CITY OF WOLVERHAMPTON COUNCIL	**Pensions Committee** 17 June 2020

Report title	Quarterly Investment Report to 31 March 2020	
Originating service	Pension Services	
Accountable employee	Tom Davies Tel Email	Head of Investments 01902 55 8867 Tom.davies@wolverhampton.gov.uk
Report to be/has been considered by	Rachel Brothwood Tel Email	Director of Pensions 01902 55 1715 rachel.brothwood@wolverhampton.gov.uk

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Recommendations for noting:

The Committee is asked to note:

1. The global market and investment update paper prepared by the Fund's Investment Consultant, Redington.

2. Asset Allocation and Performance Reporting for the West Midlands Pension Fund (WMPF)

3. Asset Allocation and Performance Reporting for the West Midlands Integrated Transport Authority Pension Fund (WMITAPF), noting that this will be the last time this element appears in this format following the merger of the WMITAPF with the Main WMPF.

1.0 Purpose

1.1 The investment report covers the range of investment issues for consideration by the Committee, primarily the market and investment background and the performance of both the West Midlands Pension Fund and the West Midlands Integrated Transport Authority Pension Fund. Supporting responsible investment activities are covered in a separate paper.

2.0 Background

2.1 This paper aims to bring together routine investment matters relevant to the management and implementation of the Fund's investment strategy and related policies:

I. The economic and market background environment in which the Fund operates and the outlook for different asset classes;

II. WMPF's investment strategy is outlined in the Investment Strategy Statement (ISS) and set in conjunction with the Funding Strategy Statement (FSS) to target a return over the long term to deliver the asset values required to meet benefit payments due to members. The Strategic Investment Allocation Benchmark (SIAB) forms part of the ISS and includes the target asset allocation and the levels of returns investment policies will be benchmarked against.

III. WMITA Pension Fund's investment strategy is set out in its Investment Strategy Statement, which also contains the Fund's investment beliefs.

IV. This report refers to Fund positioning against 2019 ISS policy targets. These were refreshed as part of the 2020 ISS review as approved by the Pensions Committee in March 2020. Implementation of the 2020 ISS updates has begun and will see the Fund transition to the new strategic policy targets to better meet the future needs of the WMPF and the rapidly maturing WMITAPF.

3.0 Executive Summary

3.1 As at to 31 March 2020, the West Midlands Pension Fund's market value was £14.8 billion. The Fund delivered strong absolute returns in 2019 as performance with significant gains from most investment markets. However, returns for the most recent quarter (ending 31 March 2020) were significantly impacted by market volatility caused by the COVID-19 pandemic and market falls in February and March largely erased the gains from 2019.

3.2 The Fund declined by 9.9% over the quarter with reported figures showing a 1.8% outperformance relative to the benchmark. Stabilising assets, particularly gilts and US TIPS (Treasury Inflation-Protected Securities) provided positive returns whilst riskier asset types suffered sharp declines.

3.3 Longer-term performance has been impacted by market conditions during the first quarter with 1-year returns dragged down to -3.9%, the 3-year return down to 1.0% and 5-year return down to 5.2%.

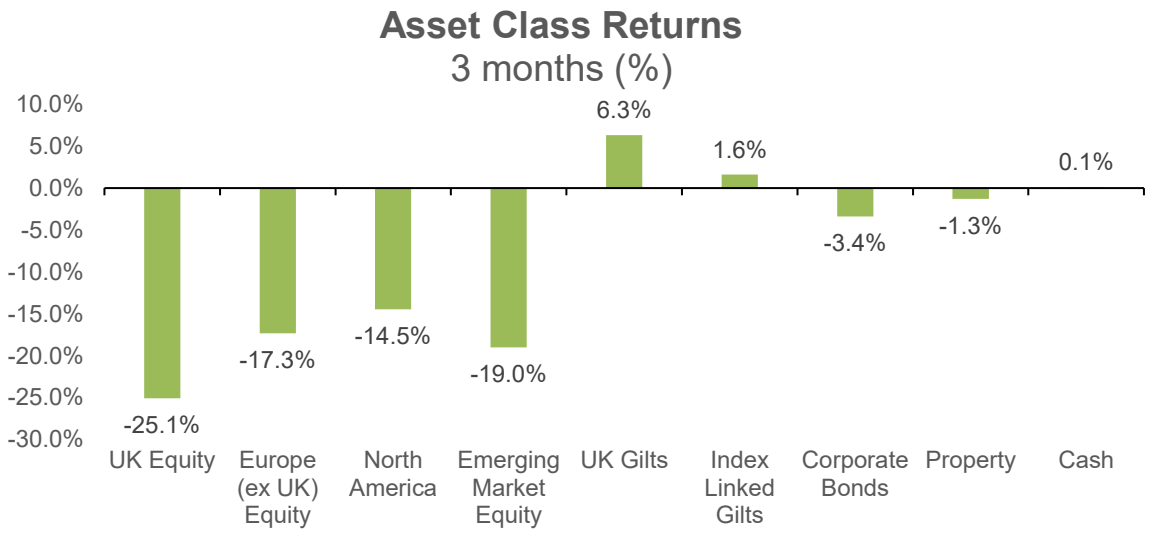
3.4 It should also be noted that 'stale' prices for illiquid assets mask true performance in some parts of the portfolio and therefore distort the absolute and relative performance presented here. Performance could be significantly impacted as valuations for these assets are received and reflected in performance reporting over the next quarter.

3.5 The West Midlands Integrated Transport Authority Pension Fund declined by 12% over the most recent quarter, underperforming its benchmark. Longer-term relative performance has also been impacted. The main drivers have been significant underperformance from both the Diversified growth Funds (DGF) and Multi-Asset Credit allocations, both of which are assessed against cash-based benchmarks.

4.0 Markets and Investment Background

4.1 The Fund's Investment Consultant, Redington provides a quarterly update on the market background and market performance over the quarter. The report for the quarter to 31 March 2020 which further sets out the outlook for the Fund's key asset classes over the coming months can be found in Appendix A.

4.2 For 2019, most major equity markets delivered returns of between 15-30% and bond markets also saw strong positive performance. However, the onset and subsequent spread of COVID-19 profoundly affected global markets in the first quarter of 2020, erasing the gains in the previous calendar year. Returns for the major asset classes for the period are shown below:



4.3 As can be seen, equity markets across both developed and developing regions saw significant declines. In response, governments and central banks announced measures to support businesses and households and reduce borrowing costs. In the US, the Federal Reserve (Fed) cut interest rates twice in March for the first time since the global financial crisis and announced unlimited quantitative easing (buying bonds). US interest rates now stand at 0-0.25%. The US Senate also passed a $2 trillion stimulus package. In line with other central banks, the Bank of England materially reduced interest rates, cutting by 65 basis points to 0.10%.

