Mercer

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Avon Pension Fund

Panel Investment Report Quarter to 30 September 2023

November 2023

Steve Turner

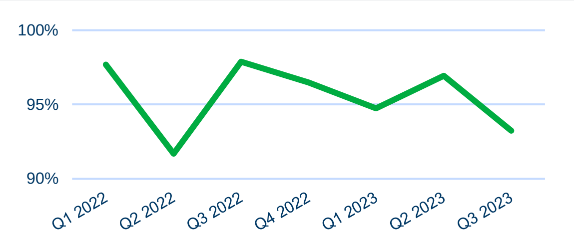
Contents

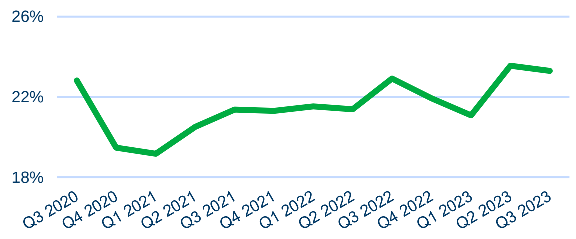
Executive Summary

1

Executive Summary

Market background	• Over the quarter equities were broadly negative and came under pressure amid some hawkish central bank announcements, particularly by the US Federal Reserve. • UK nominal and real yields rose at medium to longer tenors, and realised inflation remains considerably above target.
Mercer market views	• Our medium term outlook (as at October 2023) is mixed. • We remain cautious on equities due to expectations for flat or negative corporate profit growth in 2023. • We continue to a have a modestly positive view on growth fixed income markets (e.g. Multi Asset Credit) due to relatively attractive credit spreads and yields.
Funding level and risk	• The funding level is estimated to have decreased over the quarter to c. 93% as the assets delivered a negative return whilst the estimated value of the liabilities increased. • It is estimated to be c. 5% lower over the year to 30 September 2023 (as illustrated to the right). • The Value-at-Risk remained broadly unchanged over the quarter at £1,316m, and as a percentage of liabilities at 23%. • The reduction in risk that can be seen in 2020 was due to the move from a static to dynamic equity protection strategy. Levels have gradually increased since 2020 due to market movements and changes in forward-looking assumptions.





Executive Summary

Performance

- The negative return over the quarter was driven by the LDI portfolio and Equity assets. Overseas Property and Secured Income also detracted, whilst the rest of the portfolios delivered positive returns.
- The Currency Hedge detracted from returns over the period due to a relative weakening of Sterling.

- Underperformance relative to the strategic benchmark over the one year period to 30 September 2023 is mainly due to the underperformance of the Overseas Property and Secured Income mandates against their cash/inflation-plus benchmarks, as well as the Sustainable Equity mandate.
- These mandates, in conjunction with the Equity Protection strategy, also explain the underperformance over three years.

	3 Months (%)	1 Year (%)	3 Years (% p.a.)
Total Fund **(1)**	-2.9	-2.1	1.5
Strategic Benchmark **(2)** (ex currency hedge)	-0.1	4.8	7.0
Relative **(1 - 2)**	**-2.8**	**-6.9**	**-5.5**

- The Currency Hedge overlay had positive returns over the one year period, but has detracted over three years. It should be noted that the benchmark does not make an allowance for the currency hedge.

- Absolute returns compared to the strategic returns modelled at the strategy review in 2023 have been mostly positive for the Equity and the Liquid Growth assets,-whilst they have been generally negative within the Illiquid Growth assets.
- A key point underpinning these is that it is comparing only a nine-month period of returns, which is relatively short, so we would caution against making any meaningful conclusions at this stage, on actual performance versus the assumptions used.

Asset allocation and strategy

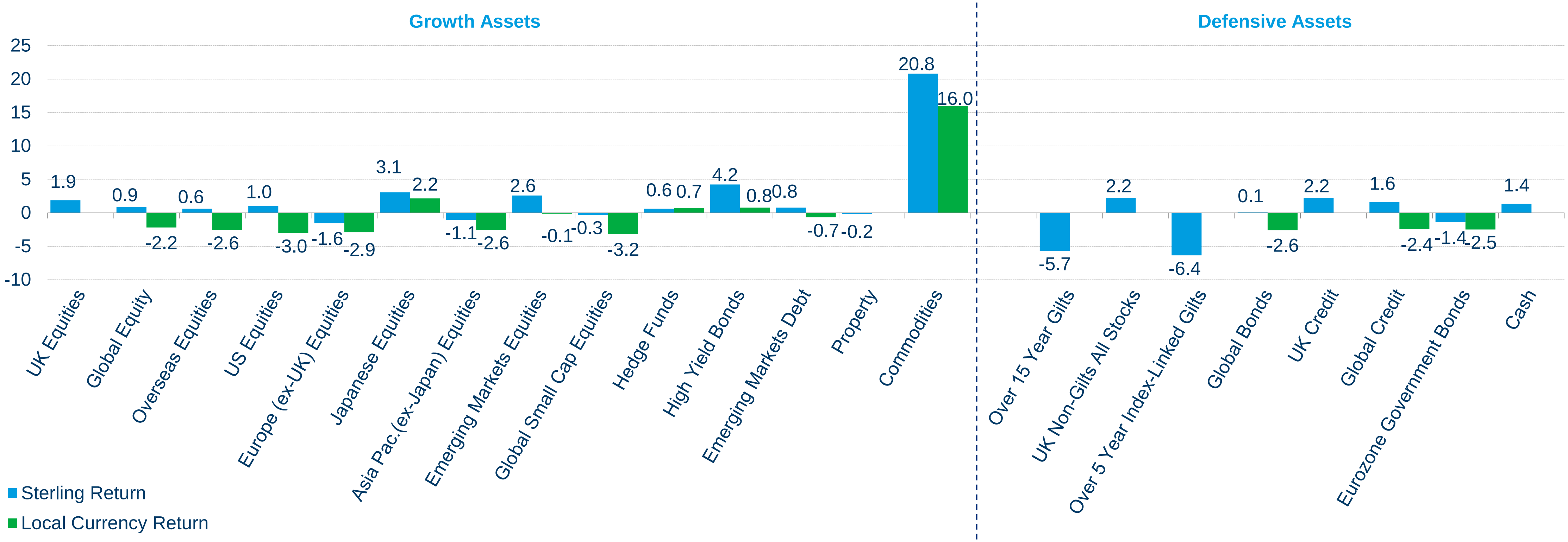
- A net amount of c. £31m was drawn down to the Brunel private market portfolios during the quarter.
- Action was taken at the end of Q3 to begin to allocate to the new 3% target allocation to the Local/Social Impact portfolio, with a £55m commitment to the Schroders Greencoat Wessex Gardens strategy, which aims to invest in renewable infrastructure assets and adjacent technologies in the South West region.

Market Background

2

Market Background

Return over 3 months to 30 September 2023 (%)

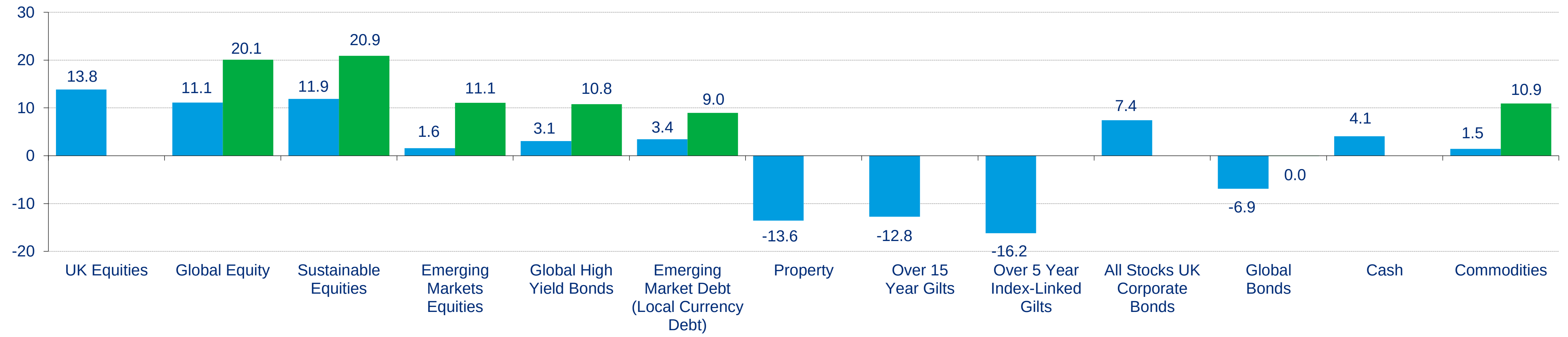


Developed market central bank actions were mixed over the quarter, with some deciding to pause hiking interest rates, and others continuing to increase policy rates. Headline inflation continued to slow and core inflation fell in most regions. Inflation expectations also continued to decline over the quarter. During the quarter, equities were broadly negative and came under pressure amid some hawkish central bank announcements especially by the US Federal Reserve.

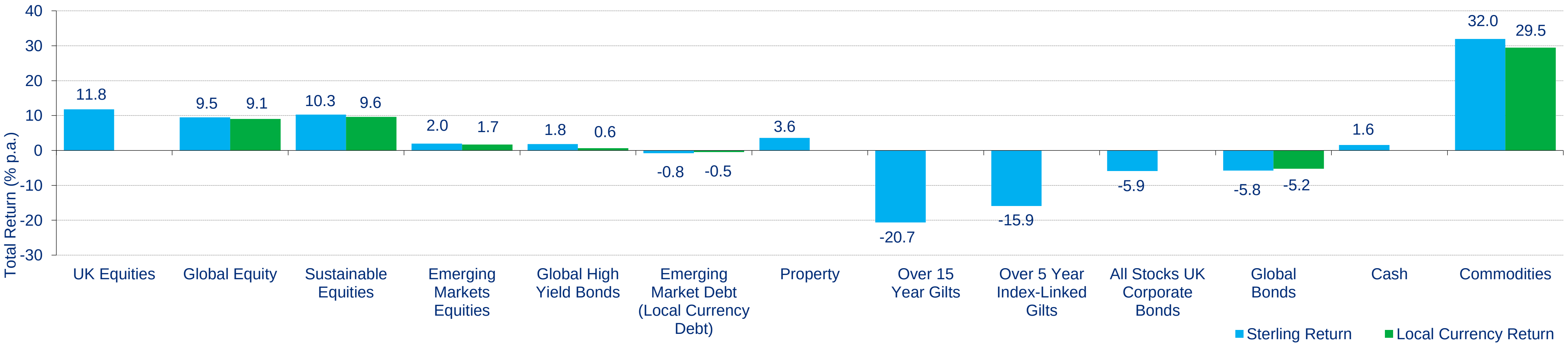
Source: Refinitiv

Market Background – 1 & 3 Years

Return over 12 months to 30 September 2023 (%)



Return over 3 years to 30 September 2023 (% p.a.)



