

Covid-19: market update

Addressee and purpose

This paper is addressed to the Officers and Pension Fund Sub Committee (the “Committee”) of the London Borough of Brent (“Brent”) as administering authority to the London Borough of Brent Pension Fund (the “Fund”). This paper should be read in conjunction with our Investment strategy transition road map.

In addition to the enormous human cost, the rapid spread of the coronavirus will inevitably have a material impact on the rate of global economic growth. It is important to note that, while growth is expected to take a severe hit in the near term, global growth and corporate profits will eventually enter a recovery. However, the timing and shape of any rebound is uncertain and depends on containment of the virus and the effectiveness of policy responses in preventing temporary disruption to businesses and consumers causing permanent damage.

The purpose of this paper is to aid understanding of the current market backdrop, through discussion of plausible economic recovery scenarios and associated market impacts and help identify the key risks and opportunities facing the Fund and hence aid decision-making.

The paper should not be released or otherwise disclosed to any third party except as required by law or regulatory obligation without our prior written consent. We accept no liability where this report is used by, or released or otherwise disclosed to, a third party unless we have expressly accepted such liability in writing. Where this is permitted, the report may only be released or otherwise disclosed in a complete form which fully discloses our advice and the basis on which it is given.

Current market backdrop

Market performance

The table below shows the returns on major assets classes year to date (to 19 June). The figures for Q1 (e.g. the c25% fall in the value of UK equities) illustrate the scale of the fall in asset values during February and March, with only government gilts and gold delivering a positive return. There has been a significant rebound in asset values since 31 March due mainly to the economic stimulus provided by governments in the UK, US and Europe.

| UK | Q2 20* | Q1 20 | 2020* | GLOBAL | Q2 20* | Q1 20 | 2020* |
|--------------------|--------|-------|-------|-------------------------|--------|-------|-------|
| EQUITIES | 12.6 | -25.1 | -15.7 | EQUITIES | 18.8 | -20.0 | -4.9 |
| BONDS | | | | North America | 21.1 | -19.6 | -2.7 |
| Conventional gilts | 1.6 | 6.3 | 8.0 | Europe ex UK | 16.7 | -20.9 | -7.6 |
| Index-linked gilts | 8.8 | 1.6 | 10.6 | Japan | 13.3 | -17.2 | -6.2 |
| Credit | 6.3 | -3.4 | 2.7 | Dev. Asia ex Japan | 15.6 | -20.6 | -8.3 |
| PROPERTY* | -2.0 | -1.4 | -3.4 | Emerging Markets | 18.0 | -20.2 | -5.8 |
| STERLING | | | | GOVERNMENT BONDS | 0.7 | 3.2 | 3.9 |
| v US dollar | -0.3 | -6.4 | -6.7 | High Yield | 10.8 | -14.9 | -5.7 |
| v Euro | -2.2 | -4.2 | -6.3 | Gold | 8.0 | 6.0 | 14.5 |
| v Japanese yen | -1.2 | -7.0 | -8.1 | Oil | 87.2 | -65.9 | -36.2 |

Percentage returns in local currency (\$ for Gold and Oil). *All returns to 19/06/2020, apart from property (31/05/2020).

Impact on the Fund

The table below shows how the market value of the Fund's assets has changed since the start of the year. It highlights the significant fall during Q1 and the rebound since 31 March 2020.