4.4 Government bonds yields fell (meaning prices rose) in Q1. Corporate bonds, and emerging market debt and currencies declined significantly, mainly in March, and underperformed government bonds, with moves exacerbated by a sharp tightening in liquidity.

4.5 In commercial UK property markets, the future for retailers is very uncertain. Future rents are likely to continue its downward slide across most market segments as more space becomes redundant and the collapse of footfall. The demand for office space is stable despite the encouragement of working from home and travel restrictions in place, all of which is helped by the limited supply in the office sector. The industrial sector has recorded strong rental growth for several years however property experts are expecting moderation in 2020, given COVID-19 and uncertainty about the impact on annual take-up.

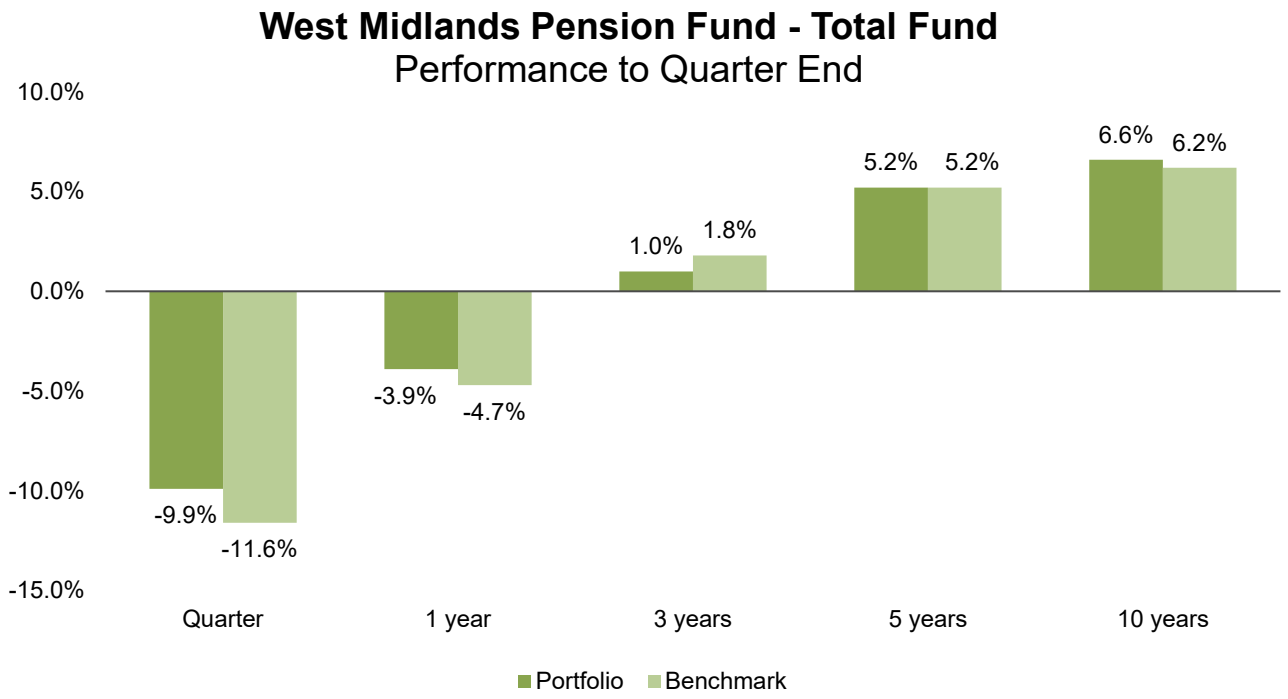
5.0 West Midlands Pension Fund

Total Fund Performance Summary

5.1 Over the quarter the Fund outperformed delivering a return of -9.9% (including the currency hedge impacts) compared to a decline of 11.6% for the benchmark return. The one-year return figure was again impacted by the COVID-19 crisis with the Fund achieving a return of -3.9% against the benchmark return of -4.7%. Over 10 years the Fund has outperformed the benchmark by 0.4%.

5.2 As highlighted earlier in this report, certain asset prices do not yet reflect weakness in Q1, and these impacts will detract from performance in subsequent quarters.

5.3 The main detractors of longer-term, 3-year relative performance remain insurance-linked securities and global active equities. The investment in US TIPs has had the largest positive impact on performance versus benchmark.



Source: Portfolio Evaluation Ltd

5.4 The asset allocation of the Fund as at the quarter end, compared to the strategic targets in place over the period (prior to adoption of the revised Strategic Investment Allocation Benchmark within the 2020 Investment Strategy Statement approved in March 2020), is set out in the table below:

Asset class	Value (£m)	Fund allocation %	Policy target %	Difference %
Growth				
Quoted equities	7,243	49.0	48.0	1.0
Private equity	1,228	8.3	10.0	-1.7
Special opportunities	210	1.4	2.0	-0.6
Currency Hedge	(77)	-0.5	N/A	N/A
Total growth assets	**8,604**	**58.2**	**60.0**	**-1.8**
Stabilising				
UK gilts	348	2.4	2.0	0.4
Index linked gilts	834	5.6	5.0	0.6
Cash	567	3.8	2.0	1.8
Corporate bonds	429	2.9	2.0	0.9
Cashflow matching fixed interest	297	2.0	3.0	-1.0
	308	2.1	0.0	2.1
Total stabilising assets	**2,783**	**18.8**	**14.0**	**4.8**
Income assets				
Specialist fixed interest	437	3.0	3.5	-0.5
Emerging market debt	610	4.1	3.5	0.6
Property	1,310	8.9	10.0	-1.1
Insurance linked funds	227	1.5	3.0	-1.5
Real assets and infrastructure	797	5.4	6.0	-0.6
Total income assets	**3,381**	**22.9**	**26.0**	**-3.1**
TOTAL	**14,769**	**100.0**	**100.0**	**-**

5.5 The Fund remained overweight in stabilising assets versus policy targets in place at the time. As a result of the recent falls in equity markets, growth assets have fallen underweight relative to the Fund's asset allocation target. The Fund's attention is now on implementing the Strategic Asset Allocation (SAA) changes as agreed as part of the 2020 investment strategy review. Initial efforts are focused on fixed income assets and planning steps to move towards new target weights in multi-asset credit and illiquid credit in particular.