Source: Refinitiv

Mercer Market Views

3

Market Outlook (November 2023)

We believe a period of macroeconomic normalisation will occur over the coming quarter with cooling core inflation and softening labour markets providing a tailwind for equity prices. Our conviction is tempered somewhat by stretched equity valuations driven by US large cap technology companies and optimistic earnings expectations. However, we believe there are regions within equities that present very interesting opportunities. Emerging market debt (and various sub segments of it) stands out as the asset class with the most attractive risk-reward profile. We are negative on developed market high yield bonds as we believe current spreads do not compensate you enough for the likely pick up in default activity as economies slow. We are overweight on developed market sovereign bonds as the latest sell-off has brought yields into a reasonably attractive territory. We are underweight cash-like assets as a funding source for these positions.

Equities

At a headline level, we are overweight equities. Within the asset class we are overweight **emerging market (EM) equities** versus developed market (DM) equities. Emerging market central banks are ahead of the curve, having hiked interest rates earlier than developed market central banks. With slowing inflation firmly underway some are in a position to begin cutting rates – something many developed market counterparts are not in a position to do. Loosening monetary policy should create a decent tailwind for emerging markets going forward.

Growth Fixed Income

We are overweight growth fixed income at a high level. Within growth fixed income, we are overweight **frontier market debt**. We view the asset class as an idiosyncratic opportunity. Yields remain attractive both for hard currency and local currency. Our GDP-weighted hard currency (HC) yield currently sits at 18.4%, compared to 8.5% available in more mainstream HC EMD. Positioning is extremely light given its low exposure in investor portfolios globally. Risks, of course, remain high in many individual countries, but when a broad selection of the bonds of these countries are combined, the risk of the asset class is much lower, with FMD one of the best performing bond asset classes in 2023 and with only modest volatility.

Defensive Fixed Income

We are overweight defensive fixed income versus cash. Government bond yields have sold off sharply and are now at close to their highest in two decades. While we think central banks are a long way from cutting interest rates, valuations are reasonably attractive for the first time in many years. Soft economic growth should lead to softer inflation over time. The main exception to this is Japan, where we expect yields to rise further. We have increased our nominal duration and moved overweight **nominal government bonds**. We do not have a preference between global nominal and real bonds because breakeven inflation rates appear at broadly fair levels. Regionally, we are also overweight UK gilts as we believe disinflation momentum will persist and the Bank of England will not need to hike rates again. Also in the UK, we prefer nominal to real because the inflation rates implied by break-evens appear too high. In Japan, we are significantly underweight duration as we believe the Bank of Japan will tighten policy over the next few years.

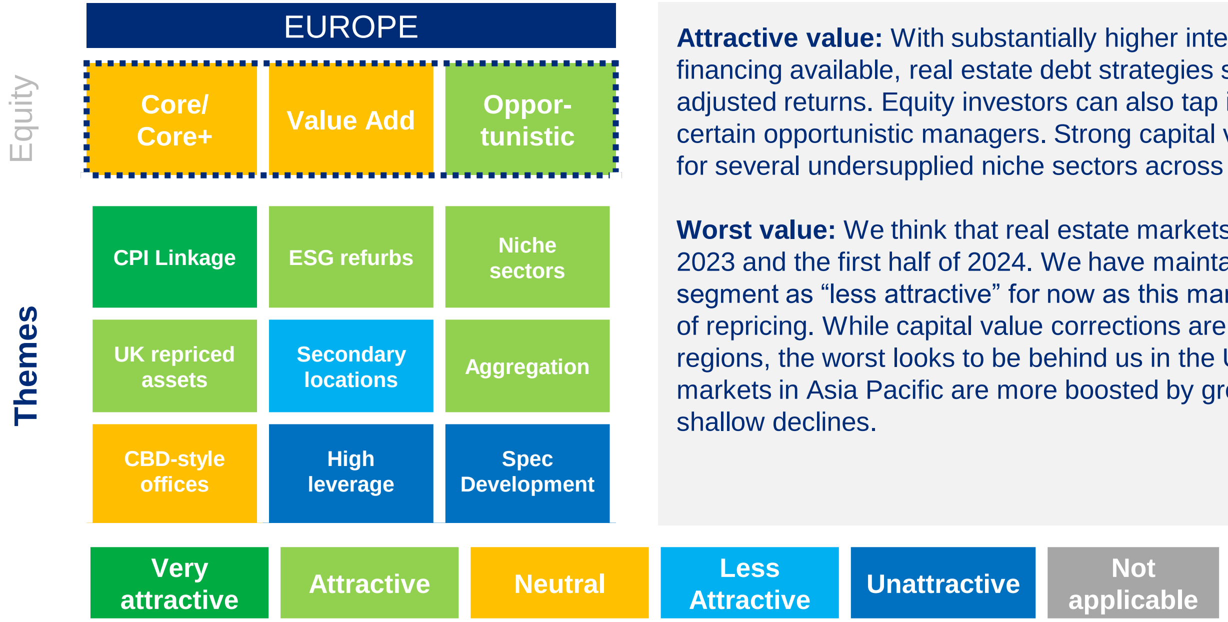
Currency

In currencies, we remain bearish on the US dollar. Large twin deficits (fiscal and current account) coupled with extended valuations against developed and emerging market counterparts are conducive in our view for significant currency depreciation. We are positive on the Japanese yen as monetary policy tightening should be supportive. In addition, the yen remains very cheap versus the US dollar, possibly providing an asymmetric investment opportunity. We continue to favour emerging market currencies on valuation grounds.

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

Global Property Market Outlook

- With inflation having fallen back to more moderate levels and growth slowing under pressure from higher borrowing costs, most economists believe major central banks are at or near the end of their rate hiking cycle. Reaching interest rate stability is the first and most important point for a turn in real estate markets.
- The yield spread of property over local government bonds (as shown in the chart on the right) is currently very low in a historic context. Reversion of the yield spread through rising property yields seems therefore inevitable. However, we expect the yield spread to move closer to the historic norms of 200-250bps rather than the 400-500bps yield spread that prevailed for much of the past decade.
- Importantly, strong fundamentals coupled with high inflation also means that the negative impact of rising property yields is partially mitigated by the positive effects of rental growth as part of valuations. Resilient labour markets and healthy savings rates are effectively softening the blow of the capital market correction.
- While some uncertainties remain, the global economy appears to be on course for a “soft landing”, supporting the strong occupational fundamentals in most property sectors and markets. Together with relatively low Net Asset Values, the period ahead could finally present the opportunity for investors seeking to gain/increase exposure to income-producing real estate to enter into core/core-plus funds. With subscription queues having reduced across even the strongest of these funds, new capital may be drawn in a matter of months.
- Finally, over the longer term, real estate can provide asynchronized returns from liquid investments or other private market asset classes due to the asset class’s inflation-linked qualities and ability to tap into different economic sectors. This remains a fundamental reason to include the asset class in a diversified portfolio.



Attractive value: With substantially higher interest rates and less bank financing available, real estate debt strategies show highly attractive risk-adjusted returns. Equity investors can also tap into this theme by backing certain opportunistic managers. Strong capital value growth prospects remain for several undersupplied niche sectors across markets.

Worst value: We think that real estate markets will see more repricing in Q4 2023 and the first half of 2024. We have maintained the US Core/Core+ segment as “less attractive” for now as this market works through this process of repricing. While capital value corrections are also still likely in the other regions, the worst looks to be behind us in the UK and parts of Europe, while markets in Asia Pacific are more boosted by growth and should see more shallow declines.

Disclaimer: For illustration purposes only. The above table presents a simplified perspective at the time of writing this report and is subject to change without notice. All categories offer attractive opportunities and optimal allocations are subject to manager selection. The outlook represented is for new investors with a non-constrained risk budget over a 3 to 5 year investment horizon. ‘Unattractive’ positions therefore do not imply advice to liquidate existing investments.

Further guidance is available in Mercer’s *Global Market Summary: Quarterly Real Estate Report, October 2023*

Funding Level and Risk

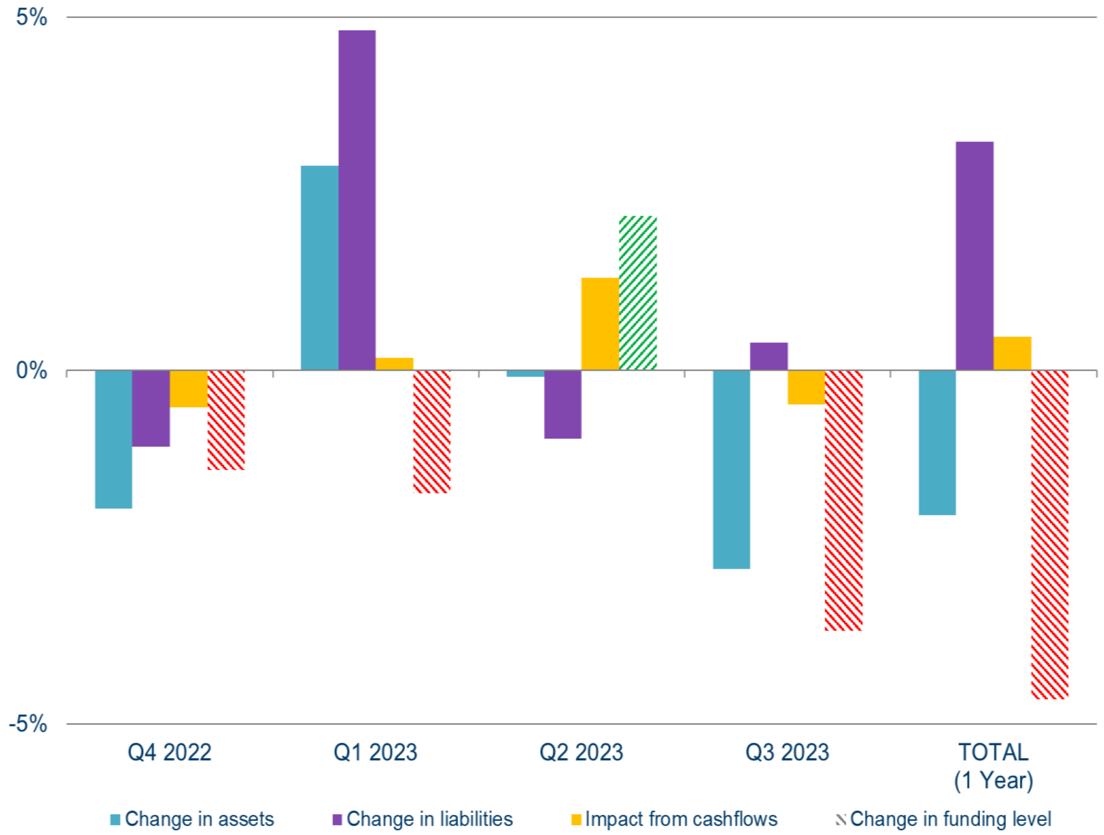
4

Funding Level and Deficit

The Fund's assets returned -2.9% over the quarter, whilst the liabilities are estimated to have increased by c. 0.4%* due to the rise in inflation expectations.