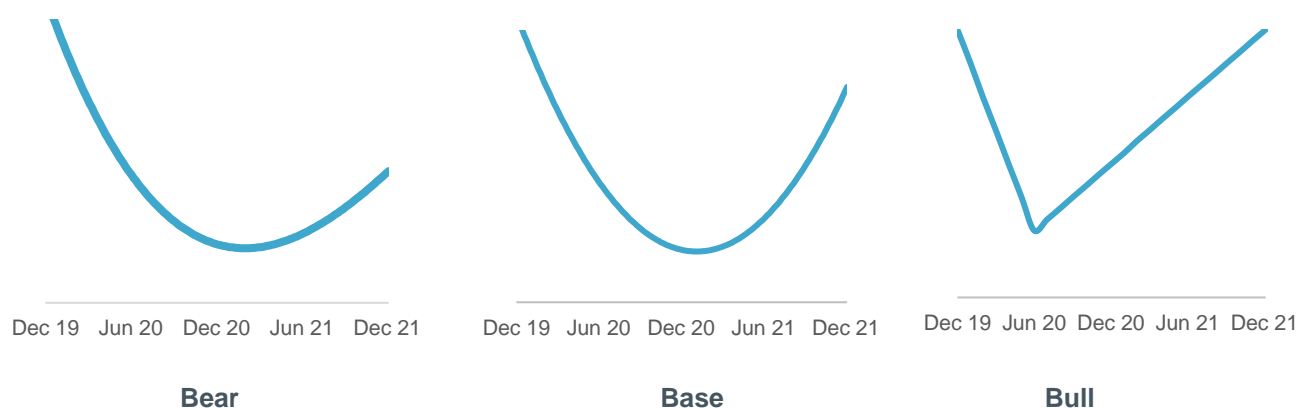
| | 31 December 2019 | 31 March 2020 | 31 May 2020 |
|-------------|------------------|---------------|-------------|
| Asset value | £934.8m | £835.3m | £917.1m |

Markets are, to an extent, looking through dismal expectations for Q2 data (GDP, corporate earnings, employment) and are now focussing on a potential economic recovery in the second half of the year. Enormous fiscal and monetary policy support has been deployed; it remains to be seen how effective this will be in supporting a strong recovery in economic activity as governments try to achieve a sustainable re-opening of their economies, and what the long-term cost of providing this support will be.

While government bond yields remain near record lows, global equity markets have rebounded strongly since their March nadir and are now touching levels seen as recently as last summer. The recent equity market rally, alongside falling earnings, has taken longer-term global equity valuation measures back towards longer-term averages. Shorter-term valuation measures, such as forward price-to-earnings ratios, are looking increasingly expensive versus history.

Outlook for recovery

As the initial phase of lockdowns ease across the globe and the dust attempts to settle, attention now turns to the complexity associated with lifting restrictions whilst trying to minimise the threat of a second wave of infections. There are a number of plausible scenarios that a recovery could take, each having different economic and market impacts over the short, medium and long terms. As the below graphs show, these range from a period of further decline and sluggish recovery (Bear case) through to a sharp recovery supported by medical breakthroughs (Bull case). Somewhere in between lies a slow and steady recovery following an initial recession (Base case).



Further details of these plausible scenarios and the accompanying impacts over the period to 2021 are set out in appendix 1. Please note these are not intended as forecasts but rather a plausible set of scenarios and the potential accompanying economic and market impacts.

Earlier this year an investment strategy review was undertaken with revised interim and long-term benchmarks agreed by the Committee. In these unprecedented times, it is worth reflecting on these agreed actions in light of the current market outlook.

Our view

Against this backdrop, we remain broadly comfortable with the Fund's strategy. Although volatility is likely to continue in the short term – due to uncertainty over the pace and scale of return in economic activity – the Fund is a long-term investor and can therefore take a long-term view. This is helped by the Fund's positive cashflow position (contribution income currently exceeds benefit outgo), which means the Fund is not a forced seller of assets. The cashflow position should continue to be monitored and capture the impact of any requests from employers to defer contributions.

Furthermore, the Fund's diversified approach to investing means it is well placed to navigate through challenging market environments with each asset class having its role to play.

Growth

The Fund's growth allocation forms around half of the strategic allocation and is the return seeking element of the portfolio.

The Fund's growth assets have pleasingly made up some of the losses incurred during Q1 supported by the rebound in equity markets. While some volatility can be expected in the short term, we remain supportive of the Fund's exposure to equities as the main source of return for the Fund over the longer term, helping to deliver on the Fund's long-term objectives - close the funding gap and keep contribution rates low. Reshaping the equity portfolio to increase exposure to low carbon and reduce the exposure to the UK over time will provide a further benefit in terms of risk diversification.

Diversifiers

The Diversifiers allocation is, as the name would suggest, there to provide meaningful and necessary diversification to the Fund's assets. They aim to provide a degree of predictability and stability to the Fund's return and income profile over the longer-term.

The Fund's multi-asset funds (Baillie Gifford and Ruffer) had contrasting fortunes during Q1, with Ruffer faring significantly better in terms of preserving capital. We remain supportive of the Fund's having a strategic allocation to multi-asset funds because of the diversification of risks they provide – they provide some ballast to equity market volatility. However, the Committee may wish to reconsider the balance between the two managers e.g. move to equal splits between the two, acknowledging their different styles which should complement each other.

