

Agenda Item No 4(a)

**DERBYSHIRE COUNTY COUNCIL
PENSIONS AND INVESTMENTS COMMITTEE**

7 September 2016

Report of the Director of Finance

INVESTMENT REPORT

1 Purpose of the Report

To review the Fund's asset allocation, investment activity since the last meeting, long term performance analysis and to approve the investment strategy in the light of recommendations from the Director of Finance and the Fund's independent advisor.

2 Information and Analysis

(i) Report of the External Advisor

A copy of Mr Fletcher's report, incorporating his view on the global economic position, factual information on global market returns, the performance of the Fund and his recommendations on investment strategy and asset allocation, is attached in Appendix 1.

(ii) Asset Allocation and Recommendation

The Fund's latest asset allocation as at 31 July 2016 and the recommendations of the Director of Finance and Mr Fletcher, in relation to the Fund's benchmark, are shown in the table below.

The table also shows the recommendations of the Director of Finance adjusted to reflect the impact of future investment commitments. These commitments largely relate to Alternatives and Property and totalled £138m at 31 July 2016. Whilst the timing of cash drawdowns is difficult to predict, the In-house Investment Fund Manager Team (IFMT) believe that these are likely to occur over the next 18 months.

Public

| Asset Category | Benchmark | | Fund Allocation | Fund Allocation | Permitted Range | Benchmark Relative Recommendation | | Recommendation | | Recommendation Adjusted for Commitments (**) | Benchmark Return |
|---------------------|--------------|--------------|-----------------|-----------------|-----------------|-----------------------------------|--------------|----------------|--------------|----------------------------------------------|-------------------|
| | Old | New (*) | | | | AF 7/9/16 | DPF 7/9/16 | AF 7/9/16 | DPF 7/9/16 | | |
| | | | | | | | | | | | |
| Equities | 64.0% | 60.0% | 66.5% | 66.7% | +/- 8% | +1.0% | +6.7% | 61.0% | 66.2% | 66.2% | n/a |
| UK Equities | 34.0% | 28.0% | 31.1% | 29.7% | +/- 6% | - | +1.2% | 28.0% | 29.2% | 29.2% | 7.7% |
| Overseas Equities | 30.0% | 32.0% | 35.4% | 37.0% | +/- 6% | +1.0% | +5.5% | 33.0% | 37.0% | 37.0% | n/a |
| N. America | 9.0% | 11.0% | 11.2% | 11.8% | +/- 4% | -2.0% | +0.8% | 9.0% | 11.0% | 11.0% | 16.5% |
| Europe | 9.0% | 9.0% | 9.0% | 9.0% | +/- 4% | - | +0.5% | 9.0% | 9.8% | 9.8% | 19.5% |
| Japan | 5.0% | 5.0% | 6.3% | 6.7% | +/- 2% | +1.0% | +1.7% | 6.0% | 6.7% | 6.7% | 13.7% |
| Pacific ex-Japan | 4.0% | 4.0% | 5.2% | 5.5% | +/- 2% | +1.0% | +1.5% | 5.0% | 5.5% | 5.5% | 17.6% |
| Emerging Markets | 3.0% | 3.0% | 3.7% | 4.0% | +/- 2% | +1.0% | +1.0% | 4.0% | 4.0% | 4.0% | 17.0% |
| Bonds | 24.0% | 22.0% | 18.6% | 18.5% | +/- 5% | -3.0% | -2.4% | 19.0% | 19.6% | 20.3% | n/a |
| Conventional | 9.0% | 6.5% | 6.4% | 6.3% | +/- 3% | -3.0% | -0.2% | 3.5% | 6.3% | 6.3% | 9.7% |
| Index-Linked | 8.0% | 6.5% | 6.7% | 6.7% | +/- 3% | -3.0% | +0.2% | 3.5% | 6.7% | 6.7% | 13.8% |
| Corporate | 7.0% | 6.0% | 5.3% | 5.2% | +/- 3% | +3.0% | -0.8% | 9.0% | 5.2% | 5.2% | 8.9% |
| Multi-Asset Credit | - | 3.0% | 0.3% | 0.3% | +/- 2% | - | -1.6% | 3.0% | 1.4% | 2.1% | 0.9% |
| Property | 7.0% | 9.0% | 6.7% | 6.3% | +/- 3% | - | -2.3% | 9.0% | 6.7% | 7.7% | 1.4% (***) |
| Direct | 5.0% | 5.0% | 3.7% | 3.5% | +/- 2% | +1.0% | -1.1% | 6.0% | 3.9% | 3.9% | 1.4% (***) |
| Indirect | 2.0% | 4.0% | 3.0% | 2.8% | +/- 2% | -1.0% | -1.2% | 3.0% | 2.8% | 3.8% | 1.4% (***) |
| Alternatives | 3.0% | 7.0% | 3.4% | 3.6% | +/- 3% | +1.0 | -3.2% | 8.0% | 3.8% | 5.1% | n/a |
| Infrastructure | 1.5% | 3.0% | 1.7% | 1.9% | +/- 2% | +1.0% | -0.9% | 4.0% | 2.1% | 2.8% | 0.6% (***) |
| Private Equity | 1.5% | 4.0% | 1.7% | 1.7% | +/- 2% | - | -2.3% | 4.0% | 1.7% | 2.3% | 8.7% |
| Cash | 2.0% | 2.0% | 4.7% | 4.9% | 0 – 8% | +1.0% | +1.2% | 3.0% | 3.7% | 0.7% | 0.1% (***) |

(*) The New Benchmark came into effect on 1 October 2015

(**) Recommendation adjusted for investment commitments at 31 July 2016

(***) Benchmark Return for the three months to 30 June 2016

Relative to the benchmark, the Fund as at 31 July 2016 was overweight in Equities and Cash but underweight in Bonds, Property and Alternative investments.

(iii) Investment activity since the last meeting

Equities outperformed Bonds between 1 May 2016 and 31 July 2016. The initial market response to the EU referendum was negative with global equities falling sharply, a general flight to safety and a significant deterioration in the value of Sterling. Whilst equity markets subsequently rallied for unhedged Sterling investors, the weakness in Sterling masked poor equity returns in certain local markets, particularly Europe and Japan. The FTSE All Share actually reported a quarterly return of 6.8% post the EU referendum, reflecting the fact that a significant proportion of earnings are generated overseas, providing protection against any downturn in the UK domestic economy. Bonds continued to perform strongly, despite the low level of yields available. Yields have fallen further in August 2016, after the BoE announced an additional package of measures to support the UK economy, including a cut in the Base Rate to 0.25%, new gilt purchases of £60bn and corporate bonds purchases of £10bn. The Financial Times estimates that the total global value of sovereign and corporate bonds with negative nominal yields has risen to £12.6tn, representing almost half of all western debt.

Net investment between 1 May 2016 and 31 July 2016 totalled £3.4m, principally reflecting continued divestment in respect of UK Equities (£16.3m) and Index-Linked Bonds (£4.7m). This was partly offset by investment into Infrastructure (£10.1m), Property (£6.2m) and Emerging Market Equities (£3.0m).

UK Equities

At the last meeting it was agreed that the Fund's weighting be reduced by 0.5% to 30.6%, 2.6% overweight. Divestment of £16.3m combined with relative market weakness, reduced the weighting to 29.7% at 31 July 2016.

North American Equities

It was recommended that the Fund maintain a broadly neutral weighting of 11.2%. Whilst there were minimal transactions in the period, relative market strength increased the weighting to 11.8% at 31 July 2016.

European Equities

It was recommended that the Fund maintain a neutral weighting of 9.0%. There were no transactions in the period and the Fund reported a neutral weighting in line with that recommended at 31 July 2016.

Japanese Equities

At the last meeting it was recommended that the Fund maintain its overweight position of 6.2%. Whilst there were no transactions in the period, relative market strength increased the weighting to 6.7% at 31 July 2016.

Asia/Pacific ex-Japan Equities

It was recommended that the Fund maintain a 1.2% overweight position of 5.2%. There were no transactions in the period but relative market strength increased the weighting to 5.5% at 31 July 2016.

Emerging Markets Equities

It was agreed that the Fund would maintain a 0.7% overweight position of 3.7%. Net investment of £3.0m, combined with relative market strength, increased the weighting to 4.0%.