The combined effect of this saw the estimated funding level decrease to c. 93%.

The funding level is estimated to be c. 5% lower over the year to 30 September 2023.



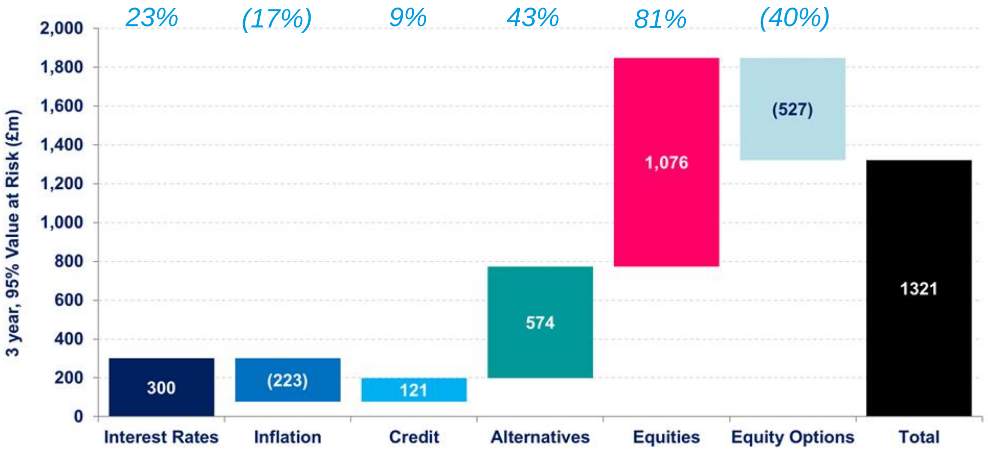
The deficit was estimated to have increased over Q3 to c. £382m:

*Since the Q2 investment report, the liability values from December 2022 to June 2023 have been restated retrospectively to reflect cashflow experience.
Liability values are estimated by Mercer. They are based on the actuarial valuation assumptions as at 31 March 2022 and the 'CPI plus' discount basis.
Impact figures are estimated by Mercer.

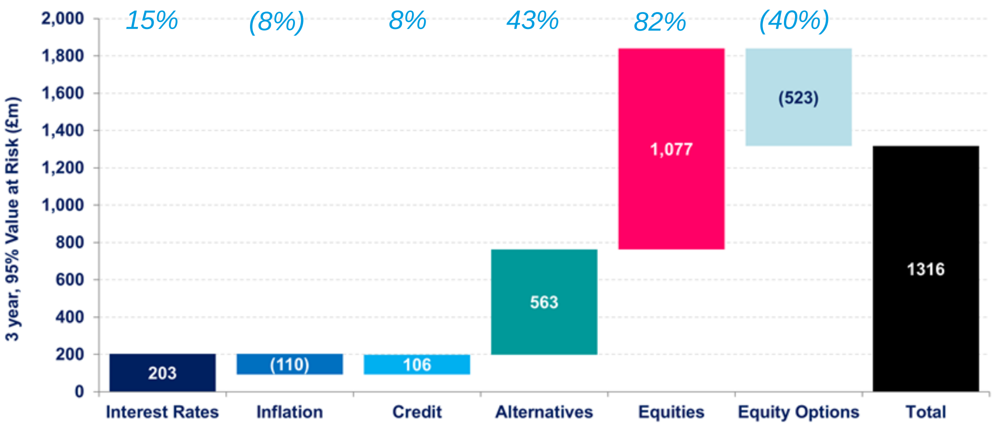
Risk Decomposition – 3 Year Value at Risk

- The two charts below illustrate the main risks that the Fund is exposed to, 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 2023



30 September 2023



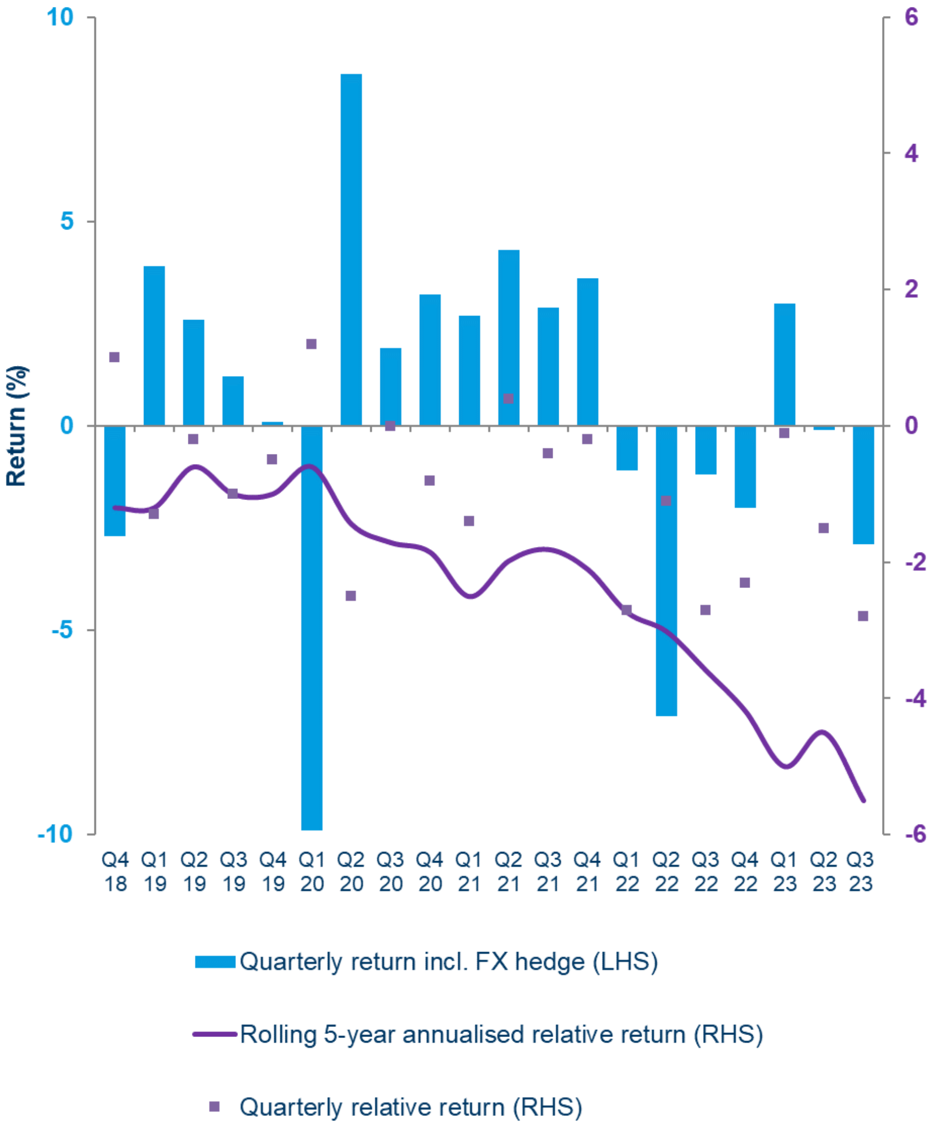
- As at 30 September 2023, if a 1-in-20 'downside event' occurred over the next three years, the funding position could deteriorate by at least an additional **£1.3bn**.
- Each bar to the left of the total represents the contribution to this total risk from the primary underlying risk exposures (interest rates and inflation, changes in credit spreads, volatility of alternative assets and equity markets, and the benefit from equity options).
- Overall **the VaR decreased by £5m over the quarter**.
- VaR remained broadly unchanged as a percentage of liabilities at 23%.

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.
Both are using cashflows from the 2022 valuation and reflecting the new SAA.

Performance Summary

5

Total Fund Performance



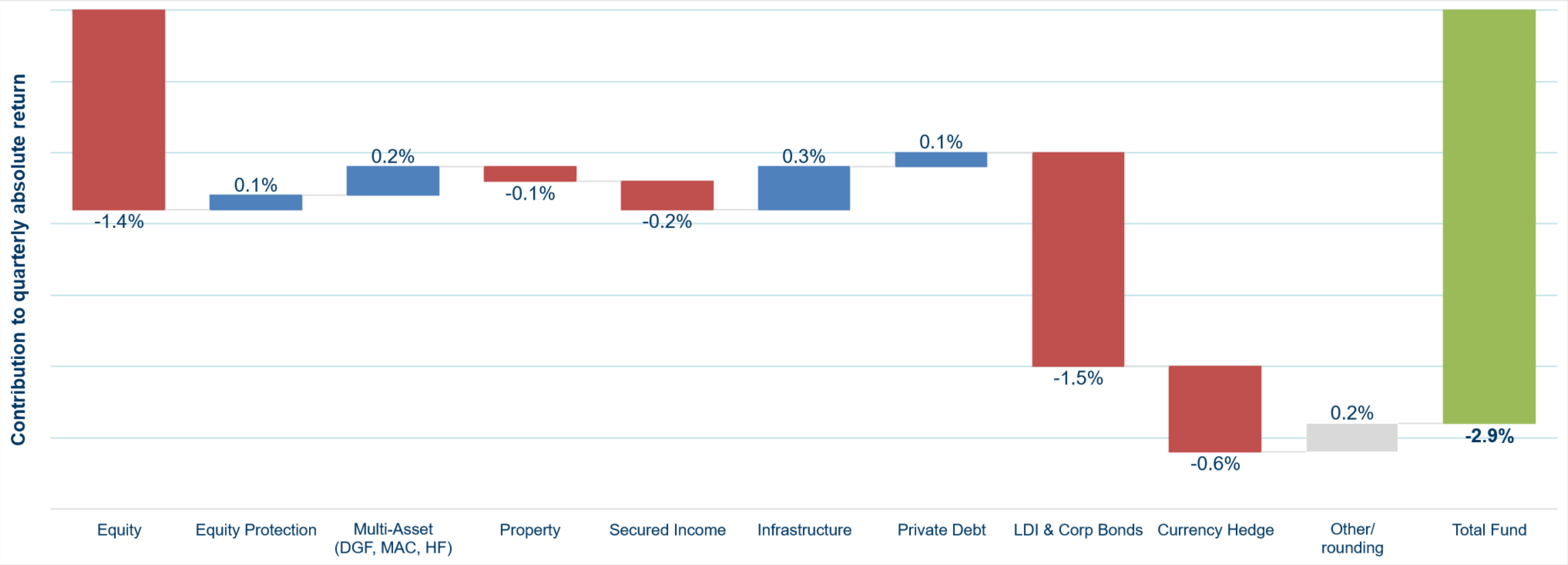
	3 Months (%)	1 Year (%)	3 Years (% p.a.)
Total Fund **(1)**	-2.9	-2.1	1.5
Total Fund (ex currency hedge)	-2.3	-3.8	1.7
Strategic Benchmark **(2)** (ex currency hedge)	-0.1	4.8	7.0
Relative (1 - 2)	**-2.8**	**-6.9**	**-5.5**

Source: Custodian, Mercer estimates. Returns are net of fees.