We remain cautious on the outlook of private markets (private debt, infrastructure) but do believe based on a 'selective' investment approach these asset classes may offer investment opportunities for the Fund as companies and markets react to the impact of the COVID-19 pandemic. With the LCIV in the development stage of its private debt sub-fund and the infrastructure mandate in its infancy, this presents an opportune time for all parties (the Fund, us and other London Boroughs) to work together to aid in shaping future portfolio structures. There is also the advantage that, when investing in these private markets, capital is "drawn" in stages which therefore reduces the timing risk of investing in them in the short term. We propose that we work with the Officers regarding agreeing any future commitments, as part of the Fund working towards its strategic allocations to these asset classes.

The final asset class making up the diversifier allocation is property. The Fund has a 10% long-term strategic target allocation to property but has only c£0.1m invested at the present time (this investment is legacy investment in wind up). Post Covid sell-off, some property funds can be bought at material discounts to Net Asset Value ("NAV") currently, while hindsight might show this an ideal opportunity for the Fund to increase its exposure, we are cautious about investing in property at the present time. Our view is that the Fund should wait before investing in property, until market values provide greater transparency (a lack of transactions means current pricing may be unreliable e.g. the price may suggest a discount to NAV, there is limited data to test how

reliable the NAV number is) and there is greater clarity on the future prospects for property investment (e.g. office space may be less attractive now because many employees are better able to work from home).

Protection

Through the initial market downturn, the Fund's bond holdings performed well (as we would expect) helping to somewhat mitigate the growth allocation's fall. This is what protection assets like bonds are there to do and why we continue to be comfortable with the current arrangements – the gilts offer low cost exposure to downside protection assets.

The other component of the protection allocation is the CQS multi-asset credit mandate with the London CIV. Although categorised as a 'protection' style mandate it is very much at the "punchier" end of the protection scale given its allocation to high yield debt. Nonetheless, we continue to have conviction in the role this asset class has to play within the portfolio – offering diversification and low duration exposure to credit markets.

Conclusions

We remain broadly supportive of the Fund's current strategy. The Fund's positive cashflow position means it is not expected to be a forced seller of assets during any period of market downturn although this will need to be monitored.

In the shorter term, the Fund is exposed to the potential (downside) impact of disappointment in the scale and speed of the economic recovery. In particular, the key risks to the Fund's funding level are from its exposure to equities. While a bear scenario presents the prospect of a fall in assets in the short term (assessed to end 2021), over the longer term we would expect equity markets to recover as the pace of economic activity picks up post 2021. Furthermore, the Fund's protection assets will continue to offer good downside protection whilst the diversifiers should provide a stabilising force for both volatility and return. For these reasons we are broadly comfortable the current strategy remains appropriate to deliver on the Fund's long-term objectives.

The one area where we have most caution is property, although we support the asset class's long-term strategic benefits, we have caution on a short-term view. Given this, we recommend pausing any potential investment into this asset class. As outline in the transition road map, we propose the long-term strategic allocation of 10% into property remains, but the interim allocation is set at 0% (previously 5%), with the assets, previously earmarked for property, now split 3% equities and 2% cash. This can be revisited once there is greater clarity on the outlook for property markets.

At a structural level, there will be opportunities for the Fund, particularly within the private market space as the recovery takes shape.

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Appendix 1 – Scenarios considered

Possible scenarios

After the initial phase of infections and full lockdown, with the associated sharp recession, attention now turns to the complexity associated with lifting restrictions whilst trying to minimise the threat of a second wave of infections. A plausible set of scenarios and the potential accompanying economic and market impacts are discussed below. These are not intended as forecasts but rather a plausible set of scenarios and the potential accompanying economic and market impacts.

Base case

In our **Base case** the gradual lifting of lockdowns, in the absence of meaningful medical progress, means consumer spending remains subdued and there are large increases in unemployment, company failures (or simply an inability to return to the same level of capacity) and a collapse in business investment, weigh on the prospects for a rapid recovery. The subsequent recovery in output follows a “**U-shaped**” path with the severe downturn followed by a gradual recovery as restrictions are loosened. The cost of accommodative monetary policy acts as a longer-term drag to growth, either through lower central spending or higher taxes. A growth and earnings recession are priced into markets to a degree but given the strong bounce in markets since their March lows, risk assets may drift lower, or sideways for a prolonged period, in this scenario.