Bonds

Conventional bonds

At the last meeting the IFMT recommended a neutral weighting of 6.5%. Whilst there were no transactions in the period, relative market weakness reduced the weighting to 6.3% at 31 July 2016.

Index-Linked bonds

It was recommended that the Fund reduce its weighting to Index-Linked bonds by 0.2% to a neutral position of 6.5%. Net divestment of £4.7m was offset by relative market strength and the weighting remained unchanged at 6.7%.

Corporate bonds

At the last meeting it was agreed that the Fund maintain its current weighting of 5.3%. There were no transactions in the period but relative market weakness reduced the weighting to 5.2% at 31 July 2016.

Multi Asset Credit

It was agreed that the weighting would be increased by 0.2% to a 0.5%, 2.5% underweight. There were no transactions in the period and the weighting remained unchanged at 0.3%.

Property

It was agreed that the Fund should increase its Direct Property weighting by 0.2% to 3.9% to reflect a specific opportunity identified by the discretionary manager. Whilst the transaction successfully completed, the impact was offset by relative market weakness, and the weighting fell to 3.5%.

It was recommended that the Indirect Property weighting be increased by 0.9% to 3.8% following the completion of due diligence on several investments. Whilst the level of commitments rose to £41m at 31 July 2016, relative market weakness, together with significant liquidity issues following the EU referendum, resulted in the level of cash drawdowns from commitments being significantly lower than expected. As a result, the weighting fell to 2.8% at 31 July 2016.

Alternatives

It was recommended that the Infrastructure weighting be increased by 0.3% to 2.0%. Net investment of £10.1m in the period was partly offset by relative market weakness and the weighting increased to 1.9% at 31 July 2016.

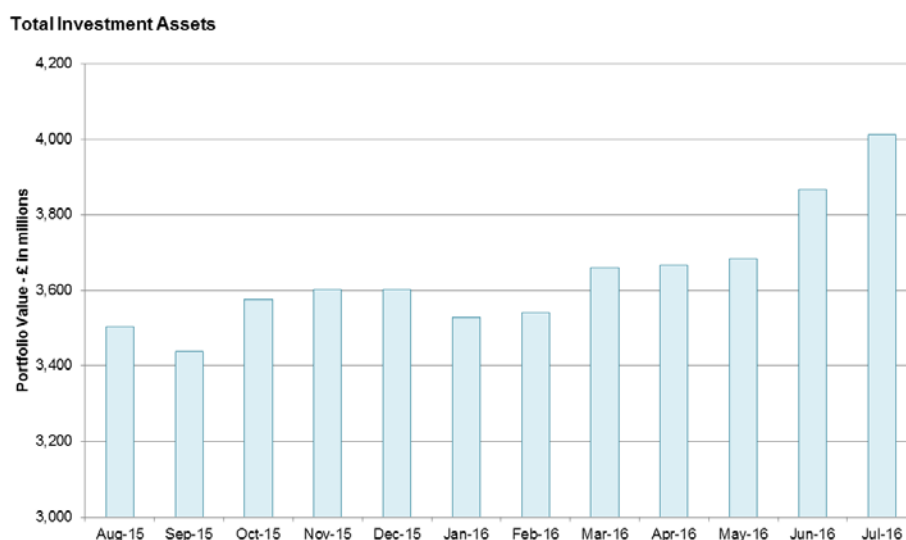
It was agreed that the Private Equity weighting of 1.7% would be maintained. There were no transactions in the period and the weighting remained unchanged at 31 July 2016.

Cash

It was agreed at the last meeting that the cash weighting be reduced by 0.8% to 3.9%. The actual cash weighting at 31 July 2016 was 4.9%, impacted by the significant reduction in indirect property cash drawdowns noted above.

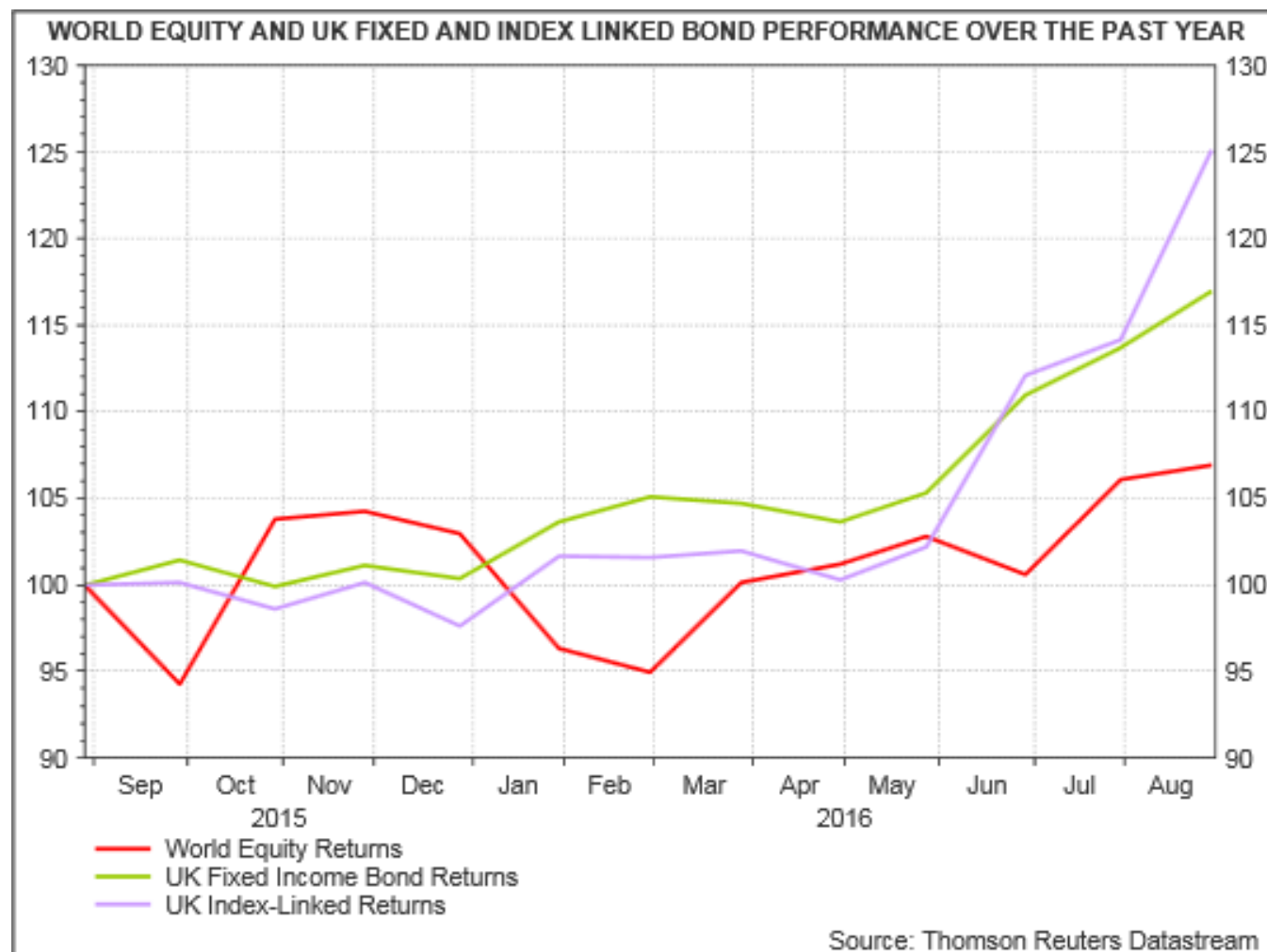
Total Investment Assets

The Fund's investment assets at 31 July 2016 exceeded £4.0bn for the first time. Investment assets rose by £346.1m (+9.4%) between 1 May 2016 and 31 July 2016 reflecting the positive returns noted earlier. Over the twelve months to 31 July 2016 the value of the Fund has been as follows:



The Fund's valuation can fluctuate significantly in the short term reflecting market conditions and supports the Fund's strategy of focusing on the long term.

Market returns over the last 12 months



The chart opposite shows market returns for world equities together with UK Fixed Income and UK Index-Linked bonds between 28 August 2015 and 27 August 2016.

The chart demonstrates that markets have been volatile over the last twelve months; a feature which the IFMT believe is likely to continue for the foreseeable future.

As noted earlier, markets have performed strongly in Sterling terms following the outcome of the EU referendum.