Commentary

- As illustrated on the next slide, the negative return of Fund assets over the quarter was driven by the LDI portfolio and Equity assets.
- Relative performance was mixed. UK Property, Infrastructure and Private Debt fared well, but total underperformance was ultimately driven by below-benchmark returns for the active equity mandates (which make up around a fifth of the portfolio), and Overseas Property and Secured Income have continued to underperform their cash/inflation-plus benchmarks in the current environment.
- These asset classes also drove underperformance over three years, and the Equity Protection strategy also detracted over this period (as we would expect given the positive performance from the physical equity holdings).
- The Currency Hedge detracted from returns over the quarter and three years due to a relative weakening of Sterling.

Total Fund Performance Attribution – Quarter

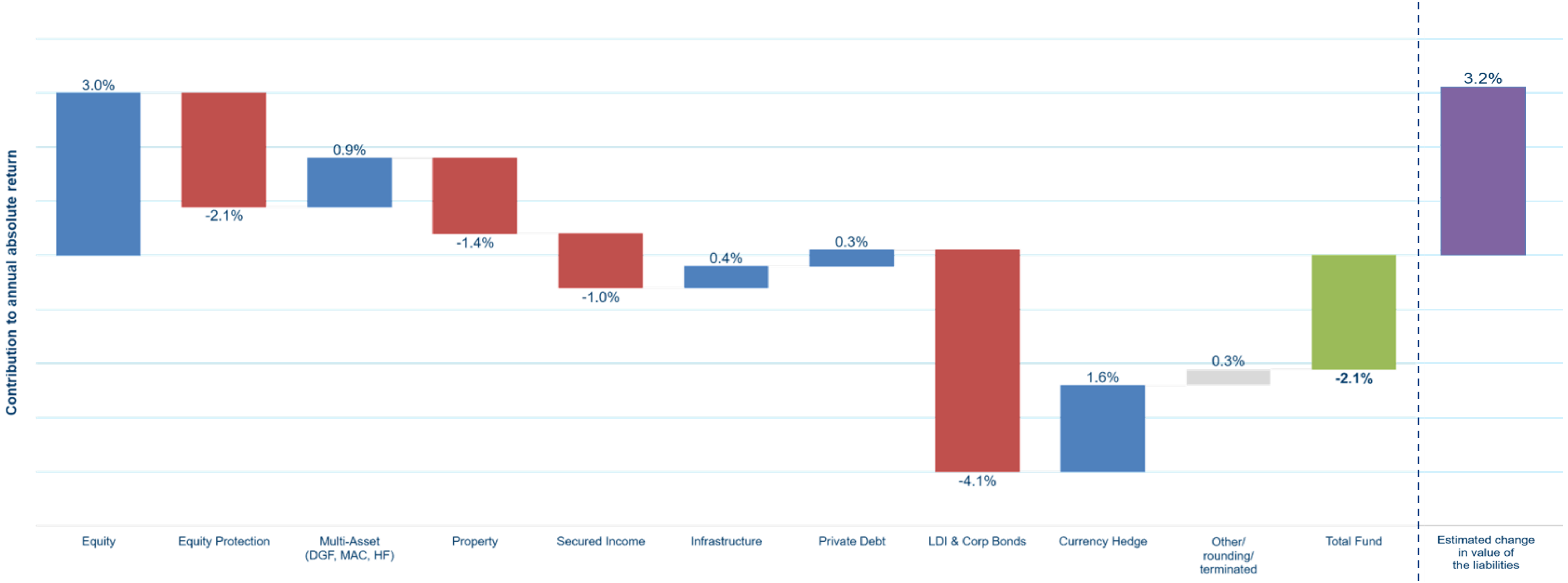


Source: Custodian and Mercer estimates
'Other' contributions to the total can include the relatively small holdings in the ETF, cash, the impact of cashflows and terminated mandates, as well as rounding.

The negative return on the Fund assets over the quarter was driven mainly by the decline in value of the LDI portfolio as nominal yields and inflation expectations rose, and negative performance from the Equity portfolio. The Equity Protection dampened losses somewhat, though proportionally this was only marginal, as the majority of the negative performance in Equities was due to active management (i.e. the underlying benchmark index returns were slightly positive).

The other broad Growth asset categories were mixed. The Currency Hedge contribution was negative due to the weakening of Sterling.

Total Fund Performance Attribution – 1 Year



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.

The negative returns from LDI and the Equity Protection were the main detractors over the 1 year period.

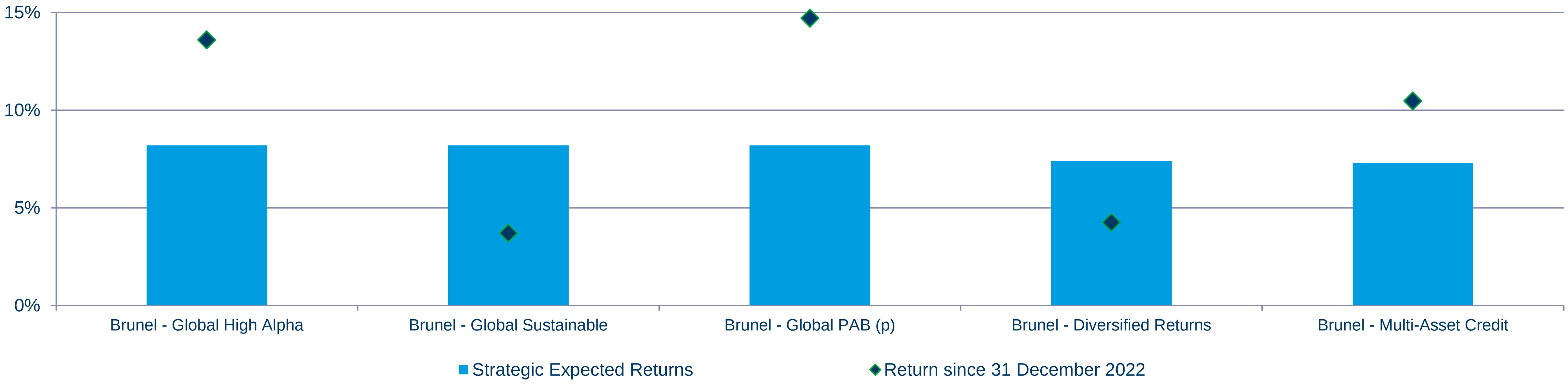
Property and Secured Income have also had a difficult year, though all other Growth asset categories contributed positively, especially Equity.

The Currency Hedge contribution was positive due to the strengthening of Sterling.

Performance vs. Expected Strategic Returns

Growth Asset	**Brunel Global High Alpha**	**Brunel Global Sustainable**	**Brunel Passive Global PAB**	**Brunel Diversified Returns**	**Brunel Multi-Asset Credit**
Benchmark Allocation	10.5%	10.5%	20.5%	6.0%	6.0%
Commentary	Returns above expectations* since December 2022 due to equity market strength year-to-date. Active management contribution has been marginally positive over this period.	Returns below expectations* since December 2022 due to a negative active management contribution. However period is still less than one year.	Returns above expectations* since December 2022 due to equity market strength.	Returns below expectations* since December 2022 due to flat Q1 performance, however period is still less than one year.	Returns above expectations* since December 2022 thanks to strength in high-yield debt markets year-to-date.

**Expected strategic returns reflect the assumptions for the 2023 Investment Strategy Review, which are as at 31 December 2022.*
Given this, the return period covers nine months whereas the expected returns are per annum, so there are limitations at this stage to making direct comparisons.



Notes:
We have illustrated the performance of the key mandates within the Fund’s investment strategy.
Actual returns are from 31 December 2022 to 30 September 2023, except if otherwise stated below. Returns for periods over a year have been annualised.
The strategic expected returns are from the 2023 strategy review, which reflect the 10 year mean Mercer Q4 2022 asset model assumptions.

Performance vs. Expected Strategic Returns

Growth Asset	**Brunel UK Property**	**Partners Overseas Property**	**Brunel Secured Income**	**IFM Core Infra**	**Brunel Renewable Infra**	**Brunel Private Debt**
Benchmark allocation	3.75%	3.75%	9.0%	4.0%	5.0%	4.5%
Commentary	Returns below expectations* since December 2022 due to the challenges seen in Property markets year-to-date.			Returns above expectations* since December 2022.	Returns for cycle 2 assets (first drawdown in October 2021) above expectations* since December 2022, though the assets within cycle 1 (first drawdown in January 2021) have reported lower returns. Mandates are still in the drawdown phase.	Returns above expectations* since December 2022. Mandates are still in the drawdown phase.