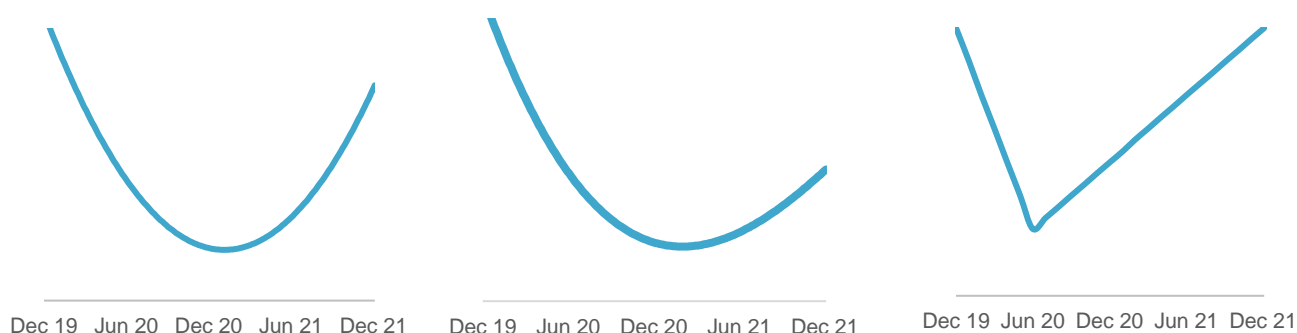
Bear case (downside scenario)

In our **Bear case** infection rates, having initially fallen on containment measures, start to rise again, as the relaxation of containment measures leads to a second round of infections. Alternatively, the lifting of lockdown is slower than anticipated, as governments try to minimise infections at any cost. Significant and prolonged economic shutdown across major economies leads to significant structural and liquidity difficulties causing an extended recession, greater impairments and further significant falls in risk assets. The subsequent path of the recovery in output is “**a tilted L-Shaped**”. Risk assets re-test their March lows and yields and base rates test a zero-lower bound.

Bull case (upside scenario)

In our **Bull case** – a sustainable and progressive reopening of economies potentially facilitated by the rapid emergence of a vaccine and/or significant advancement of test and trace technologies. Deferred consumption, production and business investment combine with unprecedented levels of fiscal and monetary support to ensure high levels of unemployment are temporary and bankruptcies limited, leading to a sharp recovery in activity and period of above-trend growth. The subsequent path of recovery in output is “**V-Shaped**”. Equity markets rebound to end-2019 levels and credit spreads return to long-term averages, while base rates and government bond yields rise a little, contained by necessarily accommodative monetary policy given substantial debt accumulation.

Illustrative output level in base, bear and bull scenarios, respectively



| | May 2020 consensus | Base | Bear | Bull |
|--------------------------------------|--------------------|---|-------------|-------------|
| UK GDP 2020 | -7.9 | -7.9 | -10.0 | -6.0 |
| UK GDP 2021 | 6.1 | 6.1 | 5.5 | 6.5 |
| 2-year change in output level | -2.3 | -2.3 | -5.0 | 0.0 |
| CPI Inflation 2020 | 1.0 | 1.0 | 0.5 | 1.5 |
| CPI Inflation 2021 | 1.4 | 1.4 | 1.0 | 2.5 |
| | | Level (change since 30 April 2020) | | |
| Base rates | 0.1 | 0.1 | 0.0 (-0.1) | 0.5 (+0.4) |
| 10-year gilt yields | 0.2 | 0.2 | 0.0 (-0.2) | 0.7 (+0.5) |
| 10-year index-linked yields | -2.6 | -2.6 | -2.2 (+0.4) | -2.8 (-0.2) |
| 10-year implied inflation | 2.8 | 2.8 | 2.2 (-0.6) | 3.5 (+0.7) |
| Global equities | | -10% | -20% | +10% |
| IG credit spreads | 2.1 | 2.1 | 3.1 (+1.0) | 1.4 (-0.75) |
| Sub-IG credit spreads | 7.6 | 7.6 | 10.6 (+3.0) | 5.1 (-2.5) |
| UK Commercial property | | -10% | -25% | 0% |