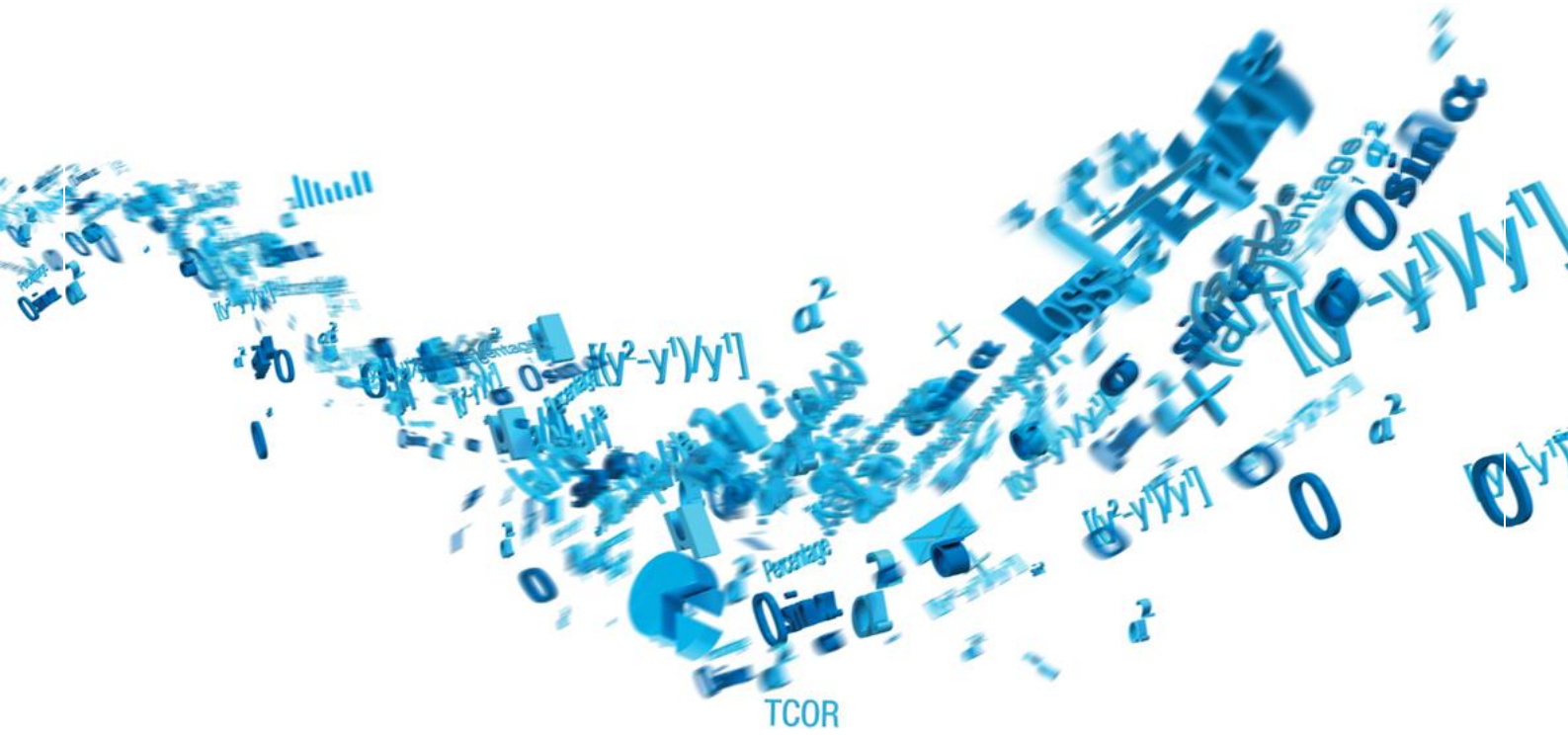

Quarterly Investment Report Q3 2019

Prepared for	London Borough of Enfield Pension Fund
Prepared by	Aon
Date	1 November 2019

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Executive Summary – Q3 2019

Performance	Quarterly (%)			Annual (%)			Since Inception p.a. (%)		
	Portfolio	Benchmark	Active	Portfolio	Benchmark	Active	Portfolio	Benchmark	Active
Equities									
BlackRock UK Passive	1.3	1.3	0.0	2.7	2.7	0.0	-	-	-
BlackRock World ex UK Passive	4.1	4.0	0.1	8.4	7.9	0.5	-	-	-
MFS Global Unconstrained	3.9	3.3	0.6	13.5	7.3	6.2	14.5	11.9	2.6
LCIV Baillie Gifford	0.7	3.3	-2.6	9.8	7.3	2.5	14.5	11.7	2.8
LCIV Henderson	-4.7	-1.1	-3.6	-	-	-	7.3	12.8	-5.5
LCIV Longview Partners	4.7	3.8	0.9	-	-	-	15.7	17.1	-1.4
Private Equity									
Adams Street	8.2	7.1	1.1	19.0	10.6	8.5	12.9	10.5	2.3
Hedge Funds									
Lansdowne Global Equity L/S	-2.0	-	-	-14.0	-	-	5.5	-	-
York Distressed Securities	-2.7	-	-	-4.8	-	-	9.7	-	-
Davidson Kempner	4.1	-	-	9.0	-	-	9.3	-	-
CFM Stratus	-3.0	-	-	3.7	-	-	-2.1	-	-
UK Property									
Blackrock	0.2	0.4	-0.2	1.9	2.2	-0.3	3.5	6.6	-3.1
Legal & General	0.4	0.4	0.0	1.8	2.2	-0.4	7.3	7.2	0.1
Brockton	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
PFI & Infrastructure									
IPPL Listed PFI	5.4	0.5	4.9	6.4	2.4	4.0	8.4	3.0	5.4
Bonds									
BlackRock Passive ILGs	3.6	3.5	0.1	8.7	8.5	0.2	3.4	3.3	0.1
Western Active Credit	6.0	6.4	-0.4	16.5	16.8	-0.3	7.4	7.8	-0.4
Insight Absolute Return Bonds	-1.0	-	-	-4.4	-	-	-0.4	-	-
LCIV CQS MAC	0.6	0.2	0.4	-	-	-	3.8	0.8	3.0
Inflation protection illiquids									
M&G Inflation Opportunities	4.7	0.5	4.2	13.2	2.4	10.8	8.2	2.4	5.8
CBRE	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Total Assets	**3.0**	**2.8**	**0.2**	**7.2**	**6.5**	**0.7**	**8.6**	**-**	**-**

Source: Investment managers/ Aon / Northern Trust. Performance is shown net of fees. In the absence of audited net performance figures from Northern Trust, performance has been sourced from the managers or estimated by Aon using manager data where possible. Totals may not sum due to rounding.
1) The Fund is invested in a passive global equity mandate with BlackRock. The performance shown is for the underlying pooled funds.
2) IPPL is measured against the UK Retail Price Inflation (RPI) index.
3) Adams Street and Brockton are close ended funds and traditional time weighted returns are not reflective of true performance. Adam Street numbers are IRR figures. Returns are lagged by a quarter due to the nature of the asset class (returns are as at Q2 2019).
4) The Adams Street, Davidson Kempner, Gruss and York returns will partly reflect currency movements. Over the quarter, Sterling appreciated against the Dollar and, as a result, these returns are weaker in sterling than in local currency terms.
5) The BlackRock property line shows the return of the BlackRock fund for the quarter and year. Since inception returns relating to the combined property portfolio are not shown as accurate figures cannot be obtained in the absence of figures provided by a performance measurer.
6) Fund benchmark is composed of 35% global equities 5% private equity (proxied by a global equity index), 10% property, 29% bond composite (based on underlying manager benchmarks) 6% infrastructure and 15% hedge funds.
7) Total assets performance since inception 31 March 1987.
8) Performance figures with 'N/A' will be available when final report is due.