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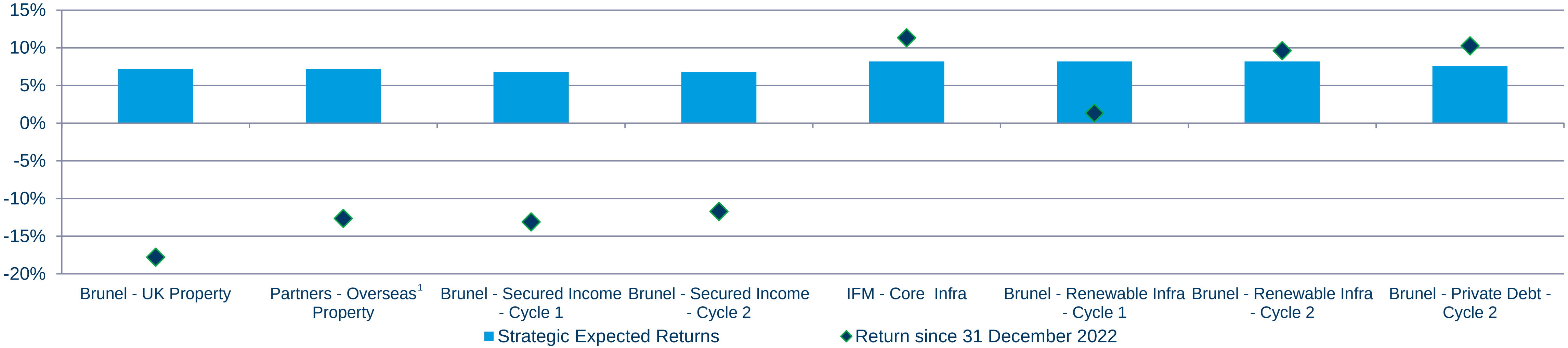

Notes:
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The strategic expected returns are from the 2023 strategy review, which reflect the 10 year mean Mercer Q4 2022 asset model assumptions.
[1] Returns are shown up to 30 June 2023, as this is the latest data available.

Mandate Performance to 30 September 2023

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
Brunel Global High Alpha Equity	-0.6	0.7	-1.3	13.6	12.1	+1.3	8.3	10.7	-2.2	+2-3	Target not met
Brunel Global Sustainable Equity	-4.1	0.7	-4.8	3.6	11.0	-6.7	3.9	9.5	-5.1	+2	Target not met
Brunel Passive Global Equity Paris-Aligned	0.2	0.2	0.0	14.9	15.0	-0.1	N/A	N/A	N/A	-	N/A (p)
MSCI World Paris-Aligned (Synthetic)	-0.7	-0.7	0.0	N/A	N/A	N/A	N/A	N/A	N/A	-	N/A (p)
Brunel Diversified Returns Fund	2.1	2.0	+0.1	4.2	7.1	-2.7	3.0	4.6	-1.5	-	Target not met
Brunel Multi-Asset Credit	1.9	2.3	-0.4	10.6	8.2	+2.2	N/A	N/A	N/A	-	N/A
Brunel UK Property	0.5	-0.7	+1.2	-15.6	-13.9	-2.0	N/A	N/A	N/A	-	N/A
Partners Overseas Property*	-4.9	2.5	-7.2	-13.9	10.0	-21.8	-2.2	10.0	-11.1	-	Target not met
Brunel Secured Income - Cycle 1	-2.6	0.4	-3.0	-13.2	6.6	-18.6	-0.1	6.6	-6.3	+2	Target not met
Brunel Secured Income - Cycle 2	-1.5	0.4	-1.9	-11.7	6.6	-17.2	N/A	N/A	N/A	+2	N/A
IFM Core Infrastructure	3.3	2.5	+0.8	11.4	9.2	+2.0	11.9	6.7	+4.9	-	Target met
Brunel Renewable Infrastructure - Cycle 1	3.8	0.4	+3.4	1.3	6.6	-5.0	6.4	6.6	-0.2	+4	Target not met
Brunel Renewable Infrastructure - Cycle 2	1.1	0.4	+0.7	9.6	6.6	+2.8	N/A	N/A	N/A	+4	N/A
Brunel Private Debt - Cycle 2	4.6	2.3	+2.2	10.3	8.2	+1.9	N/A	N/A	N/A	-	N/A
BlackRock Corporate Bonds	1.1	1.1	0.0	7.2	7.2	0.0	-11.5	-11.5	0.0	-	N/A (p)
BlackRock LDI	-7.5	-7.5	0.0	-22.7	-22.7	0.0	-1.0	-1.0	0.0	-	N/A (p)
Equity Protection Strategy	0.1	N/A	N/A	-7.0	N/A	N/A	-5.0	N/A	N/A	-	N/A

Source: Investment Managers, Custodian, Mercer estimates. Returns are net of fees. Returns are in GBP 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 target. Red = mandate underperformed target. Black = mandate performed in line with target (mainly reflecting passive mandates).

Performance for 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 30 June 2023, as this is the latest data available.
**Where the outperformance target has not already been incorporated into the benchmark returns shown. See Appendix for further details.
Performance is not yet illustrated for Private Market Cycle 3 investments, which will become more meaningful with the passage of time.

Asset Allocation

6

Valuation by Asset Class

Asset Class	Start of Quarter (£'000)	End of Quarter (£'000)	Start of Quarter (%)	End of Quarter (%)	Benchmark (%)	Ranges (%)	Relative (%)
Global High Alpha Equity	635,125	652,442	11.6	12.4	10.5	5.5 - 15.5	+1.9
Global Sustainable Equity	589,576	565,170	10.8	10.7	10.5	5.5 - 15.5	+0.2
Paris-Aligned Equity*	1,346,330	1,342,923	24.7	25.5	20.5	12.5 - 28.5	+5.0
Diversified Returns Fund	339,865	346,912	6.2	6.6	6.0	3 - 9	+0.6
Fund of Hedge Funds**	22,335	24,174	0.4	0.5	-	No set range	+0.5
Multi-Asset Credit	310,208	316,209	5.7	6.0	6.0	3 - 9	+0.0
Property	332,948	328,138	6.1	6.2	7.0	No set range	-0.8
Secured Income	543,334	546,652	10.0	10.4	9.0	No set range	+1.4
Core Infrastructure	314,803	325,290	5.8	6.2	4.0	No set range	+2.2
Renewable Infrastructure	168,655	175,333	3.1	3.3	5.0	No set range	-1.7
Private Debt	158,685	180,756	2.9	3.4	4.5	No set range	-1.1
Local / Social Impact	-	-	-	-	3.0	No set range	-3.0
Corporate Bonds	163,667	165,443	3.0	3.1	2.0	No set range	+1.1
LDI & Equity Protection	1,023,496	900,673	18.8	17.1	12.0	No set range	+5.1
*Synthetic Equity Offset**	-733,621	-728,850	*-13.4*	*-13.8*	-	-	-
Other***	239,340	127,087	4.4	2.4	-	0 - 5	+2.4
Total	**5,454,760**	**5,268,365**	**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.
*Paris-Aligned includes synthetic exposure via the BlackRock QIF; Synthetic Equity Offset reflects an offsetting value to account for the difference between the exposure to equity markets and the actual mark to market value of the holding.
**Mandate due to be terminated.
***Valuation includes internal cash, the ETF and currency instruments.

Valuation by Manager

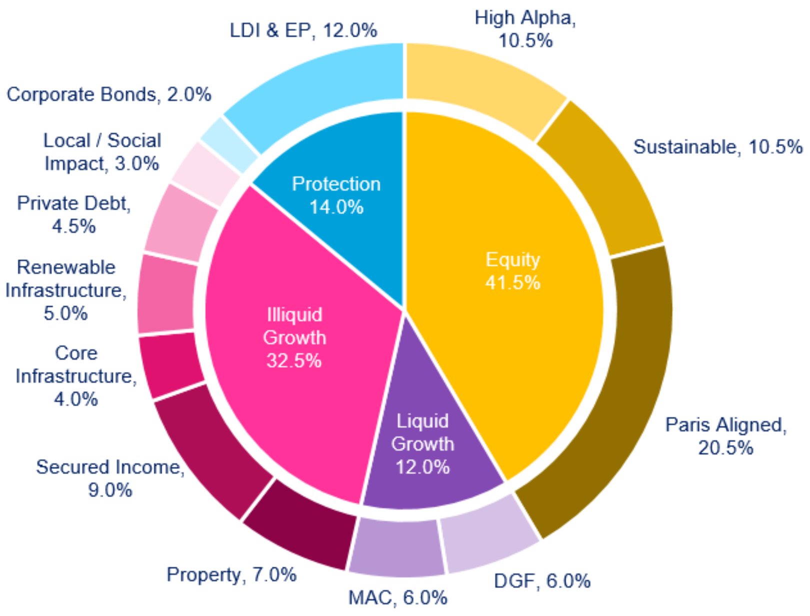
Manager	Asset Class	Start of Quarter (£'000)	Cashflows (£'000)	End of Quarter (£'000)	Start of Quarter (%)	End of Quarter (%)
Brunel	Global High Alpha Equity	621,442		617,895	11.4	11.7
Brunel	Global Sustainable Equity	589,576		565,170	10.8	10.7
Brunel	Passive Global Equity Paris Aligned	612,709	-12	614,073	11.2	11.7
BlackRock	MSCI Paris-Aligned (Synthetic)*	733,621		728,850	13.4	13.8
Brunel	Diversified Returns Fund	339,865		346,912	6.2	6.6
JP Morgan	Fund of Hedge Funds	22,335		24,174	0.4	0.5
Brunel	Multi-Asset Credit	310,208		316,209	5.7	6.0
Brunel	UK Property	181,693	-45	182,581	3.3	3.5
Schroders	UK Property	12,750	-34	12,738	0.2	0.2
Partners	Overseas Property	138,506	-367	132,819	2.5	2.5
Brunel	Secured Income – Cycle 1	319,833	-2,923	308,645	5.9	5.9
Brunel	Secured Income – Cycle 2	109,972	-2,690	105,805	2.0	2.0
Brunel	Secured Income – Cycle 3	113,528	19,802	132,202	2.1	2.5
IFM	Core Infrastructure	314,803		325,290	5.8	6.2
Brunel	Renewable Infrastructure – Cycle 1	102,773	758	107,496	1.9	2.0
Brunel	Renewable Infrastructure – Cycle 2	58,427	816	60,038	1.1	1.1
Brunel	Renewable Infrastructure – Cycle 3	7,456	407	7,799	0.1	0.1
Brunel	Private Debt – Cycle 2	138,568	9,030	154,272	2.5	2.9
Brunel	Private Debt – Cycle 3	20,117	5,483	26,485	0.4	0.5
BlackRock	Corporate Bonds	163,667		165,443	3.0	3.1
BlackRock	LDI & Equity Protection	1,023,496		900,673	18.8	17.1
BlackRock	*Synthetic Equity Offset**	-733,621		-728,850	-13.4	-13.8
Record	Currency Hedging (incl. collateral)	70,650		36,142	1.3	0.7
BlackRock	ETF	125,687	-65,000	59,927	2.3	1.1
Internal Cash	Cash	55,925	7,586	64,792	1.0	1.2
Total		**5,454,760**	**-27,190**	**5,268,365**	100.0	100.0

Source: Investment Managers, Mercer. Totals may not sum due to rounding.