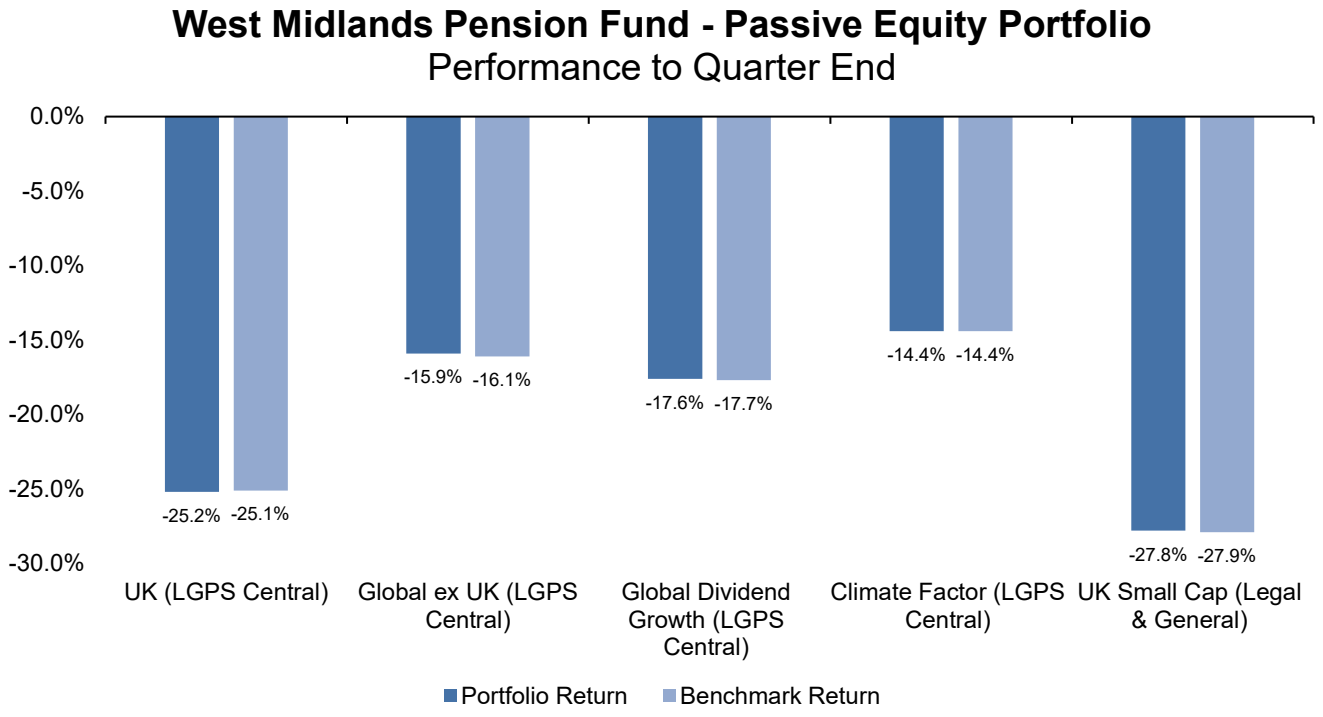
5.6 The Fund continues to work closely with its' investment pool company LGPS Central Ltd and Partner Funds to look for opportunities to transition assets where it can see value add from doing so, including the opportunity to make cost savings.

6.0 West Midlands Pension Fund

Detailed Performance Commentary

Growth Assets

6.1 The Fund's passive equity assets are now almost exclusively managed by the investment pool company, LGPS Central Ltd with a large proportion of these assets held in an LGPS Central Ltd ACS global equity passive fund. As illustrated in the below chart, all passive funds performed broadly in line with the respective benchmarks during the quarter.

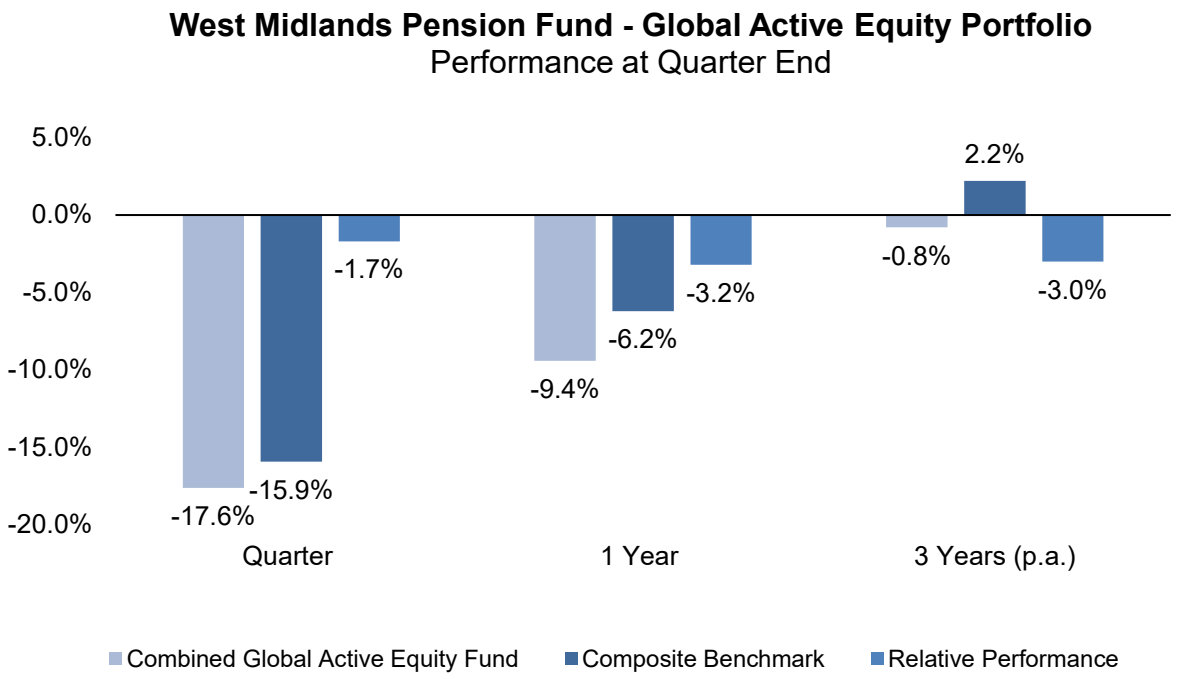


6.2 The Global ex UK Passive Equity Fund suffered steep falls but modestly outperformed the benchmark, returning -15.9% versus the benchmark return of -16.1%. With markets falling so sharply during March, the small cash balance held within the Fund added several basis points to performance. The Global Dividend Growth Factor Fund returned -17.6%, marginally underperforming its benchmark which fell by 17.7%. UK stocks suffered greater falls than global indices and many other developed market equity regions. The UK Passive Equity Fund lagged the benchmark during the quarter, returning -25.2% versus the benchmark return of -25.1%. The All World Equity Climate Multi Factor Fund also performed in line with the benchmark falling 14.4%. This outperformed the wider FTSE All World index which fell by 15.95% in the same period, as the strategies bias to more defensive companies helped avoid some of the sectors hit hardest by market falls.