Manager Allocations	30.06.2019		30.09.2019			
	Market Value (£m)	Percentage (%)	Market Value (£m)	Percentage (%)	Strategic (%)	Relative (%)
Equities	**513.8**	**42.0**	**527.8**	**41.7**	**35.0**	**6.7**
BlackRock Passive	178.8	14.6	185.8	14.7		
Trilogy Global Unconstrained	0.8	0.1	0.8	0.1	32.5	7.3
MFS Global Unconstrained	119.2	9.7	123.8	9.8		
LCIV Baillie Gifford	81.1	6.6	81.7	6.5		
LCIV Henderson	29.7	2.4	28.3	2.2		
LCIV Longview Partners	80.2	6.6	83.9	6.6		
Lansdowne Equity L/S[1]	24.0	2.0	23.5	1.9	2.5	-0.6
Private Equity	**73.5**	**6.0**	**77.6**	**6.1**	**5.0**	**1.1**
Adams Street	73.5	6.0	77.6	6.1	5.0	1.1
Hedge Funds	**99.5**	**8.1**	**99.9**	**7.9**	**10.0**	**-2.1**
Lansdowne Equity L/S[1]	24.0	2.0	23.5	1.9		
York Distressed Securities	19.8	1.6	20.0	1.6		
Davidson Kempner	28.7	2.3	30.0	2.4		
CFM Stratus	27.0	2.2	26.3	2.1		
UK Property	**76.0**	**6.2**	**76.1**	**6.0**	**10.0**	**-4.0**
BlackRock	37.7	3.1	37.5	3.0		
Legal & General	33.7	2.8	33.9	2.7		
Brockton	4.6	0.4	4.7	0.4		
PFI & Infrastructure	**60.9**	**5.0**	**64.4**	**5.1**	**6.0**	**-0.9**
IPPL Listed PFI	43.2	3.5	45.5	3.6		
Antin	17.7	1.4	19.0	1.5		
Bonds	**266.5**	**21.8**	**275.6**	**21.8**	**24.0**	**-2.2**
BlackRock Passive ILGs	89.9	7.3	93.1	7.4		
Western Active Bonds	94.3	7.7	100.0	7.9		
Insight Absolute Return Bonds	30.7	2.5	30.6	2.4		
LCIV CQS MAC	51.6	4.2	51.9	4.1		
Inflation protection illiquids	**89.5**	**7.3**	**96.0**	**7.6**	**10.0**	**-2.4**
M&G Inflation Opportunities	73.7	6.0	77.5	6.1		
CBRE	15.8	1.3	18.5	1.5		
Cash	**43.7**	**3.6**	**46.9**	**3.7**	**-**	**3.7**
Enfield Cash	43.7	3.6	46.9	3.7	-	3.7
Total Assets	**1223.3**	**100.0**	**1264.3**	**100.0**	**100.0**	

Source: Northern Trust, Managers

Note: Numbers may not sum due to rounding.

[1]Due to the equity-like nature of the Lansdowne global equity long / short hedge fund investment, the valuation has been split 50:50 between equities and hedge funds.

Summary of Key Developments

Key developments

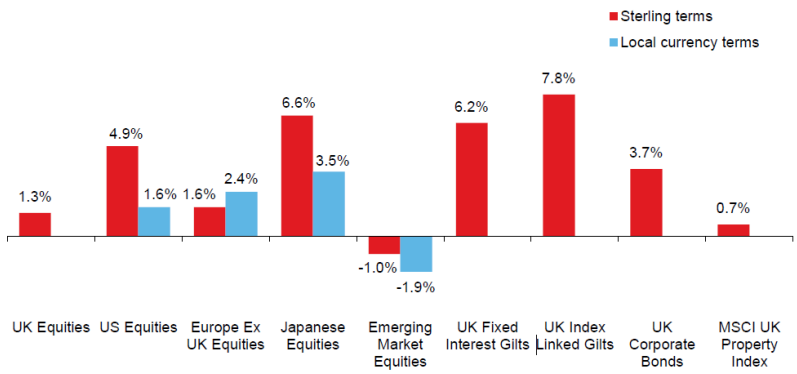
- As has been communicated in previous reports, the lead portfolio manager of the Janus Henderson Emerging Market Equity strategy, Glen Finegan has resigned from Janus Henderson, along with a number of his team members. We downgraded our rating on the strategy to Sell following this news. The strategy is used by the London CIV within the London CIV Emerging Market Equity Fund and we are aware that the London CIV are in the process of appointing JP Morgan as a replacement for Janus Henderson for managing the fund.
- We are aware that the London CIV have placed CQS on 'Watch', as a result of a number of concerns they have regarding underperformance relative to target, staff changes, and concerns over the strategy. Despite the London CIV placing CQS on 'Watch' we have not changed our view of them.
- On 23 October 2019 Brockton informed investors that the manager is cancelling part of investors' undrawn commitments with effect from 31 October 2019. This reduces the Fund's undrawn commitment from c.£14.7m to c.£10.2m. Whilst performance and asset management within the fund remain strong, we await further information from Brockton before providing further comments and views.
- Further key developments will be available in the final version of this report.

Quarterly Investment Outlook Summary

Summary

- Interest rate cuts are supporting equities, but bonds continue to send a different message on the global economic outlook ahead.
- The UK economy looks precarious. An orderly Brexit will not make that much difference here. Markets are still pricing in a rate cut ahead.
- The pick-up in bond market volatility could last. Two opposite worlds look possible – one advancing a zero/negative rate world further and a different one that could ultimately pose some upside risks to yields.
- Credit market stresses are surfacing in sub-investment grade markets even though investment grade is calm for now. Our caution on credit stays.
- US corporate profits have stopped growing. A marked recovery in profits looks unlikely given margin pressures that are now coming through. Even though triggers for large market falls are few today, rebalancing and trimming into market strength is entirely appropriate.
- The continued struggle for value stocks to keep up is setting up room for a strong rebound when the right conditions arrive, but we do not expect this to be seen quite yet.
- The evolving consensus that ESG factors matter a great deal in portfolio building still leaves open the question of implementation options. We expect viewpoints to shift over time as awareness builds and choices for responsible investing improve.
- Sterling volatility has been unnerving for quite some time. This is not going away any time soon even under a smooth Brexit. Strategic hedging approaches are best placed to cope.

Q3 2019 Performance Summary



Source: Factset, MSCI IPD

Portfolio overview

Asset class target ranges

The table below shows the discussions at the April 2018 Committee meeting where new strategic allocations were agreed.

	Strategic asset allocation	Investment Strategy Statement ("ISS") ranges
Equities (including private equity)	40%	30-50%
Hedge Funds	10%	10-20%
Property	10%	5-15%
Infrastructure	6%	3-9%
Bonds	24%	19-39%
Inflation protection illiquids	10%	

Split of equity portfolio

The table below shows the allocation to emerging markets within the equity portfolio:

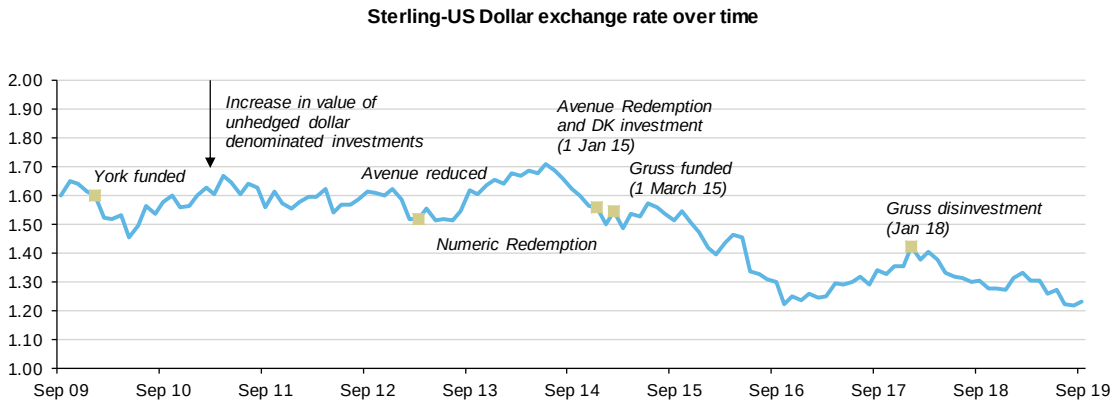
	30 Sept. 2019 value (£m)	Emerging Market Allocation (%)	Emerging Market Allocation (£m)
BlackRock	185.8	0.0	0.0
MFS	123.8	1.6	2.0
LCIV Baillie Gifford	81.7	12.9	10.5
LCIV Longview	83.9	0.8	0.7
LCIV Henderson	28.3	87.6	24.8
Lansdowne	23.5	0.0	0.0
Total	**527.0**	**7.2**	**38.0**

Source: Investment managers. Totals may not sum due to rounding. Does not include Trilogy because of the small allocation and the Fund is disinvesting from the mandate.

- c.35% of the equity portfolio is being managed passively by BlackRock. The remainder is being managed on an active basis, with MFS the largest holding.
- In aggregate, 7.2% of the Fund's equity portfolio is allocated to Emerging Markets. As at 30 September 2019, the MSCI All Country World Index had a 11.5% exposure to Emerging Markets.

Sterling-US dollar exchange rate

The chart below shows the movements in sterling versus the US dollar over time.



The appreciation of sterling versus the US dollar over the quarter decreased the value of dollar denominated holdings.

Currency analysis

The Fund has exposure to the euro, US dollar, yen and other currencies within its portfolio.

The active equity managers have exposures to various currencies as they are all global mandates, and we have approximated the currency exposures based on the geographical split of the underlying investments.

Adams Street, York and Davidson Kempner are US dollar denominated whilst Antin is euro denominated. The Lansdowne, CFM, BlackRock, CBRE, Western, M&G Inflation Opportunities, Legal & General, Brockton, Insight, London CIV MAC and IPPL mandates are assumed to have no direct exposure to foreign currencies as they are either hedged to sterling or are sterling share classes.

Currency	%	£m
Sterling	52.8	668.0
US dollar	33.3	421.3
Euro	6.4	80.3
Yen	2.2	27.5
Other	5.3	67.2
Total	100.0	1264.3

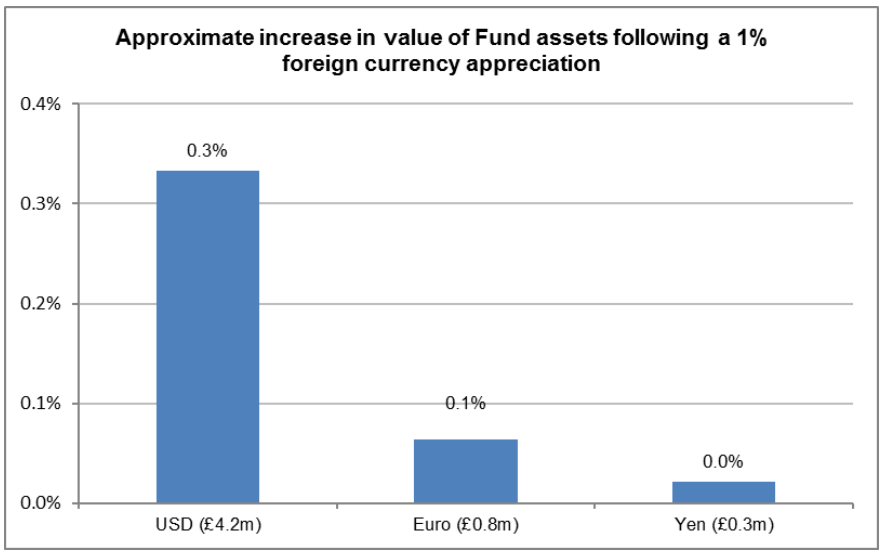
Note: Totals may not sum due to rounding.
Manager exposures are based on geographical, not currency, exposures.

Summary

US dollar exposure is the largest foreign currency risk for the Fund.

Following a 1% foreign currency appreciation (depreciation), we approximate that the value of the Funds' US dollar denominated assets will increase (decrease) by £4.2m, euro denominated assets will increase (decrease) by £0.8m and yen denominated assets will increase (decrease) by £0.3m.

Note that movements in currencies may either contribute to or be caused by factors that move other asset classes. For example, the US dollar may appreciate at times of stress which could coincide with a fall in the value of the Fund's equity holdings.



Currency	Fund exposure to currency (£m)	1% change in currency (£m)	1% change in currency (% in Fund's assets)
US dollar	421.3	4.2	0.3
Euro	80.3	0.8	0.1
Yen	27.5	0.3	0.0

Ratings	Overall	ODD	Business	Staff	Process	Risk	Performance	T&C	ESG
Equities									
BlackRock UK Passive	***Buy***	*Pass*	4	4	4	4	4	2	2
MFS Global Unconstrained	***Qualified***	*A1*	3	3	2	2	2	2	3
LCIV Baillie Gifford	***Buy***	*A1*	4	3	3	2	3	3	2
LCIV Longview Partners	***Buy***	*A1*	3	3	3	2	3	2	2
LCIV Henderson	***Sell***	*A2*	1	2	3	2	2	2	3
Private Equity									
Adams Street	***Qualified****	-	-	-	-	-	-	-	-
Hedge Funds									
Lansdowne Global Equity L/S	***Buy (closed)***	*A2*	3	3	3	3	3	3	-
York Distressed Securities	***Buy***	*A2*	3	3	3	2	3	2	-
Davidson Kempner	***Buy***	*A2*	4	4	4	3	3	3	-
CFM Stratus	***Buy (Closed)***	*A1*	3	4	3	3	3	2	-
UK Property									
BlackRock	***Buy***	-	-	-	-	-	-	-	-
Legal & General	***Qualified***	-	-	-	-	-	-	-	-
Brockton	***Buy (Closed)***	-	-	-	-	-	-	-	-
PFI & Infrastructure									
IPPL Listed PFI	***Not Rated***	-	-	-	-	-	-	-	-
Antin	***Performing ****	-	-	-	-	-	-	-	-
Bonds									
BlackRock Passive ILGs	***Buy***	*Pass*	4	3	4	4	4	2	2
Western Active Credit	***Qualified***	-	✓	✓	✓	⚐	✓	✓	-
Insight Absolute Return Bonds	**Buy**	A1	4	4	4	3	3	2	2
LCIV CQS MAC	***Not Rated***	-	-	-	-	-	-	-	-
Inflation Protection Illiquids									
M & G Inflation Opportunities	**Buy (closed)**	-	-	-	-	-	-	-	-
CBRE	***Buy***	-	-	-	-	-	-	-	-

Note:

1. All manager ratings are as at Q2 2019 with the exception of MFS, Davidson Kempner and York. These will be updated for the final report.
2. Previous quarter's ratings are shown in brackets where they have changed.
3. ER = Exceptions reported/ NER = No exceptions reported.
4. Aon does not rate the London CIV. Ratings are shown for underlying managers where appropriate.
5. Aon's process for reviewing property, private equity & infrastructure strategies has changed. Therefore, from 30 September 2019 onwards Aon's manager research specialists will not include sub-ratings for property, private equity & infrastructure strategies.

* Due to the nature of the underlying investment, Aon's monitoring of illiquid managers is conducted on an infrequent basis. Therefore overall ratings of these managers may be lagged over time.

