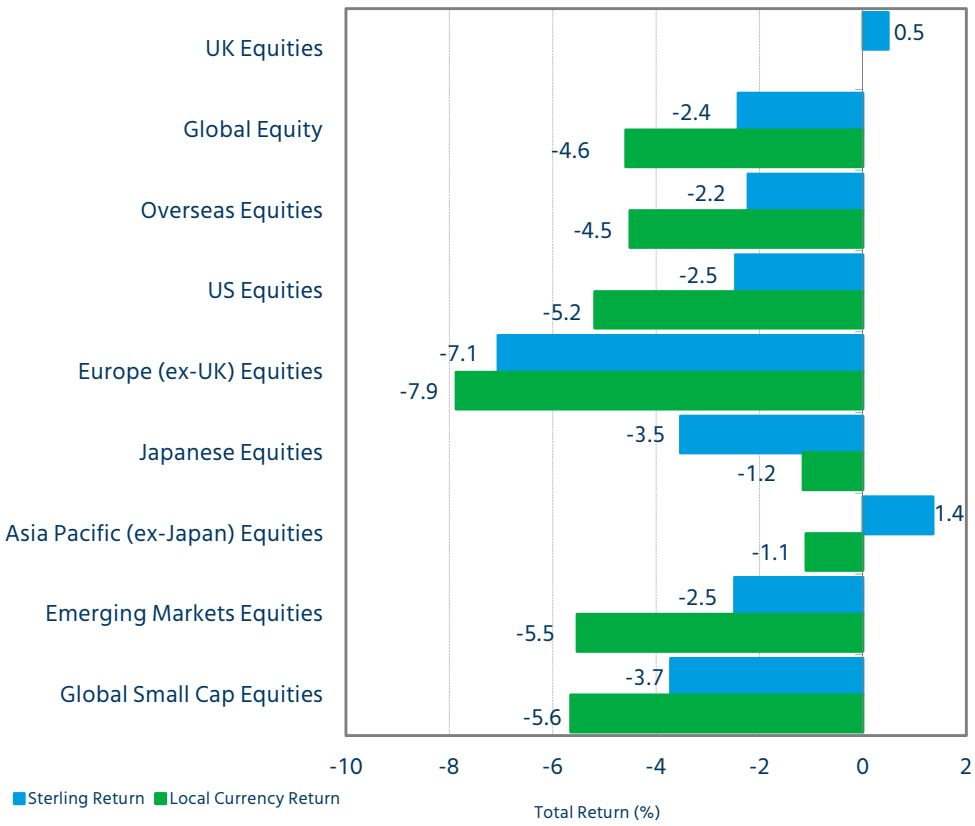
Global Equities returned -4.6% in local currency terms. Markets sold off due to monetary tightening and the Ukraine conflict, though there was some degree of a rebound towards the end of the period.

US equities returned -5.2% in local terms, whilst European (ex-UK) equities returned -7.9%. Japanese equities returned -1.2%. The US was fairly insulated from the Ukraine crisis but still had to contend with higher energy prices and tighter monetary policy. For both Europe and Japan, supply chain stresses and high energy prices were the main headwinds.

Emerging markets equities returned -5.5% in local terms. Latin America did remarkably well, Brazil in particular, as they benefitted from the rally in commodity prices. China performed poorly, driven by major lockdowns as well fears over delistings from US exchanges and sanctions, should China be deemed too supportive of Russia. Taiwan and Korea had negative returns as supply chain stress intensified and input prices rose.

Global small cap stocks returned -5.6% 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.

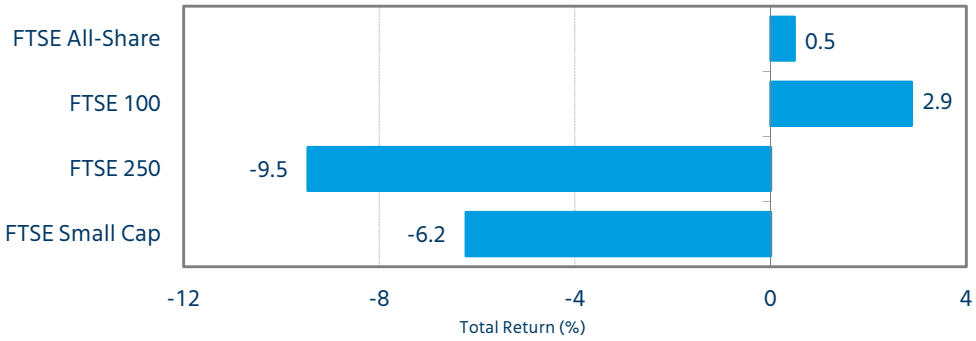
Equity Performance - Three Months to 31 March 2022



