Independent Adviser's Report for Teesside Pension Fund Committee

William Bourne **27th February 2019**

Market commentary

1. In December I commented that the risks were still on the downside for equities. While valuations were no longer expensive, the fundamental background was deteriorating in a number of ways and I expected a further down-leg in markets. In fact, US equities fell around 18% from their mid-September high to their Christmas low, although at the time of writing they have recovered most of their autumn falls.

2. Equity investors have been encouraged by better news on the trade war front. President Trump still seems determined to assert what he sees as a fair deal between the US and its trading partners, most notably China. The rhetoric is still flying around but at the moment both sides seem ready to make compromises. While the market is already partially factoring in a likely deal, further upside is possible.

3. **The most important positive signal has come from the US Federal Reserve,** which indicated that it is no longer committed to raising rates further. That does not rule out further raises but is a welcome change of direction. Previously my view had been that the level of proposed monetary tightening in the US made a recession inevitable. This change of tack may be too late to prevent that, but does make it less likely. A further point is that the Fed, because it has hiked rates to 2.25%, has more policy room to help the economy by cutting them again if needed.

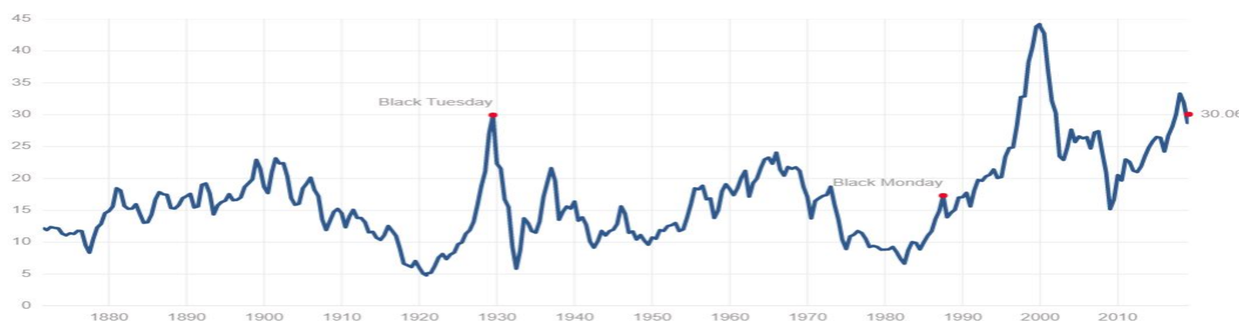
4. On the other hand, President Trump shut down the federal government for 35 days over the Democrats' refusal to fund a barrier to prevent Mexican immigrants entering the United States. The effect of this, and any further shut-downs, is likely to bring forward the US slow-down. Conversely, the rebound thereafter is likely to be correspondingly greater.

5. The European economy has been affected by a range of specific issues despite greater (compared to the US) monetary support from the European Central Bank. Italy has fallen into a technical recession, France has suffered from civil unrest and the British economy, affected by BREXIT, only grew marginally in Q4. Annual UK growth in 2018 was 1.4%, the weakest since 2009. There appears at the time of writing to be no break-through on BREXIT and a 'no deal' of some sort now appears to be the most likely outcome. **The uncertainty which this brings makes a broader recession in late 2019 or 2020 across the continent more likely**.

6. Bond yields fell back below the crucial 3% yield level (US 10 year Treasuries) I noted last time. Rising equity markets would normally see bond yields rise gently and not fall. Investors, perhaps fearing economic slow-down, remain risk-averse and there is also some strategic selling of US Treasuries from China.

7. **Equity valuations remain high despite recent falls**. The chart on the next page shows the current valuation on a highly conservative basis (ie. price divided by the average of the last ten years' earnings). Some adjustment must be made for the abnormally low level of bond yields in the past 10 years, which provides support for a higher level of valuation, but even so equities cannot be described as cheap.

Equity valuation (P/E (10 yr average) ratio) 1870-2018



Portfolio commentary and recommendations

8. The economic, political and monetary background is not particularly positive for equity markets. However, low bond yields provide valuation support and upside surprises are possible on a number of fronts: a trade deal between the US and China, more positive guidance on rates from the Fed or better news on BREXIT. To sum up, **expect equity markets at best to trade broadly sideways over the next year or so; political uncertainty means a further leg down cannot be ruled out, and while some bad news is factored in valuations are too high for a major new bull market**.

9. The Fund's 20% allocation to 'Protection' assets is currently almost all held in cash, giving a minimal return and a drag on performance. As the return from investment grade bonds are also close to historical lows, **a review of this part of the portfolio should be undertaken. It should consider the purpose of 'Protection' assets within the portfolio, whether asset classes other than Bonds and Cash should be included, and whether 20% is an appropriate allocation.** My own view is that a third high level category of Income alongside Growth and Protection would be desirable. It would cater for the need to cover the Fund's cashflow shortfall with predictable and preferably non-equity income.

10. The current equity weighting of 71.7% is 22% higher than the long-term strategic target of 50% agreed in December 2018. If equities fall sharply for any reason and this variance is not corrected, the Fund's balance sheet will deteriorate from its current strong position. That in turn may impact its ability to pay pensions.

11. In order to mitigate this risk, I advise that **arrangements for an equity protection programme are put in place without waiting for the valuation results**. Equity markets are at the time of writing within 5% of their 2018 highs, and in the course of the next valuation (due on 31st March 2019) the actuary is likely to adjust her return assumptions and the discount rate, most likely downwards. At nil financial cost, albeit some expense of governance and time, an equity protection plan can be constructed to:
    - Reduce the Fund's equity weighting in line with long-term strategy and lock in higher exit levels if equities rise; and
    - Provide some downside protection if they fall.

12. I also advise **the establishment of a process to identify and invest 20% of the Fund in alternatives according to the agreed long-term strategy**. The focus should be on identifying i) long term predictable (and ideally inflation-correlated) income streams and ii) diversifying strategies. An approach of investing in roughly equal amounts over a period of time (ie. pound cost averaging) reduces timing risk. I initially suggest a minimum investment target of 4% (ie. approx. £150m) in 2019.

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