(vi) Longer Term Performance

Figures provided by Portfolio Evaluation Limited show the Fund's performance over 1, 3, 5 and 10 years to 31 July 2016.

| Per annum | DPF | Benchmark Index |
|-----------|------|-----------------|
| 1 year | 7.4% | 7.8% |
| 3 year | 8.0% | 8.2% |
| 5 year | 7.7% | 7.7% |
| 10 year | 6.8% | 6.4% |

The Fund underperformed the benchmark over the one and three year periods. Performance was in line over the five year period and the Fund outperformed over the ten year period. The Fund's one year performance was adversely impacted by a strong Q1 2015/16 falling out of the measure, replaced by a weak Q1 2016/17.

(v) Investment Recommendations

UK Equities

Mr Fletcher recommends a neutral weighting of 28.0% in UK Equities, believing that the relatively high dividend yield should compensate for disappointing earnings growth. Mr Fletcher believes that the short term outlook is very unclear, and whilst the future for the UK outside the EU could be very positive, the path to the new reality may prove difficult and take time. The IFMT agree that the above average dividend yield provides support to the UK market, particularly in the current yield constrained environment. Given the current elevated valuations, the IFMT continue to recommend reducing the exposure to UK Equities towards the neutral position. The IFMT recommend reducing the weighting by a further 0.5% to 29.2%, taking advantage of post referendum market strength.

North American Equities

Mr Fletcher recommends a 2.0% underweight allocation of 9.0% to US Equities, highlighting that rising wages could put pressure on profit margins and valuations are elevated. With US equities trading on 19.5x earnings (up from 18x three months ago and 3.5x higher than the 15 year average), the IFMT agree that the US market is richly valued - particularly for Sterling investors following Sterling's devaluation - with little room for disappointment. The US market is also vulnerable to interest rate rises and the continued uncertainty surrounding the Presidential Elections in November, which is becoming increasingly acrimonious. The IFMT recommend reducing the weighting to a neutral position of 11.0%.

European Equities

Mr Fletcher recommends a neutral weighting of 9.0% in European Equities, although a 1.0% overweight position of 10.0% would be recommended if the portfolio was actively managed. Mr Fletcher believes that the ECB is gaining traction with its policy of making it easier for companies to access credit. The IFMT believe the economic outlook for Europe remains muted but they also believe that many of the companies forming part of the European market generate a significant proportion of their earnings outside Europe, where the economic outlook is brighter. Sterling investor returns may also be supported by a further weakening in the Sterling/Euro exchange rate, as uncertainty surrounding the Brexit negotiations intensifies. As a result, the IFMT recommend a 0.8% overweight allocation of 9.8%.

Japan

Mr Fletcher recommends a 1.0% overweight allocation of 6.0% to Japanese equities. Mr Fletcher highlights that Japanese companies are carrying large cash balances, which has led to a significant rise in share buybacks and dividends, providing support for Japanese equities. However, the Bank of Japan is nearing the limit of monetary policy, the progress of structural reforms is too slow and the strength of the Yen is problematic. The IFMT recommend a higher weighting of 6.7%, continuing to believe that trading conditions are supportive and the long awaited reallocation of the Government Pension Investments Fund's target weighting to domestic equities from 12.5% to 25.0% should provide support. To achieve the target would require up to £60bn of domestic equity purchases, although this is being implemented at a measured pace.

Asia Pacific Ex Japan

Mr Fletcher recommends a weighting of 5% in this region, representing an overweight allocation of 1%, with Pacific Basin (and Emerging Market) equity markets recovering from the Chinese induced weakness early in the year. The IFMT believe that, despite some upheavals, the outlook in this area remains positive with the long term investment case undiminished. An overweight position of 5.5% is recommended.

Emerging Markets

Mr Fletcher recommends a 1% overweight allocation to Emerging Market equities, representing a weighting of 4.0%. Regional growth of twice the rate experienced in the developed economies is highlighted by Mr Fletcher. The IFMT concur with Mr Fletcher's recommendation of 4.0%.

Bonds

Mr Fletcher recommends a 3% underweight weighting for the overall bond portfolio which equates to an allocation of 19.0%. The Fund's allocation is currently 18.5% and the IFMT recommend increasing this to 19.6%.

Mr Fletcher notes that all yields are low and many government bond yields are at all-time lows; over 74% of the stock of global government bonds are trading at yields below 1% and a substantial proportion have negative yields. Central banks are active purchasers of bonds in the primary and secondary markets, meaning the stock of bonds available for investment by Pension Funds and regulated buyers such as insurance companies, is in decline. Mr Fletcher believes that the demand dynamics look likely to continue for some time and that as a result government bond yields are likely to remain low and still have potential to go lower. Notwithstanding this backdrop, Mr Fletcher recommends a 3% underweight position in both Conventional and Index Linked Bonds. Within the Index Linked allocation, Mr Fletcher supports the IFMT's allocation to US Index Linked stocks due to their higher yields and lower maturities compared to UK Index Linked. The IFMT continue to recommend neutral positions of 6.5% for both Conventionals and Index Linked given continued stimulus support (e.g. the BoE has recently announced £60bn of new bond purchases to support the economy) and the difficulty of sourcing attractive alternative investments at the present time.

Mr Fletcher recommends a 3.0% overweight position in Corporate Bonds which represents an allocation of 9.0%, believing that the higher yield and shorter maturity of the asset class will offer protection to total return when government bond yields start to rise on a sustainable basis. Mr Fletcher also recommends investment in a more aggressive Investment Grade Corporate Bond fund, and consideration of High Yield Bonds and Emerging Market Debt. The IFMT continues to recommend an underweight position in Corporate Bonds of 5.2% and maintenance of the relatively defensive position within the asset class. Whilst investment grade corporate bond have performed strongly over the last quarter, in line with sovereign corporate bonds, the IFMT believe that the yield pick-up compared to sovereign bonds is insufficient to compensate for the increased default risk.

Mr Fletcher recommends increasing the Multi-Asset Credit allocation to the neutral position of 3.0% as soon as possible, whilst acknowledging the higher level of due diligence required to source such investments. The IFMT team continue to assess new opportunities in this sector with the aim of achieving a neutral position within twelve months. In the meantime, the IFMT recommend an increase in the Multi-Asset Credit

weighting to 1.4%, with a focus on defensive funds which offer inflation protected income streams and good asset security. This would increase the recommended weighting, including commitments, to 2.1%.

Property

Mr Fletcher recommends a neutral weighting of 9% in property as a whole, with a preference for a 1% overweight position in Direct Property and a 1% underweight position in Indirect Property. The IFMT believe that property continues to look attractive for those investors seeking income. With property yields near historic lows, the IFMT believe that the boost to the UK sector from falling yields is coming to an end. Property returns from this point are likely to be driven by development returns and rental growth. The IFMT continue to recommend moving towards a neutral position in property. The external Discretionary Manager for Direct Property is actively assessing potential new investments and the recommended near term weighting is 3.9%, an increase of 0.4% on the current position.

Due diligence has now been completed on a number of Indirect Property investments and commitments totalled £41m at 31 July 2016. However, no cash drawdowns are expected over the next quarter and the IFMT recommend that the current weighting of 2.8% is maintained. Factoring in the existing commitments, the weighting increases to 3.8%, 0.2% lower than a neutral position of 4.0%. The IFMT continue to assess investment opportunities, focusing on funds with strong covenants, where rental growth (either from demand or inflation protection) looks sustainable over the next few years. The IFMT also plans to build the European property exposure to provide diversification (European yields continue to compress and the market provides protection against the UK liquidity issues and any further weakening in sterling). After commitments, the European Indirect Property portfolio represents 18% of the total Indirect Property portfolio.

Alternatives

Mr Fletcher recommends a 1% overweight position in Alternatives, with a preference for a 1% overweight position in Infrastructure and a neutral position in Private Equity.

Whilst the Fund is currently 1.1% underweight in Infrastructure, commitments at 31 July 2016 totalled £29m, increasing the committed weight by 0.7% to 2.6%. The IFMT continue to assess an active pipeline of new opportunities and, although the timing of future cash drawdowns is difficult to work predict, the IFMT recommend increasing the weighting by 0.2% to 2.1%. This increases the committed weighting to 2.8%, broadly in line with the benchmark neutral weighting of 3.0%.

The IFMT recommend maintaining the Private Equity weighting of 1.7%. Total commitments at 31 July 2016 totalled £25m, increasing the committed weighting to 2.3%. Several new opportunities are being assessed and it is anticipated that the level of commitments will increase over the next quarter but it is difficult to predict the level and timing of any cash drawdowns.