ESG rating

Aon has increasingly been asked for input on whether and how well investment managers integrate Responsible Investment ("RI") considerations, and more specifically Environmental, Social and Governance (“ESG”) data, into their investment strategies.

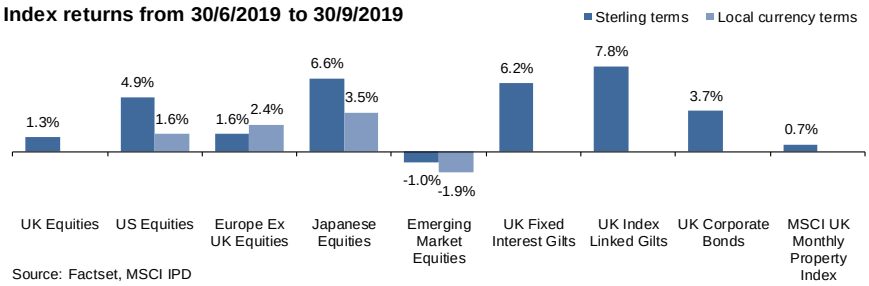
To best serve our clients’ desire to understand how non-financial ESG data may (or may not) be accommodated by various outside investment managers, Aon has developed a distinct ESG rating system for buy-rated investment strategies. This serves to provide an added dimension of fund analysis for clients who have embraced, or are considering, ESG and RI within their investment policies. At this time the strategy’s ESG rating is not designed to have an impact on the overall rating of Buy/Qualified/Sell ratings.

ESG ratings are currently being deployed for buy-rated, long-only equity and credit strategies with liquid alternatives, private equity and real estate to follow. Like our investment strategy ratings, ESG ratings are assigned on a 1 to 4 scale, please refer to the Rating Explanation section for more detail.

Manager Research Views

The commentary and views from Aon's manager research team will follow once available.

Appendix A – Market Background: Q3 2019



General Background

- The momentum which drove equity markets higher in the first half of the year slowed over the third quarter with low single-digit returns common amongst most major markets. Prevailing headwinds, namely slowing global growth and trade wars, shunted equity markets down in the middle of the quarter but accommodative steps taken by central banks, alongside the appearance of thawing US-China trade relations provided a late quarter revival for risk appetite and markets. The MSCI AC World Index posted a 1.1% gain in local currency terms.
- While not committing to an aggressive and sustained monetary easing cycle, the US Federal Reserve lowered the target Federal Funds rate twice over the quarter to 1.75%-2.00%. Deterioration in the domestic and global economy and with inflation far from target, the European Central Bank (ECB) lowered its deposit rate by 10bps to -0.5% and restarted its Asset Purchase Programme with a firm commitment to continue buying bonds until its inflation target is met.
- Expectations of further central bank easing, alongside downgraded global growth and inflation outlooks, drove developed market bond yields lower. The FTSE Actuaries UK Conventional Gilts All Stocks Index and the FTSE Actuaries UK Index Linked Gilts All Stocks Index outperformed equity markets with strong returns of 6.2% and 7.8%, respectively. UK investment-grade credit spreads edged higher but lower underlying government bond yields supported a 3.7% return.
- Once again, closely tied to Brexit developments, sterling slipped by just 0.1% on a trade weighted basis but fell by considerably more against the US dollar. Given the significant size of the US equity market in global indices, global equity returns in sterling terms were boosted by the USD/GBP move with a return of 3.3%.
- UK property capital values continue to trend lower but steady income returns supported a positive overall return.

UK Equities

- UK equities marched higher over the third quarter but, similar to other markets, equity market momentum weakened. UK equities lagged other markets with a return of just 1.3%, driven predominantly by income as prices moved only 0.1% higher. Forward-looking indicators pointed towards further deterioration in domestic economic conditions while revenue exposure to a slowing global economy also weighed on the market.

- Although the Technology sector (-15.0%) posted the weakest returns over the quarter (fully offsetting the strong gains made over the prior quarter), the significant exposure to weak commodity-related sectors contributed the most to the underperformance of UK equities relative to other markets. The Energy and Materials sectors returned -5.3% and -10.0%, respectively. Given the deterioration in the UK economy and a dimmer outlook, defensive sectors fared better with particularly strong returns from the Health Care and Telecommunications sectors.
- Despite being more exposed to a weaker domestic UK economy, UK mid-cap stocks outperformed large cap stocks. Contrary to the prior quarter when the Energy sector helped bolster large cap returns, the lower exposure to falling commodity prices this quarter led to mid-cap outperformance. Small-cap stock underperformance was pervasive across most sectors, leading to a negative return of -0.7%.

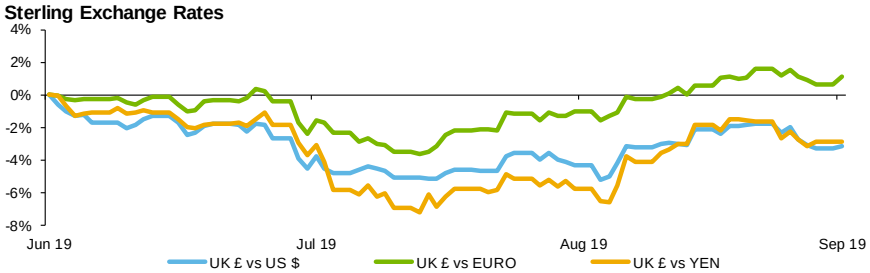
Overseas Equities

- In direct contrast to the second quarter, more defensive stocks performed well with Consumer Staples and Utilities posting near double-digit returns. The US Health Care sector was an exception to Defensive outperformance with pharmaceutical stocks facing headwinds in the shape of greater political scrutiny ahead of the 2020 U.S. Presidential election. Relative to other markets, more economically-sensitive US stocks, such as Financials and Real Estate, performed well. As in the first half of the year, valuation multiple expansion drove positive equity performance while earnings growth estimates were revised lower again.
- In a similar vein to the US, defensive stocks in Europe outperformed their more cyclical counterparts with the latter hit by data releases pointing to signs of further economic weakness particularly in the manufacturing sector. Against this backdrop, the ECB cut the deposit rate to -0.5% while also announcing that their Asset Purchase Programme would be restarted with an indefinite time limit until their inflation target is reached. While such policies in the past have hurt European banks due to the impact on their net interest margins, additional measures were incorporated to limit the impact on the Financials sector, which rebounded strongly in September. Europe ex-UK equities returned 2.4% in local currency terms with sterling appreciation against the euro leading to a more modest 1.6% return in sterling terms.
- Japanese equities erased losses made over the second quarter and led all other major equity markets with a return of 3.5% in local currency terms. Better than expected economic releases helped fuel positive returns of more cyclical stocks while greater optimism for some respite in the US-China trade war and yen weakness upon a return of risk appetite late in the quarter provided further impetus for Japanese stocks.
- Global economic and trade uncertainties weighed on emerging market equities. In general, commodity-sensitive markets and economies with significant US dollar debt exposure underperformed. Chinese economic growth decelerated to its slowest pace since official government records began in 1992, while manufacturing sector activity and profitability remained under pressure. Elsewhere, Argentina grabbed the headlines with steep equity market declines

amid rising prospects of a return of a less market-friendly government. Overall, the MSCI EM Index fell by 1.9% in local currency terms with few EM markets posting gains over the quarter.

- In the FTSE All World ex-UK index, less economically sensitive stocks outperformed, led by a 6.9% (in local currency terms) return from the Utilities sector. Even with the late quarter rally in crude oil prices following the drone attack on key Saudi Arabia oil facilities, commodity-related stocks were by far the weakest performers as weaker demand appeared to be the more dominant driver. Meanwhile, the Health Care sector was the only other sector to post a negative return.