6.3 The Fund's actively managed global equities comprise the LGPS Central Ltd Active Equity Fund and a basket of global equity futures held pending the transition to the sustainable equity mandates over the course of 2020. During the quarter, the Fund made its first subscription as part of this sustainable equity transition. Approximately £350m was invested in a fund with the objective of capturing investment opportunities related to the transition to a more sustainable economy and longer-term trends such as the move to de-carbonize the global economy, cloud computing changes in consumer habits and health, and urbanisation. This portfolio outperformed its benchmark by 2.7% over Q1, albeit posting negative returns of -12.9%. The portfolio's focus on higher quality, less indebted businesses proved beneficial during the market downturn.

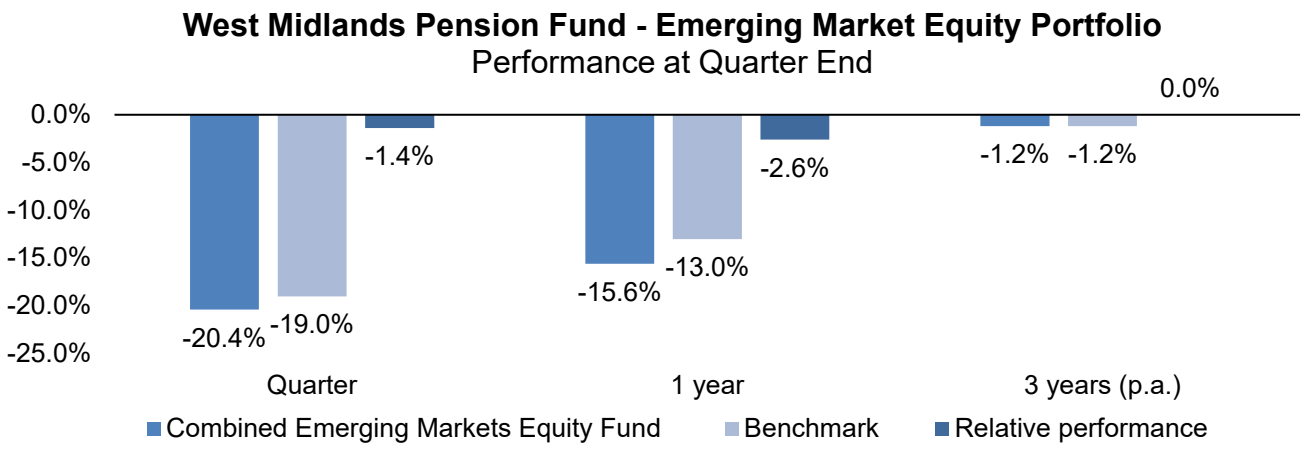
6.4 The LGPSC Global Active Equity Fund returned -18.8% against the benchmark of -15.9%. The LGPSC Global Active Equity Fund is a blended multi-manager portfolio consisting 3 portfolios with complimentary investment styles. Underperformance over the period (and longer-term) can largely be attributed to the relative performance of the investment style of one of the sub-portfolios. Discussions are ongoing with LGPS Central around the composition of the fund and the performance of the individual managers selected.

6.5 Over the 1-year and 3-year periods, the Combined Global (Active) Equity Fund is behind on its benchmark performance by -3.2% and -3.0% respectively. On the longer term since-inceptions measurement, The Combined Global Active Equity Fund is marginally behind its benchmark by 20 bps (0.20%), having generated 9.2% p.a.



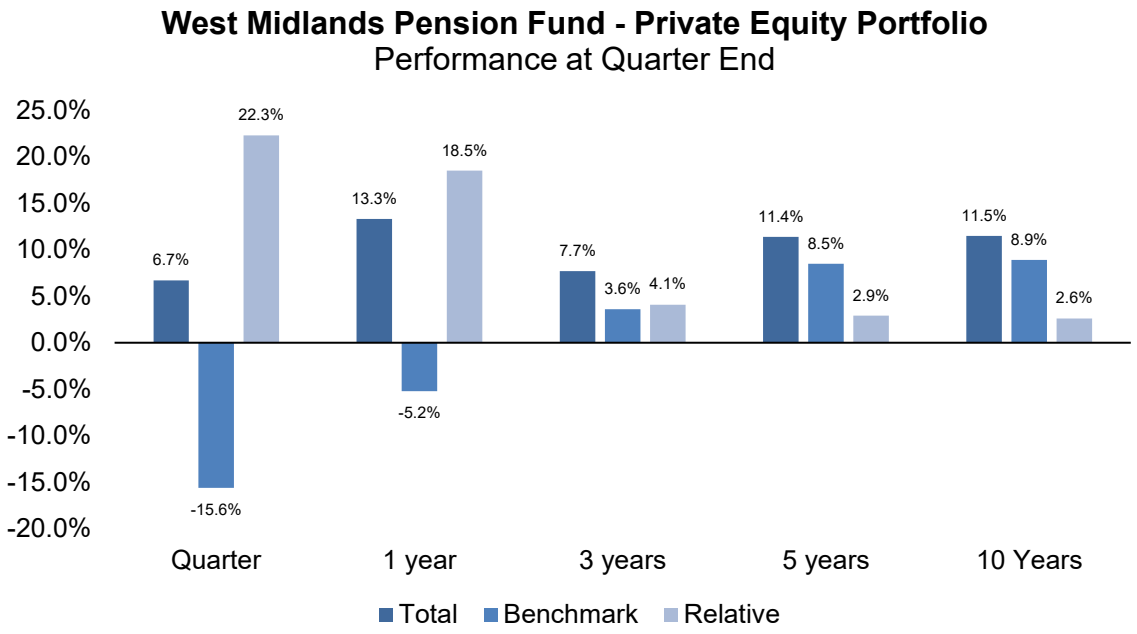
6.6 The Fund's emerging market (EM) equities are actively managed externally by three specialist managers offering complementary value, growth and quality strategies. The Combined Emerging Market Equity Fund and its benchmark have both generated negative returns over the quarter, with the Fund by -1.4%. All managers contributed to underperformance. On a regional basis, Latin American equities significantly underperformed. Brazil was the worst-performing country in EM, driven in large part by the depreciation of the Brazilian Real. Colombia also significantly underperformed, driven by the decline in oil prices. Equities in EM Asia outperformed, though still declined in absolute terms. China was the best-performing country in EM, helped by it being ahead of the curve in terms of epidemic control and resumption in economic activity.