Cash

Mr Fletcher recommends a 1.0% overweight position of 3.0%. The current weighting is 4.9%, 2.9% overweight. Whilst it remains the long term objective to achieve a neutral weighting of 2.0%, this will take time. The IFMT forecast that the cash flow impact of the investment opportunities reflected in this report (partly offset by positive cash inflows from dealing with Members), should reduce the cash weighting to 3.7% over the upcoming quarter.

3 Other Considerations

In preparing this report the relevance of the following factors has been considered: financial, legal and human rights, human resources, equality and diversity, health, environmental, transport, property, social value and prevention of crime and disorder.

4 Background Papers

Files held by the Investment Section.

5 Officer's Recommendations

- 5.1 That the report of the external advisor, Mr. Fletcher, be noted.
- 5.2 That the asset allocations, investment activity and long term performance analysis in this report be noted.
- 5.3 That the strategy outlined in the report be approved.

PETER HANDFORD

Director of Finance



Second Quarter Investment Report
Prepared for

Derbyshire County Council Pension Fund

16th August 2016

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Investment Report for Derbyshire County Council Pension Fund

This report has been prepared by Anthony Fletcher “External Investment Advisor” of Derbyshire County Council Pension Fund (the Fund). At the request of the Pension and Investment Committee the purpose of the report is to fulfil the following aims: -

- Provide an overview of market returns by asset class over the last quarter and 12 months.
- An analysis of the Fund’s performance by asset class versus the Fund specific benchmark for the last quarter and the last 12 months.
- An overview of the economic and market outlook by major region, including consideration of the potential impact on the Fund’s asset classes
- An overview of the outlook for each of the Funds asset classes for the next two years; and recommend asset class weightings for the next quarter together with supporting rationale.

The report is expected to lead to discussions with the in-house team on findings and recommendations as required. The advisor is expected to attend quarterly meetings of the Pensions and Investment Committee to present his views and actively advise committee members.

Meeting date 7th September 2016

Date of paper 16th August 2016

1. Market Background

Prior to the UK Referendum on membership of the European Union (EU), markets in general traded sideways, as they recovered from the concerns over China in the first quarter and adjusted return expectations to be more consistent with a lower but positive level of global growth.

After the initial shock of the referendum result the UK equity markets rallied to finish the quarter strongly. The FTSE 100 index returned 6% and the FTSE All share 4.7% in the second quarter. The quick action of the Bank of England, smoothed the markets concerns and triggered the beginning of another downward movement in all UK bond yields, despite the already low levels of yield, bonds again outperformed equity. The main casualty of the result was Sterling which weakened by over 10% on a trade weighted basis, boosting the returns from foreign currency denominated assets.

Table 1, below shows the total investment return in Pound sterling for the major asset classes; for the month of July 2016, 3 and 12 months to the end of June 2016.

| % Total return dividends reinvested | | | |
|-------------------------------------|----------------|---------------------------------------|-----------|
| | Market returns | | |
| | | Period end 30 th June 2016 | |
| | July 2016 | 3 months | 12 months |
| FTSE All-Share | 4.0 | 4.7 | 2.2 |
| FTSE World ex UK | 5.2 | 8.9 | 15.5 |
| North America | 4.4 | 10.3 | 20.8 |
| Europe ex UK | 4.9 | 4.4 | 6.1 |
| Japan | 7.3 | 8.8 | 7.7 |
| Pacific Basin | 6.5 | 8.5 | 15.2 |
| Emerging Equity Markets | 5.8 | 9.5 | 3.7 |
| UK Gilts - Conventional All Stocks | 2.0 | 6.2 | 13.5 |
| UK Gilts - Index Linked All Stocks | 1.4 | 9.8 | 14.8 |
| Overseas Bonds * | 0.2 | 2.7 | 8.8 |
| *Citigroup WGBI ex UK hedged | | | |
| Property IPD monthly | | 1.0 | 11.2 |
| Cash 7 day LIBID | 0.04 | 0.1 | 0.4 |

Recent developments

At its meeting ending on 3 August 2016, The Monetary Policy Committee (MPC) of the Bank of England voted for a package of measures designed to provide additional support to growth and to achieve a sustainable return of inflation to the target. These measures were in addition to the Bank's contingency plans, the extra £250 billion of funds and foreign currency reserves that were made available to the banking system announced on the 24th of June.

The August package comprised: a 25 basis point cut in Bank Rate to 0.25%; new "unconventional measures" including a "Term Funding Scheme" to reinforce the pass-through of the cut in Bank Rate; the purchase of up to £10 billion of UK corporate bonds; and an expansion of the asset purchase scheme for UK government bonds of £60 billion, taking the total stock of asset purchases to £435 billion. The last three elements will be financed by the use of central bank reserves. The Bank Rate cut and the new Term Funding Scheme was agreed by all 9 of the voting members, 8 members agreed with the introduction of the corporate bond scheme and 6 members supported further purchases of UK government bonds. The MPC has indicated that it stands ready to cut the bank rate again, before the end of the year. It also stands ready to add to any of the "unconventional measures" announced as appropriate.

The objective of the monetary policy response is to lower the cost of credit and improve the financial conditions for households and businesses in a timely, coherent and comprehensive manner across a wide range of channels, in order to try and contain the immediate impact on the financial system of the UK's decision to leave the EU.

In addition to the monetary policy changes and to improve their efficacy, the Financial Policy Committee (FPC) and the Prudential Regulation Authority (PRA), of the Bank of England announced a relaxation of Reserve Requirements and increased flexibility to smooth transition of insurance companies to new regulatory standards.

The Bank of England has effectively put into place its contingency plans to smooth the transition of the UK Economy to a future outside of the EU. But it is not within the remit or capacity of the Bank to offset the impact of such a large structural shock to the UK economy. It is now up to the Government; to make the appropriate structural changes and to best negotiate the future relationship with one of its largest trading partners, the EU. As well as to negotiate its new stand-alone position with the rest of the world.

In the August Inflation Report, the MPC has again revised down their forecasts for growth. For the balance of 2016 growth is now expected to be just above zero, in 2017 growth has been revised down from 2.3% to 0.8% and 2018 from 2.3% to 1.8%. The Governor commented that these revisions are the largest changes made in the MPC's 20 year history. The MPC now expects unemployment in 2017/18, to be 5.5% and not 4.9% as previously forecast. Mr Carney stated that the MPC now faces, a

trade-off between the degree of support it gives the economy on one hand and how fast, the economy returns inflation sustainably to the target on the other.

Headline inflation in June was (0.5%) in line with the expectations in the May Report, although there was mixed news across the components. Food price inflation was a little weaker than expected, in contrast petrol prices were higher than expected, a consequence of rising sterling oil prices since the start of the year. Services inflation also picked up by more than anticipated. Inflation is projected to rise over the second half of 2016, as the drag from past falls in petrol, food and other goods prices diminishes. In addition, greater external cost pressures have pushed up the outlook relative to May, with inflation projected to be close to 1% in September.

The Sterling Exchange Rate Index (ERI) is around 10% lower than expected in the May Inflation Report, and around 15% below its peak in November 2015. These large falls in the value of Sterling are expected to push up UK import prices, which are expected to be passed through to consumer prices in coming years. Further ahead, the outlook for inflation is likely to be sensitive to the extent to which the two countervailing forces of; higher external cost pressures and muted domestic cost pressures, offset each other.

The MPC's inflation forecast remains 0.8% year over year for 2016 but has been revised higher; in 2017, from 1.5% to 1.9% and for 2018 from 2.1% to 2.4% and the initial forecast for 2019 is for CPI to remain at 2.4%.

Bond Markets

The second quarter saw very high total returns for all bond markets, despite the low level of yields available, outperforming all developed equity markets, with the strongest returns coming from UK Government bonds. The UK markets have some of the longest durations in the world hence the very strong relative performance.

Over the quarter, the yield available from conventional UK government bonds (gilts), fell in all maturities. 10 year gilt yields fell from 1.41% at 31st March 2016 to 0.87% at 30th June 2016, as at the time of writing the benchmark 10 year gilt is yielding 0.52%, which is a new all-time low in yield. 30 year gilt yields fell slightly more from 2.29% to 1.70% over the quarter and are currently yielding 1.24%.