The FTSE All Share index returned 0.5% over the quarter with the large cap FTSE 100 index returning 2.9%. The FTSE 100 and FTSE All-Share's large exposure to energy, materials and financials was a strong tailwind over the quarter, as energy prices increased significantly following the crisis in Ukraine.

UK small cap and mid-cap stocks that are more reflective of the domestic UK economy produced negative returns in-line with the wider equity market.

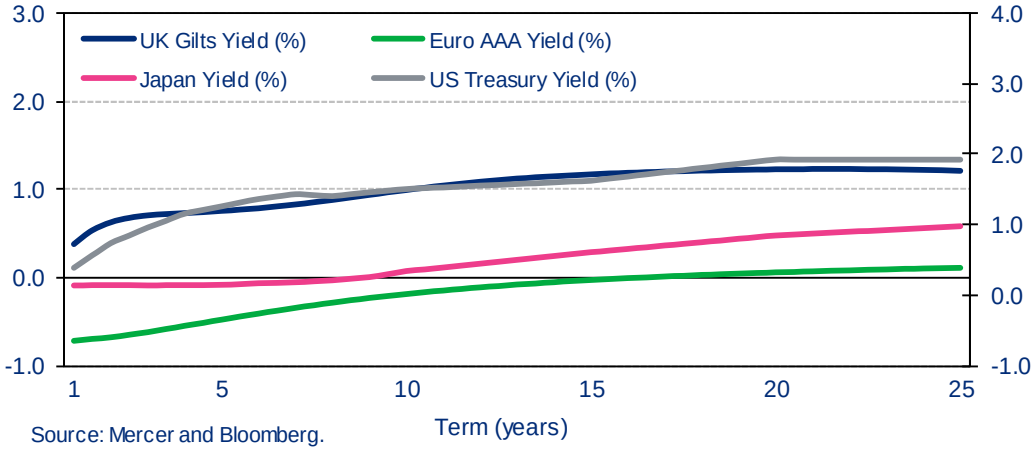
FTSE Performance by Market Cap - Three Months to 31 March 2022



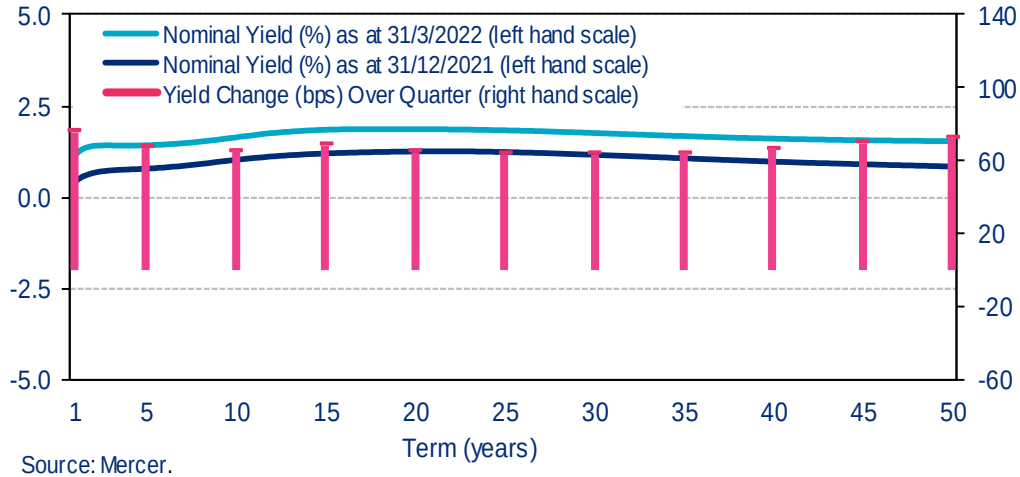
Mercer

Source: Refinitiv

Q1 2022 bond market review



Source: Mercer and Bloomberg.



