

UPDATE FROM INDEPENDENT ADVISER – Colin Robertson

Quarter to 30 June 2019

Market performance

The relentless fall in government bond yields globally continued in Q2 2019 and yields have fallen significantly further after the end of the quarter. Since 30 September 2018, UK 10 year gilt yields have collapsed from 1.5% to 0.5% at the time of writing. This remarkable development has been driven most recently by slowing economic growth, still subdued inflation and, most importantly, by central banks' reaction to the economic statistics. This led to the Federal Reserve Board in the US cutting interest rates at the end of July and the European Central Bank emphasising how monetary policy could be loosened even more.

Following a very strong first quarter of the year, equity markets generally rose again over the 3 months to 30 June 2019, be it at a considerably lower rate. For investors, the US-China trade war and other undesirable political news flow, together with the poor economic backdrop, were outweighed by the anticipated market friendly actions of central banks. However, more recently equity markets have fallen back and appear rather shaky as the political scene has not improved and investors contemplate the limited tools which policymakers have at their disposal to boost economies.

Brexit has not had a big impact on UK financial markets with the exception of sterling. Companies quoted on the UK stockmarket are very global in nature and UK gilts have been affected more by the powerful downward trend in bond yields elsewhere. In contrast, sterling has now fallen by almost 5% against the euro and over 6% against the US dollar since 31 March this year.

Economics and markets

I commented last quarter that "Few of the problems which investors faced at the turn of the year have gone away. In particular, the political situation globally has worsened". This remains the case. For example, UK politics is a shambles, damaging growth, and in Argentina the Kirshner dynasty seems set to return to power which caused the stockmarket to fall in US dollar terms by 50% in a week. Perhaps most worryingly, President Trump has now taken to attacking Jerome Powell, the chairman of the US Federal Reserve Board and his own appointee, putting at stake the cherished independence of this august institution. Given the enormous importance markets currently attach to central banks, this matters.

For the time being, economic growth is modest to moderate and inflation is rather low but not dangerously so. The issue is what happens when the economy tips over and policymakers are forced to adopt quite extreme measures with unknown consequences as most of the normal measures having already been utilised.

Equity market valuations are close to those of 3 months ago, which is not that surprising when bond yields which form part of the basis for valuing equities are lower, offsetting the poor newsflow. Forecasts for the aggregate profits of quoted companies are little changed for the most part but these forecasts are vulnerable as profit margins remain at very high levels historically. This has been true for some time and unusually companies have not competed away their 'excess' profitability. Nevertheless, the impact of higher tariffs on the

global supply chain, along with slower economic growth, will contribute to greater pressure on margins. On the positive side, the dividend yield on equities compares very favourably with the yields on other asset classes.

German 10 year bonds now yield negative 0.7% so investors are guaranteed to lose this amount every year for 10 years. Very roughly, 30% of global bonds offer investors a guaranteed loss, even before allowing for inflation. The rationale appears to be that the conditions which have driven yields down to (and prices up to) current levels are unlikely to change in the foreseeable future in a way which would raise yields. To me, this smacks of the greater fool theory (make sure you sell to someone else before prices fall) or a period of depression and / or deflation is implicitly on the cards.

Asset allocation

The fund has about 6% more invested in equities than indicated by the strategic benchmark. Given my comments above on equity markets, this appears inadvisable and it would be appropriate to reduce the equity exposure down towards the benchmark. The equity protection strategy assumes that the fund's equity exposure is in line with the benchmark and so should not be thought of as protecting against the current overweight position.

Although the fund's allocation to liability matching bonds is similar to that of many other LGPS funds, at only 5% of the fund it provides little protection against movements in the value of the liabilities. Nevertheless buying these bonds at the current yield levels described above is highly unattractive.

As suggested before, investment in infrastructure would provide some protection against movements in the value of the liabilities and, managed correctly, should be an attractive investment more generally.

While the cash raised from equity sales could be reinvested in infrastructure, in reality it takes years after the commitment is made for investment in infrastructure to be completed. For the time being, funds with a "cash plus" return target such as Diversified Growth Funds should provide a suitable home for the sale proceeds.

Investment Managers Performance Review

Active Equity Fund

The LCIV Baillie Gifford Global Equity fund outperformed its benchmark by 1.4% over the quarter. This follows relative outperformance of 2.2% in Q1 but the fund still lags its benchmark over the last 12 months as it struggles to make up for poor performance in the second half of 2018. The long term performance of the fund remains exceptionally good.

A concern is that the fund performs well in rising equity markets and poorly in falling equity markets. As equity markets rose in Q2, outperformance might have been expected on these grounds but I am unable to analyse the situation properly due to the limited information provided by LCIV who are responsible for Tower Hamlets' relationship with Baillie Gifford. I

am meeting with LCIV on 10 September and will raise this issue with them then. The fund did benefit from its overweight position in growth stocks. The significant exposure of the fund to Chinese stocks was a concern of LCIV last quarter and I will take this up with LCIV as they have not commented on this in their latest report.

Diversified Growth Funds

The Ruffer fund has a relatively high exposure to equity market movements compared to other Diversified Growth Funds while the Baillie Gifford fund has significant exposure to both equities and Emerging Market bonds. Consequently, these funds perform relatively well in times of rising markets which led to decent performance in the 3 months to 31 March and good performance over the first half of the year. However the Ruffer fund is still down over the last 12 months.

Both managers reduced the economic risks by switching into less cyclical stocks during the quarter and have various strategies in place to (partially) protect their funds against falling equity markets. However Baillie Gifford appear to have increased the property and commodity weightings by 4.5% and 2% respectively over the quarter although there is no explanation of this from LCIV. The effectiveness of the protection measures are likely to be a key to performance over the remainder of this year.

Absolute Return Bond Funds

The recovery in GSAM's performance continued in Q2 with a return of +1.3% and year to date the return is +4%, beating the target return over this period. There were widespread sources of outperformance with no significant area of underperformance.

In contrast, Insight produced a 0% return for both the quarter and the half year. For once their long US Treasuries / short German bunds position came right. However the benefit was wiped out by taking the wrong stance on US inflation and a mistaken view on Italian bonds.

Multi Asset Credit Fund

The LCIV CQS Multi Asset Credit Fund had strong returns of +1.7% and +3.9% over Q2 and the last year respectively. Encouragingly, the sources of outperformance over the quarter were spread over 3 sub asset classes.

LCIV have put CQS on their "watch list" because of senior staff changes, increasing leverage and an absence of investment grade bonds in the portfolio. Mercer disagree with LCIV's concerns. I find it disturbing that this has happened relatively soon after the launch of the fund (31 May 2018) and LCIV's assessment of CQS at that time.

Property Fund

The Schroder Real Estate Capital Partners fund underperformed its benchmark by 0.3% this quarter, bringing down the 1, 3 and 5 year relative performance figures in broad terms from being slightly ahead of the benchmark to being marginally behind. The manager's views and positioning of overweighting the industrial sector, regional offices and niche areas while underweighting the retail sector and central London offices remains unaltered.

Passive Funds

The LGIM All World Equity Index passive funds performed in line with their benchmarks as one would expect. The LGIM MCSI World Low Carbon fund outperformed its benchmark slightly over the quarter but by 0.5% over the last year which is curious for a passive fund.

The performances of the “standard” and low carbon indices were very similar over the quarter and identical over the year.