Currencies and Interest Rates



Source: FactSet

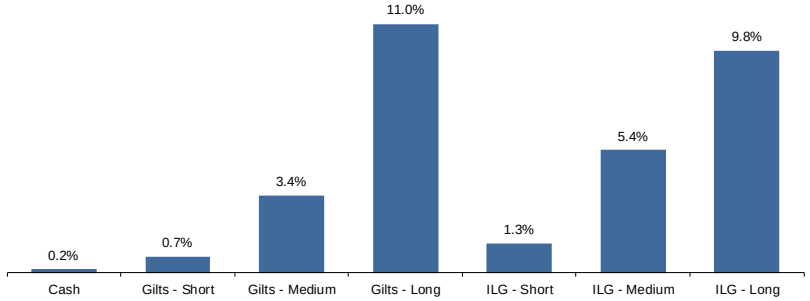
- On a trade-weighted basis, sterling ended the third quarter slightly lower – weakening by 0.1%. Brexit uncertainty ramped up significantly over the quarter given the UK government's stance on achieving Brexit by the end of October with or without a deal. This position perturbed investors and sent sterling to a post EU referendum low against the US dollar. September, however, saw a partial bounce-back as Parliament passed measures to curtail the government's ability to force through a No-Deal Brexit. This late rally helped sterling to appreciate by 1.1% against the euro over the quarter while it still ended the quarter down by 3.2% and 2.9% against the US dollar and yen, respectively.

- The US dollar continued on an upward trend with economic releases surprising to the upside in the US and cyclical supports – a wide interest rate differential and relative economic strength – remaining intact. The US dollar index (DXY) rose by 3.4% over the quarter supported by appreciation against sterling and the euro, up 3.3% and 4.5% respectively. The US dollar appreciated less against the Japanese yen which benefited from some safe haven flows during bouts of market volatility over the quarter.

- The euro was weak over the quarter as economic releases disappointed with data pointing to near-recessionary conditions in the bloc. With the region exposed to global economic activity, the ongoing trade war and decelerating growth weighed on the region and the currency. Further headwinds pushed the euro lower later in the quarter as the ECB eased monetary policy and lowered interest rates. Against this backdrop, the euro slid by c.4% against the US dollar and Japanese yen. On a trade-weighted basis, the euro ended the quarter 1.1% lower.

Gilt Returns

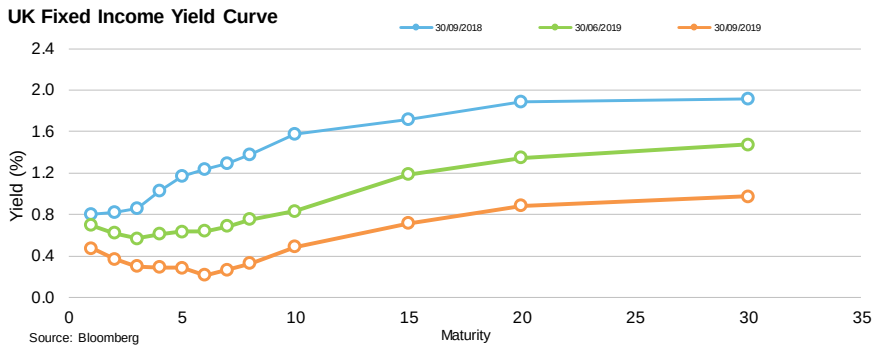
Index returns from 30/6/2019 to 30/9/2019



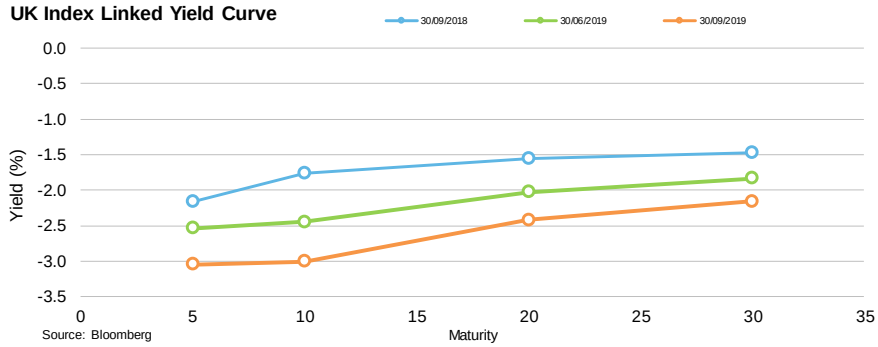
Source: Factset

- The downward trend in global government bond yields drove UK gilt yields lower over the quarter and contributed to strong UK gilt performance, particularly at longer maturities. With yields broadly unchanged over September, the gains came predominantly in the first two months of the quarter when developed market bond yields plunged lower on fears of slowing growth and further trade turmoil.
- In this falling yield environment, the FTSE All Stocks Gilts Index returned 6.2% over the quarter. The UK yield curve continued to flatten and, as a result, longer-duration bonds outperformed relative to shorter-duration government bonds. Longer-duration bonds posted an 11.0% return, above the 0.7% and 3.4% return of short and intermediate maturity bonds respectively. The return of short-dated government bonds was principally from income.
- With the exception of long-duration bonds, index-linked government bonds, outperformed their nominal counterparts with the Actuaries UK Index Linked Gilts All Stocks Index returning 7.8%. Long-duration index-linked gilts underperformed due to a fall in breakeven inflation at longer maturities.

Fixed Interest and Index-Linked Yield Curves



Source: Bloomberg

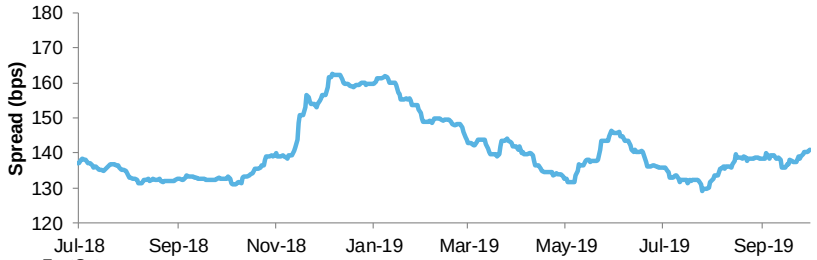


Source: Bloomberg

- Despite rebounding late in the quarter, UK government bond yields ended the third quarter lower across all maturities. Much of the move down in yields appears to be driven by global drivers: the pessimistic global economic outlook and more accommodative monetary policy. Domestic factors, particularly the uncertainty caused by Brexit, are also depressing yields. The UK economy contracted over the second quarter and, although a technical recession was averted, economic conditions remain weak. The Bank of England's August Inflation Report indicated lower expectations for growth and inflation and mentioned that Brexit uncertainties could well lead to rate cuts. Longer-term nominal yields fell the most with the 30-year yield dropping by 50bps to 0.97%, leading to the entire UK nominal gilt yield curve lying below 1%.
- The largest driver of the fall in nominal yields was the collapse in real yields as growth expectations were cut. Index-linked gilt yields fell by around 50bps at the short and intermediate parts of the yield curve while longer-term yields fell slightly less. Unlike other developed markets which continue to battle disinflationary forces, near-term inflation expectations picked up in the UK with 5-year breakeven inflation increasing to 3.3%. However, breakeven inflation at longer maturities bucked the wider trend following the UK Treasury's response on proposed reforms to the Retail Price Index (RPI). The proposals were for the publication of RPI to cease at an appropriate future date and RPI to effectively be changed to CPIH (consumer price inflation including owner-occupiers' housing costs), which has historically been around 0.8%-1.0% lower than RPI. With the expected changes only to be made after 2025, it was only longer-term RPI inflation expectations that took a hit.