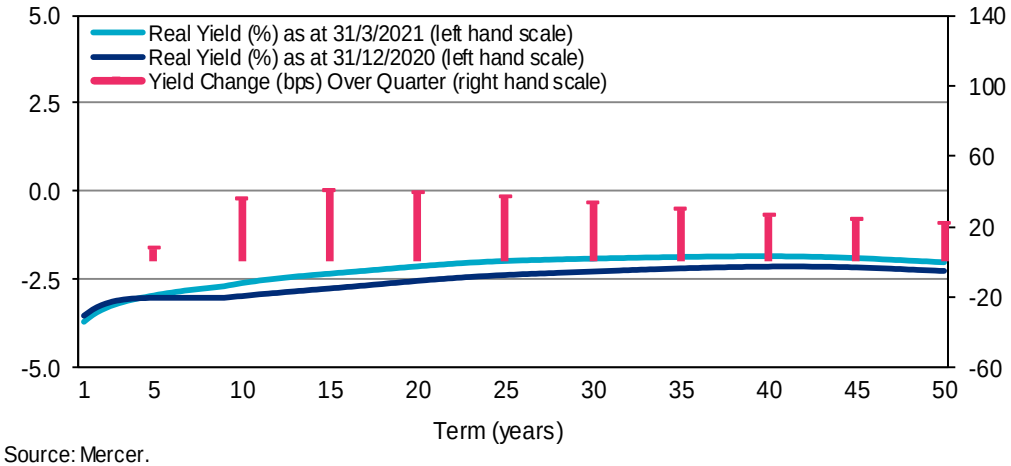
Source: Mercer.

Government Bond Yields

Global government bond yield curves bear flattened significantly over the quarter as yields at the shorter end of the curve reacted to tightening central bank policy and rate hikes. 10-year gilt yields rose by 64bps while US 10-year treasury yields rose by 83bps. Both the Federal Reserve and the Bank of England hiked interest rates over the quarter and are expected to continue to tighten policy throughout 2022. 2-year yields in the UK and US rose, 68 and 160bps respectively.

Eurozone yields also rose significantly; while the European Central Bank held off increasing interest rates, it announced an acceleration in tapering of asset prices and adopted more hawkish rhetoric in general.

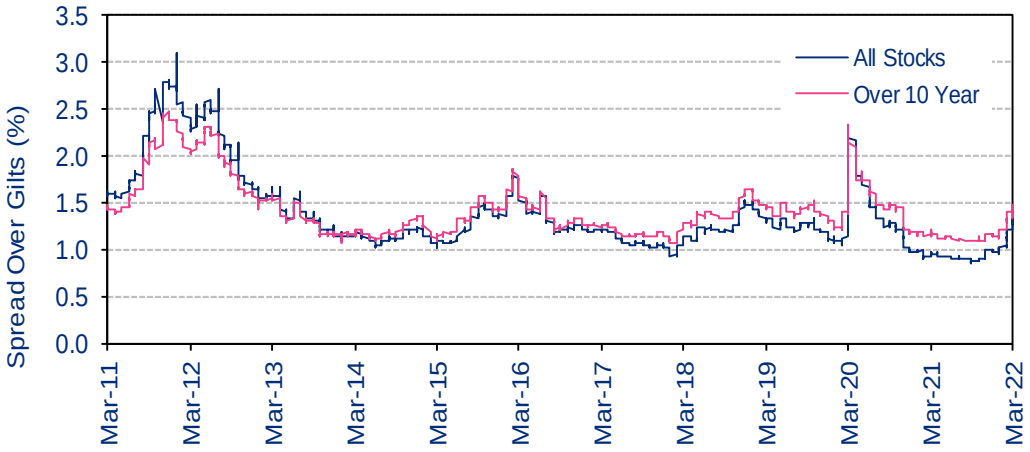
Q1 2022 bond market review



Source: Mercer.