Index linked gilts saw a similar, fall in their real yield. The real yield on 10 year index linked gilts fell from -1.0% at the end of March 2016 to -1.48% at the end of June 2016, 30 index linked yields fell slightly less from -0.90% to -1.29%. However because of the longer duration (interest rate sensitivity) of this asset class the total return over the quarter is higher. Index linked gilts are currently yielding -1.91% for 10 years and -1.65% for 30 years. This means the total return of 30 year index linked gilts is close to 30% year to date.

The yield available from other government bond markets has also fallen significantly but the local currency total returns were lower. Taking 10 year benchmark yields for these countries as a reference point:- in the US they started the quarter at 1.77% falling to 1.47%, in Germany 0.15% falling to -0.13% and in Japan the most indebted

nation in the world -0.03% falling to -0.25%. This means the yield on US government bond market is now one of the highest in the developed world.

The total returns from representative indices for Investment Grade Credit, Global Emerging Market Debt and Global High Yield (sub investment grade) Bonds were also strong but below UK government bond index returns. Global Emerging Debt indices were strongest followed by Investment Grade Credit and Global High Yield. The duration of these indices is lower, which in part explains the lower relative return, in the case of investment grade credit and high yield the weight of financial bonds in the indices will have also dragged down relative returns.

Equity markets

After an extremely volatile first quarter the majority of equity indices posted moderate positive returns in the second quarter. On a local currency basis the UK equity market was one of the strongest performing equity markets in the world in the second quarter and year to date. This could be explained by one or all three of the following factors; a perceived improvement in the conditions for companies who derive a significant amount of their earnings from overseas or commodities, this would favour FTSE 100 companies in particular. The decisions of the Bank of England and the UK Treasury immediately after the Referendum result or simply the fact that the vote is past and we now know we will be leaving the EU.

However once currency is taken into consideration, the weakness of Sterling over the quarter and 12 months results in significant outperformance for foreign equity market total returns. The only equity market that underperforms the UK in the second quarter is continental Europe. Over the 12 months the US and Pacific ex Japan equity markets produced the strongest total returns; with the weakness of Sterling obscuring some of the poor equity market returns achieved by continental Europe, Japan and emerging market equities.

2. Investment Performance

Table 2, shows the performance of the Derbyshire Pension Fund versus the fund specific benchmark for the 3 and 12 month periods to the end of June 2016. The performance data has been provided by Portfolio Evaluation Limited (PEL) using their own data for the 3 month period and a combination of PEL and WM data over 12 months and longer periods. The analysis shows that the fund underperformed the fund specific benchmark in both periods. The PEL attribution data shows that asset allocation was positive whereas stock selection was negative in the 3 months to end of June 2016.

Table 2, Derbyshire Pension Fund and Benchmark returns

| % Total return 30 th June 2016 | 3 months | | 12 months | |
|----------------------------------------------|-------------------------------|-----------|-------------------------------|-----------|
| | Derbyshire Pension Fund | Benchmark | Derbyshire Pension Fund | Benchmark |
| UK Equity | 3.8 | 4.7 | 0.9 | 2.2 |
| | | | | |

| | | | | |
|----------------------------------|------------|------------|------------|------------|
| Overseas Equity | 8.4 | 8.2 | | |
| North America | 10.7 | 10.3 | 20.1 | 20.8 |
| Europe | 4.3 | 4.4 | 6.0 | 6.1 |
| Japan | 7.9 | 8.8 | 6.2 | 7.7 |
| Pacific Basin | 9.8 | 8.5 | 7.8 | 8.3 |
| Emerging markets | 9.9 | 9.5 | 7.0 | 3.7 |
| | | | | |
| UK Gilts | 6.1 | 6.2 | 13.8 | 13.5 |
| UK and Overseas Inflation Linked | 6.8 | 9.8 | 11.1 | 14.8 |
| UK Corporate bonds | 3.8 | 4.4 | 7.6 | 9.2 |
| Multi-asset Credit | 1.6 | 0.9 | | |
| | | | | |
| Alternatives (all sectors) | 1.2 | 3.1 | 12.6 | 3.0 |
| Property (all sectors) | 1.7 | 0.9 | 15.1 | 8.5 |
| Cash | 0.1 | 0.1 | 1.1 | 0.4 |
| | | | | |
| Total Fund | 5.3 | 5.6 | 7.4 | 7.8 |
| | | | | |

Equity performance

The largest allocation in the fund is to the UK equity market representing 30% of the total fund assets at the end of the quarter. Relative to the FTSE All Share index, this element of fund underperformed the benchmark over the quarter and 12 month periods, with 3 year results broadly in line with the benchmark. Despite the recent poorer absolute and a relative returns, performance over 5 years is 6.7% and over 10 years 5.9% absolute and at least 0.5% pa ahead in relative terms.

The funds policy of holding overseas equity unhedged has made a very strong contribution to the total return of this portion of the portfolio, since the Sterling started to weaken in November 2015.

The next largest allocation is to North American equity, this portion is actively managed in a segregated portfolio, by Wellington Asset Management. In the second quarter this component of the fund outperformed the benchmark however the poor first quarter returns have dragged down the 12 month returns. Rolling 3, 5 and 10 year results are very good and remain well ahead of benchmark in what is one of the more difficult markets to outperform.

The continental European equity portfolio is passively managed by UBS. The 3 and 12 month returns are slightly behind benchmark.

The other equity assets are invested in Japan, the Pacific Basin and Emerging Markets, via pooled funds selected by the in-house team. In the latest quarter the returns from these markets were strong in absolute terms with only Japan underperforming its benchmark. For Japan the poor relative to benchmark 12month returns, have dragged down the rolling 3 year returns to flat with benchmark, however the 5 year remains over 1% ahead. In the Pacific Basin; the manager outperformed in the second quarter, underperformance in the first quarter has dragged down the 12 month result, but the 3 year and 5 year results remain excellent. Finally Emerging Market Equity, the very strong relative returns from the fund manager over the 12 months, have helped with the recovery in the 3 and 5 year returns but they still have some way to go to get into positive territory relative to the benchmark index.

Fixed Income Performance

The fixed income markets continued to produce exceptional total returns given the extremely low level of yield. Despite the fund being over 3% underweight its benchmark allocation and underweight interest rate sensitivity (duration) the aggregate total return from all bond sectors was only 0.4% behind benchmark in the second quarter. However this does hide some marked deviations between sectors. UK conventional government bonds (gilts) managed by the in-house team produced strong positive returns over 3 months albeit only in line with the benchmark. This part of the fund outperformed the benchmark over 12 months. The 5 year relative performance has slipped slightly to 0.5% pa ahead of benchmark but this is still a good outcome.

UK Index Linked Gilts because of their very high duration outperformed again with exceptional total returns. The in-house team has invested in a combination of UK Index Linked Gilts and their equivalent, US Treasury Inflation Protected Securities (TIPS). The TIPS market provides a higher yield at lower duration, as a result the absolute and relative returns of this combination of bonds was lower on both the 3 and 12 months to the end of June, and continues to drag down the longer term relative returns.

The UK corporate bond market underperformed the government market mainly because of its lower duration over the quarter and 12 month periods. The in-house team remains underweight corporate bonds for reasons of narrow credit spread and fundamental valuation. Looking at the returns over 3 months, the underperformance can be attributed to this underweight allocation. Over the longer time periods asset allocation does not fully explain the underperformance. It does appear that fund selection may be more defensive and possibly higher quality than the benchmark. Investment in "Multi Asset Credit" has proved to be a good decision. The in-house team has made an investment commitment of £40 million to the Babson Global Private Loan Fund however, so far only £10 million has been drawn by the manager. Despite this low allocation the fund has made a positive contribution to return through stock selection in the second quarter. Once fully invested this will represent 1.1% of total DPF assets under management. This is a new area of investment for the fund and one which offers significant return and diversification characteristics. Yields available from assets in this sector are significantly higher than from traditional markets, however they tend to be less liquid and require intensive research. The team is working hard on increasing this allocation through examination of other opportunities.

Alternatives

The in-house team's portfolio of investments in Private Equity and Infrastructure continues to enjoy excellent absolute returns in all but the most recent 3 month period. At the end of the quarter the allocation had increased to 3.6% with further cash committed but as yet uninvested by the selected Private Equity managers. Investment in this area is a resource intensive exercise and once a manager has been identified the DPF is reliant on funds being invested. In addition to these investments the team remains extremely active in researching new opportunities in this asset class and committed to increasing the allocation.