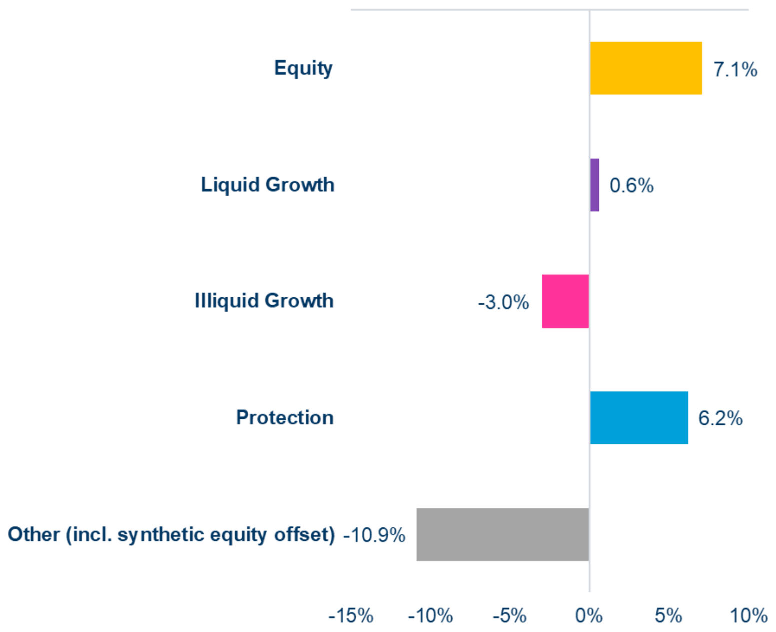
The cashflow column shows only the cash movements within the asset portfolio. It does not include non-investment cash movements such as employer contributions or pension payments made, however these amounts are included in the 'Internal Cash' start and end balance to reflect the asset value position of the total Fund. * MSCI Paris-Aligned synthetic exposure is via the BlackRock QIF; Synthetic Equity Offset reflects an offsetting value to account for the difference between the exposure to equity markets and the actual mark to market value of the holding.

Positioning relative to target

Strategic Asset Allocation ("SAA")



Relative positioning



Commentary

- The Plan last updated its Strategic Asset Allocation as part of the 2023 Investment Strategy Review.
  - Action was taken at the end of Q3 to begin to allocate to the new 3% target allocation to the Local/Social Impact portfolio, with a £55m commitment to the Schroders Greencoat Wessex Gardens strategy, which aims to invest in renewable infrastructure assets and adjacent technologies in the South West region.
- The right hand side chart displays the actual relative weights of the key portfolio building blocks compared to the SAA:
  - The overweight to Equity reflects relative outperformance to other parts of the portfolio over the past year.
  - The underweight to Illiquid Growth reflects the fact that capital is yet to be drawn down to the new allocation to a Local / Social Impact portfolio. The other parts of this sub portfolio are in line with the target in aggregate.
  - The overweight to Protection reflects the collateral boost provided by the synthesising of some of the Equity allocation; meaning that in practice an overweight to this building block is likely persist and is unlikely to trigger any consideration for action, which would continue to be driven more specifically by collateral adequacy requirements.

Current Topics

7

Current Topics

"LGPS: Next Steps on Investment" Consultation

"LGPS: Next Steps on Investment" Consultation – Proposals and Mercer Responses

Asset Pooling

Proposals to **accelerate and expand pooling** and a deadline proposed of 31 March 2025 to transition at least all listed assets.

We fully understand the government's desire to set a deadline for pooling listed assets, however we are of the opinion that 31 March 2025 is too soon from a practical perspective.
Larger pools may offer the potential for greater economies of scale, but assets under management should not be the only consideration.
In terms of passively managed funds held outside the pools, we would strongly caution against a "pooling at all costs" approach.

Levelling Up

Require funds to have a plan to invest up to **5% of assets to support levelling up**. Private markets mentioned as the principal way in which this can be implemented.

We support the comply-or-explain nature of the proposals, consistent with Administering Authorities being responsible for setting investment strategy.
Any reporting on Levelling Up needs to be cognisant of the many pressures facing the LGPS and their Officers.

Private Equity

Ambition of **10% allocation** to private equity

In our view, such guidance goes against the principle that Administering Authorities are responsible for setting the investment strategy and could potentially limit ability to manage pension fund affordability and contribution stability.
We foresee practical issues in defining private equity.
The interaction between the government's levelling up plans for the LGPS and the 10% allocation to Private Equity needs to be defined.

Relevance to the Fund

✔

The outcome of the LGPS Next will have an impact on the Fund. Further work could be done around mapping the Fund's existing investments to the Levelling Up Missions.

Improved Funding Levels

Improved Funding Position

Why may funding levels have improved?

- Likely a combination of asset returns and reduced liability values.
- As gilt yields rise, asset return expectations also tend to rise (but this is not always the case). As asset return expectations rise, the value placed on the Fund's liabilities tend to fall.
- Dependent on the **actuarial assumptions** (how much expected returns and therefore the actuarial discount rate is linked to gilt yields).
- We can help you engage with the **Fund Actuary** to understand the current state of play in terms of funding position, discount rate, contributions impact and underlying assumptions.

Interim investment strategy review

The market environment has **fundamentally changed** since 31 March 2022 with yields and inflation potentially persisting **higher for longer**

Understand the current **Risk/Return** characteristics	Consider alternatives that **Reduce Risk and Increase Liquidity**	Consider asset classes that are **attractive** in this high yield environment

Undertaking an interim investment strategy review will ensure the Fund can capitalise on a strong position ahead of the next actuarial valuation

Liquidity analysis review

Assess impact on net cashflow position if contributions were to reduce significantly

Plan for how additional **Cashflow Requirements** would be met from wider Fund assets	Assess whether the pace of **Private Markets Commitments** needs to be revised	Ensure any strategic considerations are mindful of the consultation

Important to consider investment strategy and liquidity implications ahead of the next valuation

Relevance to the Fund

✔

The Fund has been working on a strategy review throughout 2023 including liquidity analysis.

Current Topics

Private Equity

Why continue to invest in it?

Returns for private capital have outperformed public markets over long-term timeframes

- **Expanded investment universe**
- **Greater alpha potential**
- **Better diversification of return**
- **Governance and control**

PE Strategies

Venture Capital
Minority equity investments to help companies launch, develop, or expand initial operations.

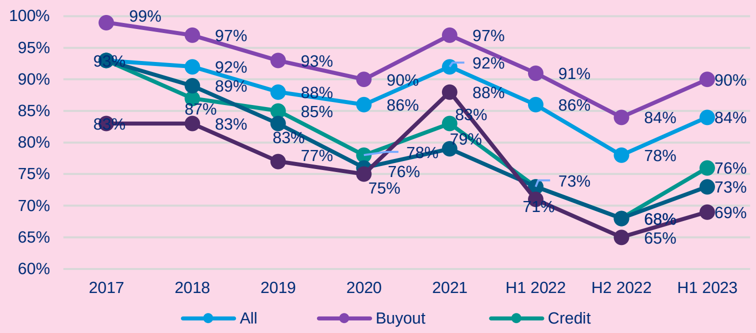
Buyout
Majority equity investments in mature companies with operating cash flows.

Growth Equity
Minority equity investments to help companies grow quickly by expanding operations or entering new markets.

Special Situations
Special Situations arise from market volatility, pricing dislocations and periods of stress/distress.

Secondary Market Opportunities

Portfolio Pricing



Relevance to the Fund

✖

The fund has considered private equity in the past but agreed not to make an allocation. Current focus within the illiquid asset portfolio is on the Local/Social Impact portfolio and Natural Capital

High Lease to Value Property: Impact of corporate DB redemptions

Implications for LGPS

Pooled Real Estate funds are shrinking, but the exit of corporate DB investors may create attractive entry pricing opportunities for some funds via the secondary market. We envisage three alternative scenarios for investors to consider:

Steady State
(low/medium probability)

Controlled Shrinkage
(base case)

Liquidity Crunch
(low/medium probability)

Relevance to the Fund

✔

The Fund has several investments in Property and we consider the market in our separate paper for the Panel

Natural Capital

Biodiversity and natural capital

Biodiversity is the variety of living things on Earth and includes the variability within and between species, and within and between ecosystems.

Natural capital includes the renewable and non-renewable natural assets providing resources and services to people and economic systems.

Why is it important?

- **Biodiversity loss can create financial risk**
- **Investing in companies that have a negative impact on nature creates reputational and legal risk**
- **Investing in nature will help realize net zero objectives**

Mercer's Sustainable Investment Pathway - Recommendations

ESG Good Practice
1. Revisit your ESG beliefs and policies.
- Understand nature and climate linkages.
- Include nature in climate policies.

2. Monitor the stewardship activity of asset managers.
3. Conduct audits of asset managers

ESG Leader
1. Revisit your ESG beliefs and policies.
   - Conduct belief sessions that include nature.
   - Include nature positivity in investment policy.
2. Include nature as a stewardship priority.
3. Understand exposure to the TNFD priority sectors.
4. Allocate to natural capital opportunities (see right hand side).

Relevance to the Fund

✔

The Fund continues to progress on ESG matters and has agreed to consider allocations to Natural Capital following the climate review workshop.

Mercer

Appendix

Q3 2023 Equity Market Review

In the US, equities were broadly negative, the rally in the so-called magnificent seven (e.g. Nvidia & Microsoft) slowed. The hawkish US Fed announcement had an adverse impact on US equities. Within equities, emerging markets outperformed developed markets but still generated negative returns on an absolute basis. Energy was the best-performing sector last quarter.