6.7 Given the short and sharp drop resulting from the pandemic, the Fund and its benchmark have both generated negative returns over the 1-year and 3-year periods with underperformance of its benchmark of 2.5% in the 1-year period and in-line performance for the 3-year period.



6.8 During the quarter the Private Equity portfolio outperformed the benchmark by 22.3%, returning 6.7% against the listed equity benchmark return of -15.6%. This level of outperformance can be attributed to the stale prices of these assets not yet reflecting the impact of the pandemic on the underlying businesses in the portfolio. As the benchmark used here is based on listed equities (which have shown steep falls), the relative performance should be interpreted with caution. The true impact performance of the Private Equity portfolio will become clearer over the coming quarters. Performance also benefited from currency movements, with returns in GBP terms over the quarter was boosted as the pound depreciated against both the USD and EUR by 6.3% and 4.8% respectively.

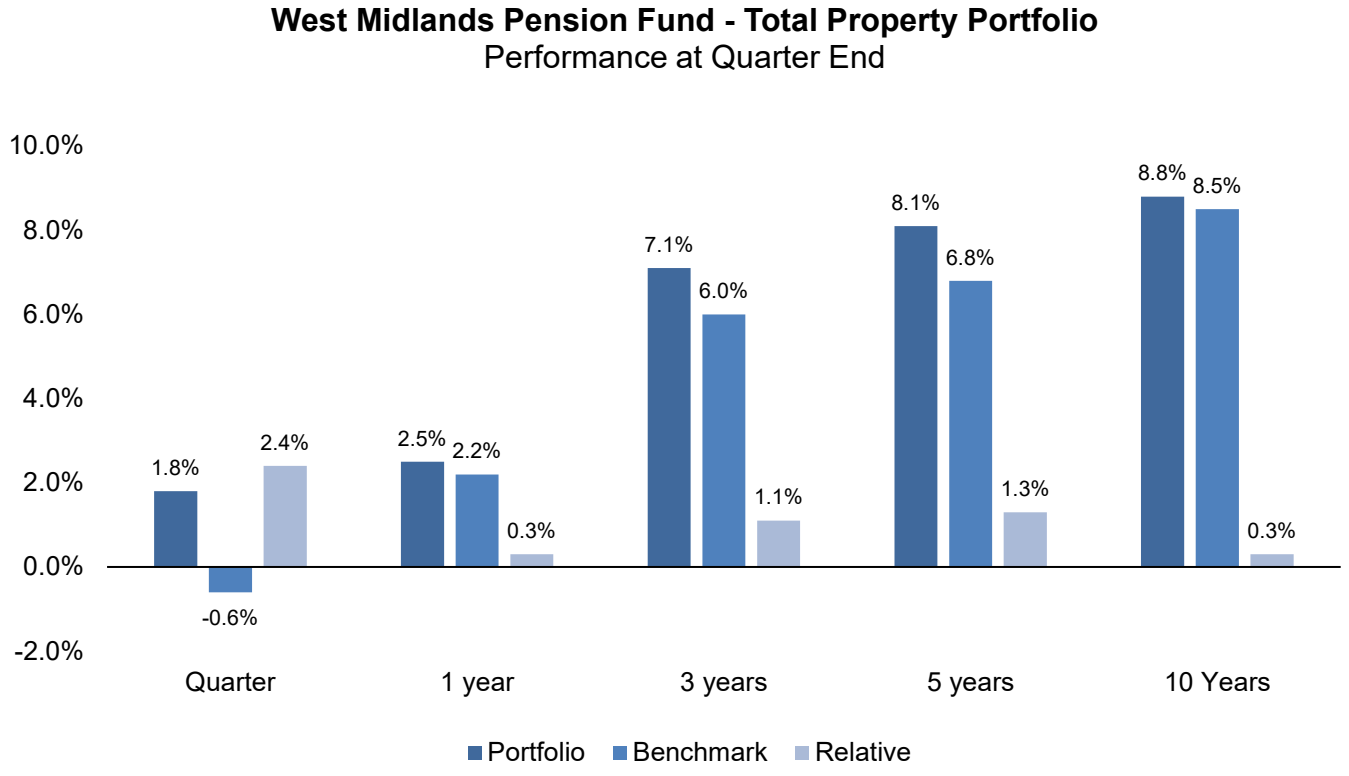
6.9 The longer-term measures of the private equity portfolio continue to show moderate levels of outperformance to that of the benchmark.



Income Assets

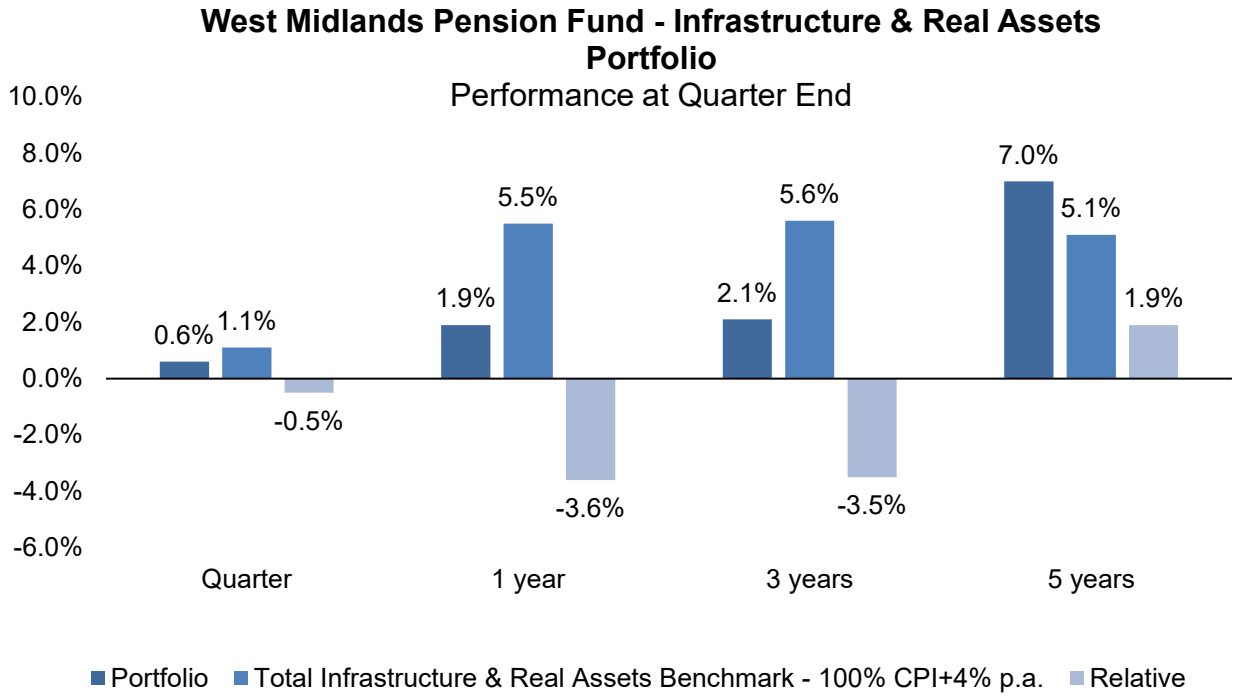
6.10 Property: The overall portfolio outperformed its benchmark during the quarter, with positive contributions from both the direct and indirect elements of the portfolio. Within the direct portfolio the small 'Other' Sector was the poorest performer and within the indirect portfolio US holdings had a particularly impressive quarter.