Property

Over the longer term Property remains one of the strongest performing asset classes, as would be expected given its relative low liquidity. The performance of the asset class did dip slightly in the second quarter because of the run up to the referendum.

The in-house team uses a mixture of indirect property investment vehicles and an external manager, Colliers Capital for direct investments in “bricks and mortar”. The aggregate allocation to property has performed well ahead of the benchmark on a 3 and 12 month time horizon and it is ahead of the strong 3 and 5 year absolute returns of the Benchmark. Asset Allocation is increasing but remains below benchmark. The team continues to seek good investments in this area. Investment in Property, as with Alternatives and Multi Asset Credit, is resource intensive and requires high quality due diligence to ensure good quality assets are purchased.

3. Economic and Market outlook

Economic background

On the 23rd of June the UK electorate decided by a slim majority to change the nature of the 43 year relationship it has developed with the European Union. Preferring instead to tell the Government that it should take full responsibility for the future Political, Social and Economic development of the UK.

The Political fallout from this decision has already been felt with a change in Prime minister, a significant restructure of the cabinet, changes in the direction of conservative policy and a leadership election in the Labour Party.

Other than some verbal position statements from various politicians in the UK and EU, the appointment of an official head negotiator for the EU and the UK, the actual process of BREXIT will not begin until Article 50 of the Lisbon Treaty, formally stating that the UK wants to leave the EU has been triggered. In the meantime the UK Government needs to decide what the negotiating strategy will be and what it can tactically give up in order to achieve the electorate's stated objective.

The Bank of England believes that it has done a lot, while standing ready to do more as required, to ease the impact of the change but it has recognised that monetary policy alone cannot smooth the path to the new reality outside the EU. It is now up to the Government to make the fiscal and structural changes required to create the environment in which the UK make the most of the future outside the EU.

Looking objectively from where we are now and the types of relationship with the EU that are currently available, outside of full membership, it is difficult to see how the UK will be able to have the full access for trade and services, that the "Leave" campaign said would be available without paying and accepting many of the EU's 4 freedoms they campaigned against.

What is clear, is that the vote to leave the European Union is likely to affect UK GDP growth in a number of different ways but at the moment there is very little data available to assess the scale of those effects. Growth was firmer than expected ahead of the referendum but growth is likely to slow over the near term as greater uncertainty and lower confidence drag on activity. This can already be seen in the housing and commercial property sectors, where indicators point to significant falls in activity. The 10% depreciation in sterling should support net trade in the near term, however it is also likely to lead to an uptick in inflation as the price of imported goods rise.

As mentioned in my last report, growth in developed and emerging markets alike, is now expected to remain low in 2016 and beyond. With the exception of the UK, growth forecasts have not become materially worse but global productivity and consumption levels continue to fall. On average over the next 5 years, Emerging economies are expected to grow by 4.5%pa and Developed economies by no more

than 2%pa. The USA is expected to be the strongest followed by Europe the UK and Japan. Central Banks are likely to remain accommodative as a result.

Government bonds

Since the end of March, 10 year UK Government bond yields have fallen by nearly 1%, with both conventional and index linked gilts reaching new all-time lows in yield. This is a direct result of; the UK's decision to leave the EU, the resulting dramatic cut in the expectations for growth and the measures taken by the Bank of England to ease monetary policy. In May it looked as though the UK would vote to stay in the EU and that growth would recover post the referendum. Expectations for Growth in 2017 and 2018 were in a 2.25 - 2.5% range and a rate hike was being priced for late 2016 early 2017. Post the referendum this has all been swept away and the markets are now expecting a further easing of monetary policy, much lower growth (see table 3 below) and are ignoring the risk of higher inflation from the weakness of Sterling. This all seems reasonable because the Bank of England is expecting pretty much the same outcome. Given my comments in my last report I find it difficult to suddenly become a fan of UK government bonds but I have to recognise the changed landscape and the increased uncertainty. I do however continue to believe that diversifying into other higher yielding income generating assets is still worth considering; although this approach does increase risk and accordingly would need to be assessed against the investment objectives of the Scheme.

Non-government bonds

Non-government bond yield spreads have fallen since the beginning of the year and since my last report, however in a way they are now even more compelling, because while spreads are lower, the % pick up in yield has increased significantly because of the dramatic fall in government bond yields. The average UK non-government bond is yielding 1.26% more than the duration equivalent gilt, whose yield is only 0.5%, the average high yield bond is yielding 5.23% more, with a much lower duration. It is true that when government bond yields start to rise, these asset classes will also see rising yields, however the extra yield that is available from the non-government market amply compensates for that risk. Things have changed since my last report; it would now appear that a significant rise in government bond yields has been pushed some way off into the future and both the Bank of England and the European Central Bank have expanded their QE bond purchase programmes to include corporate bonds.

Equities

As noted above, ironically on a local currency basis UK equity markets had a good quarter. Although this does hide a significant divergence between companies that derive most of their earnings from within the UK and those which derive the majority of their earnings from outside the UK. In contrast local currency returns for the rest of the world equity markets were low. A reflection of the subdued growth in dividend and earnings growth as well as weaker global macro-economic factors. As mentioned in my last report equity market valuations in developed markets are at or above average, in all markets except Japan whereas emerging markets valuations are

generally cheap to their average. In the second half of the year monetary accommodation will remain an important support but the heightened economic and political uncertainty generated by BREXIT for Europe and more generally the US Presidential Election campaign, could exacerbate already poor corporate earnings and productivity trends. In order to see stronger returns, either profits and or productivity needs to pick up or we need to see a re-emphasis of fiscal expansion and structural reform, both of which are possible from the UK in the second half of the year and even from the USA after the Presidential Election result.

GDP Forecasts

Table 3, shows the consensus forecasts for GDP growth in calendar 2016 and 2017 and my expectations in May and August 2016.

Table 3, GDP forecasts - Consensus versus Advisor expectations

| % Change yoy | 2016 | | | | 2017 | | | |
|--------------------|-----------|------------|-----------|------------|-----------|------------|-----------|------------|
| | May | | August | | May | | August | |
| | Consensus | AF | Consensus | AF | Consensus | AF | Consensus | AF |
| US | 2.0 | 2.0 | 1.6 | 2.0 | 2.4 | 2.1 | 2.3 | 2.3 |
| UK | 2.0 | 1.5 | 1.5 | 1.5 | 2.2 | 2.3 | 0.6 | 0.8 |
| Japan | 0.6 | 1.0 | 0.5 | 0.7 | 0.5 | 0.6 | 0.8 | 0.9 |
| EU 19 | 1.5 | 1.7 | 1.5 | 1.7 | 1.6 | 1.7 | 1.2 | 1.5 |

As you can see in the table of GDP forecasts, consensus estimates for 2016 and 2017 have been revised down for most developed markets. With the exception of the UK, the downgrade for growth is a bit surprising especially as in first half of 2016 growth outcomes while mixed were on balance slightly better than forecast. The Bank of England has now joined the ECB and Bank of Japan in extending their respective easy money policies and I do not believe that the FED will increase rates before the result of the US Presidential Election. With the exception of the UK in 2016, I now find myself slightly above consensus for 2016 and 2017.

My expectations for UK growth in 2016, reflect the better than expected first half performance and the UK avoiding recession in the second half. As for my other forecasts I will stick with “better than consensus” as I did in May. In the US the decision by the Federal Reserve to be more cautious on the number of rate hikes and their historical unwillingness to raise rates in a presidential election year leaves me comfortable with a forecast of 2%. In Europe and Japan both economies have outperformed expectations in the first half of 2016, notwithstanding the BREXIT effect for Europe, monetary policy is very accommodative in both economies and should lead to higher growth than the consensus.

The US economy grew by 0.8% annualised in the 1st quarter of 2016, revised up from 0.5% and by an estimated 1.2% in the second quarter. Increased personal consumption and exports were cited as the main reason for the higher second quarter. Early reports for July suggest that survey data and consumption may remain strong in the second half.

We now know that despite the EU Referendum, UK GDP was estimated at 2.2% annualised in the second quarter, compared to 2% in the first quarter. With services and production stronger and construction weaker. In the second half there could a continuation of growth in production especially given the weakness of Sterling but the uncertainty created by BREXIT could lead to lower investment so the overall result could be close to zero.