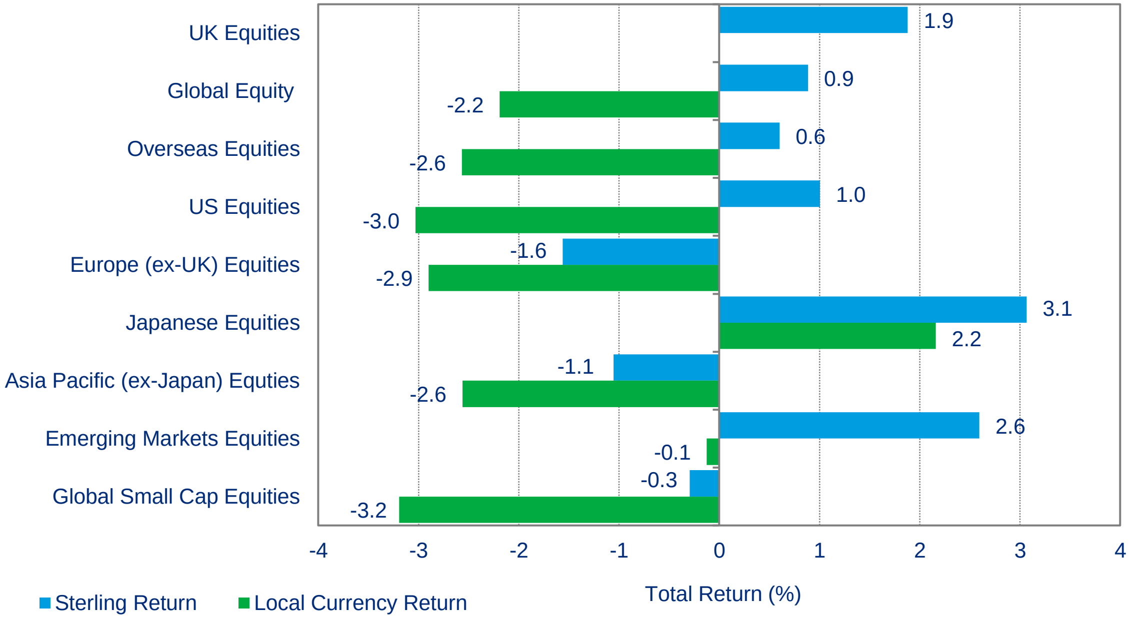
Global equities returned 0.9% in sterling terms and -2.2% in local currency terms as the dollar appreciated versus sterling.

US equities returned -3.0% in local currency terms, whilst European (ex-UK) equities returns -2.9%, and Japanese equities returned 2.2%.

Emerging markets ('EM') equities returned -0.1% in local terms.

Global small cap stocks returned -3.2% in local terms. Small-cap equities were negative as more cyclical assets underperformed during the quarter.

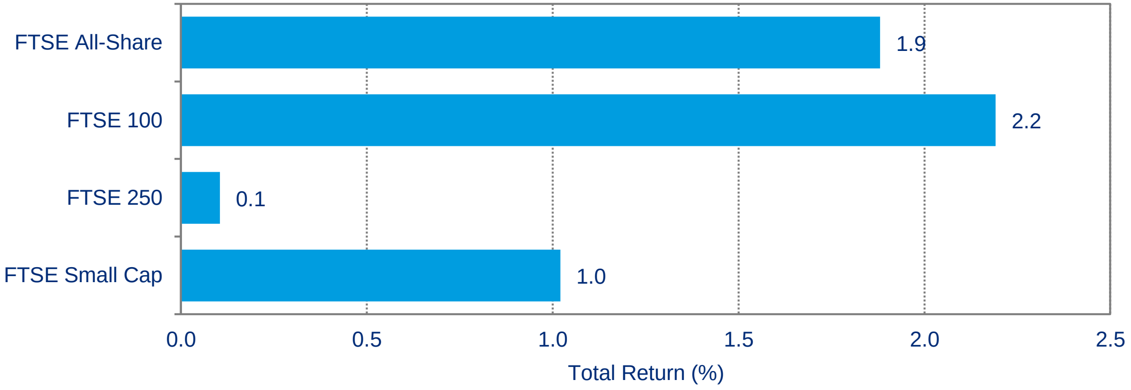
Equity Performance



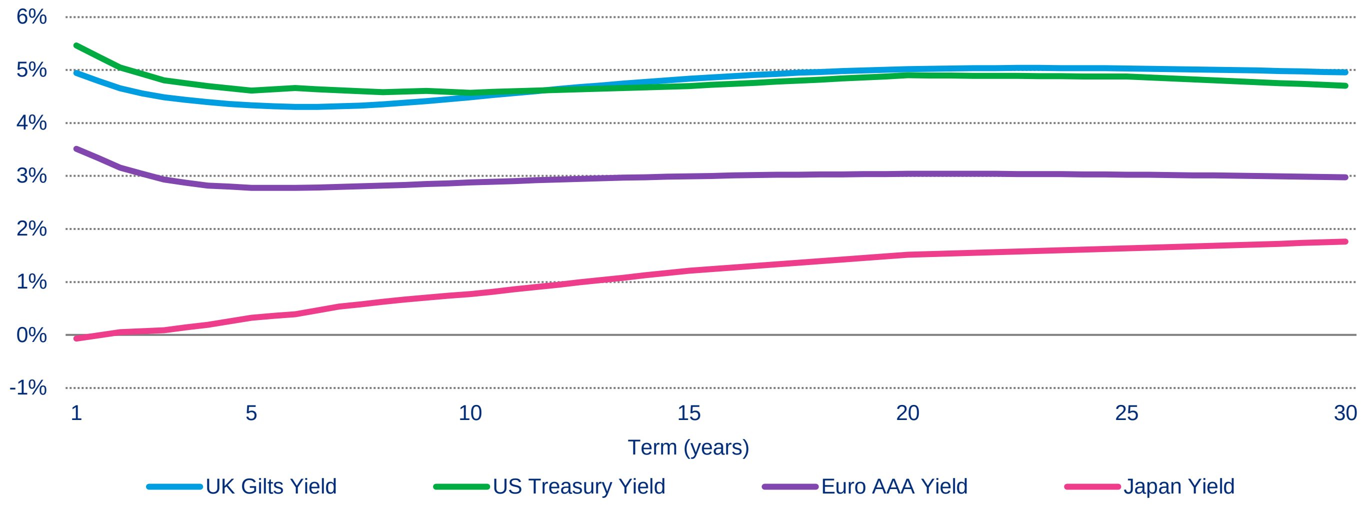
The **FTSE All Share** index returned 1.9% over the quarter with the large cap **FTSE 100** index returning 2.2%. More domestically focused, equities (**FTSE 250**) produced positive returns. The **small cap** index produced a positive 1.0% return.

Strong performance in the basic materials and energy sectors supported the UK performance relative to global equities.

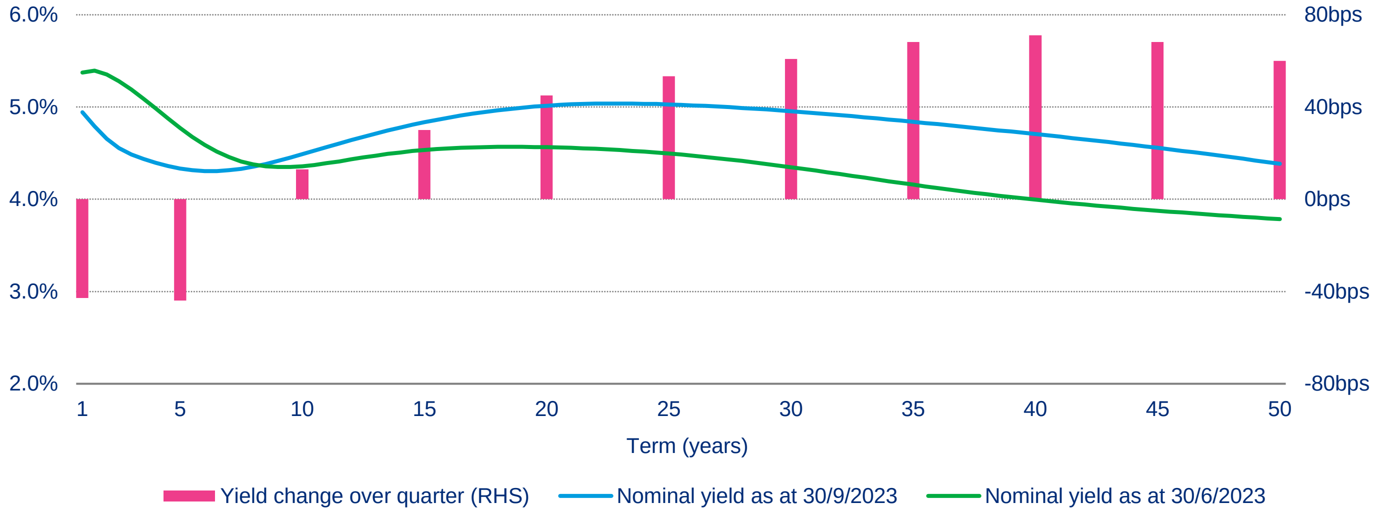
FTSE Performance by Market Cap



Q3 2023 Bond Market Review



Source: Mercer and Bloomberg



Source: Mercer

Government Bond Yields

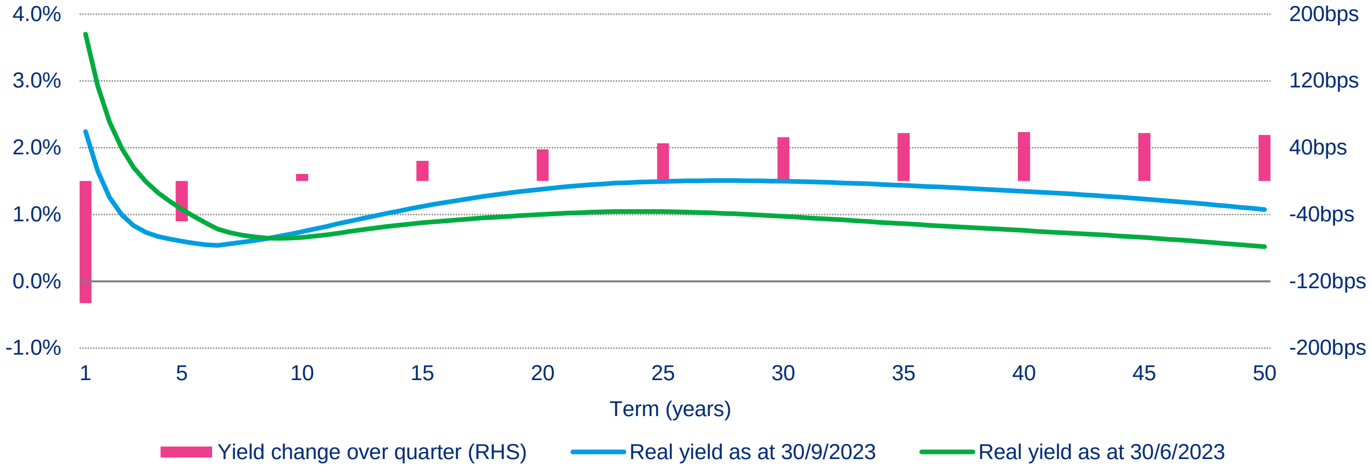
10-year global government bond yields rose sharply over the quarter. Across developed markets, curves steepened after prolonged flattening since the start of the central banks' policy tightening. In the UK, short-dated gilts were volatile and fell sharply post lower than expected inflation numbers and the BoE's dovish hikes. Intra quarter UK yields surpassed the levels witnessed during the gilt crisis in September 2022 but finished the quarter around 4.5%.