UK Investment Grade Credit

iBoxx Non-Gilts Index Credit Spread

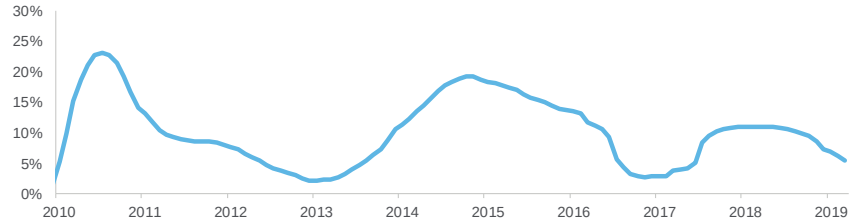


Source: FactSet

- Although reaching a 2019-low in July, concerns over UK credit escalated over the third quarter with investment grade credit spreads widening slightly to 141bps. In contrast, US and eurozone credit-spreads were unchanged or lower, respectively. Riskier areas of credit, such as US high yield bonds, saw spreads widen.
- UK credit spreads widened across all investment grade credit grades, but slightly more among lower quality corporate bonds. BBB-rated non-gilt spreads partially retraced the prior quarter's 11bps narrowing, as spreads increased by 7bps to 204bps. Meanwhile, an uptick in AAA and AA-rated spreads fully offset the fall in spreads over the second quarter.
- The positive performance of UK corporate bonds over the quarter was driven by the fall in underlying government bond yields which more than offset wider credit spreads. A still healthy coupon return was also supportive. Financials underperformed the wider index due to the lower duration of bonds in that sector.

UK Property

12 Months Rolling Returns
MSCI UK Monthly Property Index



Source: MSCI

- For the second successive quarter, the MSCI UK Monthly Index returned 0.7%. Capital value growth was once again negative, detracting 0.7% from total returns. These lower values were, however, more than offset by stable income returns. There was no discernible change in either market rents or vacancy rates over the quarter, based on MSCI IPD data.
- For a second successive quarter, Industrials outperformed with a return of 1.7% although the outperformance gap has fallen over the last couple of years as capital value growth has slowed. Retail sector struggles have persisted, reflected by the -3.1% capital value fall which more than offset the return from more resilient income.

Accounting Deficit (FTSE 350)

- The aggregate accounting balance of final salary pension schemes moved back into deficit over the third quarter as the fall in discount rates and consequent increase in liabilities outstripped the growth in assets. As risk aversion rose in August and equities sank, the deficit ballooned to approximately £35bn before paring back some of the losses in September to end the quarter at a £6.7bn deficit. This was down from the £7.4bn surplus recorded at the end of the second quarter.
- Discount rates, which are typically based on estimates of corporate bond yields at longer maturities, ended the quarter lower due to lower underlying gilt yields which more than offset the widening in credit spreads. The long-dated corporate bond yield, based on the iBoxx Non-Gilts Over 10 Year Index, dropped to 2.28% from 2.69% which supported the £46.2bn increase in pension liabilities over the period.
- Equity market momentum waned over the quarter and equities were unable to keep up with the strong returns from assets used to proxy discount rates which are directly linked to interest rate movements.

Funding Levels (Typical Pension Scheme)

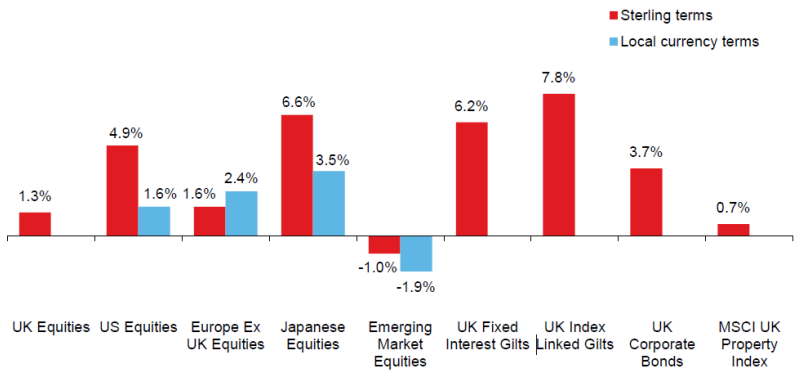
- Liabilities increased on a gilts basis over the quarter as long-dated bond yields fell significantly. This led to a deterioration in both funding ratios and the funding deficit.
- Long-dated fixed interest gilt yields (20-year duration) decreased by 47bps to 0.88% over the quarter. 20-year real yields also fell over the quarter but by slightly less than fixed due to the decrease in breakeven inflation.

Appendix B – Quarterly Investment Outlook

Summary

- Interest rate cuts are supporting equities, but bonds continue to send a different message on the global economic outlook ahead.
- The UK economy looks precarious. An orderly Brexit will not make that much difference here. Markets are still pricing in a rate cut ahead.
- The pick-up in bond market volatility could last. Two opposite worlds look possible – one advancing a zero/negative rate world further and a different one that could ultimately pose some upside risks to yields.
- Credit market stresses are surfacing in sub-investment grade markets even though investment grade is calm for now. Our caution on credit stays.
- US corporate profits have stopped growing. A marked recovery in profits looks unlikely given margin pressures that are now coming through. Even though triggers for large market falls are few today, rebalancing and trimming into market strength is entirely appropriate.
- The continued struggle for value stocks to keep up is setting up room for a strong rebound when the right conditions arrive, but we do not expect this to be seen quite yet.
- The evolving consensus that ESG factors matter a great deal in portfolio building still leaves open the question of implementation options. We expect viewpoints to shift over time as awareness builds and choices for responsible investing improve.
- Sterling volatility has been unnerving for quite some time. This is not going away any time soon even under a smooth Brexit. Strategic hedging approaches are best placed to cope.

Q3 2019 Performance Summary



Source: Factset, MSCI IPD

Global Outlook

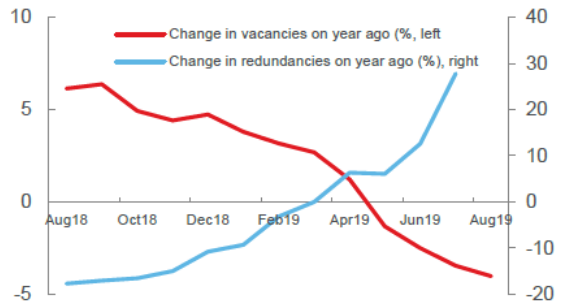
Bonds diverge markedly from equities

The highlight of the last quarter was the very sharp rollover in global bond yields. Though central bank rate cuts around the world were the trigger, behind this lay worries that the global economic slowdown was not abating. We had noted in July that global manufacturing and trade were facing outright decline, and this was readily observable over the summer. In a strong quarter for bonds, global yields fell sharply through July/August, with a respite in September. UK corporate bonds also did well, but with returns coming entirely from falling gilt yields. Strikingly, bond market worries did not bother equities very much (see chart above), arguably because central bank moves promised easy liquidity conditions. The UK's Brexit woes made itself felt mainly in higher volatility for the pound.

UK economy looks precarious

At the time of writing, the prospect of a disorderly Brexit is receding, reducing the risk of a Brexit-related shock to the economy. This is welcome, though it does not do that much to reduce the significant headwinds facing the UK. An orderly Brexit process in the next few months will still leave substantial economic uncertainty in its wake. The trading arrangements with both the EU and third countries beyond the transition period ending in December 2020 are up in the air and will still bring considerable business uncertainty.

UK labour market starting to weaken



Source: FactSet, ONS

The prolonged weakness in UK business investment and exports is partly Brexit-related, but also reflects the global economic slowdown and woes of specific sectors like cars. So far, the enduring strength of the UK consumer has kept growth just above zero, though recent indications suggest creeping weakness here too. Labour market strength that had spurred job creation looks to be subsiding, reducing income support for households. Job vacancies are lower, redundancies are rising (see chart above) and employment is starting to dip. Confidence could get a short-term boost from an orderly Brexit, but that will be about it. The likelihood that UK economic activity will stay very soft means that markets are still pricing in an interest rate cut from the Bank of England in 2020.