6.11 With the advent of lockdown measures, the inability to physically inspect a building helped thwart all but a few advanced deals progressing. Risk appetite also evaporated, effectively halting the transactional market and even where deals were progressed, terms were renegotiated. Without any transactional activity it is difficult to predict how hard valuations will be hit over the coming months especially as uncertainty over income and future rental levels persist.



6.12 Infrastructure and Real Assets: As with all other markets, COVID-19 impact was the single biggest factor during the quarter. The full impact on infrastructure sector valuations is yet to be determined but we expect to see some investments decline in value over the coming months as lagged valuations are received from managers. Not all valuations are certain to go down and those investments that have cashflows unaffected by the pandemic, i.e. renewables, may even see a degree of strengthening. However, investments that are GDP facing will most likely see valuation falls, particularly those within the transport sector.

6.13 Performance of the infrastructure portfolio for the quarter was below longer-term expectation, underperforming its benchmark of CPI+4% by 0.5%. This was despite a relatively strong performance from overseas investments, predominantly as a result of Sterling weakness. However, over the 5-year period the Fund has delivered outperformance against benchmark as can be seen in the following chart:



6.14 Absolute Return: This covers the insurance linked funds and special opportunity investments. During the quarter sterling depreciation was significantly beneficial to performance for this portfolio, which was 0.6% above its benchmark of 1%.

6.15 The insurance-linked sub-portfolio was also a beneficiary of the weakness of sterling as two of the holdings are denominated in USD. The return in the asset class of 4.2% vs. the benchmark 0.9% can be almost entirely attributed to the currency move. While currency has also been beneficial to the sub-portfolio in the more medium term this has not stopped it producing very poor returns due to the number of high-cost insured events of recent years and one, three and five-year numbers are all negative in absolute terms (at -7.9%, -18.9% p.a. and -7.3% p.a. respectively). This asset class continues to be a significant detractor to total Fund relative performance.

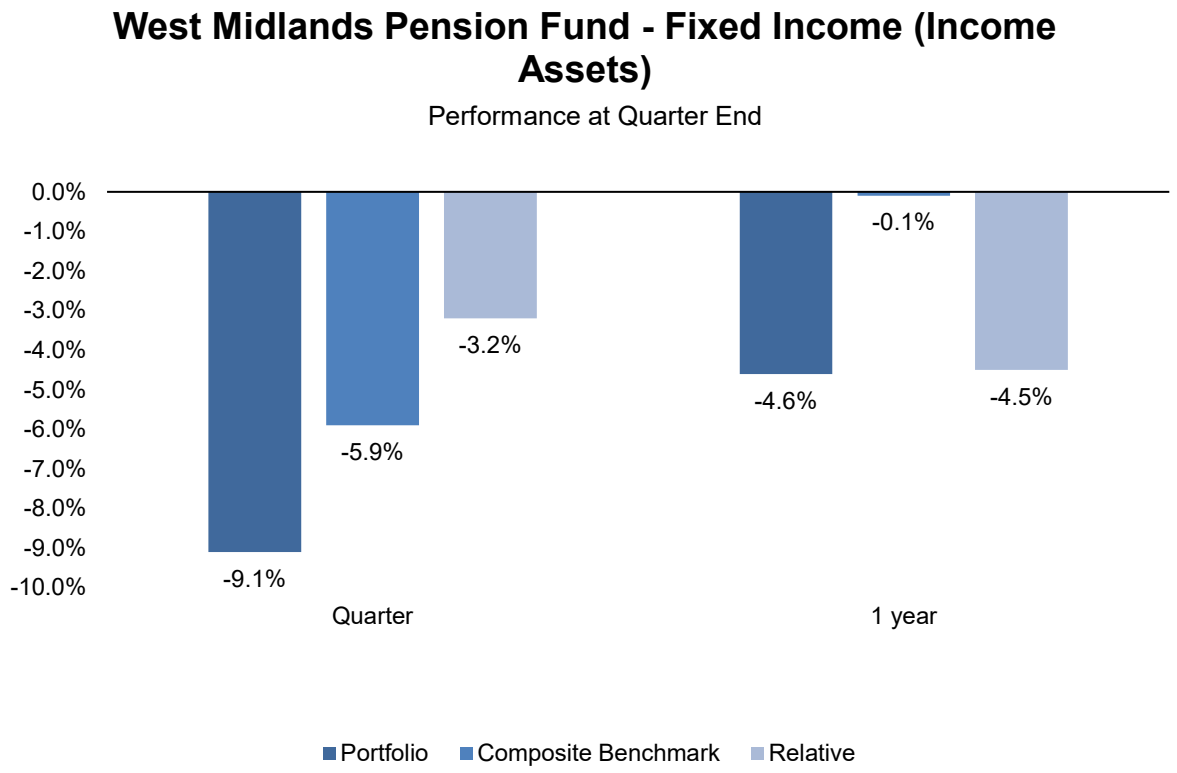
6.16 The special opportunities segment another area where lagged valuations are commonplace, and it is likely that when the March valuations are received there will be a fall in most of the valuations and that this will be reflected in next quarter's returns. The only holding that has a 'real-time' valuation (a Diversified Growth Fund) is also the biggest holding and produced a return of -13.5% during the quarter, which dragged the return of the sub-portfolio down The Fund's equity weighting was partly responsible for the loss but other holdings in credit, emerging market debt, property and infrastructure (with exposure to the latter two being gained via listed equity vehicles) also took a heavy

toll. Whilst recent experience in this sector has undoubtedly been very damaging in terms of performance over recent years, the 10-year performance is still showing a positive return, although clearly the level of volatility in the sector, notably the insurance linked sector, needs to be recognised.