UK Index-Linked Gilt Yields

UK real yields rose across the curve. Market based measures of inflation expectations, in the form of breakeven inflation, shifted upwards but this was offset by the large increase in nominal yields. The UK 10-year breakeven rate rose to 4.6% intra-quarter but fell back to 4.4% by quarter end – still the highest level since the global financial crisis.



Source: Refinitiv.

Corporate bonds

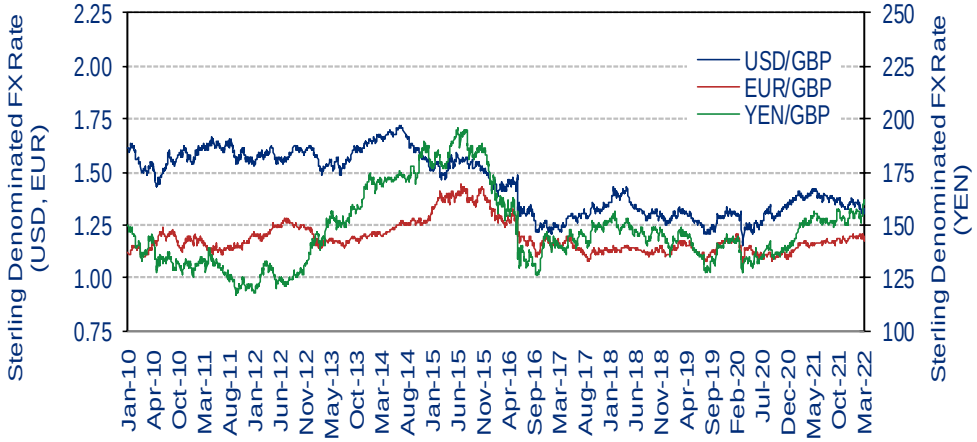
Spreads on UK investment grade credit widened for the quarter as investors initially fled risk assets, though spreads began to tighten again towards the end of March.

Q1 2022 currency market review

Sterling depreciated versus the US dollar and Euro but appreciated versus the Yen over the quarter.

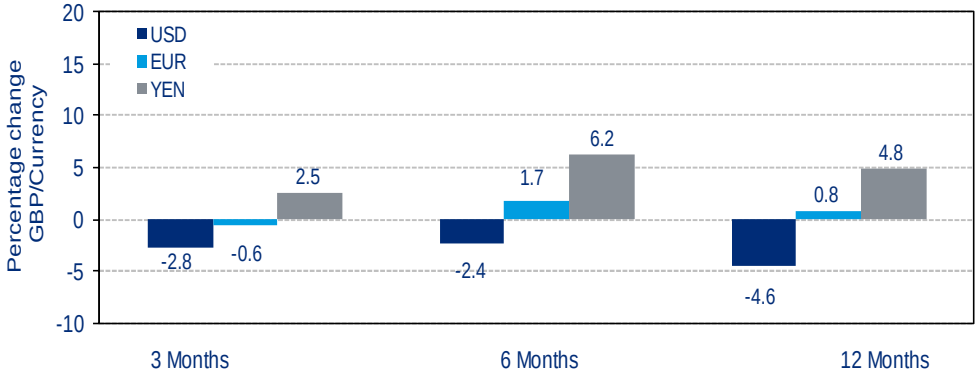
Monetary policy divergence between the regions was one of the drivers. For the year as a whole, Sterling has appreciated vs the Yen and Euro as stronger economic growth and the prospect of tighter monetary policy made Sterling more attractive relative to the former. Sterling weakened against US dollar as both growth prospects and the yield outlook favoured the latter.

Sterling Denominated FX Rate



Source: Refinitiv.

Change in sterling against foreign currencies



Source: Refinitiv.

Q1 2022 property

UK property as measured by the MSCI Index increased by 5.6% over the quarter to 31 March 2022..

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 Global Equity Paris Aligned	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	SONIA +3% p.a.	-	July 2015
Brunel	Multi-Asset Credit	SONIA	+4-5%	June 2021
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	SONIA +5% p.a.	-	April 2016
Brunel	Renewable Infrastructure	CPI	+4%	January 2019
Brunel	Private Debt	SONIA + 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	-	-	-

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

Important notices

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