Gilt yields

Expect gilts/bonds to turn more volatile

Uncertainty is increasing in fixed income markets. There is a widespread view that at current interest rates, central banks are running out of monetary policy room to react to any further worsening in economic conditions. Policy emphasis will have to shift towards looser fiscal policy to provide economic support, especially in a sharp downturn. However, such a shift is easier said than done and comes with catches. Fiscal room is not large either. Government debt is now far higher in most countries, including the UK, than a decade ago. Large scale debt-financed government spending would mean bigger bond issuance, but what if such supply is not absorbed at current high bond/gilt prices (low yields)? To take a more extreme course, if higher government spending starts being financed by new money (instead of debt), this could pressure bond markets even more, because it implies a loss of central bank independence, which increases inflation uncertainty.

Equally, an opposite path for bonds is plausible. If shifts towards fiscal policy do not come, or fail, we could be heading in the opposite direction, towards still lower interest rates and yields, following Europe and Japan into negative nominal yields. This keeps the 'lower for longer' trend intact!

The relevance is this. As these sharply opposing risks focus bondholders' minds, it seems more likely to lead to greater volatility. We are all used to lower bond market volatility as interest rates have gone ever lower, but now higher volatility looks likely for a time even though the ultimate direction of yields will remain unclear. What should be done? Such strongly opposite paths for bond yields make it high risk to act on a specific view. Remaining close to shore – i.e. near to full hedging is the way to cope with this uncertainty.

Credit views

Are you being paid enough?

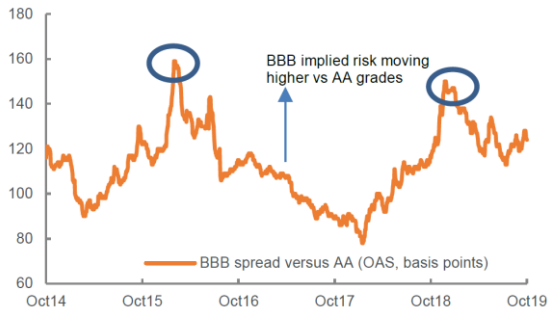
An important question that holders of corporate bonds should consider is whether credit risk in the market is being adequately compensated. One trend that suggests compensation is currently inadequate is the changing mix of credit quality in market benchmarks. In the Sterling non-gilt index, a widely used benchmark for tracking corporate bond portfolios, a key development over several years has been the shrinking proportion of higher grade bonds. We can see this by looking at the behaviour of the higher quality AA rated proportion of the index versus the lowest rung –

bonds graded BBB. The AA universe now has a much lower share of the index market value versus the BBB universe, as credit quality has worsened in the index (see table). This is true elsewhere too, so the UK is not an exception.

Shrinking AA, expanding BBB universe

% of Sterling non-gilt index	**2014**	**2019**
AA/BBB (market value, %)	50.6%	35.5%

Inadequate credit compensation for lower quality?



Source: Bank of America Merrill Lynch

This trend should be reflected in a higher risk premium (spread over gilts) for BBB bonds versus AA grades. This is especially so since downgrades from BBB bonds are a move from high grade into high yield, a transition which leads to larger price falls. Yet, when we look at how credit markets are compensating BBB bond holders, there is no marked change over time. More attractive pricing points for BBB's versus AA's (stress points of February 2016 and December 2018) have not been sustained (see chart above). Our cautious view reflects this unattractive pricing, especially if investment grade bonds are held passively.

By contrast, price differentiation is happening in sub-investment grade. In July we noted how CCC bonds were pricing better versus B rated high yield bonds. The leveraged loan market is also making clear its greater wariness of risks. In the important US loan universe, downgrades are up sharply, and the number of issues trading at large price discounts (10% or more) has been rising. As these price adjustments are at an early stage, our negative view on sub-investment grade is also unchanged.

Equities

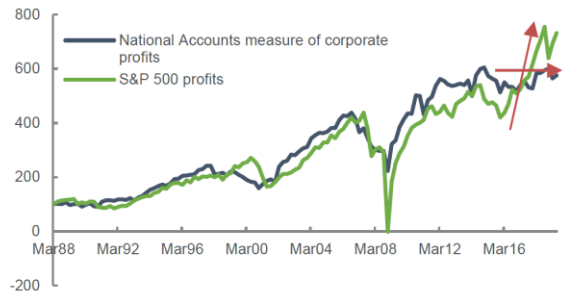
The profits slowdown

Yet another US quarterly earnings season is on us. Given the consensus that the economy has slowed down significantly in 2019, a key question for equity markets, and here the US is the undoubted global pacesetter, is whether earnings (corporate profits) are sufficiently resilient to support the market or take it higher, sustainably. If the economic slowdown continues or deepens going into 2020, can profits hold up? In the past year, the economic slowdown has clearly impacted profits already. Earnings expectations have been downgraded substantially, so that for calendar 2019, it is now touch and go whether S&P 500 profits grow at all. This means that the large gain in the S&P 500 year to date has come entirely from the market becoming more expensive.

Analysts are still optimistic for 2020, however, the latest consensus forecast for growth in earnings per share of some 10%. If stronger sales growth now comes through and cost pressures subside, a strong recovery in profits is possible, but this looks unlikely. Even if the economic slowdown ends, one key difficulty is that profit margins are still at very high levels – S&P 500 margins, while a little lower this year, are still well above levels ever seen before. Margin drivers are now weakening. This is a complex area, but one drag is already observable from the trade conflict itself; the reversal of globalisation (higher tariffs, less benefit from cost-offshoring etc), is pushing costs higher. Margin pressure makes a strong recovery in profits less likely since it impacts profits beyond just the effect of the economic slowdown on business sales.

A further warning sign emerges from the US national accounts measure of corporate profits. This data (referred to as NIPA – national income and product accounts) shows that broad corporate profits in the US (including unincorporated businesses) have been flat for a few years. The contrast with S&P 500 profits, which have substantially outgrown the national profits series, is startling (see chart). It is true that these are different measures, but also accurate to say that the cycles in both have been similar and that national profits cycles have generally led S&P 500 profits. If past patterns were to repeat, the national series is pointing to a prolonged slowdown in S&P 500 profits.

Wide divergence between corporate profit measures on national accounts and S&P 500



Source: FactSet, S&P

Contradiction beneath the bull market

Under the surface of the longest bull market ever lies a contradiction. For most of the period, investors have sought the safety of defensive segments of the market. 'Value' stocks, the cheaper segment of the market has lagged badly, while expensive so-called 'growth' stocks have carried on outperforming. This is a characteristic of a defensive investor mind-set, reflecting a preference for those stocks already expensive on a relative basis because their profits and margins seem more secure. However, the premium paid on this group of stocks is now at a two-decade high versus the cheaper – 'value' end of the market. However, extreme though this valuation

picture is, it could linger so long as the economic environment stays uncertain. Into a sharp downturn or other outbreak of strong risk aversion, the chances of a major rotation towards value are now rising, as cheaper stocks will then appear more defensive than highly priced stocks. In short, value will come back, but later, when economic and broad market conditions change significantly.

Treading with caution in equities

Our wariness on equities remains. While no immediate triggers are in place for large and sustained market falls, our 'transition market' characterisation of an upward creep in volatility with higher risks of market upsets remains accurate. Weaker earnings and valuations alongside soft economic conditions are not supportive of further sustained market gains, even as interest rates stay low or fall further. This is therefore a time when bouts of market strength offer scope to rebalance down or de-risk by trimming exposures.