6.17 Fixed Income incorporating emerging market debt and specialist fixed income:
The income element of the fixed interest portfolio underperformed its bespoke benchmark over the quarter by 3.2%, largely driven by the underperformance of the multi-asset credit allocation, whose fund returned -16.7% during the period. This fund was impacted by extreme market volatility, with a number of asset classes including loans, asset backed securities and high yield bonds suffering heavy mark-to-market losses over the period. The emerging market debt component of the portfolio also underperformed, with the hard currency allocation negatively impacted by overweight positions in South Africa and Bahrain and the local currency fund affected by overweight positions to Ukraine and Kazakhstan.

6.18 The specialist fixed interest component outperformed its benchmark by 8.9% due to the presence of a sizeable investment in a sovereign bond passive fund which tracked the benchmark and returned solid performance of 10.4% over the period. The fund invests in bonds issued by overseas governments, which performed particularly well as investors sought less risky assets.

6.19 Over the 1-year, the income portfolio underperformed its bespoke benchmark over the quarter by 4.5% as shown in the chart below. The primary drivers were emerging market debt and multi-asset credit as mentioned above.

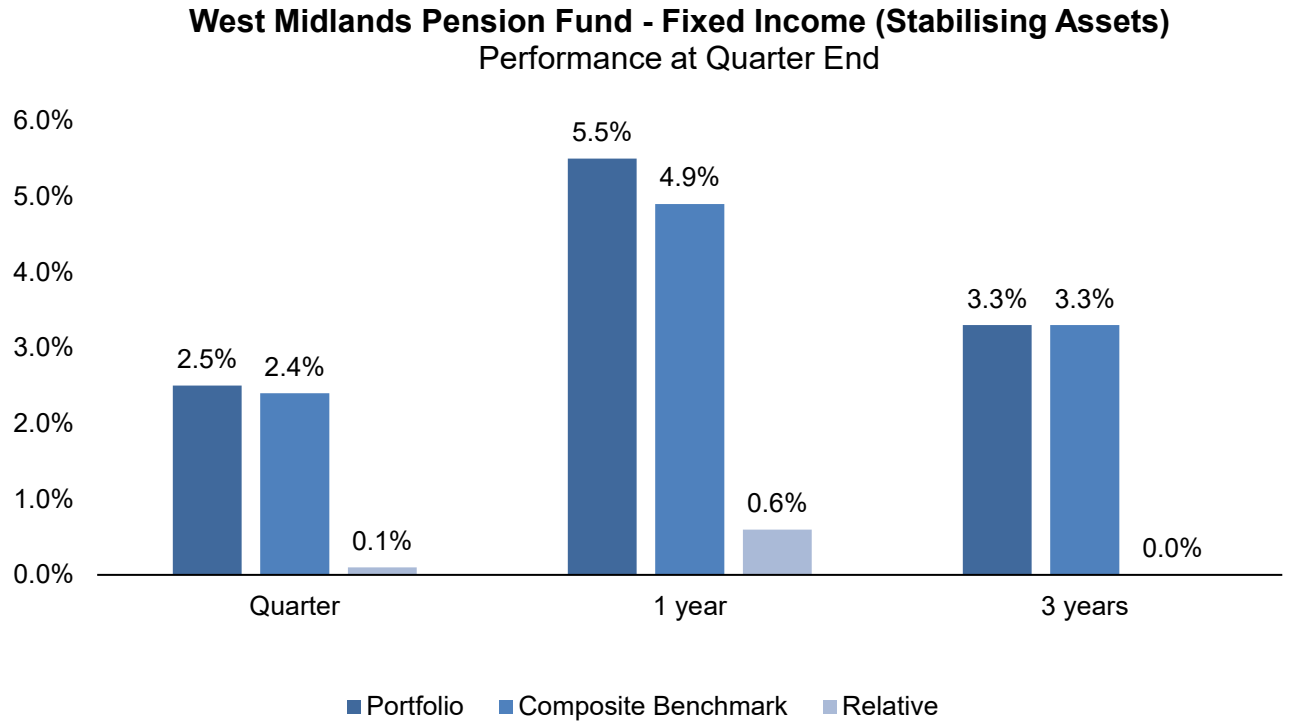


Stabilising Assets

6.20 Stabilising Fixed Income: The stabilising portfolio comprises the Fund's exposure to government bonds and index linked securities, corporate bonds, cashflow matching and cash. The stabilising component of the fixed interest portfolio marginally outperformed its benchmark. A significant positive contribution came from the US Treasury Inflation-Protected Securities (TIPS) held by the Fund, while the corporate bond segment of the portfolio also outperformed.

6.21 The cash flow matching segment of the portfolio underperformed its benchmark due to the index-linked gilt and corporate bond funds underperforming conventional gilts, on which the cash flow matching benchmark is based.

6.22 Over the 1-year and the 3-year timeframe, the stabilising portfolio outperformed or matched the benchmark as shown in the charts below:



Currency

6.23 The Fund entered into a passive currency hedging programme managed by HSBC in September 2017 to protect returns in sterling terms and to reduce currency risk within the investment portfolio. The hedge is applied to Fund's overseas quoted equity portfolios with a neutral hedge ratio of 50% based on the strategic weights for each region. To manage costs and complexity the Fund is only hedging its currency exposure in terms of Japanese yen, euros and US dollars. Proxies are used for other currencies: for example, the US dollar is used as a proxy for emerging market currencies. The hedge is rebalanced on a monthly basis to reflect changes in market values and is rolled forward on a quarterly basis, at which point the Fund realises any profit or loss.

6.24 Over the quarter, Sterling depreciated against most of the major currencies (US dollar, Yen and the Euro) which detracted from the Fund's performance. The currency hedge made a loss of £29.9 million for the quarter when the hedges matured in March. Over the 1-year period, the hedging programme also had a negative impact of -0.4%.