Japan 1st quarter GDP was 2% annualised, the second quarter slumped to 0.2% on the back of falling exports and weak corporate investment. The Abi government announced a new stimulus package and delayed a sales tax hike from 2017 to 2019, in addition to the monetary accommodation already announced by the Bank of Japan. However the much needed Structural reforms still need to be put in place if the economy is to sustainably recover.

Eurozone GDP grew by an estimated 1.6% annualised in the second quarter, this preliminary estimate is below the revised figure of 2.2% for the first quarter and the result of weaker growth in Germany. BREXIT could slow growth for the Netherlands, Belgium and the Republic of Eire in the second half as these are the UK's largest EU trading partners but it is unlikely to have much of an effect on the rest of Europe.

Consumer Price Inflation

Table 4, shows the consensus forecasts for Consumer Price Inflation and my expectations in calendar 2016 and 2017 as stated in May and August 2016.

Table 4, Consumer Price Inflation forecasts - Consensus versus Advisor expectations

| % Change yoy | 2016 | | | | 2017 | | | |
|--------------------|-----------|------------|-----------|-------------|-----------|------------|-----------|------------|
| | May | | August | | May | | August | |
| | Consensus | AF | Consensus | AF | Consensus | AF | Consensus | AF |
| US | 1.3 | 1.6 | 1.2 | 1.2 | 2.2 | 1.8 | 2.3 | 2.0 |
| UK | 0.7 | 0.4 | 0.7 | 0.7 | 1.7 | 1.5 | 2.4 | 2.5 |
| Japan | 0.0 | 0.5 | -0.1 | -0.2 | 1.6 | 1.0 | 0.6 | 0.6 |
| EU 19 | 0.3 | 0.3 | 0.2 | 0.1 | 1.4 | 1.0 | 1.3 | 1.0 |

Comparing 2016 to 2017 inflation forecasts the consensus clearly believes that the respective Central Banks will have greater success at getting inflation back to target, with the exception of Japan. Which is interesting when you look at the consensus GDP forecasts in table 3. The only significant change to inflation forecasts is in the UK, where the weakness of Sterling and the Bank of England's decision not to respond it, means UK inflation has the potential to exceed 2% over the forecast horizon. But this is by no means certain, because domestic factors may have a bigger impact on prices resulting in lower aggregate inflation. On balance, because of the debt burden in developed economies and the resultant lower potential growth, I remain wedded to "Lower for Longer" in terms of inflation and interest rates.

The Bank of England now expects inflation to be 1.9% in 2017, and 2.4% in 2018 and 2019. In July UK inflation ticked up to 0.6% annualised with the most significant contribution coming from transportation. In July US CPI rose by 0.8% yoy and 2.2% excluding food and energy. In the Eurozone headline CPI is expected to hit +0.2% in July and excluding Food and energy 0.9% yoy. In Japan CPI in June fell for the 4th month in a row, headline CPI was -0.4% and core inflation excluding food and energy was -0.5% annualised. Japan is special because of its demographics and lack of immigration however, one of my concerns is that the inflation rate in Japan

demonstrates how monetary policy on its own can fail to lead to sustainable growth and inflation. One of the features of “Abenomics” was that inflationary expectations would rise and force wage demands higher, thereby sustaining a higher rate of inflation and growth.

4. Outlook for the securities markets

Bond Markets

In table 5, below I have set out my expectations for 3 month LIBOR interest rates and benchmark 10 year government bond yields, in December 2016 and September 2017. They are not meant to be accurate point forecasts, more an indication of the likely direction of travel from where we are today in mid-August 2016 and are reliant on the success of current monetary and fiscal policy.

The current level of bond yields is a reflection of market pessimism about growth, the low level of inflation and uncertainty in the developed economies. The other main reason that yields are so low is monetary accommodation, central banks are determined to keep interest rates and bond yields low in order to try and achieve some improvement in economic growth and a return to target inflation.

The Bank of England is the latest central bank to change its previously expected direction on monetary policy, announcing a cut in interest rates and adopting new “unconventional” measures such as the “Term Funding Scheme”, the purchase of corporate bonds and the expansion of the gilt buying programme. The Bank has done this in response to the structural shock caused to the UK economy by the decision to leave the EU. It has adopted new unconventional measures because it recognises that interest rates are so low that, on their own they may no longer be able to influence economic activity. The bank also expects the UK government to implement structural and fiscal reforms that combined with its new monetary policy, should ease the impact of the structural change and may lead in the medium term to a stronger economy.

Table 5, Interest rate and Bond yield forecasts

| % | Current | December 2016 | September 2017 |
|----------------------|---------|---------------|----------------|
| | | | |
| United States | | | |
| 3month LIBOR | 0.80 | 1.0 | 1.25 |

| | | | |
|-----------------------|-------|-------|-----|
| 10 year bond yield | 1.51 | 1.75 | 2.0 |
| | | | |
| United Kingdom | | | |
| 3month LIBOR | 0.41 | 0.4 | 0.8 |
| 10 year bond yield | 0.52 | 0.6 | 1.0 |
| | | | |
| Japan | | | |
| 3month LIBOR | -0.03 | -0.03 | 0.0 |
| 10 year bond yield | -0.10 | -0.1 | 0.3 |
| | | | |
| Germany | | | |
| 3month EURIBOR | -0.32 | -0.3 | 0.0 |
| 10 year bond yield | -0.11 | 0.0 | 0.3 |
| | | | |

Outside the UK, monetary policy may be close to the end of its efficacy. The implementation of negative interest rates and more asset purchases by the Bank of Japan, seems to be failing to deliver consistently higher growth and inflation. Despite being the most indebted country in the world, the currency has appreciated by 15% so far this year on a trade weighted basis, the current account is 3.4% in surplus and government bond yields are negative out to 15 years. In March the ECB also decided to implement negative interest rates, target lending directly to business and to widen its asset purchase programme to include corporate bonds. These measures seem to be getting some traction but BREXIT is likely to mean the ECB will have to consider expanding or prolonging its QE programme when it meets in the autumn. Like Japan, German government bond yields (the benchmark for Europe) are negative out to 10 years. The US Federal Reserve Bank (FED) is now the only major central bank where there is still a chance that they may increase rates! But the chances of an increase have receded following BREXIT and the upcoming US Presidential Election, presents another reason for delay.

Recommendations

All yields are low and many government bond yields are at all-time lows, over 74% of the stock of global government bonds are trading at yields below 1% and over 30% have negative yields. As noted above central banks are active purchasers of bonds in the primary and secondary markets, which means the stock of bonds available for investment by Pension Funds and regulated buyers such as insurance companies is in decline. Japanese investors have also been big buyers of UK and US government bonds because of the yield pick-up over their home market. This demand dynamic looks likely to continue for some time, as a result government bond yields are likely to remain low and still have the potential to go lower.

UK government bonds have performed very strongly, with long dated and index linked gilts producing the strongest total returns in the world since the Referendum vote and the cut in rates from the bank of England. It should be noted that, investment in government bonds does provide a hedge for the DPF's liabilities and given the outlook, I would not recommend reducing the current, -3% total bond

allocation any further. I also believe that if the DPF is underweight duration, it should consider increasing this to neutral, by the purchase of longer dated government bonds. This could be achieved by buying higher yielding US government bonds if the relative value analysis on a currency hedged basis merits the decision, 10 and 30 year US treasuries yield 1% more than 10 and 30 year gilts. I continue to believe the extra yield available from Investment grade, sub-investment grade credit and from emerging market debt has merit from a total return and diversification point of view. I therefore stick with my recommendation increase this exposure by reducing the allocation to gilts, if possible this should be done on a duration neutral basis.

Index Linked gilts are now some of the most expensive bond assets in the world, in absolute terms and when compared to inflation linked government bonds elsewhere. In my last report I recommended keeping the position in US Treasury Inflation Protected Securities (TIPS). The very strong outperformance of Index Linked gilts means that this decision resulted in a negative contribution to overall fund performance. Considering the 2 markets today; the relative pick up in yield has increased to over 2%; UK target inflation is fully priced into Linkers whereas US target inflation is under-priced in TIPS by 0.8%. So from a relative value and inflation point of view, holding duration equivalent TIPS instead of Linkers remains an attractive tactical opportunity.