Diversifiers

Looking for shelter in a market storm

We have never been in a market environment quite like this given the large impact of such low interest rates and central banks in driving markets. This makes it difficult to answer the question of what appropriate diversifiers could be in a sustained and large market downturn. Recommendations that draw on behaviour in past market cycles may not be appropriate this time. However, our analysis suggests that some traditional diversifiers will still protect capital in a large market downturn. Sovereign bonds will still do this job, notwithstanding the risks to yields from policy shifts that we noted on p.2. Gold (exposure held through funds), already doing well thanks to such low interest rates, looks worthwhile as a diversifier too. More conventionally, private real estate and infrastructure, though not immune, are not too badly placed given their more income-driven return profile. Finally, absolute return strategies (alternative risk premium or macro strategies) that benefit from rising market volatility and have less directional dependence on equity and credit markets, should also protect capital.

ESG

A consensus is now starting to shape that ESG factors matter substantially for portfolios, a break with the not too distant past when this area was regarded as only marginally relevant. Some elements of ESG – to do with corporate governance, for example, have always mattered. In 2019, it is the E (environment) issue that has been the key focus in building portfolios – related to the effects of climate change, pollution, land use and waste disposal, to take just some of the topics of focus and the increasing effects of regulation in these areas on companies. The information flow that would lead to an accurate assessment of E risks to portfolios is still only at a nascent stage, but it is evident that there is no going back. As risks are better understood, and information flow and disclosure improve, prices will respond. As regulatory impact becomes more central to corporate life, so will the incentives to adequately measure impact beyond that of narrow financial reporting.

There are several routes to a more effective integration of ESG issues into portfolios ranging from those which build some broad awareness, to those which look to build resilience and defences against risks, all the way to those which actively seek new return opportunities being created or look for measurable impact in terms of responsible investment goals. There is a place for all these approaches. Responsible investing viewpoints and implementation approaches will evolve along this spectrum over time.

Brexit

Sterling – coping with the uncertainty

Sterling's volatility, a result of ongoing Brexit uncertainty, is challenging. Strategic currency hedging has been our preferred option to cope with the high level of uncertainty in a currency which has in the past year sometimes resembled an emerging market currency. Tactical positions in sterling are difficult to take given the wide fluctuations and the possibility of extreme moves. This is still our preference.

At the time of writing, sterling is drawing support from a seemingly lowered prospect of a disorderly Brexit. It is worth, remembering, however that even after the large recent bounce, the pound is only marginally above start of the year levels versus the US dollar. Of late, volatility has been the key attribute rather than any clear sense of direction. This may not change in a hurry. Even an ordered Brexit still leaves plenty of uncertainty for sterling to remain at elevated levels of volatility. Sterling levels will, however, matter for the attractiveness (or not) of putting on strategic hedges if prior hedging is not in place. Attractive levels for new hedges seen a few weeks ago are not available today but could easily surface again as continued sentiment shifts on the currency pull and push in opposite directions.

Appendix C – Explanation of Manager Ratings

Below we describe the criteria which we use to rate fund management organizations and their specific investment products. Our manager research process assesses each component using both our qualitative and Aon InForm criteria. With the exception of Operational Due Diligence ("ODD"), each component is assessed as follows:

Qualitative Outcome	Aon InForm Outcome	
1 = Weak	✓	**Pass**: This component in isolation meets or exceed our desired criteria
2 = Average	⚑	**Alert**: This component in isolation does not meet our desired criteria, or the lack of data on this component means that we are not able to judge whether it meets our desired criteria
3 = Above Average	-	**Not assessed**: There is a lack of data, which means that we are not able to assess this component, however we do not consider this in isolation to justify an Alert
4 = Strong	↗	Component has improved over the quarter
	=	Component remains broadly unchanged over the quarter
	↘	Component has worsened over the quarter

The ODD factor is assigned a rating and can be interpreted as follows:

Overall ODD Rating	What does this mean?
A1	No material operational concerns – the firm's operations largely align with a well-controlled operating environment.
A2	The firm's operations largely align with a well-controlled operating environment, with limited exceptions – managers may be rated within this category due to resource limitations or where isolated areas do not align with best practice.
Conditional Pass ("CP")	Specific operational concerns noted that the firm has agreed to address in a reasonable timeframe; upon resolution, we will review the firm's rating.
F	Material operational concerns that introduce the potential for economic or reputational exposure exist – we recommend investors do not invest and/or divest current holdings.

Aon Hewitt previously assigned ODD ratings of pass, conditional pass, or fail for the ODD factor. We are in the process of refreshing all ODD ratings to the new terminology. During the transition period, the prior ratings, as follows, may persist in some deliverables until the ODD factor rating is converted to the above noted letter ratings.

- **Pass** – Our research indicates that the manager has acceptable operational controls and procedures in place.
- **Conditional Pass** – We have specific concerns that the manager needs to address within a reasonable established timeframe.
- **Fail** – Our research indicates that the manager has critical operational weaknesses and we recommend that clients formally review the appointment.

An overall rating is then derived taking into account both the above outcomes for the product. The overall rating can be interpreted as follows:

Overall Rating	What does this mean?
Buy	We recommend clients invest with or maintain their existing allocation to our Buy rated high conviction products
Buy (Closed)	We recommend clients invest with or maintain their existing allocation to our Buy rated high conviction products, however it is closed to new investors
Qualified	A number of criteria have been met and we consider the investment manager to be qualified to manage client assets
Sell	We recommend termination of client investments in this product
In Review	The rating is under review as we evaluate factors that may cause us to change the current rating

The comments and assertions reflect our views of the specific investment product and our opinion of its quality. Overall rating changes must go through our qualitative manager vetting process. Similarly, we will not issue a Buy recommendation before fully vetting the manager on a qualitative basis.

The ESG factor is assigned a rating and can be interpreted as follows:

Overall Rating	What does this mean?
4	The Fund Management Team demonstrates high awareness of all known and potentially financially material ESG risks in the investment strategy and, at present, has incorporated appropriate processes to identify, evaluate and potentially mitigate these risks across the entire portfolio.
3	The Fund Management Team demonstrates an above average awareness of potential ESG risks in the investment strategy and has taken essential steps to identify, evaluate and potentially mitigate these risks.
2	The Fund Management Team is aware of potential ESG risks in the investment strategy and has taken some steps to identify, evaluate and potentially mitigate these risks.
1	The Fund Management Team appears unaware or unconcerned with ESG risks in the investment strategy and has not taken any material steps to address ESG considerations in the portfolio.
N/A (Not Applicable)	An evaluation of ESG risks is not directly applicable to this strategy and therefore an ESG rating has not been assessed.
NR (Not Rated)	An evaluation of ESG risks is not yet available for this strategy.

Ratings Explanation - Infrastructure

The standard ratings for **closed** Infrastructure funds have changed from Buy, Qualified, Not Qualified to a Performance Rating of Exceeding Expectations, Performing, or Below Expectations. This change is being made to better address the nature of the asset class and closed fund structures. The current "Buy, Qualified, Not Qualified" rating system is not really useful for closed funds since an investor can neither invest in nor exit a closed fund, except through the secondary market. The Performance Rating is designed to provide better and more useful information on a closed fund's performance. The Performance Rating is based on a series on quantitative inputs, the weighting of which adjust as a fund matures. A fund will be rated annually through the quantitative rating process. Performance Ratings will not be adjusted quarterly unless there is a very significant change in performance. The definition of the Performance Ratings is below:

Overall Rating	What does this mean?
Exceeding Expectations	The product has adequate diversification relative to its goals and is performing well relative to its peers of the same vintage.
Performing	The product has adequate diversification relative to its goals and is performing in line with its peers of the same vintage. The product may have some investment concentrations relative to its goals yet is performing well relative to, or in line with, its peers of the same vintage.
Below Expectations	The product is performing below its peers of the same vintage. The product may have some or significant investment concentrations relative to its goals.
In Review	The rating is under review as we evaluate factors that may cause us to change the current rating

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