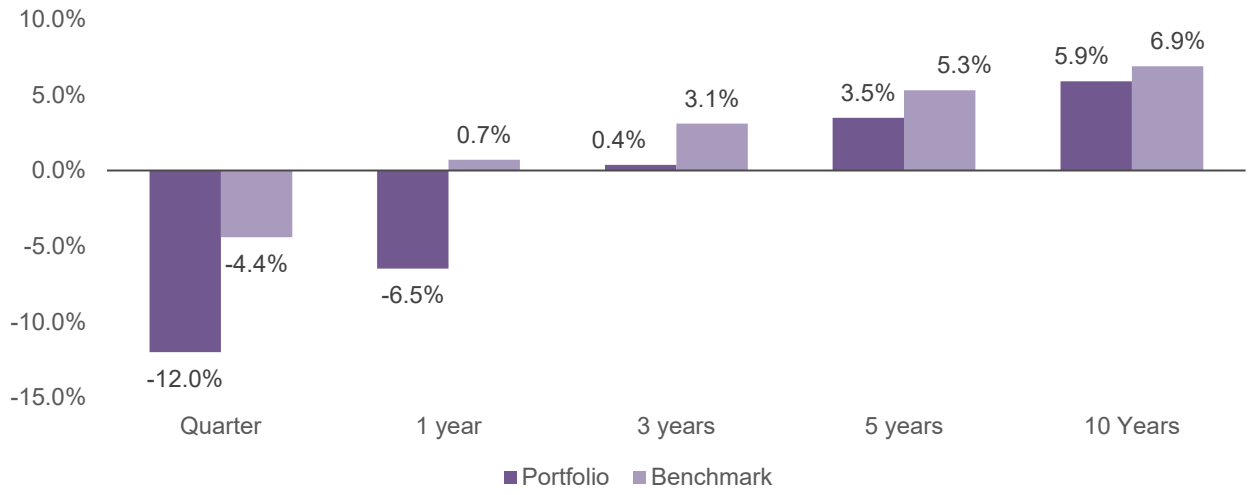
6.25 Despite the negative contribution in performance, the ex-post (actual) risk profile identifies that the Fund is relatively low risk and is lower risk than in recent years partly due to the hedging programme currently in place.

7.0 West Midlands Integrated Transport Authority Pension Fund

Total Fund Performance Summary

7.1 In the quarter to 31 March, the value of the WMITA Pension Fund decreased from £506 million to £478 million, posting a return of -12.0% against the benchmark return of -4.4%. Over the 12-month period the fund underperformed the benchmark by 7.2%, this was mainly due to the underperformance of the diversified growth (DGF) and fixed interest portfolios, both of which are assessed against 'cash-plus' benchmarks.

The chart below shows the gross and relative performance of the portfolio over the last quarter and over the longer term:



7.2 The table below sets out the different components of the performance of the portfolio to periods at the quarter end. Performance of the passive equity portfolio was broadly in line with expectations, however, the absolute level of market falls was significant with equities down by 17% at the end of Q1.

7.3 The DGF portfolio has experienced mixed performance over the long-term, but there was an uptick in relative performance over the last year until the beckoning COVID-19 crisis in Q1 2020. However, the diversified approach of the funds did not provide full protection against the severe equity falls seen globally.

7.4 The fixed income allocation is split between passive index linked exposure an active corporate bond portfolio and a multi-asset credit fund. Within this asset pool, Multi-Asset Credit was a detractor, with sharp falls and large relative underperformance.

7.5 Over the long-term, the relative return of the Fund has been dragged down by the sharp and largely indiscriminate sell-off experienced in Q1.

	Absolute performance				Relative performance			
	Quarter	1 year	3 years p.a.	5 years p.a.	Quarter	1 year	3 years p.a.	5 years p.a.
Equities	-17.1%	-8.3%	0.7%	5.7%	0.3%	0.5%	0.2%	0.2%
Diversified Growth Funds	-11.4%	-5.3%	0.0%	5.7%	-12.5%	-9.7%	-4.4%	-3.0%
Bonds	-9.3%	-6.7%	-1.0%	2.4%	-9.6%	-10.5%	-3.5%	-2.1%
Total return	**-12.0%**	**-6.5%**	**0.4%**	**3.5%**	**-7.6%**	**-7.2%**	**-2.7%**	**-1.8%**

7.6 The table below sets out the asset allocation of the portfolio at the quarter end (excluding the buy-in element of £229.4 million, last revalued as at 31 March 2020), the policy targets are those set in the 2019 Investment Strategy Statement, which are to be updated following changes agreed with Committee in late March 2020.

Asset class		Value (£)	Fund allocation	Policy target	Difference
Equities	£	64,678,679	26.1%	27.1%	-1.0%
Diversified Growth Funds	£	90,204,664	36.3%	35.5%	0.8%
Fixed Interest	£	45,096,565	18.2%	0.0%	18.2%
MAC	£	45,309,234	18.3%	20.3%	-2.0%
LDI	£	-	0.0%	17.1%	-17.1%
Cash	£	2,971,528	1.2%	0.0%	1.2%
TOTAL	**£**	**248,260,670**	**100.0%**	**100.0%**	**0.0%**

*Excludes Prudential buy-in £229.4 million as at 31 March 2019

** Policy target shows the policy targets agreed by Pensions Committee in March 2019

8.0 Investment Costs

8.1 The Fund continues to review its internal and external manager performance and fees to ensure the effective implementation of its investment strategy in line with the Fund's Investment Strategy Statement.

8.2 As previously documented the Fund has led on the cost transparency initiative to uncover hidden costs in an effort to be as transparent with the full costs of managing the portfolio as possible. Work during the previous financial year to participate in a pilot study with the PLSA (Pensions & Lifetime Savings), the Investment Association and the LGPS

Scheme Advisory Board meant that the Fund was one of the first to trial new templates to capture as far as possible all cost data.

9.0 Investment Pooling Update – LGPS Central Ltd

9.1 The Fund continues to work closely with its' investment pool company LGPS Central Ltd (LGPSC) and Partner Funds to look for opportunities to transition assets where it can see value add from doing so including the opportunity to make cost savings.

9.2 Work has taken place alongside input from the Fund and other Partner Funds to establish a Corporate Bond sub-fund for which investment occurred following quarter-end so are not captured in figures presented above. In addition, the Fund has worked with a number of Partner Funds and LGPSC to develop a mandate for emerging market debt. Two managers have been appointed and a fund is expected to be launched late 2020.

9.3 A number of other sub-funds remain in development including infrastructure, and multi-asset credit sub-funds and the Committee will be kept updated of other opportunities as they arise.

10.0 Financial implications

10.1 The financial implications are set out throughout the report.

11.0 Legal implications

11.1 This report contains no direct legal implications.

12.0 Equalities implications

12.1 This report contains no direct equal opportunities implications.

13.0 Environmental implications

13.1 This report contains no direct environmental implications.

14.0 Human resources implications

14.1 This report contains no direct human resources implications.

15.0 Corporate landlord implications

15.1 This report contains no direct corporate landlord implications.

16.0 Schedule of background papers

16.1 Investment Strategy Statement 2020 - https://www.wmpfonline.com/CHttpHandler.ashx?id=16022&p=0

16.2 Funding Strategy Statement 2020 - https://www.wmpfonline.com/CHttpHandler.ashx?id=12481&p=0

17.0 Schedule of appendices

17.1 Appendix A – Redington Economic and Market Update Q1 2020