Non-government bonds, From the PEL valuation report it appears the DPF is 0.8% underweight its allocation. I understand the caution given the low yield environment and the “sticker shock” of the credit spread entry level compared to the past but given the economic outlook, the demand and supply characteristics and the yield carry. I reiterate my last recommendation to increase the allocation to Investment grade corporate bonds and to examine the opportunity of investing in high yield bonds and emerging market debt.

As noted in the last report the benchmark has an allocation to Multi-Asset Credit. This is a higher yielding fixed income asset class that also has very good diversification characteristics. With the hunt for yield becoming more urgent I strongly recommend that the in house team increase this allocation to neutral as soon as is reasonably possible.

Equity Markets

Table 6, below I have shown the dividend yield, earnings growth and price / earnings ratio forecasts, for 2016 and 2017 provided by Citi Research, via the DPF in house investment team.

Table 6, Dividend yield, Earnings growth and Price/Earnings Ratios

| Country | Dividend Yield | Earnings Growth | | Price/Earnings Ratio | |
|-----------------|----------------|-----------------|------|----------------------|------|
| Forecast period | 2016 | 2016 | 2017 | 2016 | 2017 |
| United Kingdom | 4.0 | -1.7 | 17.5 | 17.6 | 15.0 |
| United States | 2.1 | 1.1 | 14.0 | 18.9 | 16.6 |
| Europe ex UK | 3.6 | 0.4 | 14.0 | 16.1 | 14.2 |
| Japan | 2.3 | 6.5 | 9.2 | 14.3 | 13.1 |

Source: Citi Research, Global Equity Quarterly, 4th August 2016

Citi Research have again trimmed their estimates for dividends, except for Europe ex UK and revised down earnings growth in all regions for 2016, the standout revisions are to the Europe ex UK and Japan earnings growth forecasts which have been revised lower by around 3.5%.

As noted last quarter according to JP Morgan Asset Management, all equity market valuations, in their “All Country Equity Index” are slightly above average, with developed markets expensive and emerging markets cheap. In terms of performance the best returns in local currency terms have been in Brazil, Russia, the UK and US. Countries which are all in very different stages of their economic cycles, but for their own idiosyncratic reasons have benefitted from attractive relative valuations. Japan has struggled this year because of the strength of the Yen and a perception that monetary policy may be failing to stimulate growth. In Europe the headline poor performance can be blamed on the banks which dominate the index. Outside of financials the domestic economy is continuing to recover and a dividend yield 3.6% compares very favourably to European corporate bond yields of 0.7% and a US dividend yield of 2.1%. Emerging market equity has had a very good run from the lows in February. If commodity prices and the US dollar have stabilised and there is a continued improvement in confidence in the US and China, there could be further flows to emerging markets.

Recommendations

On a local currency basis UK equity markets had a good quarter. Although this does hide a significant divergence between companies that derive most of their earnings from within the UK and those which derive the majority of their earnings from outside the UK. The decision to leave the EU has created a lot of uncertainty and makes any investment decision at the current time a difficult one. The Bank of England has done what it can to stabilise the situation but we will have wait and see what the new government can deliver on fiscal policy and structural reforms and

what it's strategy is going to be on our future relationship with Europe. In the meantime while earnings growth looks set to disappoint, the dividend yield is attractive and high compared to bonds and the weakness of Sterling could also help the adjustment. The short term outlook is very uncertain, the future for the UK outside of EU can be very positive however the path to the new reality may prove difficult and take time. Until we know more I believe it is appropriate to have a neutral stance to UK Equities.

The US economy is showing reasonable underlying growth, consumption and labour markets are strong, but rising wages could pressure profit margins and valuations are elevated. In addition we have the probability of a fairly acrimonious presidential election campaign to endure between now and November. I continue to recommend an underweight allocation of -2%.

In Europe the ECB seems to be getting traction with its policy of making it easier for companies to access credit. Growth in the first half has been strong and the domestic economy is doing OK. If the DPF had an active European equity manager/fund I would recommend an overweight of 1%. As the assets are managed passively I believe it is appropriate to remain neutral.

As mentioned before Japanese companies are carrying huge cash balances which they seem to be having problems deploying, hence share buybacks and dividends have increased significantly. Against this the Bank of Japan is nearing the limits of monetary policy, the progress of structural reform is too slow and the strength of the Yen is not helping. On balance the pick-up in regional growth should help Japanese companies, therefore I continue to recommend an overweight position of 1%.

Pacific Basin and Emerging Market Equity have recovered well from the Chinese induced weakness earlier in the year. Strategically, one has to go to where the growth is, and emerging markets are growing on average twice as fast as developed markets. Macroeconomic indicators provide supporting evidence; Price to Book and external debt, are the lowest for 10 years, currency reserves the highest for 10 years. At the company level EM Asia yields are high and poor earnings are largely factored into expectations. I continue to recommend an overweight position of +1%.

Property, Alternatives and Cash

The Strategic benchmark is well diversified and contains an allocation to Property and Alternatives. These areas of investment tend to be less liquid (more difficult to buy and sell) and require high levels of due diligence to ensure only the best opportunities are acquired. The process is resource intensive, can be slow and potentially disappointing if another buyer is willing to outbid a reasonable valuation to gain the investment.

The Property market has had a difficult time so far this year with property funds swinging from premium to discount in the run up to the referendum and with some serious liquidity issues for the actively traded funds in the immediate aftermath of the vote. This emphasises for me the need to be more long term in the approach to investment in property, to avoid these short term bouts of volatility. I continue to

recommend that a neutral overall weight to property be maintained and express a preference for being 1% overweight direct, against being 1% underweight indirect property. I realise this is more difficult to achieve but attractive opportunities can still be sourced.

Alternatives; I am aware that the benchmark has recently changed from 3 to 7% but I would like to recommend a +1% overweight position in the asset class. My preference would be for a 1% overweight to Infrastructure and a neutral allocation to Private Equity. The problem remains that the supply, of good quality assets is low, difficult to find and demand is high. However the “market” for this type of asset is becoming broader and deeper.

Finally cash, I understand that some of the cash held is already allocated to investments that have yet to be “drawn down” by the fund managers and I don’t want to force these managers to invest if they are not comfortable. In my opinion the level of cash in the fund is too high and maybe it could be allocated to boost non-government bond exposure rather than by selling government bonds to achieve the overweight position I have recommended.

Table 7, below shows the Derbyshire Strategic benchmark allocations and my relative weights as of 16th May and August 2016.

Table 7, Recommended Asset allocation

| % Asset Category | Derbyshire Strategic weight | Anthony Fletcher 16 th May 2016 | Anthony Fletcher 16 th August 2016 |
|---------------------------|--------------------------------|-----------------------------------------------|--------------------------------------------------|
| Total Equity | 60 | +2 | +2 |
| UK Equity | 28 | 0 | 0 |
| Overseas Equity | 32 | +2 | +2 |
| North America | 11 | -2 | -2 |
| Europe ex UK | 9 | +1 | +1 (0) |
| Japan | 5 | +1 | +1 |
| Pacific ex Japan | 4 | +1 | +1 |
| Emerging markets | 3 | +1 | +1 |
| Total Bonds | 22 | -3 | -3 |
| Conventional Gilts | 6.5 | -3 | -3 |
| UK index Linked | 6.5 | -5 | -5 |
| US TIPS | 0 | +2 | +2 |
| Non-government Bonds* | 6 | +3 | +3 |
| Multi-asset Credit | 3 | 0 | 0 |
| Total Alternatives | 16 | +1 | +1 |
| Infrastructure | 3 | +1 | +1 |
| Private Equity | 4 | 0 | 0 |
| Direct Property | 5 | +1 | +1 |
| Indirect Property | 4 | -1 | -1 |
| Cash | 2 | 0 | 0 |

*Non-government bonds, for AF a mixture of 6% corporate, 1.5% global high yield and 1.5% emerging market debt.

Anthony Fletcher

16th August 2016

Appendix

References

Source material was provided by, including but not limited to, the following suppliers:-

Derbyshire Pension Fund, PEL and WM performance services

GFC Economics, Citi Research, Barclay's Global Indices

Kames, Blackrock, JP Morgan Asset Management

Bank of England, UK Debt Management Office, UK OBR, UK Treasury, ONS

US Bureau of Labour Statistics, US Commerce Dept.

Bank of Japan, Japan MITI

ECB, Eurostat

Bloomberg, Markit, Trading Economics

Financial Times, Daily Telegraph, Wall Street Journal, The Guardian

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