Unlike the UK, in the US most of the steepening was driven by the long end of the curve. 2-year yields in the UK fell by 30bps while in the US it rose by 25bps. 20-year yields rose by around 50bps in the UK and 100bps in the US.

Both the Federal Reserve and the Bank of England raised interest rates just once over the quarter.

The German 10-year yield rose by c.50bps. The European Central Bank raised rates twice over the quarter and signaled that it is close to the peak of rate hike cycle and now leaning more towards leaving rates on hold for a long period to bring inflation back to target rather than continuing to hike rates further. Most of the rise in yields took place in September due to spill over from the US.

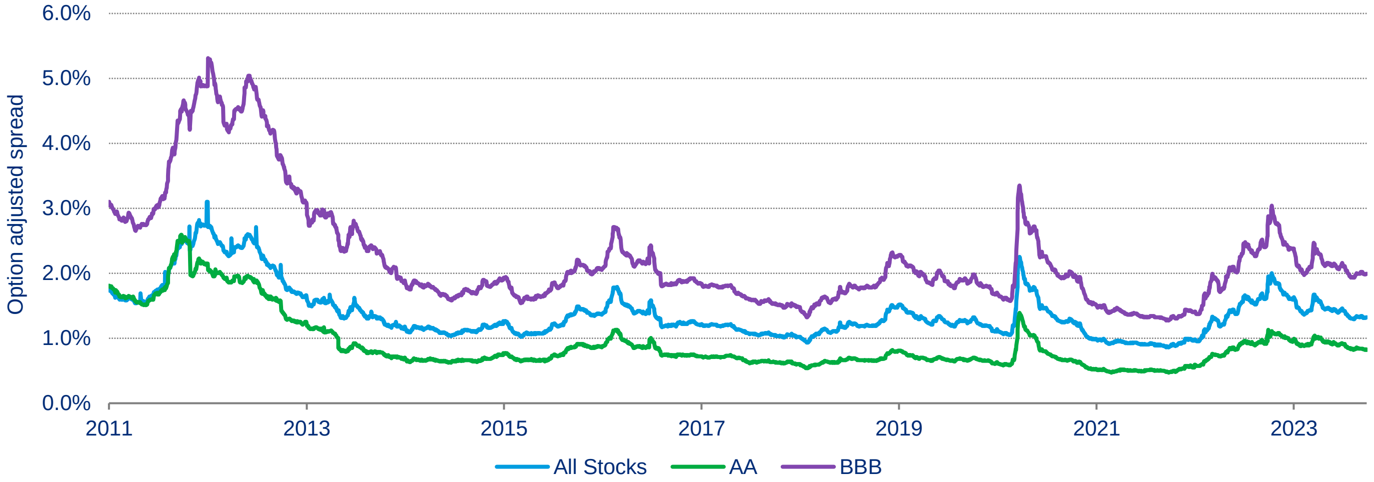
Q3 2023 Bond Market Review



Source: Mercer

UK Index-Linked Gilt Yields

UK real yields rose most in the long end of the curve, led by spillover effect from the US real yields move. UK inflation remains considerably above target. Real yields, for all maturities remain in positive territory. Market based measures of inflation expectations, in the form of breakeven inflation were flat over the quarter. The UK 10-year breakeven rate finished the quarter at ~3.85%. Market based measures of inflation expectations for the US rose over the quarter.



Source: Refinitv

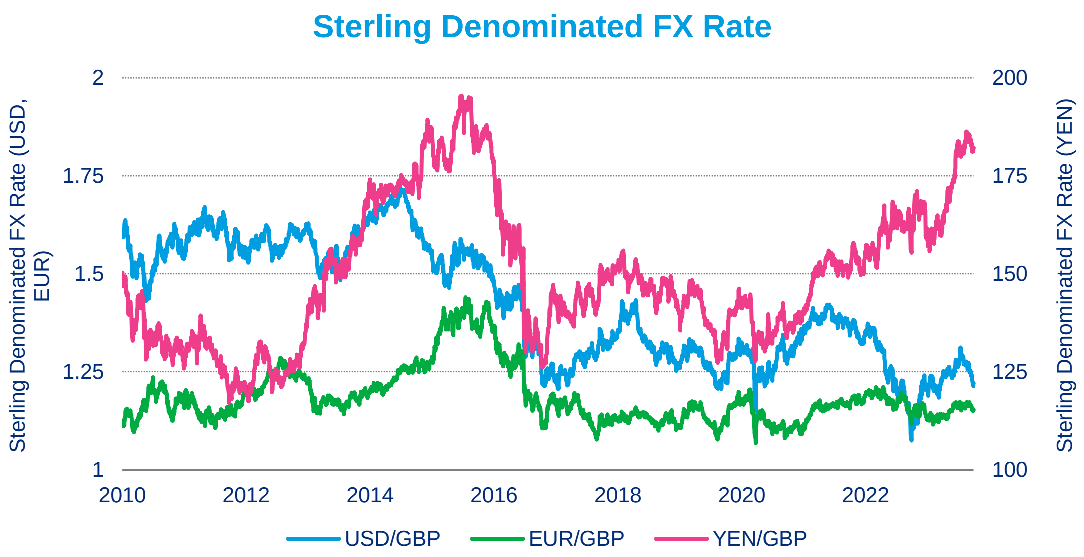
Corporate bonds

Spreads on UK investment grade credit tightened marginally over the quarter, with spreads on lower rated credit tightening more than for higher rated credit. UK credit outperformed equivalent duration government bonds.

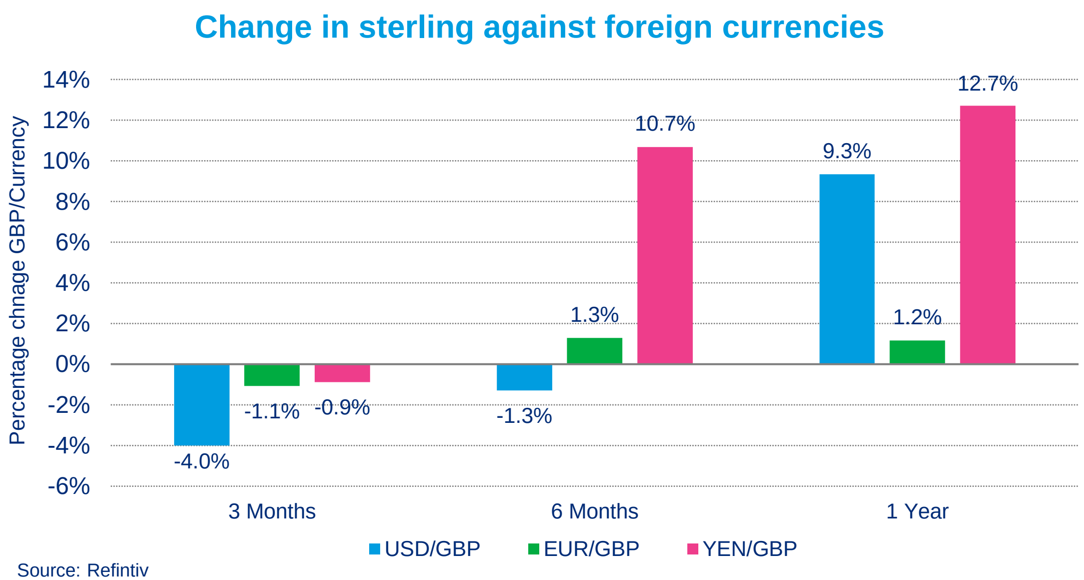
Q3 2023 Currency Market Review

Sterling's performance over the quarter was negative, depreciating versus the US dollar, euro and against yen. While the weakness was more prominent against the dollar and euro versus yen, Sterling weakness against the dollar was driven by a combination of a strong US dollar, stagflation risks in the UK, a surprise hold by the BoE in September and lower than expected hawkishness in the August meeting.

On a 12-months basis, sterling has appreciated considerably versus US dollar and yen but marginally versus euro.



Source: Refinitiv



Source: Refintiv

Q3 2023 Property

UK property as measured by the MSCI Index decreased by 0.2% over the quarter.

Summary of Mandates

Manager	Mandate	Benchmark/Target	Outperformance Target (p.a.)	Inception Date
BlackRock	Passive Paris-Aligned Equity (Synthetic Exposure)	MSCI Paris-Aligned Benchmark	-	May 2023
Brunel	Global High Alpha Equity	MSCI World	+2-3%	November 2019
Brunel	Global Sustainable Equity	MSCI AC World	+2%	September 2020
Brunel	Passive Global Equity Paris Aligned	FTSE Developed World PAB Index	-	October 2021
Brunel	Diversified Returns Fund	SONIA +3-5% p.a.	-	July 2020
Brunel	Multi-Asset Credit	SONIA +4-5% p.a.	-	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 (Cycles 1-3)	CPI	+2%	January 2019
IFM	Core Infrastructure	SONIA +5% p.a.	-	April 2016
Brunel	Renewable Infrastructure (Cycles 1-3)*	CPI	+4%	January 2019
Brunel	Private Debt (Cycles 2-3)	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	-	-	-

* The primary performance objective of this mandate is a Net IRR of 8% p.a. (GBP). Its inflation-plus benchmark is used by the custodian due to a greater ability to incorporate and the objective has value over the relative short-term, however, over time, comparison against the IRR objective will become more relevant.

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 Emerging
Global Small Cap Equity	MSCI World Small Cap
Hedge Funds	HFRX Global Hedge Fund
High Yield Bonds	ICE BofAML Global High Yield
Emerging Market Debt	JP Morgan GBI EM Diversified Composite
Property	MSCI UK Monthly Total Return: All Property
Commodities	S&P GSCI
Over 15 Year Gilts	FTA UK Gilts 15+ year
Sterling Non Gilts	ICE BofAML Sterling Non Gilts
Over 5 Year Index-Linked Gilts	FTA UK Index Linked Gilts 5+ year
Global Bonds	ICE BofAML Global Broad Market
Global Credit	Bloomberg Capital Global Credit
Eurozone Government Bonds	ICE BofAML EMU Direct Government
Cash	SONIA

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